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POLITICAL PULSE

Obamanation

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The ascendance of Barack Obama brings anti-growth political risk into focus.

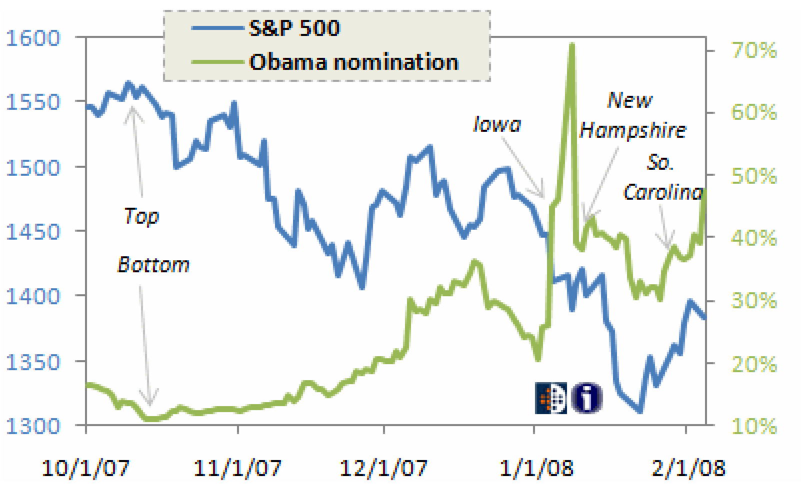
Update to strategic view

US MACRO, US STOCKS: Short term, we are optimistic on the economy and the stock market based on healing of the credit crisis, an easy Fed, and the recovery of negative sentiment. Longer term, we are running up the caution flags: we see a more restrictive Fed and a turn toward an anti-growth environment in Washington imposing important downside risks. The art of the coming year will be to accurately time when the recovery has run its course, and the longer term negatives take control.

[see Investment Strategy Dashboard]

It's no revelation that the economy and the markets face risks from the capture of the White House by the Democrats in November, and the likely expiration of the 2001 and 2003 tax cuts. But we think political risk has risen considerably, and become more complex, with the emergence of Barack Obama as a credible candidate for president.

While it may be a coincidence, we note that the October 9, 2007 *top* in the S&P 500 missed by only four days the October 13, 2007 *bottom* in the futures contracts on Obama's nomination traded online at Intrade.com. Stocks have fallen 11.2% since then, while Obama's probability of getting the Democratic nomination for president has risen from 11% to 47% here on the eve of the Super-Tuesday primaries. On the face of it, then, and assuming away all other influences, the meteoric political ascendancy of Barack Obama would appear to be a negative for stocks. This comports with our dominant concern that, if elected, Obama's enormous personal charm and his exalted status as the first African American president would give him a *charismatic mandate* and make it especially easy for his agenda of higher taxes and government control of the economy to be enacted without resistance. Conversely, if Hillary Clinton were elected, her polarizing personality would mobilize resistance against her substantially similar agenda. As we learned with George W. Bush's great popularity in the wake



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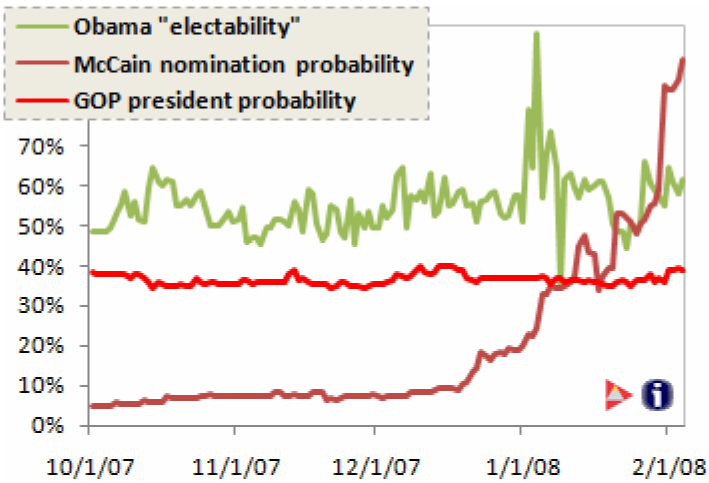
of the terrorist attacks of 9/11, extremely popular presidents are at risk of making policy mistakes that less popular ones would have been prevented from making.

