

WASHINGTON WEEKLY

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Federal Papers

Over the coming four weeks, the world will get a better idea of President Bush's priorities. When discussing his administration's objectives, the President recently said, "We're setting big goals, and whether or not those big goals will be achieved or not won't be known for a period of time. These are big goals, but I'm the kind of person that believes in trying to solve big problems before they become acute."¹ We know that Bush's stated agenda is ambitious, but three events will help markets and others gauge which issues are really priorities.

If the inaugural speech on January 20 is anything like his 2001 inaugural address, Bush will lay out themes and discuss specifics.

First, the President's second inaugural address is on Thursday, January 20. If this speech is anything like his 2001 address, Bush will lay out themes and discuss specifics. In his first speech to the American people, the new president broke from boring tradition and detailed a surprisingly aggressive agenda: Medicare and Social Security reform and tax cuts. He accomplished one of the three—tax cuts—and continues to talk about the other two, especially Social Security.

We expect the February 2 speech to be more meaningful to investors.

The second priority-defining event would be Bush's fifth State of the Union (SOTU) speech, scheduled for a little more than two weeks from today. We expect this February 2 speech to be more meaningful to investors in search of clues about where the proverbial policy rubber might meet the road this year. In our view, Americans are Bush's target audience in the inaugural. For the SOTU, the President has a unique setting to tell assembled members of all three branches of the federal government what he expects from them this year. It will be interesting to see if these speeches affect Americans' perception of sovereign satisfaction as reflected in a recent poll.

Also in This Issue

Health Care: The D.C. Pulse

We anticipate final Medicare Part D regulations to be released this week, and highlight reports of the Ways and Means Committee exploring a change in PPS systems that would benefit SNFs and hurt IRFs and LTACHs.

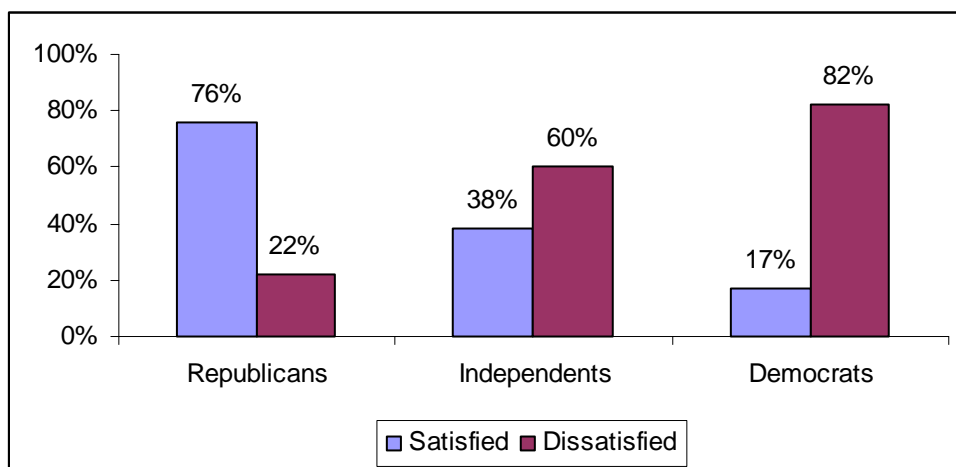
Geopolitical Risks

Although not the only events important to world politics, a recent election and an upcoming one in the broader Middle East deserve the attention they are receiving.

¹ Richard Benedetto and Judy Keen, "Bush Sees Legacy in Taking on Big Challenges," *USA Today*, January 14, 2005.

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AND IMPORTANT DISCLOSURES.**

A Rolling Stones Anthem – Americans' Sense of Country Satisfaction



Source: Gallup Poll News Service, December 5–8, 2004

From a market and political perspective, the budget will be the first peep at whether deficit reduction is viable this year.

February 7 marks the third chance in a month for Bush to signal intent, as the administration is scheduled to send Congress its FY06 budget request. The President has promised a tough budget that gores a few oxen from the spending side of the ledger. From a market and political perspective, the budget will be the first peep at whether deficit reduction is viable this year. Small steps at fiscal retrenchment are unlikely to impress people who believe that fiscal policy is the best and perhaps only way Washington can signal that combined macroeconomic imbalances totaling nearly 10% of GDP are of concern.

