
Investment Management Division

US Policy Outlook: Implications of Recent Political Developments

May 22, 2017

Investment Strategy Group

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1. Recent US Political Developments and Market Action
2. Implications for the Policy Outlook
3. Investment Implications

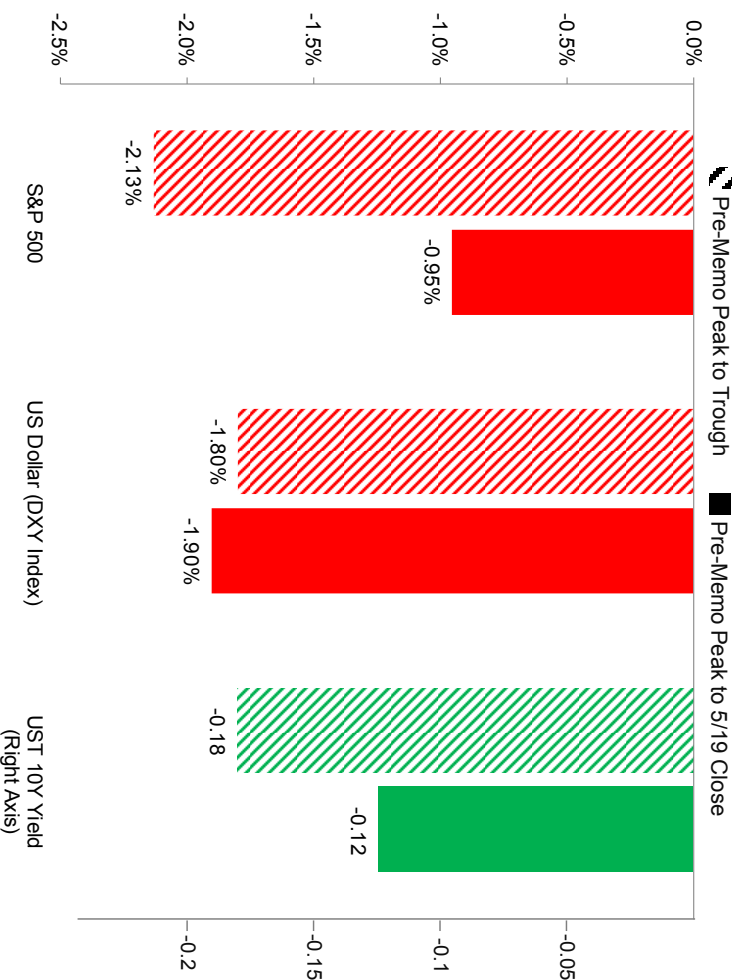
Recent US Political Developments

Date	Event
5/4/2017	The House passes AHCA, sending the bill to the Senate for deliberation
5/4/2017	The Senate approves federal spending bill to fund government through September
5/9/2017	President Trump fires FBI Director James Comey
5/11/2017	Robert Lighthizer is confirmed as US Trade Representative
5/15/2017	US officials report that President Trump shared classified intel with Russian officials in a May 10th meeting
5/16/2017	The <i>New York Times</i> reports that President Trump asked Comey to shut down the investigation into former NSA Michael Flynn, according to a Comey memo written after the February meeting
5/17/2017	Former FBI Director Mueller is named as special counsel for the investigation of Russian government efforts to influence the 2016 presidential election "and related matters"
5/19/2017	President Trump departs for his first overseas trip

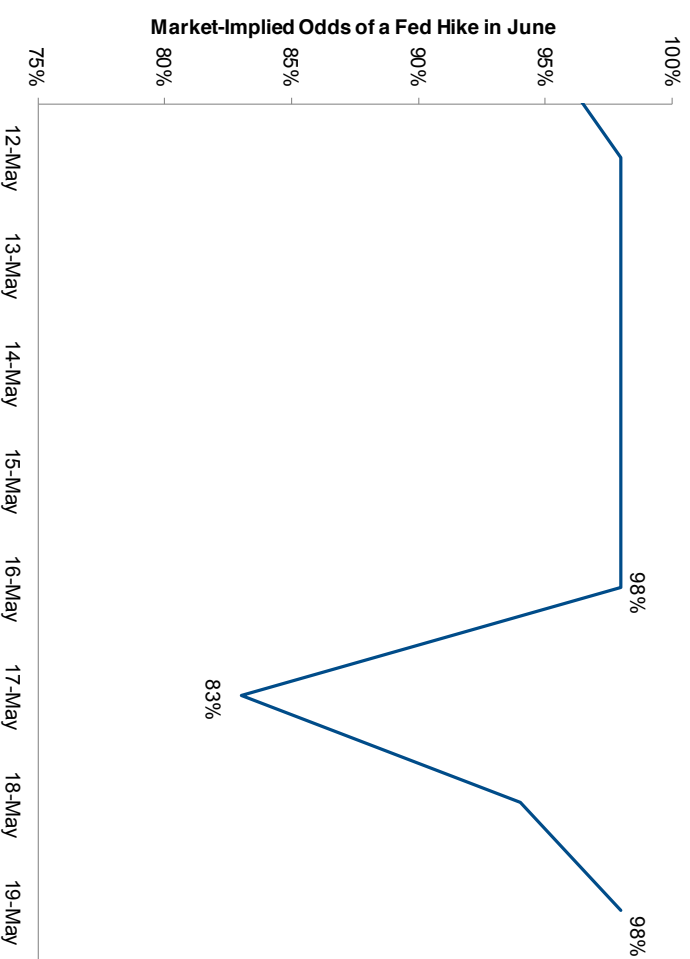
- Recent events, including the dismissal of FBI Director Comey and escalation of investigations into President Trump, have rattled markets and called into question the likelihood of fiscal legislative priorities being enacted.

Recent Market Action

1. Intra-week Market Moves Following News of Comey Memo



2. Daily Market-Implied Probability of a Fed Hike in June



- The S&P 500, US dollar and US Treasury yields moved in reaction to the Comey memo on Wednesday, May 17th.
- While risk assets rebounded Thursday and Friday, dollar weakness persisted.
- The market-implied odds of a hike at the June FOMC meeting fell by 15 percentage points upon news of the memo, but returned to 98% by the end of the week.

