A midterms GOP loss to trigger a USD mid(life) crisis?



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- **Ahead of the US midterm elections on 3 November, the market betting odds suggest that investors are expecting a Democratic sweep of US Congress. We agree that there is a strong chance of the House changing hands and that the risk of the GOP losing the Senate has increased considerably of late as well.**
- **Our US economist expects a return of legislative gridlock in DC after the midterms, with fiscal support for the economy giving way to more policy uncertainty and potential government shutdowns. Democratic control over the Senate could lead to more intense legislative oversight over the executive and frustrate President Donald Trump's foreign policy as well.**
- **Political gridlock and a continuation of Trump's foreign policy could pose downside risks to the US economic outlook and therefore the USD outlook. That said, the experience since 1976 suggests that the two possible outcomes of the midterms could have very different FX impact:**
  - **In cases of a Democratic Congress coupled with a GOP president, the USD weakened in the months after the vote. The results reflect the impact of the 1985 Plaza Accord but also the USD's weakness at the start of both George H W Bush's presidency and George W Bush's second term. The two episodes also featured a slowing economy, Fed rate cuts and a Middle Eastern conflict.**
  - **During periods with a GOP President and Senate coupled with a Democrat House, the USD rallied across the board. The last such episode was during Trump's first presidential term, after the 2018 midterms. It coincided with a recovering US economy and a hawkish Fed. Earlier episodes from the 1980s were less USD-positive, however, partly due to weak economy and Fed easing.**
- **When drawing conclusions about the impact of the US midterms, we thus consider a broader range of factors than just the impact of the midterms. We expect that, in addition to legislative gridlock in DC, a slowing US economy and Fed rate cuts could add to the USD headwinds in 2027. We further expect that a slowing AI investment boom could erode the appeal of USD-denominated assets while de-dollarisation flows could intensify.**
- **We use the 'USD-smile' as a template for our FX outlook but assume that it would start resembling a 'smirk' – to reflect the reduced appeal of the USD during risk aversion spikes due to growing reliance on risk-correlated foreign capital inflows into the US. We expect the USD to slide towards the bottom of the eponymous smile/smirk, dragged down by a loss of rate advantage and portfolio diversification flows in 2027.**

Midterms – change on the horizon

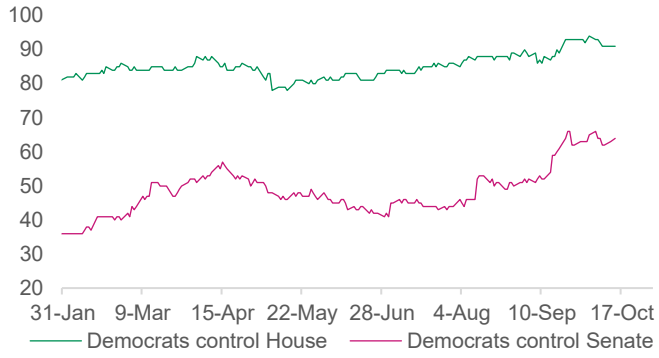
Ahead of the US midterm elections on 3 November, the market betting odds suggest that investors are expecting a Democratic sweep of US Congress. According to Polymarket, market participants attach a greater than 90% chance to the Democrats taking over the House and a more than 60% chance of the Democrats gaining control over the Senate as well (Figure 1). We agree that there is a strong chance of the House changing hands and that the risk of the GOP losing the Senate has increased considerably of late as well.

Our US economist expects a return of legislative gridlock in DC after the midterms, with fiscal support for the economy giving way to more policy uncertainty and even potential government shutdowns (Figure 2). Democratic control over the Senate

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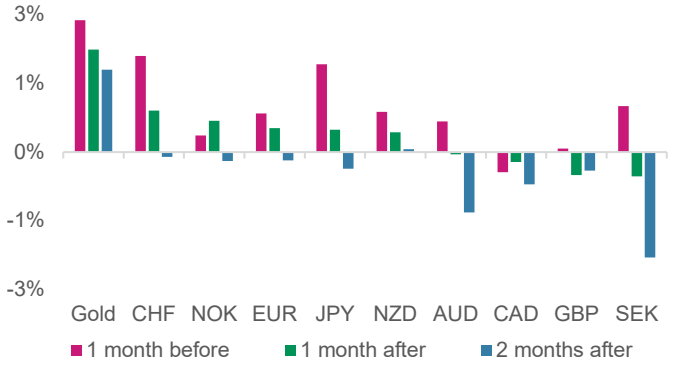
could lead to more intense legislative oversight over the executive that could frustrate Trump's foreign policy as well. Political gridlock and a continuation of Trump's foreign policy could pose downside risks to the US economic outlook and thus the USD outlook. That said, the experience since 1976 suggests that the two possible outcomes of the midterms could have different FX market impact.

