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Stuart J. Sweet, President **January 7, 2002**

POLITICAL RISK IN 2002

Relaxing at his Crawford, Texas ranch on December 26, 2001, President Bush declared that 2002 would be a "war year." The Commander-in-Chief didn't specify what he meant. He could mean that U.S. military forces could conduct a limited mop up operation against al Qaeda terrorists in the 60 or so countries thought to house sleeper cells. Or he could mean something very aggressive – that the U.S. would escalate its rhetorical fight against Saddam Hussein into a shooting war that finally toppled the Iraqi dictator. According to conventional wisdom, no attack on Hussein is likely because European, Russian, and Arab opinion opposes it. CAN believes the opposite; an attack on Iraq is more likely than not before 2002 ends, but probably during the last half of the year.

Elections will influence the events of 2002, especially with the narrow control of both houses of Congress in the balance. It surely didn't escape White House political tacticians that a Dec13-14, 2001 *Newsweek* poll found that the public favors using force against "Saddam Hussein and his military in Iraq" by a 78 to 15 margin. Furthermore, America's justified war on terrorism is bucking up GOP House candidates who have only a tenuous 223-212 edge. An early June *CNN/USA Today* poll found, by a 49 to 45 margin, that registered voters would support sending a local Democrat to the House. In mid-December, by a 48 to 43 margin those voters said they would prefer GOP House candidates.

It will be three years before the next Presidential election. However, Bush has seen his personal approval numbers leap from 55 percent on September 6 to 86 percent on September 13, and stay there for four months, since he ordered aircraft carriers to steam in anger toward the Arabian Sea. If the war on terror were not dominating the news, it is likely that the White House unfriendly themes of recession, growing unemployment, and federal deficits would. Why wouldn't *any* American President in this situation decide to make America safer, along with his own hold on the White House, by defanging an enemy who has demonstrated a willingness to use weapons of mass destruction on his own countrymen as well as his neighbors- and by the way, tried to assassinate his father who visited Kuwait in 1993? Would he really be dissuaded by the clucking of a French or Egyptian President or two?

If there is an attack on the Sunni Muslim Iraqi dictator, it's likely to be preceded first by an escalating war of words first, accompanied by the shipment of war supplies to Kurdish allies in the north and Shiite Muslims, who represent 60 percent of the country, in the south and a U.S. air force attack on Iraqi air defenses. Iraq, by the way, has a *smaller* population than Afghanistan; the U.S. is 8 times larger than Iraq and 7 times larger than Afghanistan. In 1991 and 2001, war jitters sent U.S. equity markets down at first, then they recovered as the scope of America's victories became clear. We could see a similar pattern this year. While it is impossible to predict if there will be terror at home, expect more good war news abroad in 2002.

The Budget

In May 2001, the Congressional Budget Office, Congress' official scorekeeper, announced that federal surpluses would total $5.6 trillion over 10 years if no new policy changes were adopted. This cornucopia of riches precipitated a raucous fiscal struggle. Supplysiders urged Bush to slash marginal tax rates and ignore bean counters who said it would cost $2.3 trillion. Conservative Democrats asked that complete retirement of the national debt be the priority. Defense hawks saw a rare chance to rebuild a neglected military. Liberal Republicans, and most Democrats, reminded Bush of his expensive pledges as a "compassionate conservative" to expand federal spending on education and prescription drugs for seniors.

The Jeffords Coup of One ended supplysiders dreams by elevating Tom Daschle to Senate Majority Leader. Only a 10 year, $1.35 trillion tax cut squeaked into law. Meanwhile, the recession which started in March finally caught up with budget forecasters about the same time that bin Laden's henchmen slammed their highjacked planes into America's heart. Today, the CBO predicts that 10 year surpluses will amount to $1.9 trillion, one-third the amount forecast eight short months ago.

