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POLITICAL GRIDLOCK HARDLY GUARANTEES MARKET CALM

With such emotional late campaign rallies and such high voter turnout, markets were bound to welcome almost any election outcome that would resolve mounting levels of uncertainty. The conventional wisdom is that divided governance will produce political gridlock, which will allow investors to focus back on the balance of risks between strong GDP growth and rising interest rates.

Not so fast.

The federal government's current funding runs out on December 7 this year, although both sides will likely agree to extend that a few months while they size each other up for a more brutal confrontation early next year. On March 1 2019, the temporary suspension of the debt limit ends. Given the recent tax reform, the new Congress will need to raise that limit substantially before the Treasury runs out of temporary measures to meet its obligations.

What better way for one party to extract concessions from the other than to put the full faith and credit of the United States at risk?

Investors should circle these dates on their calendars as they brace for what looks like a spring of greater political uncertainty and market volatility. If trade wars raise costs for a limited range of American companies, a protracted standoff over funding the U.S. government will raise risks sharply for investors who are already

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skittish about late-cycle headwinds.

In the near term, as Congress digests the election results and chooses new leaders, markets will indeed find a brief interlude to focus on fundamentals. Specifically, investors will have their eye on corporate earnings and look for signs that companies are spending any of their tax savings on capital projects that will boost profitability. They will also assess whether healthy wage growth will support demand or fuel inflation expectations.

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The historic record suggests the U.S. equities market rises strongly in the year after mid-term elections. Sometimes there is money that investors have kept on the sidelines ahead of an important vote and the current strong economy may well deliver a similar result.

But there are still some important economic decisions that the federal government must make, and the outcomes are hard to predict when both Republicans and Democrats are undergoing such dramatic transformations over economic policy. It's hard to see either as a paragon of fiscal discipline.

In the current political constellation, there should be little expectation of further major tax reform. At a post-election press conference Wednesday, the president hinted at possible deal for more middle-tax cuts in return for raising revenue elsewhere. But even if it were possible, the likely economic impact would be small. It's hard to imagine the president signing anything that waters down his 2017 Tax Cuts and Jobs Act as he looks to his re-election campaign.

Republicans are ending eight years in control of the House that they seized on a promise to end Obamacare and balance the budget. With little progress to show on either count, they must increasingly rely on the successes defined by the president, whose tolerance for deficits and protectionist tariffs borrows heavily from the traditional Democratic playbook.

The new Democratic House majority, meanwhile, can block Republican initiatives, but cannot really "legislate" per se. There may be some limited cooperation with the president on infrastructure spending or drug price control. There will even be Democratic support for the president's more confrontational trade agenda and a revised agreement with Canada and Mexico.

On other matters, the president will likely be prolific with his executive orders while the House will turn to investigations of financial shenanigans pending anything more concrete from Special Counsel Robert Mueller.

But like it or not, the two parties need to find a viable path forward to keep the government funded and operating. Both sides will also face the temptation to hold a continuing resolution hostage to the most emotional issues on their respective priorities, such as border security, immigration reform, health care or gun legislation.

Meanwhile, they must also cooperate to pass an increase in the debt ceiling or risk defaulting on the government's debt. In August 2011, of course, Standard & Poor's downgraded U.S. debt a notch and blamed political polarization as a threat to America's financial sustainability. Next time, other ratings agencies will be tempted to follow.

Some investors may take comfort that neither party wants to look stubborn or take the blame for a shutdown or a downgrade. With passions running so high across the political spectrum, however, there are risks in compromise, too. Even for modest policy victories, such tempting sources of leverage may be too

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