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A Blueprint for Gridlock in the Markets.

Stocks enjoyed a relief rally on Wednesday, mainly because of the great relief that the midterm elections were finally over. By week's end, however, that relief faded, and the agita resumed.

Friday's 202-point drop in the Dow Jones Industrial Average wasn't enough to wipe out Wednesday's 545-point leap, however, and the blue chips ended up 718 points, some 2.8%, for the week. Over the past two weeks, the Dow tacked on 1,301 points, or 5.3%, for its best fortnight in two years. That, of course, came after October's 5.1% shellacking.

For the financial markets and the economy, the as-expected election result of Democrats gaining control of the House of Representatives and Republicans retaining the Senate makes possible a variety of outcomes. Most depend on whether the new Congress cooperates or clashes with President Donald Trump. What can be confidently predicted is continued massive budget deficits.

Democratic control of the House probably means no further middle-class tax cuts, according to Fitch Ratings, although fiscal "consolidation" also isn't apt to be a priority for the Dems. The taxing and spending policies are likely to continue, Northern Trust economists add, which bodes poorly for the fiscal outlook. "Despite strong growth and exceptional corporate profits, government receipts were flat in the last fiscal year, thanks to tax reform," they observe. And with the loosened spending curbs, the federal deficit may reach $1 trillion this year.

Infrastructure investment may be one area of agreement between the parties, although Fitch notes that there is no clear consensus on the details, notably funding. In a paper released last February, the Trump administration recounted a proposal made a year earlier to use $200 billion in federal spending to seed $1.5 trillion in projects paid for mainly by state and local governments. Little has been heard of this recently. In contrast, Rep. Peter DeFazio, an Oregon Democrat who is set to become chairman of the House Committee on Transportation and Infrastructure in the next Congress, has proposed bankrolling projects by issuing $500 billion in 30-year bonds and indexing federal fuel taxes to inflation.

Court Street Group, a municipal bond advisory, argues that Democratic control of the House increases the chances of reviving Build America Bonds, which were taxable munis with a federal subsidy that were issued to fund capital projects in 2009 and 2010. If the ideas of issuing more long-term Treasuries and reviving Build America Bonds for infrastructure sound familiar, they were proposed by Barron's in December 2016. (For other ideas for fixing the budget, see this week's Streetwise.)

In the meantime, the only certainty is that the national debt will continue to climb. Northern Trust points out that a new deal to raise the debt ceiling will be needed when the present suspension ends on March 1. In the meantime, gridlock is the most likely outcome, according to Greg Valliere, chief global strategist for Horizon Investments, given the probability of the House focusing on investigating Trump, who will fight back by demonizing Nancy Pelosi, the California Democrat who may well return as Speaker of the House.

For the markets, Federal Reserve policy and China remain “huge wild cards, but economic fundamentals will dominate—and those fundamentals look solid,” he concludes. For now, anyway.

Barron’s

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Nov. 9, 2018

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