On January 29, George W. will address a Joint Session of Congress. He will follow up one week later with a detailed budget proposal that will state how the White House wants to dispense resources among federal claimants and taxpayers. With modest deficits predicted for the next two or three years, no faction will go away truly happy by year end:

- Tax cutters hope to resurrect the fiscal stimulus debate that might permit taxpayers to keep $100 billion of their funds over 10 years, about one-fourteenth of what they accomplished in 2001. Divided partisan control of the House and Senate offers national debt reduction enthusiasts a cup of small beer; the coming debate over *how much to increase* the national debt ceiling will force both parties to recognize an era of limits even as the national debt goes *up* slightly.

- Defense hawks had hoped to see an endless stream of Joint Strike Fighters, F-22s, Aegis Destroyers, Nimitz Class Carriers, Updated M-1 Tanks, Ospreys, and Comanche helicopters parade before them while development of a robust national missile defense system accelerated. Theirs is, at best, a dream deferred. First priority will go to replenishing stocks of missiles and munitions consumed in the Afghan campaign and hardening America against terrorist attacks. True, the education lobby carted off their trophy as the White House signing ceremony this week with Senator Kennedy (D-MA) makes clear. So, educators can't expect to pocket more gains this time.

- Seniors may have the best chance to score in this election year. The debate over prescription drugs benefits to Medicare beneficiaries will resume when Bush includes a proposal in his February budget presentation. No doubt it will have a lengthy phase-in, helping seniors most in the latter part of the decade when the bulk of those $1.9 trillion in surpluses returns. Then, such subsidies appear more affordable. Big pharma investors, watch out.

The 2002 Elections

In election years, Washington operates under different rules. The fact that the voters will decide the careers of 435 Congressmen and 34 Senators ten months from now makes them acutely concerned about attitudes back home. The anxiety level is highest for the few Members who have real fights on their hands. Currently, 33 House seats should be rated hotly competitive, with 18 occupied by Republicans and 15 by Democrats. Control of the Senate likely will be decided by six contests. The struggle of these 39 men and women to hold onto their jobs is also the struggle for control of both Congressional chambers. A loss of only seven House seats will give Dick Gephardt the Speaker's gavel, assuming Ralph Hall (D-TX) would honor his pledge to cast the deciding vote for a GOP majority if his organizational vote mattered. The net loss of a single Democrat Senate seat would flip control of the Senate back to 51-50, with Vice President Cheney once more casting the tie breaking vote. President Bush will storm strategic hamlets in the closing days of the campaign, perhaps tipping close races to the GOP, producing a Republican Congress. This is how the struggles are shaping up:

<u>The House:</u> Odds of GOP Maintaining Control are 55 percent.

Every decade, after the census results are known, 43 State governments must redraw their House Congressional boundary lines in accordance with the Supreme Court's doctrine of "one man, one vote." The remaining 7 States only send one representative to Congress and are unaffected. The Court also has said that State officials are free to gerrymander for explicitly partisan reasons provided they do not run afoul of the Voting Rights Act, which protects minority communities against having their voting power diluted. When the redrawing process began, GOP strategists felt they would gain 8 to 10 seats. Democrats scoffed and predicted a draw. With half the struggle completed, an intermediate outcome appears likely, producing a GOP gain of 3 to 5 seats. Expected GOP improvements in Florida, Illinois, Michigan, Minnesota, Ohio, Pennsylvania, and Texas mostly will be offset by Democrat gains in Arizona, Alabama, California, Georgia, Maryland, North Carolina, and Oklahoma. However, the consistent pattern in this year's redistricting process has been a bi-partisan cabal to insulate incumbents of both parties from serious threats. In a typical trade, one vulnerable GOP member sheds Democratic precincts and picks up GOP ones while in exchange elsewhere in the same state a vulnerable Democrat does the opposite. With justification, this process has been called politicians picking their voters rather than voters picking their politicians.

