

WASHINGTON WEEKLY

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Debated Breath

September 30 is Senator John F. Kerry's best chance to pull even, and possibly overtake, President George W. Bush in this presidential campaign. While it may be his last chance, that can only be judged in hindsight, so we will avoid the temptation to guess. But the importance of voters' reactions to Thursday night's debate would seem to be more crucial to Kerry than to Bush.

Only five presidential incumbents have been unseated in the last century.

- **Most polls continue to show Bush ahead of Kerry.** Leaving aside the question of whether discrepancies between *registered* voter and *likely* voter surveys are accurate or meaningful, data trends since early August generally have been favorable to Bush (this includes so-called battleground state surveys). This reality means that the Senator must score a victory, while the President only has to avoid big mistakes. Recent developments disproportionately pressure Kerry.
- **Only five presidential incumbents have been unseated in the last century.**¹ Two were the results of external events (Republicans chose Hoover over Coolidge; Watergate begot Carter). The other three challengers won on the strength of extraordinary charisma and campaign programs that resonated among a bipartisan base: (Roosevelt (1932); Reagan (1980); and Clinton (1992). Thus, history, too, disproportionately pressures Kerry.

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Cap Calls

Despite renewed Treasury pressure for action this year in light of new revelations, we believe that a new housing GSE regulator bill is more likely next year than this year.

Health Care: The D.C. Pulse

Pfizer and Montgomery County, Maryland, add fuel to the drug pricing debate.

Geopolitical Risks

Differences of opinions are widening between the Bush administration and Prime Minister Allawi, and Iraq's head Shiite cleric al-Sistani about the viability of January elections there.

¹ Philip B. Kunhardt Jr., Philip B. Kunhardt III, and Peter W. Kunhardt, *The American President* (New York: Riverhead Books, 1999).

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Capital Calls

ISSUE	RECENT DEVELOPMENTS	OUR CALL	EFFECT
Financial Services GSEs	<ul style="list-style-type: none"> • OFHEO, in its special exam of Fannie Mae, finds serious problems in accounting, internal controls, compensation, and corporate culture; SEC opens related inquiry • Fannie Mae's board forms committee of independent directors to respond expeditiously to OFHEO and SEC • Capital Markets Subcommittee Chairman Richard Baker (R-LA) plans hearing on OFHEO report, likely the week of October 4 • Senate Appropriations Committee doubles OFHEO's FY05 budget, but withholds \$10M until Director Armando Falcon is replaced 	<ul style="list-style-type: none"> • Call: Oversight shift to single GSE regulator remains unlikely in 2004, though increasingly likely in 2005 • Catalyst: Exams by OFHEO and SEC of Fannie Mae find additional problems; HUD imposes higher affordable housing goals; Treasury broadens role in GSE debt issuance • Risks: Regulatory powers, especially receivership process, capital requirements, approval of new business, and affordable housing mandates, remain contentious issues, although support for new regulator grows 	<ul style="list-style-type: none"> • Volatility: Medium • Impact: Political risk overhang, particularly on regulatory front, with ongoing OFHEO exam of Fannie Mae and resolution of current OFHEO findings; rulemaking on corporate governance, affordable housing goals, and possibly, liquidating conservatorship
Transportation TEA-21 Reauthorization	<ul style="list-style-type: none"> • Bipartisan push from Senators Kit Bond (R-MO) and Harry Reid (D-NV) for a transportation extension underscores the difficulty leadership will have in passing a full \$299B before the elections • Transportation law expired on September 24, meaning Congress is likely to adopt an extension through at least the end of September 	<ul style="list-style-type: none"> • Call: Ultimately a one- to two-year extension • Timing: 4Q04 • Catalyst: Agreement with Senate Democrats • Risks: President pushes for and receives agreement on his six-year \$299B request 	<ul style="list-style-type: none"> • Volatility: Low • Impact: Positive for highway and transit sector, energy, and aggregate concrete
Fiscal Policy FSC/ETI Repeal	<ul style="list-style-type: none"> • The House is likely to appoint conferees this week • Passage of middle-class tax relief enables Congress to focus on the FSC bill, but only two weeks remain before Congress is set to adjourn • Popular tax extenders package was removed from the FSC bill and added to the middle-class bill, taking away some impetus for FSC/ETI 	<ul style="list-style-type: none"> • Call: Congress unlikely to enact legislation that satisfies U.S. exporters, U.S. multinationals, and the European Union • Timing: 4Q04 • Catalyst: Conference agreement • Risks: Congress enacts legislation, but fails to satisfy WTO rules 	<ul style="list-style-type: none"> • Volatility: Low • Impact: Sectors most heavily targeted by sanctions, which began March 1, are precious stones and jewelry; machinery and mechanical appliances; wood and paper articles; leather articles; and toys, games, and sports equipment
Tort Reform Asbestos	<ul style="list-style-type: none"> • Senate Judiciary Chairman Orrin Hatch (R-UT) calls Minority Leader Tom Daschle's (D-SD) counteroffer a "laughing" 	<ul style="list-style-type: none"> • Call: Legislation is very unlikely to be enacted this year • Catalyst: Agreement on existing cases, smokers, and size of fund 	<ul style="list-style-type: none"> • Volatility: Low • Impact: Lack of a federal fix maintains irrational system and legal exposure for affected companies

