Superior Washington Intelligence For Investors

CAPITAL ALPHA PARTNERS LLC

Election Risk Report 2012

August 7, 2012: Issue IX

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Odds of Obama Reelect: 55%
GOP Senate Majority: 45%
Senate Projection: GOP+3

Also Inside

Romney 'Back Game,' Or Crushing Obama Offense?

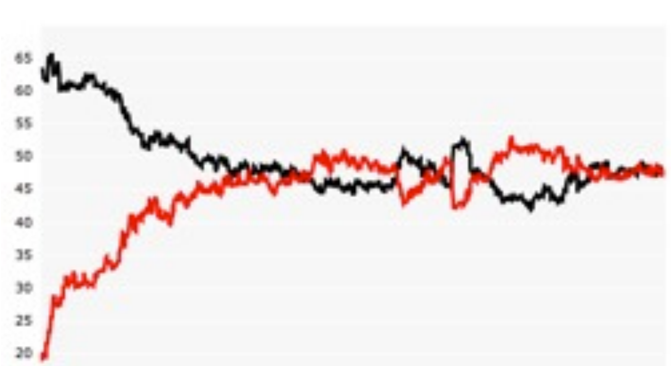
With three weeks to go before the GOP convention in Tampa, and 92 days until the elections, Barack Obama has bolstered a small but steady (+3) lead over Mitt Romney in recent polling surveys. All as political contrails from the July jobs report have continued to depict a sputtering economy, growing too slowly to boost employment above the jobless gravity zone of 8 percent but also seemingly avoiding stall speed. Meanwhile, financial markets continue to ignore concerns about a fiscal cliff, despite the prospect of such fears' being brought forward to slice a half percentage point or more off fourth quarter economic growth. Even "LIBORious" new worries over U.S. banks' potential involvement in rate manipulation seem unable to shake investors' faith in the U.S. remaining what GOP economist Douglas Holtz-Eakin has dubbed the "prettiest horse in the [global economic] glue factory."

Our polling-based Presidential Choice Indicator (PCI, p15-16) thus continues to show Obama with a 332-206 lead, including Florida's 29 electoral votes which many expect to ultimately swing Republican. And Capital Alpha thus retains for now its "Blue Stock" forecast of a 55% percent likely Obama reelect combined with narrow Democratic retention of the Senate. Indeed, we would note that since we shifted to this prediction in February, Intrade odds of a Republican Senate takeover have fallen from 75 percent to just over a tossup, with our outlying 50-50 tie prediction (denoted by Intrade's "Neither Party" contract) rising from 2.5% to 19%.

Key to this frozen dynamic has been the President's heavy outspending of Romney since May, with his campaign exploiting legal restraints on the Republican candidate's outlays ahead of his (Romney's) August 30 nomination. As a result of an unprecedented $400 million early investment in state organization, campaign personnel and advertising, Obama is betting heavily that he not only will reach the fall having negatively tarred Romney beyond repair but also to have developed a key-state ground game that the Republicans will be unable to match or overcome.

Gaffes like Romney's impolitic comments about Britain's preparedness for the summer Olympics, and diversionary Obama ads accusing him of not paying taxes and outsourcing jobs while at Bain, have taken their toll in making Romney seem socially awkward and out of touch. Perhaps more importantly, they have (so far) successfully diverted public attention from the weak economy. *-continued on page 3*

President Obama Approval



Key number: **47.6%**
Average backing at or below historically successful minimum
Source: RealClearPolitics, 8-7-12

Unemployment at 8.3%

Key number: **63.7%**
As workforce participation stabilizes, jobless rate may rise
Source: Bureau of Labor Statistics, Aug. 2012

10-Year Treasuries: Multi-Year Low

Key number: **1.5%**
Fed Out of Arrows?
Source: Federal Reserve via Dr. Ed Yardeni, June 2012

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Click underlined elements for analysis on the policy risk profile of respective stock groupings

RED STOCKS

Banks: Investment & Commercial: **MS, BAC, C, JPM, GS, WFC**
Financial Exchanges: **CME, ICE**
Mortgage REITs: **AGNC, ARR, CIM, CYS, HTS, NLY**
Homebuilders: **LEN, DHI, TOL, HOV, KBH, PHM**
Retail Hardlines: **HD, LOW**
Rating Agencies: **MHP, MCO**
Credit Card Companies: **V, MA**
Prop Schools: **APOL, APEI, CECO, COCO, ESI, DV, STRA**
Student Loan Companies: **SLM, NNI**
Brand Pharma: **PFE, SNY, NVO, GSK, AZN, MRK, JNJ**
Managed Care/HMOs: **UNH, WLP, AET, HUM, CVH**
Medtech: **MDT, ABT, JNJ, STJ, BAX, BSX, SYK, ZMH**
Energy MLPs: KMP, ETP, EEP
Coal: ANR, BTU, CNX
Oil & Gas Exploration & Production: BP, XOM, CVX, COP
Oil Services: SLB, HAL, RIG
Electric Utilities: AEP, SO, FE, GEN
Global Manufacturing Conglomerates: **GE, TWC, HON**
Defense: **LMT, NOC, GD, RTN, BA**
Tobacco: **MO, RAI, LO**
Telecom Service: **T, VZ**
Cable Companies: **CVC, CMCSA, TWC**
Federal Express: **FDX**
Auto Dealers: **KMX, PAG, AN**
Non-Union Auto Manufacturers: **TM, HMC**
Railroads: **CSX, UNP, CNI, CP, KSU, NSC**
Trucking: **HTLD, WERN, JBHT, KNX, SWFT**

BLUE STOCKS

Mortgage Insurers: **MTG, RDN, GNW**
IT: **AAPL, CTSH, ORCL**
Generic Pharmaceuticals: **TEVA, MYL, SAN**
Hospitals: **HCA, THC, CHS**
Medicaid HMOs: **MOH, CNC, AGP**
Wireless Towers: **AMT, CCI, SBAC**
Alternative/Renewable Energy: **FSLR**
Ethanol: **ADM, PEIX, AVRW, VRNM**
Environmental Remediation Cos: **BWC, URS, SHAW**
Advertisers: **LAMR**
Information Processors:
Online Gaming: **BPTY.L**
The Detroit 3 Auto Manufacturers: **F, GM**
Domestic Steel Producers: **X, NUE**
Industrials & Materials: **GVA, MLM, VMC**
Railroad Safety Equipment: **WAB**
Telecom Equipment: **MSI, HRS, ALU, SI**
Communications Towers: **AMT, SBAC, CCI**
Tax Preparers: **JTX, HRB**

PURPLE STOCKS

Television Broadcasters: **DIS, CBS, NWSA, BLC, SBGI**

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As a result, Romney's average favorability rating, at 43%, continues to be slightly underwater (with about a percentage point more viewing him unfavorably), and to trail that of Obama (at 49.4%) by over 6 points. Nevertheless, that gap may be skewed by recent polls with disproportionately Democratic sample sets, including outlier surveys from Pew and CBS/*New York Times*.

*"**Back Game** [Also spelled "backgame".] A strategy employed by a player who is substantially behind in the race but has two or more anchors in the opponent's home board. The back game player tries to hold both anchors as long as possible and force his opponent to bear in or bear off awkwardly. The idea is to hit a late shot and then contain the hit checker behind a prime."*

Source: text from Backgammon Galore! at bkgm.com; image from iStockphoto

Meanwhile, Obama has made gaffes of his own, most notably his comments that "the private sector is doing just fine" and, to successful entrepreneurs, "you didn't build that," but instead owe your good fortune to the government. Both seem tailor made to reinforce impressions that Obama is for Government First.

For their part, Romney's strategists point with satisfaction to the race having remained close despite the Democrats' soon-to-be-reversed spending mismatch. Indeed, with today's news that Romney and the RNC have outraised Obama and the DNC for a third straight month, the Republicans now have more cash on hand. As a result, they are likely to rely on help from outside spending groups for the three more weeks until they get an unfettered spending greenlight - and that will come right on top of the traditional five-point-or-so post-convention bounce that Gallup has predicted both sides might look forward to based on past history.

They also note that voters still discredit Obama for his performance in managing the economy; that the President's approval rate has remained stuck at an anemic average of 47% (from which no modern day POTUS has prevailed); and that Romney not only should have a chance to energize his base and seize the campaign narrative by choosing a running mate just before Tampa, but should also be able to redefine himself during the August 27-30 convention and three presidential debates now scheduled for October 3, 16, and 22.

