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INVESTMENT STRATEGY



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US Policy Pulse

Midterm Crosscurrents Beyond the Ballot

In this report, we examine the economic and political forces shaping the 2026 midterm elections, key races to watch and the potential implications of divided government for policy and markets.

Monica Guerra
Investment Strategist
Monica.Guerra@morganstanley.com

Kyle Kerr
Associate
Kyle.Kerr@morganstanley.com

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Key Insights:

- Democrats remain favored to regain the House of Representatives, while we now view Senate control as a toss-up with a slight Democratic edge.
- Democrats' 8.6-point congressional polling lead is broadly stable despite weaker consumer sentiment and September gasoline prices up 37.6% year over year.
- Republican issue groups aired $487 million in ads across nine Senate battlegrounds through Sept. 30, sustaining competition.
- Democratic candidates raised over five times as much as Republican rivals across 10 Senate races in the third quarter.
- Local costs, AI investment, trade and redistricting can reinforce or offset national trends, as indicated by top House and Senate races.
- Divided government could support market stability. The S&P 500 has averaged a 14% return in post-midterm calendar years, although history is not a forecast.
- Recent market outperformance and narrow breadth could amplify policy-related volatility, particularly in industries facing heightened scrutiny.
- We encourage long-term discipline; policy-driven selloffs may offer opportunities when market reactions exceed the likely business impact.

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The 2026 midterm elections are entering the final stretch against an increasingly complicated economic and geopolitical backdrop. The broader US economy has demonstrated resilience, but persistent inflation, elevated borrowing costs and renewed energy price pressures have weighed on household purchasing power and consumer confidence. These pressures have created meaningful political headwinds for Republicans, whose narrow congressional majorities leave little room for electoral losses. We continue to expect Democrats to regain control of the House, but our outlook for the Senate has shifted since September. What was previously a Republican-favored outcome is now a toss-up with a slight Democratic edge, as a widening battleground and deteriorating voter sentiment have strengthened Democrats' hand. That said, Republican fundraising resources, favorable redistricting and competitive individual races remain important counterweights.

A change in congressional control could alter the trajectory of fiscal spending, regulatory oversight and legislative priorities, while shifts to committee leadership could reshape negotiations surrounding taxes, health care, financial regulation and emerging technologies. That said, divided government would likely limit sweeping legislative changes, though executive authority, agency rulemaking and state-level initiatives could continue to influence economic and market outcomes.

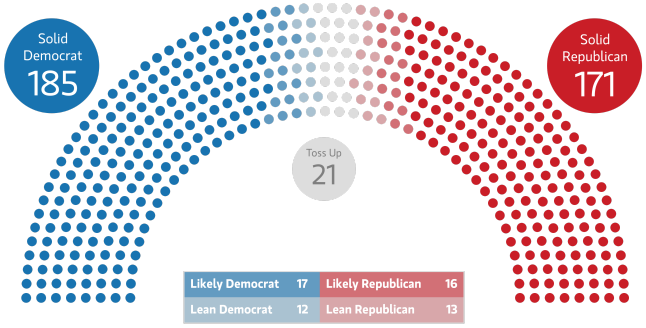
For investors, we emphasize that market performance is more closely tied to the business cycle than to political party control and that congressional gridlock may be constructive for returns. However, shifts in the balance of power can have meaningful implications for sector-level performance, particularly where government spending, regulatory changes and private capital investment intersect. In this report, we examine the economic and political forces shaping the final weeks of the midterm elections and the potential investment implications of a changing policy regime.

Election State of Play

The House remains particularly vulnerable to a shift in partisan control, as Democrats need a net gain of just three seats from the 215 won in 2024 to secure the majority of 218. Recent changes to the electoral map have further strengthened Democratic prospects. On Oct. 16, Cook Political Report (CPR) shifted 11 district ratings toward Democrats, leaving 21 toss-ups, 16 of which are Republican-held (see Exhibit 1). This imbalance puts Republicans on the defensive, although turnout, candidate strength and broader economic conditions remain critical to electoral outcomes.

