What's wrong with the US?

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September 27, 2011

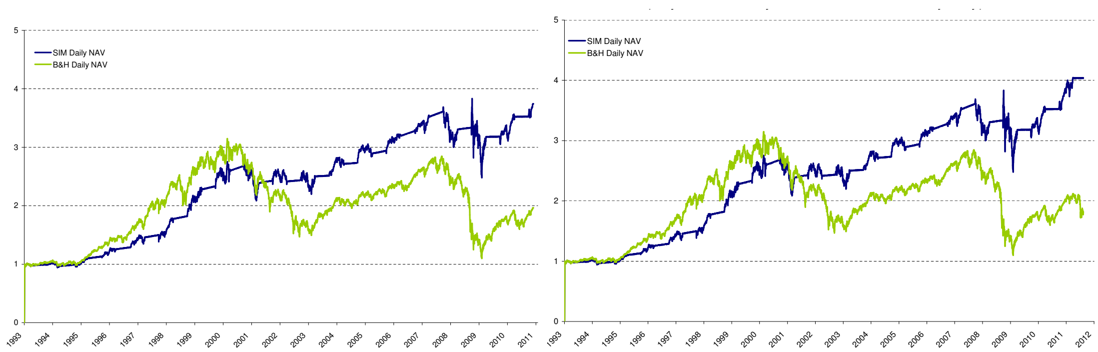
In this column I discuss the August-September stock market turmoil in the US and other markets and the deteriorating state of affairs in the US. The latter topic concerns me greatly as I grew up in the US, had all my education there with a PhD at the then greatest university of the world - the University of California, Berkeley - and I continue to have many activities there although I have lived in Canada since 1968. As a dual citizen of the US and Canada I understand the cultural differences, strengths and weaknesses.

Let's begin with the sell in May and go away anomaly for the S&P500 large cap index and Russell2000 small cap index, both of which are value weighted. Those who dismiss seasonal anomalies ought to read this.

1 Sell-in-May-and-go-away

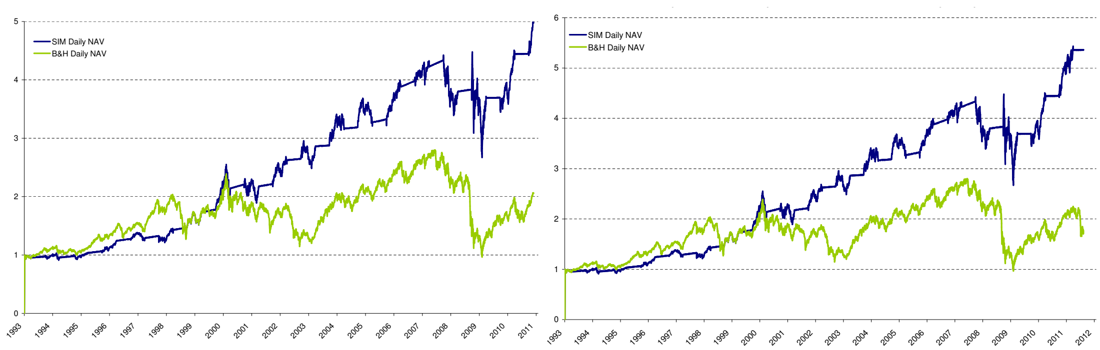
September and October have historically had low stock market returns with many serious declines or crashes occurring in October. Also the months of November to February have historically had higher than average returns; see, for example, Gultekin and Gultekin (1983) and various papers in Keim and Ziemba (2000). Recent data is in Appendix Tables A.1 and A.2. This suggests the strategy to avoid the bad months and be in cash then and only be long the stock market in the good months. Sell-in-May-and-go-away, which is sometimes called the *Halloween Effect*, is one such strategy that is often discussed in the financial press. Figures 1 and 2 show this strategy using the rule sell at the first trading day in May and buy on the 6th trading day before the end of October, for the S&P500 large cap and Russell2000 small cap futures indices for the years 1993-2010, respectively. The funds are in T-bills when they are not in the market. In both cases Sell in May and go away is greatly superior to buy-and-hold. Tables A.1 and A.2 in the appendix show the monthly returns, respectively, for the 17 plus years to September 16, 2011.

*Special thanks to Constantine Dzhabarov, Michael Intriligator, Sandra Schwartz and especially Rachel Ziemba for data assistance and helpful comments related to this material. I have strong views in this column which are mine and not necessarily those of my colleagues.



(a) 1993-2010 (b) 1993 to Sept 16, 2011

Figure 1: S&P500 Futures Sell in May (SIM) and B&H Cumulative Returns Comparison. (Entry at Close on 6th Day before End of October. Exit 1st Day of May.)



(a) 1993-2010 (b) 1993 to Sept 16, 2011

Figure 2: Russell2000 Futures Sell in May (SIM) and B&H Cumulative Returns Comparison. (Entry at Close on 6th Day before End of October. Exit 1st Day of May.)

For the S&P500 a buy and hold strategy turns \$1 on February 4, 1993, into \$1.96 on December 31, 2010; whereas, sell in May and move into cash, counting interest (Fed funds effective monthly rate for sell in May) and dividends for the buy and hold, had a final wealth of \$3.73, some 90.7% higher. For the Russell2000, the final wealth was \$2.04 and \$4.94, respectively, some 141.7% higher. For 2011, it was mid September when we went to press but so far, the SIM anomaly worked very well in 2011 with much market turbulence, particularly in August. The buy and hold strategy moved from \$1.96 on December 31, 2010 to \$1.86 on September 16, 2011; whereas SIM moved from \$3.73 to \$4.04, some 117.2% higher during 1993 to 2011, and 13.4% higher in 2011. For the Russell2000 the buy and hold moved from \$2.04 for 1993 to \$1.80 in 2010, whereas the SIM moved from \$4.94 to \$5.36. That is a gain of 197.7% during 1993 to 2011 and 20.3% higher in 2011.

Doeswijk (2005) offers a new hypotheses after reviewing two existing explanatory hypotheses. Bouman and Jacobsen (2002) confirm the empirical and historical basis of the maxim, finding that the Sell in May effect holds in 36 of the 37 countries included in their analysis. They consider vacation timing as a potential cause of the Sell in May effect, suggesting the timing of summer vacations may cause temporal variation in appetites for risk aversion. However, they find evidence of the Sell in May effect in their subset of Southern hemisphere countries, which under their hypothesis would be expected to have a different seasonal pattern.

Doeswijk (2005) offers a new hypothesis to explain the Sell in May effect. He posits that, in the fourth quarter of each year, investors are overly optimistic about the upcoming year. This excessive optimism leads to attractive initial returns followed by a renewed realism that readjusts expectations. The Optimism Cycle hypothesis reflects a constant risk premium but a varying perception of the economic outlook. In order to test this hypothesis, Doeswijk ran three analyses: 1) the global zero-investment seasonal sector-rotation strategy 2) the seasonality of earnings growth revisions and 3) the initial returns of IPOs as a proxy for investor optimism.

