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POLITICAL PULSE

TrendMacro's Election Model

Friday, September 28, 2012
Donald Luskin

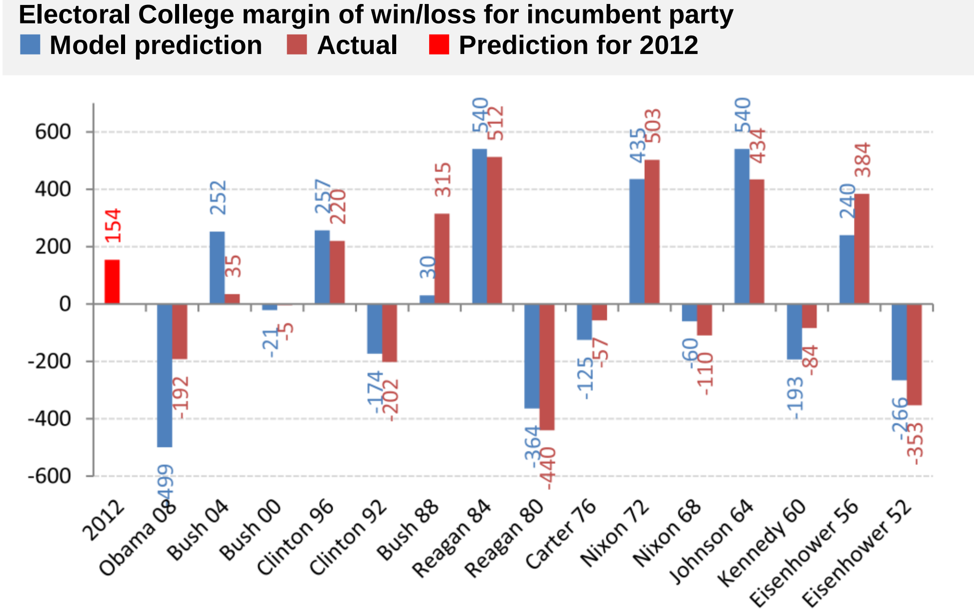
Obama by 154 Electoral College votes. The economy isn't weak enough for Romney to win.

The presidential election has gone from a coin-flip to a long-shot for Romney. We are moving ever closer to our nightmare "reflexivity" scenario in which rising stocks re-elect Obama, give him a mandate, and lead to a bargaining failure that throws us headlong off the fiscal cliff at year-end.

We think the worst-case outcomes occur under an Obama re-election: he could veto extension of all expiring tax provisions, and the GOP would then refuse to raise the debt ceiling (see, most recently, "Step by Step, Toward the Cliff" September 25, 2012). If Romney is elected, the tax provisions would be extended and the debt ceiling would be raised. The election seems decided now, but with 39 days to go, it's still not a sure thing. Our best guess comes from our quantitative election model, which we introduce in this report.

- *The model currently favors Obama, by 154 Electoral College votes.*
- *By economic inputs alone, Obama would lose. But the economy is not weak enough to overcome his advantage of incumbency.*
- The model correctly predicts every election from 1952 (please see the chart below).

Electoral College margin of win/loss for incumbent party



Update to strategic view

ELECTION MODEL, US MACRO, US STOCKS: The TrendMacro election model confirms the widespread sense that Romney will lose the election. The model, which correctly calls every election from 1952, is calling for an Obama win by 154 Electoral College votes, with 86% confidence. By the model's economic inputs alone, Obama should lose. But his advantage as an incumbent -- one whose party is not shopworn by having had at least two terms -- should be enough to overcome his economic disadvantage. With 39 days till the election, bad economic data could shift the model toward Romney, but probably not all the way. We think the most likely surprise that could help Romney would be a factor outside the model -- a sharp correction in stock prices, as investors become cognizant of the dangers of facing the fiscal cliff with Obama re-elected.

