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

INTELLECTUAL AMMUNITION

An Olympic-Size Risk

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Donald Luskin

The controversy over Olympic gymnastic gold may be a precursor of another contested presidential election.

Forgive me, during a slow market week, for what will seem at first like a digression. Don't worry -- I'll tie this back to the economy and the markets before we're done.

As everyone in the world knows, the dramatic come-from-behind **Olympic** gold medal performance by **American** gymnast **Paul Hamm** has been blemished by controversies about how the gymnastic events have been judged and scored. The **Korean** bronze medal winner, **Yang Tae-young**, is threatening litigation to get a gold medal on the grounds that the degree of difficulty for his parallel bars routine was mistakenly set too low. If it had been set right, the Korean's score in the overall competition would have beaten Hamm's.

Sounds at first like correcting the scoring error is only "fair." But no -- judging is often imperfect, and there are official rules for dealing with the imperfections in a fair way. And one of those rules is that scoring errors can only be corrected while the meet is still in progress. Once the medal is awarded, the history books are closed. Everyone who competed agreed to play by those rules.

Also, on review of the videotape of the Young's performance, it turns out that there was actually a *second* judging error. A gymnast is permitted three "holds" in a parallel bars routine, and Tae-young took four -- yet his score received no deduction for that error. The two judging errors would have cancelled out, so the Korean is back to bronze and Hamm keeps his gold. Tae-young could try to have that second scoring error overlooked, citing the rule that judges are not permitted to review videotapes. But then Hamm could counterclaim that if Tae-young gets to break the rule that complaints must be filed during the meet, then Hamm is entitled to break the rule that forbids reviewing videotapes.

So the competition for gold has evolved from a gymnastic one pursued by athletes to a procedural one pursued by lawyers and public relations consultants. Now several other male gymnasts who didn't get the medal they think they deserved are threatening to sue, just like the Korean. The result? Possibly months or years until the world finds out who really won which medals in the 2004 Olympiad. Whatever medals are ultimately awarded will be tainted.

Such tragic outcomes are the result of actions by people who have lost the athletic competition, and so feel they have nothing more to lose in a subsequent procedural competition. They are exercising what is, for them, a "free option." Well designed and sustainable systems for collective action contain effective constraints on the exercise of free options, because such exercise imposes large negative externalities. The constraints are procedural, such as the rules that forbid changing scores after the meet is concluded and the reviewing of videotapes. But more important, ultimately, the constraints are *social*. Officials must be bound by an ethos that dictates that they enforce the rules or make it very costly for claimants to seek to overturn them. The claimants themselves must be bound by an ethos of sportsmanship that would devalue a merely procedural victory. And the culture should enforce that ethos by stigmatizing such victory.

In this case all those social constraints seem to have broken down. The breakdown with the most troubling larger implications is the social. The mainstream media punditocracy has generally taken the view that Hamm does not deserve to keep his gold medal. The bellwether ***New York Times*** editorial page says Hamm's medal "reeks of injustice." It dismisses the fact that the Korean did not protest the incorrect score within the timeframe required under the rules as "an easy out," and Hamm's own claims to his gold medal as the statements of someone who was "juiced up." The *Times* says Hamm should "do the magnanimous thing" and give his gold medal to the Korean -- apparently without regard to the reality that there is no rule that permits a gymnast to retroactively and unilaterally award a gold medal to a competitor.

Now why is any of this important to investors? Because this matters to the 2004 presidential election, and that election matters a great deal to investors. The culture that sees "fairness" in the redistribution of Olympic medals based on retroactively changing the rules of the game is setting the stage for the after-the-fact legal contesting of this year's election on a scale that will make the 2000 **Florida** recount affair seem like nothing. Back then the idea of suing over an election was a novelty -- only the **Democrats** sued, and only in Florida, where **Bush** had narrowly won. The **Republicans** could have sued in other close-call states where **Gore** won, but they didn't. Florida alone was enough to turn election day into election month. This time everyone is poised to sue everyone else, everywhere.

