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MACROCOSM

Summer of Our Discontent

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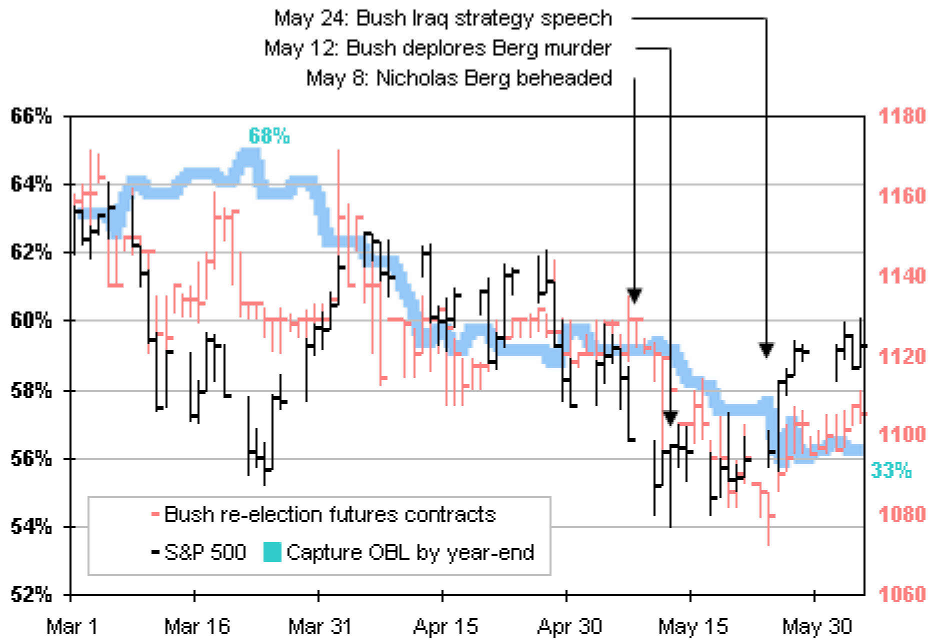
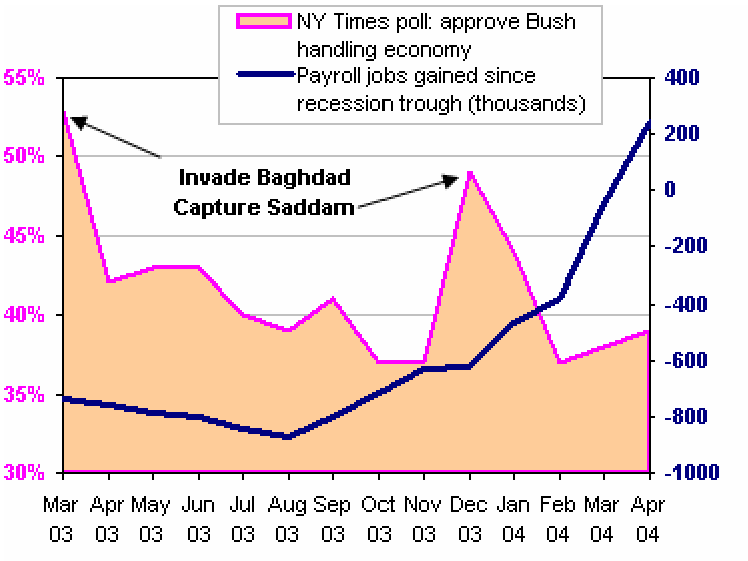
Equities are hostage to resolution on inflation and the election.

We've often looked at the strong correlation between the stock market and **President Bush's** re-election probabilities. We've argued that the market wants to see the extension of Bush's pro-growth tax policies, and that this year's pullback has corresponded to diminished expectations that Bush will be re-elected.



The market's recovery from its May 12 lows has corresponded perfectly to a revival of Bush's chances, as the president has re-emerged on the public stage after several weeks of relative isolation while developments in **Iraq** worsened. The gruesome murder of **Nicholas Berg** occurred on May 8, and it was not until three days later -- on May 12 -- that Bush made a statement about it. The end of his conspicuous silence marked the bottom. Then on May 24, Bush made the first of several scheduled major speeches on **US** strategy in Iraq. The next day the S&P 500 turned in its biggest day on the upside all year.

For the last three months the market and the president's re-election probabilities have tracked America's perceived progress in Iraq, and in the war on terror. The chart above demonstrates this by superimposing the S&P 500 on futures contracts on Bush's re-election probability, and on contracts on the probability that **Osama bin Laden** will be "neutralized" by year-end (both contracts trade online at **Tradesports.com**). Bush, the market, and the war on terror seem to be sharing a single lifeboat. But there are many ways that the lines of causation might run. The market surely wants Bush re-elected, and at the same time Bush's re-election chances are enhanced when the market is higher. Bush's chances are also enhanced by both real and perceived success in the war on terror, and at the same time the market responds positively to prospects of a world with less risk of terrorist attacks.