According to the Optimism Cycle, investors are over-optimistic at the end and beginning of the year. If this hypothesis is correct, a winning investment strategy is going long in cyclical stocks and short in defensive stocks during the winter period from November through April (winter) and following the opposite strategy from May through October (summer). (These stock groups are chosen for their relative exposure to the general economy, with cyclical stocks having a high exposure and defensive stocks a low exposure.) To test this strategy, Doeswijk uses the MSCI World index of global stock returns from 1970-2003 and tests the data as a whole, in two 17-year sub-periods, using several variations on timing of the winter period, and various sector definitions. The study runs regressions using monthly market capitalization-weighted price return indices and their monthly log returns.

Doeswijk finds that, on average during the study period, winter returns are a significant 7.6% higher than summer returns and the strategy works in 65% of the years. On a monthly basis, average performance of the global zero-investment strategy is 0.56%, which is significant at the 1% confidence level. Using further regression analysis techniques, Doeswijk also isolates the market timing effects from the seasonality and finds that seasonality alone accounts for approximately half of the excess returns.

Like the Optimism Cycle strategy, both other analyses in the Doeswijk study support the Optimism Cycle hypothesis. Doeswijk finds that expected earnings growth rates follow a seasonal cycle and that these changes have an effect on stock performance. The third analysis uses initial IPO returns, which show a remarkable seasonality, as a proxy for investor confidence. Using this investor confidence proxy as an independent variable, the regression result for remaining excess return is not statistically significant, which supports the Optimism Cycle hypothesis.

Along with the three supporting analyses, Doeswijk explains a qualitative argument in favor of his Optimism Cycle hypothesis. He argues that, since this phenomenon is one based on an aspect of human psychology, it tricks investors into repeating the same biases every year. Importantly, this cycle of optimism and pessimism is not generally accepted, which Doeswijk argues allows for investors who understand it to profit from it as a free lunch until it is more widely accepted and the arbitrage opportunity is absorbed into the market.

2 The August-September 2011 turbulent period

Nouriel Roubini, a brilliant student of market matters with a deep understanding of bond debt and other markets, has predicted a 60% chance of a US recession. He is known as Dr Doom from his correct call of the 2008 crisis and the August period was reminiscent of the three years ago period. Economists do have technical definitions of such matters based on negative GDP growth in two consecutive quarters. And there are others predicting a recession and those who think a double dip will be avoided. But looking around one sees a continuing weak economy. A recent example is the Hearst San Simeon tours at the wonderful mansion - 126 rooms - filled with treasures, many from renaissance Europe that William Randolph Hearst collected over the years. The estate up a 5 mile winding road on the California Central Coast, is so large that there were four tours which together allowed one to see it all. Now (in September 2011) over two thirds of the tour guides have been laid off, most of the rest are only part time, the four tours are three, the cost is up and the tour lengths and coverage are considerable shortened and by taking all three tours one does not see all of the castle. The tours and environs are still great but the drop in business has been so severe that they had to do this to cover their bills from the gardeners and other maintenance people who must be retained. The Hearst family gave the property to the state of California but the state is so cash strapped that the property must be self financing. The US and other countries have strict rules on such gifts that nothing can be sold - prime candidates where easy money could be made are the fruit on trees not used and the wine and other liquor spoiling in the wine cellar because of advanced age.

August was a violent month with many three digit ups and downs in the US stock market's Dow jones Industrial Average. The trouble began on August 2 and soon there were four consecutive days with movements greater than plus and minus 400 just like the week before the 1987 stock market crash. This was the first time the market had such 400+ gyrations on consecutive days. The VIX volatility index rose to 48 and stayed high all month. Figure 3 shows the S&P500, Russell2000 and VIX indices for the six months prior to our press date of September 21, 2011. Figures 4 and 5 show the euro, pound and Swiss Franc and gold and oil compared to the US dollar.

Figure 3: The S&P500, Russell2000 and VIX indices, March 22 to September 21, 2011. Source: Yahoo Finance

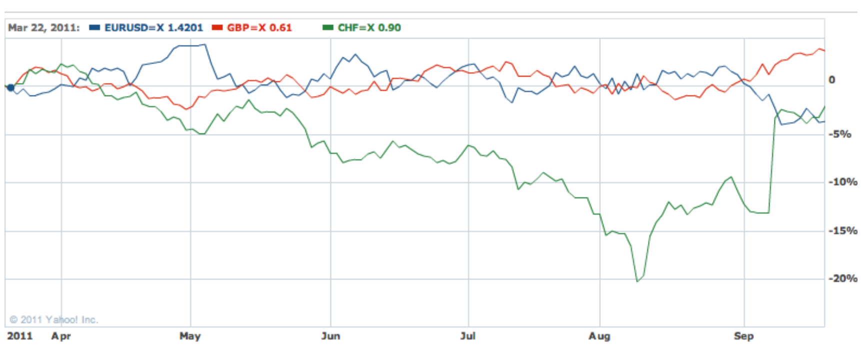


Figure 4: Currencies - euro, British pound, and Swiss franc - compared to the US dollar, March 22 to September 21, 2011. Source: Yahoo Finance

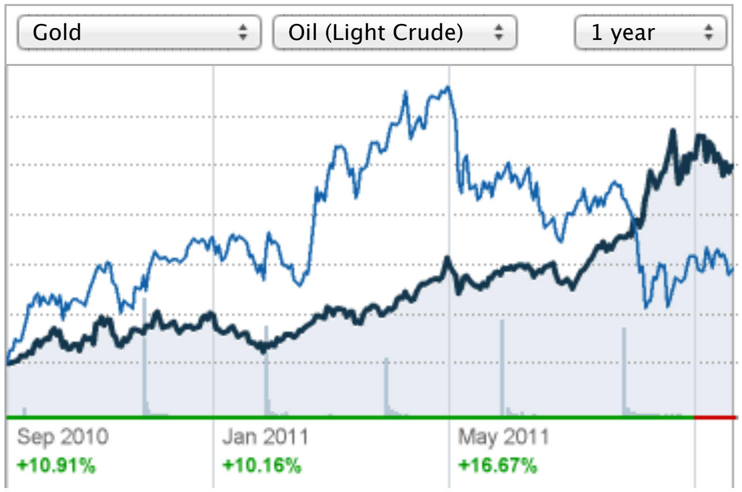


Figure 5: Oil and gold based in US dollar, September 22, 2010 to September 21, 2011. Source: CNN Money

The trouble started right after the US President Obama-Republican agreement on the debt ceiling and spending cuts. The apparent standoff and the huge amount of US debt, largely from the Bush administration's tax cuts and military spending without raising taxes, led to the downgrade of the AAA rating of the US debt to AA^+ by Standard and Poors. The downgrade of US growth the week before the Debt ceiling compromise also spooked the markets, adding to concerns as it made clear that the recession was even deeper than previously anticipated and the recovery even weaker making it clearer that the US had not really exited recession, despite a series of monetary and fiscal stimulus. This seems equally as important to the debt ceiling debacle at a time when the U.S. economy remained weak, US political leaders spent a month haggling over the passage of legislation that should have been almost automatic after the passage of a budget that required an increase in spending. Rather than on trying to come up with political solutions to deal with the underlying issues that keep the U.S. weak, such as the mortgage market. This downgrade was a symbol of the nervous market as the bond market was already pricing this in. Basically, no one liked the agreement and Obama looked more like a Republican than a Democrat. Instead of standing up to the right wing, he compromised but had to move way to the right on the political spectrum. This is one of the major US problems: the political atmosphere is very confrontational with many of the extreme right wing Tea party people not caring about what damage they do to the economy. They simply want to beat Obama in the next election even if they lose their seats. They have many inappropriate strategies such as recognizing and not telling the truth, creating rules so that poor blacks, students and others will be prevented from voting because they lack specified credentials with the places to get those credentials far away and only open limited hours. What is dangerous is that a small group, the Tea Party, have co-opted the debate.

