

POLITICAL PULSE

## The Bush-Bashing Bubble Has Burst

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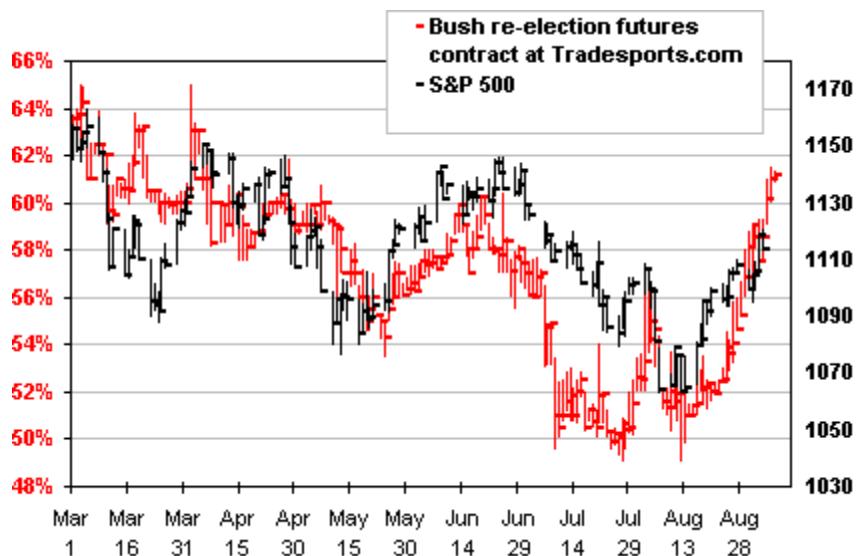
**The markets and the economy may finally be getting visibility on a Bush victory.**

We have steadfastly maintained that the economy is *not* tipping into recession. We have described the economy as being on a growth plateau at robust levels, but held back by substantive uncertainties about the outcome of the presidential election, and about the tax policies that would follow. And we have seen the economy beset by less substantive but nevertheless quite real pessimism and heightened risk perception, deliberately induced by an opposition party bent on discrediting the party in power by undermining confidence in its pro-growth policies. Now, for the first time this election year, we are in a position to move beyond these uncertainties, real and imagined. And equity markets are in a position to rally as they begin to shed the risk premia they have been accruing all year while these uncertainties have held sway.

A new political dynamic has evolved over the last three weeks that may well have swung the odds definitively in favor of the re-election of **President Bush**. As we have argued repeatedly, a Bush victory in November would be very positive for the economy and for equities -- and all the more positive if the market can get early and clear visibility into that prospect (see, for example, ["Not So Nifty Fifty-Fifty"](#) August 13, 2004).

Traditional polling data shows Bush opening up a wide lead over **John Kerry** coming out of the convention, earning a post-convention bounce well in excess of anything the **Democrats** got from their convention, and according to some observers, beyond anything incumbent presidents should expect. This bounce was fully anticipated by the futures contracts on Bush's re-election probability traded online at [Tradesports.com](#), which bottomed at 49% on August 12 and have been rising steadily

ever since, standing now above 60%. It's no coincidence that both the S&P 500 and the NASDAQ bottomed on the very same day, and that all three have rallied together for the past three weeks -- just as it's no coincidence that this year's market decline began with the growth-sensitive NASDAQ topping out two weeks after the contract started falling from its all-time high at 75% in early January (see ["Tough Time for Tech"](#) March 8, 2004).



