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Global Equity Research

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Winds of Change

Fiscal issues will dominate much of the domestic policy agenda in 2005 and 2006. Several fiscal trains are scheduled for departure. The newly reelected Bush administration, with a tight grip on its philosophical compass, will set the initial directions of these trains. The shifting fiscal context, however, presents a change in wind conditions that will affect the ultimate course and speed of these fiscal trains. The key dynamic, in our view, is the interplay between the Bush philosophic compass and these shifting fiscal winds.

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We believe that deficit reduction will be the first fiscal train out of the station. It will start today with the President's budget request, involve the budget resolution in the spring, and, if successful, will be followed by a reconciliation bill in the summer.

In our opinion, investors should focus on two key questions: Will this package be comprehensive? Will it include multiyear budget process changes that will try to force future deficit reduction? Answers to these questions will determine how, if at all, equity sector trades are influenced. The one sector today that appears most likely to be affected is health care, as Medicaid cuts look to occupy a car on any moving deficit-reduction train.

The Bush philosophical compass was pointing to large tax cuts, a flatter tax code, with special focus on reducing taxation of capital income to spur greater savings and investment. The fiscal context then supplied a strong tailwind, and the result was successive tax cuts, specifically

- a large and seemingly growing fiscal surplus, which at the outset stood at $5.6 trillion over 10 years;
- favorable procedural environment in the Senate that meant that only a simple majority was needed for 10-year tax cuts;

Also in This Issue

Capital Calls

ISSUE	RECENT DEVELOPMENTS	OUR CALL	EFFECT
Tort Reform	• The Senate Judiciary Committee passed class-action reform out of committee on a strong 13-5 vote in Feb 3 markup • Senate Judiciary Chairman Specter (R-PA) indicated that he would like to have an asbestos markup this week, and states that Majority Leader Frist (R-TN) could give floor time for debate in Mar; Feb 2 hearing highlights potential deal-breaker of mixed dust, an issue Specter has yet to solve	• **Call:** Passage of class action is likely, asbestos's probability remains below 50% • **Timing:** Class-action passage in 1Q; asbestos trading opportunities in Feb-Mar, with passage likely to take longer and is not certain • **Catalyst:** Potential class-action bill floor time; potential asbestos markup • **Risks:** Specter acceptance of Bingaman class-action amendment could cause problems with House; quick stakeholder consensus for asbestos bill passage would surprise	• **Volatility:** Moderate • **Impact:** Lack of a federal fix maintains irrational system and legal exposure for affected companies
GSEs	• At AEI forum on receivership powers, a ratings agency analyst was grilled about likely downgrades of GSE's debt if Congress creates regulator with such authority; analyst seemed to conclude that receivership powers would not necessarily cause a ratings downgrade • House and Senate GSE hearings on Feb 9 could create volatility	• **Call:** Senate passage of five-point regulatory reform bill • **Timing:** 1Q05 • **Catalyst:** Legislative hearings • **Risks:** Senate or House members' overreach by going beyond thrust of Shelby's 2004 bill, causing a slower process and possibly hurting consensus reform effort	• **Volatility:** Moderate • **Impact:** Negligible once markets adjust to high likelihood of change, including receivership authority, which all federal financial regulators possess; agency spreads likely to fluctuate (mainly widen) relative to Treasuries until uncertainty passes
Social Security	• President Bush made his Social Security pitch to a skeptical public and followed up with a barnstorming tour in red states to apply pressure to potential Senate Democratic votes	• **Call:** Privatization remains an uphill climb with solid Democratic opposition given the Senate's 60-vote hurdle • **Timing:** No action likely until 4Q05, at the earliest • **Catalyst:** A crack in Democratic solidity if President's pressure proves effective, or Republican retreat if public remains skeptical • **Risks:** Deadlock as positions harden	• **Volatility:** Low • **Impact:** Too early to determine; fiscal scenarios range from sharp short-term deterioration to potential first step of long-term structural improvement Modest sectoral impact possible, but design questions are the details, while debate remains at initial phase
Deficit Reduction	• Discussions are ongoing among Washington budget leaders and governors on the size of Medicaid cuts • President will submit FY06 budget request on Feb 7	• **Call:** Modest entitlement cutting package is possible, but starts at a relatively low probability as it faces several hoops and a crowded calendar • **Timing:** Begins with budget resolution in early spring and reconciliation in summer, if all goes well • **Catalyst:** New Republican Senate vote cushion makes budget resolution passage easier, sparking a more aggressive policy reach • **Risks:** Social Security debate fills calendar	• **Volatility:** Moderate • **Impact:** At outset appears to be largely confined to Medicaid, not Medicare Future impact could broaden if a new general spending restraint mechanism is included as a way to build on this year's expected effort
Pension Reform	• Senate Finance Committee presents a bipartisan marker that addresses defined benefit and defined contribution issues, on the heels of the Bush administration's defined benefit reform proposal	• **Call:** A long complex haul; action likely on either a comprehensive reform or another short-term fix • **Timing:** 4Q05 • **Catalyst:** Expiration of IR fix at year-end • **Risk:** Key committees have a full plate, and issue is complex in substance and thankless in politics	• **Volatility:** Low for now • **Impact:** This issue has potential for broad sectoral impact, as funding rules, interest rates, and insurance premiums are all on the table
Tax Reform	• The Advisory Panel made its first decision in advance of its first meeting, which is set for Feb 16, finding (not surprisingly) that the "revenue neutral" constraint will not apply to the cost of making the Bush tax cuts permanent	• **Call**: Low probability because of inherent difficulty that every winner means an additional loser • **Timing:** 2006 • **Catalyst**: Broadening of Social Security debate could accelerate process • **Risks:** SS debate takes all attention	• **Volatility:** Low and sporadic in early stages of debate • **Impact:** Near term, we expect trial balloons as the Advisory Panel and other policymakers initiate the effort