Fig 1. Market betting odds ahead of the midterms: growing expectation of Democrat sweep of US Congress



Source: Crédit Agricole CIB, Bloomberg, Polymarket

Fig 2. Performance vs the USD around US government shutdowns since 1990 (date shutdown = 100)

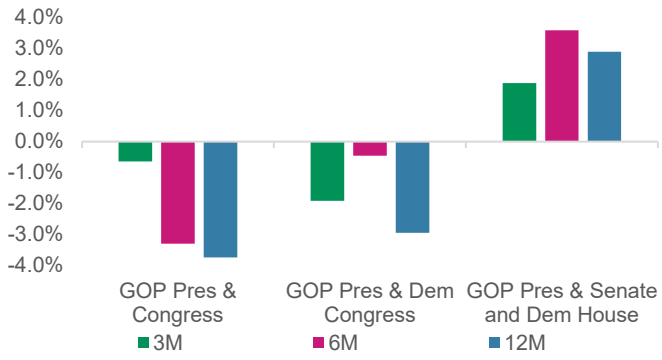


Source: Crédit Agricole CIB, Bloomberg

Historic FX impact of US elections

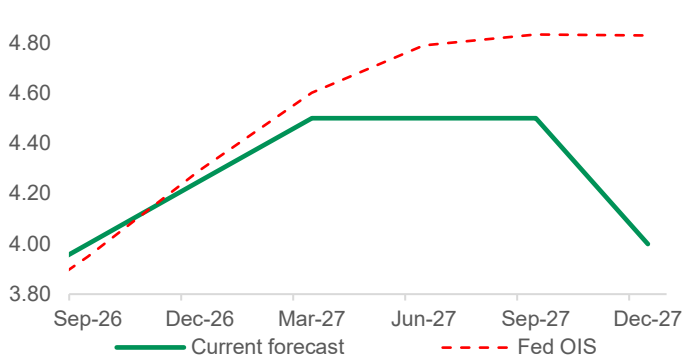
We measure the USD performance three, six and twelve months after all midterm and presidential elections since 1976. We then calculate the average currency return under different outcomes. For the purposes of our analysis, we focus on three possible scenarios: (1) GOP control of the legislature and the executive; (2) a GOP president and Senate coupled with a Democrat House; and (3) a Democratic Congress coupled with a GOP president. The results from our analysis are shown in Figure 3.

Fig 3. USD performance after US elections since 1976 (Election Day = 100)



Source: Crédit Agricole CIB, Bloomberg

Fig 4. CA-CIB Fed rate hike expectations vs US OIS implied rate



Source: Crédit Agricole CIB, Bloomberg

In the following, we focus on (2) and (3) given that they seem to be the most likely outcomes:

1. **Democratic Congress coupled with a GOP president:** in these situations, the USD weakened' in the months after the vote. The results reflect the lingering impact of the 1985 Plaza Accord that continued throughout 1986 and into early 1987 but also the USD's underperformance at the start of George H W Bush's presidency in 1991 and at the start of George W Bush's second term in 2007. The last two episodes also featured a slowing US economy, Fed easing and a conflict in the Middle East.
2. **GOP President and Senate coupled with a Democrat House:** in these cases, the USD rallied across the board. The last such episode was during Trump's first presidential term, after the 2018 midterms. It coincided with a recovering US economy and a hawkish Fed. Earlier episodes that featured a

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weakening US economy and Fed easing were less positive for the USD, however, as was the case in 1983.

USD outlook: the midterms and beyond

Gauging the FX impact of legislative gridlock in DC

Based on the above, when drawing conclusions about the impact of the midterms, we consider a broader range of factors rather than just the impact of the midterms. We expect that, in addition to political gridlock in DC, a slowing US economy and Fed easing would add to the headwinds for the USD in 2027.

To start with, we gauge the impact of legislative gridlock by looking at the average USD performance before and after government shutdowns in the last more than thirty years. The results are shown in Figure 2 and highlight that the USD could be particularly vulnerable vs XAU and the CHF.

Slower US growth and inflation => Fed rate cuts

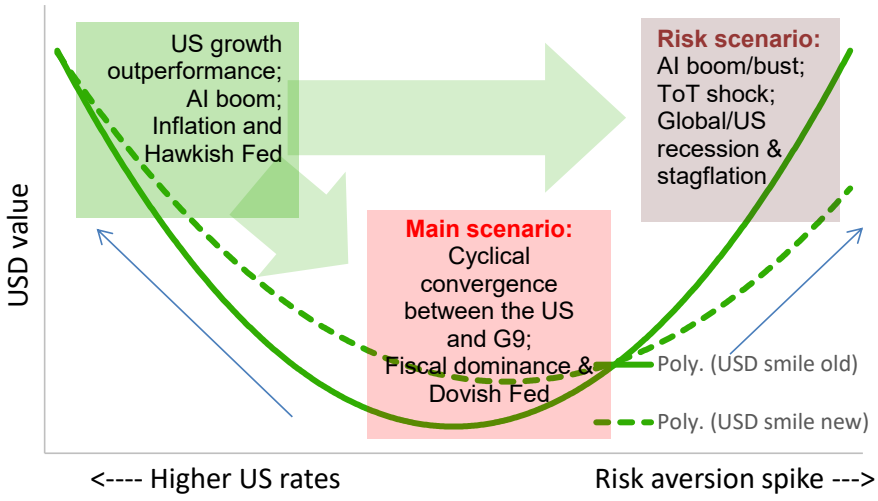
Our US economist expects US growth to cool down and inflation to slow down notably in 2027. The softening economic outlook is partly due to a loss of momentum of the AI-investment boom and renewed slackening of the labour market that could result in softening of US domestic demand. Because of that, we expect the Fed to reverse some of its earlier tightening and to cut rates twice before the end of next year. This is a more dovish outlook than is currently priced in by the rates markets (Figure 4).

