

WASHINGTON WEEKLY

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On the Other Side of Uncertainty

Hyperbole generated by a presidential election more divisive than any since the 1960 Kennedy/Nixon slugfest can mask the reality that sooner rather than later markets will look beyond U.S. election results for signals of global relative value, even as traders digest the outcome of the election (including possible judicial decisions if necessary). By year end, investors will have discounted what we think we know about the new president-elect, which will likely render Washington an overall negative factor in macro investment models. Three observations flow from our assertion.

The dollar is under pressure for several reasons, the roots of which will vex Washington no matter who resides at 1600 Pennsylvania after Inauguration Day. America is pressed to develop policy responses that will reassure markets in the near term.

The stated pretext for war in Iraq has significantly adversely affected America's standing in the battle to confront global terror.

- The dollar is under pressure for several reasons, the roots of which will vex Washington no matter who resides at 1600 Pennsylvania after Inauguration Day. Whether contemplating external or internal deficits, a counterproductive foreign policy approach that inflames natural enemies and antagonizes needed allies, or macroeconomic fundamental factors such as oil that cause enduring worries about realistic growth opportunities, America is pressed to develop policy responses that will reassure markets in the near term.
- Having completed an unusually active 10-year period of deregulation, hyper-growth, and unprecedented stimulative policy, Washington is limited in terms of traditional tools that policy makers might use to combat sluggish growth prospects and the unintended consequences of regulatory reforms.
- The stated pretext for war in Iraq has adversely affected America's standing in the battle to confront global terror. The next president will expend considerable capital to convince other countries that U.S. military superiority makes it the undisputed leader of nations in a coordinated strategic policy.

Also in This Issue**Health Care**

The election, flu politics, and drug reimportation head the list of market worries.

Geopolitical Risks

Discord over "missing" explosives obscured Kurdish rebel attacks on oil infrastructure in Turkey.

Political Calendar

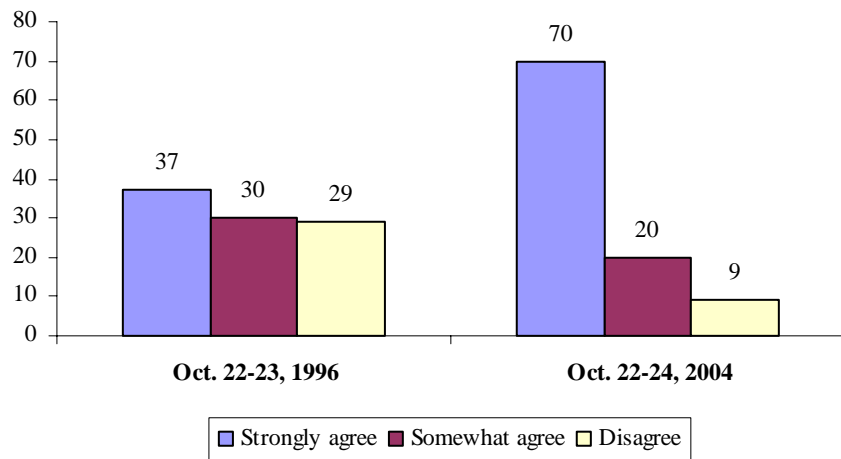
International meetings on subjects ranging from nuclear energy to corporate governance fill the month. Oh, and there is an election in the United States.

**PLEASE REFER TO THE BACK COVER FOR ANALYST CERTIFICATION
AND IMPORTANT DISCLOSURES.**

Of course it matters who wins the election. Foreign policy and macroeconomic decisions not only have defined the current administration but necessarily will preoccupy the next one. President Bush and Senator Kerry have embraced different approaches to each set of challenges. None of these policy conundrums can easily be solved, and the policies and teams hired to implement the president's proposed solutions will be different depending on who wins the election. As seen in the accompanying graphs, Americans understand the magnitude of the vote tomorrow.