Crucial to any hope of a Romney victory is the notion of his finally breaking through to gain support among independents in the crucial battleground states of Ohio, Virginia and Florida, in particular. Also key will be his ability (or failure) to limit losses among Hispanics and other minority voters, a goal that could yet spur him to choose Sen. Marco Rubio (R-FL) over less-risky/consensus choices of Sen. Rob Portman (R-OH) or former Gov. Tim Pawlenty (R-MN). Finally and most importantly, even more crucial may be the notion of Romney wooing the 6-10 percent of voters who may remain truly undecided, and thus seem poised to break away from the President if given a good alternative. With Obama scoring well below 50% in most credible polls and Romney within the margin of error, Romney thus remains within striking distance provided his moves from here are more strategically effective.

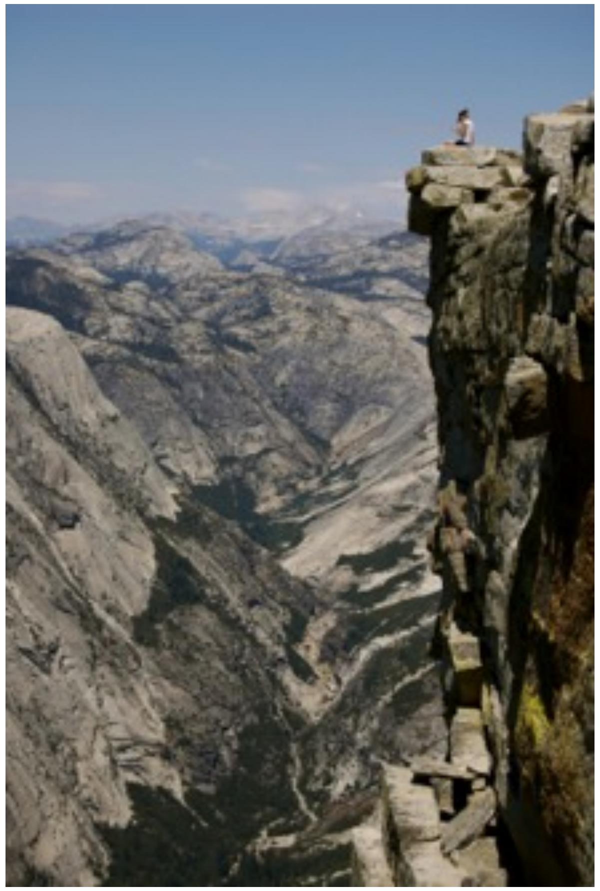
As red stock dimensions of an increasingly lopsided list of potentially affected industries become clearer, (note Robert Kaminski's thumbnail sketch of implications within the telecom sector), the question of whether Obama is mounting an insurmountable offense, or Romney is alternatively preparing a stunning 'back game' - similar to Ronald Reagan's against Jimmy Carter in 1980 - should thus begin to see answers by mid-September.

Wall Street economists still dread the fiscal cliff, yet the financial markets show no sign of worry. As we write, the S&P 500 Index is at a three-month high and, at 1394, rallying toward the psychologically important 1400 level it has not reached since May 2. Meanwhile Treasury yields remain near historic lows.

If the markets were sending a stronger signal, Washington might feel more pressure to make tough decisions on taxes and spending rather than pushing them off into the future. Our sense is that Washington feels relieved, on the one hand, that the bond vigilantes are not yet at the door and that the debt crisis which seemed in the offing only a year ago now seems to be postponed as lenders see the U.S. as a safe haven in comparison with Europe. But on the other hand, Washington is nervous about the state of the economy. Three successive subpar jobs reports have seized the attention of the city. Moderate Democrats who never saw the point of bringing down the economy in showdown over the Bush tax rates are even less enthusiastic now. Meanwhile, Republicans who have been blamed for past disasters and know the presidential race could turn on perceptions of wealthy moderate suburbanites in Virginia and Ohio are anxious to avoid a standoff as well.

The Hill is doing its best to signal that at the end of the year there will not be a crisis and members of Congress will be able to reach a deal on extending most but perhaps not all current tax rates and avoiding a sequester (given the implicit license to do so from the bond markets). Last week, with only days to go before the August recess, the House and Senate reached an agreement to extend funding for government programs at current levels for six months past October 1, thus taking a complex and potentially time-consuming issue off the table before the year-end pileup. Also, last week, the Senate Finance Committee marked up an extenders bill which the full Senate may pass during the eight days Congress will be in session in September. The Finance package is more of a messaging bill than anything else. It is supposed to show that the Senate, at least, can reach a bipartisan agreement on corporate tax issues. By choosing to extend some expiring provisions but letting others lapse, the Senate bill was also signal that the Senate might take up tax reform next year.

Still, we don't expect a comprehensive tax solution to emerge until the end of the year, after the election. In the "Red Scenario," it is a no-brainer that the Bush tax rates will be extended for one year. In the "Blue Scenario," the outlook is more difficult to predict. We don't see a re-elected President Obama going along with the extension of the top two Bush rates, but the state of the economy makes everything else a jump ball. Nervous Democrats have already made their bid on a dividend tax rate of 20% (or 23.8% with the healthcare surcharge factored in). The Republican position is a 15% top rate (or 18.8% including healthcare). This five-point spread is a much narrower difference than the nearly 25% spread investors had to contemplate earlier. The risk to dividend yield is correspondingly much less. The House will doubtless push back on what it considers to be the Senate's still-bloated extenders bill. Many more expiring provisions will be dropped, permanently. But we have a high degree of confidence that the R&D tax credit used by many pharma, IT, and manufacturing companies will survive. The Production Tax Credit for wind energy is not quite a lock, but close to it at 75% odds. Bonus depreciation used by capital intensive manufacturers, telecom service providers, and utilities is a jump ball: We think it will be extended if the economy still looks bad in December.



Watch that first step
Source: iStockphoto

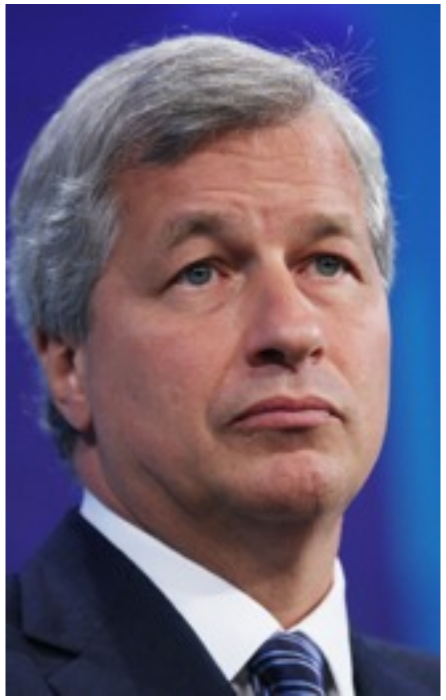
While EU banks appear most at risk in the LIBOR scandal, it now appears that at least two of three U.S. banks thought vulnerable are negotiating a settlement with U.S. regulators (i.e., per news reports, more likely **Citibank** and **JPM** rather than **BAC**). The extent of their legal liability will depend upon how clearly and extensively it can be demonstrated that they conspired to manipulate inter-bank borrowing rates. The expected September or October actions or consent decrees could thus remove confusion over which banks are liable, but the EU and U.S. institutions ensnared by regulators could still become mired in prolonged legal uncertainty. And in terms of electoral politics, traders being frog-marched in handcuffs off trading floors, just a few weeks before national elections, would be bound to generate screaming headlines.

In a worse case scenario, if too many European banks become embroiled in the LIBOR scandal and the EU fiscal crisis spikes at the same time, the flow of credit might once again become impaired. More likely, one or two individual banks may find themselves at a point of existential threat, this time with the also-tainted Federal Reserve perhaps impeded from acting as lender of last resort. Our bet at Capital Alpha is that the Fed and Treasury will probably emerge relatively unscathed and the global financial system will go on (though with an alternative benchmark to surface). <u>However, the LIBOR scandal is going to be much worse for the industry than the JP Morgan trading losses which weighed on major banks in late spring</u>. Bottom line, at least one or two U.S. institutions might ultimately be forced to pay billions and possibly tens of billions to resolve a flood of lawsuits from holders of derivatives or bank funding loans, money market funds and others who lost money due to artificially depressed LIBOR rates.

The principal lesson that market participants have learned is to insist on measurable, third-party reported data as a reference rate whenever possible. It may take some time to develop one or more alternative indexes for all of the types of transactions that have traditionally relied upon LIBOR, but the benefits of a transaction based, reportable rate not controlled by one side of the negotiations are obvious. One signal of how quickly the market is changing is the rapid market growth of one alternative in particular. The U.S. Treasury Borrowing Advisory Committee, a key outside advisor to the U.S. Treasury Department, has recently come out in support of the Global Collateral Finance Repo Index (GCF) as a replacement for LIBOR. The committee, which was initially leaning towards reliance upon the fed funds rate, took note of the rapid growth in volume, mix of counterparties and tenors of the GCF and now has recommended it as an alternative to LIBOR.