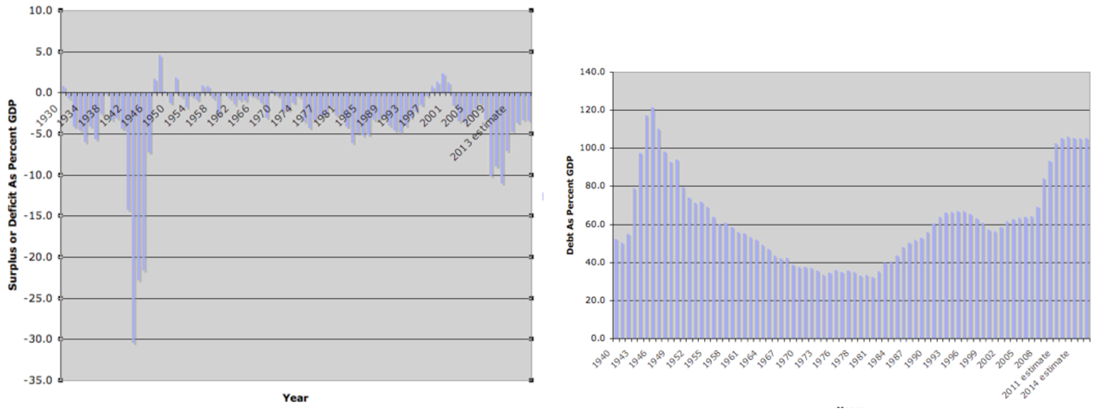
A similar situation seems to be developing in Germany. European debt issues were a major factor too and now we have the ECB and the Fed giving money at low interest rates to troubled European banks so, like 2008, they have *unlimited* access to US dollars for the rest of 2011. Christine Lagarde, the new head of the IMF, has maintained that these banks must obtain more capital and applauded this new activity of the ECB in collaboration with the US Fed, the Bank of England, the Bank of Japan and the Swiss National Bank. The idea was to ease the pressure on weak European banks by giving them access to loans - again borrow more to pay past debts, a band aid solution putting off the inevitable Greek default. A Greek default could lead to an Italian and Spanish default and that's a big worry for the world economy. The US loans are to the ECB not the European banks, so the ECB must repay the Fed in dollars. According to *The Economist* and Goldman Sachs, Europe's 38 biggest banks need between 30 and 92 billion euros to cope with haircuts to Greek, Irish and Portugese government bonds and losses on Italian and Spanish government debt. An IMF study suggest that the banks might lose about 200 billion euros if the current implied market prices based on current default probabilities prove to be correct.

The Obama-Republican agreement has a debt limit cut off of at least \$1.2 trillion by the 12-member bipartisan special debt committee who must recommend these cuts by November 23, 2011 and Congress must approve them by December 23. There is a not small chance - Nouriel Roubini has said it is 2/3rds probability that they will not reach this agreement in which case automatic across the board cuts come into play. House speaker John Boehner is against any new taxes, especially those to the rich. He argues that tax increases destroy jobs. The econometric evidence suggest otherwise.

A big issue is US spending. For example from January to August 2011, the Federal deficit was \$1.23 trillion. Figure 6 shows the debt and deficit situation versus the size of the economy.

There is 9.1% unemployment and about 20% when you count underemployed plus those who have given up trying to find a job. And there are too many poor people: the top 1% have wealth equal to the bottom 90% and their yearly income is equal to the bottom 60%. Fully 64% of all Americans cannot raise \$1000 in one day for an emergency. At a posh Del Mar restaurant WTZ gave some racetrack passes to the waitress - she said she was one of the 64%! There are too many people who cannot contribute to the economy. This waitress has a job but has a struggle to pay her bills on a daily basis. How can a country expect to move ahead economically with close to two thirds the population not contributing much.

When markets are weak and turbulent, new issues do poorly and indeed 63% of US based companies making their initial IPO's are trading below the offering price; see Cowan and Smith (2011).



(a) Surplus or deficit to GDP

(b) Debt to GDP

Figure 6: US debt and deficit to GDP, 1940 to 2015 (est), Source: dailybail.com

Update on the Fed: Operation Twist: The September 21, 2011, FOMC meeting kept short term interest rates near zero and pledged by June 2012 to sell $400 billion of short term notes and buy $400 billion of long term 6-30 year bonds. This twist, which does not affect their total balance sheet is intended to lower long term interest rates. They feel the economy has **significant downside risk**, inflation is moderating and the unemployment rate will decline but only slowly. The stock market did not react well to this - the S&P500 fell about 80 points, to put it down 6.77% for September to the 23rd and -9.64% for the year. There was also a collapse in the commodity prices with gold down over $100 and silver falling 17% to about $31. Forsyth (2011) points out that the Fed moves have not been approved by the market. The words *significant downside risk* coupled with no new buying only a switch of assets led to the decline. The market wanted quantitative easing - more financial stimulus, not qualitative easing, a shift of bond durations. This move lowers bank profitability since net interest margins will fall and so will demand for long term loans at low rates about 3.75% for 30 years. Also pension funds are hurt by low long-term interest rates. Operation twist is likely the precursor to QE3, which is unlikely to have the same reflating effect as the previous rounds of quantitative easing. Moreover, if stability-seeking global investors like China, continue to shift their portfolios on the margin to shorter-duration securities, it will undermine the effect of the Fed's move. Again this is a limited move, anticipated by the market and may do little to help the real economy, hence the desultory response. Ultimately the fiscal tool needs to be used, and in a way that will stimulate the economy, not just tide it over.

Some other US problems and strengths:

Weaknesses

- The income distribution is the worst in its history since the Glided Age.
- There are too many poor people - in 2010 there were 46.2 million people in poverty or 15.3% of the population (up from 14.3% in 2009). For blacks and hispanics were 27%, single mothers nearly a third and children over 20%. Poverty is defined as an income of $11,139 or less for a single person or $22,314 or less for a family of four.
- There is way too much unemployment (9.1% in August) and underemployment (together close to 20%). Then even if they get jobs, the pay is low and the work is likely part time. First time unemployment claims rose to 11,000 in the third week of September to 428,000 versus a forecasted decline, see Craft (2011).
- The political atmosphere is very confrontational and not cooperative.
- The tax structure does not tax the wealthy enough. The claims that greater taxation would stifle growth and lead to lower employment are inconsistent with the data. The wealthy have available many ways to reduce taxes so their net marginal tax rates are below that of the middle class.
- The wealth and living standards of the middle class have been dropping for more than twenty years; see Rugaber and Carpenter (2011).
- The country must adjust to a slow growth era where the US is less important in the world than in the past. The standard of living is dropping and must be adjusted to.
- The low bond yields are a bit helpful but the biggest beneficiaries are blue chip companies not job seekers.
- There is way too much private and public debt. Fortunately it is in US dollars so debtors do not bear the exchange risk. And more and more money can be created.
- The economy, which is weak, needs short term stimulus and cuts and a long term debt reduction plan.
- Obama is spending too much on wars he cannot win that hurt the soldiers and their families more than prevent attacks on the US. Bush started this problem but Obama sent even more troops.
- US consumer sentiment for the future outlook is, according to the Thomson Reuters/University of Michigan index survey, at the lowest level in 31 years. Consumers are frustrated with high unemployment, job destruction, not much job creation and the gridlock in Washington.
- The currency is weak from lack of exports and the debt problem is pushing it lower. Generally, strong economies usually have strong currencies. Of course, much is val-

ued such as the Swiss franc (paper gold). A weak US dollar is a signal of a weak economy. But this is complex since previous dollar strength undermined exports and strengthened imports, helping fuel imports and consumption (which accounts for over 70% of US GDP. The USD benefits from flight to liquidity and from being the best of a bad lot. Nouriel Roubini calls it the ugly contest: who is the least ugly?