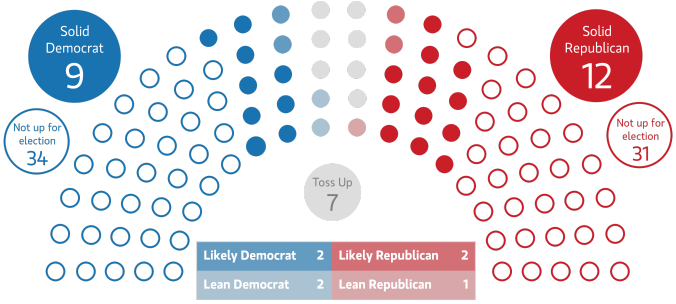
The Senate presents a more challenging path to a Democratic majority. Democrats and allied independents need a net gain of four seats to secure an outright 51-seat majority, while Republicans could retain control with 50 seats through the vice president's tiebreaking vote. However, six of CPR's seven Senate toss-ups are Republican-held, with Michigan the sole Democratic-held seat at risk, providing Democrats with many paths to a majority (see Exhibit 2).

Exhibit 1: House of Representatives Race: Seat Ratings



Note: Ratings are classifications of competitiveness; totals include all 435 seats.
Source: Cook Political Report (CPR), Morgan Stanley Wealth Management Global Investment Office as of Oct. 16, 2026

Exhibit 2: Senate Race: Seat Ratings



Note: Democratic-aligned includes independents caucusing with Democrats. Florida and Ohio hold special elections.
Source: Cook Political Report, Morgan Stanley Wealth Management Global Investment Office as of Oct. 20, 2026

Household Pressures Sustain the Political Headwinds

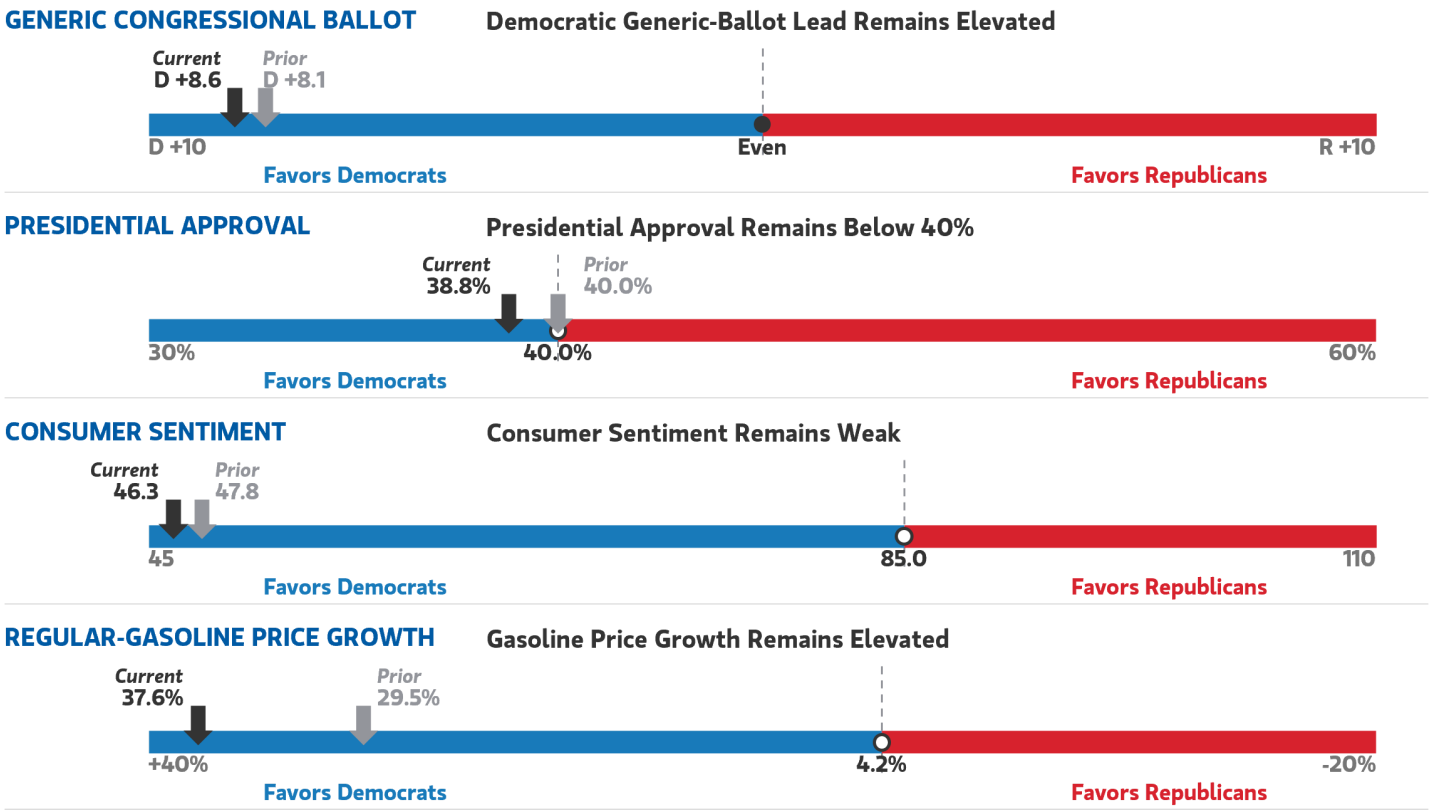
Our Midterm Signal Monitor, which tracks political and household economic indicators to assess the electoral backdrop, continues to favor Democrats, although recent polling has been broadly stable despite weaker household economic readings. For example, the congressional generic ballot, which gauges how people would vote if the election were held today, stands at +8.6 percentage points in favor of Democrats, little changed from September's 8.1-point advantage, while presidential approval is 38.8%, showing signs of stabilization but remaining below the 40% historical reference point.

