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

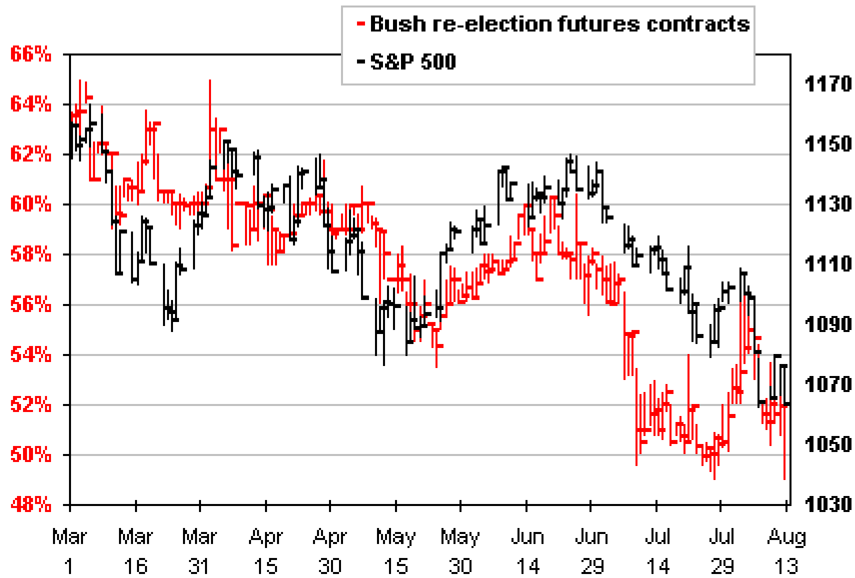
POLITICAL PULSE

Not So Nifty Fifty-Fifty

Friday, August 13, 2004

Donald Luskin

We're at the point of maximum electoral uncertainty -- and it may continue until well after the election.



Yesterday **President Bush's** probability of re-election fell back to its all-time lows at 49%, as measured by the political futures contracts traded online at **Tradesports.com**. The Bush contracts and the equity markets are now in synch to the downside, and we are playing out the bleak scenario we outlined over a month ago when Bush's chances first started to plunge toward 50%, the day **John Edwards** was announced as **John Kerry's** running mate (see "The Republic of Hanging Chad" July 7, 2004). Our hopes in the meantime for a short-term rally after the less than brilliant performance of the **Democrats** at their convention were quickly dashed by a spate of less than brilliant economic news (see "Oil, Jobs and Equities" August 6, 2004).

We have grave concerns about the negative impact on the economy and the markets of a Kerry victory. Setting aside any personal feelings any of us may have about the candidates, or about non-economic issues, it is our judgment that the higher tax and higher regulation regime that would obtain under Kerry is very bad for growth, and will create an environment very hostile to risk-taking. Since early spring we have interpreted the equity market's decline this year -- especially that of the tech sector -- as discounting for this increasing possibility (see "Tough Time for Tech" March 8, 2004). And now, here we are, at the point of maximum uncertainty: 50/50. And frankly, at this point it's hard to think of very much that either candidate is likely to say or do that is going to change that very much.

Such uncertainty is corrosive to economic growth and to markets. Already, according to our model, the equity risk premium in the S&P 500 is back to levels near those we saw near the bottom in March 2003. For the growth-sensitive tech sector, the risk premium is flying off the charts. It's now greater than it was at the panic bottom of October 2002. You'd have to go all the way back to January 1996 to find valuations this low. And it's not entirely comforting that the smart people at **Google** think that this is a good time to sell.

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

Offices:
Menlo Park CA
Parsippany NJ
Charlotte NC

Phone:
650 429 2112
973 335 5079
704 544 6900

A decent working hypothesis has been that the present uncertainties will resolve with the election at the latest. If Bush wins, there's a big rally in stocks as higher growth rates are discounted. If Kerry wins, there's a drop, as lower growth rates become more of a certainty. From an investment standpoint the risk is probably favorably asymmetrical, because either way, when the outcome is certain the risk premium will evaporate. In other words, even if the outcome is bad, at least it will be known with certainty, and the market will no longer have to exact a premium for sheer risk-bearing.

But this hypothesis must be modified by the strong possibility that today's electoral uncertainty will extend even beyond the election. We could very well be in for a replay of the contested **Florida** election of 2000, but on a grand scale. First, in many precincts around the country touch-screen electronic voting devices have been installed, largely as a reaction to the problems with punch-card ballots encountered in 2000. But these devices have already had reliability problems when rolled out in local elections since 2000, and they do not produce a verifiable paper audit-trail. We can be certain that any system glitches in close elections will be the subject of litigation from the losing side, and in the absence of an audit trail, the outcome of such litigation will be highly uncertain and definitely unsatisfying.

More dangerous is a new federal law requiring that "provisional ballots" be made available at all polling places this year. A provisional ballot allows a person not previously registered to vote to show up at a polling place on election day and vote nevertheless, with his eligibility verified by hand after the fact. Based on experience so far this year with provisional ballots, the number of them on a national basis could run into the millions. The potential for mischief, delay and strategic litigation is enormous. In any race in which the outcome is determined by a margin less than the number of provisional ballots, we may well see hotly contested ballot-by-ballot court battles.

These are the risks, and the time horizons over which they seem likely to be resolved. It's not a pretty picture for stocks. The best news that that these risks seem fully discounted in rich equity risk premia, which will leave the market subject to short, sharp rallies on any whiffs of good news. The art of playing the rest of the year will be to stay alert to potential tipping points that could definitively move the game off 50/50 in one direction or the other. TM