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How impeachment uncertainty could affect US policy and markets

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We have written already on the market impact of historical presidential impeachments (see The impact of presidential impeachment on markets). Speculation has undoubtedly risen over the possibility of the impeachment of President Trump. We are not in a position to opine on whether the president should be impeached; what follows in this note is a simple examination of the possible mechanisms and potential outcomes, both for policy and for markets, drawing on some of the lessons from our previous note.

The impeachment process

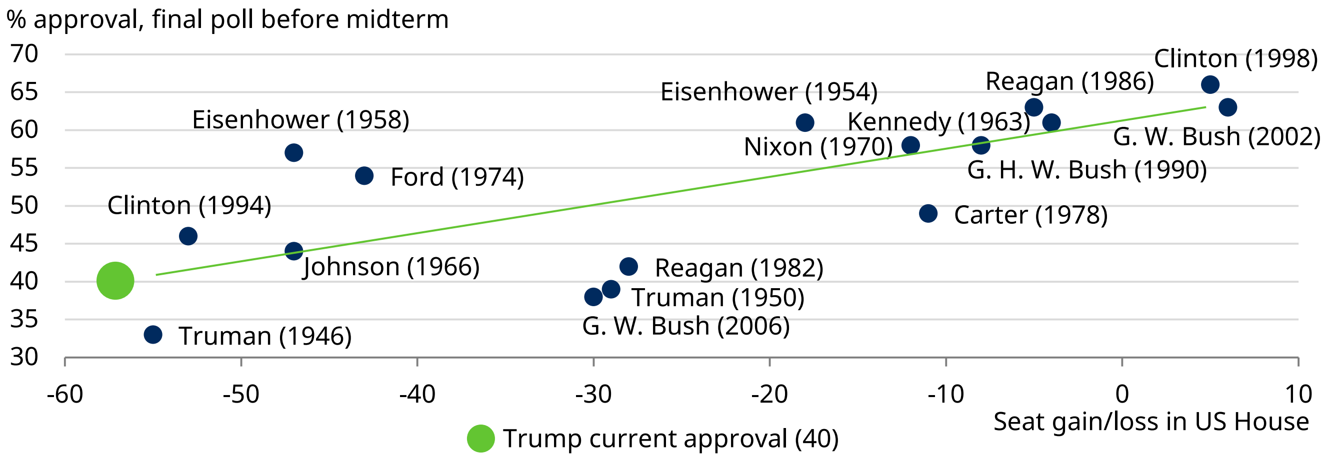
In the US, impeachment is very much a political, rather than legal, process. Governed by the Constitution, the bar is set rather low: "the President…shall be removed from Office on Impeachment for, and Conviction of, Treason, Bribery, or other high Crimes and Misdemeanours". In particular, the term "misdemeanours" gives considerable leeway. The impeachment charges against President Clinton, for example, were for perjury and obstruction of justice.

The House of Representatives decides if a president has committed an impeachable offence based on a simple majority. The Senate then determines whether this offence is sufficient to remove the president from office and requires a two-thirds majority to do so.

It should be noted that in previous impeachments, presidents have faced a House controlled by the opposing party: a Republican-controlled House and Senate awaited Clinton, and a Democratic Congress brought impeachment charges against Nixon. Today, the Republicans control the House and the Senate so the evidence against Trump would have to be compelling to gain sufficient votes to propose and impeach the president. We have no idea whether there is a smoking gun at this stage. Absent this, impeachment seems unlikely before the midterm elections, the first opportunity for Congress to change hands.

The president's low approval ratings do not bode well for the midterms due in November 2018. These elections nearly always involve losses for the incumbent president's party, with low approval ratings translating into significant losses of around 36 House seats on average. For Trump, the outcome could be worse than this (see chart below).

Chart: Republicans face a bruising midterm election battle



Source: Gallup, Schroders Economics Group, 31 May 2017.

The Republicans currently hold a majority of just over 20 seats in the House, so a loss of the size implied by the historic relationship would give the Democrats an opportunity to pass a simple majority vote on impeachment. To gain the 67 votes needed in the Senate, the Democrats would need to gain a further 19 senators. With only 35 seats (at most) up for re-election in the Senate, this would seem like a big ask unless a Democrat "wave" results in a landslide. Otherwise it would require disgruntled Republicans to vote against the president.

In the event of a successful impeachment, or a resignation by President Trump ahead of the Senate vote, as we saw with President Nixon, Vice President Pence would then assume office.

Tail risks – what could lead to impeachment?

We mentioned above that a smoking gun – clear evidence of wrongdoing by President Trump – would likely be needed to turn the Republican Congress against the president. In our view this is the only scenario where we might see impeachment proceedings commenced by the Republican House before the midterm elections, or where Republican senators would back a Democrat-led impeachment effort.

