
CAPITOL ANALYSTS NETWORK, INC.

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February 22, 2003

WASHINGTON OUTLOOK

Iraq War Risks

Give only a fifteen percent chance that war can be avoided by Hussein accepting exile or being overthrown by his military. While many possibilities exist, the most likely is that the U.S. will attack Iraq by the end of March. An invasion would succeed. Iraq has fewer people than Afghanistan, and its armed forces are less than one-third as potent as they were during the 1991 Gulf War. Meanwhile, technological advances make the U.S. stronger than in 1991. The Air Force could use less than one-fourth of the aircraft needed in 1991 to devastate Iraqi targets because 90 percent of its weapons will be “smart,” compared to ten percent in 1991. For this reason, the U.S. doesn’t really need Saudi, or even Turkish, air bases. If Hussein survives an early bombardment and elects to remain in the capitol, the U.S. probably will surround Baghdad, then wait for the city’s Shiite majority to topple him when fuel and food become scarce. There is a considerable chance that Hussein will sabotage Iraqi oilfields

After any invasion, Iraq would become a regional ally. The U.S. would likely base troops there indefinitely with the new government’s support, devaluing the Saudi’s military significance and pressuring Iran and Syria into stop backing terrorists. Iraqi oil fields are under producing. With sanctions lifted, the fields would be modernized, boosting output at OPEC’s expense. Iraq would use the new oil revenue and reduced defense expenditures to rebuild.

The Bush Tax Package: Expect Half a Loaf

The Administration will have little difficulty pushing its tax plan through the House of Representatives. It probably will do so twice – once in March to pressure the Senate and a second time, probably in late April or May, when the real bargaining will begin. The Senate is another story. Seven GOP Senators – McCain, Voinovich, DeWine, Snowe, Collins, Coleman, and Chafee – oppose the plan and seek major changes. Zell Miller is the only Democrat who backs Bush’s plan as written. With a base of 45 votes, the Administration will bargain hard to secure another five votes, then let VP Cheney break the tie. Expect the dividend tax reduction package to be cut in half to save money and to fund priorities of Republican or Democrat Senators who supply the decisive last five votes. The President will sign an investor-friendly tax package into law between Memorial Day and August. **Buy stocks with high dividends; reduced individual taxation of dividends could boost their values.**

The Surprising Sweeping Tax Reform Overhaul

The Administration’s surprise savings and investment enhancement initiative announced recently allows a family of four much better treatment on up to \$113,000 in annual savings deposits! Income from capital gains, dividends, and interest generated by these deposits could be withdrawn, tax-free. Each year, every adult could place \$7,500 in a Lifetime Savings

Account (LSA), another \$7,500 in a Retirement Savings Account (RSA), plus deposit \$12,000 in an employer's retirement plan. In addition, that family could, on behalf of every child, also deposit \$22,000 in a college savings account, plus another \$7,500 in a Lifetime Savings Account.

This proposal is more "Reaganesque" than anything Reagan attempted. Taxpayers would still fill out 1040s; however, this savings incentive package, in effect, would transform the personal income tax into a progressive consumption tax. Income not used for consumption would be invested and returns would be tax-exempt. Its authors believe revenue gains through voluntary IRA conversions into LSAs and RSAs, which would be taxable, would more than offset the plan's early costs, *reducing* deficits in 2003 through 2006, and even the eleven year total from 2003 through 2011. Ultimately, static personal income tax collections would fall by 20 percent as capital gains, dividends, and interest income disappear from the tax base. Early congressional reaction has been cool.

Election 2004

Bush will have a huge campaign finance advantage over the Democrat nominee – and he may need it. Only Hoover has a worse modern Presidential record on total job growth. Senator John Kerry (D-MA) is the early Democrat front-runner, having raised the most money while running second in Iowa polls and first in New Hampshire. In our view, in second is Rep Dick Gephardt (D-MO), followed by Senator John Edwards (D-NC), and then Senator Joe Lieberman (D-CT). Other serious candidates may enter. *Odds of a Bush Re-election: 60 percent.*

Zell Miller's (D-GA) retirement gives the GOP who enjoy a narrow 51-49 advantage, an early edge in the Senate struggle. *Odds of a GOP Senate hold: 60 percent.*

It will take a big Democrat year to dislodge the House GOP majority. They rule by a 230-205 margin, and there are few districts that voted for Gore and also a Republican congressman. *Odds of the GOP holding the House: 70 percent.*

CAN's Legislative Overview of the 108th Congress

Industry fundamentals and investment fashions matter, but policy changes do, too. CAN uses an industry risk weighting system to communicate where federal legislative or regulatory actions are likely to help or hurt investors. In CAN's rating system, positive risk weights are bullish and negative risk weights are bearish, on a scale that runs from +10 to -10. Here are our current findings.