- The country is vulnerable to Chinese interests which own too much US debt, over 3 trillion most in US treasuries plus other hard assets.
- Many of the states are near bankruptcy and their spending cuts are greatly hurting many people. See Gorenstein (2011) who cites Harvard Economics Professor Jeffrey Mison who believes that the states are in for worse trouble than currently thought because of declining revenues and large medical and pension liabilities.
- The housing situation remains bleak with many foreclosures and delinquencies. The housing market peaked in 2005-06 and has dropped since. Recent Case-Shiller data in Figure 7. In Florida, banks are bulldozing foreclosed houses and entire neighborhoods are being gutted. One of every 118 houses in Nevada was foreclosed just in August 2011 and it is one in 248 in Arizona, one in 349 in Michigan and one in 376 in Florida. Nearly a quarter of all US home mortgages are under water, nearly 11 million homes; see Benac (2011).
- The subprime mortgage policies to give anyone a house regardless of their financial situation caused much of this problem when housing prices which had risen for more than twenty years suddenly began to fall. And this was made worse by the packaging of the tranches and rating them AAA and selling them all over the world.
- A possible hard landing in China in 2013, which is a significant risk according to Nouriel Roubini and others would hurt the US and the world economy. There has been a reaction to the European debt crisis and the result of a serious monetary tightening in response to high inflation. Already, real estate has stalled. And the Chinese stock market has fallen in 2011.
- Risk control is still weak. It is not in the US but the rogue trader, Kweku Adoboli, who lost about $2.3 billion at the Swiss bank UBS in London reminds us that this issue is still not settled; see Jordans and Katz (2011). Adoboli graduated in 2003 from the University of Nottingham with a degree in e-commerce and digital business hardly the risk control training for a derivatives trader. UBS, which received a $60 billion bailout from the Swiss government in 2008 had planned to cut 3,500 jobs over two years and this loss may cause more. Previous big individual trader losers include Nick Leeson, who took down Barings in 1995 with a $1.28 billion loss. He now gives lectures for 10,000£. And in October 2010, Jerome Kerviel lost $6.7 billion for Societe Generale.

Strengths

- The top universities such as Harvard, Chicago, Stanford, MIT, NYU and others are still among the best in the world. But only at the top - the education system in most of the country is weak and in the world wide ratings the US is no where close to the top. You see this in graduate classes filled with Asian students. In mathematics and science, the US is 27th of 35 countries studied. But the non-private universities are under financial stress because state funding is dropping as is student aid. For example, at UC Berkeley, state funding is now only 12% versus 30% of their annual budget before the 2007-09 financial crisis. The University is rated fourth world wide and produced more PhDs in the last 50 years than any other US university; see Birgenean (2011) and Shanghai Ranking Consultancy (2011).
- It is still possible to start with nothing and become a great success and be rich.
- In certain areas there is confidence.
- The movie and sports industries remain the best in the world.
- Some companies are still the best in the world such as Apple and Boeing, Much of their production is abroad but the idea generation and R&D is primarily in the US. The challenge with the poor US educational system is that many employees have not been trained to move up the value chain.
- There is still the American spirit *we are the best country in the world* but this distracts them both from seeing their faults and seeing what they can learn from others.
- And there is the philosophy that *winning is not the most important thing, it is the only thing* this creates a culture of rewarding success but, in turn, this puts too much emphasis on the leader and not the contribution of the rank and file leading to a growing income disparity.
- The US also has the rule of law, encouragement of innovation, and intellectual property rights which are features that can not necessarily be taken for granted. It is still possible to start with nothing and become a great success and be rich. However this still requires access to opportunity, understanding teachers etc. Lack of a defined class system is still a plus and labor mobility is still good.

3 The US stock market and European debt issues

If the economy is so bad and the European debt issues so dire, why is the US stock market, despite the August-September turbulence still nearly twice the March 2009 lows? October 9, 2007, the S&P500 peaked at 1565.15. My bond- stock earnings yield differential went

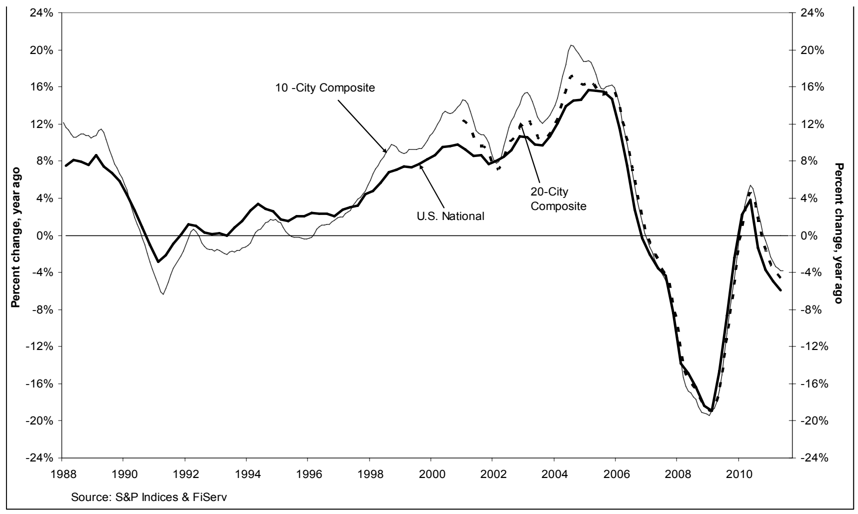


Figure 7: Case-Shiller home price indices, August 30, 2011 (data through June)

into the danger zone on June 14, 2007, see Lleo and Ziemba (2011) for results and analysis. The market fell to an intraday low of 666.79 on March 9, 2009 and has since rallied to a high of 1357.16 on May 10, 2011. As of September 16,2011, when we went to press, the S&P500 was 1216.01.

The bond-stock earnings yield model sits at

BSEYM= Ten year bond rate- 1/trailing PE ratio = 2.08-(100/20.95)=-2.693

which is far in the buy zone with earnings high and interest rates low. This uses Professor Robert Shiller's average inflation adjusted earnings from the previous ten years which are below actual trailing or forecasted S&P500 yearly earnings which give an 11 PE ratio. The 10-year treasury is the most liquid; the 30-year treasury is at 3.34. Of course, with the bond market predicting an 80% chance of a double dip recession future earnings might drop. Firms are lean and are not hiring but rather more inclined to layoff workers on any demand slump so earnings may not fall much. But the European debt issues remain and most likely will get worse. The US stock market reacts greatly to news about the European debt situation. US corporations hold $2 trillion in cash. Apple itself has more cash than the US government; see Rugabee and Carpenter (2011).

