

Market Implications of Potential Presidential Impeachment

At Cidel, analyzing the risks to ... While we view the potential impeachment of President Trump as unlikely at this time, the odds may have marginally increased and we are monitoring factors that could change our view...The likelihood of the President being impeached remains low. but the odds of it becoming a political discussion point are higher with the results of the recent mid-term election. The Republicans did retain their majority in the Senate, but no longer hold the largest number of seats in Congress.

Trump and Impeachment: Odds are still low but rising

The likelihood of President Trump being impeached may have increased marginally with the results of the mid-term elections. However, the Republicans did retain their majority in the Senate in the early November elections. Note that the President has to be convicted in both the House of Representatives and the Senate to be impeached and removed from office. According to FiveThirtyEight (a polling aggregator), Democrats have 71.5% chance of winning control of the House (as of Aug 28, 2018) while Republicans are still favoured to keep control of the Senate. Moreover, few Democrats, at this point, are talking about impeaching Trump should they win control of the House. Rather, they publicly say that they would use congressional power to oversee the Trump administration and ensure that the Mueller investigation can run its course. Obviously, what politicians say before an election and what they do after are often very different. Finally, one has to consider that the odds of impeachment dramatically increase if Mueller were able to make a clear and direct link between Russia and President Trump. In this case, even Republicans would have to seriously consider impeachment.

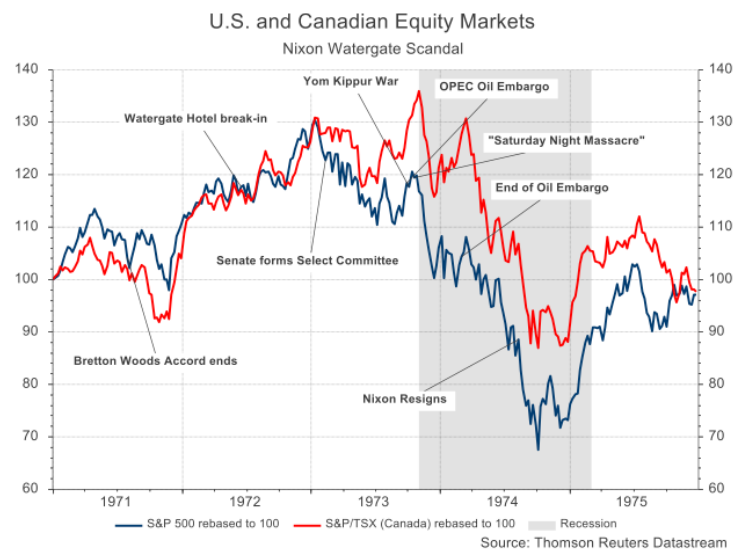
What history tells us: Difficult to isolate effect of impeachment on equity markets

We have two modern examples of Presidents behaving badly and facing impeachment: Nixon and Clinton. We also have recent examples with the impeachment proceedings in South Korea (December 2016) and in Brazil (August 2016).

Nixon: Watergate Scandal

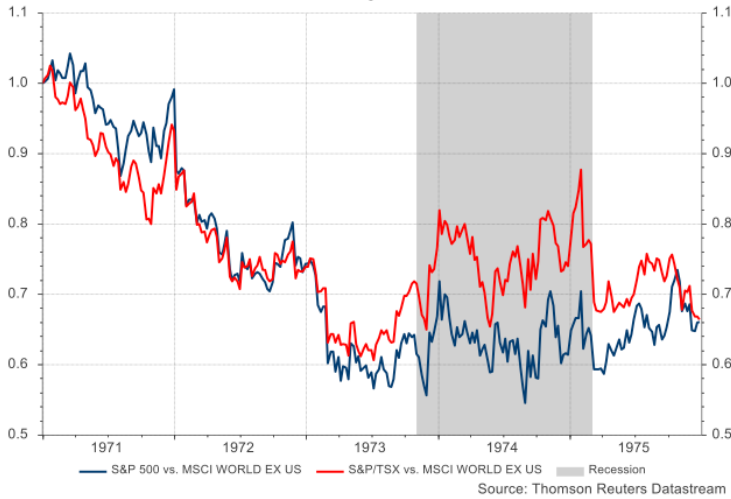
The Watergate scandal's roots go back to June 17, 1972 when burglars were caught in the office of the Democratic National Committee. The burglars, who were connected to President Nixon's re-election campaign, were involved in wiretapping phones and stealing documents. After attempting to cover up the crimes and to obstruct justice, Nixon resigned two years later on August 8, 1974.