Our economic indicators tell a different story: Consumer sentiment has declined from 47.8 to 46.3, while year-over-year growth in regular-gasoline prices has accelerated from 29.5% in August to 37.6% in September. The readings tell us that while economic factors have continued to place a drag on the electorate, polling and favorability levels have begun to stabilize (see Exhibit 3).

However, we caution investors that improved conditions would not necessarily produce an immediate electoral offset. In an Oct. 3–5 POLITICO/PF Global poll, only 9%–12% of undecided respondents said hypothetical declines in gasoline prices or inflation, or an announced end to the Iran war, would make them more likely to vote Republican—55%–57% were unsure. Those responses describe stated intentions, not how voters would respond to realized relief. A resolution of the Iran conflict could help Republicans, but the impact to gas prices would likely have little effect before Election Day. According to Morgan Stanley Research, even after a diplomatic breakthrough and the reopening of the Strait of Hormuz, it would take roughly four months to restore 75% of lost Middle East production, with full recovery extending well into 2027, due to bottlenecks such as mine clearing, tanker repositioning, full storage tanks and technical field restarts, keeping global oil and fuel balances tight through the autumn.

That said, resolution and the potential for meaningfully lower gasoline prices would still benefit households and businesses beyond Election Day, even if relief arrived too late to change the electoral backdrop.

Exhibit 3: Midterm Signal Monitor: Political and Household Indicators Remain Under Pressure



Source: RealClearPolling, University of Michigan Surveys of Consumers, Bureau of Transportation Statistics, US Energy Information Administration, Morgan Stanley Wealth Management Global Investment Office as of Oct. 20, 2026.