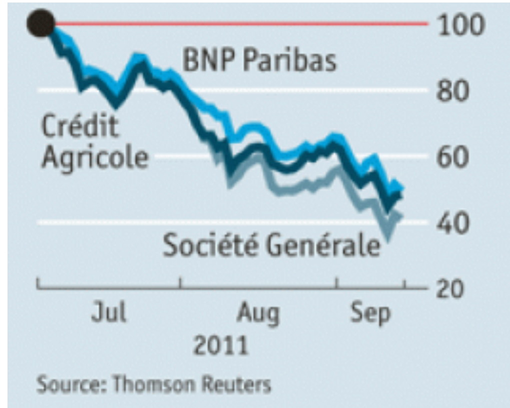
The problem is that Greece and the other PIIGS (Portugal, Italy, Ireland and Spain) are all close to bankruptcy with debts they cannot service. The French and Germans keep talking about saving the euro which is way overpriced and the European Union itself and avoiding a Greek default. But this is a bandaid solution: borrow new money to replace bad old money. What is needed is less debt in Greece and in other PIIGS. Some estimate the probability of a Greek default at 98% and the bonds are trading at high coupon rates; ten year government bonds are at 24% versus less than 3% for US treasuries, see Moulson and Paphitis (2011). The second Greek bailout, some 109 billion euros which the *Economist* thinks is not adequate, was agreed to in July but delayed because Finland wanted security of repayment. That aid is scheduled to be settled on October 3. This is already at a 21% discount, see Thomas (2011) but with a full scale default it would be about 50%. This is for current expenses. In December, a more serious debt repayment is due. Moves are being made such as the co-ordinated access by five central banks of unlimited borrowing of US dollars for three months. These seem to indicate that an orderly default is coming. That would restructure the loans. The total Greek debt is about 370 billion euros ($500 billion). Italy's government debt is about $3.5 trillion, five times Greece (see Thomas, 2011). In comparison, Argentine had $82 billion when it defaulted in 2001 and Russia had $79 billion when it defaulted in 1998. French banks have a lot of Greek debt. It is not known exactly the US exposure but one estimate is 2%, not very much. But US financial institutions may hold other derivatives tied to this toxic debt. Greece is really insolvent. Italy, which has a primary fiscal surplus could become insolvent if interest rates are high for a prolonged period. In a best case Italy can muddle through and deal with its debts although this dampens growth prospects.

Austerity measures are difficult. Among other things, unemployment is high - 10% for the euro area, Greece 16%, Spain 21.2% and Italy 8%, according the *The Economist.* Greek GDP fell by 7.3% in Q2:2011 versus 2010. Italy's bonds have been downgraded from A^+ to A by Standard and Poor's. They are selling much of their debt to Chinese sovereign wealth funds. Greek workers are reluctant to collect taxes and other charges from an already strapped public, especially after they have also been cut. The non-payment of taxes is a major problem. A notable example is swimming pools in Athens where few admit to having them while aerial photography shows thousands of pools. b Many European banks, particularly Societe Generale and BNP Paribus in France would then take huge losses. They already have these losses with mark-to-the-market accounting but these are not realized yet; see Piovano and Wagner (2011). Figure 8 shows the MSCI equity indices of French and European banks which are down about 50% in 2011 and the share prices of BNP Paribas, Credit Agricole and Societe General. To get a feel about the European bond and stock markets, lets compare them with the US. See Figure 9 for the 5-year credit-default swap spreads which have risen dramatically in 2011.

4 What can the US do to improve the situation?

What are Barack Obama's chances to win the November 2012 election? He is slightly favored in the polls as all the Republican candidates are weak and extreme in their views. However, that's not necessarily a handicap as the country is very divided politically. They

(a) MSCI indices for French banks vs European banks, January 3, 2011=100 in euro terms.



(b) Share prices BNP Paribas, Credit Agricole, Societe Generale, July 1, 2011=100

Figure 8: Bank Data: Source: *The Economist*, September 17, 2011.

are the party of insults and false claims and innuendos. And it is dangerous. Democrats check facts, Republicans make them up. There is an HPV vaccine that prevents cervical cancer and is recommended for females aged 12-25. Out of 23 million doses according to a University of Pennsylvania doctor, there were 12,000 adverse reactions with 4,000 serious. Texas mandated immunization in 2007 leaving Perry open to criticism by his party. Bachmann is using this to attack Perry and claimed some woman said her daughter had brain damage as a result of the vaccine. The doctor said this is not possible; Bachmann failed to fact check and later said she was just reporting what she heard - not taking responsibility for her statement. The real danger is to those who are not immunized because of Bachmann's false claim. Such is the hatred of regulation and the fear of sexual activity.

The Republicans never accepted Obama as their President. There was a huge campaign to discredit him from the beginning. They claimed he was not born in the US and thus could not be president. Then it was his qualifications: was he favored to get into Harvard because of his race and did he get favored grades? The facts are he was editor of the law review at Harvard and a University of Chicago professor. At the same time Republicans belittle him as being elitist for his success (Perry proudly proclaims ranking low in his class at veterinary school). In contrast, George W. Bush, a C student at Yale, did not suffer such attacks.

Betfair odds suggest that the election currently looks very close. Obama is an overwhelming favorite to get the Democratic nomination 1.09-1.12 bid-ask for the election where you bet 100 to win 90. Hillary Clinton is 17-24 and Biden 19-190

Figure 9: European banks' five-year credit-default-swap spreads, basis points. Source: *The Economist*, September 17, 2011

Obama's approval rate, while low, is higher at this stage of his presidency than any other Democrat since Truman - above Clinton's and the others. According to a September 16, 2011 *New York Times* poll, 43% approve versus 50% who disapprove. This is also better than the dismal rankings for Congress: 28% approve, 63% disapprove for Democrats and 19% versus 72% for Republicans. However, for the election, Obama is 1.93-1.95 versus Rick Perry at 5.6-6.2 and Mitt Romney 5.5-5.7. Regarding the party that wins the election, the Democrats are a slight favorite at 1.91-1.92 versus 2.08-2.10 for the Republicans. Perry is 2.46 -2.52, Mitt Romney 2.5-2.58 , Sarah Palin 22-30, Jon Huntsman 32-60, Ron Paul 19.5-25 and Michelle Bachmann 36-48. Current polls have Perry at 23%, Romney at 16%, Bachmann at 7%, Newt Gingrich at 7%, Ron Paul at 5% with many undecided.

Also most first term presidents get re-elected but a few, like Jimmy Carter and George H W Bush, lost.

What Obama can do, a shopping list:

1. Try to fight back against the toxic right wing by going directly to the people. Ask them to recall elected officials that do not represent them and are against the best interests of the country. Only 33% of the voters think the person they voted for should be re-elected. Congress has a 15% approval rating in September versus 13% in August by another poll even lower than the one discussed above.

