TrendMacrolytics

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MACROCOSM

Bush Out of Whack

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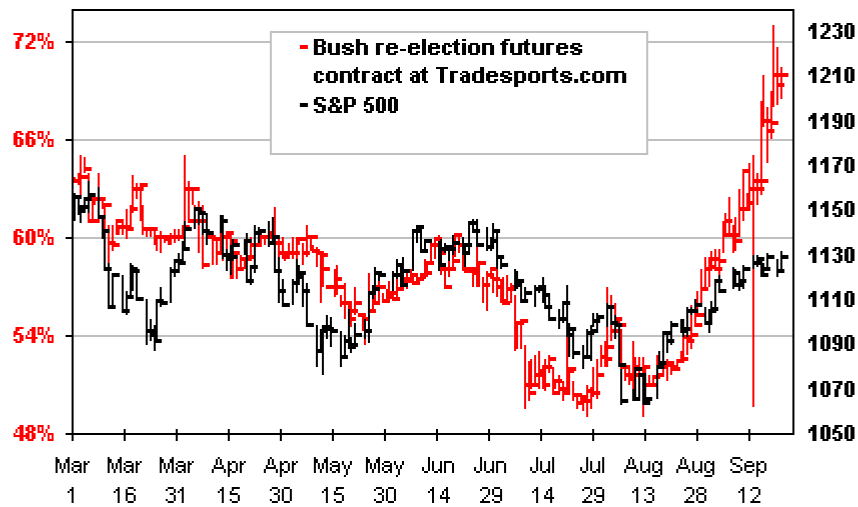
How come markets haven't rallied as much as George Bush has?

The close relationship between the stock market and the futures contracts on **President Bush's** re-election probabilities (traded online at [Tradesports.com]) has gotten out of whack. After six months of moves eerily synchronized in timing, direction and proportion, the Bush contracts have now rallied disproportionately to stocks since August 12 -- when the contracts, the S&P 500 and the NASDAQ all bottomed on the very same day. In an important sense this comes as no surprise. Nonstationarity is the rule in this kind of relationship between economic variables (perhaps especially so when it begins to be widely reported in the popular press, as this one now has). Yet setting aside the details of this particular graphical visualization, the rationale for the causal relationship between Bush's re-election probabilities and the stock market is as strong as ever. So let's think about what it would take for Bush's probabilities and the market to come more into synch than they are at this moment.



First, Bush's probabilities could fall from here. After the surge in Bush's re-election probabilities that began with the **Swift Boat Veterans** attacks and accelerated through the **Republican** convention, it would not be at all unusual to see some pullback or consolidation.

Second, stocks could rally as they increasingly shed the risk premium they have been accruing all year against the possibility of a **Kerry** victory. Don't underestimate the depth of that risk premium -- and the upside potential it represents -- just because stocks are approximately unchanged year-to-date. With S&P 500 earnings up more than 18% year-to-date through August, a flat stock market represents an "invisible crash," one that has taken place in value space rather than in price space. Our "yield gap" valuation model now shows the S&P 500 more than 33% undervalued. Removing the panic bottoms of October 2002 and March 2003, stocks are impounding a greater risk premium today than at any time in the last two decades.

It's not for us to say how rapidly the market should shed its risk premium. But we are confident that if Bush's chances hold up, it will. Remember, though, whatever Bush's re-election probabilities today, the market knows it ain't over till it's over. Clearly Bush is the favorite today,