There will be no shortage of fodder for the "fairness" arguments this election. We've mentioned here before (see "Not So Nifty Fifty-Fifty" August 13, 2004) that 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. 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. And a new federal law requiring that "provisional ballots" be made available at all polling places this year 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. In any race in which the outcome is determined by a margin less than the number of provisional ballots, we may well court battles fought ballot-by-ballot.

We have argued all year that the stock market strongly prefers the re-election of George Bush, and the continuation of his pro-growth tax-cutting policies. We have noted that the decline in the stock market this year-to-date has perfectly paralleled Bush's chances of re-election (see, most recently, "Is It 'All About Oil'?" August 20, 2004). Maybe you totally disagree with that -- maybe you agree with **John Kerry** that Bush has been a disaster for the economy. Either way, this election is going to matter a lot for the market.

And here we are now, at the point of maximum uncertainty. All the polls -- and the futures contracts on Bush's re-election probability at **Tradesports.com** -- show Bush and Kerry in a dead heat. The quantum of uncertainty is not linear across the probability scale. It becomes doubly intense at 50/50, not only because the *actual* outcome is most unpredictable there, but also because only a close-call election will trigger the legal challenges that we are worried about. Such complex uncertainty is surely playing a role in supporting the large risk premium that is currently dogging stock prices (as recently as Monday of last week, the Information Technology sector of the S&P 500 had a risk premium precisely as great as it did on the day of the panic bottom in October 2002). This uncertainty affects not only the risk premia assessed upon forecasted income streams, but on the income streams themselves -- an economy beset by heightened risks with respect to future tax rates and regulatory regimes cannot be expected to perform at optimum.

This all implies that, at the margin, the sheer resolution of electoral uncertainty ought to be good for stocks, no matter who wins the presidency. Under our view that Bush will be better for the economy, then a Bush victory is a double-win for stocks. But even the negative consequences of a Kerry win would be, to some extent at least, offset by the resolution of uncertainty. On the face of it, that sets up a bet on equities with a very attractive "house edge" -- a strongly asymmetric payoff to a proposition that is probabilistically even-money.

But for that bet to pay off, the uncertainty has to get resolved. The highest payoff would come if the uncertainty resolved itself well before the election, if for some reason one candidate or the other emerged as the strong favorite. The worst payoff -- perhaps no payoff at all, or a negative payoff -- would come under a worst-case contested-election scenario in which the ultimate adjudicated result would be seen as arbitrary, unfair and illegitimate. Remember what happened to the stock market during "election month" in 2000: from the November 7 polling day to the December 12 **Supreme Court** decision, the S&P 500 lost over 4%. And it has never traded higher since December 12, 2000. We are certainly not positing the contested 2000 election as a single-factor explanation for the onset of a recession and a savage bear market in stocks. Yet at the same time, the fourth quarter of 2000 saw a slowdown in economic activity so sudden and widespread that **the Fed** was moved reverse its longstanding hawkishness and lower interest rates sharply with a surprise inter-meeting move on January 3, 2001.

Uncertainty takes an obvious toll on economic activity. But the stakes here are greater than that. This is about more than uncertainty -- it's about trust. And trust is one of the most important elements of human capital, which is the most important capital of all. In a complex modern society, we must have trust in the interactions that produce forced exchanges in the economy, such as taxes and regulations. Ideally those interactions are infrequent and minimal -- but at the very least they must be honest, and by "honest" we mean that they are the result of agreed upon rules and processes. When elections are subject not to the rule of law, but to the rule of lawyers, that kind of honesty is reduced. Thus trust is eroded -- and, therefore, so is human capital. And, therefore, so is economic growth.

For all this, we remain generally more optimistic on the economy than the consensus. And we are attracted to stocks at these levels for that reason and because of the deep risk premiums available today. But at the same time, we see a potential source of disruption that explains those risk premiums -- though it is scarcely mentioned in conventional strategic forecasts. Today -- starting from the 50/50 point of maximum uncertainty -- there is little scope for the risk to get worse, and still plenty of time for it to get better if the polls swing decisively one way or the other. A tricky game, to be sure -- but the potential rewards are there. TM