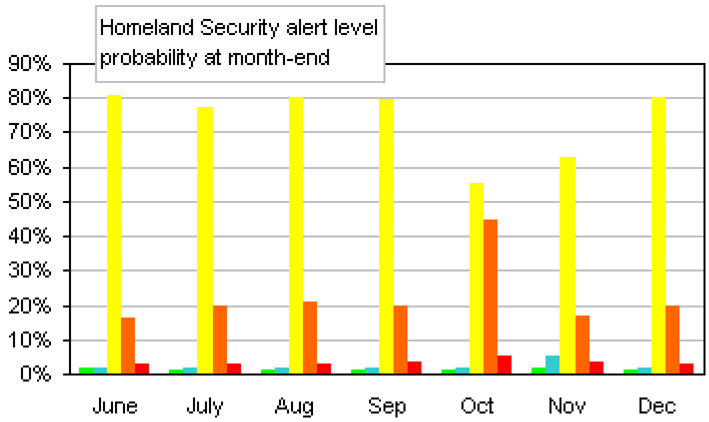


Another way of looking at the nexus of the election, the war on terror and the market is to look at voter attitudes about Bush's handling of the economy. Polling data shows that those attitudes have nothing to do with the economy at all, as they have trended lower consistently while the economy has consistently improved. Approval levels spike during periods of high confidence in the progress of the war in Iraq. It would appear that voters have conflated feelings of confidence in the war on terror with confidence in the economy.

This is all a very real concern for the market at this juncture, because economic growth is the product of the willingness to bear risk -- and the willingness to bear risk is, almost by definition, a function of confidence. We are already concerned by the potential blow to confidence that may come shortly if **the Fed** doesn't act decisively to rein in the inflation that it has created by staying too accommodative for too long (see Friday's "High Risk for High Yield"). We are also concerned that the pre-election political environment is corrosive to confidence, both because no clear-cut winner is emerging and because the tone of political discourse is so bitterly polarized. A year ago -- when the preconditions were being laid for twelve months of record growth -- economic decision-makers had much greater confidence than they do today about what their future tax and regulatory environment would look like. Based on that confidence, they took risks that have resulted in profits, productivity and job creation. The twin uncertainties of a Fed that is blind to the inflation risk it has unleashed, and an unpredictable political process that could yield sharply divergent tax regimes suggest that the next several months will be frustrating ones for equities. It's going to be difficult for stocks to do much more than move back up through the year's trading range, and growth stocks will have the hardest time of all.

But if a clear winner were to emerge -- especially if it's Bush -- then we would see a reactivation of the bull market that was put on hold late in the first quarter. What could happen that would permit Bush to establish dominance? The economy is certainly on his side, and econometric election forecasting models like that of **Yale's Ray Fair** suggest that the economy will be enough. But the voter polling data mentioned above suggests that Bush's victory may well depend on factors that are only partially under his control.

Clearly, apprehending Osama bin Laden would be a lottery win. But more mundane -- and entirely likely -- success could turn the tide, and probably will. An on-schedule transfer of power in Iraq, and the conviction that the interim sovereign government (working with allied troops) is executing well on a coherent strategy -- even if there is the occasional setback -- would work wonders. When that happens, then the reality will be that after little more than a single year and fewer than 1,000 American casualties, we will have reasonably successfully pacified a large and hostile nation and turned it on the road to independence and legitimacy.



A wild card is the possibility of a terrorist attack on American soil before the election. After the **Madrid** bombings days before **Spain's** presidential elections, the upcoming US elections would seem to be an obvious time. Heightened risk before the election is confirmed by the futures contracts on **Department of Homeland Security** color-coded alert levels that trade on line at **Tradesports.com**. For most months through the end of this year, the futures assign an 80% probability to the status quo -- yellow alert (yellow means "elevated" alert, and is the level that has been in place most of the time since the system was introduced), and 20% probability to a more severe orange alert ("high"). But in October, the month before the election, the probability of a yellow alert is only 55%, and orange is 45%.

It's interesting that in October red alert ("extreme") is assigned a probability of only 5% (the probabilities don't sum to 100% because of bid/offer spreads). That's noticeably greater than the probability of red in other months, but still small -- as though the market is forecasting the greater *risk* of a terrorist event in October, but not the *reality* of it. Or perhaps the market isn't forecasting a terror event at all, but rather only that the Department of Homeland security will hike the alert level before the election as a grandstand gesture to help **President Bush's** re-election chances. Either way, this evidence from the futures market should not be seen as a *strong* prediction of a pre-election attack.

If an attack should come, our guess is that it would strongly catalyze support for the incumbent president, at least through the election. Assuming that the attack doesn't involve vast loss of life or damage to economic infrastructure, it would probably end up being a net positive for the market (after what would no doubt be a strong initial shock).

We believe that the market already contains a significant risk premium for another attack. As of yesterday's close, the S&P 500 was only 2.1% higher than its close on September 10, 2001, the last day that the World Trade Center towers stood -- and still months before the **Enron** and **Worldcom** scandals broke. Yet gross domestic product has grown by about 10%, and S&P 500 forecasted earnings have grown by about 28% since then (and are probably more honest).

For stock prices to have essentially ignored a 20% increase in forecasted earnings -- against a backdrop of Treasury yields that are virtually unchanged since then -- there has to have been an important shift in valuation. Indeed, according to our valuation model, the S&P 500 was about 6% overvalued on September 10, 2001. Even with the economy still in deepening recession, the bloom was not entirely off the so-called bubble. Today the same model shows the S&P 500 about 12% undervalued, amidst a vigorous expansion. After the September 11 attacks, the S&P 500 fell by 13% at the worst, four days after markets reopened.

Bottom line -- inflation risk and political risk are in the driver's seat for now, as far as equities are concerned. Look for some combination of decisive Fed action, and for news developments that move the election off 50/50 as catalysts for the next leg up. Until then, it could be a long and boring summer. TM