It Would Seem to Matter

Agree or Disagree: The Stakes in This Presidential Election Are Higher Than in Previous Years (Among Registered Voters)



Source: The Gallup Organization

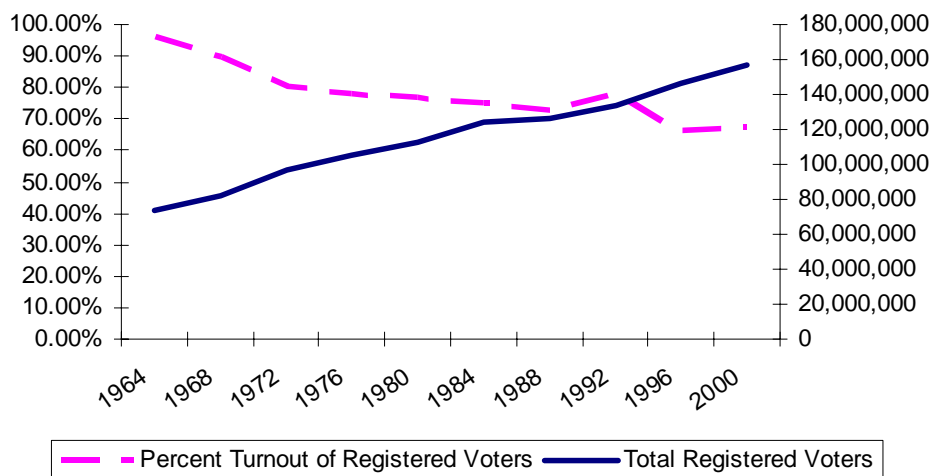
The following graph shows a steady drop in the turnout percentage of registered voters from 1964 to 2000.

The one exception to the turnout trend was in 1992, the last time economic and strategic policies disproportionately influenced voters.

Another measure of voter interest is the number of registered voters and their turnout on Election Day. The surge in first-time voter registrations in many states coupled with yearlong public opinion survey results pointing to unusually high interest in this contest lead us to conclude that national registered voter turnout will be above average this election. The following graph shows a steady increase in total U.S. voter registrations since 1964. The left-hand scale reveals a nearly consistent drop in the turnout percentage of registered voters in the same period. The one exception to the turnout trend was in 1992, the last time economic and strategic policies disproportionately influenced voters.

When More Has Usually Meant Less

U.S. Voter Registrations and Turnout in Presidential Elections (1964–2000)



Source: Federal Election Commission and The Census Bureau

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In an environment of great interest in the presidential race, state polling services lead us to conclude that there are only a few states to watch for indications of the eventual outcome of a process that begins tomorrow. We recommend that investors pay the most attention to Arkansas, Colorado, Florida, Ohio, and Tennessee. A second tier of "watch states" includes Iowa, Michigan, Minnesota, New Mexico, and Wisconsin.

Just as most Americans perceive the stakes in this election as very meaningful, we suggest that the same sense will prevail concerning the outcome of the presidential vote. Investors everywhere and voters in the United States in particular will watch keenly for the early policy pronouncements of the next administration regarding macroeconomic policy (including deficit reduction and the next Fed chair nominee), strategic policy about how best to build Iraq without solidifying Islamist fundamentalists' power (as well as developing globally-coordinated, effective counterterrorism efforts), and potential Supreme Court nominees. Regardless of who is running the government in Washington next year, none of these subjects lend themselves to a quick, painless resolution. In our view, these realities have changed Washington from a neutral-to-positive macro risk factor to something less favorable.

