Betting On An Economic Recovery

by Luke Simpson, Associate Editor, IMPO

Back home in Australia, I religiously listened to *Mornings with Ross & John*, a breakfast radio show that used news as a backdrop for discussions about social phenomena, crime and sports. They tracked a number of recurring topics, such as:

- The evolution of the spelling of names — Khloei (Chloe), De'mon (Damon)
- Football players behaving badly — who was at the local strip club associating with the Hell's Angels and known drug dealers?
- Habits of politicians — Obama's thin frame was surely a sign that he still smoked.
- The Melbourne gangland killings — not quite as famous as Chicago's Al Capone era but just as bloody, battling crime gangs and drug dealers wiped out 34 people between 1998 and 2006.

Ross & John, like a lot of people in Melbourne, were also keen punters (gamblers). During the spring horse racing carnival the two presenters would often stray from the mainstream news items to discuss the horses running that day, and more importantly, the odds offered by the bookmakers. They even set up a charity that received the winnings of certain bets. Horse racing and gambling are certainly engrained in the city's culture – we even had a public holiday for the Melbourne Cup horse race.

In the lead up to elections, both local and abroad, Ross and John would track the polls like the rest of the media. But they would also keep a close eye on the bookies' odds (yes, you can bet on election outcomes). As soon as the 2007 federal Australian election campaign started, the bookies' odds indicated that opposition leader Kevin Rudd would be the clear winner. At the time, all of the polls showed

different margins and jumped around drastically during the campaign, while the betting odds slowly and steadily shortened for Rudd.

Now Rudd did win the campaign, and yes, most of the polls eventually picked the winner, but there was something compelling about the predictions laid out by a business that stands to lose or gain money based on those predictions, as opposed to a polling group that simply generates numbers based on surveys of indifferent or emotionally-charged humans, prone to react to whatever the current hot-button issue is.

On Monday, the Institute for Supply Management (ISM) released its manufacturing index for May, a key indicator for the industry that shows growth or contraction. It came in at 42.8, up from 40.1 in April and better than the 42 predicted by analysts at ISM in a Thomson Reuters Poll [1]. Any reading below 50 indicates that the sector is generally contracting, but the steady improvement we've seen since the index bottomed out in December at 32.9 is encouraging.

In fact, it's easy to extrapolate on the upward trend of the index readings we've seen since January and predict that the manufacturing industry will return to positive growth in early August. But I can't help but wonder what the professional gamblers think.

I recently discovered intrade, a website that allows you to "trade (speculate on) events that directly affect your life, like politics, entertainment, financial indicators, weather, current events and legal affairs."

Events (contracts) listed on the website are given a value, translating to the probability of that event coming true. In the words of intrade, "the prices of our contracts are determined by traders, like you, who are confident enough to back up their opinion by risking real money. People put real money on the line in making predictions, which is better than snap judgments in opinion polls or no-stakes views of pundits."

While this predictions market is slightly different to the independent bookmakers I discussed earlier, it is an interesting way of gauging possible outcomes to events that are generally too complicated to predict using only statistics or science.

If an event on intrade is listed with an 87.6 percent probability of coming true, it will cost you $8.76 for a contract, which will be worth $10 (100 percent) if the event comes true, or $0 if it doesn't.

In no way do I encourage any of you to speculate on any of these events — in fact I would strongly encourage you not to — but it's amazing to see what you can bet on these days, which is what this boils down to. Here are a couple of interesting events:

- **Event:** 15,000 or more cases of A/H1N1 Swine Flu to be confirmed in the U.S. before midnight ET on the 30th of June, 2009

Current Probability: 91.2 percent
- **Event:** USA and/or Israel to execute an overt Air Strike against Iran by the 31st of December, 2009
  Current Probability: 12.4 percent
- **Event:** Osama Bin Laden to be captured/neutralized by the 31st of December, 2009 (what's neutralized?)
  Current Probability: 9.0 percent
- **Event:** US Unemployment Rate in December 2009 to be greater than 10.00 percent
  Current Probability: 65.0 percent
- **Event:** United States GDP growth for Q3 of 2009 will be positive
  Current Probability: 50.0 percent

Unfortunately, the last two events don't really indicate anything compelling about the economy: unemployment will probably be over 10 percent by the end of the year, and there's an even 50/50 chance that we'll see positive growth in GDP in the next quarter.

Believe it or not, intrade has created a Growth, Unemployment and S&P Depression Index (GUSD Index), "designed to measure the general condition of the United States' economy, and allow comparison between quarters to determine if conditions are improving or worsening." And you guessed it, contracts for this index can be bought and sold – you can bet on the economy.

The index is calculated by summing the percentage change in Gross Domestic Product (GDP) between quarters, the change in the unemployment rate between quarters and the percentage change in the S&P 500 stock Index between quarters. The lower the value of the index, the worse the economy is performing. The index for the first quarter of 2009 was –8.57.

There are currently 12 contracts on offer for the value of the GUSD Index at the end of the second quarter being –1 or lower, –2 or lower, –3 or lower etc. Unfortunately, there is virtually no trading occurring in this category at the moment, which I take to mean that the gamblers really aren't sure where the economy is headed.

So let's move away from the entertaining world of prediction markets and back to the people who are actually involved with the manufacturing industry. ISM's May 2009 Manufacturing Report contains quotes from respondents across a number of different areas — here's what they're saying:

- "Some amount of havoc is about to erupt, with companies pushing for increased capacity when suppliers have taken capacity offline." (Computer & Electronic Products)
- "Business is actually better than plan." (Food, Beverage & Tobacco Products)
- "Realistically, we don't see any of our major customers looking to place business until mid-2010 at the earliest." (Machinery)
- "April was flat on sales. May looking better." (Primary Metals)

- “Business still trending downward, but not as fast.” (Chemical Products)

In addition, while the ISM index is still below 50, it is in a range that indicates possible growth in GDP.

“The past relationship between the index and the overall economy indicates that the average index for January through May (38.1 percent) corresponds to a 1 percent decrease in real gross domestic product (GDP). In addition, if the index for May (42.8 percent) is annualized, it corresponds to a 0.5 percent increase in real GDP annually,” according to the report.

These are encouraging signs — not enough for me to put my money where my mouth is on the predictive markets, but encouraging signs nonetheless.

What's your take? Email luke.simpson@advantagemedia.com [2]

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