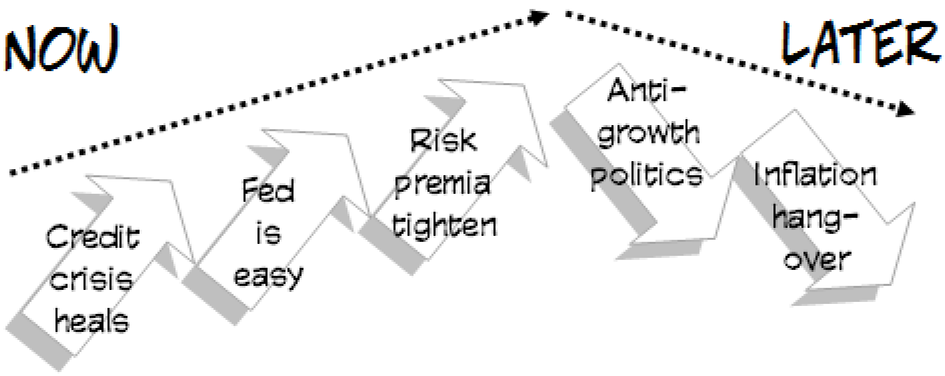
That's our dominant concern with the risk of Barack Obama, but things are not entirely that simple. As the chart above shows, the *negative* correlation between stocks and Obama *turned positive* after the media binge of Obamamania in the wake of his surprise Iowa victory was abruptly ended with his defeat by Clinton in New Hampshire. After that, stocks and Obama have generally risen and fallen together. In other words, having been *bad* for stocks for three months, three weeks ago Obama became *good* for stocks. Why? We can't rule out the possibility that the performance of the stock market in fact has nothing to do with Obama at all -- indeed, if we had to pick a single factor *most* in the driver's seat right now day to day it would be the market's nervous vigil over the ratings status of the bond insurance industry (see ["Another Leg Lower"]() January 21, 2008 and ["Jump! How High? Cut! How Low?"]() January 31, 2008). But surely as a long-term matter stocks should, to some extent at least, discount the risks to capital imposed by different possible political outcomes. So let's consider what the change in stock behavior in relation to Obama's nomination probabilities *might* mean.



First, we note that the change in the direction of correlation occurred subsequent to the New Hampshire primaries in which two political developments happened at the same time -- not only did Hillary Clinton show that Barack Obama was not an unstoppable runaway train, but also John McCain established himself as the Republican front-runner. Since McCain's emergence the probabilities of a GOP president being elected in Intrade.com trading have risen very modestly, from the mid 30%'s to the high 30%'s. And applying statistical techniques to the trading data, we can determine that Obama's "electability" -- that is, the probability of ultimately being elected president *assuming* he's the Democratic nominee -- has stayed about the same, approximately 60%, from when McCain's probability of being the GOP nominee was just 7% several months ago to now when it's 89%.

If McCain doesn't explain why stocks have become positively correlated with Obama's nomination probability, then another possibility would be that stocks prefer Obama's economics to Clinton's, at least provided that Obama is not swept into office with a charismatic mandate. After his defeat in New Hampshire, it was clearer than it seemed on the evening of the Iowa caucuses that Obama was an ordinary man who would have to fight hard and dirty for the presidency like everyone else, not a saint who would be made president by acclamation. With that clarity, it's been easier to appreciate that Obama's brand of social-democratic control of the economy is less oppressive than Hillary's, and should probably be preferable to advocates of growth. For example, Obama has not indulged, as Clinton has, in demagogic calls for sweeping *ad hoc* economic interventions such as freezing variable mortgage rates and seizing oil industry profits. So if stocks see a Democratic president as inevitable anyway, and if stocks see that Obama will have to win office in a bruising campaign that will take some the shine off his halo, then (if nothing else) he's preferable to Clinton.

But let's keep things in perspective. The political situation does not look good for growth, even though Obama may be slightly better than Clinton under the right conditions. John McCain is a credible opponent for either Democrat, but it seems now quite unlikely that he could win. Even if he did win, he's nobody's idea of a deeply committed advocate of growth. That said, we are glad to see that in some important ways the trajectory of his thinking about economics has become more sophisticated and moved in a pro-growth direction over the years. For instance, he famously voted against the tax cuts of 2001 and 2003 -- but in 2005 his early endorsement was key in getting the 2003 tax cuts extended to 2010 (see "The McCain Mutiny" September 23, 2005). Still, he is prone to endorse populist interventions that sound good on the surface, but have obvious secondary costs and consequences to which he seems naïvely blind (for example, we would expect his and Joseph Lieberman's scheme to address global warming will backfire, in its own way, as horribly as his and Russell Feingold's campaign finance reform scheme did).



In the short to intermediate term, there is a strong bull case to be made. The credit crisis is healing, the Fed is massively accommodative, and risky assets now impound significant premia that are likely to narrow as investors grudgingly give up their worst-case fantasies. It's a powerful recipe for a significant bounce-back in the economy and a recovery in stocks.

But these positive factors exist in tension with the two powerful emerging long-term negative factors. As discussed here in detail, we must brace for the real risk of a shift to an anti-growth tax and regulatory environment as the Democrats take the White House and the 2001 and 2003 tax cuts expire. At just about the same time as those risks are kicking in, it's probable that the Fed will have to start aggressively cleaning up the inflationary consequences of having been so accommodative during the credit crisis, as we have warned many times throughout the crisis (see, most recently, "Something For Everyone" February 4, 2008). These risks seem to us to be, to a large extent, inevitable. It's just a question of how bad, and of timing. Make no mistake about it -- long term, we're running up the caution flags.

BOTTOM LINE: Short term, we are optimistic on the economy and the stock market based on healing of the credit crisis, an easy Fed, and the recovery of negative sentiment. Longer term, we are running up the caution flags: we see a more restrictive Fed and a turn toward an anti-growth environment in Washington imposing important downside risks. The art of the coming year will be to accurately time when the recovery has run its course, and the longer term negatives take control.