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Amundi ASSET MANAGEMENT

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INVESTMENT TALKS

Trump impeachment is likely, but impact on financial markets would be short-lived

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- ***Impeachment process:*** *The Democratic Party has announced the opening of an impeachment inquiry against President Donald Trump following revelations that he pushed Ukrainian President Volodymyr Zelenskiy to investigate the son of Democratic opponent Joe Biden. The impeachment process is long and articulated. An 80% probability that Trump will be impeached, followed by acquittal in the Senate, which would keep him in office for the remainder of his term, is our base case scenario.*
- ***Impact on the US economy and Fed policy****: Under a scenario of intense political conflict, Washington may not be able to pass any meaningful legislation, such as the ratification of the US-Mexico-Canada Trade Agreement. Sentiment could suffer during the impeachment process, but it is unlikely to impact the US economy meaningfully.*
- ***Implications for fixed income investors****: Historically, the impeachment process has had no direct effects on the economy and short-lived impact on financial markets. While US interest rates may rally from a flight to quality in response to impeachment headlines, we believe that this would be short-lived. The economic and inflation outlook, and consequently Fed policy, will be the main driver of interest rates, beyond short-term political noise.*
- ***Implications for equity investors:*** *On US equities, we do not see any implications from the potential impeachment of President Trump. Higher risks come from a potential gain in popularity of presidential candidates that favour increased regulations and additional public spending financed through tax increases. It may also lead to the inability of the Trump administration to reach trade agreements with economic partners. This could add uncertainty at a time when the market is already dealing with earnings downgrades. We are defensive on US equities, with a focus on quality companies that trade at reasonable valuations to guard against potential downside risks.*

Why has an impeachment inquiry been opened against President Donald Trump?

On September 25, House Speaker Nancy Pelosi opened an impeachment inquiry against President Donald Trump focusing on revelations that he pushed Ukrainian President Volodymyr Zelenskiy to investigate the son of Democratic opponent Joe Biden. A whistleblower inside the White House accused Trump and his aides of attempting to cover-up Trump's actions to seek foreign interference in the 2020 election.

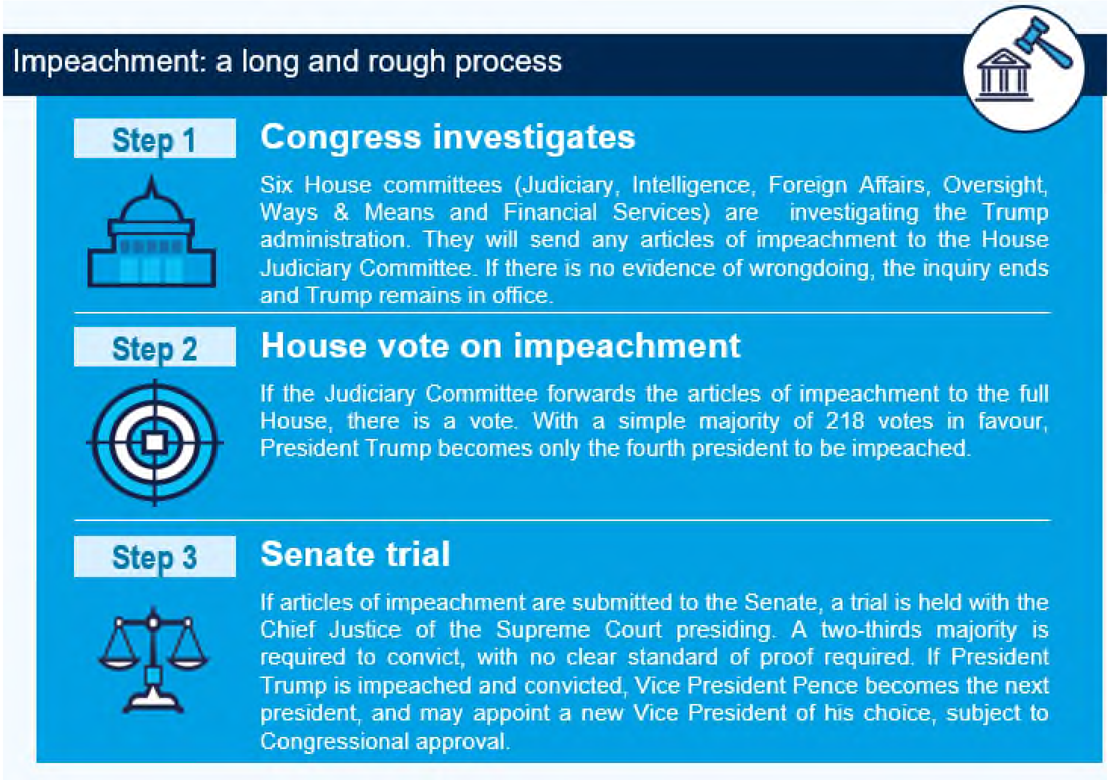
What is impeachment and how does it develop?

