

Fidelity Viewpoints[®]: Market Sense

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TRANSCRIPT

SPEAKERS:

Heather Hegedus Denise Chisholm Greg Lowman

HEATHER HEGEDUS: Hey there, everybody. Thank you so much for making the time to tune in for another episode of *Market Sense*. I'm Heather Hegedus with Fidelity. Markets have been caught in a bit of a tug-of-war as of late between persistent inflation and strong earnings. September also saw some volatility for stocks and bond yields at levels that we haven't seen in decades, and that's left some investors perhaps looking ahead to what may be next, as many companies start a new fiscal year.

And that also brings us to the midterm elections right around the corner, just weeks away. And with investor interest running high, we thought this might be a good time to examine the potential implications for the markets, both immediately following the elections and looking a little bit longer range as well. And that's why we asked Fidelity's Director of Quantitative Market Strategy, Denise Chisholm, to come on *Market Sense* today. We asked Denise to come here to walk us through historical patterns and explain what midterm elections have historically meant for stocks.

We're also thrilled to be joined today by Greg Lowman. He's a Vice President of Advocacy and Policy here at Fidelity, where he keeps close tabs on what is happening within the walls of Congress and in congressional districts as well. So we asked him to join us today to talk about the factors at play this election and the potential policy implications as well. Thrilled to have the combination of the two of you on this show today. Greg, you came all the way up from Washington, DC, to join us here in Boston. Thanks for making the trip up north.

GREG LOWMAN: My pleasure. Thanks for having me.

DENISE CHISHOLM: Yeah, it's great to be back with you and Greg.

HEATHER: All right, let's get to it because we have plenty to talk about. And today is Tuesday, October 6. I actually want to start with Greg, so hang tight for a little bit, Denise.

DENISE: Yeah.

HEATHER: I'd like to start the midterm conversation with Greg by setting the table, by getting into what might be at stake in this election. So going into these elections, Republicans held both sides of Congress and the White House. Greg, can you walk us through the scenarios that you're watching right now?

GREG: Yeah, thanks, Heather. We are just less than 30 days away from the midterm elections. So this will determine all 435 House seats and 35 Senate seats at the federal level that are up for election. And ultimately, with the president not on the ballot, this is one of those offseason election cycles, but no less important, really, for the future of policy-making and power in Washington.

As you mentioned, Heather, Republicans essentially control Washington right now through the presidency, control of the Senate and the House of Representatives. And moving forward, if the Democrats seek to take back control after November 3 and going into a new Congress that would begin in January 2027, they need to net four seats in the House of Representatives—that is, take four seats from the Republicans as it currently stands now—and actually do the exact same in the Senate, netting four seats while holding everything they have today.

So, if you're watching the news, it would probably be no surprise to you that you're hearing a lot of the polling and momentum happening for the Democratic Party. And I think there's a lot of truth to that. A lot of folks are comparing the polls, the generic ballots, the popularity, the economic confidence, the president's low levels of approval to times when there have been, quote unquote, "midterm shellacking," this idea of the opposite party really taking back control and sending a message to the party in power. And over the last 22 election cycles, only twice has the party in power of the White House held those bodies of Congress.

So all signs point to a very high potential for the House for sure to flip to Democratic control, and potentially, the Senate. The best description I've heard of this current situation, just to demonstrate maybe the consternation within the Republican Party and the lack of a true vision yet for the Democratic Party, is that this may not be a blue wave, but it's certainly a red undertow, where the president's unpopularity is dragging down a lot of candidates across the House elections and in the Senate.

HEATHER: A red undertow. So should the balance of power shift, Greg, what could that mean for getting things done in Washington and for investors as well?

GREG: Yeah, I mean, already, legislation has begun to seize up. I mean, the president got through his large tax bill at the beginning of his first year in second term in office, the One Big Beautiful Bill Act, or the Working Families Tax Cut. The next piece of legislation that got through—it actually got through on a bipartisan vote—was the GENIUS Act, which created the first regulatory and federal framework for stablecoins, this idea of a digital asset pegged 1 to 1 to \$1.