Source: Lehman Brothers

- an immediate recession that provided a compelling rationale for fiscal stimulus in 2001;
- the tragic events of September 11, 2001, led to a temporary period of reduced partisan tensions that made the 2002 tax cut easier to pass; and
- continued weak job growth kept the rationale for additional stimulus alive in 2003 and facilitated passage of the accelerations of the income tax rate reductions and the cut in the tax rates on dividends and capital gains.

Current Context

The solid reelection victory for President Bush and the increased majorities in both the House and the Senate provide philosophical momentum and an even higher confidence, if that is possible, in taking bold action. This implies that the administration will want these fiscal trains to move full steam ahead in the direction to which the philosophical compass is pointing. The fiscal and overall economic winds, however, have shifted dramatically since the beginning of the President's first term:

- In 2001, CBO projected that the 2005 *surplus* would be $433 billion. The Bush administration is now projecting a *deficit* of $421 billion for this year, an $854 billion fiscal reversal for just one year.
- The dollar is under pressure, the current account deficit is rising, and there is concern about global imbalances.
- Economic improvement, while obviously welcome, removes a rationale for aggressive tax cutting.
- There are renewed calls from abroad to the United States to address its fiscal deterioration.
- During the President's first term, loyalty to the team and the reelection led conservatives to go along with the largest entitlement expansion in decades and discretionary spending increases. At this early stage of the second term, they are sending signals that they have given enough for the team and they want to see domestic spending cuts on both the entitlement and discretionary sides.
- While at times grudgingly, Senate Republican moderates went along with huge tax cuts during the first term. The fiscal deterioration has changed their internal calculations, with ramifications for several of the fiscal trains.

A clear theme unifies the changing conditions and calls from disparate players: the shift in wind direction toward renewed fiscal restraint. Although the wind direction has clearly changed, two factors have maintained speeds at a moderate level: the dollar decline has been orderly, and bond yields and international capital flows (both portfolio and FDI) have not yet sent Washington a signal of major concern. Such a signal, if it were to occur, would intensify the fiscal wind pressure.

We take an initial look at the four main fiscal trains: deficit reduction; Social Security reform; pension legislation; and tax reform and tax cut permanence.

A critical dynamic for investors to monitor as the fiscal trains are scheduled for departure is the interaction between the Bush administration's philosophical compass and the new prevailing winds of fiscal restraint. This interaction will affect the timing of the various fiscal trains, their path, their speed, and their ultimate success at reaching their destination. Below, we take an initial look at the four main fiscal trains: deficit reduction; Social Security reform; pension legislation; and tax reform and tax cut permanence.