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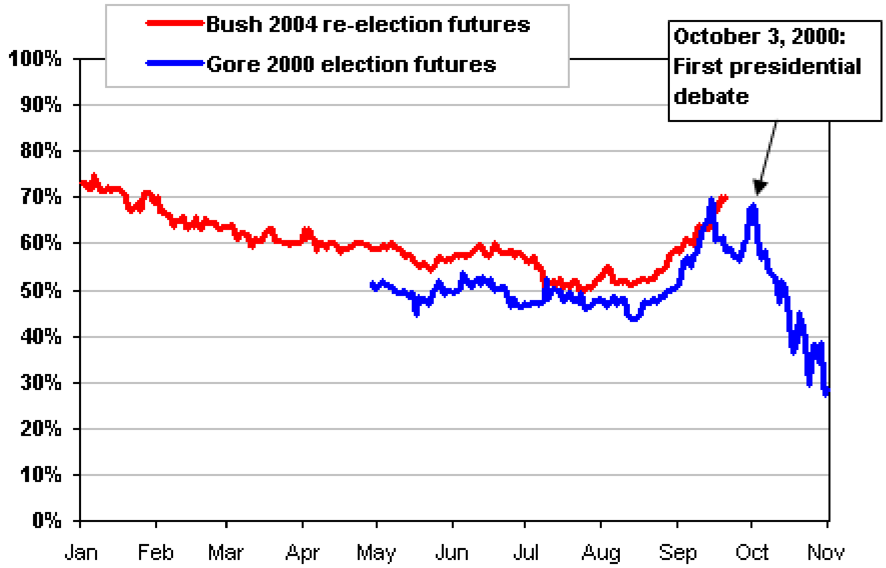
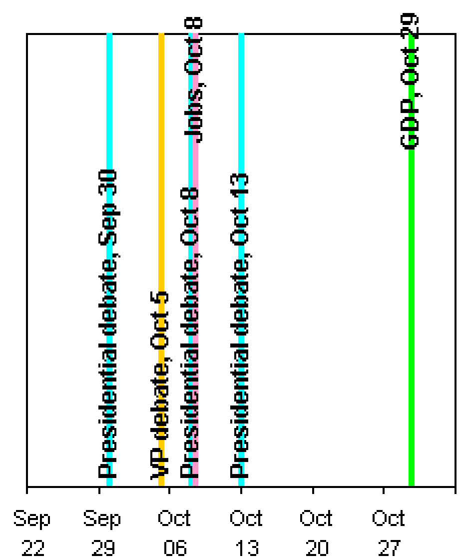


and our expectation is that he will win. But it's wise to remember that **Al Gore** was every bit as much the favorite at this point in the 2000 presidential campaign, as measured both by traditional polls and political futures contracts. What went wrong? It's hard to say, but it would appear from the evidence of political futures traded in 2000 on the **Iowa Electronic Exchange** (the university-operated futures exchange that was the longstanding predecessor of Tradesports), that the decisive break in Gore's probabilities was the first of three presidential debates. Gore's theatrical sighing and eye-rolling in the debates became a staple on **Saturday Night Live**, and may have done much to undermine his credibility in relation to the plain-spoken Bush.

As in 2000, this election year there will be three presidential debates (September 30, October 8 and October 13) and one vice presidential debate (October 5). Bush is known as an unskilled extemporaneous speaker and debater, while Kerry was a star debater at **Yale**. So it is being said widely that Bush has the advantage of low expectations -- if he merely holds his own, he will be seen as winning because, once again, he will have been "misunderestimated." It may not be that simple, though. Perhaps for Kerry, too, expectations are set quite low. So far in the campaign he has failed to effectively communicate a consistent message or to project a compelling personality. The debates, then, are a paradoxical contest between two underdogs. Both candidates have the potential to surprise on the upside.

Other forecastable events that could impact the election include one more release of payroll jobs data (October 8) and the release of advance third quarter GDP (October 29). Considering the widespread and misplaced doom-and-gloom attitude about the economy projected in the media and by the economics establishment, our guess is that these numbers are likely to surprise on the upside -- and in Bush's favor.



While electoral risk remains -- and will remain to some extent until the last moment -- the fact is that the odds now strongly favor Bush, and there's no objective reason at this time to think the odds are wrong. At the same time, the stock market remains deeply discounted, fearing the worst and shedding its risk premium only grudgingly. It's an unusually favorable risk/reward structure in markets -- the chance to earn a large risk premium for betting on the favorite. TM