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Democratic sweep: What changes for the US economy and financial markets?

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In Summary

- **The Democrats achieved a full sweep of Congress and won a majority of governorships in the midterm elections.** Results are not definitive at this stage, but the Democrats have secured a decisive majority in both the House and the Senate. Until end-August, the Republicans looked more likely to retain control of the Senate but high gas prices fueled voter discontent. Nevertheless, the near-term policy outlook will be relatively unaffected as the Democrats still lack a filibuster-proof majority in the Senate and President Trump has veto power to block legislation.
- **The results could mean a deadlock in fiscal policy, with rising risks of a government shutdown, a debt-ceiling standoff and higher fiscal deficits.** A Democratic Congress is likely to block the White House's flagship proposals, and funding and debt-ceiling deadlines could converge in Q4 2027–Q1 2028, though the Republicans could manage to pass more defense funds and/or raise the debt ceiling before year-end. A divided government should still find compromises: In 2027, Republicans could get c.USD90bn in supplemental defense spending to replenish munitions (unless the White House re-escalates the conflict with Iran), while Democrats could secure higher non-defense spending and delay some health and nutrition cuts from the One Big Beautiful Bill (OBBB), resulting in a slightly loose fiscal stance (0.2% of GDP). The federal deficit could widen from -6.2% of GDP in 2026 to -6.6% in 2027. Housing policy could also be an area of bipartisan compromise.
- **Tariff, immigration and regulatory policies will remain largely executive-led.** We expect the effective US tariff rate to reach around 8.5% by January 2027 as the administration implements new Section 301 tariffs. A Democratic Congress would bring more oversight of immigration enforcement and financial deregulation, but no major reversals of existing policy. A Democratic Senate will mainly slow confirmations, including for the Fed vacancy in January 2028, easing concerns over Fed independence. Escalation on tariff policy will remain a distinct area of risk for the next two years, while institutional friction risk between the executive and the legislative branches could cause additional volatility.
- **Energy security is the key nexus between the midterms and inflation. A Democratic Congress will have limited ability to prevent a resumption of fighting with Iran in the near term.** The main upside risk to oil and wholesale gas prices, and thus to our forecast of inflation and rates, is a resumption of military action against Iran. A brief escalation (given low US military stockpiles) could see oil prices peaking at around USD130/bbl (+15/20% vs current levels). However, all parties have an incentive to reach a deal. Greater congressional opposition under Democratic control could constrain the scale and duration of any further military action by freezing new funding, but not before January when the new Congress convenes. And the President could veto any bills that prohibit the use of appropriated funds for further offensive operations, or restrict funding for replenishing munitions used in those operations, thereby limiting the ability of Congress to prevent short-term military action.
- **A renewed escalation would likely trigger an oil-driven inflation shock, leading to a bear flattening of the Treasury curve and a more hawkish Fed.** Markets would be left repricing higher inflation at the same time as political instability and deteriorating fiscal dynamics increase Treasury volatility and the term premium, making political shocks more consequential than in previous episodes. Over a longer horizon, weakening growth, deteriorating household fundamentals and potential equity market weakness could support long-dated Treasuries

through safe-haven demand. Rates volatility is likely to remain elevated, potentially prompting Treasury-led interventions to preserve market functioning.

- **Risks for US equities are tilted to the downside.** The S&P 500 has tracked past midterm years in which the President's party lost a chamber, while credit has, as usual, been weak into the vote. Elevated yields limit multiple expansion, and tech is most exposed to AI-regulation headlines at the state level and renewed hostilities with Iran. The initial market reaction has been moderately negative, with tech-heavy Asian equity indices losing 3-4%, but later paring some of the losses. European markets opened positive and in the US, futures for the S&P 500 and Nasdaq also turned positive after an initial negative reaction. Some volatility in equity markets is expected but the results of the midterms should not cause strong corrections. From a sector perspective, healthcare looks best placed among defensives and energy offers a hedge.
- **AI policy will likely stay light-touch in Washington, but the backlash is shifting the battle to the states and turning into a growth and investment risk.** With new federal action unlikely, the leverage lies with states, which control permitting, siting and utility rates. According to our Allianz Pulse survey, 79% of Americans want AI regulation, and Gallup finds that 71% oppose data centers in their communities. This backlash already shifted the intentions of voters living near data centers towards the Democrats, who campaigned heavily on the issue, especially in swing districts. Local opposition blocked or delayed nearly USD200bn of projects in H1 2026, and New York has imposed the first statewide moratorium. The midterms have further increased this risk: Democrats won seven of the ten competitive governor races that will decide on 67 GW of planned capacity. Governors-elect who back a full or conditional moratorium now preside over 47 GW of planned data-center capacity, with three races still uncalled. A slower and costlier buildout would weigh on both growth and equity valuations.

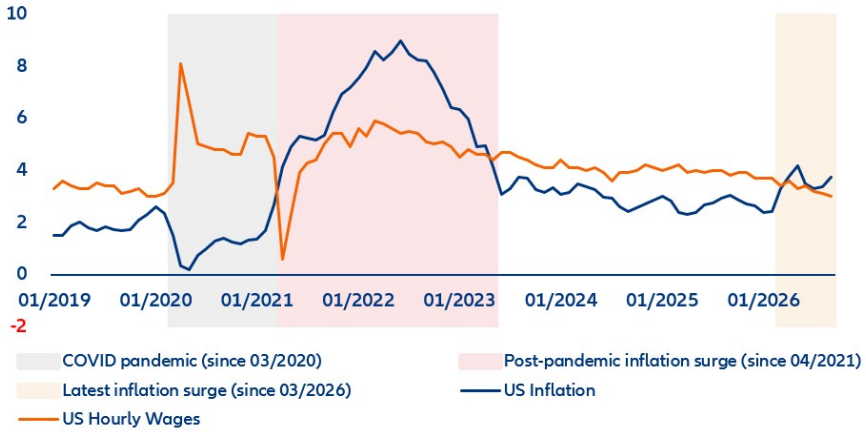
The starting point: economy and policies so far

The US economy is growing at a healthy pace while the labor market is in a relative sweet spot. US GDP is likely to grow by +2.4% in 2026 (vs +2.1% expected in our September scenario), around the same pace as 2025, despite the triple threat of rising inflation, elevated input costs and higher interest rates. The economy has benefited from staggering business investment growth, propelled by AI (with investment in high tech, data centers and electronics expected at over +20% in volume terms). In the industrial sector, strong demand for high tech, electronics, machinery, defense and aerospace products has supported production across the board, with motor-vehicle production the only conspicuous laggard. Enthusiasm for AI has, in turn, supported the stock market and fueled household consumption through the wealth effect. Meanwhile, the unemployment rate remains near historical lows at 4.1-4.3%.