Mueller Takes the Lead in Trump-Russia Investigations

Ongoing Investigations into the Trump Campaign, Administration, and Russia

Entity	Investigative Mandate
Justice Department	Ties between the Trump campaign and Russia
House Intelligence Committee	Russian intervention in the 2016 US election
Senate Intelligence Committee	Russian intervention in the 2016 US election
Senate Judiciary Committee	Conduct of former NSA Michael Flynn; circumstances around firing of former FBI Director James Comey
House Oversight and Government Reform Committee	Conduct of former NSA Michael Flynn; circumstances around firing of former FBI Director James Comey

- Former FBI Director Robert Mueller has been named by the DOJ as special counsel, a lawyer appointed to lead an independent investigation and, if needed, prosecute those suspected of criminal activity.
- Mueller, who remains answerable to Deputy Attorney General Rod Rosenstein, is authorized to investigate “any links and/or coordination between the Russian government and individuals associated with the campaign of President Donald Trump.”
- The median length of prior special/independent counsel investigations is 668 days.

Presidential Impeachments and Resignations are Rare

1. Impeachment Process

The Constitution allows for the president to be removed from office for treason, bribery, or “other high crimes”

The House: 1) Investigates claims of wrongdoing
2) Votes for/against impeachment and proceeds based on a majority vote

The Senate directs the trial of impeachment with the Chief Justice of the Supreme Court presiding. A conviction requires a two-thirds supermajority.

Possible Verdicts: 1) Acquitted
2) Censured
3) Guilty → VP becomes president

2. US Presidents who Left Office Early

President	Year	Reason
William Henry Harrison	1841	Death
Zachary Taylor	1850	Death
Abraham Lincoln	1865	Death (assassination)
James Abram Garfield	1881	Death (assassination)
William McKinley	1901	Death (assassination)
Warren G. Harding	1923	Death
Franklin D. Roosevelt	1945	Death
John F. Kennedy	1963	Death (assassination)
Richard M. Nixon	1974	Resignation

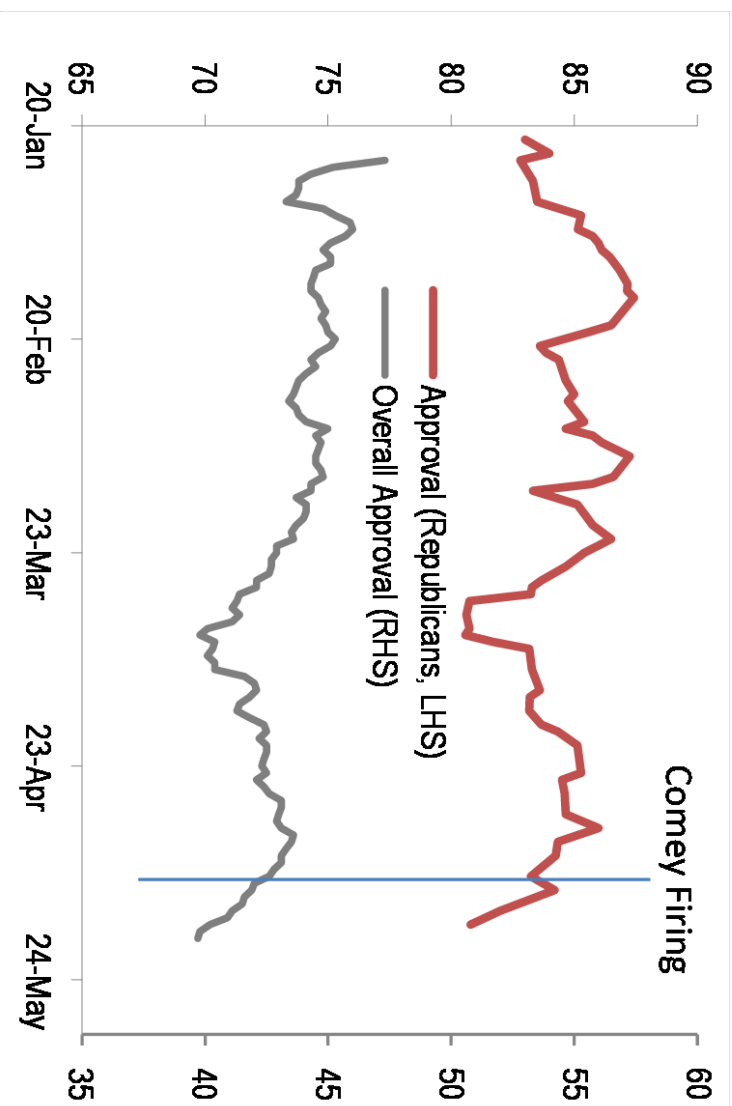
- “After watching the Clinton impeachment I thought I’d never see another one, but I think we’re in impeachment territory now for the first time.” – *David Gergen, former advisor to Presidents Nixon, Ford, Reagan, and Clinton, May 16, 2017*
- Of the nine presidents who left office early, eight died in office and Nixon resigned during impeachment proceedings.
- The House of Representatives has only impeached two presidents (Bill Clinton and Andrew Johnson), but both were later acquitted by the Senate and completed their terms.¹

(1) In both instances the Republican Party controlled the House and Senate.

Source: Investment Strategy Group, US Constitution, US Senate, *New York Times*, UCSB: The American Presidency Project, CNN.

How Much Influence Does President Trump Have Left?

