POLITICAL EXCHANGE
By JUSTIN WOLFERS

Polls Glance Backward
While Markets Peer Ahead

July 8, 2008

A straightforward reading of recent polling data makes the presidential election look like a foregone conclusion. Yet political predictions markets don't give Democrat Barack Obama the same substantial advantage suggested by the pollsters.

Polls from the past two weeks put Sen. Obama somewhere between four and 12 percentage points ahead of Republican John McCain. In the poll-of-polls aggregate on RealClearPolitics.com, Sen. Obama's lead is a massive 5.7 percentage points -- as large as it has ever been.

The Illinois senator's lead is larger than the stated margin of error of any of these polls, and the error of a poll-of-polls is even smaller still. Moreover, Sen. Obama leads in all of the major battleground states except Virginia and Florida, which remain incredibly close.

But all is not lost for Sen. McCain, at least according to the political prediction markets that rate the Republican a one-in-three chance of winning the White House. (See the latest predictions from The Wall Street Journal's own fantasy market.)

These different signals reflect a difference in perspective: markets are forward-looking, whereas polls are backward-looking. While Sen. McCain has performed poorly over the past month, he is making adjustments. The strategies (and strategists) that failed last month have been discarded, and this will likely yield a stronger performance in coming months.

In turn, prediction-market traders continue to give Sen. McCain a fighting chance in the face of terrible polls because they expect him to respond with an improved strategy. The likelihood that campaigns will respond to poor polling numbers makes the polls less useful as predictors of election outcomes.

Political scientists Robert Erikson (of Columbia) and Christopher Wlezien (of Temple) have recently mined daily polling reports from the last half-century of elections, mapping the relationship between early polling numbers and final election returns. At this point in the race, they find that around half of any lead should be discounted, as early advantages tend to dissipate. (You can read the full paper here, or an ungated version here.)

Profs. Erikson and Wlezien point to another reason to be wary of Sen. Obama's early polling lead: On average, the voting public tends to be more strongly anti-incumbent three-and-a-half years into an administration than they are on Election Day. Based on patterns in previous cycles, the professors suggest...
that this exaggerated anti-incumbent feeling is boosting Sen. Obama's lead by around three percentage points.

Combined, the two adjustments suggested by the professors explain why prediction markets have not been overwhelmed by Sen. Obama's recent polling successes. In fact, his current polling lead is exactly to expect four months prior to a dead-heat election.

These numbers raise the opposite question: Why is Sen. Obama still the betting favorite, even as historical experience suggests his polling lead will dissipate?

Again, it is worth recalling that prediction market traders are informed not only by the historical averages the professors identified, but also by the specific dynamics of this presidential race. As Profs. Wlezien and Erikson have emphasized in other research, early polls do not fully incorporate fundamentals, such as the economy. And economic forecasters are increasingly confident in projecting rising unemployment in the months leading up to Election Day.

It is likely that these projections are already informing prediction markets, even as the full force of public anger about the worsening economic situation is yet to be seen in the polls.

A naïve reading of polls suggests an Obama landslide; a sophisticated reading points to a dead-heat. Prediction markets are somewhere in the middle, suggesting a two-in-three probability that our next president will be a Democrat.

Yet it is the naïve reading of the polls, and not the more nuanced perspective of the underlying dynamics, that dominates media headlines.

Here's my forecast: Expect to spend August and September reading about momentum turning toward Sen. McCain. But to those who have been tracking the markets, that momentum won't be news, and come November, an Obama victory will still look more likely.

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