The headline data mask a persistent disconnect between Wall Street and Main Street. Geopolitical tensions have renewed inflationary pressures, weighing on households' real disposable income (flat in August). We have increased our CPI inflation forecast to above +4% by early 2027, and expect inflation to remain above +3% through October 2027. In particular, we expect food inflation to reach +4.8% by September-October 2027 (from +2.4% in September 2026). In the labor market, while unemployment is low, job creation has stalled since last year. The market remains in a low-fire-low-hire mode, with hiring concentrated in a handful of sectors (especially healthcare), limiting job opportunities especially for recent graduates. Higher inflation has also helped to push up borrowing costs, including mortgage rates (back above 7%), further increasing the price of homes.

Affordability has returned as the defining economic pressure on US households as they face a renewed loss of purchasing power. Since the latest inflation surge began in March 2026, consumer prices have risen faster than hourly earnings every month from April onwards, marking the first sustained decline in real wages since spring 2023 (Figure 1). By September, inflation stood at 3.7% against wage growth of just 3.0%, keeping real wage growth negative. Unlike in the post-pandemic inflation surge in 2021–22, however, there is little sign of a wage-price spiral: wage growth has slowed from around 4% through 2025 to its weakest pace since early 2020, consistent with a low-hire labor market, while the inflation shock is concentrated largely in energy.

Figure 1: Prices are outpacing wages again; US CPI inflation and average hourly earnings growth, y/y in %



Sources: BLS, LSEG Datastream, Allianz Research

Economic issues are the top concern for American voters, with many focused on the impact of inflation on their incomes. In our Allianz Pulse survey (conducted in Q2 2026), which is representative of the US adult population, 63% of respondents named broad economic issues – inflation, jobs and housing – as their top concern, with 41% of Americans identifying inflation as their biggest worry.[1] Politically, the frustration is increasingly directed at the White House: only 17% of Americans approve of the President's handling of the cost of living.[2] Americans fear both rising prices and falling real incomes: 74% of US respondents expect their living costs to rise by more than +2% over the next year, and 43% expect their income to fall behind. Since January 2019, consumer prices overall have risen by +33%, food by +37% and food away from home by +42%, with particularly visible increases in items such as ground beef (+67%) and coffee (+55%). The latest energy-price shock following the Iran war has added to that frustration: gasoline prices were up +34% y/y in September and fuel oil +74%, compared with headline inflation of +3.7% and core inflation of +2.6%. The pressure differs across households (see Table 1): food is the main concern overall, but housing ranks first for Millennials and Gen Z.

Table 1: Food and housing dominate spending worries driven by high inflation; spending category of greatest concern for US households, in %

Rank	All US respondents	Female	Male	Boomer	Gen X	Millennial	Gen Z	High-income	Low-income
1	Food (28%)	Food (31%)	Housing (26%)	Food (31%)	Food (33%)	Housing (31%)	Housing (27%)	Food (28%)	Food (34%)
2	Housing (24%)	Housing (23%)	Food (25%)	Housing (19%)	Housing (23%)	Food (23%)	Food (21%)	Energy (18%)	Housing (33%)
3	Healthcare (15%)	Energy (14%)	Healthcare (15%)	Energy (18%)	Energy (14%)	Healthcare (16%)	Healthcare (17%)	Housing (16%)	Energy (10%)
4	Energy (15%)	Healthcare (14%)	Energy (15%)	Healthcare (14%)	Healthcare (12%)	Energy (13%)	Energy (13%)	Healthcare (14%)	Healthcare (7%)
5	Insurance (4%)	Insurance (3%)	Transport (5%)	Insurance (7%)	Transport (4%)	Transport (5%)	Transport (5%)	Insurance (5%)	Insurance (4%)
6	Transport (4%)	Transport (3%)	Insurance (4%)	Transport (1%)	Insurance (3%)	Education (3%)	Insurance (4%)	Education (3%)	Transport (3%)
7	Education (2%)	Education (2%)	Education (2%)	Childcare (1%)	Education (2%)	Childcare (1%)	Education (4%)	Transport (3%)	Childcare (3%)

Note: Healthcare includes long-term care. Fieldwork April–May 2026, 1,000 US respondents, representative sample for the US adult population in terms of age structure and gender. Source: Allianz Pulse 2026, Allianz Research.

Consumption has remained resilient, but mainly thanks to stronger balance sheets at the top, which are offsetting pressure on incomes elsewhere. Real consumption continued to grow by around +2-2.5% y/y this

[1] See: Allianz Research (2026), "Allianz Pulse 2026 on AI – The Uneasy AI Revolution", https://www.allianz.com/en/economic_research/insights/publications/specials_fmo/261014-allianz-pulse-2026-on-ai.html
[2] See: AP (2026), "Most Americans blame Trump for high prices as midterms approach", https://www.ap.org/news-highlights/elections/2026/most-americans-blame-trump-for-high-prices-as-midterms-approach-a-new-ap-norc-poll-finds/

yeareven as real income growth stalled, while the saving rate fell from 5.6% in January to 3.8% in September. Credit conditions have not yet become a binding constraint, but households are relying more heavily on savings, borrowing and wealth effects to sustain spending. Those buffers are distributed very unevenly: The net wealth of the top 20% of households rose by more than 10% in the year to Q2 2026 and by around 17% for the top 1%, compared with roughly 5% for the bottom 40%, while the richest tenth owns around two-thirds of household wealth. The result is an increasingly K-shaped affordability picture: asset-rich households continue to benefit from high equity and property values, while households with fewer assets are more exposed to food, energy and housing costs. This also makes consumption more vulnerable to a potential correction in AI-driven equity valuations, since the high-income households that hold most equity wealth are also the ones driving spending growth.

Housing is the clearest expression of the affordability divide. Housing is the top spending worry for Millennials and Gen Z in our Pulse survey (Table 1). Mortgage rates have risen by around +140bps since the start of the year, with the 30-year fixed rate still above 7%, while pending home sales fell to a record low in September. A household now needs an income of roughly USD121,000 to afford a median-priced home – up from USD111,000 in February – while the median household earns less than three-quarters of that amount; around 5mn households have been priced out since February. At the same time, some 26mn homeowners remain locked into pandemic-era mortgage rates and would face sharply higher payments if they moved, keeping supply constrained and prices elevated despite weak transactions. The administration's measures – including agency mortgage-backed securities purchases, restrictions on institutional buyers and lower transaction costs – may ease financing costs at the margin, but they do not address the binding constraint: mortgage rates themselves. With monetary policy still tight and the term premium elevated, housing affordability is therefore likely to remain under pressure even if headline inflation gradually eases.