Adding an assumed 4 seat pick-up through redistricting to the 7 now needed, Democrats must pick up 11 seats to gain control of the House. This may be a tall order given that only 33 seats appear hotly competitive because of incumbent protection district redrawing schemes. Historic patterns should help House Democrats on their way, however. In almost all mid-term elections, the party not holding the White House gains seats. Furthermore, the small number of competitive House races minimizes the GOP's traditional fund raising advantage. Democrats are certain to raise all the funds needed to make well positioned candidates competitive; a $3 million to $2 million advantage is more telling than one that is $4 million to $3.5 million.

The Senate: Odds of GOP Regaining Control are 55 percent.

There will be 34 Senate races this fall. Currently, the GOP controls 20 of them, and Democrats hold 14. This disparity in contested seats in a mid-term election, coupled with a Republican President, historically points toward a Democrat pick-up of seats. However, many Senate races will not be competitive. Today, six toss up races appear key in analyzing the Senate's future. The GOP probably needs to win four of these six races to reclaim Senate control, 51-50. All six races should prove barn burners. The 3 GOP challengers overall are in slightly better shape than the 3 Democrat challengers, based on the most recent polls.

State	**GOP Senator**	**Democrat Challenger**	**Most Recent Poll***
Arkansas	Tim Hutchinson	Attorney General David Pryor	Hutchinson 47% Pryor 39%; (Tarrance Group)
Colorado	Wayne Allard	former U.S. Attorney Tom Strickland	Allard 39% Strickland 34%; (Talmey-Drake)
New Hampshire	Bob Smith/ Rep John Sununu (GOP Primary)	Governor Jeanne Shaheen	Smith 47% Sununu 39% American Research Group; Shaheen 45% Smith 44%; (University of New Hampshire)
	Democrat Senator	**GOP Challenger**	
Minnesota	Paul Wellstone	St. Paul Mayor, Norm Coleman	Wellstone 43% Coleman 42% (St. Cloud St. University)
Missouri	Jean Carnahan	former U.S. Rep Jim Talent	Carnahan 48% Talent 43%; (American Viewpoint)
South Dakota	Tim Johnson	Rep John Thune	Thune 45% Johnson 39%; (Fabrizio, McLaughlin)

* As reported by the Cook Political Report on December 20, 2001

Trade

It took 38 minutes to complete a scheduled "15 minute House floor vote," but with supporters finally just ahead 215-214, the gavel came down before any more members could switch their votes. The House had just voted in favor of granting President Bush fast track trade negotiating authority on December 6.

The Senate, as CAN discussed on December 4, 2001, has never been much of an impediment. Less than a week later, the Senate Finance Committee voted in favor of a bill similar to the House package by a margin of 18-3. Last week, Senate Majority Leader Tom

Daschle (D-SD) announced that he would schedule a Senate floor vote "early this year." His price for going along will be an expansion in the "trade adjustment assistance" program which helps some workers who lose their jobs to permanent import surges. President Bush should sign fast track legislation no late than July 1. His trade negotiators are already fast at work on the next WTO trade Round recently launched at Doha, Qatar and also are stitching together a "Free Trade Agreement for the Americas." Likely sectoral winners are agribusiness, environmental services, and financials.

Energy

When George W. took office only the tax cut and education reform were higher domestic priorities than addressing the nation's long-term energy needs. With these items now safely in the statute books, the Administration can be expected to rachet up its efforts to pass an energy program in 2002, building on considerable headway made in 2001.

The House passed HR4, the Securing America's Future Energy Act of 2001 on August 2, 2001by a vote of 240-189. The bill provides targeted incentives for deep water drilling in the parts of the Gulf of Mexico, keeps oil and gas stripper wells in production when prices fall steeply, and opens up the Arctic Wildlife Refuge to oil exploration and drilling. The House bill also includes conservation initiatives. It provides tax credits to auto consumers who purchase gasoline-electric hybrid engines that typically get 40 mpg or better. Also, for the first time since 1991, auto fuel efficiency standards would be tightened modestly. Electric utilities that purchase highly efficient combined heat and power systems also will pay lower taxes. Finally, manufacturers of electric appliances face costly engineering changes to boost the efficiency of their products.