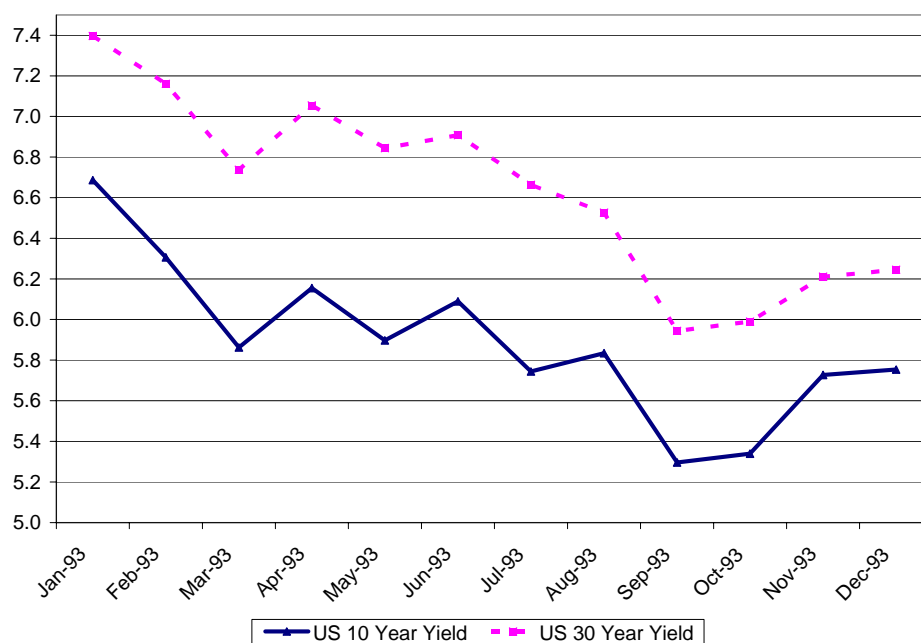
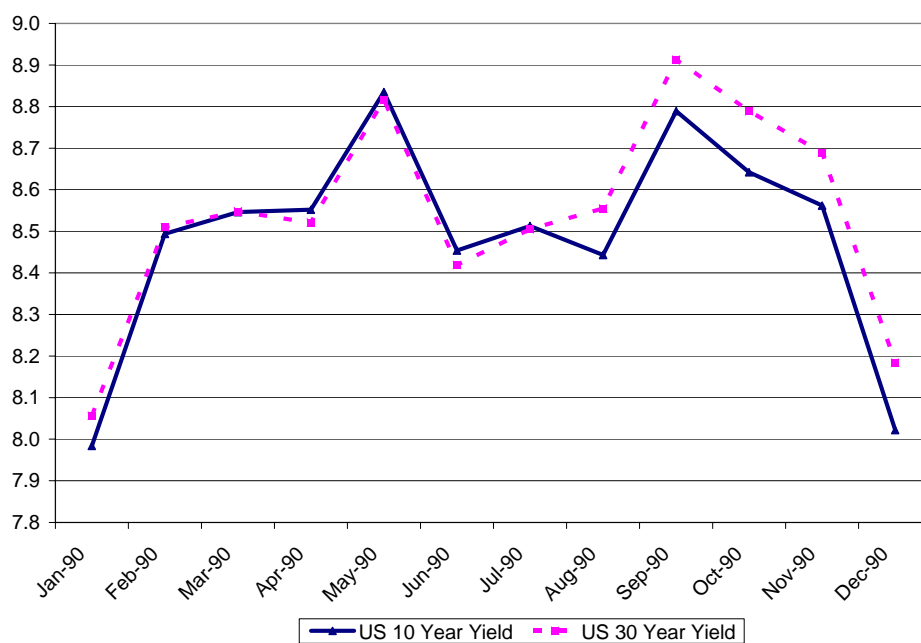
History shows and the accompanying graphs substantiate that markets respond positively to saner fiscal policies once deficits have become a focus, as there were a decade ago. The 1993 deficit reduction package was passed in mid-August solely with Democrats' votes; the tax increases it contained enlivened Newt Gingrich's "revolution" and ended unified Democratic government under then President Clinton. Those abhorred taxes aside, not only did the bond market rally as is shown, but all major equity indices did as well.

