Imran Nurginias Ibrahim | Chief Economist | inurginias@bankislam.com.my

US MIDTERM ELECTIONS: DEMOCRATIC WAVE RESHAPES WASHINGTON

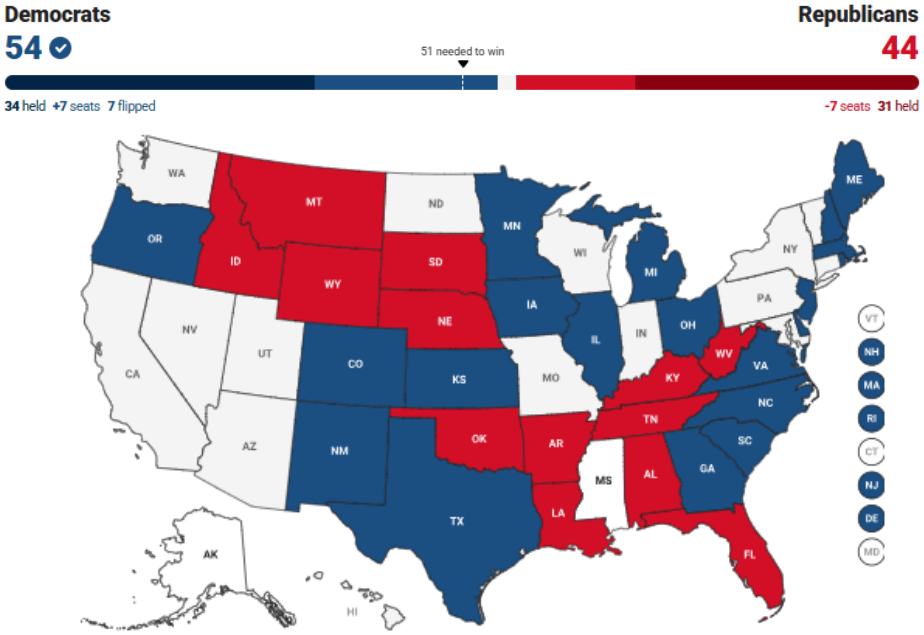
Executive Summary

- The 2026 US Midterm Elections delivered a significant political surprise with Democrats securing control of both the House of Representatives and Senate while President Trump remains in office. While the outcome does not alter the occupant of the White House, it fundamentally changes the policy landscape in Washington for the remainder of Trump's term.
- Financial markets immediately interpreted the result as reducing the scope for further fiscal expansion, lowering inflation risks and potentially constraining some of the more aggressive elements of President Trump's domestic agenda. The reaction was swift. Treasury yields declined, the US dollar weakened, gold rallied and equity markets recovered strongly after an initial period of election-driven volatility. Oil prices registered the most dramatic move, with Brent crude tumbling almost 8% amid growing expectations that congressional pressure could accelerate de-escalation efforts in the Iran conflict and reduce geopolitical risk premiums embedded in energy markets.
- However, the election result should not be interpreted as the beginning of a dovish regime shift. Market pricing continues to imply a high probability of further policy tightening by the Federal Reserve. Instead, investors are increasingly repricing the medium-term outlook for US fiscal policy, government borrowing, inflation and economic growth.
- The broader significance of the election extends beyond domestic US politics. The result potentially shifts President Trump's focus away from domestic legislative priorities towards areas where presidential authority remains strongest, particularly foreign policy, trade policy and national security. As a consequence, while fiscal risks may have moderated, uncertainty surrounding tariffs, China, Europe and broader geopolitical issues could intensify over the coming years.
- For Malaysia, the immediate market implications are largely supportive. A softer US dollar, lower Treasury yields and easing oil prices create a more favorable external backdrop for the ringgit, government bond market and domestic financial conditions. Nevertheless, slowing momentum in US AI-related investment and persistent uncertainty surrounding global trade policy remain important medium-term risks.