Republicans so far have pointed to the regulatory failures of a diffuse collection of multiple regulators to respond in a timely manner to concrete evidence--not just newspaper speculation - of deliberate misreporting of LIBOR data. Yet somehow, four years later, Fed Chairman Ben Bernanke was forced to admit at a recent Senate hearing that he could not reassure Chairman Tim Johnson (D-SD) that such manipulation was not still happening. While difficult to achieve, a new Congress may try to rationalize the regulatory structure so that future instances can be addressed in a more timely way. Secondly, Congress should pass new legislation instructing the banking regulators to require banks to rely upon objective, measurable data when possible (and possibly in all cases when retail customers are involved).

It is still too early to have a strong grasp of the likely legal liabilities, but it is beginning to appear as if individual banks have much greater differences in respective culpability than they did, say, in the mortgage servicing scandal, where *most* had significant problems. In this case, it appears to be a mostly EU bank problem, though three U.S. banks could have some liability as well. It all depends on what evidence exists of manipulation and conspiracy with others over a period of time. Even if manipulation can be demonstrated, there are some limitations. First of all, since LIBOR was updated daily, unless your rate was established or reset on a particular day where any manipulation can be demonstrated, there would be no proof of harm. And if the manipulation had the effect of lowering rather than raising the averaged rate - as would be more likely during the crisis (2008-2009) - it would have helped rather than hurt potential consumer plaintiffs. On the other hand, money market funds or bank-funding lenders would have been harmed by artificially lower rates.



Take a deep breath.

Source: Jamie Dimon from iStockphoto

U.S. banks are now greatly exposed to political risk, as the Dodd-Frank Act represents a high-water mark in the re-regulatory response to the financial crisis and it gives greater discretion than ever before to the numerous financial regulatory institutions in Washington.

Should Republicans gain a majority in the Senate, and also take the White House, significant policy shifts could be expected on the Volcker Rule, housing finance, the CFPB, derivatives regulation, Basel 3 implementation and regulation of SIFIs. The key changes in approach would include closer attention to cost-benefit analysis, impact on access to credit and economic growth, and a greater consideration for the overall impact of an unprecedented level of new rules and how they would impact the competitiveness of the industry as a whole.

By contrast, if Obama is re-elected, we expect the constant flow of regulatory rulemaking to continue, with a seemingly blind eye to its exacerbating effect upon the already adverse credit environment.

The Volcker Rule

While the SEC had signaled months ago that it would likely re-propose the Volcker Rule, the JPM trading losses (and to some extent the LIBOR scandal) have put more pressure on the regulators to finalize a rule quickly. However, even if the regulators do issue a final rule before the election, it will likely be an interim-final rule or at least the effective date could be delayed until a new administration could review it. At risk is not prop trading per se, but rather the impact the rule will have on market-making, underwriting, or hedging activity of the largest capital market banks. The current proposal threatens to impose regulatory burdens that are costly, complicated and difficult to implement (and to supervise, for that matter). U.S. capital market activity would likely shift to other regions under the current draft, and given the re-politicization of financial regulation, we do not see how the current administration could make the adjustments needed to avoid regulatory arbitrage that could send sizable chunks of business to EU or Asian capital markets.

A Republican administration would likely devise a simpler and arguably more effective set of standards to ensure banks are not prop trading, while at the same time ensuring that market-making, hedging and underwriting can still be effective tools in U.S. capital markets. More fundamentally, a Republican-led Congress could work with a new administration to rationalize the Volcker Rule, Lincoln "push-out" rule and the other elements of Dodd-Frank designed to reduce the too-big-to-fail problem. Most Republicans believe that the Volcker rule is a crude, ineffective tool to solve the problem of banks making bets with taxpayer subsidized funds. While it may take a while to agree upon an acceptable alternative, regulators would not be under pressure to use the Volcker Rule to solve problems that it can't.

Rep. Scott Garrett (R-NJ) is a key player on the GOP side in the area of financial services regulation. A big Republican win this year would mean better odds for some of Garrett's conservative proposals to advance

Source: official photo of Scott Garrett

Housing Finance

Fundamental reform of Fannie and Freddie might be challenging even if Republicans retake both the Senate and White House in November. However, there are a number of intermediate steps, such as rationalizing the rules on securitization, promoting covered bonds and other private sector incentives that could help revitalize private sector funding for this critical sector. The most important step would be for regulators to re-propose and quickly finalize implementing rules for the new 10% risk retention requirement mandated by Dodd-Frank (i.e., adopt a broader standard for "qualified residential mortgages," or QRM). While some broadening of the QRM test is likely even pursuant to a status quo election outcome, a helpful precursor might be sharper pushback from a newly realigned Congress to a parallel, suitability-related "qualified mortgage" standard that the CFPB is expected to publish before year end. Since the degree of legal insulation offered by the "ability to pay"-related QM is expected to set the common denominator for how willing banks will be to make any but the most riskless loans,the QRM standard is also expected to dovetail off the QM - and the net of both (in the event of a rightward shift) would likely allow for more resumption of lending to would-be middle class homeowners, or those seeking to refinance in order to take advantage of historically low interest rates.

Furthermore, Rep. Scott Garrett (R-NJ) has come tantalizingly close to achieving bipartisan consensus on moving legislation that would provide the legal framework necessary for a vibrant covered bond market to develop in the United States. There is a much greater chance that a Republican Congress would fast track such a bill and a Republican-led FDIC could work out some reasonable compromises to ensure that the deposit insurance fund is not put at risk. Finally, there are a number of other alternatives to improve the environment for private sector capital to once again become a major source of funding for the purchase or refinance of both commercial and residential real estate.

CFTC Commissioner Scott O'Malia - a potential chairman under a Romney administration - could mean a big change in the regulatory paradigm
Source: official photo of CFTC's Scott O'Malia

CFPB

The creation and unusual governance structure of the CFPB was one of the most controversial elements of Dodd-Frank. A Republican administration would quickly move to appoint a new CFPB head, allow for greater oversight and bipartisan control over this new agency, and perhaps restrict funding allowed for implementation of more controversial initiatives. Besides a possible course correction on the QM standard, a Republican-appointed director would likely ease the agency's new enforcement bent, which might provide particularly welcome relief to non-bank lenders and service companies engaged in everything from payday lending and prepaid cards to credit bureaus, money remittance companies and student loans. More generally, we'd expect an approach to regulation that more equally balances the need for consumer protection with the need for low-cost, competitive products that can help consumers get the financing they need.

Derivatives Regulation

While much of the regulatory implementation of the new, comprehensive OTC derivatives market reforms has been finalized, a number of key final rules also need to be completed. For instance, rules on how much margin and collateral will be required of non-banks, what margin will be required of the remaining uncleared swaps, and the new rules for swap execution facilities (SEFs) could either pave the way for an expansion of clearing and trading activity or depress volumes–all depending on how regulators balance the need to protect safety and soundness with competitive demands and the cost to consumers and the economy. A CFTC led by Chairman Scott O'Malia and SEC Chairman Dan Gallagher would likely find a balance that results in a more transparent but innovative and efficient industry that can hold its own against foreign competitors.

Meanwhile, though congressional reform may be challenging, the Lincoln "push-out" amendment and a few other areas could likely be fixed. Separately capitalizing a derivatives affiliate reduces the ability of a bank to make other loans to its customers. Customers will find it more expensive to trade with the bank affiliate because pricing will not reflect other transactions that could justify bulk discounts. Moreover, all swap dealers will face increased costs due to margin requirements, which will inevitably be passed on to their corporate customers and, ultimately, the public. For these reasons, pursuant to a rightward shift, we foresee the Lincoln amendment as being either abolished completely or, at a minimum, adjusted to avoid most of these negative consequences.

Basel 3 Implementation

While there is less room for statutory or even regulatory shifts in this area, as the U.S. is not likely to back away from its G-20 or Basel international commitments, even a few subtle shifts in how Basel 3 is implemented could have some significant changes for the industry. The new liquidity rules, as currently drafted, are unworkable and would greatly increase the cost of capital for banks. A number of adjustments need to be made, and are more likely to occur under a Republican administration. SIFI buffers could also be lowered from the current top rate of 2.5 (or even 3.5) percent down to a more reasonable 1.5 to 1 percent. Finally, some of the new risk-weightings could be adjusted to avoid increased costs of financing mortgages and hedging against inflation.