Under the US Constitution, the President, Vice President and all civil officers of the United States shall be removed from office on impeachment for, and conviction of, treason, bribery, or other high crimes and misdemeanors. The term '*high crimes and misdemeanors'* dates back to the British common law tradition, and has been interpreted as an abuse of power by high-level government officials that does not necessarily constitute a criminal offense.

This was reaffirmed in the Federalist Papers by Alexander Hamilton, who described impeachment as a political process "*as they relate chiefly to injuries done immediately to the society itself".* Impeachment is a three-step procedure.

Andrew Johnson in 1868 and Bill Clinton in 1998 were acquitted after the Senate trial. If President Trump is impeached and convicted, Vice President Michael Pence becomes the next president, and may appoint a new Vice President of his choice, subject to Congressional approval.

Impeachment: a three-step process



Source: Amundi, as of October 10, 2019.

What is the probability of President Trump actually being impeached?

Impeachment can be an unpredictable process, though at this stage, the ouster of President Trump looks unlikely. Unofficial media tallies suggest there is a majority of votes in the House to impeach Trump. In fact, the online betting markets have already priced in a 70% probability of a Trump impeachment.

On the other hand, the likelihood that the Senate votes to remove Trump from office is low, with the online betting markets pricing in 70% odds of Trump finishing his first term. Polls taken in the first few weeks after the impeachment process was announced indicate growing support for impeachment. Republican voters remained solidly behind Trump with a near 90% approval rating, although that has been softening.

Given the partisan divide of Washington politics, **we would expect the Senate to hold firm in support of the President**. Using history as a guide, Trump's approval ratings among the GOP would have to plummet to 50% before the Senate would waver. This was the point when support for Nixon evaporated and impeachment reached a crescendo.

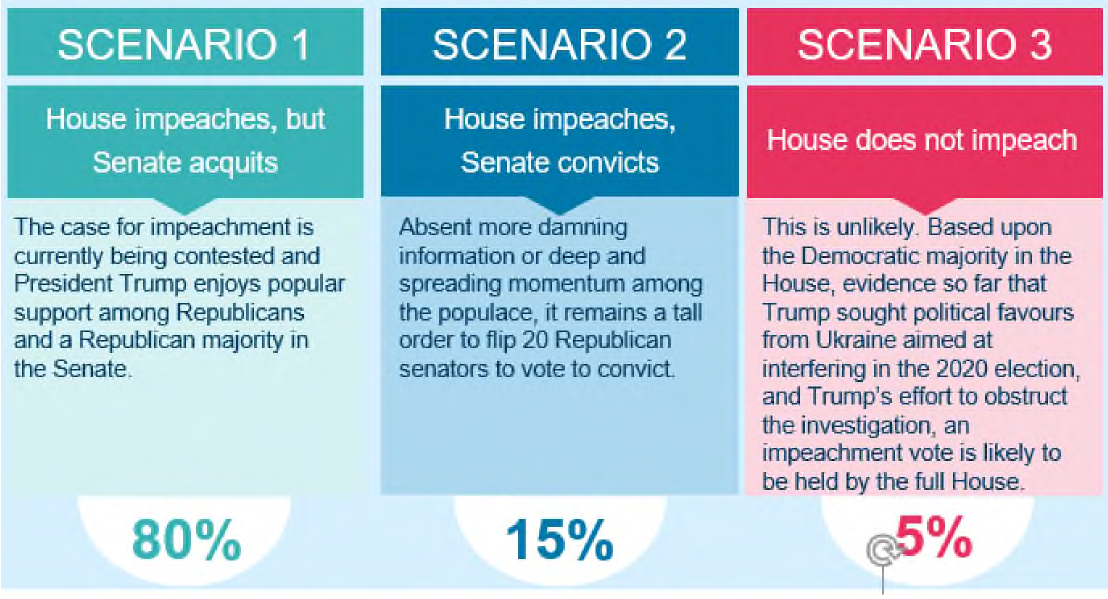
Our base case scenario is **an 80% probability that Trump will be impeached**, followed by acquittal in the Senate, which would keep him in office for the remainder of his term.