The political futures contracts state-by-state suggest deep strength for Bush. Currently Bush is the probable winner in enough states to earn 284 electoral college votes to Kerry's 254. What's more, there are currently no states in which Bush's probability of victory is between 45% and 55% -- in other words, there are no close calls whatsoever. If we widen the range to look at states where the probability of victory is between 40% and 60%, then five battleground states emerge -- but most of the risk is on Kerry's shoulders. Bush is only at risk in **Wisconsin**, for 10 votes. Kerry is at risk in **Iowa, Minnesota, New Hampshire** and **Pennsylvania**, for a total of 42 votes. The widening electoral vote margin for Bush is doubly good news for the markets, because it suggests low levels of the nightmare risk of a litigated national recount that could delay and illegitimize the election's results (see "[An Olympic-Size Risk](#)" August 26, 2004). Along the same lines, the Tradesports.com contract that gives the probability of Bush winning the *popular* vote as well has surged from 45% to 55% over the past three weeks.

**Tradesports.com state-by-state electoral college forecast**

		FAVORITE	10% AT RISK
ALABAMA	9	BUSH	
ALASKA	3	BUSH	
ARIZONA	10	BUSH	
ARKANSAS	6	BUSH	
CALIFORNIA	55	KERRY	
COLORADO	9	BUSH	
CONNECTICUT	7	KERRY	
DELAWARE	3	KERRY	
DIST COLUMBIA	3	KERRY	
FLORIDA	27	BUSH	
GEORGIA	15	BUSH	
HAWAII	4	KERRY	
IDAHO	4	BUSH	
ILLINOIS	21	KERRY	
INDIANA	11	BUSH	
IOWA	7	KERRY	KERRY
KANSAS	6	BUSH	
KENTUCKY	8	BUSH	
LOUISIANA	9	BUSH	
MAINE	4	KERRY	
MARYLAND	10	KERRY	
MASSACHUSETTS	12	KERRY	
MICHIGAN	17	KERRY	
MINNESOTA	10	KERRY	KERRY
MISSISSIPPI	6	BUSH	
MISSOURI	11	BUSH	
MONTANA	3	BUSH	
NEBRASKA	5	BUSH	
NEVADA	5	BUSH	
NEW HAMPSHIRE	4	KERRY	KERRY
NEW JERSEY	15	KERRY	
NEW MEXICO	5	KERRY	
NEW YORK	31	KERRY	
N CAROLINA	15	BUSH	
N DAKOTA	3	BUSH	
OHIO	20	BUSH	
OKLAHOMA	7	BUSH	
OREGON	7	KERRY	
PENNSYLVANIA	21	KERRY	KERRY
RHODE ISLAND	4	KERRY	
S CAROLINA	8	BUSH	
S DAKOTA	3	BUSH	
TENNESSEE	11	BUSH	
TEXAS	34	BUSH	
UTAH	5	BUSH	
VERMONT	3	KERRY	
VIRGINIA	13	BUSH	
WASHINGTON	11	KERRY	
WEST VIRGINIA	5	BUSH	
WISCONSIN	10	BUSH	BUSH
WYOMING	3	BUSH	
	<b>538</b>	<b>284</b>	<b>254</b>
			<b>10</b>
			<b>42</b>

How can we qualitatively explain these quantitative results? Having turned around in early August, the political futures contracts seem to have been prescient in picking up on the particularly devastating dynamics set in motion by the charges leveled against Kerry by the **Swift Boat Veterans for Truth**. These charges have turned out to be far more consequential than the usual election-year mudslinging. First, they hit Kerry squarely in the single element of his persona that he has aggressively used since the **Democratic National Convention** to define himself as more than "anybody but Bush." Second, in responding defensively to the charges -- and by attacking his own combat colleagues -- Kerry has undermined the image of stoicism and manliness that his combat service was intended to evoke in the first place. For a campaign built on capitalizing on the national mania for Bush-bashing, this is potentially a fatal one-two punch. A candidate who can dish it out but can't take it doesn't have the moral authority to run an effective negative campaign. And a candidate whose only *positive* brand attribute has been destroyed has nothing else to fall back on.

This may well be checkmate. The Bush campaign has done a masterful job of capitalizing on Kerry's errors -- and it's not at all clear that there's any viable response strategy for Kerry. For example, while Kerry was denouncing Swift Boat Vets for denouncing a Swift Boat Vet (that is, himself), Bush [bravely admitted](#) to **NBC'S Matt Lauer** that Kerry's **Vietnam** service was "more heroic" than his own, thereby significantly defusing long-standing questions about his **Air National Guard** service.

