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# Intelligent Money

*Current thinking from Haven Financial Advisors*

Louis Kokernak CFP, CFA
Haven Financial Advisors
Austin ~ Dallas
voice 512 514 6250
toll-free 800 898 5480
fax 800 888 5480
louis@havenfinancial.com

***Special Notes of Interest:***

A recent poll by CNN and Opinion Research revealed that 4 in 5 Americans believe that the US economy is already in recession.

Foreign oil comprised 57.9 % of US consumption in the first three months of this year, down from 58.2 % last year.

## Prediction Markets

Financial news is dominated by a narrative of the various asset markets around the globe. Turn on CNBC and within seconds you be apprised of the current status of stocks trading on the New York Stock Exchange. Wait a little longer and you'll find out how foreign stocks are doing. Besides these markets for assets, there are trading exchanges known as *Prediction Markets* that assign likelihoods to individual events. Here, we'll focus on this comparatively new phenomenon.

Prediction markets, also known as idea futures, are created for the purpose of assigning value or likelihood to propositions. Assets are created whose final cash value is tied to a particular event (e.g., Will Hillary Clinton win the Democratic nomination?) or parameter (e.g., opening weekend box office sales for "Sex and the City"). The current market prices are interpreted as predictions of the probability of the event or the expected value of the parameter. Prediction markets are thus structured as betting exchanges, without any risk for the bookmaker.

At first glance, the prediction market resembles the NASDAQ or a commodity futures market with common measures such as bid price, ask price, open interest, and trading volume. The information revealed by the prices is considered by many researchers to be an unbiased and reasonably accurate estimator of true probability.

One of the most popular areas for contracts in prediction markets is politics. An academic prediction market sponsored by the University of Iowa has been handicapping the presidential race since 1988 with excellent results. Its average error in forecasting the popular vote is only 1.4%. The Gallup poll has an average error of 2.0% over the same period. Prediction markets function well in generating voting outcomes even when there is no polling to serve as a guidepost. For example, Australian bookmakers offer markets on district level political races (without polling) and the resulting spreads have been quite accurate.

The trading volume of prediction markets thus far is insufficient to make them realistic hedging tools for investors. However, there is escalating interest in a number of innovative prediction market contracts. Among the biggest prediction markets is Intrade ( www.intrade.com) which is located in the United Kingdom. There is a wide range of economic and political propositions that are tradable on its website.

Intrade has a contract which allows investors to invest money on the likelihood that the US falls into recession in 2008. Traded since August of 2007, the ongoing price seems to reflect new economic data with reasonable speed and efficiency.

The chart below reveals that the market consensus for an American recession has ranged from a probability of about 75% to 25%. Notably the contract price began sinking in late April – just before preliminary GDP growth for the first quarter was released on April 30th. The statistical release revealed that the US economy was still growing in the first quarter – contrary to the consensus market sentiment. The recession "price" continued to fall as positive earnings and leading economic indicators became public.

Along the political front, both Intrade and the Iowa Electronic Market made Obama the odds on favorite to capture the Democratic nomination just after Super Tuesday. In retrospect, the market called the eventual winner before the political pundit class.

It is worth surveying some current prices for insight into the near future. As this issue goes to press, Intrade futures assign a 40% likelihood to a John McCain presidency while Barack Obama has been assigned a 93% chance of securing the Democratic party's nomination.

Many companies are applying prediction market theory to corporate events such as new product offerings. Research has found that play money is about as effective as real money in achieving accurate outcomes. Google is a case in point. It uses prediction markets with employee participation to forecast product launch dates and to estimate product usage.

Even if one is not inclined to gamble, it is still useful to observe the collective wisdom of a wide base of participants. Insightful market prices can be found on the internet and it is likely that both private and public prediction markets will continue to expand.

## What is a Recession Anyway?

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Politicians and economists have debated the likelihood of recession in the United States for the past several months. As you know, the president and congress have enacted a preemptive stimulus package of tax rebates to minimize the effects of a possible recession. While the term "recession" is often used in public discourse, most Americans do not understand its definition. Unfortunately, that definition is elusive. There are two generally accepted descriptions of recession and they are sometimes at loggerheads with one another. Moreover, one of those definitions is vague by design.

The traditional definition of an economic recession is two or more consecutive quarters of negative real economic growth as measured by gross domestic product (GDP). The prediction markets use this definition. Of course, it takes time to compile comprehensive data. There are three separate iterations of quarterly GDP growth - two estimates followed by a "final" number. This final compilation is not released until nearly three months after the end of the quarter it measures.

So far, aggregate economic growth has not indicated recession. The initial estimate of first quarter GDP growth was actually positive at +0.6%. A revision to this estimate is due out next week.

Since 1961, The US government has recognized the National Bureau of Economic Research's (NBER) Business Cycle Dating Committee as the "official" arbiter of recession. This is a seven member group of academic economists. The NBER does not use any specific methodology for determining the start and end dates of a recession - instead it looks at a variety of economic indicators over various time periods and determines whether to declare that the economy is in a recession based on that data. Here is the NBER's official policy on recession:

> A recession is a significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in real GDP, real income, employment, industrial production, and wholesale-retail sales.

The NBER is very deliberate in its assessment of the underlying data to avoid the need for revision. Its own policy is to wait "6 to 18 months" after the beginning of a recession to declare that one has started. In fact, they waited 20 months to declare that the last recession officially ended in November 2001! It is interesting to note the US economy actually never had two consecutive quarters of GDP decline during the 2000-2001 period.

NBER committee members can complicate things by voicing their own views. They are not restricted as are government bureaucrats. Martin Feldstein, opined in March that his "personal view" was that the United States was already in recession. He reinforced those views just last week in declaring that this recession would be "severe". In contrast, Edward Lazear told a meeting of *Wall Street Journal* journalists that "the data are pretty clear we're not in a recession." Even the guys who are supposed to decide what a recession is cannot agree.

Meanwhile, the economic data offers a glimmer of hope. The US trade deficit is falling faster than anticipated and this will likely spur an upward revision the 1st quarter GDP due out next week. The consensus of economic experts now is that GDP growth in the 1st quarter was actually +0.9%. Monday's release of the Leading Economic Indicators for April was also positive as it evidenced mildly improving conditions- the second consecutive monthly upswing.

In an election year with anemic growth, the labeling of the US economic condition will take on urgent meaning. This will put the NBER's business cycle dating committee to the test.