Regulation of SIFIs

It is unclear whether a Republican Congress would attempt to eliminate the FSOC or the concept of designating certain banks (and non-banks for that matter) as systemically important. But it is much more likely that they would not support some of the more excessive elements of the proposed regulation of bank SIFIs. The currently proposed single counterparty credit limit is largely viewed by most experts as excessive, and would likely be recalibrated to a more reasonable percent limit. Furthermore, the approval of living wills and annual stress testing - especially regarding the limits placed on capital management - would likely become less obtrusive. Not even the most ardent supporters of Dodd-Frank intended for two officials at the Federal Reserve to become the CFOs of the largest financial institutions.

Any Risks to the Banks If Republicans Win in November?

Most likely in the housing finance area, where Republicans largely want to move away from any government guarantees - though a large minority of Republicans favor some form of "catastrophic" or conditional government role. This internal disagreement may delay fundamental reforms to housing finance, and those discussed earlier are the only ones likely to emerge quickly. Nevertheless, even these changes could have a salutary effect and help the nascent housing recovery.

Red Stocks: Cable and satellite multichannel video programming distributors (MVPDs) - TWC, CVC, CMCSA, DISH, DTV

Given developments in online video and other non-traditional video distribution, both parties question whether the current media regulatory framework reflects pay TV market realities. In the open debate on whether to expand existing law and increase regulation, cable and satellite companies are supported by conservative "free market" Republicans who seek to abolish most video distribution regulations and weaken the bargaining position of television broadcasters in program carriage negotiations.

Purple Stocks: Television broadcasters - DIS, CBS, NWSA, BLC, SBGI

Both parties are calling into question the regulatory benefits afforded to broadcasters in the existing policy framework. "Free market" Republicans have proposed to abolish most media regulation, which would strengthen the hand of cable and satellite companies against broadcasters in negotiations to retransmit broadcast signals. A Republican White House and Senate increase the odds of media de-reg. Liberal interest groups and "pro consumer" Democrats have also sought to weaken broadcaster retrans negotiating power by prohibiting signal "blackout" and requiring binding arbitration during carriage disputes.

Blue Stocks: Wireless towers - AMT, CCI, SBAC

An Obama re-elect would be a continuation of this administration's anti-consolidation antitrust posture, most recently reflected in the rejection of AT&T's bid to buy T-Mobile and other regulatory and administrative proceedings. Telecom industry consolidation can be viewed as negative for the tower companies, which would generally prefer a multiplicity of wireless tower tenants than fewer tenants. Tower companies also benefit from wireless spectrum scarcity, which we see as being aggravated by a re-elect. For carriers that face increasing wireless traffic and limited spectrum, one congestion mitigation is to deploy more towers. Administration rhetoric on bringing more spectrum to market has softened from exclusive use to shared use with incumbent federal users, which is of little value for capacity-constrained carriers.

Red Stocks: Telecom equipment and network infrastructure - MSI, HRS, ALU, SI

We previously listed the telecom equipment companies as blue stocks. Their blue stock catalyst has already happened in the passage in early 2012 of Democratic legislation to build a nationwide broadband communications network for first responders. We now focus on the implementation and deployment of this network over the next several years, during which we see the telecom equipment companies now benefiting from a Republican executive branch. Dueling visions for the network pit Democrats (federally-managed process with little state input) against Republicans (interconnected state and regional networks). The companies have long-established vendor relationships in the states and would be better off negotiating RFPs there than at the federal level. The current Democratic administration has already materially impacted the sector by withdrawing previous approval for long-planned state and local networks (most without federal funding) and will be less inclined to grant the state "opt-outs" provided in the statute.

Red Stocks: Top-tier wireless carriers - T, VZ

High dividend-yielding AT&T and Verizon benefit from low corporate tax rates in general as well as low dividend tax rates, which are championed by Republicans. Also, a continuation of a Democratic administration will continue to create regulatory headaches for AT&T and Verizon, who are seen by Democrats as wielding too much market power. Several red stock catalysts occurred and we believe suggest a trajectory that is likely to continue: DOJ rejection of the AT&T/T-Mobile merger; Democratic-designed statutory language giving FCC discretion to create spectrum auction rules that would disqualify AT&T and Verizon, and material business restrictions designed by the FCC for AT&T and Verizon in potential dealings with now-defunct LightSquared. We see Republicans recognizing benefits to scale in the wireless industry and believe a Romney administration specifically would be more permissive of industry consolidation executed by T and VZ.

In a landmark but now controversial agreement, attorneys for merchant-plaintiffs and the major card issuers associated with **Visa** and **Mastercard** agreed on July 13 to a settlement involving $6.6 billion in direct payments and $1.2 billion in initially escrowed proceeds from an eight-month/10 basis point reduction in interchange fees.

The deal came in better than consensus expectations among bank and card industry stakeholders - not only in the dollar terms but, more importantly, in the broad range of grievances for which the agreement will now be deemed to fully atone. These agreed-to provisions regarding “going forward” practices by the industry should effectively shield the networks and card issuers against additional legal challenges over the next ten years, assuming that a critical mass of plaintiffs doesn’t reject the final deal.

That threat has subsequently grown to seem more credible, amid initial saber rattling from **Target** and representatives for convenience stores, as well as the big box retailers' primary Hill champion, Sen. Richard Durbin (D-IL), see at right. Nevertheless, we doubt that such mutiny will rise to the 25% dissenting threshold that might prompt Visa and Mastercard to pull the plug before next spring. And we also see such an outcome as posing risks to the merchants, given its potential to alienate federal Judge John Gleeson, who has been trying to adjudicate between the two sides since 1999.

Meanwhile, the agreement should also provide a measure of insulation against another, credit-interchange- related “Durbin amendment” in Congress, where members are burnt out on the issue and might easily become persuaded to accept Gleeson’s verdict as a final answer. We see such burnout, and reconfirmation of bipartisan support for small card-issuing banks in particular, as likely to persist regardless of the election result after November. Still, Durbin's demotion to minority leader (in the event of a GOP Senate) would greatly reduce even the perceived threat from headline risk, and also increase hopes of a (for the industry) constructive throttling of the CFPB.

As for the agreement’s surcharging green light, we believe that it might ironically prove a less-worrisome-than-initially-feared threat to card players, plus an ultimately imperfect levering tool sought by the retailers, due to a potential gag reflex from shoppers, mixed sentiments among consumer protection advocates and liberals, and (thus) likely continued resistance in many key states. Specifically, anti-surcharging laws in 10 key states, representing almost half of all card volume, are unlikely to be changed easily, if at all, in no small part because such levies have long been seen by many as anti-consumer. Similarly underwhelming to many retailers is their newfound right under the settlement to individually or collectively bargain with card companies for lower rates.

Indeed, the dissension among several key merchants, as well as Durbin's sharp criticism, seem a direct confirmation of these facts.

Nevertheless, other consumer protection voices have supported surcharges on credit cards, largely as a deterrent to borrowers’ taking on more debt. These have included US PIRG’s Ed Mierzwinski and former Harvard Professor and current Massachusetts Senate candidate Elizabeth Warren. Warren’s interest in the issue only reinforces the “red stock” patina of the card industry this November.

Durbin maintains that the current system still “needs to be fixed going forward, and I am confident it will be fixed.”
Source: official photo of Sen. Richard Durbin (D-IL)

...But Durbin's Contempt for the Deal Portends Residual Risk

In a Thursday, August 2, 2012, Senate floor speech, Senate Majority Whip Dick Durbin gloated that doomsayers were wrong about his Dodd-Frank amendment's impact upon small banks and credit unions. He also slammed the proposed July 13 class action settlement as "a capitulation to the Wall Street banks and credit card giants . . . and a bad deal for merchants and consumers."

Capital Alpha continues to doubt that Durbin will be able to recreate the perfect storm that allowed him, in May 2010, to force fellow lawmakers to make the "Sophie's choice" between local merchants and bankers back in their districts (i.e., in the form of the floor vote on his original swipe fee amendment). Moreover, we see the big box retailers for whom the senator speaks as directing their political capital towards an alternatively ripening political objective in the next Congress, namely legislation to reverse the 1992 Quill decision and force online retailers to collect state taxes for purchases made over the Internet. We see that legislation as quite viable, and likely expending the big merchants' primary political chits. For these and other reasons, we believe risks to the card industry are modest, but also see the further throttling of Durbin's agenda, and likely check on CFPB regulation, as ample cause to label card-related companies as "red stocks" for this election cycle.

Excerpts: Sen. Richard Durbin (D-IL) on the Senate Floor, August 2, 2012

By 2010, the U.S. swipe fee system was growing out of control with no end in sight. U.S. swipe fee rates had become the highest in the world - far exceeding the actual costs of conducting a debit or credit transaction.

And there were no market forces serving to keep fees at a reasonable level. Merchants and their customers were being forced to subsidize billions in windfall fees to the big banks.

I stepped in and introduced an amendment to the Wall Street reform bill that for the first time placed reasonable regulation over debit swipe fees.