US Electoral Landscape After the 2026 Midterm Elections

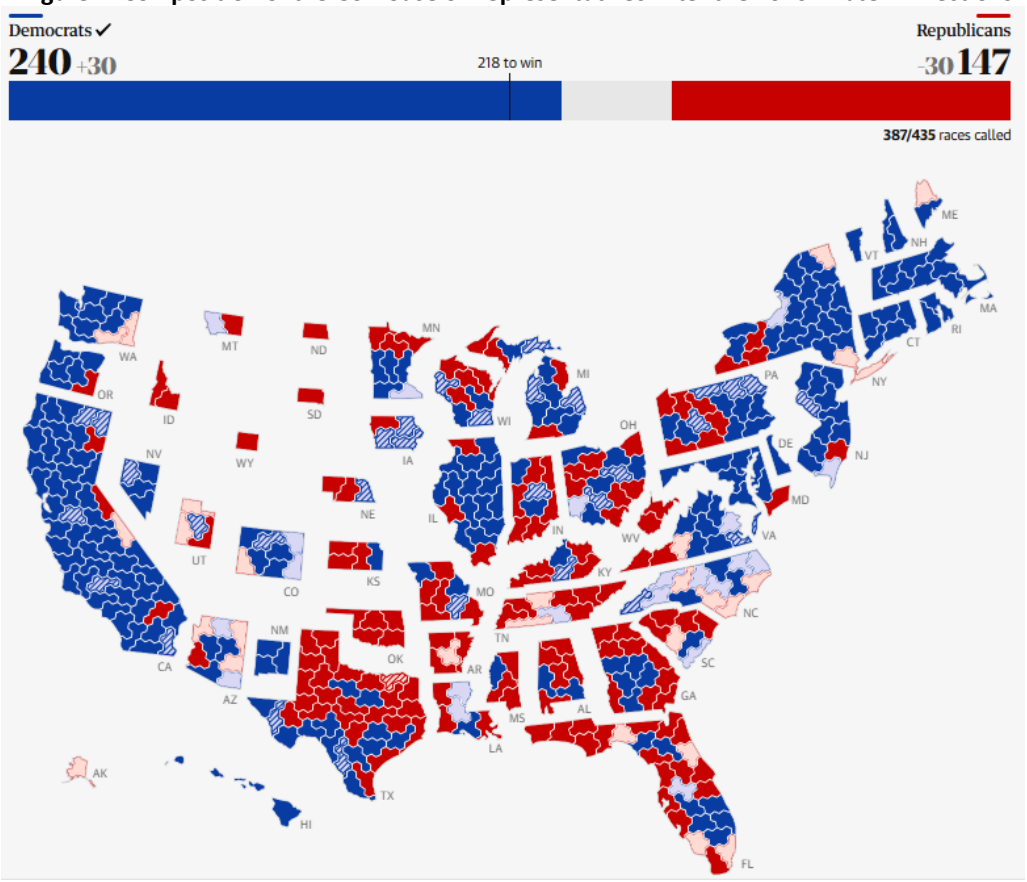
- The Democratic Party emerged from the 2026 midterm elections with an estimated 55 seats in the Senate, allowing it to regain control of the upper chamber while simultaneously strengthening its influence over legislative proceedings, committee leadership and congressional oversight. The result marks an important shift in the balance of power in Washington and substantially increases the constraints facing the Trump administration during the remaining two years of the presidential term.

Figure 1: Composition of the US Senate After the 2026 Midterm Elections



Source: FOX News

Figure 2: Composition of the US House of Representatives After the 2026 Midterm Elections



Source: The Guardian

- While the outcome does not alter presidential authority, Senate control significantly enhances the Democrats' ability to delay or block legislative initiatives involving fiscal spending, taxation and regulatory reforms. The result therefore reduces the probability of further expansionary fiscal measures and reinforces market expectations that policy gridlock could become a defining characteristic of the US political landscape through 2028.
- Control of the House of Representatives provides Democrats with substantial influence over legislative priorities and congressional investigations. Together with Senate control, Democrats now possess the institutional capacity to significantly slow or prevent the implementation of major domestic policy initiatives proposed by President Trump.
- Historically, periods of divided government have tended to reduce fiscal activism and increase the likelihood of legislative stalemate. Financial markets generally view such outcomes favourably because they limit policy uncertainty and reduce the probability of large-scale spending programmes that could exacerbate inflationary pressures and government borrowing requirements.
- As a result, investors interpreted the election outcome as reducing medium-term fiscal risks and increasing the likelihood of a more constrained policy environment.

Table 1: Key Electoral Developments

State	Result	Significance
Texas	Democratic Gain	Major political breakthrough in a traditional Republican stronghold; signals changing demographic and suburban voting patterns.
Michigan	Democratic Hold/Gain	Critical manufacturing and automotive state. Outcome may strengthen support for industrial, labour and clean-energy policies while reinforcing Democratic competitiveness in the Midwest.
Pennsylvania	Democratic Gain/Hold	Reinforces Democratic strength across the Rust Belt and remains crucial for future presidential elections.
Wisconsin	Democratic Gain	Highlights continued Democratic momentum in key battleground states and strengthens influence across the industrial Midwest.
Arizona	Democratic Hold	Confirms sustained Democratic presence in the Sun Belt and evolving demographic trends.
Kansas	Democratic Gain	Symbolically important given its traditionally Republican voting history and evidence of broader voter shifts beyond coastal states.