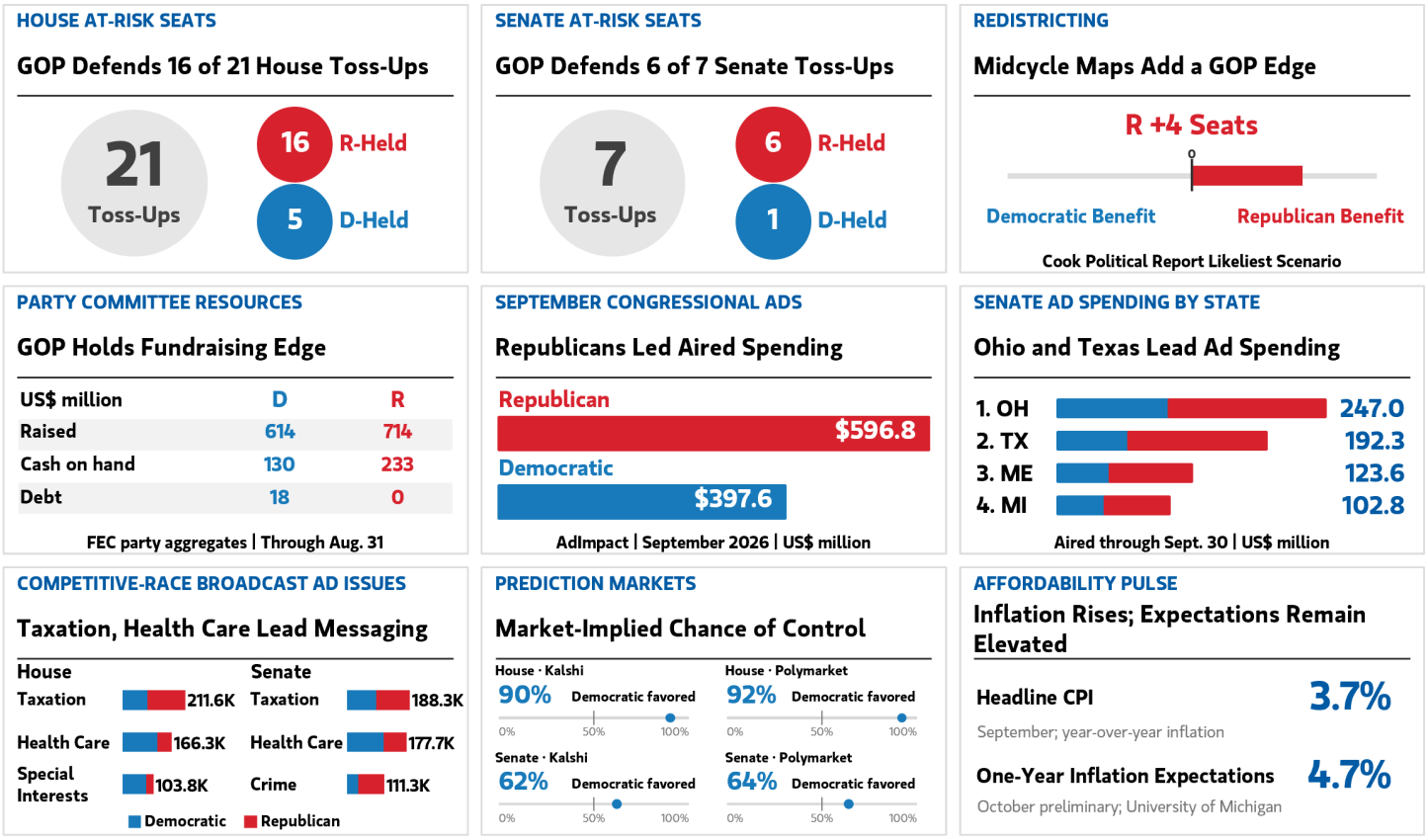
Campaign Resources and the Competitive Map

We dig deeper into current campaign dynamics through our Midterm Election Dashboard, which highlights the structural and race-specific forces that could either reinforce or offset national signals heading into Election Day.

For example, the three Republican national-party committees raised $114.4 million in the second quarter, 19.7% more than the $95.6 million raised by their Democratic counterparts. Outside support reinforces Republican advertising strength: AdImpact reports that Republican issue groups accounted for $487 million in aired advertising across nine Senate battlegrounds through Sept. 30, representing 87% of Republican advertising spending in those races. In contrast, Democratic strength is more pronounced in candidates' own accounts, where POLITICO's 10-state review found that third-quarter receipts were more than five times those of Republican opponents, excluding joint fundraising committees. That said, Republican campaigns entered October with larger cash balances in five of seven Senate toss-ups, although combined balances were closer at $38.7 million for Republicans versus $37.2 million for Democrats. The distinction between fundraising momentum and available resources therefore remains important to the competitive outlook.

