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AND THE WINNER IS . . .

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The global economic landscape has become dramatically impacted by geo-political events, particularly driven by the current U.S. administration, which will be tested on **November 6** according to the outcome of the mid-term elections in the U.S. These elections occur every four years at the mid-point of the Presidential term and cover all seats in the House of Representatives as well as a portion of the Senate seats (CBC: 2018 U.S. midterms: A primer on why November's elections matter).

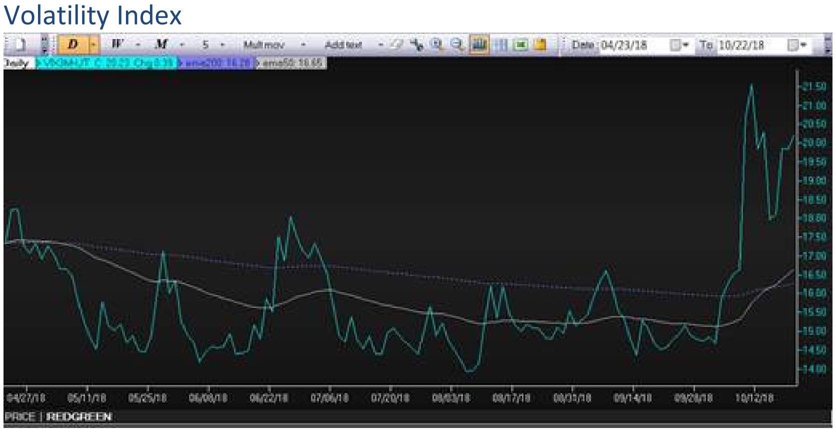
The significance of this particular election is that the current U.S. administration has initiated and implemented a set of policies which have greatly divided public and political opinion domestically and abroad as many of these policies have impacted global regions and markets. These include:

- The introduction of trade tariffs

- Questioning the validity of existing global agreements such as NATO, NAFTA (now USMCA), the WTO, TPP
- Deference to aggressive political leaders of recognized oppressive regimes such as North Korea, Russia and Saudi Arabia
- Strict and insensitive treatment of refugees seeking entrance to the U.S.
- A $US 1 trillion+ tax cut which has been largely funded through an increase in the national debt

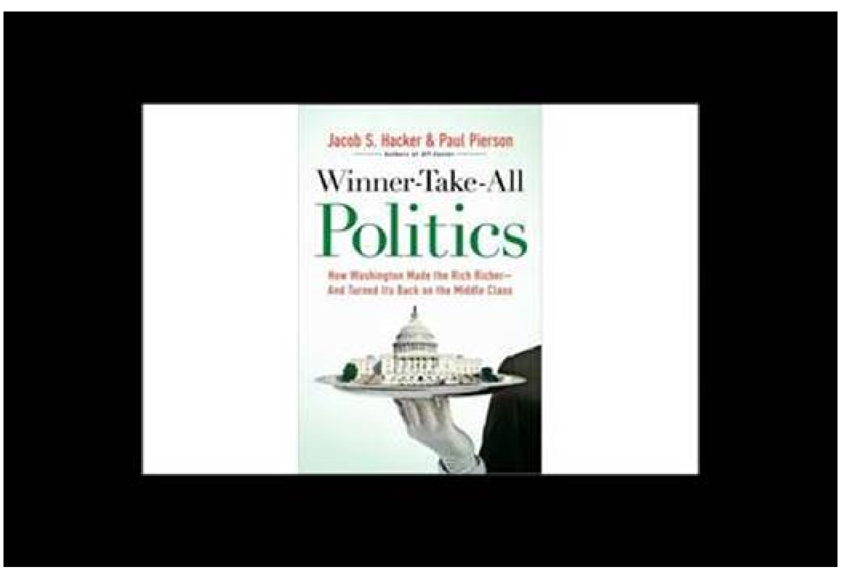
The mid-term elections are effectively a referendum on the presidency and the current policies which have become the Republican platform under Donald Trump. In economic terms the effect of these policies has been to create considerable investor uncertainty and on-going market volatility which has caused investment capital to be cautious about expansion. <u>As a result, the financial markets have been performing more in response to political actions than economic fundamentals.</u> As described in September's newsletter, the passing of the tax cut in 2017 produced a 20%+ rally in the Dow Jones index and a -11%+ decline in the index following the introduction of trade tariffs in 2018. The advent of the mid-term elections alone has created an approx. -4% decline in the month of October alone (26651-25521 as at the time of writing) with the volatility index (VIX) increasing from -14.7 on October 1 to 21.6 on October 11 (Thomson Reuters).

Volatility Index



Source: Thomson Reuters

A HOUSE DIVIDED



Source: Google Images

Recognizing the emergence of populist style politics globally has created a divisive political climate, the mid-terms are likely to result in a stand-off between the Republicans and Democrats on a partisan level. **There are two possible political, and consequent economic, outcomes worth considering:**

1. **The Republicans retain control of both the House of Representatives and the Senate, allowing the administration to continue to pursue its policy course.**

    - This will provide a political mandate to complete a planned second phase of tax cuts to be added to the national debt. The ratio of U.S. National Debt to GDP reached 105.4 in 2017, only ever exceeded during the period of World War II (www.tradingeconomics.com).
    - Trade tariffs will likely continue to be imposed and extended as a method of indirect taxation to help offset some of the debt created by the tax cuts. A predictable consequence of this will be higher cost of goods leading to lower consumer demand, foreign trade and GDP.
    - <u>Financial markets will continue to be reactionary in response to political initiatives rather than economic fundamentals. A persistent symptom of this will be continued high levels of volatility. While declines are likely to continue to feed investor anxiety, the market rallies will likely be notably dramatic although overall growth will be a product of the net gain.</u>

2. **The Democrats gain control of the House of Representatives and possibly the Senate as well.**

    - The current administration will be subject to far greater scrutiny and accountability. This will act as a check which will re-introduce an element of stability and confidence nationally and globally in the political process.
    - Business will be discouraged by the likely loss of further tax cuts, leading to near term market weakness. However, greater political stability will reduce investor anxiety and market risk.
    - <u>Financial market volatility will likely decline with growth resuming at a more moderate but consistent pace.</u>
    - Economic fundamentals will become more influential in the direction of the markets.

What's the takeaway?

Capital, like water, will always find its course. Whether through explosive, aggressive populist cycles or continued gradual accretive pace, market forces will ultimately direct the financial markets to their true value over time.

A key consideration is where we are positioned in terms of our investment horizon as these cycles occur. Defensive portfolio actions including the management of cash reserves, the use of appropriate market hedges and the generation of alternative forms of returns such as income will help manage the risk over the investment time line. However, the shorter the horizon before a need to utilize the capital, the more the portfolio should exercise defensive measures.

IN THE MEANTIME, INVESTORS SHOULD BE PREPARED FOR MORE HEIGHTENED MARKET VOLATILITY IN THE NEAR TERM AND BE PATIENT KNOWING THIS LATEST EVENT RISK WILL ALSO RUN ITS COURSE.

Regards

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