The White House's policies so far have focused on tax cuts, deregulation of the financial sector, tighter immigration and trade policy.

On **fiscal policy**, the One Big Beautiful Bill (OBBB) Act, passed in summer 2025, has delivered tax cuts to the tune of USD110bn for corporates and households in 2026. Fiscal policy was pretty tight in 2025 (we estimate 1.2% GDP of improvement of the primary cyclically-adjusted balance), thanks to higher customs receipts, DOGE-driven cuts to discretionary spending and modifications to the federal student loan program. The fiscal impulse switched to slightly loose in 2026 (0.2-0.3% GDP estimated) thanks to the OBBB: firms benefited from tax provisions, including full expensing of R&D costs and 100% bonus depreciation, while households benefited from higher state and local tax (SALT) deductions, a new tax break for seniors and added deductions for auto loan interest, income from tips and overtime pay, among others. Corporates also benefited from tariff refunds following the Supreme Court decision to strike down part of the tariffs put in place in 2025. However, new tariffs were then levied and discretionary spending tightened further, offsetting these loosening measures. Before the new Democratic-controlled Congress takes over in January 2027, the Republicans will try to pass around USD95bn (0.3% GDP) in mostly new spending for defense and the Middle East conflict, farm aid and voter-ID grants. Against a backdrop of political confrontation, this spending package looks less likely to pass the Senate in full this autumn. Republican fiscal hawks are likely to stall the bill unless the White House agrees to offsetting savings measures.

On **tariff policy**, the administration has targeted imports across countries and products, though with important exemptions. The effective US tariff rate (customs receipts over imports) has climbed from 2.5% in early 2025 to over 7% estimated in September. Effective tariff rates range from 7% on the EU to 11% on Japan and 23% on Chinese products. Effective tariffs on steel and aluminum products (Section 232) reached 25% (vs 4% in early 2025), on autos and auto parts 6% (vs 2%) and on electrical machinery 15% (vs 2%). Pharmaceutical products kept a zero-duty rate, while many inputs in the AI ecosystem generally have low duties as well. Tariff policy has contributed to fuel inflation (+0.4pp to headline inflation in 2025, +0.3pp in 2026), with little effect so far on the US aggregate trade deficit, though the tariffs redirected import flows significantly away from China but towards Mexico and South East Asia.

On **immigration policy**, the Trump administration's stance has been very tight, particularly by cracking down on unauthorized immigration through increased border controls and ramped up deportations. While data are patchy, we estimate that total net immigration has slowed from 3.4mn in 2024 to flat in 2025 and -0.4mn in 2026. This has helped to hold down the potential growth rate of the US economy to close to +2% since 2025, and probably contributed to keeping inflation higher against a backdrop of strong AI-related demand. Wage growth in sectors that relied on unauthorized immigrants has not shown signs of acceleration so far, despite declining availability.

On **financial regulation and the administration's deregulation agenda**, much of the heavy lifting is done. The enhanced leverage ratio for the largest banks was recalibrated in November 2025, cutting Tier 1 requirements at

their bank subsidiaries by USD219bn (-28%), according to FDIC staff. In March 2026, the Fed, FDIC and OCC re-proposed a Basel III endgame far less demanding than the 2023 draft, alongside a G-SIB surcharge redesign that would lower the average surcharge from 2.7% to 2.3%. A final rule is targeted for year-end. The Fed finalized its stress-test overhaul on 30 September, and from 2 November OCC and FDIC examiners can no longer act on purely reputational risk. The CFPB has been largely sidelined, although courts have so far kept it funded. Crypto is the partial exception: the GENIUS Act created a federal stablecoin regime in 2025, but the market-structure bill (CLARITY) stalled in the Senate in September. Finally, the Supreme Court's June ruling in Trump v. Slaughter, broadened presidential removal authority over independent agency heads (the Fed excepted), which may shape how financial regulators are overseen.

On AI and infrastructure policy, the administration has treated the AI buildout as a strategic priority, combining a light-touch regulatory stance with targeted support for compute and energy capacity. While federal regulation has been kept deliberately light, some states have moved forward with restrictive measures, including issuing moratoria on the data-center buildout. The July 2025 AI Action Plan was paired with an executive order to accelerate federal permitting of data centers. It was followed in December 2025 by a second order seeking to curb state regulation through litigation and conditions on federal funding. Its legal reach has so far been limited: Congress has twice declined to legislate preemption, and no AI laws at the state level have yet been invalidated. Most recently, a September executive order labeling AI as "super intelligence" came alongside a voluntary industry accord on model reviews rather than a new regulatory framework.

Trade, industrial and energy policy have been calibrated to shield the buildout. The Section 232 tariff of 25% on advanced chips, in force since January 2026, exempts import duties for US data centers, R&D and startups. However, a broader second phase that could extend to servers containing chips remains pending. Industrial policy has turned more interventionist, including a near-10% government stake in Intel in August 2025. On energy, the administration has backed nuclear and gas-fired capacity. It has also sought to defuse energy cost concerns through the Ratepayer Protection Pledge, under which Amazon, Google, Meta, Microsoft, OpenAI, Oracle and xAI committed to cover the cost of new generation for their data centers. In July, the pledge was extended to include nearly 200 utilities, governors, cooperatives and developers.

This policy mix has supported an unprecedented investment cycle: the four largest hyperscalers are expected to spend around USD725bn of capex in 2026, up 77% from USD410bn in 2025. The buildout is also spilling into consumer prices. AI-driven demand and a shortage of memory chips have pushed prices for computer software and accessories up more than 15% y/y in the PCE index, according to Oxford Economics.[3] Power prices on the largest US grid rose 76% in Q1 2026 on data-center demand.