But ultimately, since then, there has not been a ton of major legislative activity in Washington. And what we happen to see is, usually, when the party in power's second side of their presidency comes into view, the regulators become a lot more relevant, this idea of unilaterally being able to use the pen from the executive branch and their independent agencies, which they control, so independent sort of a misnomer there. But ultimately, providing new rules of the road for industries, new ways in which they can unilaterally move things around the chessboard in Washington, a lot of those issues can be very institutional.

I think what our clients should be thinking about is, when it comes to big tax policy and incentives for financial products, which are shaped by legislation, those potential opportunities are going to be few and far between over the next two years. There is a possibility that the two parties come together. Let's say, hypothetically, the Democrats take over the House of Representatives and the Senate, for that matter. Whether they take one or both, there's likely going to be divided government in the new year and for the remainder of Trump's two years in office.

So the vehicles for bipartisanship start to crop up in must-pass bills. And those usually center around government funding, national defense, the debt ceiling, and other things that ultimately have to move, or operations sort of seize up and can have really bad knock-on effects for the economy and our national security. And what you find is sometimes there emerges areas where those bills become vehicles for other moving legislation.

And bipartisanship can sprout up, but it's not a guarantee, particularly in a very volatile political environment really preparing for—I know people don't want to hear this, but another presidential election cycle in 2028 and the messaging that will be so important for each party to get across from their opposite corners in those two years. So call me optimistic still, but cautiously.

HEATHER: OK, yeah. And buckle up, because two years from now, we are going to be definitely talking about the next election cycle, for sure. We're going to talk to you more about the policy implications of the midterms in a moment, Greg, but I want to bring Denise in. Thanks for your patience, Denise. So from what Greg is saying, sounds like odds for divided government are pretty high. What does your research show about what divided government can mean for markets?

DENISE: Yeah, and Greg actually highlighted it. It is very typical that you see a shift back to divided government after a president takes power. I think 80% of the year since 1980, see some shift in government, which that is irrespective of economic conditions. So I think that that's a base case. The interesting thing for the market is, you might think that just because all parties don't agree, that that would be a problem for the market. This is actually usually the best setup for the market.

And I say that with the data since 1930. I mean, the S&P 500 advances in any given year 75% of the time. And when there is unified government, now, again, these odds are not very significant, but it's lower. It's around 72% odds. And divided government is closer to 77%, 78% odds. So if you had to pick one versus the other, you would actually pick divided government. Again, those odds are a little bit very tight. Part of the reason that people think that exists is because, then, the rules of the road are known. And that is the typical cycle when you see in terms of a market impact.

HEATHER: It's not necessarily what you would expect, but that's great news. So let's talk more about the issues shaping this election now. So recent polling suggests the president's approval ratings have dropped to the lowest of his career. And not just as investors, but as consumers, there are a lot of considerations these days. There's the ongoing concerns of the cost of living, the conflict with Iran, gas prices, the impact of tariffs. There's just a lot of consumer pressures that voters are facing these days, guys, so I'm wondering, Greg, from you, what are you hearing and experiencing from lawmakers about the issues that are really shaping this election this go-around?

GREG: Yeah, that's where the angst is. And I think when you look back on the first year, I think there was just a ton of optimism from the Republican Party after passing, really, a historic reconciliation tax cut for the American people, extending the individual rates that were first passed in the first term of the president permanently, and then also extending a lot of incentives and immediate depreciation, CapEx expensing for businesses of all sizes of 100% in those years of 2025 and moving forward, which generated a ton of investment, alongside the AI boom. Paired, as Denise covers so well, with strong earnings and free cash flow, it really had, I think, people brimming with confidence.