Four Fiscal Trains

Deficit Reduction

As noted above, this could be the first train on the tracks. The philosophical compass is pointing this train in the direction of entitlement cuts. Key early stops include

- the President's budget request, especially size and policies of Medicaid cuts, as well as other entitlement changes;
- the budget resolution in early spring, with a focus on the dollar amount of entitlement savings, the so-called reconciliation instruction; and
- a possible reconciliation bill this summer.

Social Security

Social Security reform is the administration's top domestic policy priority and will be the largest fiscal train scheduled for 2005. The Bush philosophical compass is strongly pointing toward adoption of individual accounts through the diversion of a carved-out portion of payroll taxes. This proposal is the centerpiece of the Social Security contract and will be debated fiercely. The second dimension of the debate, the key fiscal dimension, is the long-term solvency of Social Security as the retirement of the baby boomers looms and the ratio of workers to retirees continues to climb with the aging population.

During his State of the Union, the President presented dual goals with respect to this issue: adoption of "voluntary personal retirement accounts" and passing reforms that solve the "financial problems of Social Security once and for all." The key points of his ambitious plan include

- voluntary personal savings accounts, with a maximum 4 percentage points of payroll taxes, phased in from 2009 to 2011, with an initial $1,000 cap;
- personal accounts would include limited investment options, such as broad index funds;
- potential upside reward for account holders is the extent of return in excess of 3% benchmark (downside risk returns below the 3% benchmark); and
- borrowing cost for transition estimated at $754 billion for 2006–15; and
- no impact on Social Security solvency, as reportedly conceded by administration officials in press briefing.

In a leaked White House email, the administration signaled its early support and interest in changing the indexation of initial benefits from wage gains today to inflation, which would have substantial benefit and solvency effects. During the State of the Union address, the President did not take ownership of this idea or confirm his administration's support (this underscores the sensitivity of this debate). Instead, he listed it as a proposal made by a former Democratic congressman.

The administration points to a Congressional Research Service report whose authors estimate the unfunded liability at $3.7 trillion over the 75-year actuarial period on a present value basis. The permanent shortfall is $10.4 trillion (present value of the unfunded liabilities over an infinite time horizon).

From a different perspective, the Center on Budget and Policy Priorities points out that the costs of the first-term tax cuts and prescription drug benefit are at least five times as large as the Social Security surplus.

Key Dates

- **2011:** First baby boomers reach 65 (in 2008 they reach 62)
- **2018:** Cash reversal (payouts exceed incoming payroll taxes)
- **2042:** Trust fund will be depleted, according to Social Security actuaries

Pension Legislation

A combination of factors has led to the scheduling of a pension legislation fiscal train in 2005:

- Temporary interest rate fix expires at year-end.
- The PBGC is in troubled financial state, underscored by the recent $2.3 billion cost of assuming US Airways' pension plan.
- The administration and bipartisan leadership of the Senate Finance Committee have presented early proposals.
- There is pent-up demand for defined contributions changes, including holdovers from the Enron collapse and the administration's savings account proposals.

Pension legislation is a complex issue that will be a substantive and political lift. Consider the difficulty that arose in the past with efforts to obtain a temporary fix—and that legislation was really all about pension funding relief. It allowed companies with defined benefit plans to use a higher interest rate (corporate bond rate instead of the 30-year Treasury rate) and provided special relief to troubled sectors (airlines and steel) to give them breathing room for addressing their underfunding.

This year's defined benefit debate is generally the opposite. While the issue of which benchmark to use going forward has a relief component, as does the issue of allowing companies to contribute more to plans during good times, most of the proposals are geared to shoring up the funding of plans and addressing the exposure of the PBGC. The shifting fiscal winds imply a stronger stakeholder role for taxpayers.

A key early question is how sustainable the initial interest in pension legislation is, given that the tracks will be crowded with the very large Social Security train.

The shifting fiscal winds could also affect the direction of the defined contribution part of this train, specifically by making it more difficult to enact proposal will large long-term revenue losses. A key early question is how sustainable the initial interest in pension legislation is, given that the tracks will be crowded with the very large Social Security train. The timing and interest in early hearings will be the first signals.