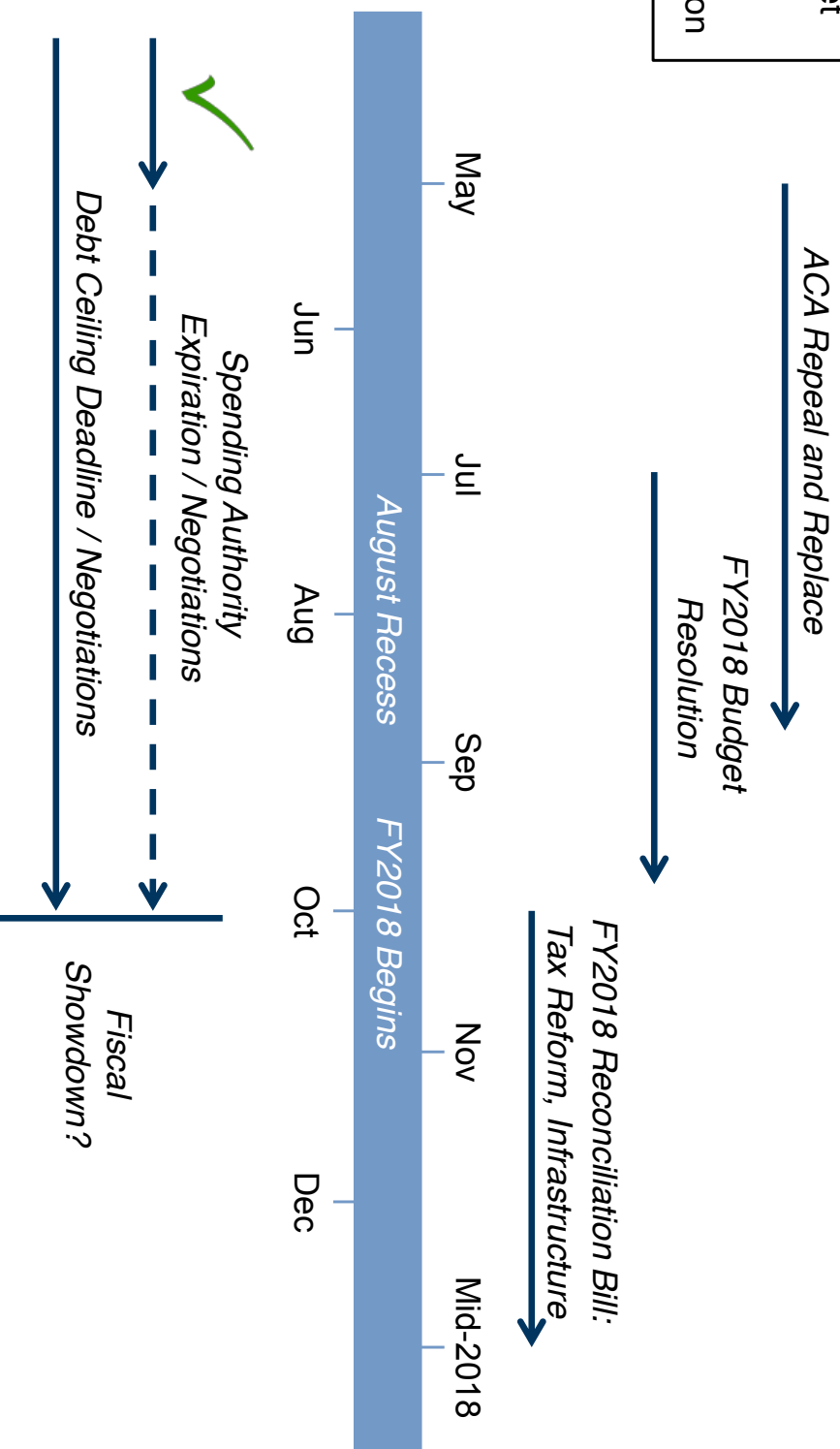
President Trump Job Approval Rating



- Republican support for President Trump, while resilient in the face of historically low overall approval ratings, appears to have weakened in recent weeks.
- To what degree will congressional Republicans look to the White House for leadership on the legislative agenda?

2017 Timeline: Intricate Sequencing

- Elements of the
Budget Process
- White House Budget
 - Budget Resolution
 - Reconciliation
 - Continuing Resolution

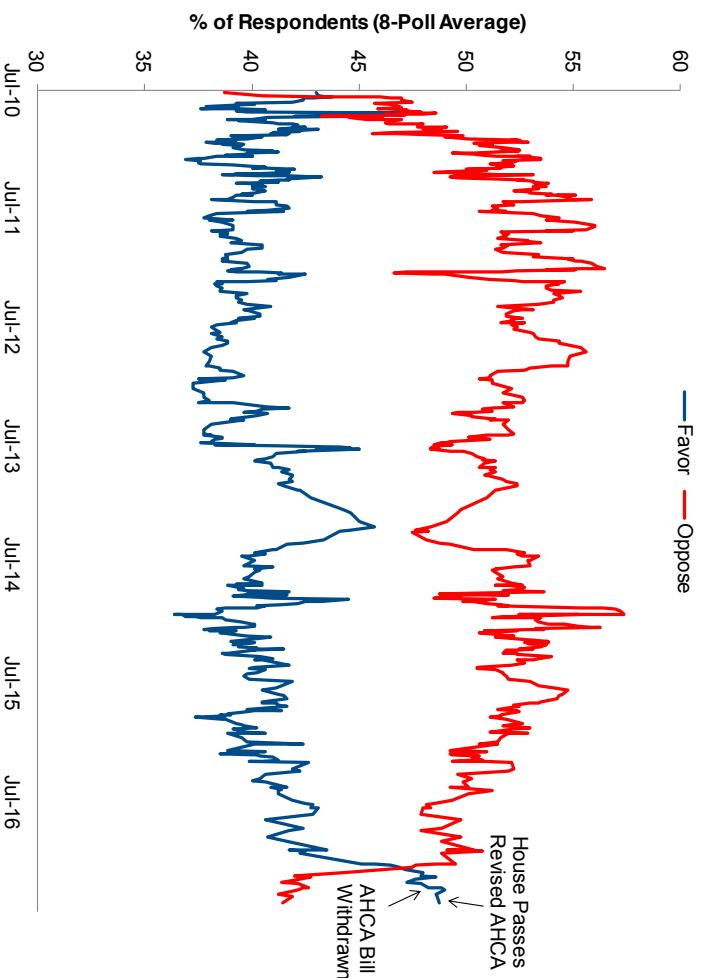


Note: Illustrative timeline. The US 2017 fiscal year ends on September 30, 2017.

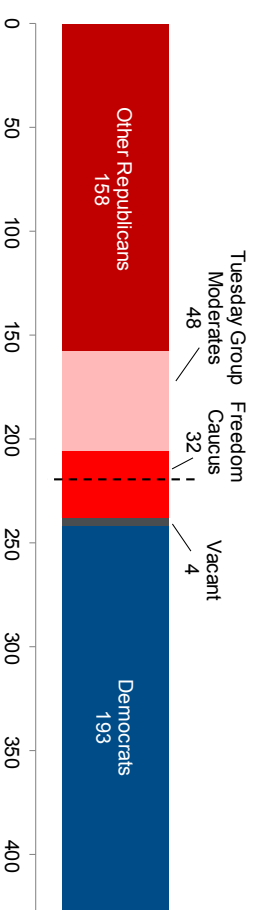
Source: Investment Strategy Group, Goldman Sachs Global Investment Research, US Treasury, Congressional Budget Office (CBO).

