Donald Luskin, Chief Investment Officer
David Gitlitz, Chief Economist
Thomas Demas, Managing Director

POLITICAL PULSE

Iowa -- Who's Upset?

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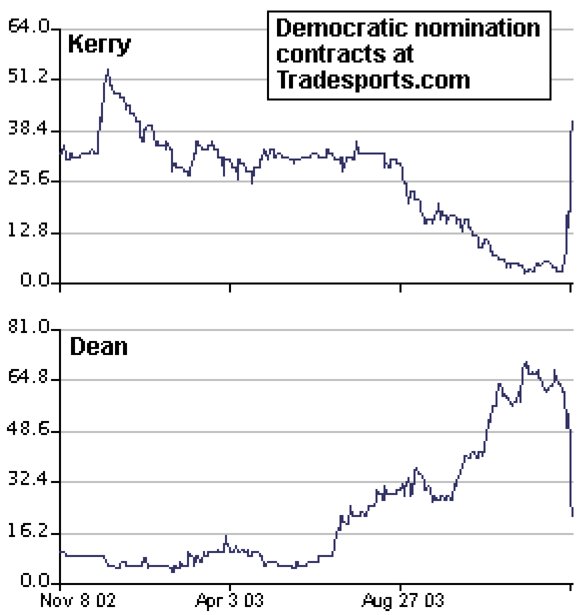
Donald Luskin

Kerry's Iowa surprise changes the market's perceptions of electoral risks for the economy.

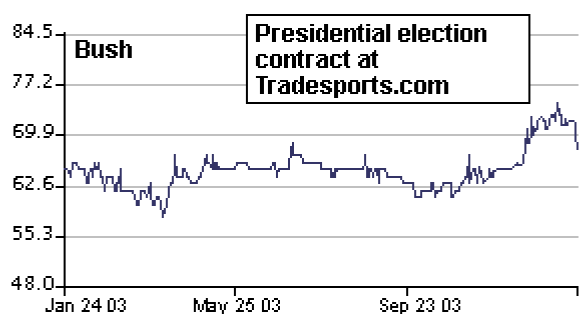
Equity markets have moved to new recovery highs in the wake of Monday night's surprise defeat of **Howard Dean** in the **Iowa Democratic** caucuses. This suggests a subtle but important shift in the distribution of outcomes for the November election's impact on the economy.



First, there is hard evidence that the Iowa win by **John Kerry** really was a surprise, reversing in a moment months of declining probability of his nomination. Kerry's win came entirely at the expense of Dean's chances.

The charts at left shows the value of actively traded futures contracts on Kerry's and Dean's nomination chances, respectively, listed at **Tradesports.com**. The contracts settle after the Democratic convention, with the winning candidate's contract at par and all the others at zero. Therefore, the price of a candidate's contract today, expressed as a fraction of par, can be understood as the expected probability of that candidate winning the nomination. You can track these and other political contracts at [Tradesports.com's website].

Kerry's surprise win lowered the probability of **President Bush's** re-election, as reflected in a visible drop in his Tradesports.com election contract shown in the chart at right. It is unambiguous that the market sees Kerry as a more dangerous competitor for Bush than Dean. Apparently the Democratic primary process is homing in on putting forth the party's best candidate.



We take it as nearly axiomatic that the stock market would prefer to see President Bush re-elected rather than any of the Democratic field, all of whom have vowed to reverse Bush's pro-growth tax cuts. So how should we understand the market's positive tone this week in light of the downtick in Bush's re-election probability?

http://www.trendmacro.com
don@trendmacro.com
dgitlitz@trendmacro.com
tdemas@trendmacro.com

Offices:
Menlo Park CA
Parsippany NJ
Stamford CT

Phone:
650 429 2112
973 335 5079
203 322 1924

As we see it, while Dean would be an easier opponent than Kerry for Bush to beat, a Kerry/Bush match-up is nevertheless a better one for the stock market in risk-adjusted terms. After all, in a Dean/Bush match-up there would always be some chance, however remote, that Dean might win -- and that would be a death warrant for the economy. Kerry has a higher (but still low) chance of winning, but the economic damage of a Kerry win would be far less. In other words, the tails of the distribution with Kerry are not as fat.

It is also probably the case that a Kerry campaign would probably be less divisive and acrimonious than a Dean campaign. So while a Bush win against Kerry is somewhat less likely than a win against Dean, it would be a "higher quality" win -- leaving Bush in a better position to implement a pro-growth agenda in his second term.

Additionally, there are two other messages from the Iowa caucuses that are good news for the economy. First, Dean's defeat suggests that the "angry liberal" movement focused on "taking back America" doesn't have a lot of traction. This pushes lower the already low probability that the **Republicans** could lose control of **Congress**, and indeed supports expectations for gains in the **GOP's** majorities in the **Senate** and the **House**.

Second, **Richard Gephardt's** Iowa blow-out suggests that the power and influence of labor unions today may be less than has been previously thought (see "TrendMacro Talking Points: Unions" January 21, 2004). This bodes well for reducing the role of protectionist appeals in the campaign and in **Bush administration** policy deliberations.

For all this, it cannot go unsaid that the market is not being moved exclusively by electoral prospects. Just as important this week, at the margin, has been the marked re-acceleration of S&P 500 forecasted earnings growth, following three months of decline. Yes, this is continuing evidence of robust economic recovery, and is all to the good. At the same time, we remain as concerned as ever that **the Fed** is inducing a new round of inflation. It is no coincidence that the re-acceleration in S&P earnings growth is being led by faster growth in the inflation-sensitive energy and basic materials sectors, while tech has notably stalled out.