Three years earlier, the 1990 deficit reduction package allowed by then President George H. W. Bush elicited a similar markets embrace. That deal was not passed until October 27, but fixed income markets started pricing in the action six weeks before final passage. Then too, the equity markets rallied some, although the 4Q00 rally unmistakably was due largely to growing signals from Washington that then Iraqi President Saddam Hussein was about to get kicked out of Kuwait. Nonetheless, both experiences show that investors favor deficit reduction when imbalances become unsustainable—a condition most would agree exists today.

Away from the heat of the elections and the euphoria of the outcome (for some), President Bush's priorities will be more clearly delineated over the next month. However, not until mid-2Q05 will Congress indicate which of those priorities it shares.

All these words on paper pertaining to federal policy underscore the challenges confronting elected policymakers. We reiterate our theme for policy this year: macro risks (economic and geopolitical), but trading and investing opportunities from sector policies.

Just Rewards – 1990 and 1993 Yield Curves for the 10- and 30-Year Bonds



Sources: Bloomberg

Health Care: The D.C. Pulse

Sector	Recent Developments
Brand-Pharma Generics Biotech Med-Tech	Drug Reimportation We anticipate two key events in the next month that could provide reimportation news. We note that proponents continue to face an uphill battle to push reimportation proposals. <ul style="list-style-type: none"> On January 19, former EPA Administrator and Utah Governor Mike Leavitt (R) will face the Senate Finance Committee for his nomination to become HHS Secretary. Senator Byron Dorgan (D-ND) could place a procedural hold on the nomination until he receives a guaranteed Senate floor vote on reimportation. Although the timetable has slipped, Canadian Health Minister Ujjal Dosanjh has indicated that he will push for a February vote in Canada on a proposal to prohibit Canadian doctors from co-signing prescriptions for American patients, severely limiting if not restricting exports of drugs from Canada. Canadian suppliers have already threatened to move to the UK.
	Oxygen Reimbursement On January 13, CMS announced that expected OIG data on oxygen reimbursement levels would not be received by January 15. As a result, Medicare will stop holding oxygen claims and begin paying them immediately as of 2004 rates. CMS will <i>not</i> retroactively adjust payments once rates are adjusted. As a reminder, CMS announced in mid-December that it would reconsider earlier OIG findings on the differential of oxygen payments between Medicare and FEHBP. The September OIG report had set a baseline expectation of a 10%-20% cut in reimbursement for oxygen. We expect CMS to come in under this range in its final recommendation.
	Stem Cells and State Governments As governors across the country give State of the State speeches this week, stem cell research has emerged as an increasingly popular issue. In our view, stem cell research remains a "hot" political issue, although we are unlikely to see considerably more states offer incentives for stem cell research beyond the three that have already come forward. On the heels of California voters approving a ballot initiative, we note two developments this week: <ul style="list-style-type: none"> In New Jersey, Acting Governor Richard Codey (D) proposed that New Jersey spend \$150 million on a "New Jersey Stem Cell Institute" and \$230 million more for grants (through debt issuance). In Wisconsin, Governor Jim Doyle (D) announced a proposal for a \$750 million investment in biotech and stem cell research, "including the Institute of Discovery, which will unlock new medical cures and launch new businesses that will benefit the entire state."
	Big Pharma Offers Uninsured Drug Discounts Eleven pharmaceutical companies announced a new discount card program for the uninsured to provide discounts on 275 brand name drugs. Those under 65 with incomes not exceeding \$30,000 for individuals, \$40,000 for couples, and \$60,000 for families of four are eligible, with estimates that as much as 80% of the uninsured population could be eligible.