As a result, the voluntary approach is being tested and the political backlash is building. In Congress, a bill to shield households from data-center-driven power costs passed the House almost unanimously (417-3) in September, but has stalled in the Senate, where Democrats are pushing for stronger protections. According to our Allianz Pulse survey, a large majority of Americans want more oversight: 79% of Americans are in favor of AI regulation and 58% say the administration needs to do more, while only 7% see no need for further rules. Local opposition is even stronger: 71% of Americans oppose a data center in their community, 261 local moratoria are already in force and 26 states are considering state-wide ones.[4] The backlash is also moving votes. Since May, Democratic support among voters within a 2km distance of a data center has risen from 54% to 61%, against 53% to 55% nationally, and Democratic candidates in competitive districts in Nevada, Colorado and Ohio are campaigning on the issue.[5]

Local opposition is now delaying projects at scale and moving from county to state level. Data Center Watch counts at least 75 projects worth around USD130bn blocked or delayed by local opposition in Q1 2026, a record that roughly matches the total for all of 2025. A further 45 projects worth nearly USD68bn followed in Q2, bringing the first half of the year to nearly USD200bn. Meanwhile, the number of opposition groups has doubled to 833 across 49 states. Not every delay is a cancellation, but for scale, the first-half total exceeds a quarter of this year's hyperscaler capex. Regulation is following: 261 local moratoria are in force and 32 states have imposed restrictions on data centers. In July, New York became the first state to impose a statewide moratorium, pausing discretionary

[3] See: Oxford Economics (2026), "Holiday cheer, at a higher price", Research Briefing US.
[4] See: Gallup (2026), "Americans Are Opposing AI Data Centers in Their Area", https://news.gallup.com/poll/709772/americans-oppose-data-centers-area.aspx
[5] See: The Economist (2026), "Data centres are turning Trump voters into Democrats", https://www.economist.com/graphic-detail/2026/10/12/data-centres-are-turning-trump-voters-into-democrats

permits for facilities of 50 MW or more for up to a year.[6] Maine's governor had vetoed an 18-month moratorium in April. 26 states are now considering statewide moratoria. Even where outright bans fail, the price of local consent is rising: Arizona's governor has signed a three-year moratorium on new sales-tax breaks for data centers.

What the midterm results could mean for fiscal policy, immigration, foreign policy and tariffs

The Democratic sweep means legislative gridlock, higher risks of extended shutdowns and debt-ceiling confrontations and mildly loose fiscal policy. The results will affect the administration's room for maneuver, but likely not reverse policies already implemented, with significant latitude remaining over executive-led policies. A majority in the Senate also gives Democrats the power to block presidential appointments, including nominations to the Fed, the Cabinet or the Supreme Court. The only Fed vacancy within the next two years will be after Jerome Powell's term ends in January 2028. A Democratic Senate will have more leverage over Fed nominations, which some investors may view as supportive of institutional continuity at the Fed. However, even if the Democrats won both chambers, they fall short of the 60-seat Senate majority required to bypass the filibuster and pass most legislation, while the President would maintain veto power.

Table 2: Summary of policy expectations under the Democratic sweep

Policy expectations
• Frictions over judicial appointments (Senate is needed to appoint federal judges) • Greater uncertainty around Cabinet and Fed staffing (one vacancy at the Fed in Jan 2028) • More institutional friction • 2027 bargain: Republicans get a c.USD90bn emergency defense supplemental to replenish munitions (c.USD50bn paid out in 2027); Democrats, with more leverage, get more welfare spending – higher non-defense spending and delayed OBBB health and nutrition cuts; limited offsets (customs receipts broadly absorbed by tariff refunds) → looser fiscal policy in 2027 (0.2% GDP) • 2028 bargain on the FY2028 budget (late 2027/early 2028): Republicans get some temporary OBBB provisions made permanent (tips and overtime deductions, higher SALT cap); Democrats get limited tax increases, partial restoration of enhanced ACA subsidies and partial reversal of Medicaid and SNAP cuts; defense outlays slow → moderate fiscal tightening in 2028 (0.4% GDP)

Source: Allianz Research

Fiscal policy: deadlock or compromise? Under a Democratic Congress, major fiscal policy changes are unlikely, including major defense spending hikes pushed by the White House. Fiscal policy is the area where a change in congressional control most constrains the executive branch's ability to pursue its agenda, so major changes in fiscal policy are unlikely in 2027-28. On the one hand, the President's veto will likely block the Democrats' flagship legislative proposals, including tax hikes on wealthy individuals and corporations. The Democrats also fall short of the 60-seat Senate "supermajority" needed to overcome the filibuster and pass most legislation. On the other hand, the Democratic Congress will close the reconciliation route the Republicans have used to pass their agenda with a simple majority. This will leave the pending "Reconciliation 3.0" package (about USD95bn for defense and the Iran war, farm aid and voter-ID grants), the debt ceiling and any further party-line bills dependent on the lame-duck session on 11 December, before the new Congress is sworn in on 3 January 2027. After that, the White House's major fiscal changes proposals – including a USD500bn hike in the defense budget hike and USD5,000 payments to citizens – will likely be rejected.

Policy and market risks could rise in Q4 2027 or Q1 2028, with potentially the concomitance of a government shutdown and a debt-ceiling accident. Government shutdowns will become more likely as both parties struggle to agree on appropriations and continuing resolutions (i.e., short-term spending bills that fund government

[6] See: Jones Day (2026), "New York Enacts First Statewide Data Center Moratorium", https://www.jonesday.com/de/insights/2026/07/new-york-enacts-first-statewide-data-center-moratorium

operations). FY2026 already saw three funding lapses, including the 43-day government-wide shutdown in autumn 2025 and a record 76-day lapse in Homeland Security funding, so political infighting could soon be back on the agenda. The first test comes on 11 December 2026, when the current stopgap funding expires (Figure 2). The next major milestone is 1 October 2027, when FY2028 begins and Congress must have passed funding for it. Soon after that, Congress will have to agree on raising the debt ceiling (if not raised before the end of the year). The debt limit itself is expected to be reached between late winter and mid-summer 2027. Extraordinary measures should then allow the Treasury to keep paying its bills for another six to nine months, which puts the X-date between late 2027 and early 2028. Republicans may try to avoid this by raising the debt limit in a final reconciliation package during the lame-duck session, before end-2026. If they do not, the funding and debt-ceiling deadlines could converge in Q4 2027. Democrats will likely demand budgetary concessions in exchange for a debt-ceiling increase and face stiff Republican opposition (and the threat of a presidential veto). We could see a repeat of the 2023 debt-ceiling standoff, where an agreement between the Democrats and the Republicans was reached just two days before the X-date.