But policies that have been taken, really, from the executive branch level—of which Congress from both the Senate Republican, House Republican side, have not had much luck getting in the way of, as that party coalesced around the president's plans—around geopolitical actions and tariff policy have definitely been drivers of the increase in costs. Whether it be at the grocery store or at the pump, the inflation levels were already very high as a result of the last administration. But there hasn't been a deceleration or a pivot that the American public have seen.

So that's really what's driving concerns here. And that's where you're seeing Senate seats, where House seats are a little bit more partisan, and there's less competition, you could argue, because of the gerrymandering and how these districts get so split along party lines over the years. There's just been a drastic reduction in competitive House seats. That still may not stop what could be a blue wave. But that's been the trend, is just a lack of competition at the House level because of all of those gerrymandering districts.

But at the Senate level, you're running statewide. And that's where you're seeing Texas, Iowa, even Kansas, certainly, Maine and Michigan up for competitive seats that, I think, the Republicans would have told you two years ago were a shoo-in for them. And that has a large part to do with the rise of costs, as well as the tariff policies in certainly some of those bordering states.

I should mention, the Senate's Democrats, they still have a challenge ahead of them. They have to hold everything they have and take four seats away from the Republicans. And holding everything they have includes Michigan and New Hampshire, where they currently have toss-up seats with senator candidate John Sununu, who used to be a senator, very strong candidate. And Mike Rogers used to be a statesman-like policymaker with upstart candidates.

And then moving into Texas and Ohio and Iowa and Maine, the candidate quality is really up for grabs there. There's going to be still a big challenge for Democrats to overcome to take those seats. Texas hasn't gone to the Democrats since the late '80s. But certainly, candidate quality and the spending from the political parties and momentum is on the Democratic side.

HEATHER: Certainly Senate races I know you'll be watching, Greg. But Denise, let's dive into the potential impact of elections on markets. This is something you're watching. So you've analyzed decades of historical data. And I know one of your key findings is the period leading up to a midterm election is often the most volatile for markets and investors because of that uncertainty.

But despite that historical pattern, markets have posted strong returns so far in 2026. So investors might be wondering, is this time different? Especially, this bull market seems to be so resilient. Can you talk about what's driving the resilience? And any signs that this year could be shaping up differently because of this AI boom that we're in?

DENISE: Well, I mean, when you look back through history, you can definitely see a clear pattern of the first two years of a president's cycle delivering below-average returns and then the average being much higher the final two years of the presidential cycle. But in that, investors should know the ranges are very, very wide, which tells you that elections aren't a core driver behind how your portfolio actually outperforms. And one of the key differences this time has been the strength of earnings.

And it's not just the AI cycle. I mean, you're looking at median earnings companies that have gone from, more or less, contraction over the past few years to the first year of a real earnings recovery. And I think that when you look back through history, you see that there's some symmetry behind how long earnings growth has struggled, and then how long those durable earnings cycles last. And given the median company actually peaked profits in 2018 and is just now getting back to that prior peak, well, that might explain a lot behind the strength of the bull market.

HEATHER: OK. So if markets tend to experience volatility heading into a midterm election, what does the historical data tell us about market performance after elections are decided?

DENISE: Yeah, I would say, even though that we've seen returns stronger than average in terms of that election cycle math, we have seen uncertainty rise with that as well. So that is a pattern recognition that is typical this cycle. And it is typical of midterm years where you see stocks struggle. Here's a great chart. I mean, it shows you just how wide those ranges really are.

And you can really see that even though that you have lower averages the first two years and higher average in the second two years, something else is probably driving stock market returns. When that uncertainty actually recedes is usually the point at which drives those higher returns. Because if you remember, we talked about this a lot in our outlook series. High uncertainty is not often a bad thing for investors, because the starting point actually means that you have higher probability of that uncertainty actually getting clarified. And that's usually what happens around midterms, is you might not like the result, but then the rules of the road are clear. And that's usually what moves markets.