	Medicaid Reform: The States Senate Budget Chairman Judd Gregg (R-NH) indicated that he will focus on Medicaid reform after the President presents his budget. "Less money with more flexibility - I think that's probably what you're going to see," he said, adding, "but I don't know that." At least three states provide a guide for what they can do with the flexibility they have in the current system. <ul style="list-style-type: none"> Florida: Perhaps the most radical proposal of all, Governor Jeb Bush proposed allowing Medicaid beneficiaries to choose their own plans, allowing them to opt out of Medicaid and use state premiums to purchase insurance in the private market, while allowing providers enhanced flexibility to design the programs. Tennessee: Gov. Phil Bredesen's (D) latest proposal to fix TennCare would result in the elimination of 300,000 enrollees and a reduction in doctor visits, hospital stays, and drug coverage for those individuals that remain in the program. Bredesen indicated he would look for waiver approval later this month, and potentially begin changes as soon as April. California: Governor Schwarzenegger (R) has proposed expanding managed care offerings in as many as 13 counties.
Facilities Managed Care PBMs Retail Sector	Medicaid Reform: Federal Government Taking on IGTs We expect Congress and President Bush to again propose curbing the use of intergovernmental transfers (IGTs) among health care providers and states, representing some of the "easiest money" available to find cuts in the Medicaid program. In his FY05 budget, Bush had proposed curbing the practice, which he estimated could save \$9.6 billion over five years. We expect Bush to once again propose reductions. We note that the House Energy and Commerce Committee has recently prepared a letter for providers, asking for details on how IGTs work, with a deadline of January 25 to receive information. We expect the Committee to lead the effort to restrict these provider maximization schemes. Meanwhile, Senator Ted Kennedy (D-MA) and Massachusetts Governor Mitt Romney (R) wrote a letter to CMS Administrator Mark McClellan strongly defending Massachusetts' three IGTs that generate approximately \$600 million per year in increased revenues for the state.
	Unified SNF/IRF/LTACH Payments? Reports indicate that the House Ways and Means Committee, under Chairman Bill Thomas (R-CA), is at least exploring ideas to integrate inpatient rehabilitation facility (IRF), long-term acute care hospital (LTACH), and skilled nursing facility (SNF) payments into one reimbursement system. We note that these meetings appear to be quite preliminary. However, such a proposal could be attractive in the next one to two years as Congress could be forced to look for savings as part of a budget bill, and the Ways and Means Committee has a disproportionate role in determining where those savings will come from. Nursing facilities would likely benefit the most in our view, while IRFs and LTACHs could be hurt. We remind investors that SNFs aggressively argued that Congress should finalize the 75% rule for IRFs last year, as they indicated that they could provide similar services for a lower cost. We note that Congress has often called on CMS to implement far-reaching changes as part of budget reconciliation bills, and does not just provide instructions for cuts. Such a far-reaching proposal would need a considerable gestation period, and stands a higher probability in 2006, in our view.
Health Care Trends	Health Spending Growth Rate Lowest in Seven Years A <i>Health Affairs</i> article published this week found that health care spending grew 7.7% in 2003. Although still high, it represents the lowest growth rate in seven years, and it helped drive total spending to \$1.7 trillion, more than 15% of the U.S. GDP. CMS argued that the growth-rate reduction resulted from tighter Medicaid reimbursements and the expiration of higher Medicare reimbursements for hospitals and nursing homes from 2002. This suggests that MMA-mandated increases in reimbursements could drive health care spending growth rates higher in future years.