Health Care: The D.C. Pulse

Sector	Recent Developments
Brand-Pharma Generics Biotech Med-Tech	Backdoor to Drug Reimportation? Speaking to reporters about FDA inspections of up to 5 million doses of flu vaccine in Europe and Canada which may be brought to the United States, HHS Secretary Tommy Thompson provided a curious justification which essentially opens the theoretical door for drug reimportation in the United States. "The law says it is legal to import provided the secretary can claim that it's safe. And so that is what FDA is doing. If they find that it is safe, we will import it." However, Thompson went to lengths to reinforce the view that it is not a change in the administration's position on reimportation, because the FDA would be inspecting the vaccines. Regardless, the flu vaccine importation could help reinvigorate the drug reimportation debate.
	Reimportation and Flu Illinois Governor Rod Blagojevich (D) continued to press FDA Acting Commissioner Lester Crawford to allow Illinois to purchase additional doses of vaccine from Canada and Europe. Blagojevich leveraged existing relationships with European wholesalers to find 50,000 doses of Aventis flu vaccine, but cannot (legally) proceed without FDA approval. The FDA and Thompson have indicated that the FDA will work with Illinois to find vaccines, but Crawford's letter to Blagojevich indicates that the FDA is wary about allowing him to proceed on his own and is likely to reject his request.
	Inevitable Reimportation? While the push for drug reimportation was slowed by the end of Congress and the presidential election, many industry experts believe that reimportation will be enacted in 2005 (we note that similar sentiments have been expressed for 2004 as well). The CEO of the Healthcare Distribution Management Association, John Gray, told reporters that reimportation will "happen yesterday" if John Kerry is elected, and that reimportation "is going to come to pass one way or another." "Even if there isn't a change of administration, my personal belief is just from what we're observing there will be movement in that direction," Gray said.
	Drug Reimportation and Market Supply Caremark CEO Mac Crawford told a conference that a legalized importation system could result in "maybe 8 to 10% of the total supply" of U.S. drugs coming from Canada. The challenge, Crawford notes, is in finding which U.S. purchasers would actually receive the discounted drugs.
	Dialysis Changes on the Way Manufacturers of dialysis drugs including Epogen (EPO) as well as large chain dialysis facilities could benefit from unexpected payment increases in the final Medicare physician fee schedule, targeted for release by November 1. The preliminary physician fee schedule adopted an ASP less 3% payment methodology for dialysis drugs, splitting the difference between rates that low- and high-volume dialysis facilities pay for these drugs. Under intense pressure from affected companies, biotech industry trade groups, and members of Congress, CMS could potentially increase the rate to ASP or establish separate payment rates for high- and low-volume purchasers. Rather than push for an increase in drug reimbursement rates (which they fear could lead to price increases from drug manufacturers) chain dialysis facilities have reportedly pushed for higher add-on payments to the dialysis composite rate. CMS has already indicated that its proposed rule was "controversial" and we expect changes to the methodology for the final rule (see October 27 First Call Note "Dialysis Manuf. And Providers Could Gain").
Facilities Managed Care PBMs	Medical Malpractice In a filing with the Texas Department of Insurance, Medical Protective indicated that landmark caps on non-economic damages in malpractice suits would only reduce its expenses by 1%. Consumer groups have latched onto the filing as proof that caps do not bring down medical liability costs.
	MMA and PPOs The Congressional Budget Office (CBO) estimated that new Medicare PPOs will cost the federal government \$14 billion over the next 10 years, largely because of short-term increases in rates, as well as the \$10 billion stabilization fund. Once the PPOs are up and running, the CBO does not anticipate substantial costs for Medicare above the costs of fee-for-service.
	Specialty Hospitals Medpac meets today to discuss additional findings as it works toward a final report early next year. Meanwhile, almost 50 members of Congress wrote House and Senate leadership urging an extension of the moratorium or a permanent ban, while Senator John Kerry (D-MA) came out strongly against specialty hospitals this week.
Election Watch	Elections, Hype, and Health Care We expect a short-term market overreaction in the health care space to a Bush or Kerry victory in the election, as a combination of budgetary pressures on the federal government and cost overruns on the new Medicare drug benefit and Medicare trust fund will, over time, limit the perceived good news from a Bush victory and the perceived bad news from a Kerry victory. We suggest that these reactions may be overstated. Over the long run of a presidency, budgetary pressure is likely to force tough choices on health care for either candidate as president. In addition, congressional balance of power is likely to limit any large-scale health policy change, instead forcing policies of incrementalism through regulation. Risk to the health care space from DC is likely to revolve more around implementation of the MMA, investigations, and budget-induced cuts, than it is from major White House proposals or Congressional action (see October 28 First Call Note "Elections, Hype, and Healthcare").