Source: US Midterm Election Results 2026

- The election map highlights the broad geographical nature of Democratic gains across both traditional battleground states and historically Republican-leaning constituencies. Democratic victories and strong performances in states such as Texas, Michigan, Pennsylvania, Wisconsin, Arizona and Kansas suggest that voter dissatisfaction extended beyond conventional Democratic strongholds and reflected a broader reassessment of policy priorities among suburban, independent and working-class voters.

- Particularly noteworthy was the Democrats' strong performance across the industrial Midwest, including Michigan, Pennsylvania and Wisconsin. These states have historically played a pivotal role in determining presidential election outcomes and are closely associated with US manufacturing, automotive production, labor-market dynamics and industrial policy. Democratic success in these regions suggests continued voter support for domestic manufacturing initiatives, infrastructure investment, supply-chain resilience and strategic industries. This is especially relevant given the growing importance of semiconductor production, electric vehicle supply chains and advanced manufacturing in shaping the future direction of US economic policy.

- Meanwhile, gains in Texas and Kansas highlight the increasingly broad-based nature of electoral shifts occurring across the United States. Texas, traditionally regarded as a Republican stronghold, has significant implications due to its large electoral weight, economic importance and concentration of energy, technology and manufacturing industries. Kansas, while smaller economically, is symbolically significant as it underscores changing voter preferences even in traditionally conservative regions.

PUBLIC

- For investors, the importance of the election map lies not in the partisan outcome itself but in the resulting policy framework. The Democratic control of Congress substantially lowers the likelihood of significant legislative changes proposed by the Trump administration while increasing the probability of policy gridlock over the remainder of the presidential term. As a result, markets have shifted their focus away from electoral politics towards the implications for fiscal policy, government borrowing requirements, inflation dynamics and Treasury issuance. The outcome is therefore being viewed less as a political event and more as a catalyst for a reassessment of the US fiscal outlook, with broader implications for bond yields, the US dollar and global financial conditions.

Democratic Sweep Creates a New Political Reality in Washington

- The significance of the Democratic victory lies not merely in the transfer of congressional control but in how it changes the balance of power within the US policy-making framework. Democrats appear set to control both chambers of Congress with a larger-than-expected majority, allowing them to shape legislative priorities, committee investigations and oversight activities over the remaining two years of President Trump's term.

- The result effectively transforms Washington into a divided government. Historically, divided government has often been viewed favorably by financial markets because it reduces the likelihood of major policy swings and limits aggressive fiscal experimentation. Investors generally prefer political certainty, even when it results in legislative paralysis.

- This appears to be the lens through which markets are currently interpreting the election outcome.

- Over the past two years, investors have become increasingly concerned about persistent US fiscal deficits, rising government borrowing requirements and the implications for inflation and long-term interest rates. The Democratic victory immediately reduced expectations that the Trump administration would be able to push through further tax reductions, large-scale spending initiatives or additional fiscal stimulus programs.
- Consequently, investors began unwinding a portion of the inflation and fiscal risk premium that had become embedded in Treasury yields during recent months.
- The election therefore represents less of a partisan event and more of a structural shift in the medium-term fiscal outlook of the United States.

What Democrats Can Do and Why Trump's Domestic Agenda Faces Greater Constraints

- One of the most important implications of the election is the effective freezing of major domestic policy initiatives. Any substantial legislative proposal from the White House must now pass through a Congress controlled by the opposition party. As a result, ambitious policy measures involving taxation, spending programs, immigration reform and industrial policies face significantly greater political obstacles.
- In practical terms, Democrats possess several powerful tools to constrain the administration.
- First, they can prevent further deficit-expanding legislative packages. This effectively closes the door on new fiscal stimulus initiatives that could otherwise increase government borrowing and inflationary pressures.

PUBLIC

- Second, congressional committees are expected to intensify oversight and investigations into the administration. These investigations may focus on executive actions, regulatory decisions, conflicts of interest and government appointments. Although a successful impeachment remains highly unlikely, increased political scrutiny could create additional uncertainty for policy implementation.
- Third, Democrats are likely to exert greater pressure on sectors perceived to be benefiting from light-touch regulation under the Trump administration. This is particularly relevant for the technology sector and the rapidly expanding AI ecosystem.
- The AI-themed investment cycle has been one of the defining drivers of US economic exceptionalism over the past two years. Massive investments in semiconductor fabrication, cloud infrastructure, power generation and data centres have supported corporate earnings, capital expenditure and productivity growth.
- The election result introduces a degree of uncertainty into this narrative. A Democrat-controlled Congress may place greater scrutiny on AI infrastructure development, energy consumption, environmental considerations and technology market concentration. While outright restrictions remain unlikely, the emergence of regulatory uncertainty is enough to cause investors to reassess some of the more aggressive assumptions embedded in AI-related valuations.
- This partially explains why the technology sector underperformed traditional sectors in the immediate aftermath of the election despite overall gains in equity markets.

