



WASHINGTON OUTLOOK

The 110th Congress: Democrats Set the Agenda, GOP Decides What Part Becomes Law

The Democrats take over the House and Senate when the 110th Congress begins on January 3, 2007. House Democrats will do so, looking over their shoulders. If they are not careful, the GOP will take control back in 2008.

House Democrats face a structural problem. Democratic voters are concentrated in urban areas, thinning their support elsewhere. Twenty House Democrats, for example, won with 80 percent or more of the vote, but no Republicans did so. As a result of Democratic clumping, 60 of 232 House Democrats represent districts that George Bush carried in 2004. Thus, more than one-fourth of House Democrats represent conservative leaning districts, and this will place an important limit on how far policy will swing from right to left with the change in party control. By comparison, only eight House Republicans feel heightened pressure to vote with Speaker Pelosi because their districts tilt leftward, having voted for John Kerry. A skillful White House could exploit this situation, creating a conservative Democrat/GOP coalition on the House floor. President Ronald Reagan achieved landmark victories this way despite facing a larger 242 House Democratic majority. We do not know who really controls the House yet on key votes – Speaker Nancy Pelosi (D-CA) or President Bush.

Senate Democrats are more confident of keeping or expanding their 51-49 majority since in 2008 Republicans must defend 21 Senate seats while Democrats will try to hold their 12. The earliest indications are that only five Senators are highly vulnerable, Norm Coleman (R-MN), Wayne Allard (R-CO), John Sununu (R-NH), Mary Landrieu (D-LA), and Tim Johnson (D-SD). GOP problems will escalate if some Republican Senators retire. Still, Senate rules will permit Republicans to filibuster most legislation that is “too liberal.”

Congressional Republicans, however, have to be careful not to overplay their hand. They will have to let Democrats lead, follow them when polls say they should, and block them when Democrats go too far. Having lost the mid-term elections, Republicans have reason to fear that further miscues will cost them the presidency in 2008 as well as the Congress, throwing the GOP into the political wilderness. With both Congressional parties hugging the center and President Bush eager to produce a positive legacy in his remaining 25 months in office, the 110th Congress may prove legislatively productive.

CAN uses an industry risk-weighting system to communicate where legislative or regulatory actions are likely to impact investors. Our rating system runs on a scale from +10 to -

10, with +10 communicating maximum bullishness and -10 maximum bearishness. In today's report, we list the industries where opportunities and risks currently are concentrated. We will specify the companies with the greatest exposure in subsequent issues. If you wish an early "sneak peak" of our specific company findings, please contact us.

Small Cap Companies, NASDAQ, and Sarbanes-Oxley Reform: +4

As CAN predicted, SEC Chairman Christopher Cox recently announced that "significant changes" will be made to the implementation of "Section 404" of Sarbanes-Oxley, with an emphasis on making the regulation cost-effective, especially by taking the asset sizes and complexities of regulated companies into account. Full relief could boost profits of many micro caps by 20 percent or more. Even incoming chairman of the House Banking Committee, Barney Frank (D-MA), supports such reform and said so publicly.

Biofuels: +4

Given the emphatic statements by Democratic leaders about the need to reduce our dependence on foreign oil by developing "green energy" at home, it is likely that the 2007 Farm Bill will include provision of incentives for farmers to grow more biofuels. Democrats also are likely to use the tax code to stimulate production and consumption of alternative energy.

Homeland Security Contractors: +4

Congressional Democrats want to boost federal spending to increase security at the nation's ports and the rail system. Companies that specialize in X-ray scanning equipment should see a boost in orders.

Health IT: +3

Eighty-five percent of all health records are still on paper, according to HHS Secretary Mike Leavitt. Physician usage continues to grow, however, with 25 percent of physicians now using some form of electronic records. There is bipartisan consensus in favor of digital systems that cut health care administrative costs, which now consume 30 percent of all health dollars. Congressional Democrats can be expected to develop a program to accelerate their adoption.

Deep Water Oil and Gas Drillers: +3

Congress is expected to end a 25-year drilling moratorium in the eastern part of the Gulf of Mexico which would open up a rich area for exploration equal in size to the state of Maryland. After marathon negotiations, the Senate passed this proposal, 71-25, on August 1, 2006. The House passed a broader bill on June 29, potentially opening up offshore acreage in the Atlantic as well, 232-187. House GOP leaders have decided to take what they can get before ceding power to the Democrats. Therefore, the House should pass the Senate bill by *this Thursday*, and send it to Bush, who will eagerly sign it.