Tax Reform and Tax Cut Permanence

The Bush administration had tremendous success on taxes during its first term. With fiscal winds at its back (from the surplus and economic weakness), the administration followed its philosophical compass to a lower top rate, elimination of the estate tax, and a substantial cut in the tax rate on dividends. Because of this tax-cutting success, revenues as a share of GDP in the United States are now lower than they have been since before the Great Society. The only recourse for the minority Democrats was to use procedural maneuvers to force all of the Bush tax cuts to be sunsetted.

As the second term opens, the philosophical compass is pointing this fiscal train toward

- consolidating the first-term successes by making the tax cuts permanents (and in a major piece of fiscal deterioration); and
- making a run at fundamental reform, with the dual goals of driving the top rates down for a flatter rate structure and continuing to reduce the taxation of capital.

Revenues as a share of GDP in the United States are now lower than they have been since before the Great Society.

The fiscal winds have shifted, however, and this train no longer has a tailwind at its back but will ride into a fiscal headwind. On January 7, the President created and appointed members to an Advisory Panel on Tax Reform. The panel, chaired by former Senators Connie Mack (R-FL) and John Breaux (D-LA), is tasked to report its recommendations to the Secretary of Treasury by the end of July. Its first meeting is scheduled for February 16, and it has made its first decision: the cost of making the tax cuts permanents will not be constrained by the deficit-neutrality mandate. The panel will assume permanence, and its additional proposals will be deficit-neutral.

The Executive Order issued provides hints to the administration's current thinking:

- Do not touch the mortgage interest or charitable deductions: "recognizing the importance of homeownership and charity in American society."
- Put a priority on lower rates, especially on capital: "better encourage work effort, saving, and investment, so as to strengthen the competitiveness of the U.S. in the global marketplace."
- Work off the current income tax: "At least one option submitted by the Advisory Panel should use the Federal income tax as the base for its recommended reforms."

This train is expected to move very slowly in 2005 and likely will not get a clear track until 2006 or until the Social Security train is out of the way. For investors, interest will be sporadic in the first half of the year, as ideas are floated by the Advisory Panel and key members of Congress begin to make noises on their priorities. Major action will likely not come until after the Social Security debate is concluded.

Watching Train Tracks

Guided by its philosophical compass, the Bush administration has scheduled several fiscal trains to run during its second term. It is this philosophical compass that determines the direction in which the administration wants to drive these trains. The shifting fiscal winds toward restraint will affect the timing, success, and ultimate course of these trains.

In the absence of a sharp market signal on interest rates and/or international capital flows, the fiscal winds are not strong enough to cause all these trains to move in a fiscally improving direction (witness priority on unfinanced tax cut permanence); however, the winds are strong enough to be perceptible in Washington, and we will begin to see their effect, perhaps first with a modest deficit-reduction entitlement package in 1H05.