My amendment said that if the Nation's biggest banks are going to let Visa and MasterCard fix swipe fee rates for them, then the rates must be reasonable and proportional to the cost of processing a transaction. No more unreasonably high debit swipe fees for big banks.

The regulatory steps that my amendment proposed were modest. Most other countries have gone much further in regulating swipe fees.

But the banks and the card companies screamed bloody murder. My amendment passed the Senate with 64 votes, and it was signed into law with the rest of Wall Street reform.

And the swipe fee reforms took effect last October. As it turns out, debit swipe fee reform is working pretty well.

So far, reform has led to an estimated $7 to $8 billion in annual debit swipe fee savings for merchants. That savings is a real shot in the arm for American businesses that have been crushed by ever-rising swipe fees.

Consumers are also benefiting as savings are passed along from merchants through competition. After reform took effect in October, we saw a massive level of retailer discounting that extended beyond the usual holiday season discounts.

And according to a *USA Today* article from May 11, a number of individual merchants are offering debit card discounts for items such as gas, furniture, and clothing. This trend is expected to continue and to grow.

Furthermore, the banking industry had claimed that small banks and credit unions would be hurt by debit swipe reform - even though all institutions under $10 billion in assets were exempted from fee regulation.

As it turns out, small banks and credit unions have thrived since reform took effect.

Why? Because under my amendment, small banks and credit unions can continue to receive the same high interchange rates from Visa and MasterCard far higher than the rates that their big bank competitors receive.

In May, the Federal Reserve confirmed that exempted banks and credit unions were receiving the same average interchange rates they had gotten before reform.

The *American Banker* newspaper has noted that the ``Small Banks' Durbin Shield Worked'' and prominent card industry analyst Andrew Kahr noted that the ``Durbin Doomsday Never Came.''

Credit unions in particular are doing well after swipe reform. Last year 1.3 million Americans opened new credit union accounts, up from about 600,000 the year before. And credit unions now have a record number of members- almost 92 million overall.

Now, it is important to note that there should be even more savings from swipe fee reform to merchants and consumers.

When the Federal Reserve was writing its final rule, the banks lobbied them to weaken the final rule and raise the debit swipe cap from 12 to 24 cents. Then Visa and MasterCard promptly jacked up any swipe fee rates that were below 24 cents so that this 24 cent ceiling became a floor.

Basically, the banks and card companies lobbied the Fed for a loophole, and when they got one, they ran through it.

This needs to be fixed going forward, and I am confident it will be fixed. The bottom line, though, is that the swipe fee reform that Congress enacted in 2010 has gotten off to a good start.

It is working, and it is laying a solid foundation for further reforms to improve the credit and debit systems.

I am afraid, however, that while swipe fee reform has made important strides in Congress, the big banks and card companies are trying to undercut that reform in the courts.

Recently a proposed settlement was announced in a long-running class action lawsuit. This lawsuit had been filed back in 2005 by a number of merchants against Visa, MasterCard, and the big banks that issue most of their credit cards.

[continued on following page]

The lawsuit was over credit card interchange fees and the associated rules that Visa and MasterCard impose on merchants. The suit alleged that these fees and rules violate the antitrust laws in the way that they are set.

This lawsuit had the potential to bring about important changes to the credit card system that would have promoted transparency, enhanced competition, and helped consumers. But the proposed settlement does not do that. In fact, I believe this proposed settlement represents a capitulation to the Wall Street banks and credit card giants. It is a sweetheart deal for them and a bad deal for merchants and for consumers.

The settlement was negotiated in secret between Visa, MasterCard, the big banks, and the attorneys representing a small number of merchants. The vast majority of merchants had no idea what was in the proposed settlement until it was unveiled.

The terms of the settlement include a $6 billion dollar payout from Visa, MasterCard and the banks to the plaintiff merchants.

That is a large number it is nearly twice as much as the previous record payout in an antitrust case. And it is a clear sign that the card companies knew that their fees were unreasonably high.

But, $6 billion is only 2 months worth of credit card interchange fees. And the settlement does not prevent Visa and MasterCard from simply jacking up their fees even higher than before.

The settlement does nothing to change the anticompetitive fee-fixing that Visa and MasterCard do on behalf of their member banks.

In fact, it gives Visa and MasterCard broad and permanent legal immunity to continue doing exactly that in the future.

Also, the settlement not only binds the merchants who are parties to it, but it also binds every single American merchant, charity, university, and State or local agency that accepts a Visa or a MasterCard today or in the future.

It bars all of them from ever bringing a legal claim in the future against Visa, MasterCard, or the big banks relating to any swipe fee, other merchant fee, or network rule, no matter how unfair or unreasonable the fees or rules may be.

And this settlement gives Visa and MasterCard legal immunity not just for credit cards, but also for debit cards, and prepaid cards and mobile payment systems.

The extent of the free pass Visa and MasterCard would get under this proposed settlement is breathtaking. No wonder the banks and cards were so quick to come out in favor of this settlement. And no wonder Visa's stock hit an alltime high the next business day.

Now, the proposed settlement would make some temporary changes to Visa's and MasterCard's rules. But in my view, these proposed changes will be ineffective in reining in Visa and MasterCard's unreasonable fees.

The bottom line is that this proposed settlement does not make our credit card system better.

Instead, it gives Visa and MasterCard free reign to carry on their anticompetitive swipe fee system with no real constraints and no legal accountability to the millions of American businesses that are forced to pay their fees.

This is a stunning giveaway to Visa and MasterCard, all for a payout of a mere 2 months worth of swipe fees.

This is a bad deal, but it is not a done deal. The merchant plaintiffs still have to decide if they will support it, and the court must approve it.

Several plaintiffs - the National Association of Convenience Stores, the National Grocers Association and the National Community Pharmacists Association - have already rejected the deal.

Now, I am not a party to this lawsuit, but I care deeply about making the credit and debit card systems in this country more transparent, more competitive, and more fair.

I have worked hard over the years to make sure that merchants and consumers do not get nickled and dimed to death with hidden and unreasonable fees from Visa and MasterCard, and we have made great strides.

That is why I am speaking out about my concerns with this proposed settlement. I know that Visa, MasterCard, and the banks are thrilled with this settlement, but this is not a settlement I would agree to.

I hope that the remaining merchant plaintiffs will review the proposed settlement carefully and think hard about whether it will be good for the future of our credit and debit card systems. They should not be anxious to sign away that future and settle for a bad deal.

For-profit colleges have been targeted by both the Obama Education Department (ED) and the Democratically-led Senate HELP Committee. On July 30, Chairman Tom Harkin (D-IA) of that panel released a damning report detailing the findings of a two year investigation of the prop schools. But particularly after another steep slide for the industry in the wake of July 26 earnings misses from **Strayer (STRA)** and **ITT Education Services Inc (ESI)**, the committee print,"For Profit Higher Education: The Failure to Safeguard the Federal Investment and Ensure Student Success," seemed to provoke little incremental fear.

Allegations that career colleges represent 10 percent of enrollments yet suck up far more federal aid while generating disproportionate student defaults (as Harkin would say, "debt without a degree") have been repeated so many times as to seem rote. A new attack line based on alleged gaming of the 90/10 rule and preying upon military personnel have kept companies on the defensive. The industry's response is that it serves higher-risk, non-traditional students, including minorities, soldiers, and transitioning part-time adults - and that measured against community colleges with similar cohorts it stacks up well. As for their higher costs, company officials add that public school tuition is heavily subsidized with taxpayer dollars - so the price of diversity and increased flexibility (brought on via online and non-traditional course offerings) is understandable.

Regardless, the group had been abandoned as all but "uninvestible" in 2010, as the Obama White House, beginning in 2009, had let reformers surgically attack the for-profit industry in the context of novel regulatory rulemaking that sought to use repayment rates and debt-to-income ratios to measure educational outcomes of the schools' graduates. Interest returned after spring 2010 moderation of these "Gainful Employment" rules and the partial political realignment from Republicans' House takeover that November - helping at one point to spur a 50% move off the bottom for industry leader **Apollo (APOL)**. But the window then closed again last February: Shares of APOL, **Devry (DV)**, **Capella (CPLA)** and other "quality" names have since sunk back to new lows, and the group, even before the 7/26 falloff, was selling at 9 times consensus 2012 earnings (9.5 x 2013), down 27% year to date, compared to 12.5x and +6.4% for the S&P.