Source: Lehman Brothers

Bush's campaign will promote his "homespun" public speaking manner, hoping to figuratively concede the debates to Kerry while creating an impression among voters that Bush is most focused on counterterrorism.

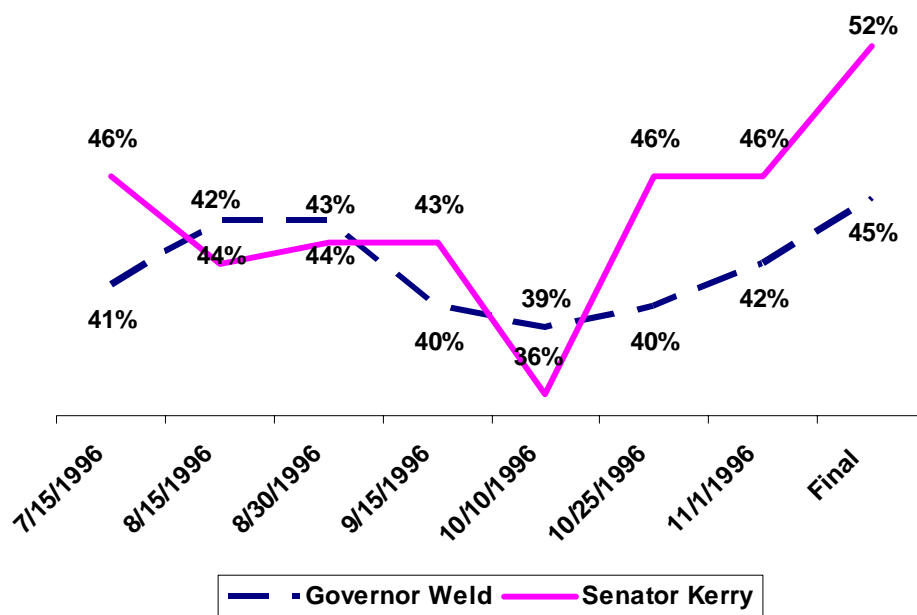
Like former Vice President Al Gore, Kerry is an accomplished debater.² No doubt, the Bush campaign will intensify efforts this week to highlight Kerry's style. Bush's campaign will promote his "homespun" public speaking manner hoping to figuratively concede the debates to Kerry while creating an impression among voters that Bush is most focused on counterterrorism. This dichotomy that Kerry's camp allowed to blossom for too long is an advantage for the incumbent in the minds of a majority of public-opinion survey respondents. Perceptions on the most important issue in this campaign place disproportionate pressure on Kerry.

Having watched Senator Kerry up close and in person over the past two decades, our sense is that, although he has even better debate credentials than Gore, he will not underestimate these pressures. He is very unlikely to display the boorish behavior that doomed Gore in the first 2000 debate, which means that he will not have to waste time in the second and third debates futilely trying to clean up a self-made mess (Gore never recovered). Also, of late, Kerry has presented a sharper juxtaposition of his presidential approach on a range of foreign/strategic policies that differ from the President's approach.

Kerry has proven an ability to close approval-rating gaps.