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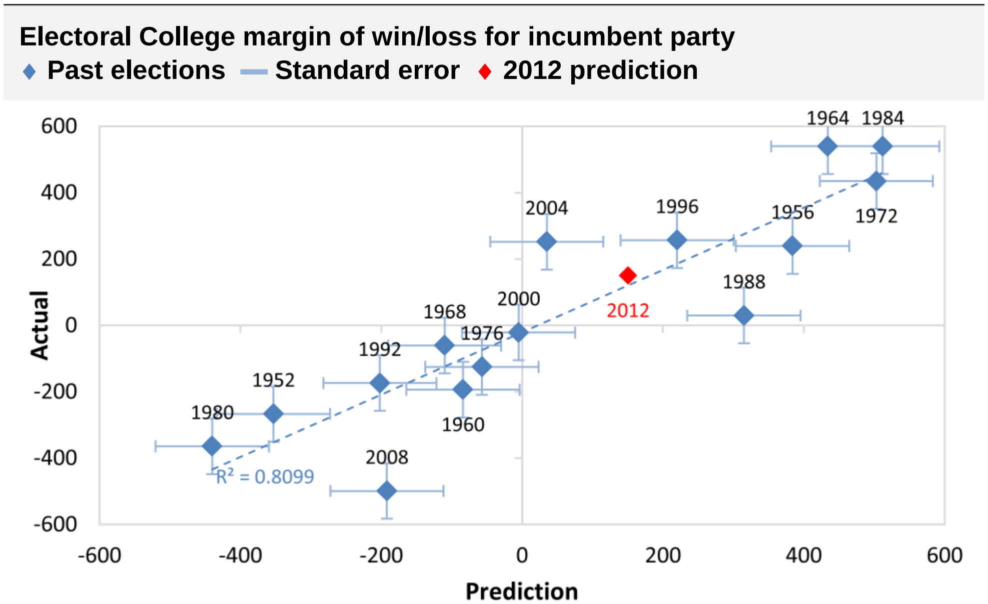
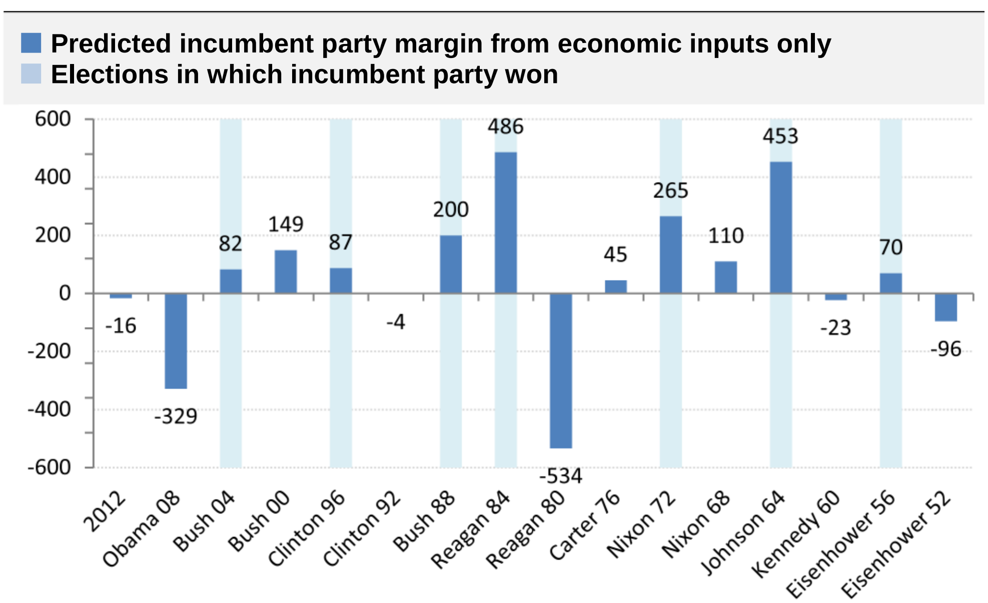
- The r-squared for the model's predictions versus actuals is 81. (please see the chart below). The model's standard error is 142 Electoral College votes -- which means our model gives Obama us 86% confidence of an Obama win (the Intrade political futures markets give him a 79% probability).



Our model stands on the shoulders of a giant: Yale econometrician Ray Fair's famous election model. Ours uses six economic inputs: the one year change in payrolls, gross domestic product, consumer prices and per capita disposable personal income; and the four year change in the crude oil price and comprehensive tax burden. And it uses two inputs based on incumbency: whether a *candidate as an individual* is an incumbent; and whether a *candidate's party* has been incumbent for two terms or more.

- The incumbent party has never won re-election with our model's economic inputs as weak as they are now (see the chart below).