Trump's Focus Likely Shifts Towards Trade and Geopolitics

- While the election limits Trump's legislative flexibility, it does not diminish the power of the presidency in key areas. Trade policy, foreign policy and national security remain largely within the authority of the executive branch. As a result, the election outcome may actually encourage a greater concentration of presidential attention in these areas.
- This has important implications for global markets. Unable to secure substantial victories through Congress, the administration may increasingly utilise tariffs, sanctions and trade measures as policy instruments. The US-China relationship therefore remains a major source of uncertainty despite the election outcome.
- Similarly, relations with Europe, NATO members, Iran and Russia could become increasingly important drivers of market volatility. In other words, while fiscal risks have diminished, geopolitical risks may become more prominent. This distinction will be crucial for investors in 2027.

Markets Respond: Repricing Fiscal Risk Rather Than Monetary Policy

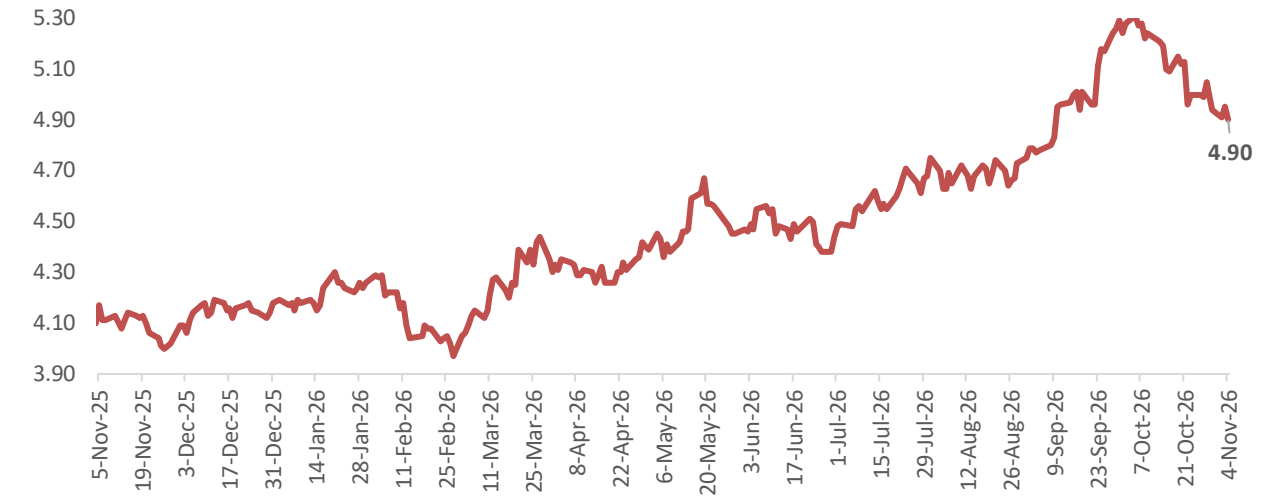
- Perhaps the most notable aspect of the market reaction is that it was not driven primarily by expectations of Federal Reserve easing. Market pricing for near-term Fed policy remains remarkably stable.
- Investors continue to assign a high probability of additional policy tightening, reflecting ongoing concerns regarding labor market resilience and inflation persistence. Rather than changing monetary policy expectations, the election outcome has prompted markets to reprice longer-term fiscal and growth expectations.
- This is an important distinction. The market is not saying the Fed is finished. The market is saying that Washington is likely to generate less inflation than previously feared.

Treasury Yields Fall as Fiscal Expectations Are Reassessed

- The strongest signal emerged from the Treasury market. The 10-year Treasury yield declined to around 4.85% from levels above 5.36% recorded in October. This represents a substantial decline over a relatively short period.
- The move reflects several concurrent developments. First, lower oil prices reduce headline inflation risks. Second, divided government decreases the probability of large fiscal packages that would require additional debt issuance. Third, investors increasingly believe that policy gridlock could moderate medium-term economic momentum.
- Collectively, these factors have contributed to a reduction in term premiums and inflation expectations. Nevertheless, investors should avoid concluding that Treasury yields will continue falling indefinitely.
- The structural fiscal position of the United States remains challenging. Federal deficits remain historically elevated, debt servicing costs continue to increase, and demographic spending pressures are rising rapidly.
- This suggests that Treasury yields may decline further in the short term, but structural downward

pressure remains limited. Our base case remains for the 10-year Treasury yield to trade within a broad 4.50%-5.00% range over coming quarters, rather than returning to the ultra-low levels seen in previous cycles.

