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Investment Update

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US mid-term results: What does the blue tide mean for investors?

4 November 2026

We look at what the Democrats' new control of Congress could presage for financial markets.

Quick take:

- Democratic attempts to de-escalate the Iran War could reduce inflation and interest rates, but Trump may resist this.
- Democratic desire for regulation could hit stocks and corporate credit in sectors such as AI and banking.
- US stocks have consistently done well in the year after the mid-terms.

The Republicans have decisively lost the mid-terms, losing control of both the House of Representatives and the Senate. What does this mean for investors?

Democratic victory in the House of Representatives was close to a dead cert according to polls, betting markets and analysts, but taking the Senate was not so. At the time of writing the Democrats have gained 25 seats in the House, bringing their current tally to 225 seats, with only 218 needed to win. In the Senate, the Democrats have taken 7 seats, bringing them to 54 seats. Only 51 were needed to take control.

For the Democrats to take the Senate, they needed to win Republican stronghold states. Many believed it was possible, but perhaps unlikely. Those people miscalculated: the Republicans lost Senate seats in Texas (which had voted Republican in every Senate election since 1988), South Carolina, Ohio, and Kansas (which hadn't voted for a Democratic Senator in almost a century). The Democrats have also, so far, gained 5 governorships, putting them at 28, compared with the Republicans' 20.

These mid-terms were seen as a referendum on President Donald Trump's second term in office. It was the Republicans' to lose. How did they lose?

It came down to the cost-of-living crisis brought about by Trump's unpopular conflict with Iran. The rise in energy prices increased the cost of refined products and transportation, causing consumer prices

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to increase. John Wyn-Evans, our Head of Market Analysis, has recently written about energy prices and inflation. In response, interest rates have risen across the yield curve. The biggest implication for households is the rise in mortgage rates: the average 30-year rate has risen above 7%. In other words, households must increase expenditure on basic goods and mortgage payments at the same time. And, with inflation rising at a rate equal to or greater than wage growth, real incomes are flat or worse.

Looking at the effects of AI on US GDP growth, Oxford Economics has shown that the rise in the value of AI-related shares has generated significant wealth effects – the tendency for people to spend more when the value of their assets rises. This is contributing, on average, 0.4 percentage points to recent annualised quarter-on-quarter growth. But that's only a positive to people who own the shares – not a spillover into the wider economy. The majority of mid-terms voters are unlikely to have benefited from the wealth effect. Instead, they're more likely to have an often unwelcome data centre in their backyard. That has been one of the key driving forces behind this Blue Tide, as the Democratic victory is being called (blue is the Democrats' colour).

What does this mean for markets, going forward? As John said in his note, there are three major global themes: AI, the Iran War, and inflation/interest rates. All three come into play.

AI

AI was probably one of the most important themes that shaped mid-terms voting. There are two main areas for investors to focus on: the AI infrastructure buildout and regulating the development of AI models.

It was expected that, regardless of the mid-terms results, there would be policies introduced to reduce the growth of AI data centres. Analysts believe that in 2027, we'll start to see statewide moratoriums to slow AI data centre buildout. So far, 36 states have a local data centre moratorium. At present, only New York has a statewide one.

To date, Trump believes AI model regulation isn't necessary. He sees it as a headwind to development, allowing competitors (notably China) to catch up. But even some of the industry's senior executives and wealth-owners have called for regulation. Anthropic's Form S1, its initial document to prepare for a stock market listing, asks for this.

Regulation and asset prices

We expect the impact on equities and corporate credit to be moderately negative in the sectors likely to be subject to regulation and additional scrutiny.

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These sectors include AI models and the data centres that enable the use of AI. We also include some parts of financial services, such as banks and crypto finance. The Democrats could also generate a headwind to Trump's deregulatory agenda in sectors such as fossil fuel energy and healthcare. But we don't anticipate a market-wide sell-off.

