First Trust
Weekly OUTLOOK

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A Very Political Week

In a better world, politics would not be important to investors. The government would have little influence over the economy, public policies would be reasonably stable, and investors could be confident it'd stay that way. Unfortunately, we don't live in that world. Instead, investors need to read the tea leaves of election results, pay attention to lawsuits about some of those policies, and follow the day-to-day news on events like the recent federal government shutdown. Last week saw important events in every one of those categories.

To start, last week's election results were very good news for the Democrats and bad news for Republicans. A year ago, VP Kamala Harris lost the national popular vote to President Trump by about one and a half percentage points, while still winning New Jersey and Virginia by about six percentage points. That means those two states were about 7.5 points further to the left than the country as a whole.

So, in the statewide governors' races you'd think that if New Jersey and Virginia were 7.5 points to the left of the national average last November, then maybe that's where they are today. In a "politically balanced" or "neutral" political environment the Democrats would win those races by 7.5 points, or maybe a little more than 7.5 because with a Republican in the White House, the Democrats could be expected to turnout to vote with greater than usual intensity, while Republican voters might be a little more complacent than usual.

But the Democrats didn't win these races by 7.5 points or a little more; instead, they won by almost 15 points in Virginia and almost 14 points in New Jersey. Were these flukes? Nope. Democrats did well in statewide races in Georgia and Pennsylvania, and also won a ballot measure in California to let the state redraw congressional district lines to make it more favorable to the Democratic Party.

As a result, the odds of the Democrats taking back control of the US House after the midterm election cycle next year soared from 58% last Monday, the day before the election, to 70% by Wednesday, when the election results were in.

Time will tell. Some GOP-controlled states are also redrawing district lines and a Supreme Court reinterpretation of the Voting Rights Act could give others a freer hand to redraw even more. And those battles will play some role in how many House seats the two parties win next year. But in the meantime, the Democrats look like favorites to take back the House. If they do, then starting in January 2027 every congressional bill that gets to the president's desk is going to have to have bipartisan support to get there, because the Senate will likely remain in GOP control.

The next big political event last week was the Supreme Court hearing a case asking it to strike down many tariffs implemented by the Trump Administration, including the 10% across-the-board tariff and extra "country-specific" tariffs like the 10% on China and 25% on Canadian and Mexican products not covered by other free trade arrangements.

Based on our reading of the opinions from the Court of Appeals as well as the tone of the questions asked last week by the Justices, it looks like those tariffs will be struck down on the basis of being a too aggressive interpretation of the president's authority to "regulate" trade with other countries.

However, we are skeptical the Supremes will order a refund of the tariffs already paid. Even if it is possible to figure out which companies paid how much, some Justices are likely to shy away from ordering the Treasury Department to cut checks worth well north of $100 billion. Meanwhile, the entities that cut tariff checks to the government are not necessarily the people or companies that absorbed the economic burden of the tariffs. Imagine, for example, if a retail sales tax in a state is found unconstitutional. Yes, the stores cut checks to the government and could receive a refund, but the stores were probably passing the cost along to consumers who wouldn't get the refund.

We are also skeptical that striking down these Trump tariffs would mean a permanent reduction in tariffs. Instead of declaring an "emergency," Trump could impose tariffs based on "unfair trade practices," or balance of payments imbalances, or on countries discriminating against US businesses.

Now, in the past 24 hours comes word the parties have reached a deal to re-open the government, at least through the end of January. The Democrats will get a vote on extending the supposedly temporary enlarged Obamacare subsidies originally enacted during COVID. But with a sixty-vote threshold still in place in the Senate, there's no guarantee they'll win. In the meantime, federal workers will get their jobs back with back pay and it reverses layoffs made during the shutdown. Meanwhile, President Trump wants to force a legal fight about his Constitutional authority to reduce spending unilaterally.

With the next deadline at the end of January, well past Christmas, another shutdown and spending battle is brewing early next year. Investors will need to watch the next one closely to see if policymakers who want to control deficit spending are able to make progress