ACA Repeal & Replace: Back to the Front of the Line

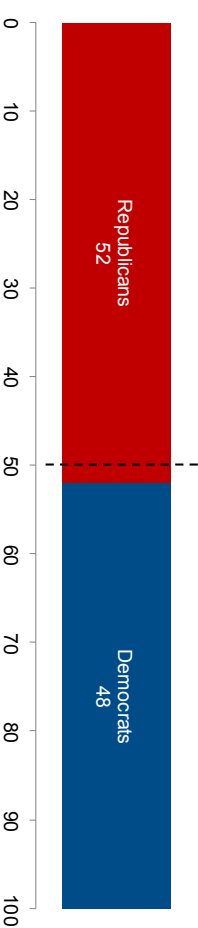
1. Public Approval of Affordable Care Act ("Obamacare") – Since July 2010



2. US House of Representatives Composition



3. US Senate Composition



- After withdrawing a first draft of AHCA in late March, House Republicans passed a revised version on May 4th, sending the bill to the Senate for deliberation.
- What will be the key points of negotiation as the Senate crafts its own version of the bill? Is the House likely to accept changes?

Tax Reform: Resetting Expectations

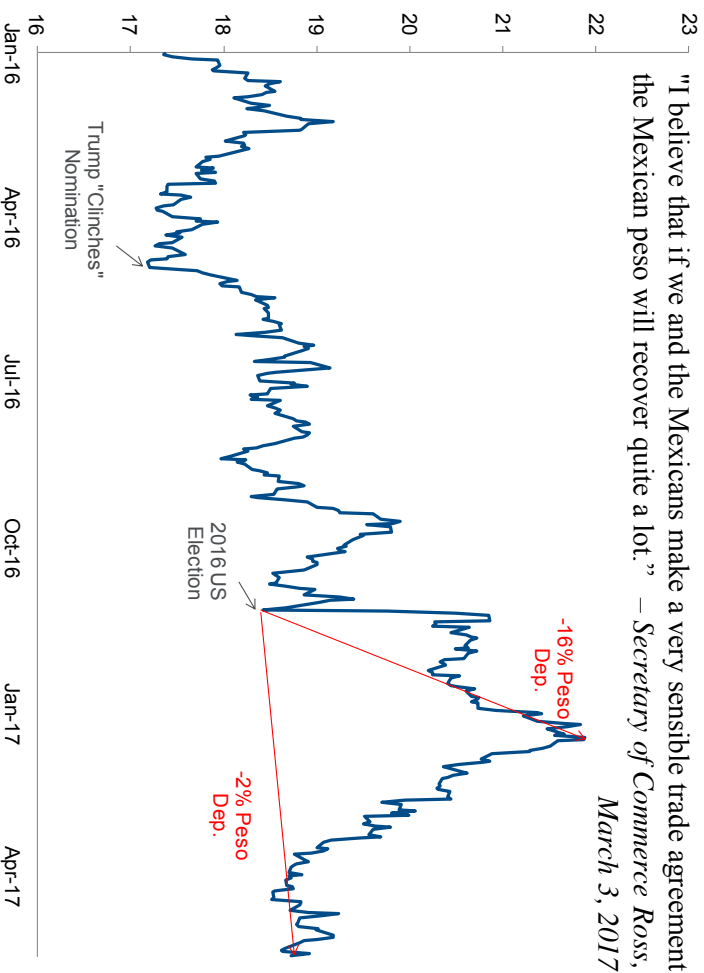
Federal Tax Proposals

	Current	House Republicans	Latest White House Proposal (April 26)
Income (Top Tier)	39.6%	33%	35%
LT Capital Gains	20%	16.5%	20%
– ACA-Related	3.8%	0%	0%
Corporate	35%	20%	15%
– Foreign Income (minus foreign tax credits)	35%	Territorial System	Territorial System
– Treatment of Imports/Exports	N/A	Border Adjustment Tax	No Border Adjustment Tax
– Repatriation (minus foreign tax credits)	35%	8.75% on cash, 3.5% otherwise	Repatriated earnings would be taxed at a "competitive rate"

- GIR recently lowered expectations for fiscal policy changes over the next year and revised tax cut expectations from \$1.75 trillion over 10 years to \$1 trillion.

Pricing of President Trump's Trade Policies

1. Mexican Peso vs. US Dollar – Through May 19, 2017



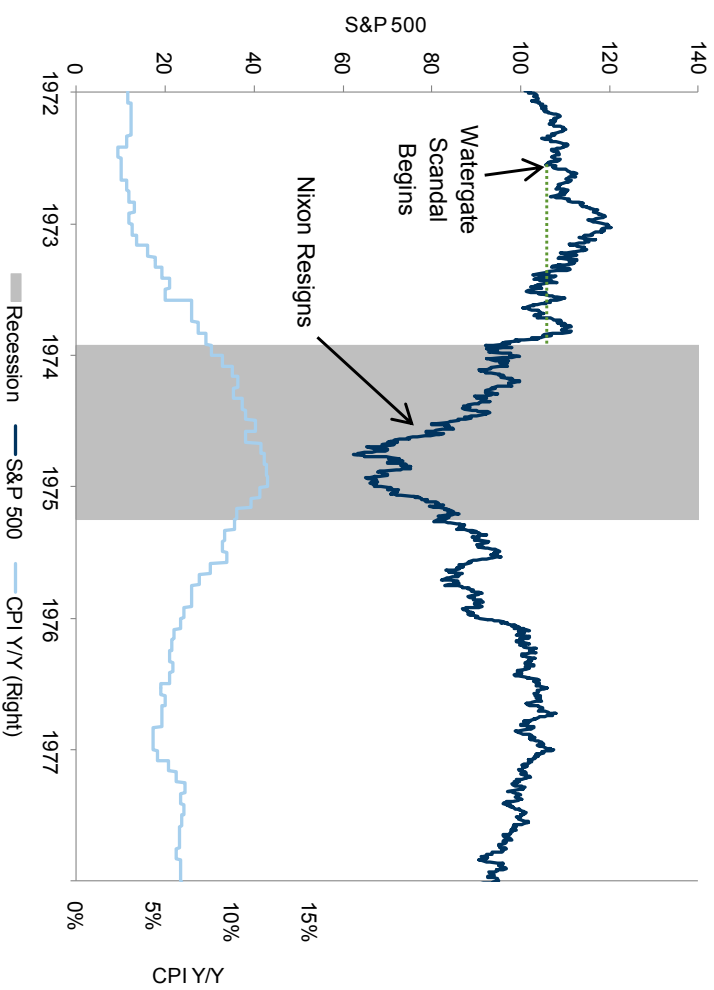
2. Potential US NAFTA Negotiating Issues

Controversial	Relatively Non-Controversial
A level playing field on tax treatment, possibly a reference to border-adjusted VATs in Canada and Mexico.	Eliminating non-tariff barriers.
Changing rules on government procurement to give an advantage to US firms.	Strengthening NAFTA rules-of-origin to keep Asian goods out of supply chain.
Allowing reciprocal tariffs in cases where domestic entities are harmed.	Improving customs enforcement.
Eliminating NAFTA's Chapter 19 dispute settlement.	Strengthening protections for intellectual property.
	Creating rules for market access for services and investment.
	Adding a digital trade chapter.
	Policy updates on regulatory reform, anti-corruption, competition, and SOEs.

