TrendMacrolytics

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POLITICAL PULSE

Going for Broke?

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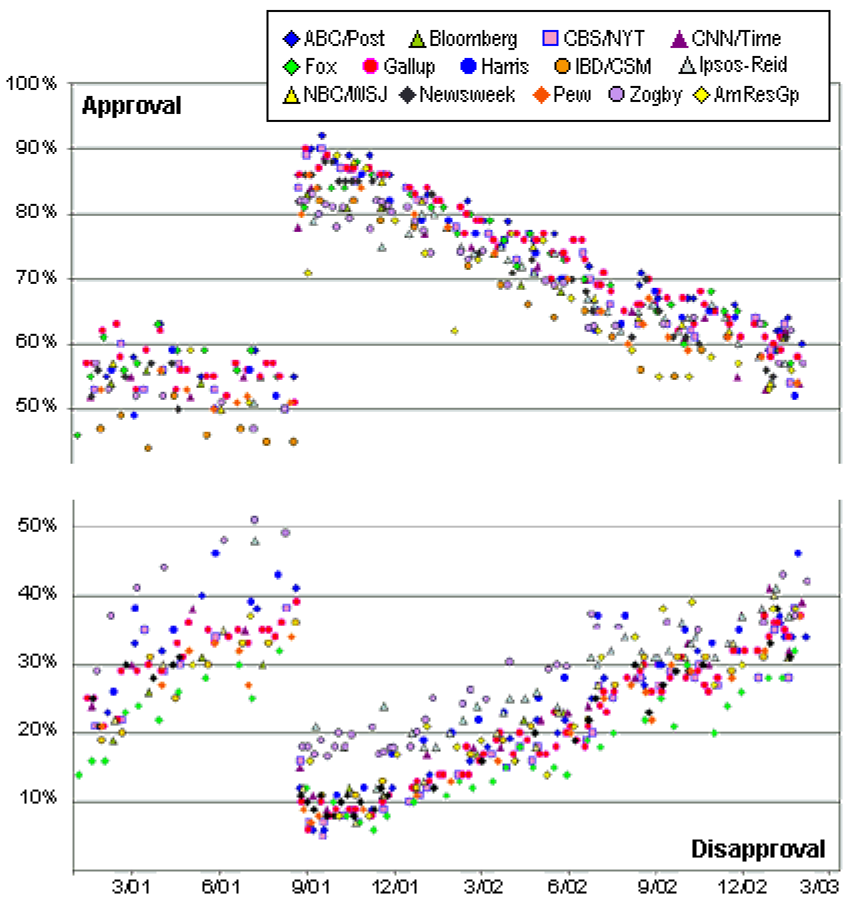
The paradox of Bush's strategy is that he's ramping up political risk as his approval ratings decline.

Over the last several weeks, my colleague **David Gitlitz** and I have tried to explain exactly how the prospect of war with **Iraq** is playing into equity market dynamics -- without getting sucked into the loser's game of asserting that *"war is good for stocks"* or *"war is bad for stocks,"* leaving us obliged to explain every little wiggle up or down as a function of shifting beliefs that *"the war is on!"* and then the next moment *"the war is off!"* In our model war in Iraq is not, in prospect, inherently good or bad -- it a *risk* factor, not a *return* factor.

We continue to believe, abstracting from the risks of war, economic recovery is plodding along as well as it ever has -- nothing terribly exciting, but stronger than the pervasive mood of gloom and apprehension would suggest. Continued strong relative performance from high-yield bonds and technology stocks indicates that the likelihood of a double-dip recession is very small. So what explains a stock market stalled out at levels that offer near-historic risk premia? It's *uncertainty* pure and simple -- an unusually wide forecasted distribution of outcomes associated with a possible war, including very positive ones and very negative ones impacting not only military contingencies, but everything from regional stability to international cooperation to the effectiveness of the **Bush administration**.