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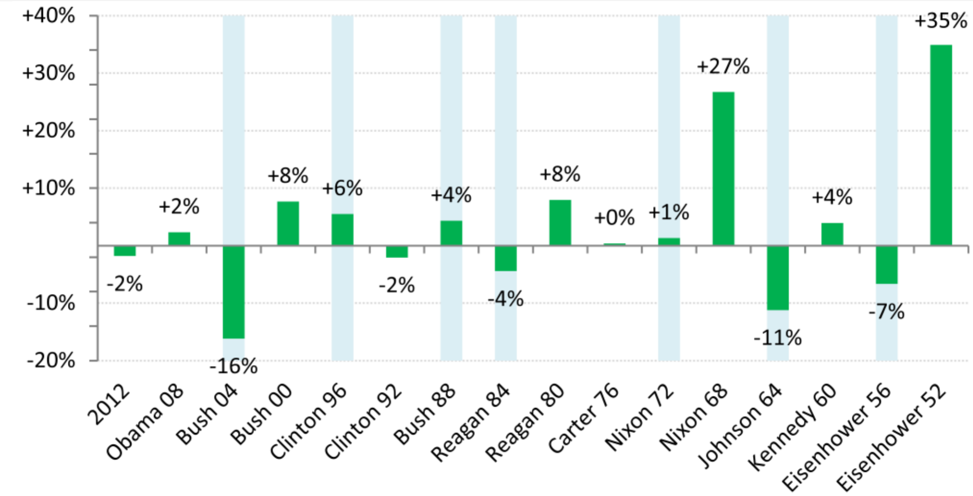
[About us]

- But the economy is not *exceptionally* weak -- it was weaker in four elections: 2008. 1980, 1960 and 1952.
- Of the six economic inputs, three count *against* Obama: payroll jobs, GDP, and DPI. These are the three inputs most highly correlated with election outcomes.
- But three other economic inputs count *in favor of* Obama: CPI, the oil price, and the tax burden. Yes, the tax burden has fallen over the last four years (please see the chart below) -- both because falling incomes have moved households into lower brackets, and because of the payroll tax holiday.

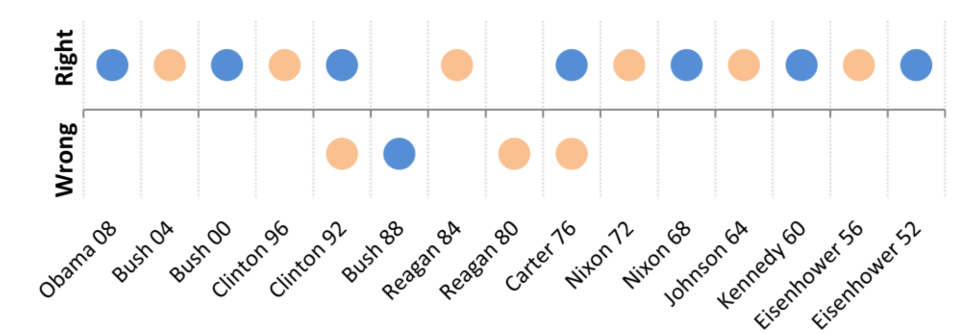
Four year change: comprehensive taxes as portion of gross income
Elections in which incumbent party won



Source: BEA, TrendMacro calculations

- Altogether the six economic inputs predict that Obama should lose by 16 Electoral College votes -- which is to say that the election would be a toss-up if these were the only inputs that mattered.
- However economic inputs are not sufficient to predict elections -- on their own, they miss 1968, 1976, and 1992. In those years the economic inputs were positive, but not strong enough to overcome the fact that the incumbent party had been in power for two terms -- that it was *shopworn*. In fact, in all but one of the eight such cases (please see the chart below: the miss was 1988), the shopworn

Prediction accuracy of incumbency factors
Incumbent party two terms or more *loses* **Incumbent individual *wins***



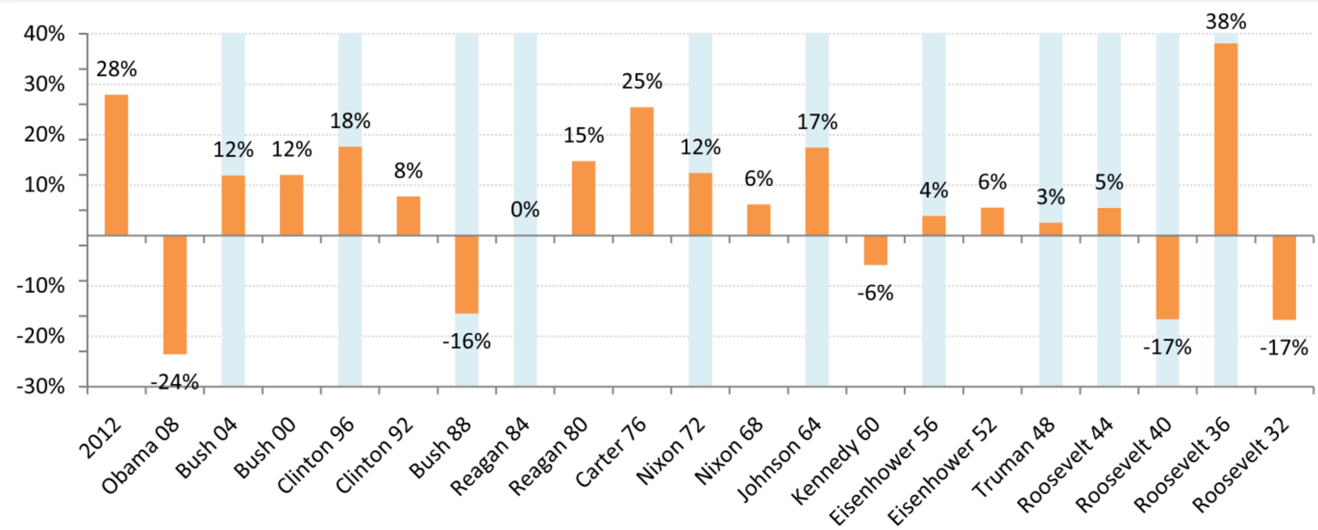
incumbent party has lost, irrespective of the economic inputs. So the model includes a penalty against the economic inputs under that condition. *However, that is not relevant in this election, as the incumbent party has been in power for a single term.*