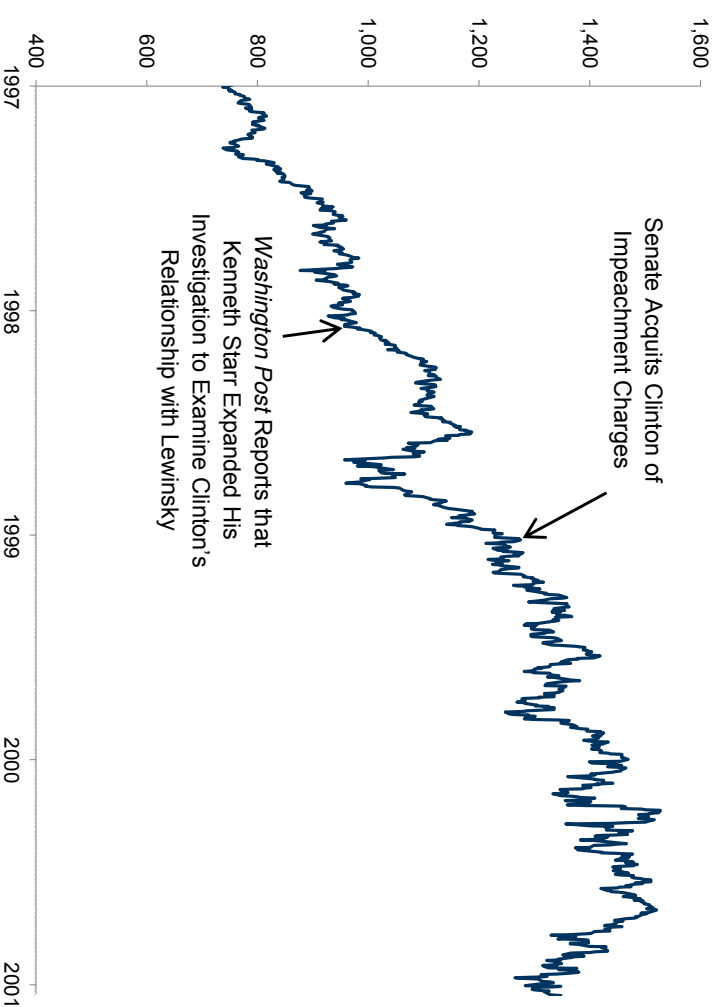
- The Mexican peso no longer incorporates meaningful risks from trade disputes with the US.
- A trade war is not our base case scenario → “trade friction” is more likely, according to Myron Brilliant of the US Chamber of Commerce.
- If the probability of tax and health care reform has declined, is the probability of aggressive trade policies higher?