Moreover, Kerry's 1996 Senate reelection contest against a popular Massachusetts governor demonstrated his ability to come back from behind and prevail. That race, of course, is not predictive of the 2004 outcome (different opponent, bigger stakes, more factors at play); however, as shown in the following chart, Kerry has proven an ability to close approval-rating gaps. In the Fallows cover article of the July/August *Atlantic Monthly*, former Governor William Weld sums Kerry 1996 debate performance by observing, "He is well informed, and he's not easily stampeded. I don't recall him ever getting flustered or ever being seriously thrown off his pins." The 1996 Weld/Kerry pattern is more similar to the 2004 race in that Kerry had a lead before squandering it in both races.

Now *There's* a Flip and a Flop



Source: Kuyper Institute

² James Fallows, "When George Meets John," *The Atlantic Monthly* (July/August 2004).

One risk to our notion that Kerry needs to "win" the debates is that some evidence suggests that the importance of debates to the eventual outcome, like polls, can be over-stated.

One risk to our notion that Kerry must "win" the debates is that some evidence suggests that the importance of debates to the eventual outcome, like polls, is overstated. James Campbell's seminal work on presidential campaigns shows that bounces in a candidate's approval rating after a debate usually dissipates shortly thereafter.³ Campbell looked specifically at data from the 1984 Reagan/Mondale contest. We continue to believe that these debates have the potential to change Kerry's recent fortunes, primarily because he has the opportunity to enunciate an Iraq/terrorism policy that might attract a few needed votes.

We close this week by re-running the schedule for upcoming debates, including three presidential debates and one between the vice presidential candidates.

Talk Time: 2004 Presidential and Vice Presidential Debates Schedule

Date	Debate	Location
Thursday, September 30	First presidential debate	University of Miami Coral Gables, Florida
Tuesday, October 5	Vice presidential debate	Case Western Reserve University Cleveland, Ohio
Friday, October 8	Second presidential debate	Washington University in St. Louis St. Louis, Missouri
Wednesday, October 13	Third presidential debate	Arizona State University Tempe, Arizona

Source: Commission on Presidential Debates

³ James E. Campbell, *The American Campaign: U.S. Presidential Campaigns and the National Vote* (Texas: Texas A&M University Press, 2000).