Fannie Mae/Freddie Mac: +2

With the retirement of Senator Sarbanes (D-MD), the Senate Banking is expected to show more enthusiasm for a compromise over GSE reform. Prospects for a legislative solution have never been higher. They now are 70 percent. In fact, negotiators are even trying to finalize one today. Still, this is not a risk-free investment. Unless a GSE regulatory reform bill which is satisfactory to the Bush Administration passes by August 2007, we expect the Treasury

Department, using existing legal authority, to require the housing GSEs to shrink their portfolios considerably, sending earnings plummeting.

Tech/Telecom: +2

The new Chairman of the House Energy and Commerce Committee, John Dingell (D-MI) does not currently favor early passage of a sweeping telecommunications bill. He views energy and health legislation, as well as oversight hearings over regulatory agencies and possible White House misconduct, as more pressing. Dingell also has been an ally of the RBOCs in the past, and their enthusiasm for a major bill has diminished considerably because liberal Democrats want to force from them major concessions on “net neutrality” as the price for granting them a national “video franchising” charter that would help them enter the cable business. The RBOCs believe that they are winning the needed concessions on video franchising from the states and do not want to pay the price. Do not expect serious legislating to begin until the summer and perhaps later.

Now that Kevin Martin has been confirmed as Chairman of the Federal Communications Commission, there is a 75 percent chance that the FCC will approve the merger between ATT and Bell South.

House Energy and Commerce Chairman Dingell has made it clear he believes that additional spectrum must be found to assist fire fighters, police, and other first responders. If Dingell’s views become law, scarcity may drive up the value of existing spectrum and the price of spectrum offered for sale.

Congress has decided that TV broadcasters must switch over to a digital-only format no later than February 17, 2009. This will require almost 15 percent of consumers, those owning analog TVs who do not subscribe to cable or satellite, to purchase set top boxes if they wish to continue receiving over-the-air signals – up to a \$5 billion boon for their manufacturers.

Prison Operators: +2

There is a consensus that the policy of “catch and release” governing the treatment of apprehended illegal non-Mexican immigrants should end. This will lead to more business for private prison operators.

Asbestos Litigation Reform: +2

Senate Judiciary Chairman Pat Leahy (D-VT) is a committed advocate of reform. A bid to transform the litigation system by creating a trust fund narrowly failed in the 109th Congress, due to Democratic opposition. Leahy may be able to bring together the 60 vote coalition needed to pass a Senate bill. Bulls should keep their enthusiasm for a surprise win in check until they hear from House Judiciary Chairman, John Conyers (D-MI), and other senior House Democratic leaders. They may not feel the same way as does Leahy.

Chemical Industry: -2

Democrats are likely to restore the Superfund tax placed on chemical feed stocks. The Congressional GOP let it lapse during the Clinton Administration. While Bush has not had to

address this issue, it is unlikely he would veto a restoration of the funding mechanism used to speed the clean up of the nation's most serious toxic waste dumps.

Pharmaceuticals: -3

The Chairmen who will hold oversight hearings will be Senator Ted Kennedy as Chairman of the Health, Education, Labor, and Pensions Committee, Ways and Means Chairman Charlie Rangel, Energy and Commerce Chairman John Dingell, and Government Affairs Chairman Henry Waxman. All are fierce industry critics. President Bush will veto any bill that mandates that the federal government negotiate directly with pharmaceutical companies on behalf of insurance companies offering drug coverage under Part D Medicare. He is unlikely to take such action when Democrats take steps that boost usage of generic drugs under Part D. Investors should consequently overweight generic companies.

The industry also will face a challenge late in 2007 when the Prescription Drug User Fee Act comes up for renewal. PDUFA shortens the time that the FDA takes to approve new drugs by assigning additional safety reviewers when companies ask for them and pay for them. A slowdown in approval times means drugs have fewer months, or even years, of patent protection.

Defense: -3

A Democratic takeover of Congress has given them the "power of the purse." One wild card will be how they use this power to limit, or not to limit, Iraqi war funding. Savings due to troop withdrawal could be used to boost procurement – or transferred to fund domestic spending priorities. Most likely, long-term defense procurement spending will flatten. Defense contractors will have their Iraqi war activities aggressively investigated, generating headline risk.