Furthermore, both parties are choosing strategically where to deploy resources. Texas PAC, a Republican super PAC, reported $158 million of third-quarter receipts, underscoring the concentration of Republican outside support in an expensive battleground state. On the Democratic side, the Senate Majority PAC announced plans on Oct. 12 to withdraw its North Carolina advertising and direct $7 million to Ohio and $2.5 million to Iowa, following an earlier $5 million Kansas purchase. These spending shifts illustrate how changing confidence in one contest can release resources for other areas that have become more competitive (see Exhibit 4).

Exhibit 4: Midterm Election Dashboard Separates Electoral Signals From Financial Counterweights



Source: Cook Political Report, Federal Election Commission, AdImpact, Kalshi, Polymarket US Bureau of Labor Statistics, University of Michigan Surveys of Consumers, Morgan Stanley Wealth Management Global Investment Office as of Oct. 20, 2026

Exhibit 5: House Contests Connect Affordability, Investment and Redistricting

District / Current Control	Major-Party Candidates	Electoral and Policy Significance
Iowa 1 **Republican-held** **Toss-up**	Mariannette Miller-Meeks (R) Christina Bohannan (D)	**Fuel and health costs connect affordability with legislative action.** Miller-Meeks cited pump prices when backing the Sept. 15 Iran war-powers resolution and joined bipartisan legislation to cap monthly insulin cost-sharing at $35 for privately insured patients. Her veterans' health chairmanship and Energy and Commerce membership add oversight responsibilities.
Wisconsin 1 **Republican-held** **Lean Republican**	Bryan Steil (R) Mitchell Berman (D)	**AI investment brings jobs and power-cost obligations.** Microsoft reported nearly 550 full-time onsite jobs in Mount Pleasant. Participating large-load customers face minimum 15-year contracts and assigned generation-capacity costs under the state regulatory framework. Steil's digital-assets, financial-technology and AI chairmanship concerns a separate federal policy channel.
Texas 34 **Democratic-held** **Toss-up**	Vicente Gonzalez (D) Eric Flores (R)	**Redistricting creates a Republican pickup opportunity.** The district's 2024 presidential Republican margin would have been about 10 percentage points on the new boundaries, versus 4.5 points previously. Reported enforcement-related labor shortages add a regional economic counterweight.

Note: Texas margins reallocate 2024 presidential votes, not 2026 polling; labor evidence is regional, not a district vote estimate. The insulin measure concerns proposed patient cost-sharing, not an enacted manufacturer-price cap.
Source: Cook Political Report, US Congressional Record, Morgan Stanley Wealth Management Global Investment Office as of Oct. 20, 2026

Races to Watch

The House: Economic Pressure and Redistricting Tensions

While the election dashboard highlights the national trends and political factors shaping the congressional landscape, individual races reveal how those dynamics are playing out at the local level. Affordability pressures, particularly rising energy and health care costs, remain central to voter sentiment, while growing investment in AI infrastructure and redistricting are creating distinct political challenges and opportunities.

We have examined three districts to illustrate how household costs, investment trade-offs and redrawn boundaries can shape local contests differently. Iowa's 1st District, rated Lean Democratic, highlights the influence of fuel and health care costs; Wisconsin's 1st, rated Lean Republican, underscores the growing tension between AI investment and electricity affordability; and the 34th in Texas, a Democratic-held toss-up, demonstrates how redrawn boundaries could create a Republican pickup opportunity despite broader Democratic momentum (see Exhibit 5).

Senate: Local Issues Tangle with National Policy Stakes

While the Senate map has become increasingly competitive, Democrats face a higher hurdle to flip the chamber, needing a net gain of four seats to secure a 51-seat majority. Six of Cook Political Report's seven toss-ups are Republican-held, providing Democrats with multiple pickup opportunities, although local economic conditions and candidate dynamics remain critical.