Chart 1: UST 10Y Yield (%)



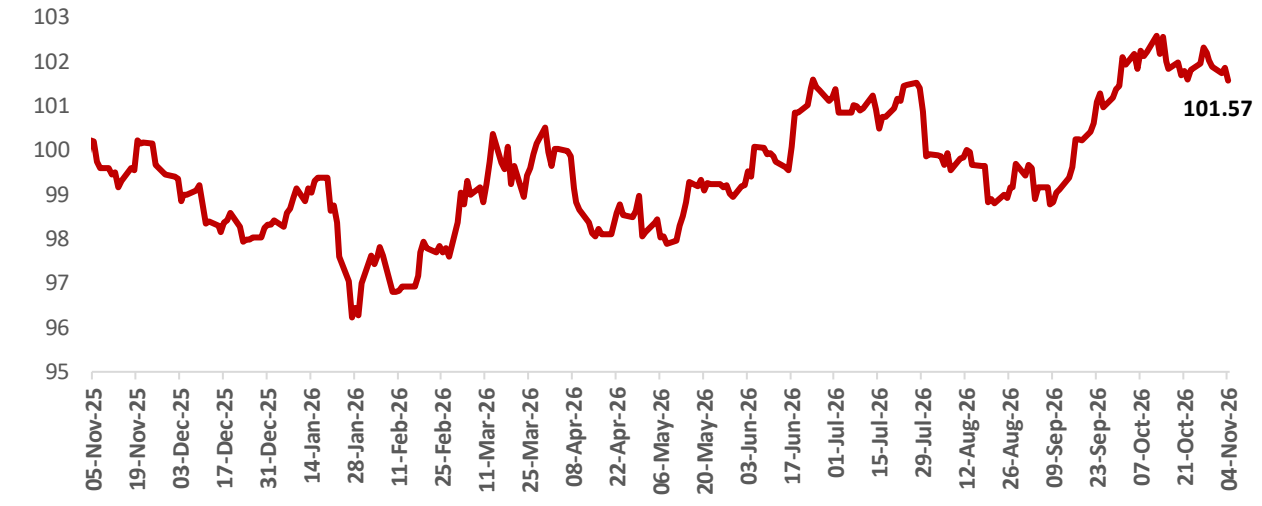
Sources: CEIC Data, Bank Islam

Dollar Weakness Reflects Fiscal Rather Than Fed Repricing

- The decline in the Dollar Index is similarly important. The DXY has fallen from its recent high of 102.50 to around 101.37 currently. Importantly, this weakness has occurred despite stable Fed expectations.

PUBLIC

Chart 2: US Dollar Index (DXY)



Sources: Bloomberg, Bank Islam

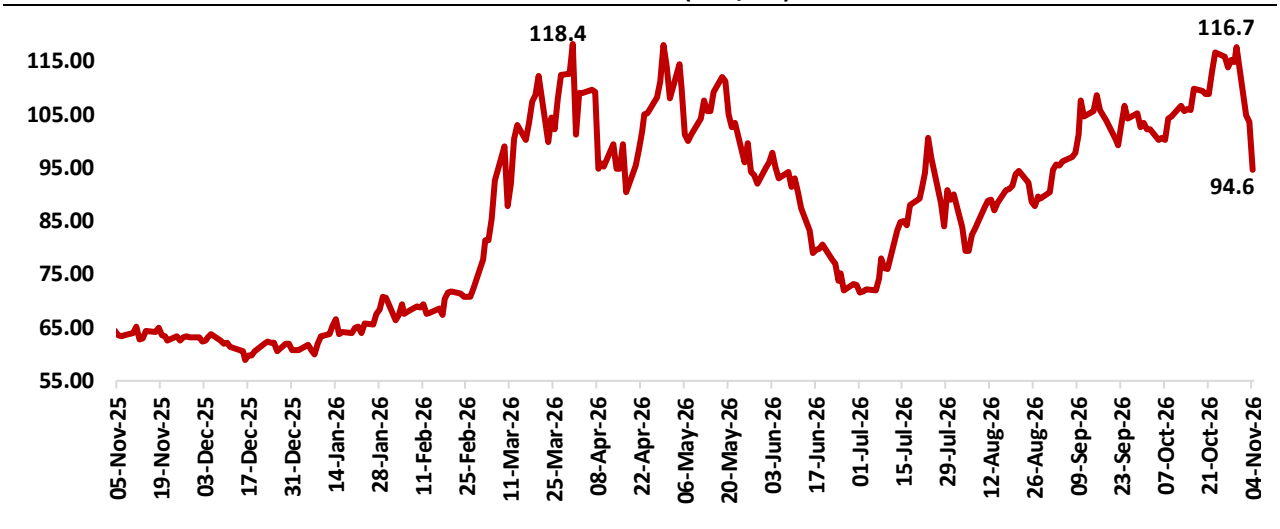
- Normally, significant dollar weakness requires either lower interest rates or weaker economic growth expectations. Neither has materially occurred. Instead, the market appears to be discounting a future characterised by lower fiscal stimulus, slower government spending growth and reduced inflation pressures.