"The most likely outcome is for Trump being impeached but acquitted by the Senate, staying in office until the end of his term."

What are alternative scenarios for the impeachment process?

Three alternative scenarios may unfold in the coming months.

Impeachment: alternative scenarios and their probabilities



Source: Amundi, as of October 10, 2019.

"Historical evidence suggests that while distracting and politically charged, impeachment does not have a lasting impact on markets."

What have been the historical implications of impeachment on financial markets?

There have been only two modern day instances of Presidential impeachment, and both occurred in diametrically opposite economic environments. The Nixon impeachment and resignation occurred when the US economy was already heading into a recession and inflation was surging. This led the Fed to tighten policy aggressively and slash rates soon after, with the net change in the Fed funds interest rate largely flat. Financial markets were in a deep bear market, with the S&P 500 plummeting 41% and 10-year Treasury yields rising 100 basis points (bps). The US Dollar (USD) soared 7.8% in response to higher rates.

During the Clinton Impeachment, the US economy was booming, growing in excess of 4% with stable inflation just below the Fed's target of 2%. The Asian debt crisis prompted the Fed to cut rates mid-cycle, contributing to a strong rally in the S&P 500 (+26.5%), higher 10-year Treasury yields (+82 basis points) and a stronger USD (+4.1%).

The only conclusion we can draw from the last two impeachments is that the process, while distracting and politically charged, does not have a lasting impact on markets. The moves in financial markets were primarily driven by pre-existing economic conditions that led to bust or boom.

"The impeachment process is unlikely to weigh on either US economic developments or the Fed's monetary policy."

What impact do you foresee on the US economy and the Fed's monetary policy?

We see two primary areas where risk could emerge under a tail scenario:

- First, under intense political conflict, it is unlikely that Washington will pass any meaningful legislation, such as the ratification of the US-Mexico-Canada Trade Agreement, a prescription drug bill, or a potential fiscal spending bill for 2020. A negative surprise could fill the void left by the lack of effective governance.
- Second, consumer confidence, and especially business sentiment, could suffer during the drama of the impeachment process. However, the state of trade negotiations between US and China is more impactful to spending and consumption, and we expect trade talks to continue, as congressional approval is not required.

While it is not our base case, **we are reassured that an unexpected slowdown in US economic activity will be met with pre-emptive response from the Fed**. We see little risk of a change to our US economic and Fed outlook as past impeachments tell us there is scant evidence that the impeachment process influences economic conditions. As highlighted in our recent piece, we remain constructive on the US economy and still view the Fed's recent easing as a mid-cycle adjustment.

"In fixed income we prefer securitised products and inflation-linked bonds, while being cautious on corporate bonds with tight spreads."

What impact do you expect in US fixed income?