During the Watergate scandal, markets exhibited a high level of volatility, however, the political upheaval in the United States was but one of the many factors affecting global markets. The Yom Kippur war, the OPEC oil embargo, emergent inflation, and a particularly difficult recession all contributed to market weakness and volatility. The following graphs shows how the S&P 500 and the S&P/TSX fared during the mid-1970s both in absolute and in relative to the MSCI world excluding U.S. Interestingly, immediately following Nixon's resignation, the S&P 500 underperformed. While Watergate likely produced increased volatility and some market weakness, it is difficult to see a clear lesson from this era that would be applicable to today's situation due to the amount of factors buffeting the market during that time.

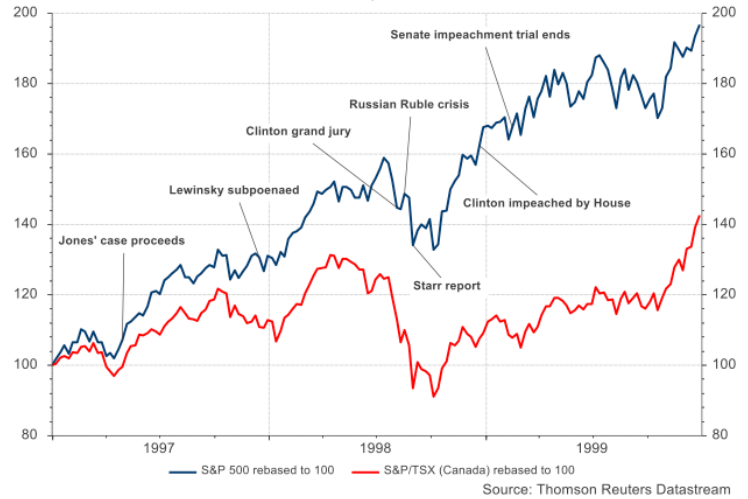


Market Implications of Potential Presidential Impeachment – Cont'd

Equity Markets vs. MSCI World excluding U.S.
Nixon Watergate Scandal



U.S. and Canadian Equity Markets
Clinton Impeachment

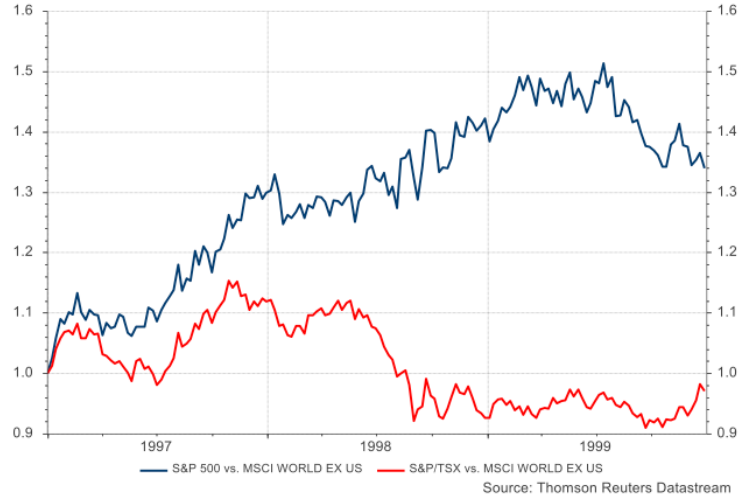


Clinton: Impeachment Proceedings

In December 1998, the House of Representatives initiated the impeachment of President Clinton on charges of perjury and obstruction of justice stemming from a sexual harassment lawsuit filed by Paula Jones. An investigation by Independent Counsel Ken Starr concluded that Bill Clinton had committed perjury. Clinton was subsequently acquitted of these charges by the Senate on Feb 12, 1999.

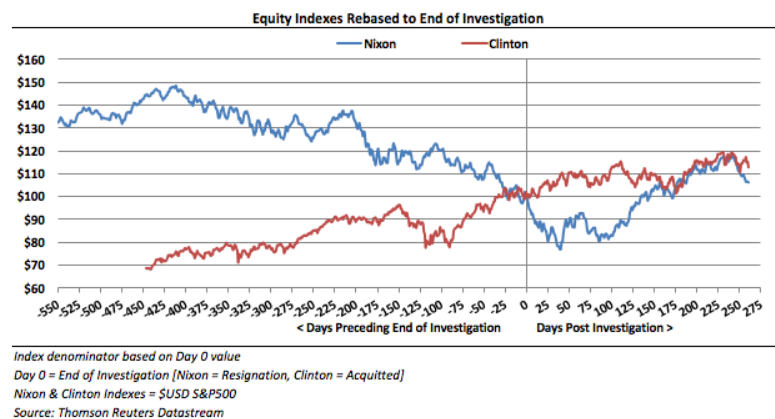
Once again, volatility in capital markets in the months leading to Clinton's impeachment were at least partly caused by other factors such as the Russian Ruble crisis. Interestingly, following the Starr Report and during the actual impeachment process, the S&P 500 performed very well. In the late 1990s, the economy was strong and the Clinton impeachment volatility turned out to be just a small blip in the strong upward run of the Dotcom bubble. On a relative basis, the Clinton impeachment proceedings did not affect the outperformance of the U.S. market versus the MSCI World excluding U.S. during this phase of the Dotcom bubble. The Canadian market with less exposure to the Technology sector, lagged the U.S. market during this period. Once again, extrapolations to the current period are difficult.

