TrendMacrolytics

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

MACROCOSM

Getting Back Into Whack

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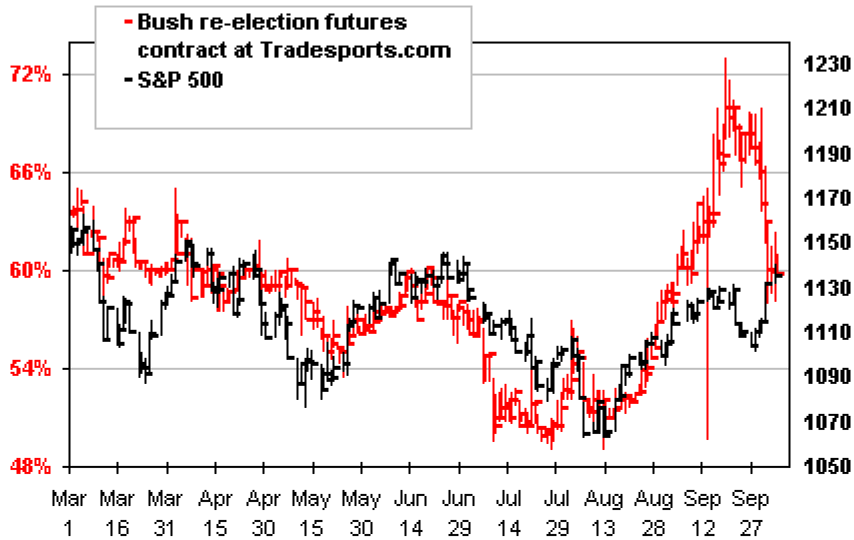
Donald Luskin

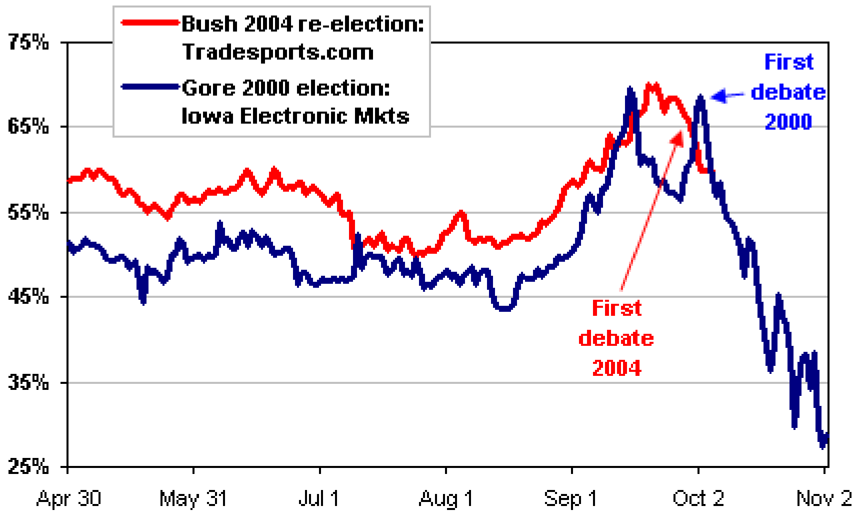
Political markets, capital markets and labor markets are all recovering from extreme disequilibriums.