The [convention speech](#) Monday night of former **New York mayor Rudolph Giuliani** evoked memories of Bush's own heroism in the days following the 9-11 terrorist attacks, and portrayed Bush as all the more heroic for having stood silent over the last year while criticism of him has become so intense. Quite clever that -- making the measure of Bush's virtue equal to the magnitude of the attacks against him. Considering that attacks against Bush pour daily from every newspaper, television set, bookstore, movie theater and cocktail party, that's a lot of

virtue. How unvirtuous, then, must be John Kerry -- so few people are attacking *him*, and he takes it so badly when they do.

At this point, then, can we say that the Bush-bashing bubble has burst? To be sure, so far the political pundits who have fanned the flames of the mania all along have not subsided one bit. In fact, some Democratic strategists have argued over the last several days that Kerry's problem is that he hasn't played dirty enough. But remember how long after NASDAQ 5000 it took for stock market pundits to stop writing that "valuation doesn't matter" in the "new economy." The point is not that the attacks will stop: it's that they will *stop working* -- and indeed will be counterproductive -- to the extent that they are seen as unvirtuous.



Another powerful element to emerge in the last week is the introduction of the expression "girlie men" into public discourse. Only someone with the charisma and unique persona of **Arnold Schwarzenegger** could have gotten away with what amounts to impugning the masculinity of the Bush-bashers, especially those who have been trash-talking the economy all year. As we have argued here before, this trash-talking has potentially had a significant effect on sentiment and on markets (see ["Bond Market Riddle"](#) September 2, 2004). It would be too grandiose to compare Schwarzenegger to **J. P. Morgan**, who single-handedly quelled the Panic of 1907. But when an alpha-wolf like Schwarzenegger issues a message like this -- especially one that will work its way into daily language like a virus -- changes in the *zeitgeist* can be quite profound.

In the strictly economic context in which he was nominally speaking, Schwarzenegger's [convention speech](#) Tuesday night could work to close the gap between reality and perception about the economy. We have noted that conventional polls have shown deteriorating approval for Bush's handling of the economy, even as job growth has tangibly improved (see ["Summer of our Discontent"](#) June 7, 2004). Schwarzenegger's "girlie men" barb could trigger voters to walk into the voting booth focused on the reality that they have good jobs, not the fantasy that their jobs will be "outsourced." At the same time, Schwarzenegger could help Republican politicians and surrogates restore their confidence in and advocacy for Bush's policies that encourage economic risk-taking. Here the phrase "economic girlie men" is remarkably apt. Risk-taking is a *sine qua non* of capitalism -- and it is, at root, a matter of courage. Bush's tax cuts in the face of growing deficits were a risky political strategy, but they triggered a boom because they called forth that courage, by raising the after-tax return to risk-bearing.

In summary, we see a political dynamic in favor of Bush's re-election that has properties that are sustainable. Of course we cannot fail to acknowledge there are still two months till the election, and one can certainly imagine unlikely surprises that could upend Bush's new momentum. And we are unlikely to get from here to the election in straight line, either in terms of politics or markets. Yet in our view, it's difficult to see a high-probability scenario in which Kerry survives.

And yes, we're probably headed into a bad warnings season as earnings disappointments bred of the fear and pessimism built up over the last several months of economic trash-talking come pouring out of the pipeline. But if confidence is truly restored in the domain of expectations, then the market can rally into that bad earnings news just at it fell most of this year on good earnings news. Remember -- the risk premium in the S&P 500 Information Technology sector (as measured by our "Yield Gap" model) was greater at the recent August 12 bottom than it was at the panic bottom of October 9, 2002. There's a reason why the NASDAQ is more than 5% higher than it was three weeks ago, even after **Intel**. **TM**