Why Red? Excessive Disdain + Political Realignment = Sentiment Shift

As we wrote on July 25, this is a sector whose fast and unimpeded growth had been fetching multiples two and half times higher when Obama was inaugurated. They clearly aren't going back to those heady days, and the cyclical reregulation begun in 2009 has given way to something more secular. But there just might be excessive disdain in the air, and things could get better as companies adjust to tough new recruiting restrictions, the reputational hit from critics' assaults, and rules restricting their reliance on federal aid. As evidence of perhaps better days ahead, a federal district court struck down core (enforcement-related) elements of the Gainful Employment rules on July 10, while Romney has pledged to repeal the new reg and has spoken positively of the industry on the campaign stump.

Even if Harkin's report *had* brought something besides a fresh recapsulization of what critics find wrong with the industry - which we find doubtful despite chatter re DOJ referrals - it will likely represent, in any event, a final blow in the reformers' three-year-old jihad against the for-profit colleges. And a potential bottoming in sentiment or valuation this summer or fall - somewhat similar to the one that emerged in late 2010 - could thus set the stage for the election outcome as a catalyst.

Republicans have long been more supportive of the for-profit industry and "distance education. Meanwhile, the GOP contingent on Senate HELP has bristled as Harkin, through six hearings, has surgically attacked educational outcomes, costs and default rates at for-profit schools, representing one in ten enrollments, while giving a free pass to public and private non-profit universities and community colleges. All while a related education debt "bubble" has continued to grow on Obama's watch. Conservatives in both chambers have threatened to extend the "outcomes" scrutiny to the rest of the educational community, which we would expect to give them leverage during Higher Education Act (HEA) reauthorization deliberations set to begin in 2013 - putting the politically-powerful and Dem-shielded traditional four-year schools (aka the "One Dupont Circle" crowd) on the defensive and thus garnering leverage to perhaps play offense in an effort to constructively rewrite the 90-10 rule, using a different and perhaps broader set of metrics.

Capital Alpha's Bottom Line

Should Romney win the presidency and Republicans retake the Senate, both the backdrop and outlook for the industry would change markedly, and we would expect sentiment to gradually improve. [Some have argued that budget conscious GOP lawmakers might whack Pell grant funding, which is the mother's milk of the career colleges - but a recent House appropriations bill actually hiking the maximum grant belies this theme.] Should Obama win reelection, by contrast, also helping to retain a Democratic Senate, the prop schools might look forward to at least a stabilizing risk outlook anyway.

Defense Remains a Jobs Issue - *Byron Callan*

Defense continues to be a tertiary issue in the 2012 election. Mitt Romney's trip to Israel, and then Defense Secretary Leon Panetta's trip to Israel (and Egypt and Tunisia) briefly resurfaced Iran and its nuclear program as a talking point. But national security is far down the list of concerns on voters' minds and that's not unusual in most election years. But that doesn't mean this election is defense-free. On the contrary, August-October should see a couple of issues that will impact defense stock sentiment with the Nov. 6 election a gate from which there are several different paths for the sector.

In most recent meetings with investors when we say the word "defense," they say "sequestration." Sequestration and the risk of deep, chaotic DoD budget cuts remains the single most important risk for the sector. We too are of the view that there will be some sort of post-election deal to postpone its implementation on January 2, 2013 if not just because of the impact on the DoD, but also because of the mayhem it could unleash with cuts to non-defense discretionary spending. While defense cuts have dominated talk surrounding sequestration, there has been more discussion in the past month on sequestration's impact on air traffic control, border control, local school budgets and delivery of other government services. These potential cuts seem abstract for now, with 147 days to go until sequestration is implemented under current law, but we are certain that there will be far more detailed discussion of the impact of these reductions on the daily lives of Americans in 2013.

That said, we still believe that sequestration is not discounted by defense stocks and is certainly not reflected in consensus sell-side earnings estimates. The risk for defense stocks remains that depending on the outcome of the November 6 election, institutional investors may not want go for another ride along Brinkmanship Cliff - not in mid-late December when portfolio performance is being locked in for the year and liquidity - in terms of the volume of shares traded - makes it difficult to reduce positions without unduly affecting the stock price.

Defense jobs are the main pre-election issue for the sector, barring a geopolitical event. The late July guidance letter issued by the Dept. of Labor that WARN Act notices would be inappropriate given the uncertainty of sequestration may have temporarily dissuaded some companies for issuing such notices this October in New York and California, which require 90-day notices and in November just before the election when the 60-day rule kicks in for other states and the federal government. However, both the House and Senate passed the "Sequestration Transparency Act of 2012" and assuming President Obama signs it this week or next, in early September, a report will be delivered to Congress detailing how sequestration will be implemented. That report could conceivably provide more detail to enable where job cuts could fall as the law now stands.

For swing states such as Virginia, Colorado, Ohio and Florida where defense spending is higher on a per capita basis than the national average, job losses under sequestration could become a greater issue. We don't know at this point if Republicans or Democrats can use this issue to their advantage. An August 1 HASC (House Armed Services Committee) hearing on sequestration was a microcosm of how a campaign debate could play out. OMB Acting Director Jeffrey Zients, who was a witness at the hearing, blamed Republicans for their opposition to tax increases as the reason why sequestration was unresolved. Republican members pushed back with their own views on tax increases and their impact on the economy and that President Obama had signed the Budget Control Act after it was passed by the House and Senate. We think prospects for a pre-election compromise that defuses sequestration as the law now stands are nil.

Defense spending could still get whacked by sequestration
Source: iStockphoto

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With the completion of the new Highway Bill, it seems likely that the next bill, in the 2014-2015 timeframe, will build on the direction of this one. Republicans seem inclined to accept current spending levels with offsets from other parts of the federal budget, though under the scenario of a large GOP win, that could be challenged. Meanwhile, they seem inclined to pursue a tax and regulatory reform agenda that would be helpful to companies operating in relevant industries.

Should Democrats emerge victorious in November, however, we would not expect a significant spending increase, but the pace of policy reforms would grind to a halt. That puts relevant companies in our Red-for-Republican Stocks category for this cycle.

A recent tax initiative in Georgia rejected by nine of twelve jurisdictions strengthens our view that new tax revenue is not likely to make a significant contribution to transportation spending. We see spending on a flat-to-down trajectory.

However, regulatory reform and increased tolling at all levels of government could more than offset revenue challenges. We believe transportation finance is likely to move in these directions. The net would be a slight positive for relevant companies like **CAT**, **MLM**, and **VMC**.

Republicans in particular will be aggressive in proposing reforms. These could include labor reforms such as the Davis-Bacon prevailing wage law. Transit funding could also be targeted. While neither idea is likely to pass in 2014 or 2015 – when the next Highway Bill should be negotiated – compromise steps could be taken.

We also think tolling could be a more feasible revenue answer. Ultimately, if the question is one of trust, legislators could attempt to address this by the merits of transparency and direct financing. Tolling could allow for more direct tracking, but voter perceptions of politicians willing to make off with the money for their own projects remains an obstacle. Having projects managed on an individual basis, however, either via privatization or by a localized government structure, is a solution we expect to be advanced.

A Vehicle Miles Traveled tax, or VMT (also known as a Mileage-Based User Fee system) faces long odds. Most voters react viscerally to the concept, however distorted, of the government tracking their cars. This sentiment is unlikely to change in the current decade.

The renewed focus on public-private partnerships in the new Highway Bill could be significant as well, particularly the expanded TIFIA grants. A more derived effect was Congress' decision to reject the Bingaman Amendment. That would have closed off certain PPP types from eligibility. Specifically, it would have penalized states for privatizing or leasing roadways.

If spending stays close to current levels and regulations are loosened, it could be a win
Source: iStockphoto

Near-Term

	6/8/2012	6/27/2012	7/4/2012	7/11/2012	7/18/2012	7/25/2012	8/1/2012	8/6/2012
Obama	314	314	314	332	303	332	332	332
Romney	224	224	224	206	235	206	206	206

Medium-Term

	6/8/2012	6/27/2012	7/4/2012	7/11/2012	7/18/2012	7/25/2012	8/1/2012	8/6/2012
Obama	343	314	328	328	332	332	332	332
Romney	195	244	210	210	206	206	206	206

PCI

	6/8/2012	6/27/2012	7/4/2012	7/11/2012	7/18/2012	7/25/2012	8/1/2012	8/6/2012
Obama	332	332	332	332	303	332	332	332
Romney	206	206	206	206	235	206	206	206

How We Derive the PCI

Step 1: Calculate candidates' sub-totals in each of the 13 battleground states, based on the following weightings:

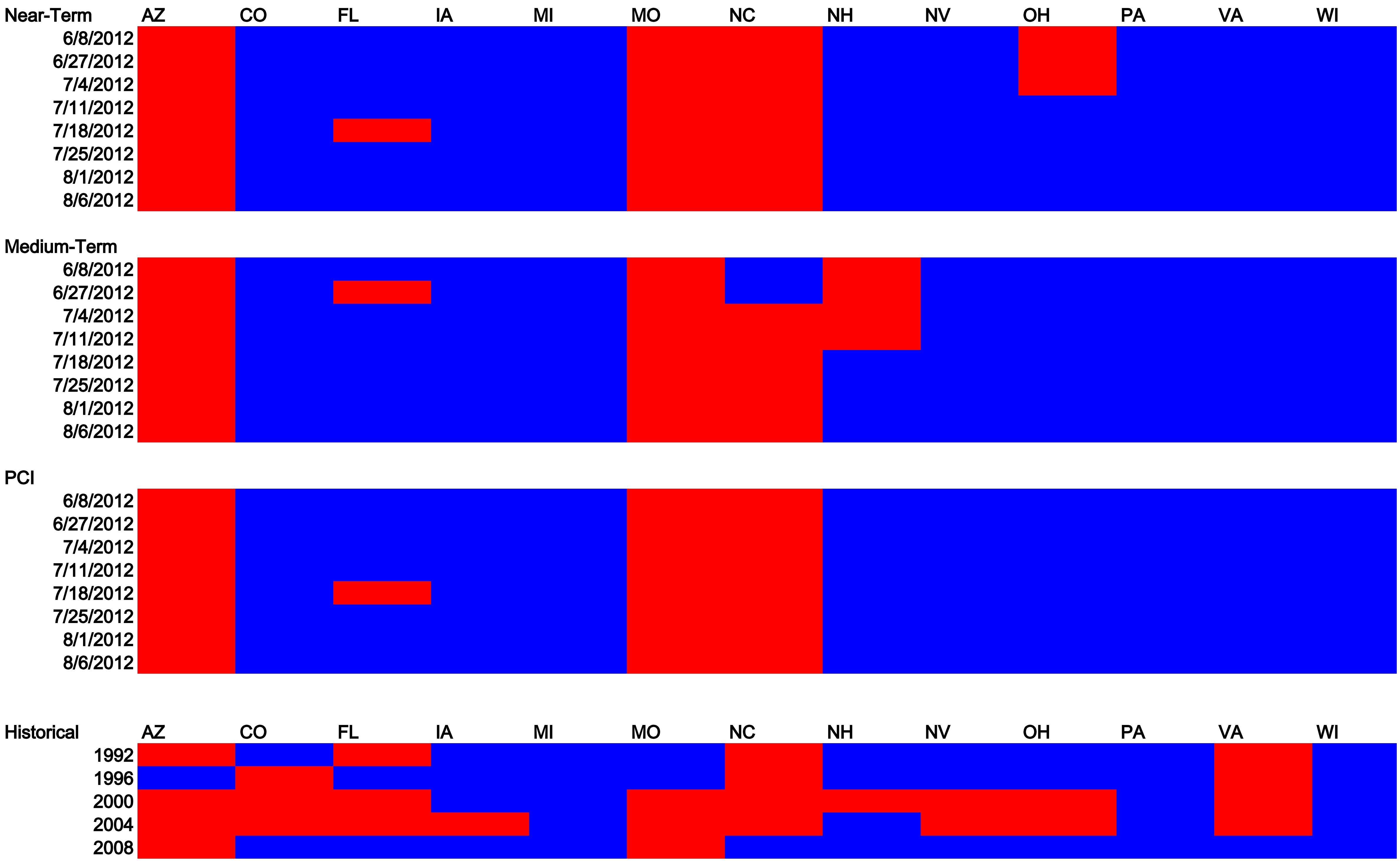
- 30%: Near-term Index (Last three polls: 10 percentage points for each lead; discounted 50% if averaging below 3%).
- 35%: Medium-term Index (Last ten polls: 3.5 percentage points for each lead; discounted 50% if averaging below 3%).
- 15%: 2008 Election (15 percentage points based on whether the state went red or blue in 2008 presidential race).
- 10%: Last Five Elections (2 percentage points for each time the state voted for the nominee of the candidate's party).
- 10%: Unemployment Factor (award to Obama or Romney based on whether each battleground state is above or below the national average of 8.2%).

Step 2: Award battleground-state electoral votes (EVs) on a winner-take-all basis to the candidate achieving the highest subtotal.

Step 3: Add EVs from uncontested red and blue states (e.g. 201 EVs for Obama, 170 for Romney).

Step 4: Sum to arrive at PCI totals.

Presidential Choice Indicator: Battleground Momentum Matrix



There are a number of factors that traditionally feed into how a running mate is selected. These include whether the individual hails from a key state, or has some perceived tactical advantage due to physical qualities like youth, ethnicity, or gender. The running mate may be chosen to add some quality - ideological or personality-wise - felt to be underemphasized by the presidential candidate. The particular status of the presidential candidate's campaign - whether leading in the polls, trailing, or locked in a tight race - may also influence the decision. If Mitt Romney appears comfortably ahead in August, he may be more likely to pick a "safe" choice such as Portman. If Romney is trailing significantly, a bolder pick is likelier, such as Ryan, or even one of the darkhorses, such as Sen. Rand Paul (R-KY). If the race is extremely close, Jindal might get the closest look.

Should Romney's choice not reflect the matrix at right with respect to whatever the consensus state of the race happens to be at that time, it could be a *tell*. That is to say, it could be an indication of where the campaign either believes the race truly is or truly will be by late October.

If Romney...	**...is trailing Obama significantly**	**...is clearly leading Obama**	**...is essentially deadlocked with Obama**
These options might be enhanced	Paul Ryan; Marco Rubio; Chris Christie; Rand Paul	Rob Portman; Bob McDonnell; John Thune; Tim Pawlenty	Bobby Jindal; Kelly Ayotte
Tactical reasoning	Romney will be seeking a spark, even if it means a riskier and/or more ideological choice.	Romney will be seeking a safe, almost boring option that minimizes the risk of any stumbles.	Romney will be seeking an option that can bring a spark without creating a major risk.

Credibility encompasses both the candidate's resume - is this someone with relevant experience? - and general air of competence or charisma. Can voters visualize this person serving as commander-in-chief?

Do No Harm covers whether a candidate is gaffe-prone, vulnerable to scandal, or in general is disciplined enough to be Mitt Romney's sidekick. This is always an important factor in the VP selection process, but perhaps moreso than usual, given Romney's reputation for risk-aversion.

Activation of Conservatives is important to generate the volunteer army Romney will need to compete with President Obama in door-knocking, literature distribution, and other get-out-the-vote (GOTV) efforts necessary in political campaigns.

Appeal to Political Independents is important to win the battle over the ~10% of the electorate that remains persuadable. The election itself will most likely be decided by a few percentage points, meaning that those voters hold the key to victory.

...And How the Choices Stack Up

Rob Portman scores well in the first two categories, but would not excite conservatives and is not well-known or charismatic enough to make a difference with political independents. On the other hand, **Marco Rubio** is beloved by conservatives and could hold significant popular appeal, but represents a challenge both on credibility (due to his youth and inexperience) and potentially on Do No Harm, due to a lack of vetting.

Paul Ryan has a middling level of credibility - as a youngish congressman, he doesn't fit the prototype of a VP selection, but his position of leadership within the House and national profile helps. On both Do No Harm and independents, Ryan is also mid-tier. As a scandal-free, photogenic policy wonk, Ryan is appealing. However, the sharp fiscal medicine in his budget blueprint will be used by Democrats to savage Romney. But conservatives would be thrilled to have Ryan on the ticket.

Bobby Jindal scores well in all four categories, owing to his 4.5-year record as governor and status as the first Indian-American politician at the higher levels of U.S. politics, but is weakened by a poorly-delivered, nationally-televised speech in 2009, and his age and charisma.

John Thune could be a safe pick particularly with independents, but his long track record as a legislator and limited appeal to conservatives make him a mixed choice.

Chris Christie would be a bold gamble by the Romney campaign - assuming they could lure Christie out of New Jersey. Some conservatives might have heartburn, but the real risk would be a misstep by Christie during one of his famous press conferences. **Rand Paul** is an even more high-risk, high-reward option that could supercharge the Romney turnout effort or backfire completely.

Tim Pawlenty and **Bob McDonnell** are safe, credible choices that run into trouble with their ability to generate enthusiasm. The otherwise-likable Pawlenty was never able to create a spark during his own brief run for the Presidency; McDonnell would be an extra helping of vanilla.