From USD smile to USD smirk

Turning to the USD outlook, for our analysis we use the USD smile – the framework that links the currency performance to the prospects for higher US rates and/or risk aversion spikes. In Figure 5, we show two paths for the USD smile using a green and a green dashed line respectively. Our goal is to illustrate the impact from the increase of risk-correlated capital inflows into the US that we observed in the last three years.

We discussed that topic on several occasions and most recently as part of our FX market outlook. Our conclusion is that the growing importance of foreign buying of US risk-correlated assets has rendered the USD a less-attractive safe-haven during bouts of escalating risk aversion. This is why the 'new USD-smile' is starting to resemble a 'smirk' that points at less pronounced USD gains in response to risk aversion spikes (eg, the dashed green line in Figure 5).

Fig 5. The USD smile/smirk and our USD outlook



Source: Crédit Agricole CIB

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USD outlook: two scenarios

Also shown in Figure 5 are the two main scenarios that we consider for the next six to twelve months.

1. **Main scenario:** under our central scenario, we expect a slowing growth and inflation outlook to reduce the relative rate appeal of the USD and thus push it towards the bottom of the USD-smile/smirk (Figure 5). Another important assumption we make is that the slowing AI-investment boom and its negative impact on US domestic demand would erode the international appeal of USD-denominated assets. Concerns about fiscal dominance over the Fed and thus lower US rates and yields could abound while de-dollarisation flows could intensify. In all, we expect portfolio diversification out of the USD to go up a notch next year.
2. **Risk scenario:** under our risk scenario, we assume that the AI boom turns into bust and triggers a negative demand shock to the US economy. Another risk we consider is persistently high energy prices that fuel US (and global) stagflationary headwinds. We see market risk aversion surging and thus giving the USD a boost, under the risk scenario. As highlighted above, the USD may struggle to benefit fully due to its growing exposure to risk-correlated foreign capital inflows (eg, the dashed green line in Figure 5).

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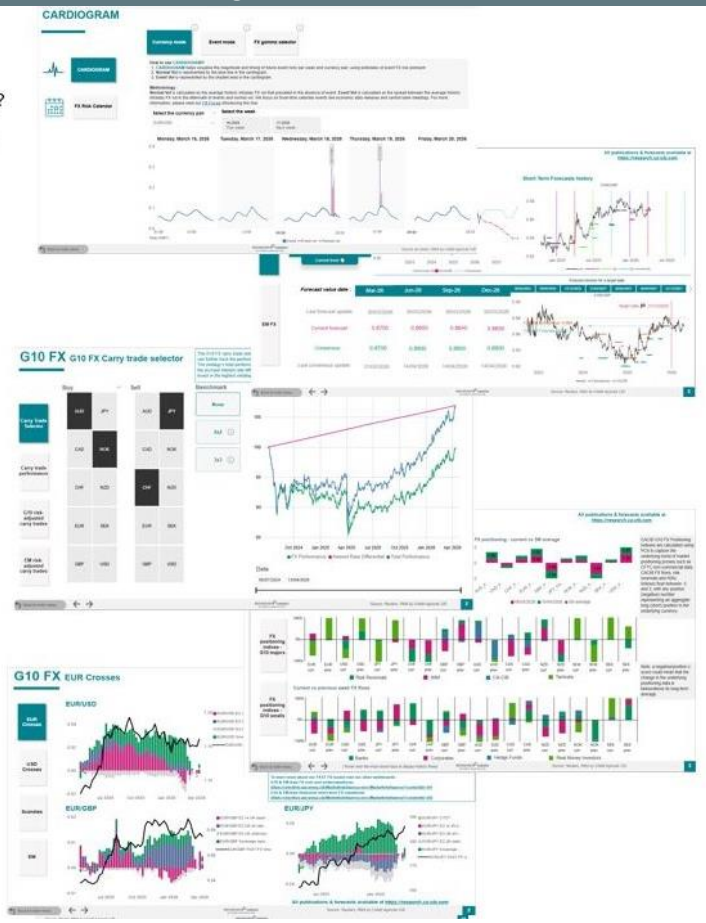
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