Historical Analogs Argue the Economy Trumps Politics

1. S&P 500 Closing Price and Consumer Price Index (YoY) : 1972–1978



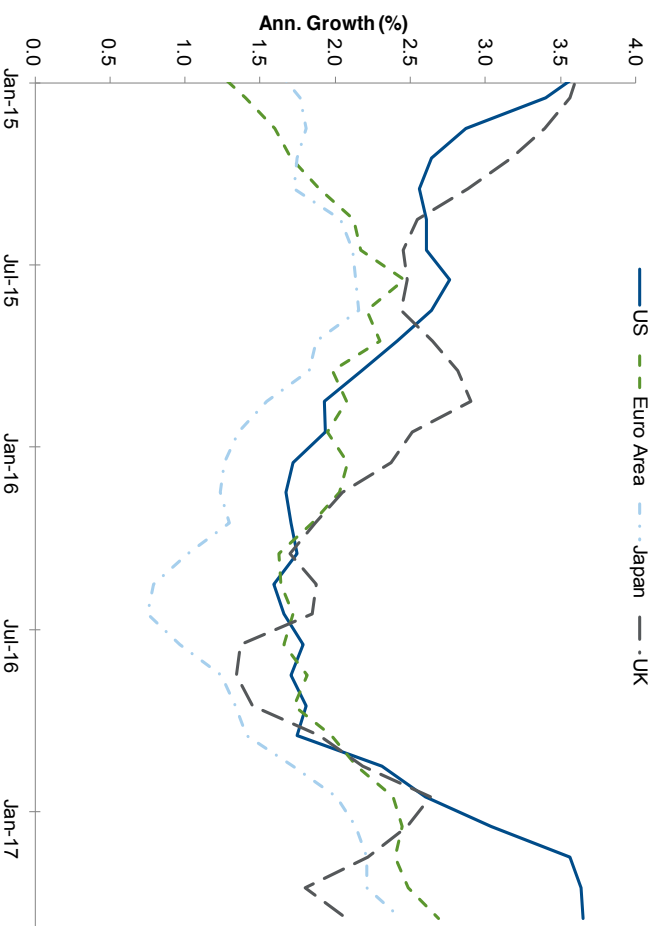
2. S&P 500 Closing Price: 1997–2001



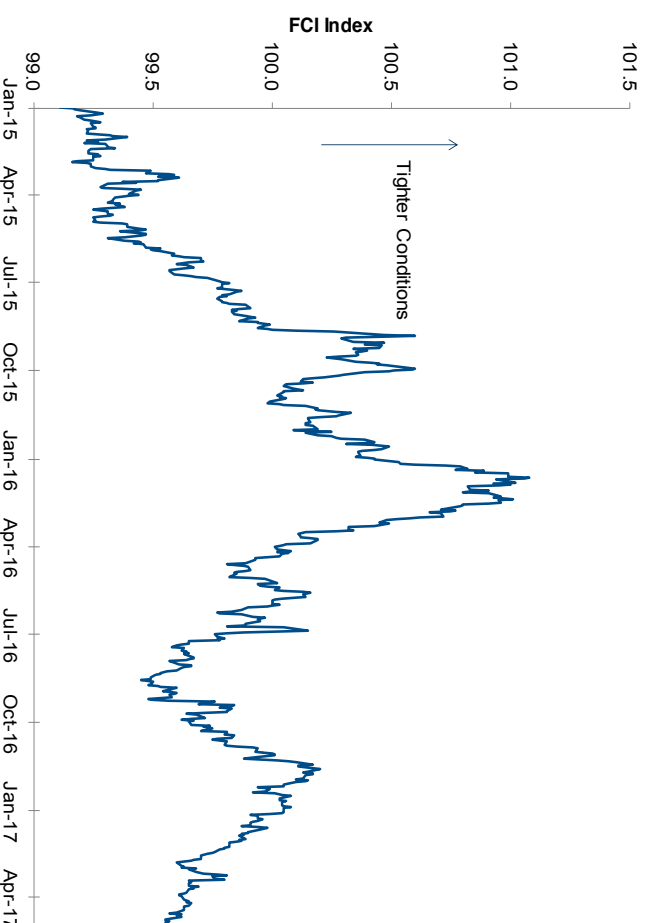
- **Nixon Impeachment:** A US recession and spiraling inflation, not the Watergate scandal, led to the 40% market decline in the early 1970s. In fact, the S&P 500 spent the majority of the year and a half after the scandal broke at higher levels.
- **Clinton Impeachment:** The S&P 500 gained 24% on the back of accelerating GDP growth and falling unemployment during the Clinton / Lewinsky scandal, which began in Jan. 1998 and ended with his Senate acquittal in February 1999.

Global GDP Growth is Accelerating

1. Goldman Sachs Current Activity Indicators (3-Month Average)



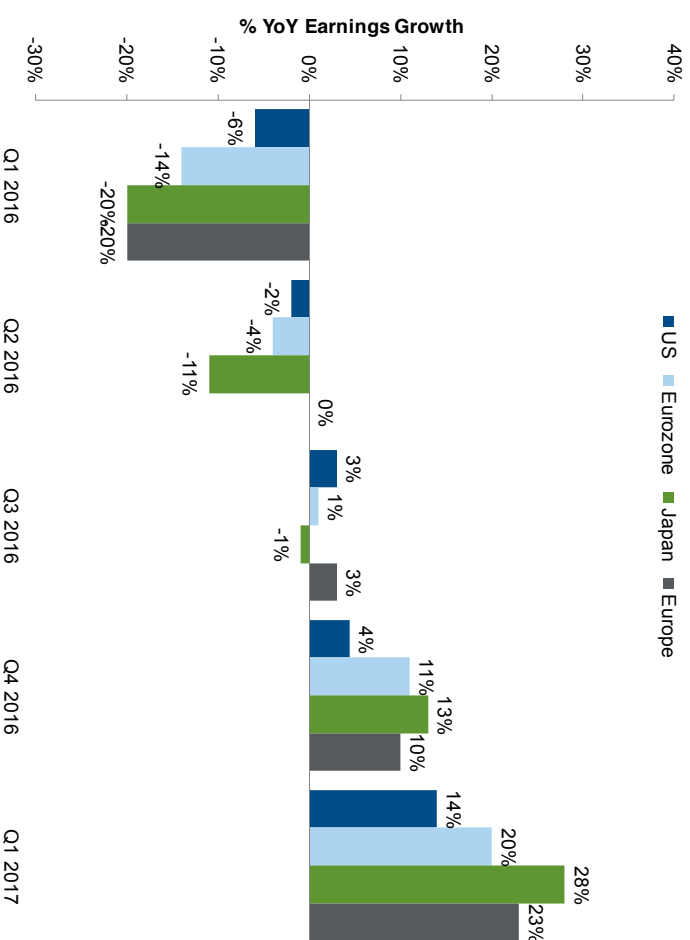
2. Goldman Sachs GIR Financial Conditions Index



- Global GDP growth has accelerated and is broad-based. In fact, for the first time since 2010, no G20 country is forecast to have negative GDP growth this year.
- As discussed on last week's ISG call, better-than-expected economic data has resulted in upward revisions to some of our 2017 GDP growth ranges, including for the Eurozone and the UK, and likely for Japan as well.
- The recent easing in financial conditions and improvement in leading indicators suggest robust growth momentum should continue.

In Turn, Earnings Growth Has Accelerated Globally

EPS Growth for Major Developed Equity Markets (%YoY)



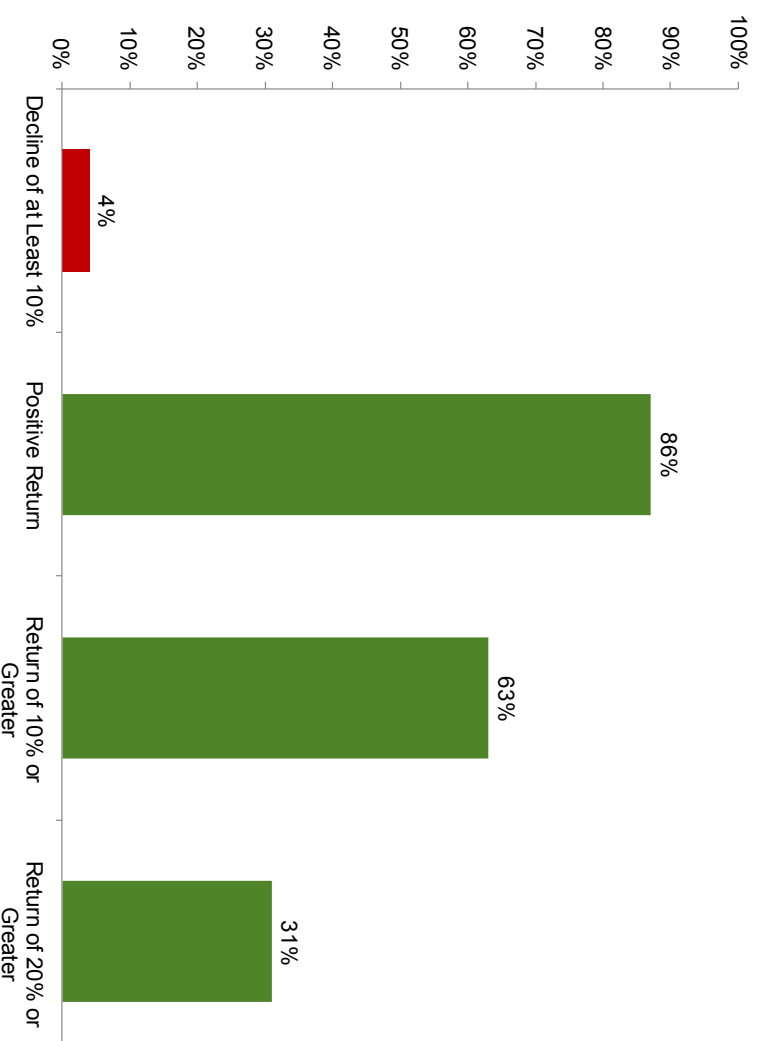
- Better GDP growth has translated into better earnings growth, with a broad-based acceleration across developed markets in each of the last two quarters.
- The market ultimately follows the path of earnings.