2. Start a public works program with the unemployed to rebuild roads, bridges, etc by getting funding approval from Congress. Bill Clinton has a suggestion regarding clean green energy.

3. Simply tell the Republicans that he was elected by the people fair and square and go back to the policies that got him elected. But a factor is the Republicans won the House of Representatives in 2010.

4. Figure out how to tax the risk, especially those earning one million per year or more. Ask Warren Buffett to lead this activity. He needs congressional backing, they pass legislation, he signs or vetos. So some negotiation is needed. So far Obama's tax rates are the same as Bush's at a very low level. Taxes were lowered just before 9/11 and the cuts were not suspended when the wars began. Usually taxes or government bonds support wars.

5. Cut back a lot on military spending: does the country really need huge bases all one the world - smaller ones and co-operation with allies would save a lot. Also the ill advised wars in Iraq and Afghanistan need to be wound down. What's important is to protect the country and the allies. This was a huge Bush mistake that Obama perpetuated. Kamrany and Intriligator (2011), who have their own ten suggestions, many of which parallel mine, point out that each soldier in Afghanistan costs $1 million per year. Bush sent 70,000 troops there and Obama another 30,000 so this is -$100 billion per year wasted. Obama added soldiers but they are now drawing down, albeit not fast enough to fully cool the military spending. In part this reflects the need to retool the army after a decade of wars, and to pay for all the human costs of the war, medical care, including psychiatric care and pensions. These labor related and health costs account for the greatest increase in spending growth in military spending in the last decade.

6. Cut back on useless checks at airports but hire El Al inspectors who do real checks to devise a better system. I find checking my passport and boarding pass six times and not really checking me is a a waste of money and it is not safe. The tradeoff here is cost which I think would be less than current but waiting time would increase.

7. Cut waste in government - roll back salaries that are much higher than in the private sector.

8. Make peace with Wall Street. It is believed that Obama does not favor wealth creation and corporate profits. The facts are that since June 2009, 88% of the gains in gross national income went to corporate profits and only 1% to wages. Convince them that he is a Democrat and not a socialist. Remind them that the Dow Jones Industrials index was 7949 on January 20, 2009 when we took office and is now 31% higher at 11,509.

9. Be sure that all financial institution bailouts have conditions where the funds given to financial institutions cannot just be given in the millions to top executives of firms losing money. TARP was way too lenient and not transparent enough. This has led to great resentment of the many agains Wall Street. They see rich people who they think caused the problems receiving aid but they get nothing.

10. Ask Professor Ed Altman of NYU who really understands bond ratings to lead a panel to study the rating agencies and propose a new rating agency that is more

> accurate, less sticky to old ratings and is independent of this they are evaluations. The current rating agencies, Standard and Poor's, Moody's and Fitch have a number of flaws and conflicts of interest so a fourth and independent rating agency would be a good idea.

Sandra Schwartz points out that the computer and internet world we are living in has lost a lot of jobs and these benefits are not counted properly. Also, the weak infrastructure situation of the US which as helped the rich while paid for by all the populate needs updating. This would renew for the future and provide jobs for many unemployed construction workers. Most firms have capital accounts for investment versus current spending wages and salaries, etc but all government expenditures are counted as current consumption and not as investment.

Obama does have a jobs plan, see Table 1. However he faces the usual fight with the Republican House over the tax increases for the wealthy. The Republicans say that will hurt jobs. Corporations are sitting on $2 trillion in cash and confidence is needed to get them to move on job creation. Obama is now more on the offensive and returning to the policies he was elected on; see Newman (2100). Indeed instead of creating jobs, there are layoffs, 35,000 at the US Postal System, 30,000 at HSBC, 11,000 at Bron's and 1000 at Goldman Sachs for example.. His supporters are more pleased. Time will determine how successful he is. He is in campaign mode and the days of capitulating to the Republicans seems to be over. Blinder (Democrat) and Hubbard (Republican) both well known economists who have served on the Fed and Council of Economic Advisors have a bipartisan plan:

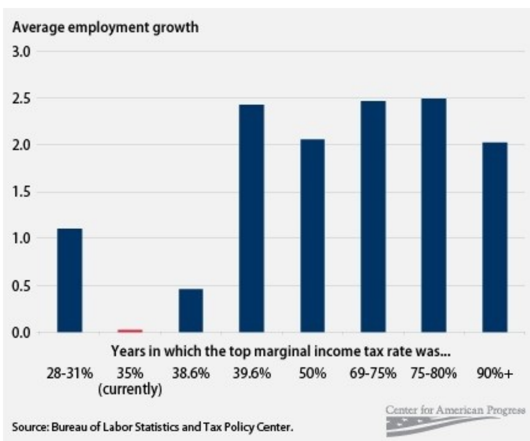
- an increase in the normal retirement age - eventually - in social security
- cuts in Medicare and Medicaid including greater means-testing in Medicare
- tax reform - broaden the base rather the raise the rates by eliminating some tax deductions.

The Republicans that proclaim that the *job creators* should not be taxed have not checked the facts. Regarding tax rates for millionaires and unemployment in 1995, the tax rate was 30.4% with 5.6% unemployment and by 2009, the rate was 22.4% and unemployment was 9.3%. Linden (2011ab) observes that economic growth has historically, from 1950-2010 been stronger during periods of higher tax rates as shown in Figure 10. Of course, wealthy people have many sources of income so the overall tax paid will vary. It is clear that higher taxes for millionaires will not necessarily lower job growth and will result in a more fair tax system when they pay their share.

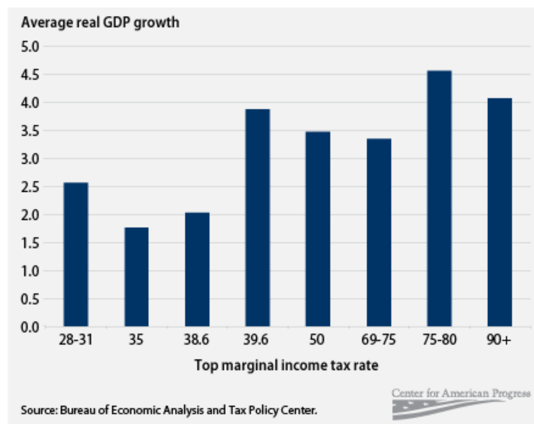
Michelle Bachmann says 47% of American's do not pay any tax. That's right - however, according to Colbert they take advantage of the ultimate tax loop - having little or no income. Her statement that everyone should pay their share of taxes forgets about the 9.1% who are unemployed, 16.6% in poverty, etc. Who are these people who pay no tax?

Table 1: Obama's jobs plan. Source: *The Economist*, September 17, 2011.

New stimulus measures	$bn
Business tax cuts	70
Infrastructure spending, state and local government aid	140
Unemployment insurance and training	62
Payroll-tax cut	175
Total	447
Paid for by	
Limiting deductions for upper-income earners	405
Treating carried interest as ordinary income	18
Limiting oil and gas company tax benefits	40
Removing corporate jet tax breaks	3
Total	467



(a) Average annual percent growth in total payroll employment



(b) Average annual growth in real gross domestic product

Figure 10: Economic growth compared with top marginal tax rates, 1950-2010. Source: Linden, 2011ab

According to the Colbert (September 20, 2011): 50% have incomes under $22,000; 22% are seniors, 15% are low income families with children and 13% others.