- Technically, the failure to sustain gains above 102.50 suggests the dollar has entered a near-term consolidation phase. Should Treasury yields continue moderating and risk sentiment remain constructive, the dollar could gradually move towards the 100 level over coming months.

Oil Markets Deliver the Strongest Verdict

- The most dramatic market reaction occurred in crude oil. Brent crude prices have fallen from a recent peak of USD118/bbl to approximately USD94/bbl.
- Unlike other asset classes, the catalyst here was not fiscal policy. Instead, markets focused on geopolitical implications. Investors interpreted the Democratic victory as increasing political pressure to de-escalate US involvement in the Iran conflict and reduce military tensions in the Middle East.
- The sharp decline in oil prices has broader macroeconomic significance. Lower energy prices effectively act as a tax cut for consumers and businesses, support disinflation trends and ease pressure on central banks globally.
- For policymakers worldwide, including the Federal Reserve, lower oil prices materially improve the inflation outlook.

Chart 3: Brent Oil (USD/bbl)

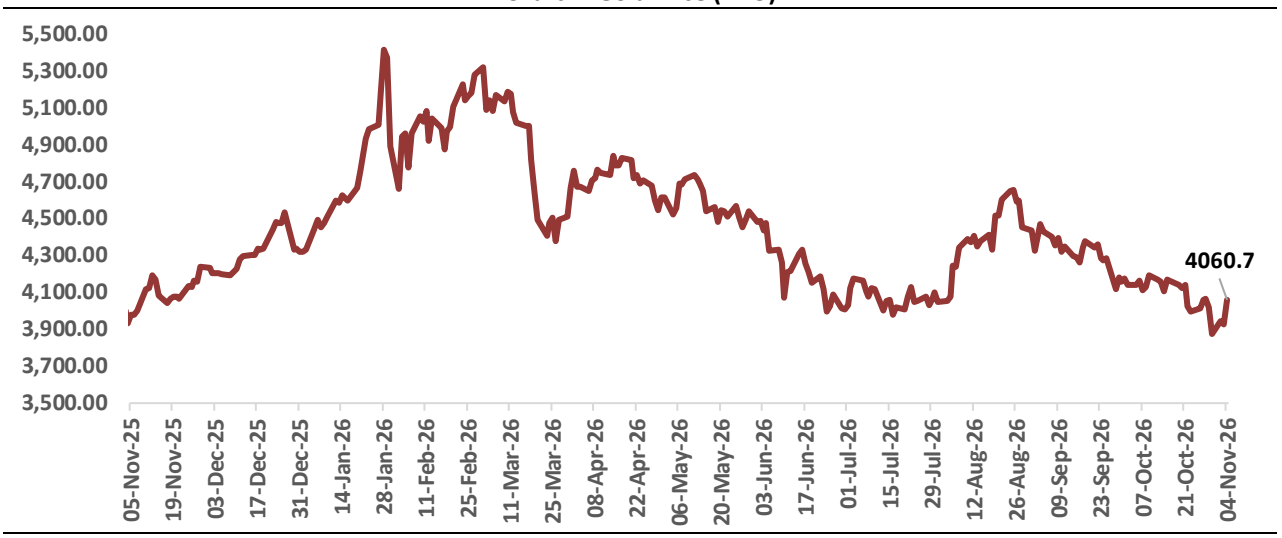


Sources: Bloomberg, Bank Islam

Gold Regains Safe-Haven Appeal

- Gold has staged an impressive rebound from its recent lows. The move reflects the combination of weaker real interest rates, a softer US dollar and elevated political uncertainty.
- Unlike previous rallies that were primarily driven by geopolitical risks, the current advance appears increasingly linked to expectations of lower real yields and concerns surrounding longer-term US fiscal sustainability.
- The outlook for gold remains constructive, particularly if the dollar continues trending lower and inflation moderates without triggering a significant rise in real yields.

Chart 4: Gold Price (XAU)