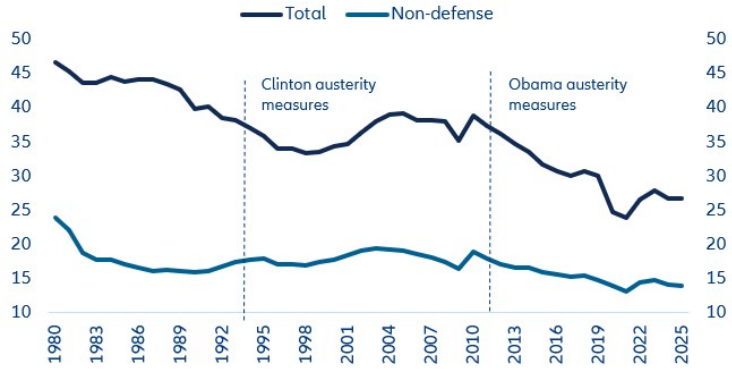
Figure 2: Budget and fiscal policy timeline



Sources: CRS, Bipartisan Policy Center, National Taxpayers Union, Allianz Research
Note: debt-limit dates are estimates

The current polarization and dwindling room to cut discretionary spending further makes reaching a grand bargain on fiscal consolidation difficult. With the X-date approaching, both parties will likely advance their budget proposals. Democrats will likely push for OBBB-induced ACA subsidies and SNAP cuts being reinstated, and propose tax hikes to reduce fiscal imbalances. Republicans will push for more defense and border control spending, with reduced Social Security and discretionary spending as the main avenue to narrow fiscal imbalances. Entitlement reforms to Social Security need the supermajority of 60 Senate votes to pass, which both parties will not have. Likewise, any attempt by the Democrats to pass tax hikes will likely face Republican pushback in Congress and the likely veto of the President. Besides political hurdles, Congress has much less room to decrease discretionary spending than in the past. Excluding defense, discretionary spending makes up only 14% of total federal spending (Figure 3) – this is much less than during previous episodes of bipartisan fiscal consolidation: Clinton and the Republican-dominated Congress in the second half of the 1990s, Obama and the Republican-dominated Congress in the 2010s. We do not see a compromise being reached in Congress to rein in Social Security/healthcare spending and/or raise taxes – the only two avenues to reduce the deficit significantly.

Figure 3: Discretionary vs mandatory spending (% of total federal spending)



Sources: CBO, Allianz Research

The fiscal stance should loosen modestly in 2027 (0.2% GDP), with additional defense and welfare spending, and turn back modestly restrictive in 2028. In the past, divided governments were sometimes forced to compromise, leading to some form of fiscal consolidation (eg. under Clinton in 1994-95 and Obama in 2011). But this looks unlikely now, given increased political fragmentation both between parties and within: the left-leaning part of the Democratic Party is on the rise, pushing for sharp increases in taxation and regulation, although these policies have a lower chance of passing. Nevertheless, they could encourage the Democrats to ask for more concessions on social safety-net spending.

In 2027, with President Trump retaining his veto power, we do expect Congress to agree on supplemental spending of around USD90bn for defense, mainly to replenish depleted munitions inventories, though a re-escalation of tensions with Iran could delay new military funding. Given procurement lags, only just over half (c.USD50bn) would be paid out in 2027 (Figure 4). In exchange, Democrats would likely secure higher non-defense spending and delay some of the OBBB's health and nutrition cuts. Offsets should be limited: Additional customs receipts would be broadly absorbed by tariff refunds, leaving traditional revenue-raisers (real bracket creep) and perhaps a few billion USD of bipartisan tax increases. In all, the fiscal impulse should be slightly loose, at around 0.2% of GDP. Any re-escalation with Iran would lead Democrats to reject any new military funding.

For 2028, with neither side wanting to be blamed for another extended shutdown or a debt-ceiling standoff ahead of the elections, we expect a compromise on FY2028 budget priorities to be reached in late 2027 or early 2028. The deal could make some temporary OBBB provisions permanent[7] (tips and overtime deductions, the higher SALT cap) in exchange for limited tax increases, a partial restoration of the enhanced ACA subsidies and a partial reversal of the OBBB's Medicaid and SNAP cuts. Meanwhile, defense outlays should slow as the supplemental winds down, while the OBBB's scheduled spending cuts and bracket creep reduce the deficit. In all, we expect a moderate fiscal tightening of around 0.4% of GDP in 2028.

[7] The temporary provisions of the OBBB Act run through FY 2028/29.

Figure 4: Expected changes in main spending & tax items and fiscal stance (Democratic sweep)

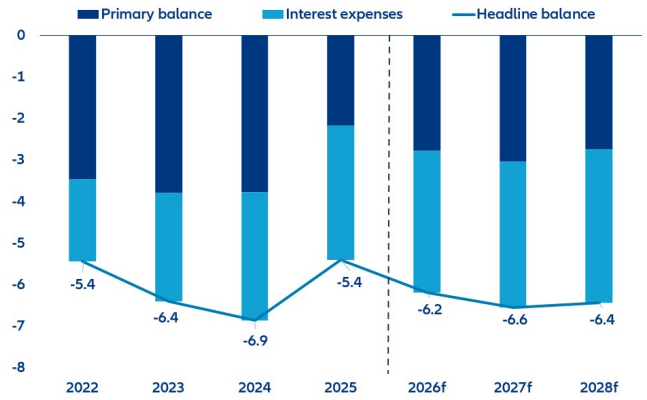
In USD bn	2026	2027	2028	% GDP 2026	% GDP 2027	% GDP 2028
OBBB tax cuts	(110)	-	-	(0.34)	-	-
Additional customs receipts	77	48	-	0.24	0.14	-
OBBB spending cuts	10	-	45	0.03	-	0.13
Tariffs refunds	(127)	(48)	-	(0.39)	(0.14)	-
Other tax changes (real bracket creep, etc)	30	40	50	0.09	0.12	0.14
Iran/defense emergency supplemental (outlays)	-	(50)	23	-	(0.14)	0.06
Non-defense parity add-ons (outlays)	-	(15)	5	-	(0.04)	0.01
ACA subsidy concession (outlays)	-	-	(20)	-	-	(0.06)
SNAP cuts partial reversal (outlays)	-	-	(8)	-	-	(0.02)
Democratic sweep add-ons (outlays)	-	(23)	(45)	-	(0.07)	(0.13)
Bipartisan tax/fee offsets	-	5	10	-	0.01	0.03
Other spending (mandatory + discretionary)	33	(26)	76	0.10	(0.08)	0.21
FISCAL STANCE (+ = reduce deficit)	**(87)**	**(69)**	**135**	**(0.3)**	**(0.2)**	**0.4**
of which spending	43	(114)	75	0.13	(0.33)	0.21
of which revenues	(130)	45	60	(0.40)	0.13	0.17
Base case fiscal stance (rows 97-107)	(87)	(41)	216	(0.27)	(0.12)	0.61

Sources: LSEG Datastream, CBO, Allianz Research. Note: Spending changes are expressed relative to US potential GDP growth rate (estimated at 2%), meaning that spending rising above it are a loosening and below it a tightening. For revenues, when they grow above US nominal.

The bottom line is that the federal deficit should increase again in 2027-28, to -6.6% and -6.4% GDP. We forecast the US federal deficit (cash-based definition) to rise in 2027, from -6.2% GDP estimated in 2026 to -6.6% GDP in 2027 and -6.4% in 2028. We see the primary deficit deteriorating in 2027 (from -2.8% GDP to -3.0%) and rising interest expenses (from 3.6% GDP to 3.8%) pushing the headline deficit up. In 2028, we see a decrease of the primary balance (to -2.7% GDP), but the fiscal effort being partly negated with still rising interest costs (to 3.7%), keeping the headline deficit elevated at 6.4%.