The Odds Favor Remaining Invested During an Expansion

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Probability of Various One-Year Total Returns During Economic Expansions
Based on Post-WWII Data



- The state of the US economy is a key driver of market performance, with high odds of positive returns and a low probability of large losses during past non-recessionary periods.
- In fact, nearly 3/4ths of bear markets¹ have occurred during US recessions.
- There is clear upside bias to returns as well, with nearly 2/3rds of one-year total returns exceeding 10%.
- We assign a 10% probability of a recession occurring in the remainder of 2017.

(1) Defined as recession 12 months prior or 1 month after decline of 20%.

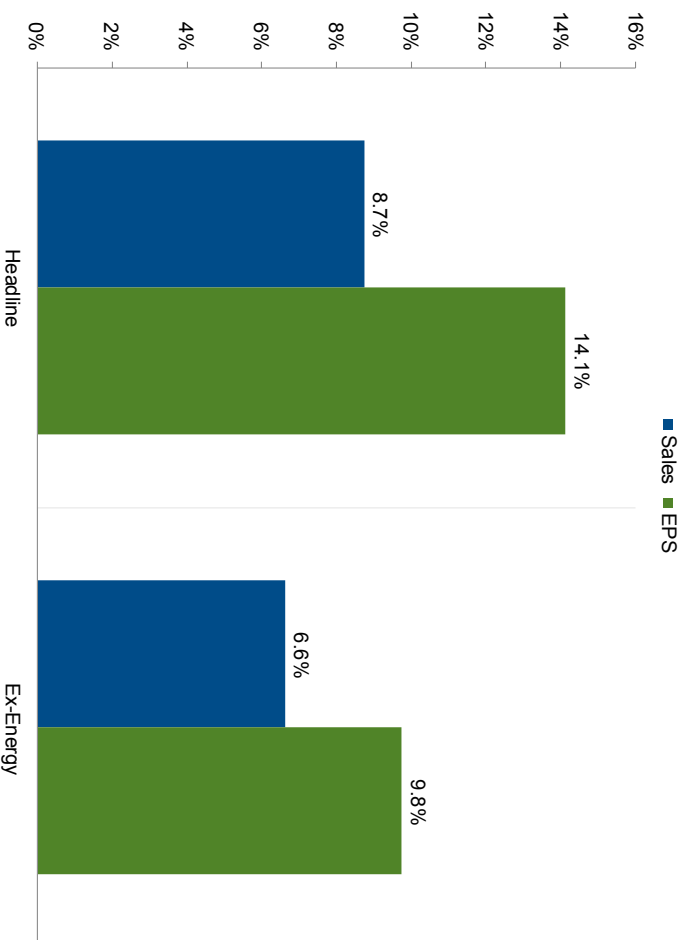
Source: Investment Strategy Group, Haver Analytics, Standard & Poor's, Bloomberg.

Earnings and Valuations Are a Source of Upside Risk to Our Base Case

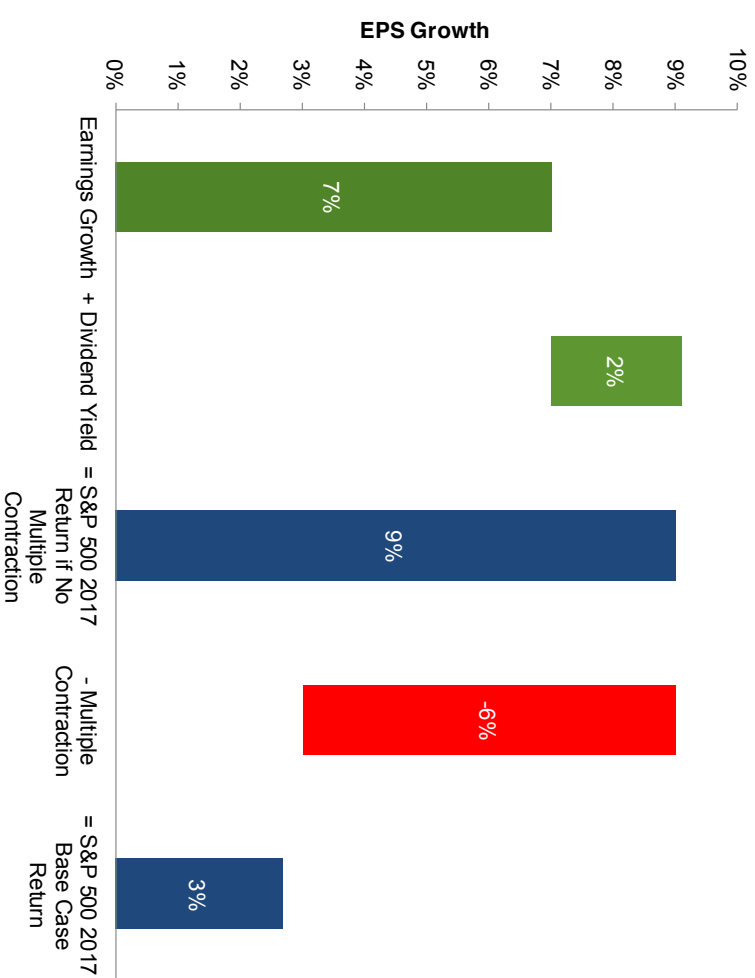
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1. S&P 500 Reported Sales and Earnings Growth for Q1 2017