Pharmacy Benefit Managers: +6

The Bush Administration rolled out its revised seniors pharmaceutical discount card program in late August, but a federal judge blocked it four weeks ago, saying Congress must approve it first. It is likely to do so. PBMs are expected to get 10 million seniors as new customers.

Agribusiness: +6

As a result of the recently passed farm bill, Congress will bankroll prosperity in the rural economy by providing record subsidies to crop farmers for the next six years. Also, the next Round of WTO talks will help American agribusiness, especially biotech. Ethanol producers will have to wait to benefit from a mandatory increase in ethanol usage as part of a coming energy bill struggle.

Asbestos Impaired Manufacturers: +6

The GOP would like to move a bill that would reduce industry exposure and aid speedy delivery of compensation to the truly ill. Until Senate Democrats demonstrate their willingness to negotiate, however, investors should be cautious. Watch carefully the progress made on an expected bill from Senators Orrin Hatch (R-UT) and Ben Nelson (D-NE). Buy with both hands if Pat Leahy (D-VT) supports Hatch's bill. It would mean there will be a filibuster proof majority. The House would go along, and an enthusiastic President would sign such legislation. *Hatch and Leahy will hold an asbestos litigation hearing on March 5.*

Highway Builders: +4

Congress will approve legislation boosting spending on America's highways, probably by October. Pick companies with modest exposure in California, New York, and Texas. Their deficit problems will cause them to cut back on local funding for roads.

Defense: +4

The public's militant mood toward terrorist threats means that the Administration should get its way on defense funding this year. However, the Administration's request, and the cost of any Iraqi war, will be less than many expect. Sell the group soon after any Iraqi hostilities erupt.

Medical Malpractice Insurers: +4

Publicity over "doctor strikes" will cause the House to pass tort reform, putting pressure on the Senate to follow suit. Some Democrats think the problem is insurers are overcharging, and they may demand harmful reforms.

Sallie Mae: +4

There will be a concerted effort to raise federal student loan limits in 2004 as part of reauthorization of the Higher Education Act. Possibly, the direct lending program, through which the federal government lends to students directly, may be curtailed.

Managed Care: +3

Only 15 percent of seniors are enrolled in managed care. Medicare overhaul legislation under development at the White House eventually would create a large incentive for them to join PPOs. However, a phase in period could prove lengthy; current beneficiaries probably will get access to pharmaceuticals without having to join. The GOP Congress is unlikely to pass a patient bill of rights bill that hurts much.

Credit Card Issuers and Auto Lenders: +3

The collapse of the bankruptcy code compromise on the House floor last year means negotiators must pick up from where they left off. The compromise helped credit card issuers that market to above average income families and also auto finance companies. The bill narrowed the bankruptcy rights of abortion clinic protestors, inflaming the pro-life community.

Pharmaceuticals: 0

The Bush discount card plan will cause margins to shrink somewhat. However, Medicare overhaul legislation will help by expanding total seniors' consumption.

Fannie Mae/Freddie Mac: -1

The Administration has considerable latitude, if it wants to use it, to curb the companies' growth rates. It can, for example, block further GSE debt issuances or forbid entry into new product lines. Eventually, perhaps years from now, new restrictions will arise. Mark Brickell, OFHEO's likely new leader, will prove a more aggressive regulator than his predecessor.

Skilled Nursing Homes, and Home Health Care: -2

The Administration feels they are overcompensated. Congress feels they are underpaid. Expect a major battle.

Retail Pharmacies: -7

The Administration will push hard in Congress and in the courts to implement its private sector based plan offering uninsured seniors discount cards for pharmaceuticals. Retail pharmacies would be forced to give up generous margins on sales to seniors.

Tax Haven Headquartered Corporations: -7

Bermuda headquartered Ingersoll-Rand, Cooper Industries, and Nabors Industries, among others, are targets of aggressive loophole closing tax reformers. Senate Finance Committee Chairman Charles Grassley (R-IA) wants action, and he will move against corporate "inversions" later this year.

Airlines and Tourism: -7

If the U.S. defangs Iraq by force, and there is an eighty-five percent chance of this happening unless Hussein is overthrown or flees, these industries could suffer badly. Due to war jitters, they already have.

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