Three Senate races highlight these competing forces: Iowa, an open Republican-held seat, underscores the impact of agricultural costs, trade policy and rural credit, and Sen. Joni Ernst's (R) retirement creates potential committee leadership changes; Maine, a Republican-held toss-up, highlights the growing importance of household heating costs and federal energy assistance, and challenges to Sen. Susan Collins (R) include a changing political tide where her history of working across the aisle is becoming less favorable; and Michigan, an open Democratic-held seat, pits Abdul El-Sayed (D) against Mike Rogers (R), with automotive supply chains and Canadian tariff disputes shaping the economic debate. Michigan Sen. Gary Peters' (D) retirement also creates potential changes in Homeland Security leadership and Senate Appropriations Committee representation. We highlight these three races for the contrasting economic and political tensions they illustrate. Exhibit 6 outlines the distinct policy and leadership stakes across all seven Senate toss-ups.

Exhibit 6: Seven Senate Toss-Ups Carry Distinct Economic and Policy Stakes

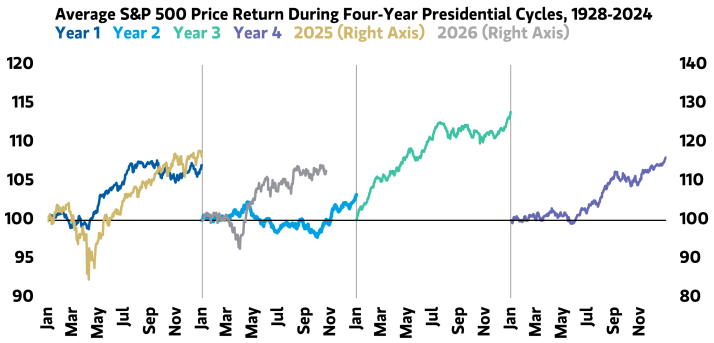
State / Seat Status	Major-Party Candidates	Electoral and Policy Significance
Alaska R-held Incumbent	Mary Peltola (D) Dan Sullivan (R)	**Energy development and household affordability create competing priorities.** Resource investment and living expenses bring different economic interests into the electoral debate.
Iowa R-held Open seat	Ashley Hinson (R) Josh Turek (D)	**Trade policy and rural credit shape the outlook for US agriculture.** Agricultural production costs and access to financing connect national policy with Iowa's rural economy.
Kansas R-held Incumbent	Adam Hamilton (D) Roger Marshall (R)	**Agricultural costs and payment fees broaden the affordability debate.** Marshall sponsors credit-card competition legislation, bringing business payment costs into the discussion.
Maine R-held Incumbent	Susan Collins (R) Troy Jackson (D)	**Heating costs sharpen the affordability debate.** Collins supports federal heating assistance and opposed Russian diesel imports.
Michigan D-held Open seat	Abdul El-Sayed (D) Mike Rogers (R)	**Automotive supply chains shape the trade debate.** Rogers seeks an end to Canadian tariff disputes, linking trade policy with the state's manufacturing economy.
Ohio R-held Special election	Sherrod Brown (D) Jon Husted (R)	**Industrial investment meets electricity-cost pressures.** Ratepayer policy connects new development with the costs borne by households and businesses.
Texas R-held New senator	Ken Paxton (R) James Talarico (D)	**Affordability and turnout test outside campaign financing.** Data-center development adds questions about electricity, water and local costs.

Note: R = Republican; D = Democrat. HELP = Health, Education, Labor and Pensions. Major-party candidates shown; titles shortened. Assignments are not inherited; leadership depends on Senate organization.
Source: Cook Political Report, Morgan Stanley Wealth Management Global Investment Office as of Oct. 20, 2026

The Policy and Market Implications of Divided Government

In our view, Democrats remain favored to regain the House, while the contest for Senate control has become increasingly competitive. The resulting gridlock could limit sweeping legislative changes, but greater policy stability may prove constructive for financial markets by reducing uncertainty surrounding taxes, regulation and government spending, as we outlined in our election preview on Sept. 17, 2026. Equity markets have often strengthened following midterm elections, with the S&P 500 averaging a 3% annual return in the second year of a presidential term before rising to 14% in the third year. Importantly, in 2026, the S&P 500 Index has already outperformed the typical second-year trajectory, with equities advancing despite persistent inflation, elevated borrowing costs and geopolitical uncertainty (see Exhibit 7).