2. Base-Case S&P 500 2017 Return Decomposition



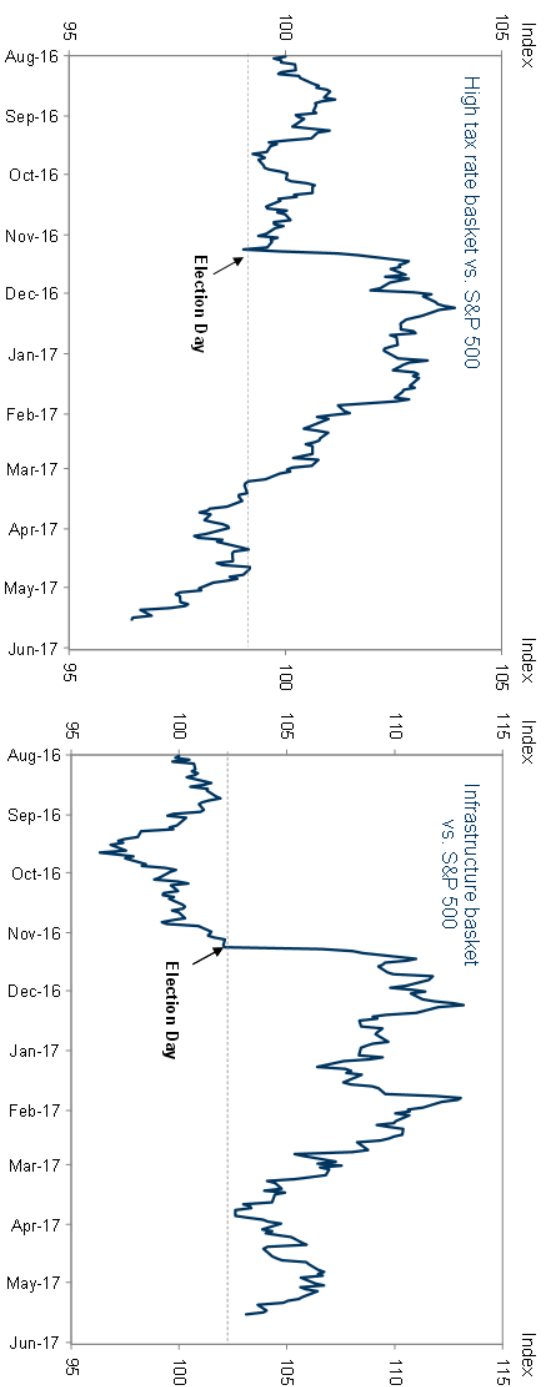
- First-quarter results exceeded expectations by 6 percentage points, putting headline yearly earnings growth in the double digits and even ex-energy growth close to that mark.
- These strong results pose upside risk to our 7% earnings growth forecast for 2017.
- In fact, if the Q1 growth rate were sustained it could fully offset the assumed valuation multiple contraction in our forecast, which is itself a source of potential upside should interest rates remain lower than we expect.

Financial Markets Have Priced Out Policy Upside, Lowering the Risk of Disappointment

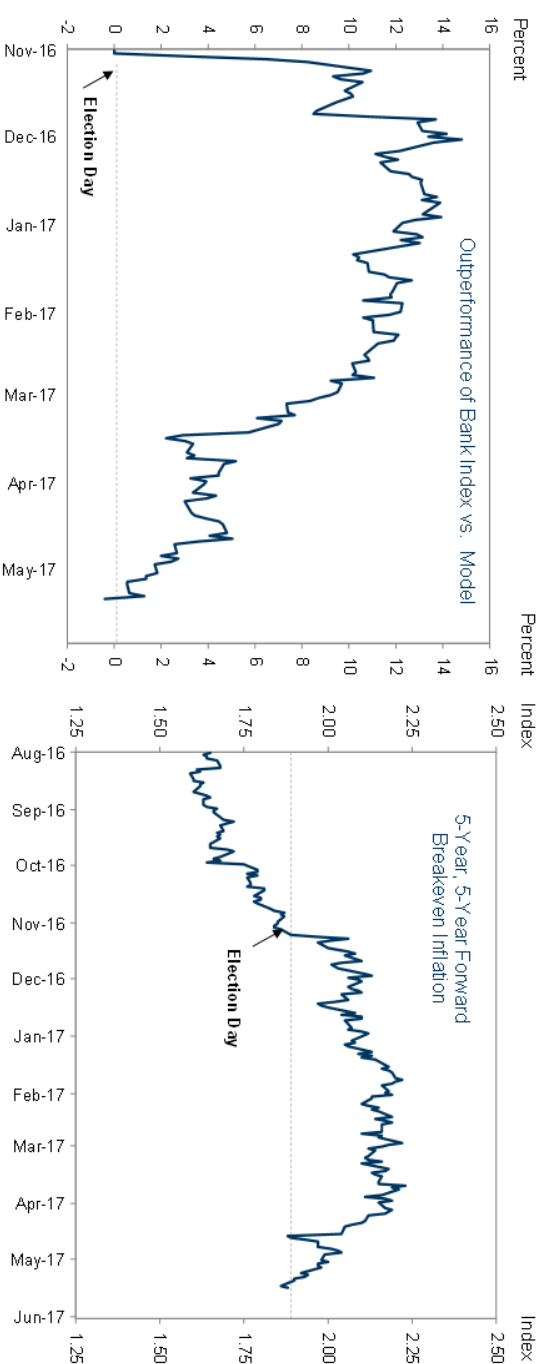
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Change in Equity Relative Value: Nov 8, 2016 – May 18, 2017



- Market expectations of policy changes have returned to pre-election levels or lower.
- This is true for both specific policy changes (e.g. tax cuts, infrastructure spending, bank regulation) as well as expectations for broader macroeconomic effects (e.g. reflation).
- As a result, any tangible progress on pro-growth tax reform/cuts or deregulation could represent a source of market upside going forward.



- Investigations of the Trump campaign and White House will likely extend into 2018.
- History suggests that President Trump is unlikely to resign or be impeached: only one president has ever resigned, and Congress has never removed a president.
- The probability of President Trump leaving office early would increase, however, if clear evidence of a serious crime emerges, or if Democrats win control of the House and Senate in 2018.
- Progress on health care reform and tax reform will be slower than previously expected, and the probability of passage has declined in both cases.
- Even so, these developments do not change our core investment recommendations because:
 - Recent political uncertainty is not likely to undermine the above-trend economic growth and earnings momentum discussed.
 - Scope for policy disappointment appears limited, as market expectations of policy changes have returned to pre-election levels or lower.

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