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Broken?

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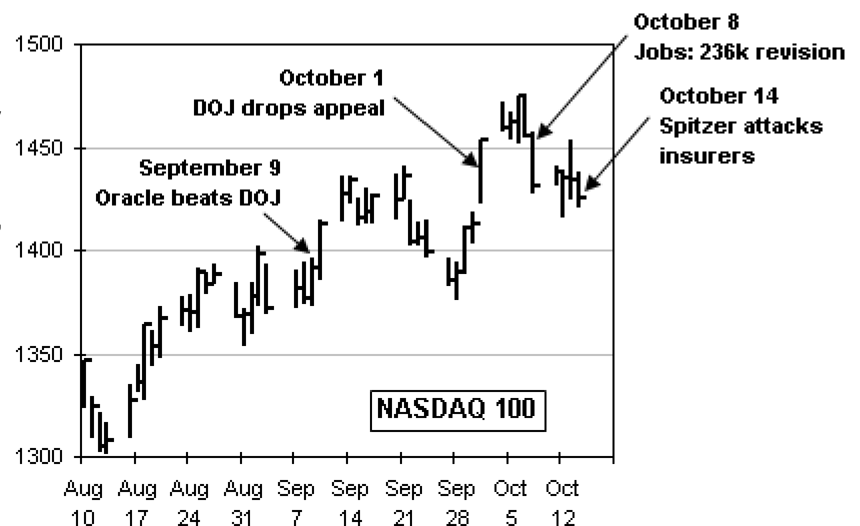
Some important things are broken. But stocks are priced as though they can never be fixed.

The latest spell of stock market weakness began a week ago, when lower than expected job growth was reported for September. The talking head cliché, of course, is that it revealed weakness in the consumer economy. Our take would be more along the lines that the report detracted from **George Bush's** chances for re-election, thus increasing the risk that Bush's pro-growth 2003 tax cuts will be repealed -- and that the continuing perception of poor labor market performance could cause **the Fed** to waver in its rate-hiking regime, thus increasing the inflationary forces already in the pipeline (see "Scary Kerry?" October 8, 2004).

A special concern with the report was the small upward revision in the number of jobs the **Bureau of Labor Statistics** said it is currently estimating for next February's annual benchmarking. A revision of only 236 thousand jobs barely begins the necessary reconciliation of the number of jobs reported in the "establishment survey" with the far larger number reported in BLS's "household survey," and with virtually every other indicator of the job market (see "Getting Back Into Whack" October 5, 2004). If anything, it lends credence to the concern that the deeply respected and widely followed payroll jobs statistics are, quite simply, broken. Any public or private decision reliant on those statistics, then, is likely to wrong.



No doubt some portion of the near-record equity risk premium priced into stocks today is because of the sense that so many trusted institutions are now as fundamentally broken as the jobs statistics. As examples at the margin, note that since the bottom on August 12, the two big up days enjoyed by the NASDAQ that were associated with two significant victories for regulatory sanity scored by **Oracle** in its quest to be free to acquire **Peoplesoft** (or not). Growth-sensitive technology stocks liked it less when jobs statistics were revealed to be dysfunctional, and when the attorney general of a single state decided it's time to unilaterally revamp the business model of the insurance industry. These are only modest recent examples, yet longer term, markets surely remain discounted to some extent both because of the uncertainties engendered by the institutional breakage of 9-11 and the corporate scandals, and by ongoing institutional responses to them that themselves seem as though they are broken.

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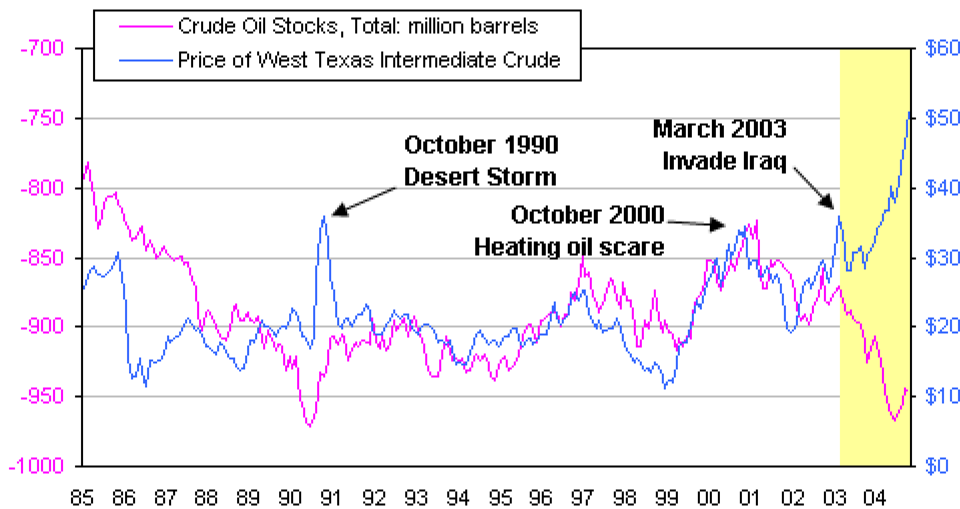
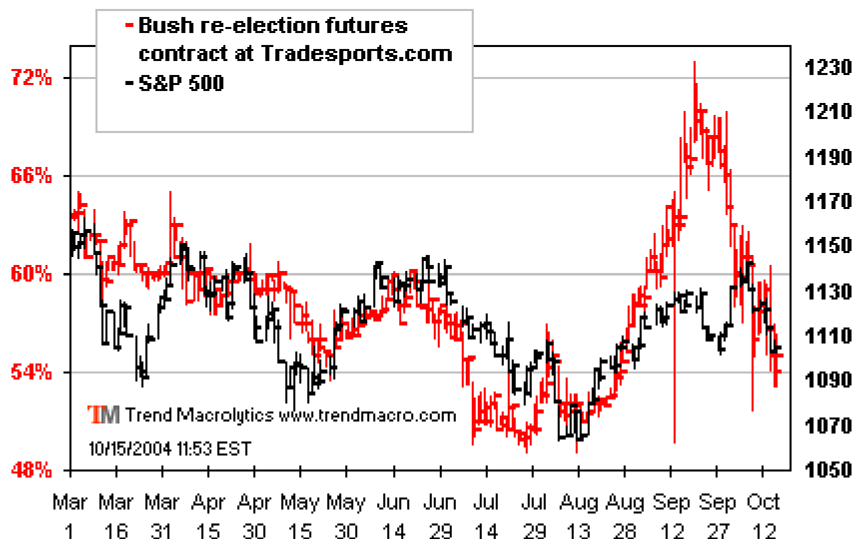