Source: Lehman Brothers

GPR Weekly

Issue	The Week Just Past	Our Call
Iraq <i>"This is a high explosives risk, but not necessarily a proliferation risk."</i> - A senior Bush administration official, on the disappearance of approximately 350–400 tons of explosives from the Al Qaqaa military facility	<ul style="list-style-type: none"> • Al Qaqaa: Approximately 350–400 tons of high-grade explosives used either as conventional standalone weapons or as detonation devices for a nuclear arsenal have disappeared from the Al Qaqaa military facility near southern Baghdad. The facts, including the timing and current whereabouts of the weapons stockpile are still uncertain. According to reports inside of Iraq, Al Qaqaa (one of the largest military facilities in Iraq) was being picked over by looters as recently as October 24. • Sadr City: The U.S. army is readying \$330 million of the \$20 billion Iraqi reconstruction fund for sewer and water projects in the recently embattled Sadr city, following the mixed success of a weapons buyback program. According to 1st Brigade Combat Team spokesman Capt. Brian O'Malley, <i>"(we) are still cautiously optimistic...If there's no violence, we are going in and setting up infrastructure projects all over Sadr City."</i> • Troops: NATO presented strategic plans (which include the training and graduation of 1,000 new Iraqi troops per year) for the construction of a new Iraqi military academy to the 26 allied nations. Sixteen of the 26 countries indicated willingness to contribute troops for training missions, a strong indication that approval is pending. 	Short-Term Catalysts Increased stability through decreases in factional violence more important for foreign investment positions in Iraq than Iraqi elections. Long-Term Call Iraqi elections are minor in comparison with the monumental task of reconstruction, and the broader ideological conflict gaining ground in the country amid the United States' prolonged presence.
Terrorism/Iran <i>"My fellow countrymen you are guilty, guilty, guilty, guilty. You are as guilty as Bush and Cheney. You're as guilty as Rumsfeld and Ashcroft and Powell... Allah willing, the streets of America will run red with blood matching drop for drop the blood of America's victims."</i> - Alleged American al-Qa'eda member, on a tape found in Pakistan	<ul style="list-style-type: none"> • Iran: Iran once again walked away from the bargaining table, rejecting the U.S./EU incentive package for disbanding its nuclear programs. With a heavy hand in the Middle East and a desire for more regional power, we believe there is a high probability of continued disregard for the EU, IAEA, and UN. • Terrorism: The CIA is currently analyzing a new tape from Pakistan in which a veiled American portends a pre-election attack of magnitude greater than 9/11, claiming <i>"the streets of America will run red with blood."</i> The lack of terrorist activity around the presidential conventions and debates illustrates the difficulty of successfully maneuvering past anti-terror measures surrounding high-profile U.S. events, but effective terrorists attacks will more likely attack those targets that we do not anticipate. 	Short-Term Catalysts November 25 UN transparency deadline for Iran. Long-Term Call Continued threats to the United States and Israel, and disregard for the EU and IAEA, shifts focus to escalating situation between Iran and Israel.
Oil <i>"The suspects are believed to have been planning attacks against oil pipelines, oil storage areas, security forces and civilians."</i> - Statement from Turkish news agency Anatolia, following the arrest of suspected PKK members with nearly six pounds of C-4 plastic explosives on their person.	<ul style="list-style-type: none"> • Crude Talk: A new spate of geopolitical risk factors once again proved that small supply interruptions (and the potential for small supply interruptions) have larger market impacts. Potential strikes forthcoming in Nigeria (November 4) and Norway (November 8), documentation of PKK plans to target oil refineries and pipelines in southern Turkey, and an OPEC message to the United States requesting the release of oil from the Strategic Petroleum Reserve, maintained near record high light sweet crude prices on the NYMEX (approximately \$55 per barrel). 	Short-Term Catalysts OPEC calls for release of U.S. SPR oil rather than produce more itself. Long-Term Call More bad news surrounding negotiations in Nigeria/Norway could be impetus for secular price increases.
Other Developments <i>"Israel has no problem negotiating with a new Palestinian leadership as soon as it starts fighting against terror as the (Middle East peace) roadmap requires."</i> - Israeli Foreign Minister Silvan Shalom	<ul style="list-style-type: none"> • Afghanistan: Interim President Hamid Karzai is poised to retain his position without challenge, as voter totals gave him a 39% margin over his closest competitor. When Karzai is sworn into office in late November, he will be faced with a number of structural problems, including the drug trade, warlordism, and terror cells. <i>Please see our October 15 GPR Weekly for an in-depth look at the post-election landscape of Afghanistan in "A House of Cards."</i> • Palestine: Ailing Palestinian leader Yasir Arafat left his home and headquarters in the West Bank for the first time in more than two years after being airlifted to a hospital in France for medical treatment. The potential leadership change, should Arafat no longer be capable of retaining his post, will pave the way for a more pragmatic and equitable Palestinian Authority, in our view. 	Short-Term Catalysts Election protests have dissipated; interim President Hamid Karzai carried a nearly 40% margin over his closest challenger. Long-Term Call Afghanistan's development or lack thereof portends difficulty for Iraqi reconstruction.

