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Market Manipulation Muddies Election Outlook

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Prediction markets can yield valuable insight into the dynamics of political campaigns, a conclusion we've drawn from years of intensive study and research. We've even proselytized about the value of these markets, extolling their ability to yield sharper insights than pundits or polls.

But prediction markets are far from perfect. The insights they yield can be muddied by market manipulation.

Over recent weeks Barack Obama has opened a healthy lead in the presidential race. And Friday's debate clearly helped his chances -- unless you were following along with the share prices on Intrade.com.

Focus group tickers shown on the major cable networks during the debate consistently put Sen. Obama above the line more often than John McCain. Instant polls by CBS and CNN also pointed to an Obama victory, as did subsequent polling by Gallup and Rasmussen. Daily tracking polls have also shifted toward the Illinois senator.

Yet during Friday's debate, share prices on the Intrade market initially appeared to favor Sen. McCain. On closer inspection, however, this appears to reflect the influence of some unusual trading activity.

By Sunday night the market had digested the usual trades, and Sen. Obama was rated three percentage points more likely to win the White House than he was prior to the debate. He has gained an additional five percentage points since Monday afternoon's failed House vote on the Wall Street bailout bill.

Over recent weeks we've observed a pattern of large orders for Sen. McCain on Intrade -- home of the most-closely watched markets -- executed at times when liquidity is particular scarce. These orders have caused markets to shift sharply, often against the broader political narrative.

The odd pattern has given market-watchers a hint that something was awry, a point recently emphasized by Nate Silver, the election analyst behind FiveThirtyEight.com. This unusual trend, which several academics have suggested reflects attempted manipulation, has not let up.

Prediction markets are currently supervised under gambling rather than financial regulation, and hence market manipulation is not illegal. But it is still a legitimate concern to those of us looking to prediction markets for a clear look at the presidential campaign. To the extent that this manipulation has been successful, Intrade might be understating the true chances of an Obama victory.

All of this makes scoring the current election rather difficult for market watchers. Subsequent to each short-lived burst of buying, the prices of McCain securities have tended to drift back towards their previous prices, although some residual effect may remain.

On Intrade, Sen. McCain is currently given a 36% chance to win compared to Sen. Obama's 64%, which amounts to a 20 percentage point shift to Sen. Obama in recent days. Some part of this shift toward Sen. Obama may simply reflect the fact that his price had been artificially depressed in previous weeks.

Other markets detect an even larger lead for Sen. Obama. BetFair.com, the British prediction market, shows the Democrat to be a 74% favorite to win. The Iowa Electronic Markets suggest a 70% chance that Sen. Obama will triumph in the popular vote, with a seven-point edge in his expected vote share.

Even as BetFair and Intrade point to different chances of winning the election, they each suggest a roughly similar set of outcomes in the swing states, most of which currently favor Sen. Obama. Colorado, which is likely to be the pivotal state, is rated a 68% chance to go to Sen. Obama on both markets.

How can we be sure that these pricing anomalies were the product of intentional manipulation? Why would someone want to do this?

Manipulation is nearly impossible to prove. But the trader placing the suspicious orders moved the contracts to price levels that weren't sustained, so it's nearly impossible that they made money on the transaction. That suggests to us that the trader had an ulterior motive, such as a desire to raise Sen. McCain's stock and alter the public perception of how the horserace was unfolding.

The biggest difference between typical market movements and manipulation is that honest traders will usually try to minimize the impact of their trades on the market price -- paying higher prices for an asset only cuts into profits. But a market manipulator, intent on buoying the market's ratings of their preferred candidate, will work to maximize the impact of their trading on the price.

And indeed, the suspicious behavior on Intrade involves large purchases of Sen. McCain's stock executed at times when most traders wouldn't be active. A flurry of buying at about 8 a.m. on Tuesday drove McCain's stock from 47 to 51; a follow-up buying spree about 12 hours later drove the price from 48 to 51. The same pattern continued on Wednesday, with an 11 p.m. buy from 43 to 46, and was seemingly repeated with another 11 p.m. buy on Thursday, which pushed McCain's price from 42 to 47.

These price changes are unusually large and occurred during periods of relative political calm. By comparison, neither of the vice-presidential announcements caused comparable market shifts on Intrade.

And prediction markets assessing the fate of important swing states did not mirror these movements in Sen. McCain's overall share price. Alternative prediction markets, including BetFair, British sports books or play-money markets, also failed to register similar movement for the Arizona senator.

The dynamic during the presidential debates was similar. Had you simply turned to Intrade as the debate came to a close, you might have concluded that Sen. McCain won: his price rose sharply throughout the debate. But how it did so was quite unusual. The first uptick occurred at around 9:30 p.m., a point when Sen. McCain was doing quite poorly. A second buying spree occurred around 10:15 p.m.

Once the market dealt with these bumps, the trend immediately reverted toward Sen. Obama.

As prediction markets continue to march into mainstream political commentary, the temptation for such shenanigans will only increase. As such, it is particularly important that market-watchers dig a bit deeper in order to avoid being fooled.

Our job as analysts is to look beyond the temporary manipulation-induced blips to see the true state of the race. On that score, it looks like Sen. Obama is at least twice as likely to win in November as Sen. McCain -- and perhaps he's an even better bet.

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