- In this election, the power of the incumbency of the *person*, not the *party*, comes into play. Our model perfectly predicts all elections since 1952 even without taking this element into account. But we have decided to include it because of its strong track record. The incumbent candidate won in all but one of seven cases in which the incumbent person's party was not shopworn (please see the chart on the previous page: the miss was 1980, when the weakest election year economy in our dataset was bad enough to overcome incumbency).

A curiosum about the model is that the stock market is not one of the economic inputs. It turns out that stock returns are simply not correlated with election results.

- This seems to fly in the face of our often-repeated view that a rising stock market this year could improve sentiment sufficiently to re-elect Obama (see, first, "The Fiscal Cliff Bites" July 12, 2012).
- The objective statistical evidence doesn't dissuade us from our admittedly subjective view. That's because our statistical method is simple linear regression, a mode of analysis that has a blind spot for "black swans." What we have on our hands now in the stock market is very much a black swan, which could be a non-linear shock event for the election.
- The 28% return to the S&P 500 over the last year is an outlier, a near-record, second only to the 38% return the year before the 1936 re-election of Franklin D. Roosevelt (see the chart below). To

One year performance S&P 500, dividends not included
Elections in which incumbent party won



Source: Bloomberg, TrendMacro calculations be sure, in the previous second place year, 1976, the incumbent party lost. That first post-Watergate election was arguably unique. But our model explains the seeming anomaly without taking account of such subjective considerations. In 1976 the loser had the *penalty* in the model of having his party in power for two terms -- conversely, in 1936 the winner had the *benefit* in the model of personal incumbency.

- While our subjective view about the role of stocks in the election is refuted by the objective evidence, *it nevertheless points in the same direction* -- an Obama win.

Again, there are still 39 days till the election. Much can change in the subjective and objective realms. Scandal, geopolitical shock, terrorist attack, sickness, death -- there are an infinite number of possible "October surprises." Perhaps this year such things would have less impact in light of increasing use of early voting, in which citizens lock in their choice before a surprise can even occur.

- Abstracting from that, surprises could cut either way. But at this point, a surprise that elects Obama wouldn't really be a surprise in any important sense -- he's already the favorite.
- The subjective surprise we think is most to be expected would be a correction in stock prices. If we are right that rising stock prices will ultimately catalyze a crisis, at some point there ought to be recognition of that, and a sharp equilibrating correction.
- Objectively, economic data is coming in weak and is likely to continue to do so through the election. There will be updates in all six of the economic inputs before the election. Even if they all break bad, it probably wouldn't be by enough to drive our model all the way to calling for a Romney win. But it would push the model's forecast well within its standard error, making the election a toss-up.
- We will update clients with new model forecasts whenever the economic inputs change.

Bottom line

The TrendMacro election model confirms the widespread sense that Romney will lose the election. The model, which correctly calls every election from 1952, is calling for an Obama win by 154 Electoral College votes, with 86% confidence. By the model's economic inputs alone, Obama should lose. But his advantage as an incumbent -- one whose party is not shopworn by having had at least two terms -- should be enough to overcome his economic disadvantage. With 39 days till the election, bad economic data could shift the model toward Romney, but probably not all the way. We think the most likely surprise that could help Romney would be a factor outside the model -- a sharp correction in stock prices, as investors become cognizant of the dangers of facing the fiscal cliff with Obama re-elected.