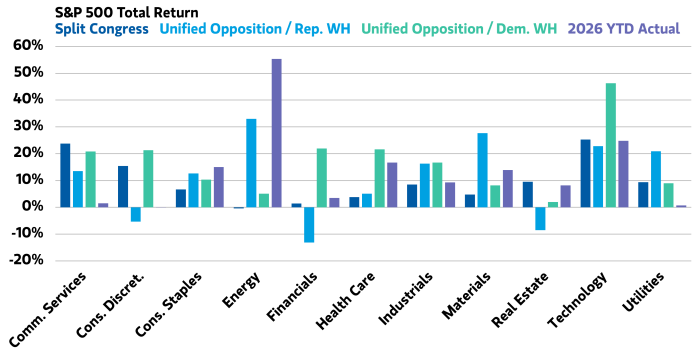
Exhibit 7: Equities Have Strengthened Following Midterm Elections



Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of Oct. 20, 2026

Strong performance across several policy-sensitive sectors this year, including technology and energy, has raised the stakes for shifts in regulatory and fiscal expectations. Through Oct. 16, technology had gained 22.1% year to date, while energy advanced 55.9%, underscoring the strength of recent market performance (see Exhibit 8). In our view, congressional gridlock may support broader market stability while simultaneously creating opportunities for increased dispersion across industries, particularly where policy scrutiny threatens earnings expectations or challenges assumptions about future investment.

Exhibit 8: Sector Returns Have Varied Widely Under Divided Government



Source: Bloomberg, Morgan Stanley Wealth Management Global Investment Office as of Oct. 20, 2026

Selective opportunities may emerge when a selloff implies a broader policy change than the likely outcome warrants. We would assess price weakness against earnings expectations, financing requirements and implementation, rather than treat gridlock as uniformly favorable or a lower price as sufficient evidence of an opportunity.

Committee Turnover Will Reshape Negotiations

Against the current market backdrop, election results and subsequent shifts in committee leadership may be consequential for investors. Importantly, the retirement of senior lawmakers across key committees adds another layer of uncertainty, potentially reshaping negotiations over taxes, health care, financial regulation and government spending even where partisan control remains unchanged.

However, the distinction between legislative gridlock and policy inaction is particularly important. Committee hearings, investigations and proposed legislation can generate headline risk and opportunities even when the prospects for enactment remain limited. Greater scrutiny of AI infrastructure costs, financial deregulation and health care pricing could contribute to episodic volatility without necessarily changing long-term earnings fundamentals. These dynamics reinforce our view that the midterms may have a greater influence on sector-level performance than on the overall direction of equity markets (see Exhibits 9a and 9b).

Exhibit 9a: Congressional Committee Changes Introduce Investment Risk and Opportunity

House Committee	Potential leadership (D/R)	Potential Democratic priorities	Potential market implications
Ways and Means	Richard Neal (D)/ Jason Smith (R)	Extend ACA premium tax credits, revisit elements of the 2025 tax law and strengthen Medicare protections.	**Health care and consumer:** Subsidy extensions, if enacted, could support insurance enrollment, provider revenues and household purchasing power.
Energy and Commerce	Frank Pallone (D)/ Brett Guthrie (R)	Advance ratepayer protections for AI data centers and strengthen electricity affordability measures.	**Utilities, AI and energy:** Measures shifting infrastructure costs toward large power users could raise hyperscaler expenses while supporting select grid-equipment, efficiency and on-site generation providers. Effects would depend on policy design and implementation.
Financial Services	Maxine Waters (D)/ French Hill (R)	Broaden oversight across executive-branch agencies, not just bank regulators; pursue consumer financial protections and digital-asset safeguards.	**Financial services and digital assets:** We expect regulatory reform, including at the SEC and CFTC, to continue despite a sharp rise in congressional oversight. Absent digital asset market-structure legislation, agencies are expected to pursue a permissive framework through rulemaking and executive action, although these measures remain vulnerable to reversal by future administrations.

Note: Selected scheduled departures, not a comprehensive membership forecast. Election-dependent continuity appears in the race tables; no successor is presumed.
Sources: US Congressional Record, Morgan Stanley Wealth Management Global Investment Office as of Oct 20, 2026.