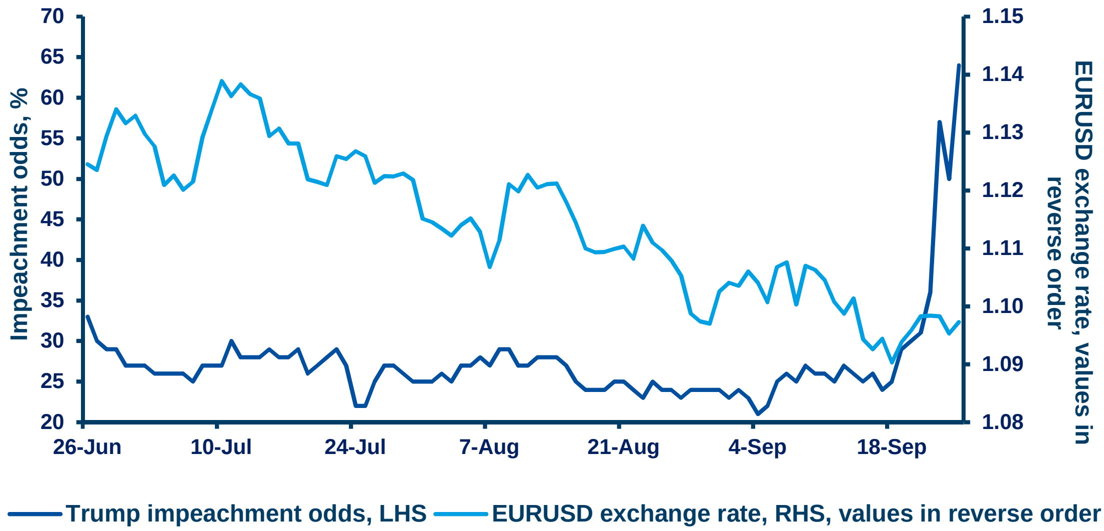
As long-term investors, we focus on industry, company and economic fundamentals, rather than react to near-term sources of volatility. Valuations in the US fixed income markets support a conservative approach from a quality and interest rate perspective.

While **US interest rates** may rally from a flight-to-quality move in response to impeachment headlines, such a move should be short-lived.

The strength of the services sector and consumer in the US is central to our domestic growth outlook and our emphasis on securitised assets. Offsetting our preference for the residential mortgage and consumer credit sectors is our caution on selected corporate credits with relatively tight spreads. Inflation-protected government bonds look attractive, reflecting low break-even levels and relatively attractive carry versus nominal treasuries.

We anticipate a re-emergence of inflation that should help steepen the yield curve, and investors should benefit from limited exposure to longer-maturity bonds. In case of stalling trade talks, geopolitical conflicts or negative economic surprises, we expect further Fed rate cuts. Any evidence of economic and monetary policy convergence may give rise to a turn in the USD bull market, while the news about impeachment had no impact on the USD. The Japanese yen and Swiss franc are likely to be the big winners in this environment.

Trump impeachment odds and USD



Source: Amundi, Bloomberg as of October 10, 2019.

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"On US equities we stay defensive and focus on quality companies that trade at reasonable valuations."

"Currently there is little political risk premium priced in US assets."

What are the implications for investors in US equities ?

The impeachment process is unlikely to have a significant direct impact on **US equity prices** for two reasons: first, Trump is likely to remain in office given the Republican majority in the Senate; and second, if Trump is removed, Vice President Pence would replace him and is likely to maintain pro-business policies while being more predictable and stable in his policies and communications.

Larger risks for the equity market are:

- A possible increase in the popularity of presidential candidates that favour increased regulations and additional public spending financed through tax increases.
- The Administration takes military action against Iran or elsewhere in retaliation for the attack on Saudi Arabia.
- The inability to reach a trade agreement with the main economic partners.

Such risks are likely to be underestimated by markets. **Currently there is little political risk premium priced in US assets,** with yields and credit spreads near recent lows, and equity prices near record highs. If we consider slowing US and global growth, as well as trade policy uncertainty, it is prudent to be defensive on equity positioning with a focus on quality companies that trade at reasonable valuations to guard against potential downside risks.

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Definitions:

- **Breakeven Inflation:** Breakeven inflation is the difference between the nominal yield on a fixed-rate investment and the real yield on an inflation-linked investment of similar maturity and credit quality.
- **Credit spread:** Differential between the yield on a credit bond and the Treasury yield. The option-adjusted spread is a measure of the spread adjusted to take into consideration possible embedded options.
- **Volatility:** a statistical measure of the dispersion of returns for a given security or market index. Usually, the higher the volatility, the riskier the security/market.
- **Yield curve steepening:** A steepening yield-rate environment means that short-term rates are rising less than long-term ones, or, alternatively, that short-term rates are dropping more quickly than long-term rates. This causes the yield curve to steepen.

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