

THE CAPITALIST ADVISOR

TOP DOWN INSIGHTS...BOTTOM LINE RESULTS

Don't Expect Miracles After Election Day

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With the U.S. mid-term elections scheduled to occur two weeks from now (November 2nd), investors must anticipate what will likely happen that day (electorally) and how a political re-alignment might affect markets in subsequent months. Historically, *betting odds* have been more prescient and accurate in predicting election outcomes than mere polls taken by political strategists or independent groups; those who put their own money on the line have no reason to be emotional or biased, unlike those who administer (and respond to) opinion polls. Moreover, as "land-line" phones shrink as a share of all phone lines (due to the vast growth of cell phones), the traditional method of polling-by-phone (still mostly land-based) is increasingly obsolete and inaccurate. Meanwhile, political betting systems proliferate.¹

In Figure One below, the betting odds from one such service (Intrade.com) reveal that the Republicans now stand a good chance (85%) of regaining control of the U.S. House on election day (control which they lost in the 2006 mid-term elections). There are a total of 435 House seats, all subject to election every two years, so it takes 218 seats for either party to secure a simple majority and control the chamber, including its committee chairs, agendas, hearings and legislative schedules. The GOP now holds only 178 seats in the House (versus 255 for Democrats), so it needs a net gain of 40 seats to regain control. Based on the history of political betting odds and actual, subsequent election results, the GOP's current odds of 85% (quite high) suggest a net gain of approximately 45-50 seats (for an edge of 223-212).

Figure One
The Probability of Republicans Gaining Control of the U.S. House of Representatives is Now 85%, Up from 69% a Month Ago

*A Gain of 40 Seats (Net) is Necessary for the GOP to Regain Control
Intrade Odds in the Month Ending October 17, 2010*

HOUSE.REP.2010

Sep 18, 2010 - Oct 17, 2010

■ Closing Price: 85.2

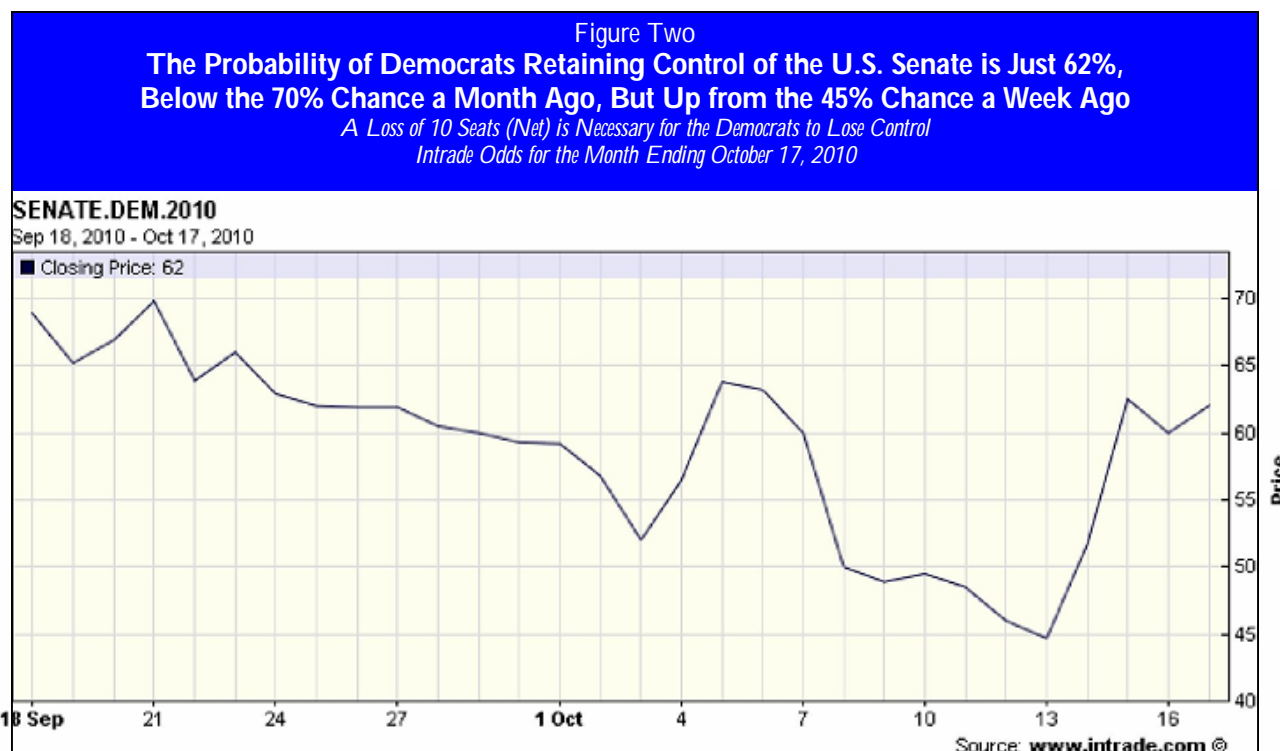


¹ In the U.S. the oldest system for betting on elections is the Iowa Electronic Markets (see [www.http://tippie.uiowa.edu/iem/index.cfm](http://tippie.uiowa.edu/iem/index.cfm)), but see also www.intrade.com and www.electionprojection.com.