Housing policy could be an area of bipartisan compromise. Since 2025, the Trump administration has focused on deregulation, expanding mortgage credit and promoting homeownership. Key measures include easing federal permitting and construction requirements, encouraging manufactured housing, directing Fannie Mae and Freddie Mac to purchase USD200bn in mortgage-backed securities and restricting large institutional investors' purchases of single-family homes. The July 2026 bipartisan ROAD to Housing Act further strengthened this framework, while the One Big Beautiful Bill expanded Low-Income Housing Tax Credit (LIHTC) allocations to incentivize affordable rental construction. With a Democratic Congress in 2027–28, a bipartisan compromise could build on these initiatives rather than reverse them. The most likely areas of consensus would include further zoning and permitting reforms to boost housing supply, expanded tax incentives and federal grants for affordable housing construction, and targeted support for first-time buyers through down-payment assistance and easier mortgage access. Both parties could also agree to maintain restrictions on institutional investors purchasing existing single-family homes, while exempting new build-to-rent developments. Democrats would likely push for additional rental assistance, housing vouchers and tenant protections, although agreement on broader rent regulation or large-scale federal spending would be more difficult. Overall, policy could shift towards a broader affordability agenda while retaining President Trump's supply-side approach.

Figure 5: US federal deficit forecast (cash-based, calendar years)



Sources: LSEG Datastream, CBO, Allianz Research

Foreign policy, particularly renewed tensions with Iran, remains a key post-election risk. Further escalation could drive oil and wholesale gas prices higher, reigniting inflationary pressures and adding to upward pressure on bond yields. Greater congressional opposition under Democratic control could only constrain the scale and duration of further military action in the medium term. Congress controls federal appropriations and has the constitutional power to declare war and regulate foreign commerce. Under Republican control, Congress has generally provided limited institutional resistance. If Democrats regain control of one or both chambers, they could implement funding restrictions, oversight and investigations. However, a Democratic majority would not transfer control of foreign policy to Congress: The President would retain substantial executive authority, including the ability to order certain military operations without prior congressional approval. Congress could raise the financial and political costs of further escalation by restricting funding for military operations or replenishing munitions, although binding restrictions would face legislative hurdles and potential presidential vetoes.

On immigration policy, the Democrats in the House will mean greater oversight, but limited immediate policy change. With Democrats controlling the House, immigration policy will become a more contentious area of congressional oversight, with investigations into ICE operations, detention conditions and deportation practices. Democrats could also seek to limit future enforcement spending through appropriations negotiations. However, the administration will retain considerable executive discretion, while previously approved funding would continue to support enforcement operations. A Democratic House alone would therefore be unlikely to produce a substantial near-term reversal of the administration's immigration policy.

A Democratic Senate will bring in greater constraints, but again no automatic reversal. With control of both chambers, the Democrats will have more scope to constrain future funding and pursue legislative changes. Nevertheless, President Trump could veto legislation, and existing appropriations and executive powers would limit the scope for an immediate policy reversal. A significant relaxation of immigration restrictions would likely require difficult legislative negotiations or changes in executive policy, potentially subject to judicial review.

We expect pragmatic adjustments, with limited impact on overall flows. Targeted adjustments remain possible, particularly exemptions or more flexible visa arrangements for sectors facing labor shortages and pressure from employers. Such pragmatism could mitigate some economic costs without fundamentally changing the administration's approach to both authorized and unauthorized immigration. Overall, the midterm results are unlikely to trigger a major rebound in immigration flows in 2027–28. The main difference would be greater political and legal friction around enforcement, rather than a decisive change in the direction of policy.

Tariff and deregulation policies will be unaffected by a Democratic Congress. Congress has limited ability to block policies enacted by executive order, such as certain tariff and foreign policies, so the President is likely to keep relying on executive action, with the courts as the main constraint. We expect the US effective tariff rate to settle at around 8.5% by January 2027 as the administration is likely to implement a wave of Section 301 (on overcapacity) tariffs on major foreign partners, with the effective tariff on EU products settling at 8-9%, on Chinese products at 29% and Japanese at 11%, with deals limiting the upside for the EU and Japan. After that, there are risks that the White House will continue to leverage tariffs as an instrument of foreign and trade policy, including via a further escalation with Canada (eg. tariffs at 50% on Canadian motor vehicles), increasing threats to pull out of the USMCA, a retaliation against European countries on the Global Service Tax or another wave of Section 301 tariffs on transshipped goods. However, on the USMCA, Congress would likely oppose withdrawal, and any unilateral move by the President would probably face legal challenges and ultimately reach the Supreme Court. The Court could freeze the withdrawal while ruling, keeping the USMCA in place but increasing uncertainty.

A Democratic Congress will also have a limited impact on deregulation policy as that runs through the agencies, which makes it slow to build and just as slow to reverse. Overturning a final rule takes a law, which the President would likely veto. A Democratic House brings scrutiny, with Maxine Waters expected to return as chair of the Financial Services Committee, with hearings and subpoenas on capital relief, lighter supervision, large bank mergers and cryptocurrency. That raises the political cost of the most contested files, but does not change a single rule. It would also stall the Republican plan, approved by the House committee in September, to make the CFPB depend on annual funding votes in Congress.

The real constraint is the Senate for deregulation, through confirmations. Key posts are already held by the President's appointees: Michelle Bowman as the Fed's top supervisor, Jonathan Gould at the OCC, Paul Atkins at the SEC. A Democratic Senate, with Elizabeth Warren likely chairing the Banking Committee, will control the process outright, but would have little to block unless seats fall vacant. Its leverage lies at the margin: slower confirmations

for any replacement, antitrust enforcers included and conditions attached to must-pass spending bills, which would need to be modest and bipartisan to survive. Midterms are thus more about pace than direction: nothing already finalized will go away, but new appointments and new rules slow sharply, while agencies grow more cautious on the next round.