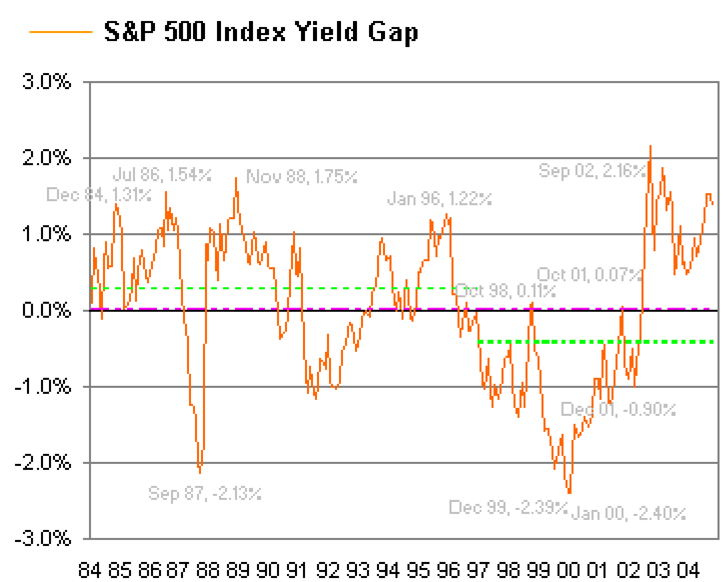
Several critical relationships in markets have been in severe disequilibrium, and have come back toward equilibrium over the past week. First and foremost, we noted two weeks ago the violation of the longstanding parallelism of the S&P 500 and the **George Bush** re-election probability futures contracts (see "Bush Out of Whack" September 22, 2004). At that time the Bush futures had rallied off their August 12 bottom at a 49% probability of re-election all the way to a high 73% probability on September 19. The S&P 500 and the NASDAQ 100 both bottomed on the same day as the Bush futures, and as of September 19 they had rallied 6.3% and 9.7%, respectively. Nice moves indeed -- but small in proportion to the move in the Bush futures, given the tight relationship that has obtained for the last six months.

Over the last week, though, the S&P 500 has rallied, and the Bush futures have fallen in the wake of the first presidential debate (see "Many A Slip" October 1, 2004). From being severely out of whack two weeks ago, they are now precisely back in whack. Does this mean that the market has changed its mind about Bush, and now wants **John Kerry** to win? Hardly. When longstanding relationships in markets get as deeply into disequilibrium as this one did, it's generally the case that the move back to equilibrium will be shared by *both* sides of the relationship.

Assuming the continuity of our thesis that the market prefers Bush's pro-growth tax and regulatory policies, what if we were to passively take the relationship between the Bush futures and the S&P 500 literally, and to the exclusion of all other modes of analysis? Then we would have to say that at this moment there is no risk-adjusted advantage to taking a position in stocks one way or the other -- at least not based on the best forward-looking market-based estimate of Bush's re-election probabilities. An alternative active-management approach might be to treat the Bush futures' present 60% probability as tantamount to a win for Bush -- which, in our view, would be a strong reason for owning stocks. Over the history of organized presidential election betting markets from 1884 to 1940, a 60% probability this close to the election predicted a win in every election but one (for a surprising and colorful history of these markets, we highly recommend that you see Rhode and Strumpf, 2004: "Historical Presidential Betting Markets"). Election futures contracts traded online since 1988 at the **Iowa Electronic Markets** of the **University of Iowa Business School** show the same results -- 60% this close to the election meant a win in every case but one (for an analysis of the predictive efficacy of these markets, see Berg, Nelson and Rietz, 2003: "Accuracy and Forecast Standard Error of Prediction Markets").