The Iran War, inflation, and interest rates

The immediate market focus is likely to turn to the Middle East. If the Democrats can facilitate credible de-escalation, oil prices will drop, as will the inflation premium – the extra yield investors demand from bonds to compensate specifically for inflation. So de-escalation would be bullish for bonds across the yield curve. Lower inflation means a less hawkish Fed and a bull steepener in the yield curve (the short end of the yield curve falls relative to the long end) as markets anticipate fewer hikes than currently priced in by financial markets. This could boost equities and corporate bond prices (compressing yields and the cost of capital to firms) over the medium term, as lower yields and energy prices raise economic growth and corporate margins.

Trump has said he will resume attacks on Iran following the mid-terms. If so, the risk to energy prices, inflation, and interest rates are to the upside. But this war is widely unpopular in the US and the Democrats will use their new Congressional majorities to try and stop it. Their incentive is sharpened by the popularity it might generate among voters, as the country heads towards the 2028 presidential election.

Separately on the US Federal Reserve – but not unrelated – the Fed didn't hike rates the week before the mid-terms. It would have been highly political to have either hiked or cut (a cut would have been unlikely, given the recent macroeconomic environment, but it's worth mentioning because Trump has complained that rates are too high). So keeping the Fed Funds Rate unchanged was sensible. This no-change decision was helped by the fact that the most important economic data, GDP and the Fed's preferred inflation measure, were both published after the October meeting. If you're going to be data-dependent to inform your decision-making, as central bankers like to be, you need data.

On fiscal matters, the Democrats can use Congress to remove or negotiate on expenditure on some matters important to Trump, but much of the spending runs on autopilot. Congress is only responsible for about 25% of the Federal budget: the part referred to as Discretionary Spending. No less than 60% of the total budget is Mandatory Spending, which includes Social Security, Medicare/Medicaid, etc.

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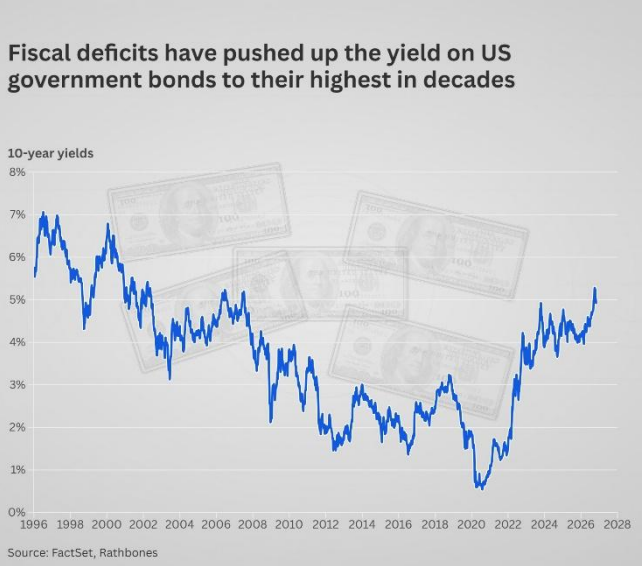
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The final 15% is net interest on debt.

This result is likely to be bullish for US Treasuries, particularly for longer-dated bonds, if markets conclude the Democrats can put the brakes on President Trump's tax cuts and higher Federal spending. This could lower yields by reducing future Treasury supply and the fiscal term premium – the extra yield that investors demand for holding longer-dated bonds, to compensate for risks such as inflation and creditworthiness.

We've taken a long-term view of the relationship between politics and the fiscal deficit in an earlier piece on the mid-terms.



A happy statistic

Analysts have noted that, since the end of the Second World War, the S&P 500's best performance over any 12-month period always occurred in the 12 months immediately following the mid-terms. This suggests that, despite investor fears that Democratic pushes for regulation could hit some sectors, there's scope for a rise in equities. But there's no guarantee that this pattern will be repeated.

But much of this depends on how President Trump, ever unpredictable, responds to the mid-term results.

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