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1 Appendix

The Appendix contains additional data and tables of results.

Table A.1: S&P500 Futures Average Monthly Returns, 1993-2011, 2004-2011

MOY Trading in S&P 500 futures contract. Geometrically Linked Returns.																						
	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	Average	StDev	t
Jan		3.14%	2.33%	3.07%	5.69%	0.73%	2.71%	-5.91%	2.97%	-1.76%	-2.98%	1.82%	-2.67%	2.25%	1.00%	-6.82%	-9.14%	-3.72%	2.30%	-0.28%	0.041	-0.288
Feb	-1.28%	-3.29%	2.73%	-0.02%	0.28%	6.30%	-3.76%	-2.20%	-9.94%	-2.22%	-1.73%	1.28%	1.85%	-0.13%	-2.46%	-3.63%	-11.13%	2.98%	3.35%	-1.21%	0.043	-1.241
Mar	1.83%	-4.22%	3.92%	1.94%	-4.24%	5.65%	4.49%	10.07%	-5.89%	3.73%	0.44%	-1.82%	-1.72%	1.61%	1.49%	-0.85%	7.28%	5.57%	-0.51%	1.51%	0.042	1.582
Apr	-3.13%	0.74%	2.43%	0.49%	5.69%	0.70%	3.19%	-2.36%	6.83%	-6.38%	8.00%	-1.73%	-2.23%	0.94%	3.97%	4.55%	9.07%	1.47%	2.89%	1.85%	0.040	2.008
May	2.56%	1.26%	3.15%	1.78%	5.84%	-2.60%	-3.08%	-4.54%	-0.04%	-1.10%	5.05%	1.34%	2.88%	-3.41%	2.96%	0.96%	5.27%	-8.41%	-1.21%	0.46%	0.037	0.538
Jun	0.17%	-2.50%	2.54%	1.45%	4.52%	4.61%	6.41%	3.12%	-1.44%	-7.45%	0.95%	1.64%	0.24%	0.47%	-1.22%	-8.69%	-0.44%	-5.94%	-2.23%	-0.20%	0.040	-0.218
Jul	-0.69%	3.09%	2.88%	-5.22%	7.47%	-1.86%	-2.99%	-2.10%	-1.98%	-8.64%	1.54%	-3.50%	3.43%	0.12%	-3.65%	-1.30%	7.34%	6.80%	-2.16%	-0.07%	0.044	-0.074
Aug	3.39%	3.28%	-0.07%	1.32%	-5.91%	-15.59%	-1.73%	5.73%	-6.72%	0.05%	1.80%	0.21%	-1.28%	1.84%	0.79%	1.07%	3.46%	-4.69%	-6.40%	-1.02%	0.050	-0.894
Sep	-0.87%	-2.17%	4.48%	6.09%	5.51%	6.86%	-1.79%	-4.58%	-8.38%	-11.31%	-1.43%	0.94%	1.03%	3.02%	4.07%	-9.79%	3.16%	8.31%	-1.25%	0.10%	0.056	0.077
Oct	1.87%	2.59%	-0.77%	2.59%	-3.78%	7.38%	5.73%	-1.15%	1.46%	7.96%	5.51%	1.32%	-2.08%	2.79%	1.00%	-20.11%	-2.07%	3.74%		0.78%	0.061	0.536
Nov	-1.35%	-4.78%	3.98%	6.80%	3.21%	5.06%	1.04%	-8.46%	7.35%	5.49%	0.75%	3.83%	3.39%	1.39%	-4.85%	-9.22%	5.88%	-0.11%		1.08%	0.050	0.908
Dec	1.09%	1.59%	1.80%	-1.93%	2.40%	6.92%	6.60%	0.30%	0.71%	-6.25%	4.82%	3.34%	0.27%	1.80%	-0.56%	-0.40%	1.40%	6.18%		1.67%	0.032	2.206
Average	0.33%	-0.11%	2.45%	1.53%	2.22%	2.01%	1.40%	-1.01%	-1.26%	-2.32%	1.89%	0.72%	0.26%	1.06%	0.21%	-4.52%	1.67%	1.02%	-0.58%	0.38%		
StDev	0.020	0.031	0.016	0.032	0.046	0.066	0.039	0.052	0.056	0.060	0.033	0.021	0.023	0.017	0.029	0.067	0.064	0.056	0.031		0.045	
t	0.546	-0.120	5.466	1.652	1.687	1.063	1.229	-0.672	-0.774	-1.352	1.977	1.172	0.394	2.135	0.257	-2.321	0.903	0.634	-0.566			
Geom r	3.46%	-1.78%	33.54%	19.34%	28.75%	23.93%	17.18%	-12.73%	-15.61%	-26.10%	24.53%	8.76%	2.85%	13.29%	2.11%	-44.22%	19.28%	11.00%	-5.47%			

MOY Trading in S&P 500 futures contract. Geometrically Linked Returns.																						
	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	Average	StDev	t
Jan												1.82%	-2.67%	2.25%	1.00%	-6.82%	-9.14%	-3.72%	2.30%	-1.87%	0.044	-1.195
Feb												1.28%	1.85%	-0.13%	-2.46%	-3.63%	-11.13%	2.98%	3.35%	-0.99%	0.048	-0.582
Mar												-1.82%	-1.72%	1.61%	1.49%	-0.85%	7.28%	5.57%	-0.51%	1.38%	0.034	1.149
Apr												-1.73%	-2.23%	0.94%	3.97%	4.55%	9.07%	1.47%	2.89%	2.36%	0.037	1.831
May												1.34%	2.88%	-3.41%	2.96%	0.96%	5.27%	-8.41%	-1.21%	0.05%	0.043	0.031
Jun												1.64%	0.24%	0.47%	-1.22%	-8.69%	-0.44%	-5.94%	-2.23%	-2.02%	0.035	-1.613
Jul												-3.50%	3.43%	0.12%	-3.65%	-1.30%	7.34%	6.80%	-2.16%	0.88%	0.044	0.565
Aug												0.21%	-1.28%	1.84%	0.79%	1.07%	3.46%	-4.69%	-6.40%	-0.63%	0.034	-0.529
Sep												0.94%	1.03%	3.02%	4.07%	-9.79%	3.16%	8.31%	-1.25%	1.19%	0.052	0.640
Oct												1.32%	-2.08%	2.79%	1.00%	-20.11%	-2.07%	3.74%		-2.20%	0.082	-0.710
Nov												3.83%	3.39%	1.39%	-4.85%	-9.22%	5.88%	-0.11%		0.05%	0.053	0.023
Dec												3.34%	0.27%	1.80%	-0.56%	-0.40%	1.40%	6.18%		1.72%	0.024	1.901
Average												0.72%	0.26%	1.06%	0.21%	-4.52%	1.67%	1.02%	-0.58%	-0.02%		
StDev												0.021	0.023	0.017	0.029	0.067	0.064	0.056	0.031		0.046	
t												1.172	0.394	2.135	0.257	-2.321	0.903	0.634	-0.566			
Geom r	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	8.76%	2.85%	13.29%	2.11%	-44.22%	19.28%	11.00%	-5.47%			

