TrendMacrolytics

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POLITICAL PULSE

Y2K Then, EY04 Now

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Democrats say they will litigate the election -- and markets believe them.

We've been warning for over two months about the increasing risks of a legally disputed presidential election (see, first, "Not So Nifty Fifty-Fifty" August 13, 2004). Over the last week this risk has finally begun to receive the mainstream media attention it deserves, as **Democratic** spokespeople have become increasingly frank about their election litigation and public relations plans. For example, **Democratic National Committee chairman Terry McAuliffe** told **"Meet the Press"** yesterday that "We will have 10,000 lawyers who will be at polling booths... We will have 2,500 in Florida. They will be there with a badge that says 'Voting Rights Institute.'" And the **Kerry** campaign told the **Associated Press** last week that Kerry "will not hesitate to declare victory Nov. 2 and defend it," and that he "will be prepared to name a national security team before knowing whether he's secured the presidency." The **Republicans** may have their own versions of these plans.

We have no doubt that the prospect of a disputed and prolonged election weighed heavily on markets last week, and it may well continue to do so again this week. All the markets are badly out of whack, and need this important election to be *over* -- decisively so. Our valuation model shows the S&P 500 to be 37% undervalued now -- an enormous risk premium that has only been exceeded three times in the last 20 years. Treasuries are trading at low yields that don't even begin to reflect the rising inflation that is *already* showing up in official statistics. And the oil market remains beset by hoarding, speculation, and (potentially) politically motivated manipulation. It's not just objective uncertainty about which of two fundamentally different visions of the role of government in the economy will dominate the coming years. It's also the pervasive mood of fear and pessimism -- deliberately aggravated by both candidates. In this atmosphere, one counts the days in fear of a pre-election terrorist attack, of an assassination attempt on one of the candidates, and of an election-day collapse of **America's** most fundamental civic institution -- voting itself.

In one sense, the concern about prolonged litigation in election year 2004 is not unlike the concern in 1999 with the millennium date rollover. Both Y2K then and EY04 now are visions of a systemic breakdown with chaotic and potentially pervasive effects. But the differences between Y2K and EY04 are significant. First, Y2K was a problem that the interested parties had a motive to solve -- and they *did*. EY04, on the other hand, is a problem that the interested parties have a motive to exacerbate -- and they *will*. Second, Y2K was a deterministic problem of physical systems about which many economic actors had valuable first-hand information. EY04 is an indeterminate problem of human action about which no one knows anything. So stocks rose in the weeks approaching Y2K, fully discounting the fact that the problem had been solved, and they fell in the first several days *after* Y2K, in a classic "sell on the news" reaction once it was clear there was *no* problem. Now it's just the reverse. Markets are selling off in the run-up to EY04, trying to discount what are completely incalculable risks. Once the shape of EY04 is known -- and especially if the election is decisive, or is seen as becoming decisive in a short time -- there could well be a strong "*buy* on the news" reaction.

Make no mistake about it, there are considerable risks to be borne over the coming weeks. But if we get the best-case, most market-friendly outcome -- a **Bush** re-election decisive enough to shut down all litigation potential -- the consequences for stocks are likely to be highly positive. From the current position of extreme undervaluation, it would not at all be a stretch to contemplate a 20% rally in the S&P 500 by year-end, with even stronger results for risk-sensitive high-beta sectors like technology and basic materials.

Much of the impetus for such a move would come from release of the tremendous risk premium currently impounded in equities. But there would be other factors at work, too, once the deliberately created climate of fear began to fade away. Fear-driven speculation in the oil market may well finally flame out. Indeed, a re-elected President Bush could make that so, once he no longer has a political motive not to release oil from the **Strategic Petroleum Reserve**. Falling oil prices would allow the bond market to re-think its over-pessimistic view on economic growth. And **the Fed** may well find the courage to recommit to an unwavering march back to a normalized Fed funds rate. Yes, bond yields would rise -- but stocks would celebrate nevertheless, with renewed growth expectations in the air and the specter of a large inflationary mistake off the table.

That's the potential -- and it's not at all impossible that it will happen just that way. But the single most likely case at this point is that there will be *at least* a brief period immediately following election day in which the Democrats explore and seek to maximize their litigation options. After all, doing so is the Democrats' explicit tactical doctrine, and only very decisive Bush wins in big battleground states like **Florida** and **Ohio** will shut it down. So we may well get to the best case -- but it could easily be by way of several painful days without a Kerry concession, featuring noisy pro-forma voting fraud protests which go nowhere, but are nevertheless breathlessly covered by the media. Remember, it will probably take an unusually close vote-count in an unusually large state to give a challenge high potential -- and then you have to prove it. Without all those conditions being met, a challenge would be just a diversion on the way to the best case, and if it proves to be brief, it could set up the last great buying opportunity this year in equities.

Another possibility to be considered is that Kerry wins decisively, though that seems unlikely based on current polls. If it happened, we would expect a moderately positive reaction in stocks, based simply on the release of today's enormous risk premium. But a Kerry win alleviates less uncertainty than a Bush win (Kerry remains an unknown), and a Kerry win also portends a lower growth trajectory for the future, and more risk of inflationary politicization of the Fed (see "Scary Kerry?" October 8, 2004).

The worst case is a prolonged period of litigation, like we had in 2000 or even worse -- based on new complexities of widespread use of "provisional balloting" and touch-screen voting terminals -- carried out by lawyers all around the country, with the ultimate result depending on a crazy-quilt of separate state-by-state contingencies. Then we would expect stocks to move lower pending the ultimate resolution. The longer it takes, the lower stocks will go and the less they will ultimately recover. The climate of fear and divisiveness will persist and intensify. An economy already expanding at less than potential will be held back even further -- and at some point it risks hitting stall speed. And a Fed that is already only tenuously committed to rate normalization could opt to go on hold while things play out, giving already dangerous inflationary impulses more of a foothold than they already have.

And the culture of divisiveness and of ends-justify-the-means ruthlessness gets more of a foothold, too. Consider what is at risk, now that we have come to a place from which we must look back nostalgically at **Richard M. Nixon** as a model of exemplary political norms. *He* chose not to challenge highly suspect votes in **Illinois** and **Texas** in the close-call 1960 presidential election, because to do so would be, he said, "dangerous for the nation at a critical time." Today's political norm is the take-no-prisoners brutality of **Eliot Spitzer**, whose most recent nuclear strike against the financial services industry seems fortuitously timed for his party and his ambitions, to say the least.

As a matter of pure speculation, what could send us even a few small steps back toward the world of admirable self-restraint in public life? Perhaps what we've described as the most likely case -- a decisive Bush win that nevertheless receives noisy pro-forma challenges for several days -- is just the thing. One might hope that the self-indulgent pointlessness of such challenges would inspire voter revulsion so obvious that even a politician could detect it. TM