Equity Markets vs. MSCI World excluding U.S.
Clinton Impeachment



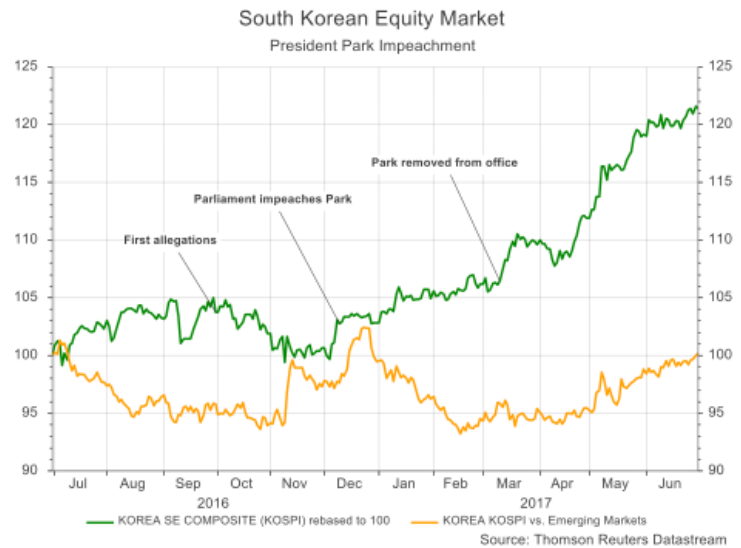
Market Implications of Potential Presidential Impeachment – Cont'd

The following graph shows how the end of the impeachment process in the United States, either through resignation or acquittal, does not change the overall trend of the market. During Clinton proceedings, the uptrend of the market simply continued. Following Nixon's resignation, the downtrend continued but seemed to accelerate. This acceleration was potentially caused by worsening economic conditions.



Recent Impeachments: South Korea and Brazil

In South Korea, President Park was accused of being overly influenced by a presidential aide who was the daughter of a religious cult leader. Initially, Park was suspended for 180 days then fired from her position on March 10, 2017, with new elections held in May. During the impeachment process, Korean equities outperformed the rest of the emerging markets. However, the positive effect did not last long, with the outperformance all but erased by the time Park was removed from office. Following Park's removal, Korean equities started outperforming but it could be related to the arrest of a Samsung VP and the hope of corporate governance reforms.



In Brazil, President Rousseff was plagued by a money laundering scandal which revealed corruption at the highest levels of Brazilian business and politics. As the prospect of Rousseff's removal improved, the outperformance of the Brazilian equity market became more evident. The outperformance was likely driven by the hope that the political paralysis would end and by the prospect of moving away from a left wing government. Michel Temer, who became interim President then President, was seen as a much more market friendly option than Rousseff. In this case, the impeachment process and ultimate removal of the President did lead to better equity market conditions.



Market Implications of Potential Presidential Impeachment – Cont'd

What is different this time?

President Trump's populist approach is very different than the strategy used by many of his predecessors. To achieve political victory, President Trump played into a rising anti-establishment sentiment and presented himself as a Washington outsider. Even with all the scandals surrounding him, Trump remains very popular amongst Republican voters. If the "establishment" tries to impeach him while he remains popular with his base, he will likely be able to use his populist platform and play a deeply polarized American society in an attempt to save his presidency. This approach could be destabilizing to both the American political system and perhaps to American society itself. On the other hand, if new information from the Mueller investigation or from other sources erodes the support Trump enjoys from his base, then he will have a tougher time using populism to his advantage.

Today, we have a U.S. President that threatens the people who are involved in a criminal investigation against him. He seemingly has little respect for the Judicial Branch of government and has made his unhappiness about some legal decisions known publicly. By potentially delegitimizing the judiciary, Trump may make it more difficult for judges to play their role as unbiased arbiters.

Trump's associates have also been the target of a number of investigations. As such, a Trump impeachment could also affect a number of current senior officials within the White House, further destabilizing the Executive Branch and increasing the chance of political missteps.

In the age of social media and of a U.S. President who uses Twitter to communicate with the people, an impeachment fight could become very public, very fast. This gives the President tools, not used in the past, to influence public opinion and attempt to create distractions.

