

POLITICAL PULSE

## October is Half Over -- Where's the Surprise?

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**The race is narrowing, but Obama will probably win. The march toward the cliff starts soon.**

Last night's second presidential debate, in our estimation, [didn't advance](#) the potential turnaround for Mitt Romney begun in the first debate (see ["On the September Jobs Report"](#) October 5, 2012). He's running out of runway for an ["October surprise."](#) Without one, our base case has to be that our election model will be correct (see ["TrendMacro's Election Model"](#) September 28, 2012), and that Barack Obama will be re-elected.

- If that is right, it moves us down a very dangerous path toward the post-election negotiation of the fiscal cliff and the debt ceiling (see ["Step by Step, Toward the Cliff"](#) September 25, 2012).
- Stocks are now more than a month off their post-QE3 highs. We said then "stocks won't be at new highs for long" (see ["On the September FOMC"](#) September 13, 2012). As the election draws nearer, and afterward as negotiating positions harden in Washington, we urge clients to be prepared for a major volatility event (see ["Positioning for the Fiscal Cliff"](#) October 3, 2012).
- It's probably too little too late, but our election model does see the race narrowing somewhat. Three weeks ago it was predicting

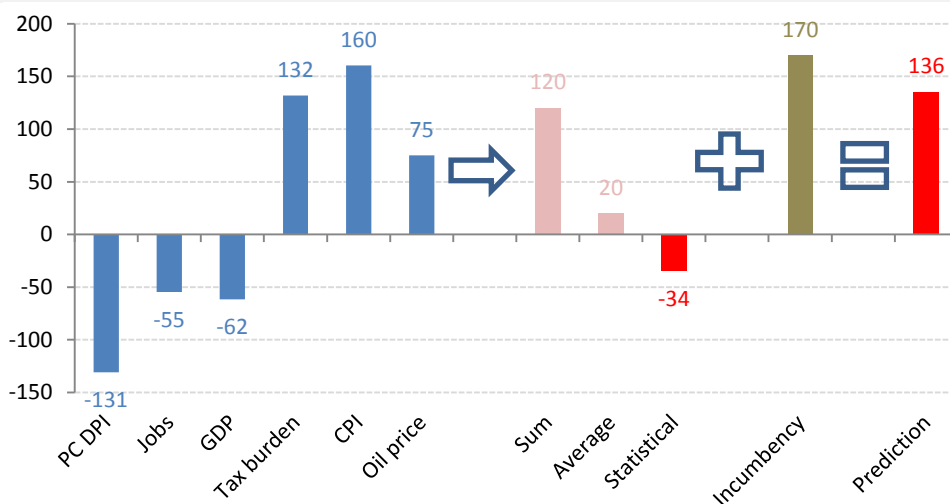
### Update to strategic view

#### ELECTION MODEL, US STOCKS, US MACRO:

The second debate didn't clinch Romney's turnaround, so the base case now has to be that our election model is correct: Obama will win. The model sees the race narrowing, but the economy isn't weak enough to elect Romney. For all the supposedly good economic news, stocks are already off their post-QE3 highs. As we approach the cliff, prepare for a major volatility event.

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### TrendMacro's election model



Source: Various, TrendMacro calculations

Obama would win by 154 Electoral College votes. Now with [yesterday's report](#) of a rise in the Consumer Price Index from 1.7% to 2.0% year-on-year (see ["Data Insights: CPI/PPI"](#) October 16, 2012) it is forecasting an Obama win by 136 (please see the chart on the previous page).

- In addition to updating CPI, the change is driven by new data on payroll jobs, oil prices, per capita disposable income and tax burden. We have also updated real GDP with the Bloomberg consensus of 1.8% for Q3 as a placeholder for actual data we won't get until October 27.

How can it be that the balance of economic inputs has worsened for Obama? After all, we just had a large drop in the unemployment rate (see ["On the September Jobs Report"](#) October 5, 2012), a positive surprise last week in new jobless claims, this week's upside surprise in retail sales and this morning's in housing starts.

- Our model ignores these particular inputs, because they aren't the most relevant for forecasting elections.
- Our research reveals that payroll jobs are more important to elections than the unemployment rate. *What counts is how many people are working, not how many people are not working.*
- And real GDP growth and income growth are more important to elections than consumption growth. *What counts is what people produce and earn, not what they spend.*
- As to housing starts, we don't doubt they are an important economic factor, and part of a gradual improvement in the housing market over the last two years that may be the economy's best hope (see ["It's Okay You Didn't Build That"](#) July 20, 2012). But data doesn't go back far enough to permit robust determination of their importance in elections.

With the economy mired in a Not So Great Expansion following the Great Recession, how can our model predict the incumbent will win?

- Overall, the six economic inputs in our model are net negative for Obama. If they were all that counted, Romney would win.
- But offsetting the economic factors, our research has proven to us that incumbency is a singularly powerful predictor. With only one exception since 1892, no incumbent has lost unless his party had occupied the White House for two terms or more. The one exception was Jimmy Carter in 1980 -- the economy then was so weak it defeated him.
- Though the economy is weak today, *it is not weak enough to overcome Obama's advantage of incumbency.*

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## Bottom line

The second debate didn't clinch Romney's turnaround, so the base case now has to be that our election model is correct: Obama will win. The model sees the race narrowing, but the economy isn't weak enough to

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