Adding to the risks of war is the fact that President Bush faces those risks with approval ratings that have fallen back to almost the same levels that prevailed before 9/11. More important for this analysis, his *disapproval*

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ratings have *already* matched -- and are now even beginning to exceed -- their pre-9/11 levels. It was said that last November's mid-term elections were a referendum on Bush, and that he won big -- but you'd sure never know it from the trends in these numbers. To be sure, presidents have won decisive electoral victories with lower *absolute* approval ratings than these, but the relentless trend from the peaks of 9/11 must certainly be a grave concern to Bush.

Throughout much of last year, when Bush was still immensely popular, we interpreted Bush's generally passive approach to most policy issues as being "sticking with a pat hand" -- why should he take risks when his approval ratings are already so high? But over the last six months as his ratings have eroded, Bush seems to have decided he had better draw some cards -- lots of them. The initiative against Iraq has been accelerated and enlarged to the point where, with Wednesday's speech, it has now blossomed into a vast nation-building enterprise -- no, make that *region*-building. And after two years of somnolence, the protean Bush economic team introduced the most sweeping tax-cut package since the **Reagan administration**.

If Bush can pull it all off, it will be a beautiful world. But as **Dan Quayle** said, "If we don't succeed, we run the risk of failure." In this case failure involves some pretty grisly scenarios. As we've said before, it's a distribution with very fat tails.

A troubling implication in this -- and perhaps what infuses this moment in history with such a heightened sense of anxiety -- is that an important "agency problem" may have evolved between Bush and the electorate that he serves. An ideal agency relationship would be one in which the *amount* of risk taken by the leader corresponds to the *demand* for risk expressed by the electorate in the form of its approval of him. People are generally more comfortable having risk taken on their behalf by leaders they *approve* of. Yet just the opposite principle seems to be in operation now. When Bush enjoyed broad support, he took no risk. And now that his support has significantly eroded, he's taking lots of risk.

It must be said that there are several ways we could interpret the cause-and-effect relationships here. One way would be to posit that the reason Bush's support eroded in the first place is that he took too little risk with his mandate. If that were the case, then Bush's taking more risk now would be an appropriate response to negative feedback about that deficiency. We would expect then, as more risk were taken, that we would see Bush's support *increasing*. But that's manifestly *not* what we are seeing.

Thus we are forced to consider another interpretation -- that the new scope of risk being taken is Bush's attempt to "go for broke." The theory would be that while the particular risks being taken may not be approved of by the electorate during the time they are being taken, nevertheless the electorate will richly reward Bush for a strongly positive outcome *if* he's able to deliver one. And with his approval numbers headed where they're headed... what does he have to lose? If he wins, he's king. If he loses, it's just back to the hanging chads where he started anyway.

But there are severe practical problems with the "go for broke" strategy in game-theoretic terms, especially when it is played with other people's money. Such a strategy entails ever-mounting costs in anxiety that will be counted against any eventual rewards for winning the gambit. If it drags on long enough, the accumulated anxiety of Bush's taking more risk than his approval ratings can support will outweigh any eventual gains. And *that* engenders a further risk -- that to overcome the mounting costs, the player using the "go for broke" strategy will raise the stakes again and again, and become even less popular with the people who are putting up the stakes.

So the market watches the clock, and lives with an enormous irony. Truly good things are in prospect -- a Middle East liberated from weapons of mass destruction, oil supplies stabilized, terrorism risk reduced, massive pro-growth tax cuts. But this is a tough game against expert opponents, and Bush is far from a perfect player. With each passing day both the scope of what is trying to be achieved -- and the anxiety about trying to achieve it -- go up. Every day it seems there's another mission statement to rally support that never materializes. Another protest march. Another member of the economic team leaves. Another weapons report. Another *new* member of the economic team whose past convictions aren't consistent with Bush's tax-cut plans. Another drop in approval ratings.

There's still time for "go for broke" to pay off -- while there's any support left, and while the scope of ambitions are still within the realm of the possible. But the window of feasibility won't last forever. The market needs this to be over. And *that's* the nature of the risk now. TM