Health Care: The D.C. Pulse

Sector	Recent Developments
Brand-Pharma Generics Biotech Med-Tech	<ul style="list-style-type: none"> USP Formularies and the Medicare Drug Benefit United States Pharmacopoeia (USP) met with stakeholders from the pharmaceutical industry on September 20 in a set of meetings that are scheduled to take place for three weeks, as the group continues to attempt to balance the pharmaceutical industry against the demands of PBMs. USP is working toward a December deadline to provide CMS with its recommendations for drug classes. Reports indicate that CMS formulary review efforts could undermine any decisions that USP makes, as CMS Administrator Mark McClellan has continually highlighted that USP's classes would be only one element in formulary development.
	<ul style="list-style-type: none"> Hemophilia, Dialysis, Respiratory Therapy The comment period for the physician fee rule ended September 24, with a final rule expected by November 1, according to CMS officials with whom we spoke. We await three key outcomes: <ul style="list-style-type: none"> Facing 15%-30% cuts in hemophilia drug reimbursement, providers are looking for an increase in the \$0.05 add-on payment to at least \$0.08. Smaller dialysis providers may pay more than 7% above CMS reimbursement levels for the drugs, while larger facilities retain a 3% margin. While CMS has encouraged smaller facilities to enter into group purchasing agreements, the disparity could force a reapportionment of add-on payments. Respiratory therapy providers continue to push for an add-on payment above the \$5/day in the current regulations. While we continue to believe that Apria and Lincare will receive money back, industry trade group's proposal of a \$65-plus add-on payment is unlikely to be enacted.
	<ul style="list-style-type: none"> Therapeutic Equivalence Research The Senate Appropriations Committee increased funding for the Agency for Healthcare Research and Quality (AHRQ) to conduct an MMA-mandated study comparing the effectiveness of various drugs. The \$15M falls short of the \$50M initially authorized under the bill, but it highlights another avenue through which HHS is working to gain increased information to help it make decisions for the most effective and efficient care.
	<ul style="list-style-type: none"> Reimportation News and Notes <ul style="list-style-type: none"> A bipartisan group of senators, including John McCain (R-AZ), Tom Daschle (D-SD), and Ted Kennedy (D-MA), wrote Senate Majority Leader Bill Frist (R-TN), urging him to schedule a floor vote on reimportation. A Rhode Island law allowing license of Canadian pharmacies is likely to face a court challenge. 60% of Americans are in favor of drug price controls, according to a Harris Interactive poll.
Facilities Managed Care PBM	<ul style="list-style-type: none"> Medicare: HMOs Cost More George Washington University Professor Brian Biles estimates that Medicare Advantage plans will receive 12% more than FFS plans, even more than the MedPac estimates that caused Democrats to attack Medicare advantage over the past two weeks. The differences are not over fact (most agree that Medicare Advantage is more expensive) but over the degree to which Medicare Advantage is more expensive. While these reports will influence longer-term public policy toward Medicare Advantage, in the short term they are unlikely to materially affect the payments that are made to providers. However, some Capitol Hill staff have indicated that the \$12B stabilization fund that is intended to keep Medicare Advantage plans could be under pressure in the out years, particularly as Medicare faces problems in updating physician payments.
Medicare Watch	<ul style="list-style-type: none"> Medicare Discount Cards Bowling to both political pressure from Democrats and the reality that the drug discount card enrollment has fallen well below expectations, HHS Secretary Tommy Thompson indicated that Medicare will send drug discounts cards to approximately 1.8M low-income beneficiaries. These beneficiaries will be able to access the \$600 annual subsidy by calling an 800 number and answering questions from CMS staff. While not quite autoenrollment as Democrats have pushed for, this latest move by CMS is expected to substantially increase expenditures through the drug discount cards when they become effective on November 1. As the enrollment period for 2005 discount cards is scheduled to take effect by November 15, enrollment by November 1 will likely provide strong guidance for total 2005 enrollment figures.
Election Watch	<ul style="list-style-type: none"> Bush and Health Care HHS Secretary Tommy Thompson and Commerce Secretary John Snowe defended President Bush's health care plan in a New Hampshire forum, with Thompson telling voters, "We're too damn fat in America," in reference to the administration's efforts to combat obesity.
	<ul style="list-style-type: none"> Kerry and Health Care Senator John Kerry, despite turning his campaigning back to Iraq, sharply criticized President Bush over the nation's uninsured rate, citing once again high Medicare premiums and increasing costs. In addition, Senator John Edwards told campaign supporters to "pray you don't get sick" under a Republican administration, and his wife Elizabeth Edwards appeared at two town hall forums in the northeast to discuss health care.
	<ul style="list-style-type: none"> Lewin Releases Comparison of Health Plans The Lewin Group added another relatively nonpartisan perspective to analysis of the Bush and Kerry health care proposals, finding that the Kerry proposal would cost \$1.2T (between the Thorpe and AEI analysis) while covering 25.2M people. They estimate that the Bush proposal would reduce the uninsured by 8.2M while costing \$227B.