HEATHER: And that's posted a positive 12-month return the following year after midterms for decades.

DENISE: Exactly. No, you can see that upward skew. It's interesting. So I looked at price data, I think, going back to the '60s, and you can see the clear upward skew. You've got a 95% hit rate. If you look at total return data and the calendar year the year following that, all of a sudden, you've got 65 years of the S&P 500 advancing the year post a midterm year. Now, look, I mean, past performance is no guarantee of future performance. But again, it's back to that upside skew where you see a clear skew in the data of whatever that you were angsty about. It makes it increasingly likely that the market is able to climb that wall of worry.

HEATHER: All right, Denise, thank you for that. So Denise talked about where markets might head after the election, but what about what we might expect from fiscal policy after the election, Greg? Can you talk about what we might expect in terms of whether lawmakers are going to be rushing this calendar year to try to get stuff done before the new congressional class comes in, in 2027? What's on your radar for 2027 and for the near term?

GREG: Yeah, for the near term, we're just embroiled in this uncertainty of these elections and how policymakers are going to be feeling after the results roll in. One thing's for sure, is government funding runs out on December 11. So they have to solve for that, which can always be fun games of chicken and 11th hour backroom conversations and negotiations to avert any sort of government shutdown.

I think it's funny. There's always just these superficial pressures of daily life on even policymakers when it comes to the seasonal holidays, obviously, at the end of the year and wanting to get home. But we'll have to see. Certainly, industry would like to dream of some sort of bipartisan kumbaya that could emerge in those lame duck months for policymakers who say, you know what? I want to leave a bit of a legacy. I want to get that pet project done. I want to pick up what was left on the cutting room floor when they had the last tax package last year and try and move a few things forward. And maybe we can get together and for the good of the country, pass a bipartisan tax package attached to government funding.

I wouldn't hold your breath. But I think, if I was going to guess, they're probably going to extend as a sort of status quo—they call it a continuing resolution—the government funding levels into the new Congress and have them sort it out and start fresh, is what I would think they're thinking through as the most likely scenario going into the end of the year.

HEATHER: And just speaking of must-act-on issues or issues that might bring both parties together, I'd be remiss if I didn't ask you about government debt. We get a lot of questions about this. And the national debt just crossed the \$40 trillion mark. How key could that be to this election? And how much is each party focusing on that during the campaign season?

GREG: Yeah, and Heather, just before I touch on that, I'll just also mention real quick, it's important to remember that the regulatory process and the implementation of prior bills continues. So you're seeing a lot of headlines around Trump accounts and Saver's Match and Trump IRA. So there will continue to be policy happening around personal savings. And I think that's important to remember, that Washington continues with a lot of different decisions from the Treasury, the SEC, the Department of Labor that can impact Americans' opportunity to save more and, hopefully, close the coverage gap. So I just want to say, we don't always have to wait for these big bills every four years.

But your point on the debt is a good segue into how it's framing, frankly, on the ground the conversations we're having with lawmakers all the time. You reach that symbolic, \$40 trillion scary number, and policymakers become deficit hawks pretty quickly again. And everything is framed in what a legislative idea costs, which can be frustrating at times, because it's measured in these arbitrary 10-year budget windows as to what it costs.

And so if you have ideas around making investment products more tax equitable between different products, ways to incentivize Americans to save more or find a vehicle that could be more enhanced with tax policy, which is what Fidelity and many of our peers are thinking about all the time, you're often asked, well, that's great, but what's it going to cost? And sometimes it costs money within that 10-year budget window, and it can really dictate the chances of smart, innovative policy getting through when you have this cloud-over policy, which is this unfortunate and dire fiscal situation at play.

14% of the federal budget is non-defense discretionary. That's just the government running—almost \$800 billion. 60% of it is that mandated spending—Social Security, Medicare, and Medicaid. And Congress is really going to have to think about how to get after that piece of the pie if they're going to want to change the trajectory, which is about a \$2 trillion deficit running in 2026, to solve for what is continuing to be an escalating fiscal policy issue.