The midterms results are unlikely to change federal AI policy, but they could reshape the buildout at the state level. Although Democrats won control of the Senate, they remain well short of the 60 votes needed to pass new federal rules, which would also require the President's signature, making gridlock likely. The real leverage lies with the states, which control permitting, siting and utility rate-setting. Here the election has shifted the balance: Democrats won seven of the ten competitive governor races that together cover around 67 GW of planned data-center capacity, with three still too close to call.[8] Governors-elect who back a full or conditional moratorium now preside over around 47 GW, or 70% of that capacity. That is the 32 GW in Ohio, Iowa, Michigan, Oregon and Wisconsin, where both candidates backed a moratorium, plus Georgia's 15 GW, where only the Democratic winner did. A further 9 GW in Nevada, Kansas and Alaska hinges on races in which the Democratic candidate, who supports a moratorium, currently leads. Ohio is the clearest case: It is the second-largest planned data-center market after Texas. Democrat Amy Acton, who won the election, supports a conditional moratorium, and will also appoint all five members of the state utility commission. Exposure is concentrated: OpenAI alone has 14.1 GW of planned capacity in these ten states, more than Amazon, Microsoft, Google and Meta combined.

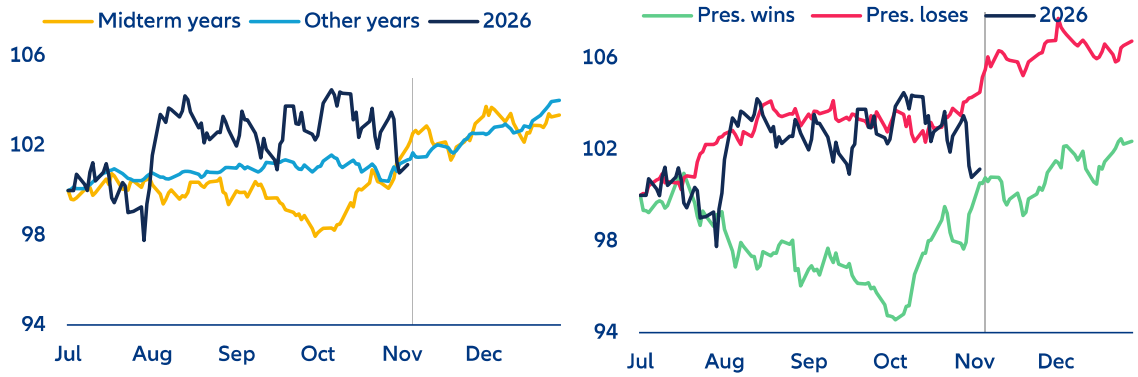
For investors, the risk is less an abrupt halt than a slower, costlier and more uneven buildout. Moratoria and conditional approvals stretch timelines. Requirements to fund grid upgrades, cover full utility costs or sign community-benefit agreements raise project costs and push capacity toward more permissive states. With AI-related investment accounting for more than a third of 2026 GDP growth, such delays would weigh on growth. And with tech valuations premised on sustained capex growth, they raise execution risk for hyperscalers, AI labs and their suppliers.

Financial market impacts and sector allocation

The S&P 500 has followed the pattern seen in previous midterm years when the president's party lost control of at least one chamber. Since the mid-1960s, the second half of a midterm year has followed a recognizable pattern: the index declines from summer to early autumn, then recovers towards the end of the year and closes at levels similar to those of any other year. 2026 followed this pattern until July, when it began to rally from August. This move does not appear unusual when midterm years are split by outcome. In the seven years when the president's party lost control of at least one chamber, the index held up through the autumn (+4.3% at the end of October) and ended the year 6.7% above its level on 1 July. In the eight years when the president's party did not lose control of either chamber, the index fell by almost 5.5% in early October and ended the year 2.4% above its level on 1 July. Therefore, the autumn dip comes from the years in which the president kept control, and 2026 sits with the other group. The recent drop reflects a tech sell-off and possibly pricing expected higher AI regulation under a Democratic Congress. The initial market reaction this morning was moderately negative, with S&P 500 futures down 0.3%, Nasdaq futures down 0.4%

[8] See: Cleanview US Data Center Database, https://cleanview.co/data-centers/us

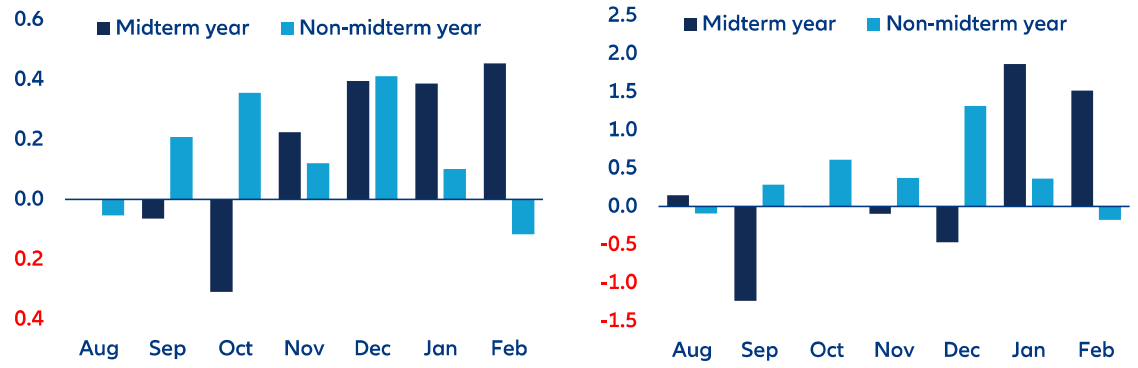
Figure 6: Average S&P 500 performance around midterm elections



Sources: LSEG Datastream, Allianz Research

Credit has also followed the usual midterm script: weak into the vote, with relief likely once the electoral uncertainty clears. In the seven midterm cycles since 1998, the median excess return from August to October was -0.3% for investment grade and -0.4% for high yield, compared with +0.3% and +0.7% in other years. From December to February, median excess returns were positive in all seven cycles (+1.2% and +2.4%, respectively). The election itself is rarely the cause. When credit weakened in previous midterm cycles, it was usually due to a growth scare or a rate shock. This year the rate backdrop looks similar, with a Fed expected to tighten further, a 10-year yield near 5% and a record volume of AI-related issuance. High yield has been hit hardest, with an excess return of -1.7% from August to October, worse than in five of the previous seven midterm cycles, while investment grade (-0.6%) slightly below its median. With spreads already near cycle tights, the direction after the vote will depend on the Fed and on supply, rather than on who controls Congress.

Figure 7: Credit excess returns in midterm vs non-midterm years: investment grade (left) and high yield (right)



Sources: LSEG Datastream, Allianz Research

The question is how the new configuration will affect the three factors which matter for equities: earnings, interest rates and regulations. The Q3 earnings season has been quite strong so far. If the escalation with Iran renews after the election, that would affect margins through increased input costs and a consumer that is already under pressure, though we do not think markets are anticipating this for now. Regarding rates, continued uncertainty on tariffs and increased spending keep inflation and yields elevated, so the scope for multiple expansion is limited. With the hyperscalers' build-out being increasingly debt-funded, higher rates could become an issue the AI complex can't look through. In terms of regulation uncertainty, a Democratic sweep is expected to bring oversight in the form of a louder push for AI regulation, with headlines that could move prices without the need for legislation. However, President Trump has veto power, which could limit the scope for major legislative changes. Should strikes in Iran resume, data centers within Iran's reach could themselves become targets, posing a physical risk to the AI build-out that has not had to be priced in during previous midterm cycles. Overall, the balance of risks for US equities in the run-up to 2027 might bring some volatility .

