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END OF SESSION, BATTLES ON MANY FRONTS

A year ago, CAN ended its "Terrorism 101" report with a section entitled: What If We Win the War Against Terrorism but Lose the Battle Against Recession? In twelve months, the War has shifted to a new target, while the Recession Battle still rages. One may wonder if there has been more blood in the streets of Kabul or New York's financial district. President Bush continues to fight on both fronts. Now he faces a third front, the fight for control of Congress. At the moment, Bush and his GOP allies enjoy a narrow and volatile advantage in this new theater.

War Risks: On to Iraq?

Before military action is possible, the U.S. must first exhaust diplomatic solutions. That effort begins in earnest with Bush's U.N. speech this week. There's some chance, perhaps 25 percent, that Hussein will agree to an intrusive, go anywhere, at anytime, inspection regime that prevents war. Before recess next month for the November elections, Congress will publicly back Bush in advance if he decides to attack. While many possibilities exist, the most likely is that the U.S. will overthrow Saddam Hussein next spring or summer, using a force over 200,000 to do so.

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 U.S. still needs time to replace the 21,000 missiles and smart bombs, and to repair overtaxed air carriers and aircraft, all used during the Afghani campaign. Meanwhile, the Administration recently signed lengthy contracts with commercial ship owners to begin transporting heavy military equipment to the area.

If an invasion is launched, it will have multi-lateral support, especially from Russia and France – who now are vocal critics. Iraq's two major creditors will switch sides once it becomes clear a new government will be formed which they can't afford to alienate. Other creditors also would make similar calculations and back the U.S. when it's safer to do so. After any invasion, Iraq would turn from an enemy into a regional ally. The U.S. is likely to 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, they would be modernized, boosting output at OPEC's expense. Iraq would use the new oil revenue and reduced defense expenditures to rebuild.

The 2002 Elections are Close, But Favor "No Change" in House Control

Currently, forty races in House are considered competitive, and so are nine in the Senate. The outcomes will decide who controls Congress. A loss of seven House seats will give Dick Gephardt the Speaker's gavel, assuming Ralph Hall (D-TX) votes as promised for a GOP majority if his

organizational vote matters. The net loss of a single Democrat Senate seat would flip control of the Senate back to 51-50, with Republican Vice President Cheney casting the tie breaking vote.

President Bush will not sit on the sidelines and give the Democrats the chance to make Gephardt Speaker of the House. The President will storm strategic hamlets in the closing days of the campaign, hoping to tip close races to the GOP. Bush remains highly popular. In June 2002, when the Princeton Survey Research Poll simulated a 2004 White House rematch, Bush beat Gore, 56 percent to 32 percent. Such strong support from the top, along with some help from the way states remapped their Congressional districts after the 2000 census, gives the GOP a 60 percent chance of keeping control of the House of Representatives.

After the 2000 census concluded, State governments had to redraw their House Congressional boundary lines. GOP reapportionment strategists felt they would gain 10 seats. Democrats predicted a draw. With the struggle over, the GOP gained only two to four seats. However, this year's redistricting process insulated 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 three seat pick-up through redistricting to the seven now needed, Democrats must win 30 of 40 competitive races to gain control of the House. Historic patterns could help House Democrats. 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 fund raising advantage. Democrats will raise all the funds needed to make well positioned candidates competitive.

Republicans Have the Better Prospects for Senate Control

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 Democrat gains in seats. However, many Senate races will not be competitive. Today, eight races are key in analyzing the Senate's future. The GOP probably needs to win five of these eight to reclaim Senate control, with Vice President Cheney's vote, 51-50. All eight could prove barn burners.

If the GOP wins only four of eight key Senate races and Mary Landrieu (D-LA) fails to get 50 percent of the vote against three GOP opponents in November, a runoff on December 7 will decide who controls the Senate. Political observers who enjoyed the 2000 Florida Presidential controversy will relish watching Bush nationalizing the runoff; the nation wouldn't know who controls the Senate for a month! By defeating Landrieu in December, the GOP would win the tiebreaker and regain Senate control, 51-50.

A second Senate anomaly is possible. If Jean Carnahan (D-MO) loses the special election in November, the GOP will declare they should control the Senate temporarily until January 3, 2003, 51-50, even if the GOP lost seats this November. Ms. Carnahan was appointed to office after her husband posthumously defeated then Senator John Ashcroft (R-MO) in November 2000. She will have to turn her seat over to her opponent immediately if Democrat Governor Bob Holden and GOP Secretary of

State Matt Blunt both certify she lost. Holden could demur. With a lame duck Congress likely, Trent Lott (R-MS) could close out the 107th Congress as he began – Senate Majority Leader!

State	GOP Senator	Democrat Challenger	Most Recent Poll
Arkansas	Tim Hutchinson	Attorney General David Pryor	Hutchinson 41% Pryor 51%; (Arkansas News Bureau-Stevens Media Group) Aug 19-24, 2002
New Hampshire	Bob Smith/ Rep John Sununu (GOP Primary)	Governor Jeanne Shaheen	Sununu 56% Smith 34% (U of New Hampshire) Sept 3, 2002; Sununu 44% Shaheen 43% (Research 2000); Aug 28, 2002
Texas	Attorney General John Cornyn	Former Dallas Mayor Ron Kirk	Cornyn 37% Kirk 32% (Scripps Howard Texas Poll); Aug 7-27
Colorado	Wayne Allard	Tom Strickland	Allard 42 Strickland 34% (Rocky Mountain News); Aug 11, 2002
	Democrat Senator	GOP Challenger	
New Jersey	Bob Torricelli	Doug Forrester	Torricelli 40%, Forrester 40% (Torricelli Campaign) Aug 15, 2002; private polls show Forrester well ahead
Missouri	Jean Carnahan	Former U.S. Rep Jim Talent	Carnahan 46% Talent 47%; (Zogby) Aug 22, 2002
South Dakota	Tim Johnson	Rep. John Thune	toss up; Johnson and Thune campaign polls conflict, 3% leads
Minnesota	Paul Wellstone	St. Paul Mayor, Norm Coleman	Wellstone 44% Coleman 41%; (Mason Dixon) June 27, 2002

Are There Any Stock Plunge-Fighting Tax Breaks On the Horizon?

