While some races are still too close to call, Democrats won enough seats in yesterday’s midterms to gain control of the House, and Republicans retained control of the Senate. Democrats made inroads at the state level. The market reaction to the results has on balance been muted.

With a divided Congress, we don’t expect policy changes that will significantly alter our economic outlook. We foresee GDP growth around 2.9% this year followed by a 2.5% advance in 2019. Despite partisan divisions, Congress and the president will have to confront some must-pass items on the legislative agenda. Compromise is possible on a few other items including infrastructure, but House-led investigations into the Trump Administration may further damage relations between the parties, limiting the potential for cooperation.

There are a few items Congress and Trump will have to address during the lame-duck session, most notably passing remaining spending bills for fiscal 2019 before December 7. One can easily imagine that, given the election results, opposition to border wall funding could lead to a partial government shutdown in early December.

While significant tax and spending legislation is unlikely, Congress and the Administration will have to agree on some key items in 2019. We foresee USMCA ratification taking place early next year since there is no viable alternative. Congress will need to raise the debt ceiling by next summer. Congress will also need to pass a budget for FY 2020 to prevent a mini-fiscal cliff.

President Trump and a divided Congress may compromise on infrastructure spending and policies to lower prescription drug prices, though it’s not clear whether Democrats’ self-interest will outweigh their opposition to Trump.

Trump will continue to exert significant influence over the economy, including through his deregulatory agenda and his unilateral executive powers on trade.
Democrats will have a healthy majority in the House, while the GOP boosted its majority in the Senate by at least two seats

While some races have not been officially called, Democrats have already picked up 27 House seats following yesterday’s midterm elections, more than enough to take control of the chamber. Several Senate races are also not final, but Republicans are on track to boost their majority by at least two seats to 53-47. Meanwhile, Democrats made inroads at the state level, increasing the number of Democratic governors by seven and flipping some state legislatures.

Major legislation in 2019 likely limited to must-pass items

A divided Congress will stand in the way of any major legislation that could significantly affect our forecast. Congress and the Administration must agree on a handful of items in 2019. Failure to do so would lend downside risk to our outlook.

1. **Approve the USMCA.** Under the Trade Promotion Authority (TPA), there are several steps required before the USMCA (aka Nafta 2.0) can take effect, with Congressional approval of legislation implementing the deal marking the final step. We believe that will happen early next year as we don’t believe Democrats will derail the USMCA without a viable alternative just to deprive Trump of a “win”. Further, Republicans can accelerate the process and get it done this year if they think that is a risk.

2. **Raise the debt limit.** The debt limit will have to be raised sometime during the summer of 2019. While we know from experience over the past decade that no party benefits from a debt ceiling standoff, we cannot discount the possibility of a last-minute agreement that raises market fears of a default and sharp economic slowdown.

3. **Passing government budgets** The Bipartisan Budget Act of 2018 (BBA) increased discretionary spending caps for fiscal years 2018 and 2019. Unless new legislation is passed, spending caps will come back into force for fiscal 2020 and 2021. Failure to raise the spending caps in those two years would cut GDP growth in 2020 by 0.3ppt. While we don’t expect that to happen as the spotlight shifts to the 2020 election, we believe passing government budgets with a split Congress will not be a simple walk in the park.

**Look for House Democrats to pass symbolic tax bills to distinguish themselves from Trump and the GOP**

House Democrats may pass tax legislation that reverses provisions of the Tax Cuts and Jobs Act (TCJA) that benefit corporations and the wealthy. However, such efforts would be purely symbolic since they would be dead on arrival in a GOP-controlled Senate and would certainly face a Trump veto. Still, Democrats will be looking for opportunities to highlight their differences with Republicans and Trump ahead of the 2020 presidential election. Democrats might run into political trouble if they try to undo the TCJA’s cap on SALT deductions, since repeal of the SALT cap would predominantly benefit upper income households.

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Any hope for infrastructure?

Increased investment in infrastructure has long had bipartisan backing, but efforts to boost spending typically get mired in disagreements over how to finance the new outlays. Earlier this year, Trump proposed leveraging $200 billion in federal funding to attract more than $800 billion in funds from state and local governments and private investors. That proposal might have more legs in 2019 given the crop of new Democratic governors, many of whom campaigned on specific proposals to boost infrastructure spending in their states.

There a few other areas where Trump and a divided Congress might find common ground. When we published our preview of the midterms, we highlighted the possibility that policymakers might agree on a way to permanently grant legal status to the Dreamers, undocumented immigrants brought to the US as children. Given the president’s more recent rhetoric on immigration that seems less likely, although Trump may see it as way to win back some of the moderate voters that abandoned House Republicans in the midterms.

An agreement on a plan to lower prescription drug prices is also possible. Trump hasn’t conformed to GOP orthodoxy on this issue and unveiled a proposal last month that takes a small step in the direction of allowing the government to negotiate prices with drug companies.

Trump will still have a lot of power

Trump will still have significant influence over the economy through executive actions, most notably on trade. Democratic gains in the midterms are unlikely to soften Trump’s stance toward China. Indeed, many Democrats have been supportive of Trump’s trade agenda.

Trump is expected to continue to pursue an aggressive deregulatory agenda and to continue efforts to chip away at the Affordable Care Act (ACA) following Republicans’ unsuccessful efforts at repeal. An important ruling in a case that could significantly undermine the ACA is expected soon. That case was brought by Republican attorneys general and supported by the Trump Administration. They’re arguing that since the TCJA repealed the individual mandate the entire ACA should be struck down. Meanwhile, ballot initiatives to adopt the ACA’s Medicaid expansion passed in three states yesterday.

With GOP still in control of the Senate, Trump will also still be able to nominate federal judges, including to the Supreme Court should another vacancy arise.

Don’t forget the lame duck session; hearings on tap in 2018

Congress and the president must agree on legislation funding fiscal 2019 spending. Recall that Congress has passed spending bills funding 70% of 2019 discretionary outlays. Remaining spending bills must be passed by December 7 or there will be a partial government shutdown. Agencies yet to be funded include the Department of Homeland Security, which will receive any funding to build a border wall. With Democrats controlling the House next year, Trump will see this as his last chance to secure significant wall funding, but Democratic votes will be needed in the Senate to passing any spending bills, so we should not discount the possibility of a government shutdown in early December.

Look for Democrats to launch investigations on several fronts into Russian interference in the 2016 election, Trump’s business dealings and the actions of cabinet members. Given their relative narrow majority, we expect Democrats will be cautious in pursuing impeachment unless any report from the special counsel is particularly damaging. Further, Democrats will likely want to avoid a rally in the Trump base around a common theme.