Source: Lehman Brothers

GPR Weekly

Issue	The Week Just Past	Our Call
<p>Iraq</p> <p>We know that we will have to fight for the elections.</p> <p>— General John Abizaid, commander of U.S. troops in Iraq, on keeping the January election date in Iraq</p>	<ul style="list-style-type: none"> • Attacks: The uptick in factional violence continued in Iraq, as air strikes in Sadr City, a large-scale car bombing in Baghdad, and an increase in kidnapping cases accounted for upward of 300 deaths in the region; anti-U.S. sentiment and militant resistance continue to gain leverage as U.S. forces increasingly assert their presence • Elections: U.S. leaders, Iraqi Prime Minister Iyad Allawi, and Shiite cleric Grand Ayatollah Ali al-Sistani indicated that they are determined and optimistic about holding free elections in January 2005; while an aide to al-Sistani stressed the importance of maintaining the current timeline for elections, Secretary of State Colin Powell indicated that this may be an increasingly difficult goal, stating, "Obviously, security is a problem [but] we intend for elections to be held." • United Nations: In their respective speeches to the U.N. and Congress, Iraqi Prime Minister Iyad Allawi and President Bush reassured the world that democracy is advancing in Iraq as a result of continued battle between coalition forces and Iraqi insurgent groups; both warned, however, that progress takes time and that fighting in the region is likely to worsen before it improves 	<p>Short-Term Catalysts</p> <ul style="list-style-type: none"> • Any indication that kidnappings force the hand of Iraqi interim government policymakers increases the likelihood of future kidnappings <p>Long-Term Call</p> <ul style="list-style-type: none"> • Expedited training of Iraqi Security Forces facilitates partial U.S. pullback and curbs some regional conflict, but fails to significantly diminish the insurgent base
<p>Terrorism</p> <p>Not only do we invite you, we also welcome whole-heartedly countries to invest in our nuclear program for civilian purposes.</p> <p>— Mohammad Hossein Mousavian, secretary of the political department of Iran's Supreme Council on National Security</p>	<ul style="list-style-type: none"> • Iran: Iranian President Mohammad Khatami stated, "[Iran] will continue on this path even if the result is the cutting off of international supervision," should the international community fail to recognize Iran's "legal right" to enrich uranium for energy purposes, continuing its defiant attitude toward the IAEA and the global community; the U.S. is unlikely to take strong action on the issue before the November 2 presidential elections, in our view • Russia: In response to the spate of recent terrorist attacks, Russian authorities have proposed a U.N. crackdown on the abuse of political asylum by terrorists; in his U.N. General Assembly address, Foreign Minister Sergei Lavrov suggested the following updates to a U.N. terrorist policy: a consolidated U.N. blacklist of individuals, groups, and entities involved in terrorism who would be subject to an asset freeze; an arms embargo; and expedited extradition 	<p>Short-Term Catalyst</p> <ul style="list-style-type: none"> • Iran's successful production of gas from raw uranium adds to an already tenuous geopolitical environment <p>Long-Term Call</p> <ul style="list-style-type: none"> • Candid rebukes of E.U. and IAEA nonproliferation agreements, if left unchecked, strengthen Iran's hand in the Middle East and the world
<p>Oil</p> <p>We've always said that the Strategic Petroleum Reserve was set up to protect against physical disruptions of oil supplies, such as national emergencies or natural disasters, and not to manipulate prices of oil for political purposes.</p> <p>— Scott McClellan, White House Press Secretary</p>	<ul style="list-style-type: none"> • Crude Talk: U.S. light sweet crude on the NYMEX hit \$49/bbl (a monthly high and the second-highest nominal price ever), as Hurricane Ivan curtailed imports and domestic production, leading to the eighth consecutive week of declines in U.S. crude supplies; statements from the White House indicating that the loan of 1-2M bbl of oil from the Strategic Petroleum Reserves and another round of mixed news for Russian oil giant Yukos were only moderately positive factors in easing prices off their monthly highs 	<p>Short-Term Catalyst</p> <ul style="list-style-type: none"> • A continued mix of positive and negative news pertaining to Yukos keeps oil futures off balance <p>Long-Term Call</p> <ul style="list-style-type: none"> • Failure to effectively secure global oil infrastructure from geopolitical risks leaves headline risks on the upside
<p>Other Developments</p> <p>We cannot rule out a possibility of a missile launch, so South Korean and U.S. intelligence authorities are working closely together to follow the movements.</p> <p>— Nam Dae-Yeon, spokesman of South Korea's Defense Ministry</p>	<ul style="list-style-type: none"> • North Korea: South Korea and Japan reported missile activity in North Korea; Japanese intelligence initially indicated that a short-range missile would be tested, but Japanese Prime Minister Junichiro Koizumi quickly downplayed the report by stating, "I think the chances are low that they will launch a missile." • Saudi Arabia: Kroll's, a leading security consultancy, rated Saudi Arabia as the riskiest investment state in the Middle East, citing a growing Islamist insurgency movement, an uncertain political and economic future, and an unclear progression of leadership; Kroll's top Middle East analyst noted, "Other Gulf states are growing in their attractiveness while the perception of risk in Saudi Arabia is only increasing." 	<p>Short-Term Catalyst</p> <ul style="list-style-type: none"> • Ongoing conflict between royal family and al-Qa'eda in Saudi Arabia increases opportunity for regional instability <p>Long-Term Call</p> <ul style="list-style-type: none"> • Saudi regime cannot stop terror funding, radical clerics, or cells in Saudi Arabia

Source: Lehman Brothers

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