After testimony provided by former FBI director Comey on Thursday 8 June failed to produce much in this regard, other channels to eye include:

- Leaks from law enforcement agencies, and others. Disgruntled employees could reveal damaging materials which sway public opinion of Trump and change the calculus for Republican politicians
- The progress of the special investigation under Robert Mueller. Set up to investigate possible ties between President Trump's campaign and Russia's government, the inquiry has expanded to include a criminal probe of a former Trump staffer, and could continue to grow. In previous impeachment efforts, special investigations have uncovered entirely new lines of inquiry. This happened with President Clinton in the US (the focus began with real estate and ended with Clinton's alleged perjury regarding Monica Lewinsky). Elsewhere, the ongoing corruption scandal in Brazil has broadened from its original remit to include a large chunk of Brazilian politics and business
- Subpoenas. The demand for documents relating to the current probe can also reveal new areas for investigation, which could cause a marked shift in the perception of impeachment risk

Policy implications – could legislation be derailed?

There is a risk that a White House distracted by the ongoing investigation is unable to provide leadership on healthcare and tax reform. However, a contrarian perspective might be that this provides an incentive to achieve something of substance before the midterms. Republican Congressmen may decide their only hope for re-election is to notch up a significant policy victory before the midterm elections, and so could unite behind the White House on its reform programme.

Though we are not legislative experts, our understanding is that healthcare reform is likely to occupy political energies for most of the summer. After that, and before tax reform can be addressed, the 2018 budget will need to be passed to obtain the reconciliation instruction for tax reform. This is an important element as it would mean only a simple majority vote would be needed to pass tax reform, as opposed to a two-thirds vote. However, this (and the debt ceiling issue) could take us into October, creating a tight timetable for tax reform before the next year's midterm elections.

Our base case at this point would be that both healthcare and tax reforms are achieved before the midterm elections, though undeniably the probability has fallen. However, if one of our tail risks comes to fruition, reforms could be derailed. If the White House were to be incontrovertibly tainted by illegal activity, fewer Republicans may be willing to associate themselves with its legislative agenda.

It seems likely that the midterms will yield a Democrat-controlled House, with the Senate less certain. At this stage it is too early to tell whether Democrats will achieve the necessary votes to impeach the president. However, there is clearly a risk that Republicans may lose the House, thus creating gridlock and a lame duck president in Washington. Potentially, the Democrats may be more inclined to work with a post-impeachment President Pence, particularly on areas with bipartisan support like infrastructure spending.

Market implications – what next for the "Trump trade"?

In an earlier note (The impact of presidential impeachment on markets) we examined the impact of impeachments on financial markets, both in the US and in emerging markets. We concluded that we can link the impact on market performance to expectations of policy change resulting from an impeachment. Where the perception is that a government's policies are damaging the economy, the possibility of a change in government boosts asset performance. However, where a government is seen as benefitting the economy, or at least doing no harm, the prospect of an end to that policy set can induce market jitters.

Broadly speaking, the "Trump trade" has been linked to fiscal stimulus and deregulation hopes. An independent research firm, Strategas, constructed equity baskets based on these themes which outperformed following Trump's election. These baskets have underperformed as impeachment speculation has grown. We would expect this theme to evolve depending on the findings of the special counsel's investigation.

Given the underperformance so far, if Congress can deliver on tax reform ahead of the midterm elections, we should see a significant rally in "Trump trade" related assets. Similarly, should the special investigation conclude that there has been no wrongdoing, there is definite potential for another leg up in asset prices.

However, if we reach the midterms with no reforms enacted, it is unlikely the markets will take it well. Barring a break with historical norms, control of the House would likely pass to the Democrats, ending any hope of implementing President Trump's agenda. The "Trump trade" would die a final death as legislative battles might increasingly centre on a push for impeachment, or at least revenge by the Democrats for perceived obstructionism by the Republicans during the Obama administration.

At this point, markets could come to see impeachment as desirable because it would bring an end to uncertainty, with reforms off the table either way. The replacement of Trump with Pence as president at that point would pose little to no downside policy risk. It might, if anything, provide some upside. Democrats may be willing to cooperate with Pence on infrastructure spending, and Pence seems less disruptive for foreign policy than President Trump. We would not rule out a rally as a result.

Overall, the best case scenario for markets would be one in which President Trump is cleared of all suspicion by the special investigation, removing impeachment risk and emboldening Republicans to push ahead with the reform agenda. This could reignite the "Trump trade" which has flagged recently. By contrast, the worst case would be that concerns over impeachment dog the administration throughout the remainder of President Trump's term, preventing reform as Republicans distance themselves from the White House, but never proving substantive enough to impeach Trump and replace him with Pence, who might have some limited chance of pursuing some limited programmes.

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