Exhibit 9b: Congressional Committee Changes Introduce Investment Risk and Opportunity

Senate Committee	Potential leadership (D/R)	Potential Democratic priorities	Potential market implications
Health, Education, Labor and Pensions (HELP)	Bernie Sanders (D-aligned)/ Republican successor TBD	Expand prescription drug affordability measures, strengthen PBM oversight and protect federal health research funding.	**Pharma, biotechnology and providers:** Implemented drug-pricing and PBM reforms could affect margins and redistribute profits across the pharmaceutical supply chain, while sustained research funding could support biotechnology and medical innovation.
Banking, Housing and Urban Affairs	Elizabeth Warren (D)/Tim Scott (R)	Pursue consumer financial protections and digital-asset safeguards; increase oversight of executive-branch agencies, including their approach to bank capital and housing finance.	**Financials and housing:** Greater oversight is not expected to materially impede regulatory relief, although measures adopted without legislation remain vulnerable to future reversal. Housing initiatives may support mortgage activity but remain sensitive to interest rates.
Appropriations	Patty Murray (D)/ Susan Collins (R), if reelected	Prioritize health research, housing, education and federal agency funding; revisit administration spending priorities.	**Defense, infrastructure and health care:** Funding negotiations could alter procurement timelines and revenue visibility for federal contractors. Sustained research and infrastructure funding could support select beneficiaries, subject to final appropriations.
Judiciary	Democratic successor TBD/ Chuck Grassley (R)	Renew technology antitrust initiatives, expand oversight of federal enforcement and influence judicial confirmations.	**Technology and M&A:** Congressional antitrust scrutiny could generate headline risk for large platforms. Effects on acquisitions, compliance costs and competitive conditions would depend on enacted legislation or changes in enforcement.

Note: Selected scheduled departures, not a comprehensive membership forecast. Election-dependent continuity appears in the race tables; no successor is presumed. PBM: pharmacy benefit manager.
Sources: US Congressional Record, Morgan Stanley Wealth Management Global Investment Office as of Oct 20, 2026.

Importantly, not all policy risks carry the same investment consequences. Congressional hearings and proposed legislation may generate near-term volatility, but changes to funding, regulatory implementation or corporate costs are more likely to have lasting implications for earnings. We believe this distinction will be particularly important following strong market gains, as policy-driven dislocations may create opportunities where valuations adjust more sharply than underlying fundamentals warrant.

Investment Conclusion

The 2026 midterms are increasingly shaping up as a referendum on household affordability, with persistent inflation, elevated energy costs and weakening consumer sentiment creating meaningful headwinds for Republicans. Democrats remain favored to regain the House, where narrow margins and a growing number of competitive Republican-held districts provide multiple paths to a majority. The Senate has also become more competitive, shifting from a Republican-favored outcome to a toss-up with a slight Democratic edge. However, the path to control remains narrow, as Republican financial resources and race-specific dynamics continue to provide important counterweights. Importantly, local economic issues are playing an increasingly prominent role across both chambers, from health care and electricity affordability to agricultural costs, trade policy and redistricting.

We expect the midterms to produce divided government, potentially reinforcing a constructive backdrop for equity markets by limiting sweeping legislative changes. Historical market performance suggests that reduced political uncertainty can provide an additional tailwind, although earnings, inflation and the business cycle remain the primary drivers of returns. Importantly, legislative gridlock should not be mistaken for an absence of policy risk, particularly as changes in congressional leadership could introduce greater regulatory scrutiny and sector-specific uncertainty. That said, negative policy headlines do not equal negative fundamentals, and we encourage investors to stay disciplined in their long-term investing strategies.

Disclosure Section

For index, indicator and survey definitions referenced in this report please visit the following:
https://www.morganstanley.com/wealth-investmentsolutions/wmir-definitions

Glossary

Term premium is the excess yield that investors require to commit to holding a long-term bond instead of a series of shorter-term bonds.

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Treasury Inflation Protection Securities' (TIPS) coupon payments and underlying principal are automatically increased to compensate for inflation by tracking the consumer price index (CPI). While the real rate of return is guaranteed, TIPS tend to offer a low return. Because the return of TIPS is linked to inflation, TIPS may significantly underperform versus conventional U.S. Treasuries in times of low inflation.

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