Health Care: The D.C. Pulse

Sector	Recent Developments
Brand-Pharma **Generics** **Biotech** **Med-Tech**	• **FDA Commissioner** Reports indicate that Acting FDA Commissioner Lester Crawford may soon be named as permanent FDA commissioner. In his confirmation hearing, HHS Secretary Mike Leavitt indicated that he expects a permanent FDA commissioner to be named soon. Crawford's challenge would be to restore FDA credibility in light of the recent concerns about antidepressants, flu vaccines, and COX-2 inhibitors. Being named the permanent commissioner would likely give Crawford more credibility to take a comprehensive reform approach on his own.
	• **Drug Safety Pressure** Top aides to Senate Health, Education, Labor and Pensions (HELP) Chairman Mike Enzi (R-WY) indicate that the HELP committee will hold a number of hearings on drug safety. This occurs as Senators Chris Dodd (D-CT) and HELP ranking member Ted Kennedy (D-MA) have introduced their own bills. Drug safety has the opportunity to be a bipartisan issue in 2005, particularly with Dodd's bill as a potential model.
Facilities **Managed Care** **PBMs** **Retail**	• **The Uninsured and the State of the Union** As expected, President Bush called for the expansion of Health Savings Accounts and tax credits for the uninsured to purchase health care. HHS Secretary Leavitt indicated that the tax credits and incentives could ultimately total $140 billion. Passage of such a proposal would likely be positive for hospitals, as it could reduce bad-debt expense. However, passage of credits of this size appears unlikely in the current difficult budgetary environment.
	• **PBM Transparency** Thirty employers formed a new group called the Rx Collaborative to monitor Medco Health Solutions and the rebates they receive on their drug costs. We expect substantive efforts on transparency in the rebates of PBMs to occur at the private level or potentially through litigation, not through Congress. With the CBO having scored PBM transparency as costing the federal government $40 billion over 10 years if applied to the new Medicare program, Congress likely will not address this issue in the foreseeable future.
	• **Bush Budget and Health Care** President Bush is likely to propose $60 billion in Medicaid reductions in his budget on Feb 7, targeting $15 billion over 10 years from reforming the Medicaid AWP system (a potential negative for drug retailers) and $40 billion over 10 years from provider maximization schemes. Leavitt indicated that the administration would like to reform the Medicaid drug pricing system in 2005, citing potential savings of $15 billion for the federal government and $11 billion for states. This could have a negative impact on drug retailers. Leavitt indicated that some of the Medicaid savings could be used as part of a program to encourage home health participation at the expense of nursing homes, which Leavitt has indicated are far more expensive (though the details and impact are unclear). Leavitt also proposed $5 billion in savings from tightening loopholes on asset drawdowns for inclusion in the Medicaid program, which could be positive for nursing homes. While we expect proposals for significant Medicaid cuts, the administration has been unusually quiet about Medicare reimbursements. This leaves the door open to the President proposing no or marginal proposals for Medicare cuts, though Congress could ultimately enact cuts despite this.
	• **Medicaid Reform-Waiver Changes** Speaking at a conference, CMS Administrator Mark McClellan reiterated comments similar to those of HHS Secretary Mike Leavitt on the need for flexibility in the Medicaid program. Medicaid needs "flexibility that works," said McClellan. Leavitt and McClellan's comments point to major changes to rewire the waiver program for states, potentially by tying waiver proposals to the saving of money (rather than making them budget-neutral) or to quality care.
Health Care Trends	• **Health Care Leading to Bankruptcies** Health Affairs reports that approximately 50% of bankruptcies filed in 2001 were due to the rising cost of medical bills, while 76% of those who had a medical bankruptcy originally had health insurance when they first became ill. The findings have raised concerns that, even if individuals have health care, they will lose it in catastrophic circumstances and be driven into bankruptcy. Others suggest that the results highlight the limitations of employer coverage.
	• **Quality Care** CMS Administrator McClellan announced a demonstration project to award bonuses to physicians that improve care and lower costs for beneficiaries. CMS has selected 10 physician groups, representing 5,000 doctors and 200,000 Medicare beneficiaries. These bonuses could provide extra reimbursements of up to 5% of annual Medicare payments.
	• **What Does Medicare Cost?** We may never know. Reports indicate that the cost of the Medicare Modernization Act will be reevaluated, again, as part of the President's budget in on February 7. However, Administrator McClellan indicates that the revision may be downward, not upward. MMA is likely to be reevaluated every year going forward as CMS gains a better understanding of the actual cost of providing this drug coverage.