Wal-Mart: -3

Democrats likely will organize well publicized hearings on Wal-Mart's labor practices. This may fuel "living wage" campaigns across the country. The Congress also could destroy Wal-Mart's bid to open an industrial loan corporation.

Airlines: -3

The Federal Aviation Administration must be reauthorized next year. This bill will provide a convenient legislative vehicle for Congressional Democrats to attach amendments that will improve security or favor passengers. Both could cost the industry money.

It is unclear whether the large carriers will win their dogfight with the growing number of private jets for control of the skies. As the number of private jets grows, the number of commercial flights will fall. There is not enough safety capacity currently to accommodate everyone's preferred schedule.

Coal and Hard Rock Mining: -4

The incoming Chairman of the House Resources Committee is West Virginian Nick Rahall (D-WV). Rahall has expressed interest in reviving programs that require coal companies to reclaim abandoned sites. He also favors requiring hard rock miners on federal land to pay more in royalties. Renewed interest in a "carbon tax" will disproportionately hurt coal.

Cutting against the grain, there is growing interest in developing “clean coal” technology with federal help. Separately, the likely House Subcommittee on Energy Chairman, Rick Boucher (D-VA), is pushing for a federal coal-to-liquid fuel price support program which would kick in when oil prices slid below \$40 a barrel. Senator Robert Byrd (D-WV) who likely will take over as chairman of the Appropriations Committee will be a powerful supporter.

Speciality Finance: -4

House Financial Services Chairman Barney Frank (D-MA), and Senate Banking Committee Chairman Chris Dodd (D-CT) both will explore legislative remedies to “predatory lending” involving mortgage products and credit cards.

Medicare Advantage Health Insurers: -4

Congressional Democrats believe that Medicare HMO’s serving seniors are overpaid and only are doing well because of GOP favoritism. They may pass legislation cutting funding and send the savings to Medicare’s underpaid doctors. Chairman Dingell has announced his intention to pass a “Patient’s Bill of Rights” aimed at protecting HMO customers.

Cable: -4

The telecom companies are planning to deploy video products over the next five years with full backing from Washington. Congress may approve the sale of “white spectrum” as a way to expand wireless broadband options for consumers.

Restaurants, Hotels, Agricultural Commodity Producers: -4

The prospects for “comprehensive immigration reform” brightened considerably when Democrats captured the House of Representatives. Reform would lead to higher labor costs as the flow of illegal workers slows due to stronger border enforcement. Meanwhile, illegal aliens now working in the U.S. would gain legal status and improved bargaining positions with employers.

Private Mortgage Insurers: -5

The House has passed legislation reforming FHA mortgage insurance, increasing the size of mortgages that HUD will insure and lowering down payment requirements. The Senate wants to explore the idea more carefully and therefore final action will await the next Congress. However, the House reforms, or something similar, would damage private mortgage insurers.

Corporate “Inverters”: -6

Several publicly traded corporations use paper shells to create foreign domiciled corporate parents to save on federal taxes. Congressional Republicans “grandfathered” inverters in 2004 over Democratic objections.. However, this may not be the last word on the subject now that Democrats will write the tax laws and “pay as you go” rules will add pressure to find politically expedient ways to raise revenue. Inverters were branded by some Democrats as “corporate traitors.”

Meat Packers: -6

Congressional Democrats may resume their efforts to force large integrated meat companies to choose between divesting themselves of most of their herds, or to get out of the

meatpacking business during consideration of the farm bill in 2007. The chances of them succeeding are 50 percent.

Equities With High Dividend Yields: -6

President Bush has signed legislation extending the 15 percent maximum tax rate on dividends and long-term capital gains for two years until December 31, 2010. The extension will help shareholders of companies that distribute an above-average amount of their earnings through dividend distributions. Unfortunately for investors, this likely will be the last extension. There is only a 30 percent chance that Washington will renew these tax rates beyond 2010. Almost all congressional Democrats, and a few Republicans, view the 15 percent rate as too low.

Iran War Winds: Blowing in 2007?

In the event there is no negotiated settlement, President Bush or Israel is likely to destroy Iran's nuclear weapons making machinery by aerial attack before Bush's term ends. Bush may try a naval blockade first, because Iran must import 40 percent of its gasoline.

Presidential Election 2008: Advantage Republicans

When party frontrunners are matched up, polls show Senator McCain (R-AZ) narrowly ahead of Senator Barack Obama, 41 to 39. McCain's lead over Senator Clinton (D-NY) is higher, 48 to 40, in the race for president.

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