Source: Lehman Brothers

Political Calendar, November 2004

Monday	Tuesday	Wednesday	Thursday	Friday
1 1-6 IAEA Fusion Energy Conference, Vilamoura, Portugal	2 Election Day, United States 2-3 Asian Corporate Governance Roundtable, organized by the Directorate for Financial and Enterprise Affairs, Seoul, Korea	3 Treasury Department briefing on quarterly debt management refunding 3-4 Trade and Structural Adjustment, OECD Global Forum	4 Medicare Coverage Advisory Committee meeting on the use of bariatric surgery for the treatment of morbid obesity American Enterprise Institute conference "The Need for U.S. Dollar Adjustment"	5 OECD statistics release: Unemployment Rates and Composite Leading Indicators Brookings Institution conference "2004 Elections: How Will They Affect Politics and Policymaking?"
8 7-9 American Bankers Association Mortgage Management conference, Orlando, FL CMS Special Open Door Forum, Special Needs Plan	9 FCC Open Commission Meeting U.S.-Mexico Binational Commission Meeting, Mexico City 9-10 25th Meeting of the Presidential Advisory Council on HIV/AIDS, Washington	10 10-13 Statistics, Knowledge and Policy, OECD World Forum on Key Indicators	11 11-12 Global Forum on Sustainable Development: Development and Climate Change 11-12 Russian Corporate Governance Roundtable, meeting organized by the Directorate for Financial and Enterprise Affairs, Moscow, Russian Federation	12
15 Possible start to Congressional "lame-duck" session	16 CMS Special Open Door Forum Listening Session, MMA and Long Term Care Pharmacies	17 17-25, World Conservation Congress, Bangkok, Thailand 17-18 Asia Pacific Economic Cooperation (APEC) Joint Ministerial, Santiago, Chile 17-20 Sixth Defense Ministerial of the Americas, Quito Federal Deposit Insurance Corporation conference "Facing Challenges of Technology in Financial Institutions" Federal Housing Finance Board open meeting	18 FTC Chairman Deborah Platt Majoras, Assistant Attorney General R. Hewitt Pate, European Commission Director General for Competition Philip Lowe, and Canadian Competition Bureau Assistant Deputy Commissioner Chris Martin will participate in the ABA Antitrust Section Fall Forum: "Looking Back and Forward"; the National Press Club, 529 14 th St. NW, Washington, DC National Credit Union Administration open board meeting 18-19 America's Community Bankers investor conference, New York, NY	19 20-21 Asian Pacific Economic Cooperation (APEC) Economic Summit, Santiago
22	23	24 24-26 Promoting Economic Growth Across Europe, 7th Central European Initiative Summit Economic Forum 2004, with participation of OECD's Programme on Local Economic and Employment Development (LEED), Portoroz, Slovenia	25 Thanksgiving Day 10th Meeting of the States Parties to the Convention Against Torture and Other Cruel, Inhuman or Degrading Treatment or Punishment, Geneva IAEA Board of Governors Meeting, Vienna, Austria	26
29 29-12/7 UN Framework Convention on Climate Change, Tenth Session of the Conference of the Parties 29-30 Fighting Corruption and Promoting Integrity in Public Procurement, global forum on governance	30 30-12/2 Strengthening Procurement Capacities in Developing Countries, roundtable meeting organized by the Development Assistance Committee and the World Bank, Johannesburg, South Africa			

Source: Lehman Brothers

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