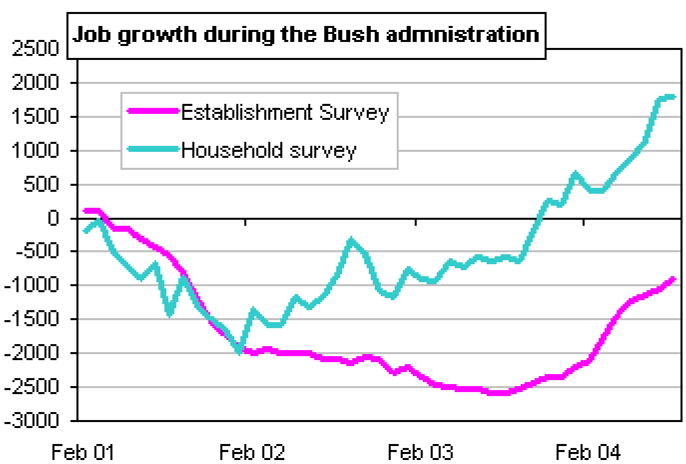


It is sobering to note which two elections the betting markets failed to correctly predict. The one miss for the pre-electronic betting markets was in 1916, when the dominant issue was one not entirely unlike today's: whether the **US** should join the war raging in **Europe**. **Woodrow Wilson** was elected as an anti-war candidate (though he drew **America** into the war in the first year of his second term). He beat the favorite, challenger **Charles Evan Hughes** (who was something of the **Eliot Spitzer** of his day), in a cliff-hanger election that hinged on a handful of votes in **California**. In the electronic era, the one miss for the betting markets was in 2000. Though the **Al Gore** futures fell steeply as the election drew closer, *at this point* they still had Gore favored at 60% probability -- exactly where Bush is now. As we pointed out two weeks ago, Gore's probabilities fell immediately after the first presidential debate, and never recovered. Here, then, is another relationship that is now very much in whack -- the troubling correspondence between Gore's falling probabilities in 2000, and Bush's in 2004. We're certainly not arguing for some form of predestination that ordains that Bush follow in Gore's footsteps. Indeed, Bush is now set up to come into the second debate on Friday as the underdog -- just the position from which Bush plays most effectively. But one would be a fool to fail to admit that Kerry got some traction in the first debate, and that this election ain't over till it's over.



The strong performance of equities and the weak performance of bonds over the last week -- in the face of a decline in Bush's re-election probability -- is evidence of another major disequilibrium coming back into whack. As we've mentioned repeatedly over the last several weeks, the risk premium between stocks and bonds has been at historically steep levels (our measure of the risk premium compares the forward earnings yield of stocks to the income yield of long-term Treasury bonds). Just last week, the S&P 500 was 35% undervalued by this measure. It has only been more undervalued three times over the last two decades: November 1988, October 2002 and March 2003, all of which preceded important rallies. Today the risk premium suggests an undervaluation of 27%, still steep but not as radically so as last week. What has happened? As with the relationship between the S&P 500 and the Bush futures, the move toward equilibrium was a joint effort in harmony with our view liking stocks and loathing bonds -- stocks went up (3.5% on the S&P 500) and bonds when down (long term Treasury yields have risen 20 basis points). Happily, forward earnings didn't fall in order to contribute to this down-payment on re-equilibration -- they're up half a billion dollars since last week.

Another important potential to move back toward another type of equilibrium comes Friday, when the **Bureau of Labor Statistics** announces what may be a major upward revision to its previous payroll jobs estimates. To put a finer point on what we wrote last week on this subject (see "Bonds: Sell 'Em While They're Hot" October 1, 2004), each February the BLS "benchmarks" its statistical model by incorporating state-by-state unemployment insurance data. Revisions to previously published payroll jobs statistics can be large, and may extend back over several years. Each October the BLS produces a preliminary estimate of some of these revisions since the last benchmarking, in this case for the months between April 2003 and March 2004. Historically revisions have been upward in expansions and downward in recessions. Considering the pace of the expansion over the period in question, we can reasonably expect a large upward revision.



Another reason to expect a large upward revision is the important disequilibrium between the BLS's payroll jobs estimates (based on its "establishment survey") and its employment estimates (based on its "household survey"). The two surveys closely tracked each other in measuring the job losses from the onset of the last recession. But since the recession trough in November 2001, the two measures have sharply diverged, with the household survey showing robust and consistent job growth, while the establishment survey showed a "jobless recovery." By polling people instead of establishments, the household survey is inherently better at capturing job growth in new firms, small firms and among the self-employed. It is precisely this deficiency in the establishment survey that the annual benchmarking procedure is intended to redress. A decent September jobs number and a large upward revision could easily cure half the disequilibrium between the two series.

Normally we don't regard backward-looking statistics as terribly important -- and certainly not revisions to such statistics stretching back more than a year into the past. But this time, considering the extent to which stock and bond markets -- and the election -- have been mired in misconceptions about the strength of the current expansion, a large upward revision could go a long way toward realigning perceptions for the better. With the BLS's revision scheduled for the morning of Friday's presidential debate, that could be the most important equilibration of all.