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MARKET CALLS

# Don't Miss the Obvious

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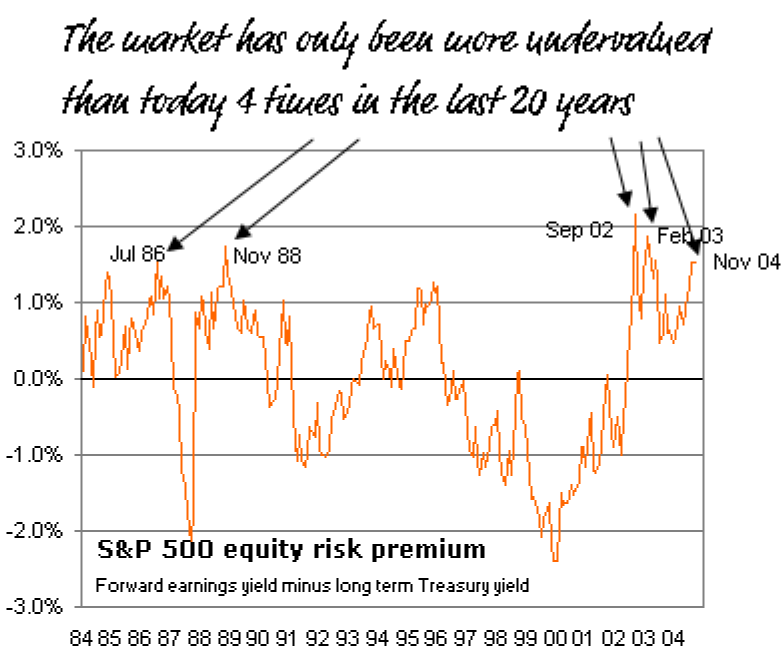
**A bubble of fear has driven stocks to deep undervaluation, and that bubble is about to burst.**

Here on election day, visibility into the election's result should be at maximum. Instead, visibility has deteriorated over the last month. One month ago **George W. Bush** enjoyed a 60% probability of re-election, according to the political futures contracts traded online at **Tradesports.com**. That probability level, measured with a month still to go till election day, has been sufficient to have correctly called the winner in every presidential election in which betting markets have operated since 1884, with a single exception (see "Getting Back Into Whack", October 5, 2004). But as election day approaches, that probability should rise toward convergence with 100%. For example, on election day in 2000, Bush's probabilities had risen to 84%. But instead, as of this writing early on election morning, Bush's probabilities have fallen to 56%. *Bush's chances have fallen when they should have been rising*, and that's not an encouraging trend for the president. At the same time, this means *uncertainty itself has risen when it should have been falling*. We should pretty much know right now who the next president will be. Unfortunately, we don't.




As a consequence, the equity risk premium has expanded. According to our valuation model, forward earnings growth and falling long-term Treasury yields should have led to stock market gains of about 4% in October. Yet the S&P 500 is virtually unchanged from a month ago -- another invisible leg down in the invisible stock market crash of 2004 (a crash taking place not in price, but in valuation). Today, according to the same model, the S&P 500 is 30.8% undervalued. To put some perspective on just how cheap that is, consider the fact that there have only been four periods (entailing seven month-ends) in the last 20 years during which stocks were this cheap or cheaper. In every single instance stocks were higher three, six and twelve months later. The *lowest* 12-month return, excluding dividends, was 13.4% (the highest was 36.7%, and the average was 27.6%).

So on valuation grounds alone, the obvious thing to do in the face of uncertainty about the election is to take equity risk, and lots of it. That means shifting out of cash or bonds into stocks -- or shifting out of defensive sectors into riskier ones -- and selling fear-driven assets like oil. Yet the obvious is sometimes surprisingly difficult to force one's self to do. For one thing, smart investors always want to fancy themselves to be contrarians, so the obvious is often ruled out simply because it is obvious. But truth be told, doing the obvious can take some real courage. For example, during the week when the markets were closed after the terrorist attacks of 9-11, historical precedent for how markets reacted to crises of that sort were heavily publicized. The obvious lesson from history was to buy the opening, while there was "blood in the streets." But did you?

Today it's just as obvious that, after the election, investor psychology will emerge from a bubble of fear that has been intentionally engineered by both parties and dutifully amplified by the media. All the markets that have been distorted by fear -- stocks unchanged against a surging earnings background, 10-year Treasuries priced at 4% in the midst of a robust expansion and rising inflationary risks, and oil in a speculative frenzy egged on by exaggerated terrorism fears that have materialized to no greater extent than a grainy video tape. Just as with the bubble of irrational exuberance in 1999 and 2000, this bubble is obvious -- yet it takes courage to bet against it. It will be *really* obvious in retrospect, but then it will be too late.

Today the decision to buy cheap stocks would be easy if it were obvious that Bush was going to win (but then the opportunity would surely not be available). As we've written so many times this year, equity markets demonstrably prefer the continuation of the pro-growth Bush policy environment, and all year have been building up a near-historic risk premium to discount the growing possibility of losing that environment. Is Bush wins, much of that risk premium could be absorbed quite quickly, which could result in a rally of 20% or more, possibly in a matter of weeks after the election. Remarkably, while a Bush victory is admittedly quite far from certain, it is nevertheless still the most likely outcome, albeit only moderately, based on both conventional polls and the online political futures markets. So we find ourselves in the rare and admirable position of being able to bet on a better-than-even probability and get very long odds for doing so.