Source: Lehman Brothers

GPR Weekly

ISSUE	THE WEEK JUST PAST	OUR CALL
<p>Iraq</p> <p><i>"They function like an underground."</i></p> <p>-An official of the independent electoral commission, Adil al-Lami, comparing workers for the Iraqi election to a clandestine political movement</p>	<ul style="list-style-type: none"> • Elections: Top U.S. and Iraqi officials have lowered their expectations for turnout during the January 30 elections, amid increasing attacks by insurgents (most recently, the assassinations of the Baghdad election center director and an aide to a top Shia cleric), who continue to threaten officials, candidates, and poll-goers. Officials stress the process of the elections as more legitimizing than actual voter turnout in and of itself. • Military: Iraq's U.S.-backed interim government is to spend over \$2.2 billion in modern weaponry on its security forces, a sum that represents some 11% of the country's total budget. Iraqi officials also plan to increase the number of active duty troops to 150,000. Along with these proposals, Secretary of State Powell has announced that the U.S. could begin withdrawing its forces as early as this year. Any significant U.S. troop pullout, even if the January 30 election is executed without major conflict, will embolden insurgents to increase the frequency of their attacks on the anemic Iraqi security forces. • WMD: U.S. authorities announced that they have abandoned the search for WMD, with the Iraq Survey Group determining that not only have weapons not been found, but that Saddam Hussein didn't have the capability to make WMD since 1991. Charles Duelfer, the CIA special adviser who led the ISG's weapons search noted that few changes will be made to the group's initial WMD report to Congress. 	<p>Short-Term Catalysts</p> <p>Pressure for a revamped strategy in Iraq will continue to mount on the Bush administration and Defense Secretary Rumsfeld in particular, in the bloody run-up to and run-down from January 30 elections.</p> <p>Long-Term Call</p> <p>More U.S. troops alone fails to accelerate stabilization and rebuilding timetable.</p>
<p>Iran & Terrorism</p> <p><i>"We are watchful. We have allowed inspections into our military installations but we will not allow any espionage or the theft of information from our military sites."</i></p> <p>-Hossein Mousavian, member of Iranian nuclear negotiations team</p>	<ul style="list-style-type: none"> • IAEA: IAEA inspectors arrived in Iran on Wednesday for a visit to the Parchin military complex outside Tehran. In line with the country's typically evasive tactics, Iran has said that it will allow U.N. nuclear experts to take environmental samples from landscaped areas outside the military complex's ammunition production workshops, but that it will not allow them to inspect military equipment. • Iran: The race for the Iranian presidency has begun, with elections tentatively set for June 17. Of Iran's significant young population, only 6% of Iranian students said they are still interested in politics, while the rest plan to practice a passive resistance. We are concerned that the loss of a politically-charged student demographic will have a negative influence on the prospect for change in Iran. • al-Qa'eda: International efforts to curtail funding to al-Qa'eda have made it more difficult for the group to operate. While U.S.-led authorities have frozen approximately \$14 million in terrorist-related assets, the group may be starting to adapt to more informal ways of moving and raising money. 	<p>Short-Term Catalysts</p> <p>The United States and IAEA lack "effective" diplomatic and non-diplomatic tools to dissuade Iranian nuclear initiatives.</p> <p>Long-Term Call</p> <p>Continued mixed rhetoric to the EU and a disregard for the IAEA shifts focus to Iran at the center of escalating regional politics.</p>
<p>Oil</p> <p><i>"What they are trying to do is establish a strong-enough foothold that Western oil majors won't have an opportunity to get in."</i></p> <p>-Philip McCrum, Economist Intelligence Unit's Sudan editor, on the rapid movement of Asian companies toward investment in Sudanese oil</p>	<ul style="list-style-type: none"> • Crude Talk: Light sweet crude oil on the NYMEX steadily inched back toward \$50/barrel, finishing the week at roughly \$47/barrel. Prices were buoyed by: a U.S. government report showing a decline in oil inventories; uncertainty ahead of the election in Iraq; increased evidence of OPEC production cuts (roughly 1 million barrels/day) at or ahead of the January 30 meeting in Vienna; and disruptions in North Sea crude production. Forecasts for colder weather in the coming months in the U.S. Northeast also contributed. • Sudan: Interest in Sudan's vast oil reserves has been renewed after the signing of a peace deal last weekend. Sudan, which already produces 320,000 barrels/day, has proven reserves of 635 million barrels. While current figures pale in comparison to the main oil-producing states, if the peace deal remains intact and exploration yields results, Sudan could emerge as a major oil player within the decade. We await further political developments, as oil reserves are likely to be controlled by the fledgling Sudanese government. 	<p>Short-Term Catalysts</p> <p>OPEC will likely cut supply by as much as 1.5 million barrels per day at or before a January 30 meeting.</p> <p>Long-Term Call</p> <p>Failure to effectively secure global oil infrastructure from geopolitical risks leaves headline risks.</p>
<p>Other Developments</p> <p><i>"Russia's internal demographic situation is extremely unfavorable. It might worsen even further in the near future."</i></p> <p>-The Russian Security Council</p>	<ul style="list-style-type: none"> • Palestine: As anticipated, Mahmoud Abbas won the Palestinian elections in a landslide, carrying well more than 60% of the popular vote throughout Palestine. The clear mandate given to Abbas builds momentum for a reconstructed Gaza deal, but Abbas' unwillingness to crack down on terrorist groups and Israel's unwillingness to retreat from the occupied areas remain significant barriers. • Russia: According to the Russian Security Council, the Russian population could fall by one-third to about 100 million people by the middle of this century, with the possibility of an even worse decline. We await further details from the Council on this development. 	<p>Short-Term Catalysts</p> <p>Start of meaningful talks between Abbas and Sharon.</p> <p>Long-Term Call</p> <p>Any attacks on Israelis in Gaza temporarily or permanently halt a regional reconstruction effort.</p>

Source: Lehman Brothers

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