Table A.2: Russell2000 Futures Average Monthly Returns, 1993-2011, 2004-2011

MOY Trading in Russell 2000 futures contract. Geometrically Linked Returns.																						
	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	Average	StDev	t
Jan		2.95%	-1.60%	-0.32%	2.04%	-2.48%	0.32%	-3.17%	3.91%	-1.37%	-3.03%	4.16%	-4.50%	8.54%	1.12%	-7.74%	-11.93%	-3.79%	-0.41%	-0.96%	0.047	-0.875
Feb	-3.16%	-1.43%	4.17%	1.58%	-2.87%	7.31%	-8.02%	16.64%	-7.33%	-3.05%	-3.21%	0.67%	1.39%	-0.70%	-1.35%	-4.18%	-12.63%	4.35%	5.34%	-0.34%	0.064	-0.233
Mar	2.59%	-4.43%	1.38%	3.48%	-4.20%	5.20%	1.15%	-6.53%	-3.92%	8.00%	0.93%	0.62%	-2.69%	5.34%	1.51%	-0.01%	6.83%	7.74%	2.08%	**1.32%**	0.043	1.352
Apr	-3.05%	-0.55%	2.39%	4.59%	-0.10%	-0.13%	8.47%	-7.92%	6.33%	0.56%	9.29%	-5.36%	-6.16%	-0.48%	1.29%	3.79%	14.65%	5.50%	2.56%	**1.88%**	0.056	1.461
May	4.00%	-1.16%	2.21%	3.17%	10.25%	-6.34%	1.64%	-7.30%	1.83%	-4.81%	10.49%	1.34%	6.16%	-6.26%	3.54%	4.26%	2.51%	-8.25%	-2.02%	**0.80%**	0.055	0.635
Jun	1.51%	-3.49%	4.64%	-3.66%	4.75%	1.13%	4.66%	9.34%	3.00%	-5.14%	1.53%	4.10%	4.11%	0.94%	-0.86%	-7.82%	0.93%	-8.54%	-2.83%	**0.44%**	0.047	0.408
Jul	0.55%	2.00%	5.28%	-9.32%	4.13%	-9.34%	-3.88%	-3.52%	-5.04%	-15.86%	5.96%	-7.03%	5.96%	-3.90%	-7.41%	3.05%	9.29%	6.48%	-3.78%	-1.39%	0.068	-0.889
Aug	3.95%	5.42%	1.44%	5.01%	1.98%	-20.31%	-3.99%	6.04%	-3.70%	-0.82%	4.35%	-0.81%	-2.30%	2.30%	1.42%	3.18%	2.64%	-7.67%	-10.27%	-0.64%	0.065	-0.428
Sep	2.47%	-0.58%	1.82%	4.17%	7.70%	8.02%	0.36%	-1.99%	-13.82%	-7.55%	-2.13%	4.64%	0.66%	1.34%	2.15%	-9.21%	5.30%	11.85%	-2.51%	**0.67%**	0.062	0.471
Oct	2.96%	-0.40%	-5.11%	-1.50%	-5.13%	3.75%	0.44%	-5.48%	5.24%	2.48%	8.11%	1.71%	-3.62%	5.21%	2.15%	-24.11%	-7.11%	4.00%		-0.91%	0.072	-0.535
Nov	-4.28%	-4.75%	4.42%	3.89%	-1.16%	4.24%	4.69%	-10.54%	7.38%	8.50%	3.30%	8.42%	4.38%	2.04%	-7.96%	-14.20%	2.87%	3.31%		**0.81%**	0.066	0.522
Dec	4.12%	2.84%	3.13%	2.01%	2.05%	6.76%	12.58%	8.02%	5.94%	-5.87%	1.78%	3.06%	-0.03%	0.88%	0.10%	3.42%	7.60%	7.62%		**3.67%**	0.041	3.836
Average	**1.06%**	-0.30%	**2.02%**	**1.09%**	**1.62%**	-0.18%	**1.53%**	-0.54%	-0.02%	-2.08%	**3.11%**	**1.29%**	**0.28%**	**1.27%**	-0.36%	-4.13%	**1.75%**	**1.88%**	-1.32%	0.44%		
StDev	0.031	0.031	0.029	0.042	0.047	0.084	0.056	0.085	0.066	0.067	0.047	0.043	0.042	0.040	0.037	0.089	0.084	0.071	0.045		0.058	
t	1.124	-0.329	2.388	0.896	1.205	-0.076	0.948	-0.219	-0.009	-1.072	2.302	1.049	0.231	1.098	-0.338	-1.614	0.722	0.924	-0.876			
Geom r	11.76%	-4.03%	26.46%	12.78%	19.88%	-6.17%	18.06%	-9.77%	-2.67%	-24.27%	42.85%	15.50%	2.43%	15.38%	-4.95%	-42.69%	18.43%	21.75%	-11.98%			

MOY Trading in Russell 2000 futures contract. Geometrically Linked Returns.																						
	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	Average	StDev	t
Jan												4.16%	-4.50%	8.54%	1.12%	-7.74%	-11.93%	-3.79%	-0.41%	-1.82%	0.066	-0.783
Feb												0.67%	1.39%	-0.70%	-1.35%	-4.18%	-12.63%	4.35%	5.34%	-0.89%	0.056	-0.445
Mar												0.62%	-2.69%	5.34%	1.51%	-0.01%	6.83%	7.74%	2.08%	**2.68%**	0.036	2.088
Apr												-5.36%	-6.16%	-0.48%	1.29%	3.79%	14.65%	5.50%	2.56%	**1.97%**	0.066	0.848
May												1.34%	6.16%	-6.26%	3.54%	4.26%	2.51%	-8.25%	-2.02%	**0.16%**	0.052	0.087
Jun												4.10%	4.11%	0.94%	-0.86%	-7.82%	0.93%	-8.54%	-2.83%	-1.24%	0.049	-0.724
Jul												-7.03%	5.96%	-3.90%	-7.41%	3.05%	9.29%	6.48%	-3.78%	**0.33%**	0.066	0.142
Aug												-0.81%	-2.30%	2.30%	1.42%	3.18%	2.64%	-7.67%	-10.27%	-1.44%	0.050	-0.807
Sep												4.64%	0.66%	1.34%	2.15%	-9.21%	5.30%	11.85%	-2.51%	**1.78%**	0.061	0.821
Oct												1.71%	-3.62%	5.21%	2.15%	-24.11%	-7.11%	4.00%		-3.11%	0.102	-0.805
Nov												8.42%	4.38%	2.04%	-7.96%	-14.20%	2.87%	3.31%		-0.17%	0.079	-0.055
Dec												3.06%	-0.03%	0.88%	0.10%	3.42%	7.60%	7.62%		**3.24%**	0.033	2.615
Average												**1.29%**	**0.28%**	**1.27%**	-0.36%	-4.13%	**1.75%**	**1.88%**	-1.32%	0.13%		
StDev												0.043	0.042	0.040	0.037	0.089	0.084	0.071	0.045		0.061	
t												1.049	0.231	1.098	-0.338	-1.614	0.722	0.924	-0.876			
Geom r	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	0.00%	15.50%	2.43%	15.38%	-4.95%	-42.69%	18.43%	21.75%	-11.98%			