President Pence: Economically, probably more of the same but likely more favorable on trade wars

The odds of Vice-President Pence getting a promotion are long but the market's view on what kind of president he would be is sure to play an important role in the market's reaction to a Trump impeachment. Pence has been described as a full-spectrum conservative on social, moral, economic and defence issues. While Trump has won through populism, Pence has found more conventional support from the Republican big donors (well connected to the Kochs) and would support a more rightward course for the U.S. Pence, an early supporter of the Tea Party, would likely fight for smaller government, support the current tax cuts, and less regulations. On the other hand, if Democrats win the House during the mid-term election in November, it would make it more difficult for President Pence to effect drastic changes. Equity markets would likely react positively if he changed course on Trump's trade wars and eliminated the tariffs imposed by Trump. If Pence becomes President, we do not know what economic policies he will follow but the new President would likely be viewed as a neutral to positive change from an economic stand point.

Alternative Scenarios: Trump's reaction is also important

Trump's sometimes erratic behaviour forces us to consider alternative and less likely scenarios. If impeachment proceedings are started against him how will he react? His words have proven powerful tools that can influence his base. Will he ask people to "defend" him? Will he use his power as President to fight the proceedings to such an extent as to undermine the political stability of the United States? While it is impossible to predict how he could react, the odds are not zero that his reaction could dramatically increase volatility in financial markets and potentially even affect the social fabric of American society.

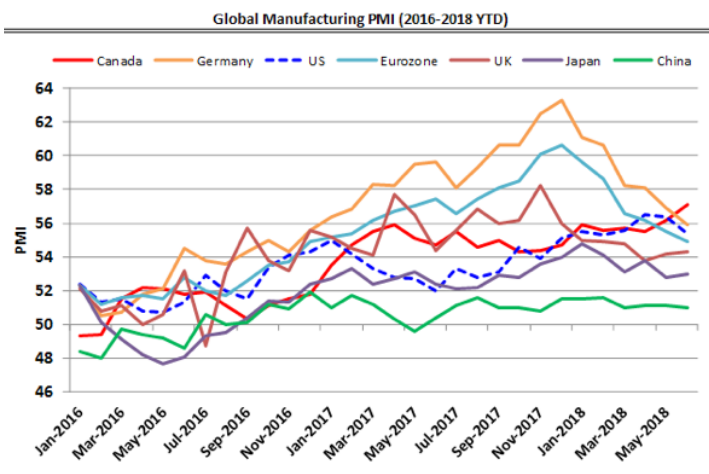
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It is also worth considering how America's adversaries might react to political instability in the United States. Will countries such as China, Russia or Iran take advantage of it to achieve national goals opposed by the United States? Taiwan, South China Sea, Ukraine, Yemen, Syria, are all flash points that could give financial markets pause. The odds of such events seem remote but they are worth watching.

A final scenario to consider is the ability of the US government to react to potential economic shocks while proceeding with impeachment. One can imagine how much worse the financial crisis could have been if the US government executive branch had been incapable of acting decisively. Although it is worth noting that the financial crisis demonstrated the amazing resilience and flexibility of the U.S. political system as it occurred while the Bush administration left office and the Obama administration took over. Once again, it is difficult to place odds on this scenario but with an aging economic cycle, governments may be called to action in the next few years as we potentially enter a recession.

How is your portfolio positioned?

The team at Cidel Asset Management noted rising equity market risk some months ago. We have been particularly concerned about the effect Trump's trade wars will have on the global economy. Moreover, our concerns are widely shared and reflected in the weaker purchasing managers indices worldwide except in the U.S.



Source: Markit, Bloomberg, Cidel

In this environment, we believe that managing risk is key and as a result, we have decreased the pro-cyclical exposure of our portfolios. While we have not moved to a defensive stance as the current cycle does not appear to be on the verge of ending, clouds are gathering on the horizon and we prefer to be careful. Specifically to your portfolio, we have:

- Taken a neutral stance on oil and gas producers;
- Reduced the holdings of metal mines;
- Reduced or eliminated weaker cyclical industrial holdings;
- Reduced the holding of Magna International, which could be negatively impacted by either auto duties or an economic downturn; and
- Added to grocery stores, consumer stocks, and utilities.

When combined, these changes make the portfolio more resilient to negative market shocks while not being fully taking a defensive stance.

Putting it all together

The events leading to an impeachment and the impeachment process would likely add a layer of volatility to the market. However, as long as the process is orderly, it should not affect the overall economy in a meaningful manner. President Pence is likely a neutral to positive economic actor and as such, the overall trend of the market should be unaffected. In the event that the process is disorderly, impeachment proceedings would likely be quite negative for equity markets as the risks to the economy meaningfully grow.

In the case of a more disruptive impeachment process, it is worth noting that Canada with its stable political system and solid public finances would likely be able to weather the storm better than most. The situation could be similar to the outperformance of the Canadian economy during and following the financial crisis of 2008.

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