So in some sense, the only question is: how bad will it be for stocks if Bush loses? On the face of it, if **John Kerry** were able to enact the many "plans" he has campaigned on, he would be a disaster for the economy and the markets. Fortunately he would not be able to enact *all* of them, since many are mutually exclusive (such as nationalizing health insurance and reducing the deficit at the same time). Kerry will also be constrained by what will surely be a **GOP**-dominated **Congress**. What looks like a gain of three net seats in the **Senate** will not make the **Republican** majority strong enough to overturn a Kerry veto on extending the tax cuts on dividends and capital gains, but it should act as an effective brake on the worst of Kerry's welfare state impulses. Thus the worst case for stocks with a Kerry win is probably less bad than deeply undervalued

**Tradesports.com Senate forecast**

| RACE, INCUMBENCY, PROB | | | KEEP | | GAIN | |
|---|---|---|---|---|---|---|
| AK.MURKOWSKI | GOP | 44 | | | | DEM |
| AL.SHELBY | GOP | 97 | GOP | | | |
| AR.LINCOLN | DEM | 96 | | DEM | | |
| AZ.MCCAIN | GOP | 96 | GOP | | | |
| CA.BOXER | DEM | 99 | | DEM | | |
| CO.COORS | GOP | 34 | | | | DEM |
| CT.DODD | DEM | 97 | | DEM | | |
| FL.MARTINEZ | DEM | 63 | | | GOP | |
| GA.ISAKSON | DEM | 97 | | | GOP | |
| HI.INOYE | DEM | 95 | | DEM | | |
| IA.GRASSLEY | GOP | 97 | GOP | | | |
| ID.CRAPO | GOP | 97 | GOP | | | |
| IL.OBAMA | GOP | 98 | | | | DEM |
| IN.BAYH | DEM | 97 | | DEM | | |
| KS.BROWNBACK | GOP | 97 | GOP | | | |
| KY.BUNNING | GOP | 85 | GOP | | | |
| LA.VITTER | DEM | 54 | | | GOP | |
| MD.MIKULSKI | DEM | 96 | | DEM | | |
| MO.BOND | GOP | 95 | GOP | | | |
| NC.BOWLES | DEM | 37 | | | GOP | |
| ND.DORGAN | DEM | 97 | | DEM | | |
| NH.GREGG | GOP | 97 | GOP | | | |
| NV.REID | DEM | 97 | | DEM | | |
| NY.SCHUMER | DEM | 97 | | DEM | | |
| OH.VOINOVICH | GOP | 96 | GOP | | | |
| OK.CARSON | GOP | 23 | GOP | | | |
| OR.WYDEN | DEM | 97 | | DEM | | |
| PA.SPECTER | GOP | 96 | GOP | | | |
| SC.DEMINT | DEM | 88 | | | GOP | |
| SD.DASCHLE | DEM | 42 | | | GOP | |
| UT.BENNETT | GOP | 97 | GOP | | | |
| VT.LEAHY | DEM | 97 | | DEM | | |
| WA.MURRAY | DEM | 93 | | DEM | | |
| WI.FIENGOLD | DEM | 96 | | DEM | | |
| | 34 | | 12 | 13 | 6 | 3 |

GOP set to pick up 3 seats, net

stocks have already priced. That means that the downside risk assumed by betting on the enormous upside in the event of a Bush re-election isn't really very great.

The only part of all this that isn't obvious, then, is the extent of the risk that a lengthy legal dispute could effectively extend the election -- and the bubble of fear -- long after election day (see "Y2K Then, EY04 Now" October 25, 2004). So far the economic expansion has stayed on the rails despite all the consequences of the bubble of fear: general uncertainty, high oil prices, and an indecisive **Federal Reserve**. But the expansion is not infinitely resilient, especially if the consumption of democracy by litigation itself appears to present important new long-term risks to policy stability. The good news is that as we approach the possibility of a litigated election, the expansion is still strong. In 2000, the risks and costs of post-election litigation were imposed upon an economy that was already sharply braking. We would also note that in 2000, post-election litigation was a surprise, and this time around it has been thoroughly aired as a possibility -- suggesting that, here too, markets may have already discounted a great deal of the risk.

It may also be the case that the most likely structure of potential post-election litigation favors Bush. So far allegations by Republicans have been mostly in the area of vote fraud (for example, the registration of fictitious persons). Such allegations have the advantage of being amenable to remedy (the fraudulent vote is simply not counted, at least assuming that it has been detected). But allegations by **Democrats** have been mostly in the area of voter suppression (for example, eligible voters kept off the rolls, or voters confused by computer voting terminals). Such allegations are much less amenable to remedy (since it is not clear how you tally the vote of someone who didn't vote in the first place).

The bottom line is that, to us, it is obvious that stocks are very cheap, and have been made very cheap by an election season that is at or near its end. While we don't know how the election will turn out, at this moment there is an edge in favor of the most market-friendly outcome. And it is probably the case that the most market-unfriendly outcomes have already been discounted -- perhaps more than discounted. So we can't call the election, but we have to call this a good time to take equity risk. TM