Sources: Bloomberg, Bank Islam

Implications for the Global Economy

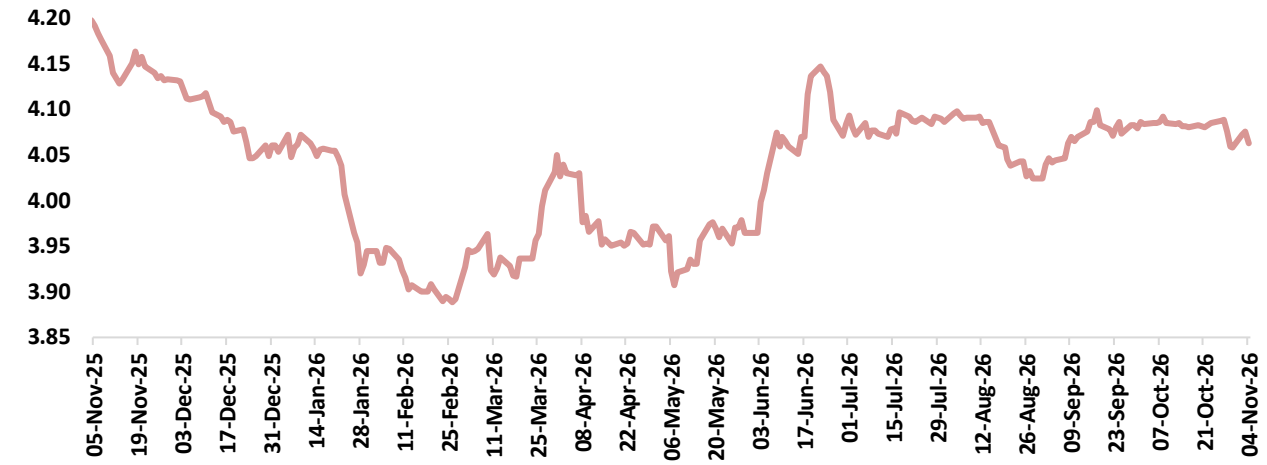
- For the rest of the world, the election result creates a complex mix of opportunities and risks. The positive aspect is clear.
- A weaker dollar, lower Treasury yields and lower oil prices collectively ease global financial conditions. Emerging markets benefit from improved capital flows, reduced financing costs and stronger currency performance.
- However, the political implications are less straightforward. A constrained White House may increasingly rely on foreign policy and trade policy to achieve strategic objectives. This raises the possibility of renewed tariff disputes, sanctions and trade frictions.
- Consequently, while global financial conditions may improve, policy uncertainty could remain elevated. The world may experience a paradoxical environment characterised by easier financial conditions but greater geopolitical risk.

Why Malaysia Could Be an Early Beneficiary

- Malaysia stands among the more immediate beneficiaries of current market developments. The ringgit has already appreciated alongside the broader weakening of the US dollar.
- With USD/MYR moving below recent highs, additional gains are possible should Treasury yields continue declining and global risk appetite remain supportive.
- The outlook for Malaysia's bond market is similarly favorable. Lower US Treasury yields have historically encouraged foreign inflows into higher-yielding emerging market sovereign debt, including Malaysian Government Securities.
- Meanwhile, lower oil prices help moderate imported inflation pressures and reduce risks to household purchasing power. However, Malaysia is not immune to the longer-term risks arising from a more protectionist global environment.

- As a highly open economy deeply integrated into regional supply chains, Malaysia remains exposed to any deterioration in global trade conditions.
- In addition, any slowdown in AI infrastructure investment could eventually affect demand for semiconductors and electronics products, an area that has been an important support for Malaysia's export performance.

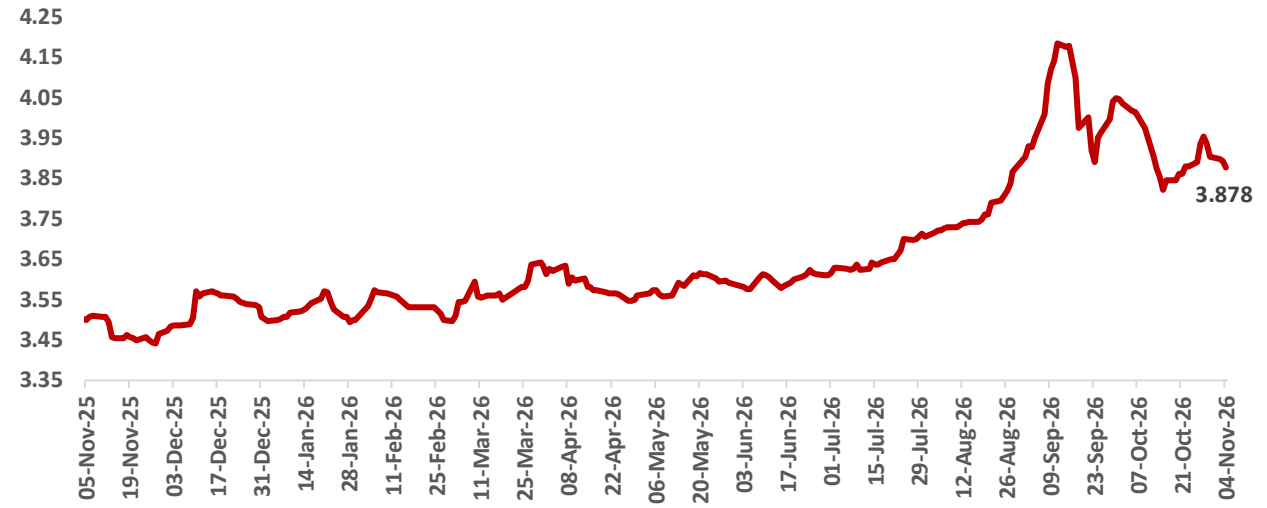
Chart 5: USD/MYR



Sources: Bloomberg, Bank Islam

PUBLIC

Chart 6: MGS 10Y Yield (%)