The boomlet set off by President Bush when he expressed support for allowing individuals with capital loss deductions larger than the maximum \$3,000 per year now permitted is dying, as is the idea of permitting individuals to receive corporate dividends tax free. Some small changes are still possible in the context of a large end of session budget bill. Don't expect much.

CAN's Legislative Overview of the End Game in the 107th Congress

Industry fundamentals and investment fashions matter, but politics does, too. War risks, corporate scandals, and chances that Democrats will regain full control of Congress are pressuring the markets. Against this backdrop, legislative events will help some groups and harm others. 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.

Telecommunications (DSL equipment providers): +7

The FCC has initiated a rule making process that will accelerate broadband deployment. Formal FCC action is anticipated between December and March. Their review is expected to especially help DSL providers. House passage of the Tauzin-Dingell bill last March, which offers incentives to regional Bell companies to roll out DSL to the public, will buttress the FCC. The idea here is to buy companies that sell picks and shovels to gold prospectors. RBOCs should benefit, too.

Mining: +7

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

Pharmacy Benefit Managers: +6

The Bush Administration rolled out its revised seniors pharmaceutical discount card program in late August. If it survives a likely court challenge, PBMs are expected to get 10 million seniors as new customers. If they lose in court, the Administration will rely on the House GOP to pass remedial legislation by year end that will authorize their program. Senate Democrats may support it.

Agribusiness: +6

Control of the Senate hinges on a handful of farm state races that conclude this November. 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. A possible bill to assist drought victims may emerge. Also, the next Round of WTO talks will help American agribusiness, especially biotech. Ethanol producers hope Daschle's 200 percent production boost survives a coming energy bill House-Senate Conference.

Property Casualty Companies and Terrorism Insurance: +5

Senators from both parties are negotiating behind closed doors trying to reach a consensus. Daschle will bring the bill to the floor quickly if that happens and pass it. A House-Senate Conference would follow. Senate Democrats oppose GOP efforts to preclude punitive damages in lawsuits involving terrorism. A possible plan: Insurers would face up to \$10 billion in liabilities, then Washington will absorb 90 percent of any amount above this.

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. Conferees have almost ironed out all differences. Only a nettlesome fight over bankruptcy rights of abortion clinic protestors remains. There's a 65 percent chance Bush signs a bill this year.

Paper and Wood Products: +5

Eventually a revised U.S.-Canadian trade agreement will be reached that restricts Canadian imports. Canada is unhappy about the recent sanctions imposed by Bush.

Defense: +5

The public's militant mood toward terrorist threats means that the Administration should get almost everything it asks for on defense this fall.

Smaller Energy Utilities: +4

There's a 60 percent chance that an energy bill clears Congress this year. If it does, Depression era restrictions that limit the growth prospects of large utilities, under the Public Utility Holding Company Act, will be sharply curtailed. Buy smaller utilities after PUHCA is history; smaller companies will be bought out by larger firms.

Tobacco: +4

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.

Rural Hospitals: +3

Congress likely will boost Medicare payment rates before October's adjournment.

Skilled Nursing Homes: +3

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Managed Care: +2

The events of September 11 delayed passage of a Patients's Bill of Rights, and now an impasse has developed between the White House and Senator Kennedy, who holds the Democrats' proxy. There is only a 25 percent chance now that 2002 is the year the industry has to eat 3 percent of mandated incremental costs, courtesy of Washington, with no offsetting revenues.

Fannie Mae/Freddie Mac: -3

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 new restrictions are expected, but not this year.

Pharmaceuticals: -4

Senate Democrats will push for a more aggressive plan to help seniors than the Bush Administration can support, probably producing a deadlock. The House has already passed its version. Canadian importing issue will resurface. The Bush discount card plan will hurt somewhat.

Life Insurers and Health Insurers: -4

Daschle and the White House agree that legislation is needed banning genetic discrimination. Those who learn they are healthy will reduce coverage; the risky will expand it. It will be illegal to charge more for genetic predisposition toward disease. Action is still possible this year.

Asbestos Impaired Manufacturers: -5

Senator Leahy, Chairman of the Senate Judiciary Committee, has agreed to hold a September hearing on asbestos reform ideas. A temporary rally may follow, but the chance for reforms passing

this session that would help companies is non-existent. If the GOP controls Congress next year, it will be time to buy impaired companies.

Retail Pharmacies: -5

The Administration will push hard to implement its private sector based plan to offer uninsured seniors discount cards for pharmaceuticals. Retail pharmacies will be forced to give up generous margins on sales to seniors.

Fast Food Restaurants: -5

Prospects for an increase in the minimum wage are rising rapidly. Senate Majority Leader Daschle has told his caucus of plans to use the pension reform bill as his vehicle.

Tax Haven Headquartered Corporations: -7

Bermuda headquartered Ingersoll-Rand, Cooper Industries, and Nabors Industries, among others, are targets of aggressive loophole closing tax reformers. Reinsurers are at risk, too. Before Congress quits for the year, there is a 70 percent chance they will move against flagrant corporate expatriates.

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