Consider the oil market since the invasion of **Iraq.** For the first time on record, oil prices have risen at the same time as oil inventories have risen -- both are at or near all time highs (in the chart above, oil stocks are plotted on an inverted scale, for clarity). High inventories have always indicated glut, but that relationship is now broken in the post-Iraq world. Today, inventories represent risk aversion (and probably a dose of speculation, too, at this point). For that matter, traditionally the president has released supplies from the **Strategic Petroleum Reserve** at price peaks, as **George H. W. Bush** did in 1990 and **Bill Clinton** did in 2000. That process, too, seems to be broken.

Now we're just two weeks away from a presidential election that is, in many respects, another broken institution -- broken in the disputed 2000 election, with the decent chance that we'll have another one like that this year. Based on the political futures contracts traded online at **Tradesports.com**, we give **President Bush** a slight edge. But even this futures market is, in some sense, broken now. There have now been three speculative attacks on this market -- the first on September 14, and then two more on the nights of the second and third presidential debates (see "On Bush Under Speculative Attack" September 14, 2004). According to sources at Tradesports, the attacks have all been by the same single investor. Rather than act as a consistent scaled seller seeking the best prices, he has entered the market only episodically and has accelerated his selling into falling prices. His selling has been in quantities that represent about twice typical total daily volume. After the first attack the market entirely recovered, almost instantly. After the second, it took a full day. The market still hasn't fully recovered after Wednesday night's attack. Do we sense the fine hand of **George Soros**? The "man who broke the **Bank of England**" and has vowed to spend $100 million to unseat the president wouldn't hesitate to move an online futures contract if he thought it had signaling value that could impact the election.



Many are skeptical of the validity of market-based political event forecasting (as they surely should be equally skeptical of forecasting by conventional public opinion polling). These speculative attacks may increase that skepticism for some. Or a more libertarian view might be that trading activity of *any* sort is a valid and valuable force in setting prices -- perhaps the increasingly slow recovery of

prices after each attack is evidence of that. Be that as it may, the Bush re-election futures have been perfectly in synch with the S&P 500 for the last ten days. Based on the relationship that has obtained strongly for the last seven months, and with the futures showing a 55% Bush probability of re-election, stocks are now priced exactly to reflect what amounts to a coin-flip election with a slight Bush advantage. In 2000 on this date, the futures showed **Al Gore** with a 47.7% probability of election.

What if **John Kerry** wins? The 2003 tax-cuts on capital gains and dividends are history, either by immediate repeal or by sunset after 2008. Would **Eliot Spitzer** be appointed attorney general of the **United States**, giving him officially the job he now performs only unofficially? Would **Robert Rubin** be appointed Fed chairman? Who knows what would happen in Iraq. Much mischief would no doubt ensue. But the **House** appears to be solidly in **Republican** hands, and state-by-state analysis of futures markets suggests that the **GOP** is poised to pick up one **Senate** seat. So the most anti-growth of Kerry's many promised "plans" would likely not be enacted. With stocks already trading 34% below fair value (based on comparing forward earnings yields and interest rates) -- an equity risk premium exceeded only three times in the last two decades; and exceeded only two times if you exclude technology stocks from the calculation -- it seems to us that stocks have pretty much discounted the worst.

We're biting what's left of our nails, and playing this one day at a time. But today the bet still has to be on stocks. With the worst mostly discounted and the best still a slightly favored probability, deeply undervalued stocks offer a very attractive risk/return tradeoff right now. Yes, much is broken -- but nothing is so broken as the national mood, a mood that assigns extraordinary high value to that which is broken, and creates the sense that the broken can never be fixed. That mood has been exacerbated by the most vicious and dishonest presidential election campaign we've ever seen. Make no mistake about it -- there are real challenges here. But we could easily find ourselves on November 3 with the election behind us, and with a few things that have been broken suddenly on the mend -- and the rest suddenly feeling not nearly so irreparable or important as they seem today. TM