Senator Daschle has promised to call up the Democrat alternative, S.1766, the "Energy Policy Act of 2002," for full Senate consideration by Presidents' Day, February 18. S.1766 is silent on what tax incentives should be provided for conservation and production. It also didn't specify how much auto fuel efficiency standards would be raised. These major elements will be added as Democrat floor amendments after they are drafted by the Senate Finance and Commerce Committees.

Expect a bill to become law sometime this year.

CAN's Industry Overview: More Winners Than Losers in '02

To open the new year, CAN provides an industry risk forecast which identifies many of the industries that CAN will highlight individually in the months ahead. In our rating system, positive risk weights are bullish and negative risk weights are bearish, on a scale that runs from +10 to -10.

Telecommunications (DSL equipment providers): +9

This may be the best politics driven tech play on the board and led CAN's president to purchase shares in leading companies personally. The FCC is conducting a review on how to accelerate broadband deployment. Their review is expected to especially help DSL providers.

Also, the House is expected to pass in March the Tauzin-Dingell bill which offers incentives to regional Bell companies to roll out DSL to the public. The idea here is to buy companies that sell picks and shovels to gold prospectors.

Mining: +8

Interior Secretary Norton has ended the war on miners on federal land. Highly profitable leases will once again be let.

Agribusiness: +6

Control of the Senate hinges on a handful of farm state races that conclude this November. This year, Congress must consider how much assistance to provide for the next five years when it debates the farm bill. Also, the next Round of WTO talks will help American agribusiness.

Steel: +6

The Administration will slap counterveiling duties on selected imports, probably next month. It already has launched talks to reduce global supplies. Investors should not count much on Washington relieving the industry of “legacy” health care and pension costs, however.

Tobacco: +6

The Justice Department lacks the financial resources to fully prosecute the Clinton case, which was viewed as weak anyway. If the Department offers a good enough settlement deal, the companies will take it.

Credit Card Issuers and Auto Lenders: +5

The House and Senate have passed bankruptcy reform bills that help credit card issuers that market to above average income families and also auto finance companies. Nettlesome differences have stalled a final resolution. There’s a 2 to 1 chance they get resolved by year end.

Deep Water Oil and Gas Drillers: +5

If an energy bill makes it to Bush’s desk, drillers will pay reduced royalties to the government.

Paper and Wood Products: +5

Eventually a revised U.S.-Canadian trade agreement will be reached that restricts Canadian imports.

Rural Hospitals: +5

Few Medicare providers should look upon 2002 as a chance to improve federal payments. This is one group that has a chance because of acknowledged payment disparities with their urban colleagues.

Fannie Mae/Freddie Mac: -2

House leadership efforts to give federal charters to new companies, specifically designed to create competitors for the two housing GSEs, will surface.

Airlines: -2

Washington has done all it thinks it needs to do to bring the industry back. The new loan guarantee board will be increasingly tough on petitioners who want a part of the $10 billion in loan guarantees. American West had to offer Washington warrants covering one-third of their outstanding shares.

Defense: -5

Until the economy turns around, or the Administration tries to topple Saddam Hussein, defense spending will grow by little more than the inflation rate. Now is a good time to underweight the group, and then revisit the situation later in the year.

Managed Care: -5

The events of September 11 delayed passed of a Patients's Bill of Rights. Now, 2002 looks like the year the industry has to eat 3 percent of mandated incremental costs, courtesy of Washington, with no offsetting revenues.

Life Insurance: -6

Majorities in both the House and Senate want to pass a federal statute prohibiting life insurers from making pricing decisions based on genetic testing. Risky customers will purchase added coverage while the healthy will purchase less.

For further analysis or information, contact Capitol Analysts Network, Inc. at:

4405 Bradley Lane
Chevy Chase, Maryland 20815
website: www.capitolanalysts.com

Phone: 301-951-9161
Fax: 301-652-5831
Email: capnet@erols.com