

January 2, 2008 8:18 p.m. EST

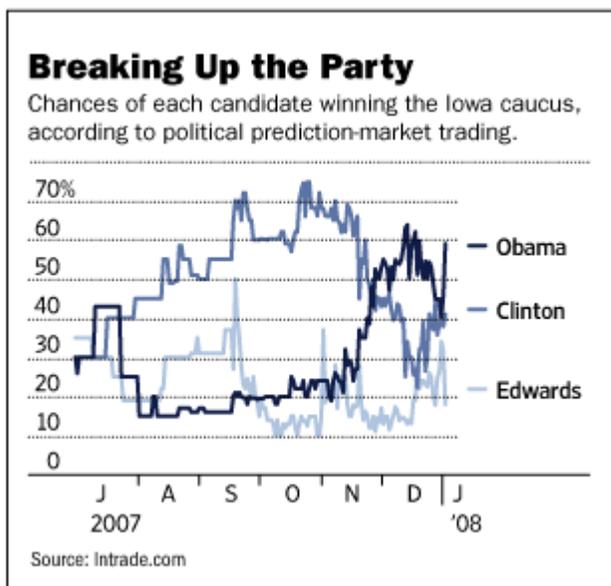
Using Markets to Handicap Iowa

 By **JUSTIN WOLFERS**
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The one sure bet about this Thursday's Iowa caucuses is that each campaign will claim to have outperformed expectations, and that by Friday morning, each will be claiming to benefit from subsequent "momentum." And so we begin the strange ritual of each campaign playing down expectations, so that they can exceed them.

Instead, I would suggest turning to prediction markets for a forecast of what to expect when the tallies are counted on Thursday evening. These markets also provide a useful baseline against which to assess the performance of each campaign. The Wall Street Journal is running a [political futures market](#)¹ where you can "trade" on candidates' future performance or see how others assess their chances.

On the Democratic side, Iowa is expected to be a virtual three-way tie. On New Year's Eve, markets ranked each of Barack Obama, Hillary Clinton and John Edwards at least a 30% chance of winning. The subsequent release of the final assessments by a slew of pollsters has given each campaign cause for both optimism and pessimism, depending on which numbers they are reading.



As prediction-market traders have tried to make sense of these conflicting signals, they have upgraded Mr. Obama's chances of winning (he's now a better than 50-50 bet), while Ms. Clinton is a clear second-favorite, with a just-under one-in-three chance of winning.

The Iowa caucuses look particularly important for the Edwards campaign as this is the only state in which he is not rated as a clear outsider; All of the other early races look to be two-horse races (Ms. Clinton v. Mr. Obama). Unfortunately for Mr. Edwards, the markets have revised downward his chances of winning, to around one-in-six. Markets also rate Mr. Edwards at least a four-in-ten chance to drop out of the nominating race by the end of the month (and before

"Super-Duper Tuesday"), suggesting that a third-place showing in Iowa will end his candidacy, and even a weak second-place puts him in danger. Thus Thursday's caucuses are essentially a referendum on the viability of Mr. Edwards' candidacy.

The Republican field remains substantially more crowded, but only two of the main candidates, Mike Huckabee and Mitt Romney, are competing in Iowa. Mr. Romney has been campaigning in the state for

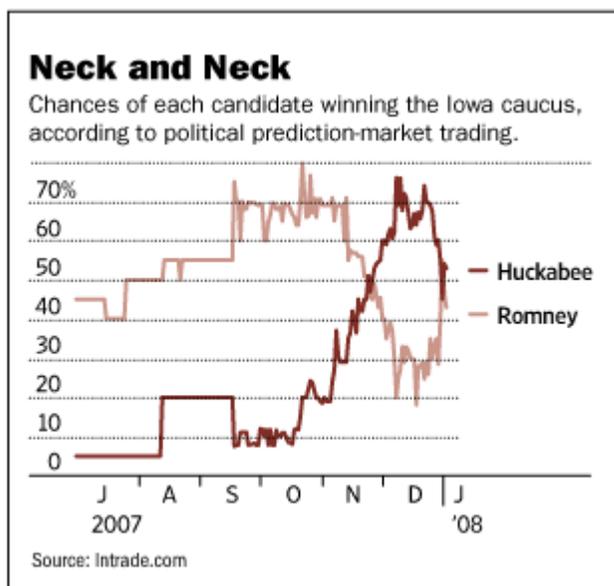
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months, while Mr. Huckabee has surged into contention from virtual obscurity.



It looks like a fairly even race, although in recent hours, the markets have broken somewhat toward Mr. Huckabee. Even though the balance of probabilities rest about 60-40 (toward Mr. Huckabee), this is a fairly slender lead. The similarity of the prices on these two candidates may well reflect the uncertainty of forecasting the complexity inherent in the Iowa caucuses, rather than a view that the caucus totals will be close.

Meanwhile the two Republican candidates with the strongest national reputations, Rudy Giuliani and John McCain, have stayed away from Iowa, and neither has much to gain or lose from Thursday's balloting. It is also worth remembering that Fred Thompson was an early favorite to win the caucuses, a lead that

ironically enough disappeared nearly as soon as he announced his candidacy.

Finally, a caveat: the Iowa-specific prediction markets are quite lightly traded, with trading volumes measured in mere thousands of dollars. This definitely suggests some caution is warranted before putting too much faith in these projections, although the track record accumulated over recent election cycles suggests that even very thinly-traded prediction markets have proven surprisingly accurate.

The Iowa caucuses have a history of throwing up surprises, and let me suggest a simple check for whether a candidate gains momentum from the Iowa caucuses: Did the prediction markets for New Hampshire (and beyond) respond to Thursday's results?

Justin Wolfers is an Assistant Professor of Business and Public Policy at the University of Pennsylvania's Wharton School. He will be writing for the Journal about the 2008 presidential campaign through the prism of prediction markets. You can reach him at predictions@wsj.com⁸.

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