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It's not far-fetched to conclude that U.S. stocks have performed much better in the three months *since* mid-July than they did in the three months *prior* due largely to the shift in political odds in favor of the GOP, with the expectation that it might regain control of the House and partly check an out-of-control Obama Regime. It was in mid-July that the probability of a GOP take-over of the House first exceeded 50%, and its odds have climbed steadily since then, to 86% (see the trend since November 2009 in the **Appendix**). The S&P 500 has increased 8% in the three months since mid-July, whereas in the *prior* three months it had *declined* by 10%. We'd say this six-month upward acceleration (+18% points) in S&P 500 performance is attributable in part to the rising likelihood of GOP control of the House, that is, of some degree of political "gridlock" (i.e., less political activism in Washington), which is *bullish*, historically.

However, the electoral story isn't looking so positive for Republicans when it comes to the likely outcome in the U.S. Senate. There are 100 Senate seats, in total, but only 1/3rd of the seats are subject to election every two years. The GOP currently holds only 41 seats, versus the 59 held by Democrats (including two "Independents" that tend to vote with Democrats). Thus the GOP needs a net gain of 10 seats (out of only 33 up for grabs this year) to regain control of the Senate (which it lost in the 2006 mid-term elections). That outcome is unlikely.

Figure Two above plots the changing probability, over the past month, of the Democrats *retaining control* of the Senate (even while losing some seats) – and the probability is now 62%, down from a recent peak of 70% in September (and from a contract peak of 95% in early January), but up from a mere 45% chance a week ago.

Put another way, Figure Two tells us that the GOP now has only a 38% chance of regaining control of the Senate, but that's up from only 5% in January 2010 (before Republican Scott Brown won the Senate race in Massachusetts) and up from 30% in September. Based on history, we predict the GOP will gain 7-8 Senate seats in early November – not enough to gain control.

Even if the GOP regains control of the House, and even if many of its newly-elected members are of the "Tea Party" variety (who favor less-expansionist government and are willing to challenge some Democrats) relative to "Establishment Republicans" (who, like George W. Bush, favor expansionist government and appeasing Democrats), they will not have the power to repeal any of the atrocious policies enacted by Bush-Obama in recent years. Even if they tried to do so, Obama would simply veto their futile efforts – and it takes a 2/3rds majority to override a presidential veto; that's a minimum of 290 votes in the House, and to get that many, the GOP would have to secure a net gain of 112 seats on

election day, whereas they'll probably only get an additional 45-50 seats. In short, the Republicans won't be able to override an Obama veto, so our guess is that they won't even bother to try and repeal ObamaCare, or the stimulus scheme, or the TARP bailout. As this becomes apparent to the populace at large, the reputation of the newly-elected as "radicals" will fade into cynicism.

Even if the GOP had the power to exercise its will in the House, it wouldn't have the power in the Senate. And even if it had the power in the Senate, there's little evidence it has the moral fortitude or ideological backbone to effect real change back toward capitalism. I predicted as much after the victory of Scott Brown last January,² and it's sad to realize I was right. Nor is the Tea Party's "Contract From America" a radical, pro-capitalist plan.³ The one encouraging aspect of it is the (seemingly) renewed respect for the U.S. Constitution. But as with most "conservative" plans, the aim is merely to *conserve that which Democrats have already enacted*. The Bush and Obama Administrations reversed these roles recently, but this only shows how close the U.S. is to a *one-party rule*.

The typical sequence and trend in U.S. public policy in the past century has been something like this: the Democrats – the so-called "voice of the people," the intrepid "reformers" and "agents of change" – enact some crazy new intervention, and conservative Republicans, instead of opposing and repealing it, accept it *on principle* and merely *codify and solidify* it (after complaining only of its cost). The new level of statism, now sanctioned by *both* sides, serves as a *baseline* or plateau from which further and future government interventions are launched. This is largely what happened with the imposition of 1) antitrust laws in 1890, 2) federal income taxes in 1913, 3) the Federal Reserve in 1913, 4) fiat paper money in 1933, 5) Social Security in 1935, 6) Medicare and Medicaid in 1965, and 7) the EPA (plus scores of other regulatory agencies) in the 1970s. Few (if any) of these agencies, departments, pro-

grams or taxes are ever repealed or scaled back – and meantime *they're inexorably bankrupting the nation*. The America Experiment was launched in 1789 with just four (and legitimate) cabinet-level agencies.⁴ The country grew rapidly in the following century. But starting about a century ago, activists pushed for interventions of all kinds, to the point where today *Washington now has 11 additional cabinet departments* – all illegitimate⁵ – which cover (and smother) nearly *every sector* of the economy.