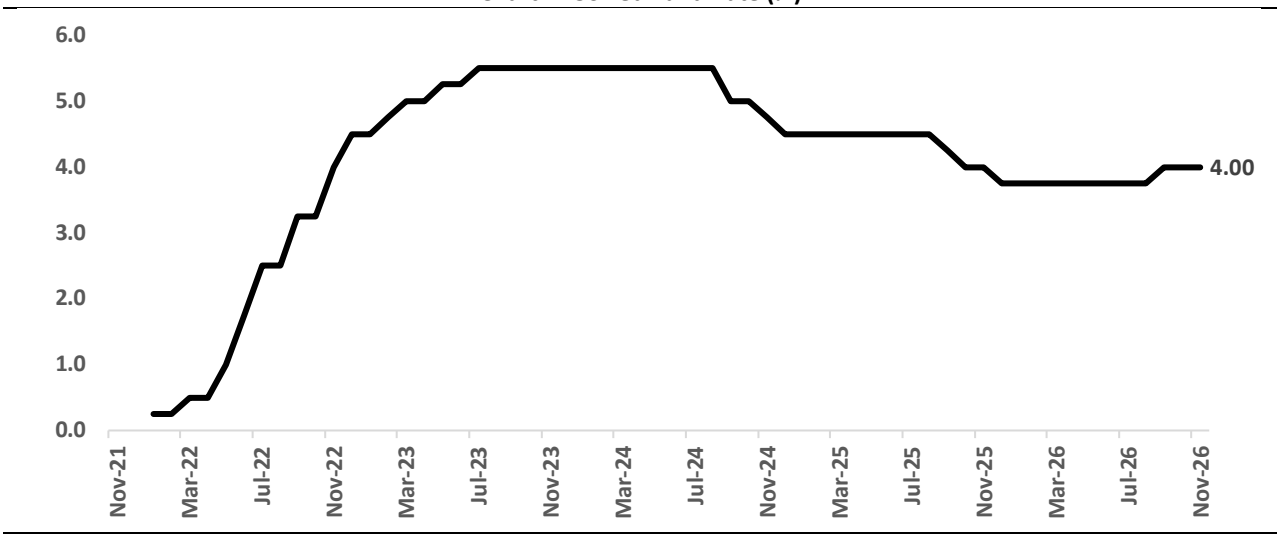
Sources: CEIC Data, Bank Islam

Fed Outlook: Election Changes Fiscal Narrative, Not Monetary Policy

- One of the key misconceptions emerging after the election is that a Democratic victory automatically implies a more dovish Federal Reserve.
- Current market pricing does not support this conclusion. Labor market conditions remain relatively resilient, service sector inflation remains elevated and policymakers have repeatedly emphasised their commitment to maintaining restrictive policy settings until inflation is firmly under control.

- As such, the election outcome alone is insufficient to alter the Fed's near-term policy trajectory. Our base case remains for a 25bps rate hike in December, with CME FedWatch currently indicating approximately 82% probability of such an outcome.

Chart 7: US Fed Fund Rate (%)



Sources: Bloomberg, Bank Islam

Conclusion: From Fiscal Expansion to Political Gridlock

PUBLIC

- The 2026 midterm election marks the beginning of a new phase in the global macroeconomic narrative. Over the last two years, markets have largely been driven by themes of US fiscal expansion, AI-led investment growth and inflationary pressures linked to energy and government spending.
- The Democratic sweep introduces a different narrative. Markets are increasingly pricing a future characterised by policy gridlock, slower fiscal expansion, moderating inflation risks and a softer US dollar. This represents a meaningful shift in the investment landscape.
- For global investors, the immediate implications are constructive. Lower oil prices, weaker dollar dynamics and declining bond yields provide support for risk assets and emerging markets. For Malaysia, these developments improve the outlook for the ringgit, domestic bonds and financial conditions.
- However, investors should not mistake political paralysis for policy stability. A constrained President Trump may increasingly deploy trade and foreign policy tools to achieve strategic objectives, introducing new sources of volatility into the global system.
- Thus, the defining feature of the post-midterm environment may not be lower inflation or lower interest rates, but rather the transition from fiscal uncertainty to geopolitical uncertainty. That shift is likely to become the dominant theme shaping markets throughout 2027.