The pressure is concentrated in the tech sector that carries the index, with the push for AI regulation, consensus earnings that leave little room for a disappointment or a prolonged energy shock and the data-center tail if strikes resume. It has the most to lose and a lower discount rate is not on the table while inflation stays sticky. Financials are more likely to see a headline dip than a reversal, since deregulation runs through the agencies and a Democratic House can hold hearings but not rewrite rules. Among defensives, healthcare looks best placed to lead: it is the least rate-sensitive of the three and the one a Democrats are most likely to talk up rather than down. Utilities and real estate would need yields to fall to repeat their 2018 run, which is not our baseline. Energy stands out as the sector most likely to outperform if Iran escalates again, and the one with the most direct offset to the risk that weighs on everyone else.

Table 3: Asset reaction by outcome

Asset	Democratic sweep
S&P 500	▼ Modest drag. Control change raises uncertainty and starts to price 2028 risks (corporate taxes, AI rules).
Equity volatility	▲ Higher. Change of control adds index-level uncertainty.
UST short-term rates	► Policy rate path pricing remains unchanged
UST long-term rates	► Little change to slightly higher. Republican spending is off the table but risk premium for uncertain Democrat fiscal path appears.
USD	► Little change. A Democratic Senate eases Fed-independence concerns; looser fiscal risk offsets this.
IG credit	► Neutral for the index. Spreads widen at first, then tighten within months.
HY credit	► Neutral for the index. Sector and issuer differences emerge.

Table 4: Sector impact by outcome

Sector	Democratic sweep
Health care and insurance	**Positive.** Partial relief on ACA subsidies and Medicaid becomes more likely; health-care stocks track Democratic House odds. Best-placed defensive, least rate-sensitive.
Technology (semis and AI infrastructure)	**Negative.** AI guardrails and data-center restrictions become more likely; consensus earnings leave little room for disappointment.
Financials	**Neutral.** A Democratic Senate could slow bank deregulation, but rules run through the agencies; headline dip, not a reversal.
Energy	**Neutral.** Less deregulation; still a hedge against Iran re-escalation.
Utilities	**Neutral to positive.** More support for renewables; rates cap the upside.
Staples and restaurants	**Positive.** Stronger pressure to soften the cuts; the veto limits what can pass.
Consumer discretionary	**Negative to neutral.** Household pressure persists; limited help from softer benefit cuts.
Industrials and defense	**Neutral.** The USD500bn hike is likely rejected; a USD90bn supplemental is likely.
Real estate	**Neutral.** A 2018-style run needs lower yields, not our baseline.

A renewed escalation with Iran remains the main downside risk for US Treasuries. A disruption to oil supply would likely push the crude curve back into steep backwardation and trigger a renewed rise in energy prices, reinforcing inflationary pressures and forcing markets to reassess the path of US monetary policy. In the short term, such a shock would most likely result in a bear flattening of the Treasury curve as the front end reprices higher inflation expectations and the risk of additional Fed tightening. Political division could amplify this move through higher Treasury volatility. Unlike the disputed 2000 election or the January 2021 Capitol events, the current macroeconomic backdrop is characterized by large fiscal deficits, elevated debt-servicing costs and inflation pressures linked to geopolitical developments. As a result, political uncertainty is more likely to be priced as both a fiscal and inflation risk, contributing to a higher term premium across the curve. Over a longer horizon, however, deteriorating growth conditions could provide support to long-dated Treasuries. Real disposable income remains weak, job creation is slowing and household savings are declining, suggesting that the economy is becoming increasingly vulnerable to a negative demand shock. In such an environment, any meaningful correction in equities could revive safe-haven demand for duration, particularly if investors begin to focus on recession risks rather than inflation alone. This would favor relative outperformance of the long end versus the front end, although the magnitude of the move would likely

be constrained by a structurally higher term premium. More broadly, the combination of political uncertainty, deteriorating market liquidity and a still-hawkish Federal Reserve is likely to keep rate volatility elevated. Such conditions could eventually require policy intervention to preserve Treasury market functioning. In that context, the Treasury would likely be the first line of defense through expanded buybacks or adjustments to the issuance mix, while a Fed led by Kevin Warsh would probably remain reluctant to provide outright monetary accommodation as long as inflation remains above target. Beyond episodic interventions, the medium-term direction for the term premium remains biased higher, reflecting growing fiscal concerns and elevated macroeconomic uncertainty.

For private markets, the Democratic sweep is more a story of timing and financing conditions than of a policy break. With the presidential veto intact, sweeping changes to the tax treatment of private markets look unlikely before 2028. Carried interest and the expanded QSBS exclusion may well resurface in the debate, but we see them more as themes for the 2028 campaign than as 2027 legislation. The more immediate effect is oversight: Hearings and document requests are likely to target private credit (including insurer exposure and stress-testing) and PE in healthcare, housing and other affordability-sensitive sectors. These are largely headline risks, but they could raise funding costs for highly leveraged credits. Exit conditions should remain supportive: The administration's permissive stance on M&A should underpin large corporate deals from H1 2027 and reopen an exit route for sponsors, while pending secondaries and listing-reform proposals and the SEC's review of the accredited investor definition could modestly broaden liquidity and fundraising options. In VC, AI (c.83% of US deal value) should remain lightly regulated at federal level, although congressional hearings on AI safety and data centers, together with state-level moratoria, add execution risk to the most capital-intensive parts of the value chain. In infrastructure, demand driven by AI-related power needs should remain intact, but permitting and grid-cost allocation rules raise development risk for data centers, favoring transmission and generation assets. Defense tech should stay well supported, even if the larger budget increase is unlikely to pass; a supplemental of c.USD90bn is the more probable outcome. The bigger swing factor is macro: higher long-term rates (up to 30bps), sticky inflation and a possible shutdown or debt-ceiling standoff around Q4 2027–Q1 2028 keep financing costs elevated. We therefore expect selectivity rather than retrenchment, with sponsors leaning on operational value creation and moderate leverage, and capital concentrating where earnings visibility is strongest, notably AI, defense and healthcare.

These assessments are, as always, subject to the disclaimer provided below.

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