HEATHER: Well, yeah. Let's talk about Social Security, obviously top of mind for many Fidelity customers. And it plays a critical role in many people's retirement plans. What is being done right now to address the potential Social Security funding shortfall? And you had mentioned Trump accounts. Could something like Trump accounts or other retirement vehicles replace Social Security someday?

GREG: It's funny you mentioned that. The Treasury Secretary, Scott Bessent, actually said that at an industry conference several months ago. I don't know how much of that was in his planned remarks or off the cuff, but they did auto-enroll 60 million Americans under the age of 18 in Trump accounts just this week. So those accounts can be sought out and activated.

We're still waiting on a ton of guidance and regulatory clarity in that space, so that there can be an ability to bring those accounts into your preferred financial services provider. But that's an amazing milestone, that the administration has essentially auto-enrolled 60 million Americans under 18 in a youth savings vehicle. Of course, if you're born within the 2025 to 2028 window, they're seeded with \$1,000. Otherwise, they have to be contributed to by employers or individuals, up to \$5,000 a year.

But to your point on Social Security, it's a disturbing deadline, too. 2032 would be the first time there's maybe a shortfall in benefits being paid out. There's talk of it maybe being cut by 20% for recipients. There's a lot of discretion each administration can take when controlling Social Security. So I don't want to prescribe any exacting cuts that we're predicting. But typical Congress—they're not going to look out six years or five years and say, let's get ahead of this.

I really believe, unfortunately, this is going to come down to probably another 11th-hour policy solution. I know there are bipartisan attempts that are being announced intermittently of senators, policymakers on both sides of the aisle trying to think through ways to enhance this. A frequent one is removing the cap on the Social Security tax from \$185,000, so that that continues on and scales up the income curve, providing more revenue.

And my sense is there's going to be some element of that at play to drive up the balances of Social Security versus providing any sort of cut in benefits, which would always really be a political loser, I think, proportionality to those that receive it, versus raising taxes on some on the higher income side—which won't be popular either, don't get me wrong. But we'll have to watch that closely, which we're tracking. And I know our customers are constantly thinking of ways to plan. And I think there is a high likelihood that Congress will act in this space, but it is going to be probably down to the wire.

HEATHER: Well, we appreciate you watching that for us, Greg. And we appreciate your unique perspective here. Unfortunately, we have to wrap this discussion, even though it's been just fantastic getting the opportunity to hear from you, Greg. I would love to hear from both of you the three things that our audience might want to think about or watch as we get closer and closer to election day. And Greg, I'll start with you.

GREG: Three things—I would say, watch the Supreme Court. I would say, watch trade policy. And I would say, watch the implementation of Trump accounts.

HEATHER: All right, Denise?

DENISE: Good ones. I'll take credit spreads for the stress in the market. I will take earnings, which is about to start, I think, in the next few weeks. And then, I would say, technology stocks because they look like leadership.

HEATHER: OK, we've got to leave it at that. But Denise and Greg, just a fantastic, super timely, and insightful discussion today. We talked about a lot of the potential impacts on the markets. But if you are curious at home about how the upcoming midterm election might move the crypto market specifically, and why, we've got a pretty fantastic webinar that we want to recommend to you from our partners at Fidelity's Covering Crypto Livestream team. The host, Jim Armstrong, used to be the host here at *Market Sense*. And you can find the link to the replay in our show notes, which are available on Fidelity.com/MarketSense by the day after our live show.

So on behalf of Denise Chisholm and Greg Lowman, I'm Heather Hegedus. Thanks for the pleasure of your time. We'll be off next week because of the holiday for some, but we will see you right back here after that. We're on live every Tuesday at 2:00 with the replay available on YouTube and wherever you get your podcasts. Have a great week.

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