No GOP "comeback" or Tea Party surge next month would reverse or curb these interventions (now sacrosanct "entitlements"). The GOP will gain some extra political seats in Washington after Election Day, but that doesn't mean they'll have attained any greater appreciation for genuine capitalism or of the crucial need to move the country back *toward* it. We'd be encouraged, and investors would be justified in bullish toward stocks in the year after the election, only if the Republicans were to *stand up in unison and on principle* during the forthcoming "lame duck" session (running from November 3rd to January 19th of next year) and demand just two things: 1) *no new tax-rate hikes* to take effect in early January (as they currently would, if no legislative changes are made), whether on the rich, the middle class or the poor – and 2) a repeal of ObamaCare, coupled with a pledge to help on nothing else, legislatively, unless it is repealed *post haste*.

Don't hold your breath. The would-be Speaker of the House, Republican John Boehner (OH) has *already* said he'd *sacrifice the rich* to help Obama.⁶ Like many others in the GOP, Boehner's a coward; significantly, he stands at summit of his party's leadership. That's their "best" man. The GOP will cave-in again, as it has historically, to the destructive Democrats. Thus investors shouldn't expect miracles from the coming election; that is, they shouldn't expect the GOP to morally defend, legally protect or energetically hail capitalism (or capitalists). So there'll be no need to get very bullish on U.S. stocks.

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² Richard M. Salsman, "Scott Brown: A Mere Speed Bump on the Conservatives' Road to Serfdom," *Capitalism Magazine*, January 20, 2010 (see <http://www.capitalismmagazine.com/index.php?news=5697>).

³ See <http://www.thecontract.org/the-contract-from-america/>.

⁴ The initial cabinet departments in the 1790s were the Department of Treasury, Department of State, Department of Justice, and Department of War (Defense).

⁵ See especially the Department of Agriculture, Department of Commerce, Department of Education, Department of Energy, Department of Interior, Department of Labor, Department of Health & Human Services, Department of Housing & Urban Development, Department of Transportation – and the Department of Veterans Affairs and Department of Homeland Security, both of which should be part of the Defense Department.

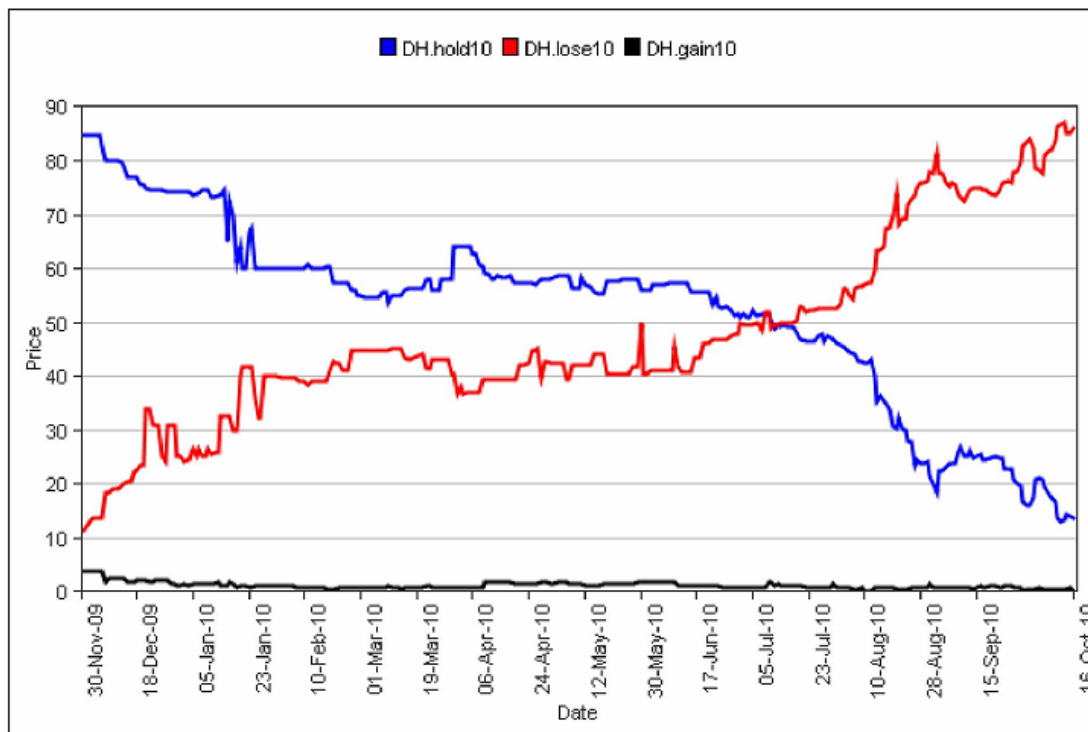
⁶ See "Boehner Says He'd Vote for Democratic Tax Proposal," *CNN*, September 12, 2010.

APPENDIX

Iowa Electronic Betting Markets Also Predict that the GOP Will Regain Control of the U.S. House, While Democrats Retain Control of U.S. Senate

Source: <http://tippie.uiowa.edu/iem/index.cfm>

A. Current Probability the Democrats Will Lose the U.S. House ["DH.lose"] = 86%



B. Current Probability the Democrats Will Hold the U.S. Senate ["DS.hold"] = 80%

