CIBC GLOBAL ASSET MANAGEMENT

US midterm elections

Christine Bourgeois, Executive Director and Senior Investment Strategist
Éric Morin, Global Head of Research

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Blue wave: Clearer skies for markets, but storm clouds still on the horizon

The Democratic sweep was substantially larger than expected, giving the party comfortable majorities in both chambers. A unified Democratic Congress may change the tone in Washington, with more oversight, negotiation, and headline noise, but Democrats lack a Senate supermajority and cannot pass laws over a presidential veto. For markets, this still looks more like change at the margin than a full reset, with a clearer near-term backdrop but no dramatic shift in policy regime.

Although presidential veto power still limits major legislative change, the size of the victory strengthens Democrats' hand in fiscal negotiations and increases the potential for policy concessions on healthcare, tariffs and Iran. A Democratic sweep clears one layer of political fog for markets, which is supportive for markets. But it does not mean the road ahead is suddenly smooth. The election may be over, but the policy and market tests are not. The risks investors need to worry about have not gone away—they have simply shifted from the ballot box to contested politics, fiscal deadlines, AI policy noise, and oil.

The Blue Wave should not alter a reasonably constructive macro backdrop for equities. Clearing the election event is often supportive in its own right, and the post-midterm pattern has historically been favorable for markets. That said, we think market leadership will matter more than the overall direction of the major indices, making this more a market of winners and losers than a simple broad-beta story. In other words, sector and stock selection may matter more than the broad market move. Policy decisions and policy risks could have a more pronounced impact on specific sectors. For example, parts of healthcare could benefit from fiscal tailwinds if Democrats are able to restore some healthcare spending through budget negotiations, particularly as the Trump administration may face government shutdown and debt ceiling pressures, while also needing to finance the conflict with Iran. The story for AI appears more nuanced: Democrats can shape the debate and turn up the policy heat, but they are unlikely to be able to drive major federal legislation anytime soon. That suggests AI-related stocks will remain driven more by fundamentals than by immediate Washington action.

In fixed income, the story is also fairly balanced. We do not see this outcome as pointing to a major new fiscal expansion on its own. If growth expectations cool or oil prices fall, bonds could still perform reasonably well. But there are enough fiscal and political flashpoints ahead to keep investors from getting too comfortable.

For the US dollar, this outcome is probably neutral to modestly negative at the margin. A decisive election result and reduced uncertainty about the outcome and policy path may support broader risk sentiment, while potential upside pressures on deficits, political woes between a Blue Congress and a politically isolated US President, and less compelling returns on US assets relative to other markets could take a bit of shine off the dollar over time.

But this is where the story gets more complicated.

What could get in the way?

Investors may be leaving the ballot box behind, but they are not leaving risk behind. If anything, the risks are now changing shape. Five issues matter most from here.

First, the immediate AI policy risk is less about sweeping federal regulation and more about the data-center build-out. At the federal level, Democrats may push for tighter guardrails, liability frameworks, and oversight, but they are unlikely to deliver disruptive anti-data-center legislation in the near term, especially given the limits on federal action and the potential for a presidential veto. That could change after the 2028 presidential election. The main risk is from states and local governments. Democratic gains in several key states could bring stricter environmental and power requirements, permitting delays, reduced tax incentives, or even efforts to block the construction of data-centers. While investors could relocate their AI capital to states with friendlier jurisdictions, new restrictions could slow the pace of the AI buildout, especially since few states can easily replicate the combination of scale, low regulation, and low energy costs offered by major hubs such as Texas. In other words, the real risk may be less Washington and more friction on the ground.

Second, fiscal deadlines now become the market's main Washington watchpoints. The first test is the risk of a government shutdown in December when the current funding patch expires. The larger confrontation sits in mid-2027, when the debt ceiling issue returns. Democrats hold real leverage at both deadlines and could use it to extract concessions. Markets can absorb routine gridlock; they respond less well to brinkmanship. A December shutdown would be a sentiment drag. A debt-limit standoff in mid-2027 would be more consequential, especially for Treasuries and for confidence in US fiscal governance.

Third, healthcare may improve at the sector level but worsen the fiscal arithmetic. Democrats may be able to soften earlier healthcare cuts through budget negotiations, which could help parts of the healthcare complex. But that would also leave the deficit somewhat wider than otherwise expected. Over time, that is more relevant for bonds than for stocks, particularly if investors begin demanding a larger premium for fiscal slippage.

Fourth, and most importantly, Trump's foreign policies could worsen. After the midterms, less constrained by domestic politics, Trump could step up military pressure on Iran to win better terms on the Strait of Hormuz and Iran's nuclear program. Escalation is the president's call, but a Democratic Congress can demand oversight and attach conditions to additional funding, slowing its approval. Overall, this risk could increase policy uncertainty, deficits, oil prices, and—as a result—political turmoil in the US and globally. If oil moves materially higher, financial conditions would tighten, the inflation picture could become more problematic, and the case for equities would become harder to sustain. For fixed income, the picture would likely be more mixed, with higher oil reinforcing inflation and fiscal concerns while periodic flight-to-quality flows support government bonds; credit, however, would likely face a more difficult backdrop.

That leaves a fairly simple takeaway: we do not expect the outcome of the election to derail fundamentals, but investors should pay attention to underlying risks. We would read the result as market-neutral on balance, but we should not mistake it for an all-clear signal. Because these risks are political and hard to forecast, well-constructed portfolios and a focus on fundamentals will matter even more from here.

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