Source: Lehman Brothers

GPR Weekly

ISSUE	THE WEEK JUST PAST	OUR CALL
Iraq We are going to respect the choice of those who voted, and we will consider the new government—if all the parties participating in the political process agree on it—as a transitional government with limited powers. — A spokesman for the Association of Muslim Scholars, which represents some 3,000 Sunni mosques in Iraq	• **Elections:** Sunday's elections took place with a relatively low level of violence, but the Sunni boycott took its toll and Sunni leaders are questioning the legitimacy of the vote; hopes for a quick US pullout were written off, although the Iraqi Interior minister stated that his nation's troops could possess the wherewithal to take over military operations as soon as 18 months from now; we expect continued military presence for at least this period, but it is more likely that American troops will remain engaged in high-intensity counterinsurgency campaigns for at least two years as the fledgling government gains legitimacy and control • **Attacks:** Incidents of insurgency on Election Day were similar in number and type to other insurgent operations; we are concerned that insurgents conserved resources due to the heightened security and that they will increase attacks once the perception of security is once again vulnerable; insurgency could also gain traction if Sunni minority groups are underrepresented in the new government, which could cause Sunni Arabs to become embittered to the nascent democratic process	**Short-Term Catalyst** • 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 rundown from Jan 30 scheduled elections **Long-Term Call** • More US troops alone fail to accelerate stabilization and rebuilding timetable
Terrorism We just do not believe there is enough infrastructure in place to make it user-friendly to drivers. — Cliff Harvison, president of National Tank Truck Carriers, on new legislation requiring transporters of hazmat to undergo fingerprinting and background checks	• **Patriot Act:** The federal government effected legislation requiring truck drivers who transport hazardous materials to submit fingerprints and undergo background investigations in the hopes of curbing potential attacks inside the United States, but it will take roughly five years to register each driver, and facilities for conducting the investigations are inadequate; for these reasons, we believe that the measure is primarily an attempt to quell growing fears of terrorism in the homeland and will have minimal effect on preventing attacks, at least in the short term • **Kuwait:** A shootout between Islamist militants and Kuwaiti security forces left at least five people dead, marking the third incident of its kind in Kuwait in the last month; the American embassy in Kuwait warned of potential attacks on soft targets as security measures surrounding US facilities are increased	**Short-Term Catalyst** • The war in Iraq and Israeli-Palestinian tensions provide ideological basis for short-term terrorist activities **Long-Term Call** • Terrorist networks will continue to conduct global operations in a battle of ideologies between the democratic West and Islamists
Oil It was a peaceful protest, but instead of talking to us [Nigerian security forces] sent the military to shoot us. — Austin Ajurenmisan, a peaceful protestor on events outside a Nigerian oil export terminal	• **Crude Talk:** Light sweet crude oil prices on the NYMEX softened, ending the trading week around $47/bbl; EIA reports indicate that US crude inventories slipped a bit but remained more than 9% above levels at this time last year; in our view, OPEC could act on further news of positive inventory stockpiles by cutting its daily production levels at or before the group's upcoming meeting; we reiterate our belief that the smooth process of Iraqi elections does not change the geopolitical threat to oil pipelines and oil infrastructure throughout Iraq, particularly in the northern regions of the country • **Venezuela:** President Chavez, in conjunction with government officials from Iran, announced a plan to drive oil exports to China in lieu of the traditional US market; the decision comes after a diplomatic dispute between Venezuela and the US-backed Colombian government ended; Venezuela's foreign minister assured critics that his country is merely interested in diversifying its markets, not punishing the United States, despite the fact that sending oil to China is not as economically viable; our view is that closer ties between Iran and Venezuela could hurt the oil market should the United States become engaged with Iran	**Short-Term Catalyst** • OPEC recently maintained output and price levels but is apt to shift paths as excess supply builds in the run-up to the group's Mar 11 meeting **Long-Term Call** • Failure to effectively secure global oil infrastructure from geopolitical risks leaves headline risks
Middle East, Russia I'm happy to say that our plans to launch bilateral consultations in the security sphere are being implemented. — Russian President Vladimir Putin	• **Peace Process:** Israeli PM Sharon and Palestinian President Abbas agreed to meet in Egypt this week to restart peace talks; the meeting is the highest-level summit between the two sides in over four years; Israel's plan to pull out of the West Bank and release Palestinian prisoners is an extremely positive breakthrough in regional relations ahead of the proposed summit; we believe that the talks have a greater chance of success in light of the Israeli pullout plan • **Russia:** Russia and China agreed to set up a bilateral body to coordinate with each other over security issues, citing "close positions on the international situation"; Russia remains China's largest supplier of arms, and the energy-hungry Chinese are also interested in Russia's oil industry	**Short-Term Catalyst** • Russia and China will likely conduct joint military exercises in late summer 2005 **Long-Term Call** • A continued post–Cold War rapprochement between China and Russia could lead to a strong military and economic coalition in the Eastern Hemisphere

Source: Lehman Brothers

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