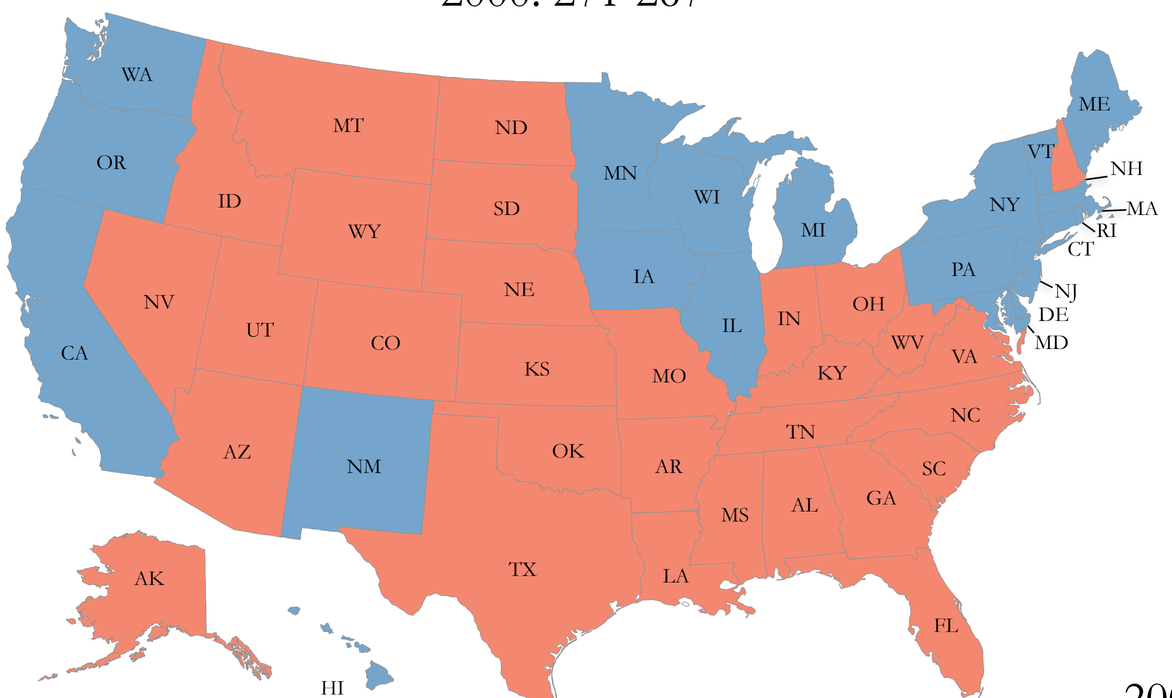
Kelly Ayotte, **Susana Martinez**, and **Nikki Haley** have potentially bright futures on the GOP's national scene, particularly given the party's struggles among women. However, all were first elected to major office in 2010, and could prompt criticism over their relative lack of experience.

Jeb Bush, **Mitch Daniels**, **Mike Huckabee**, and **Condoleezza Rice** are frequently mentioned, but Bush and Daniels seem strongly opposed, Huckabee would be a gamble, and Rice's pro-choice stance on abortion would appear to rule her out.

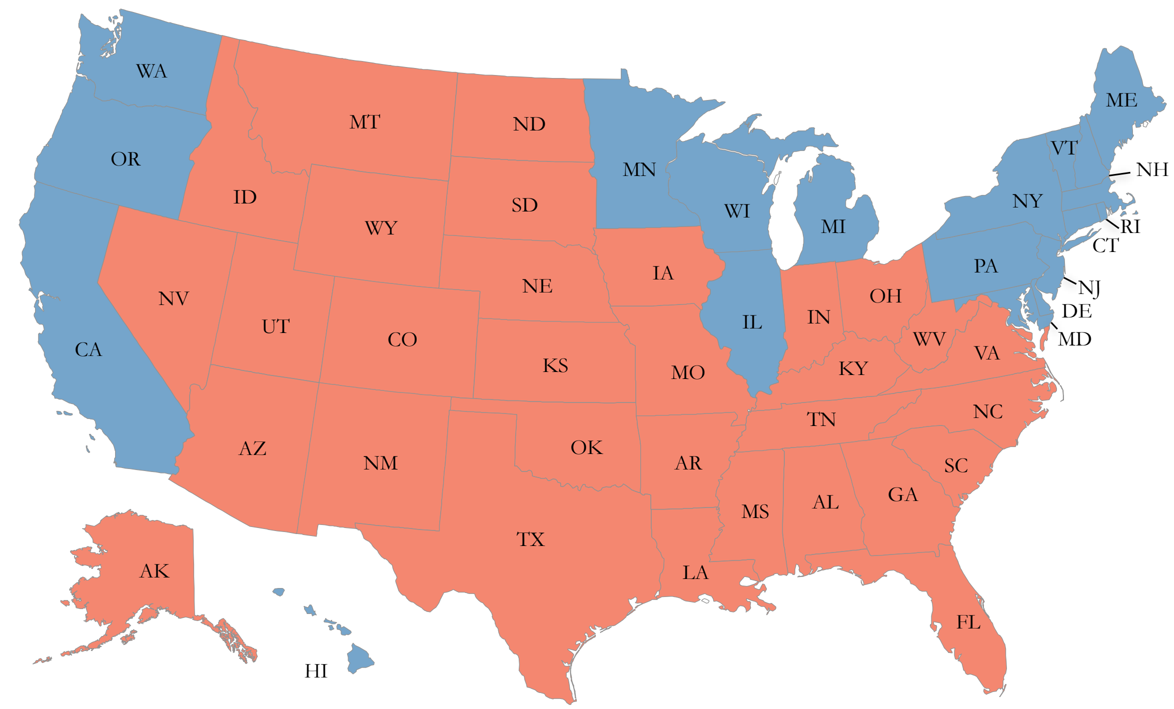
Needed for Victory: 270

Rovian Matrix*: Having gained a net six seats via apportionment following the 2010 census, Romney or another Republican candidate needs to win back states yielding a net 91 electoral votes in order to reach the 270-vote threshold and beat Barack Obama. Simply winning back Virginia, North Carolina, Florida, Indiana, and Ohio - all of which have gone Republican two of the last three elections - will perch them within a handful of their goal, making victory possible in states as unlikely as New Hampshire, Iowa or Nevada.

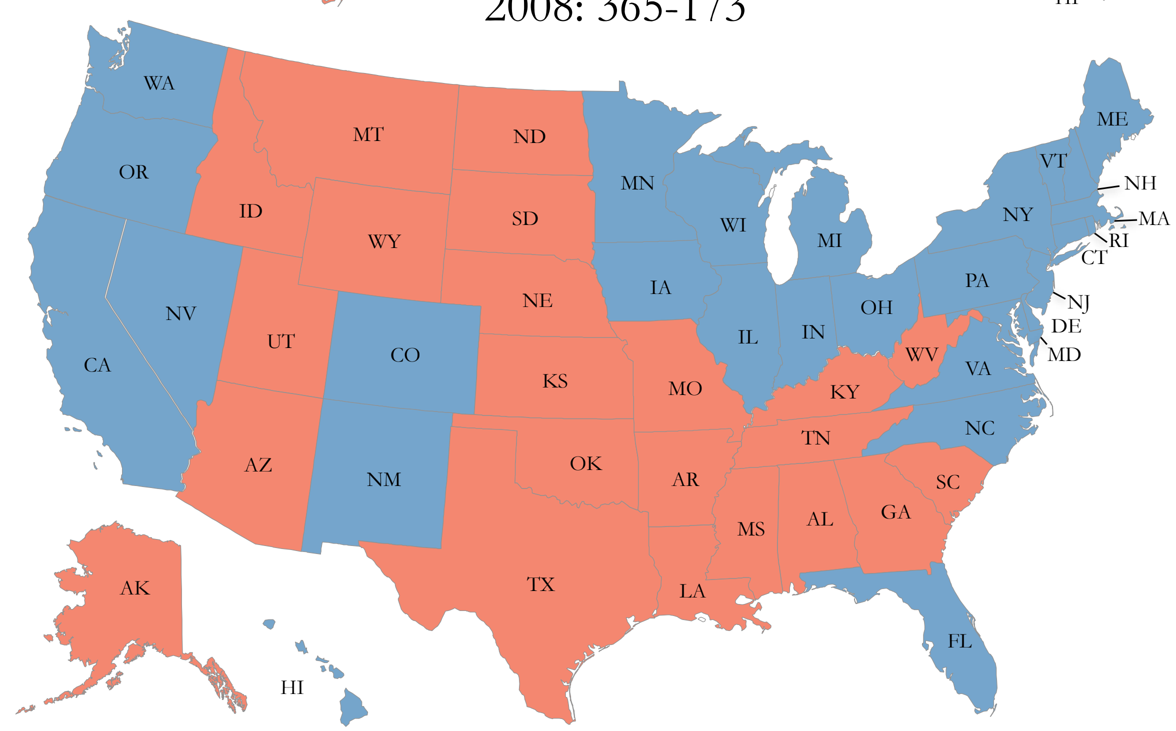
2000: 271-267



2004: 286-252



2008: 365-173



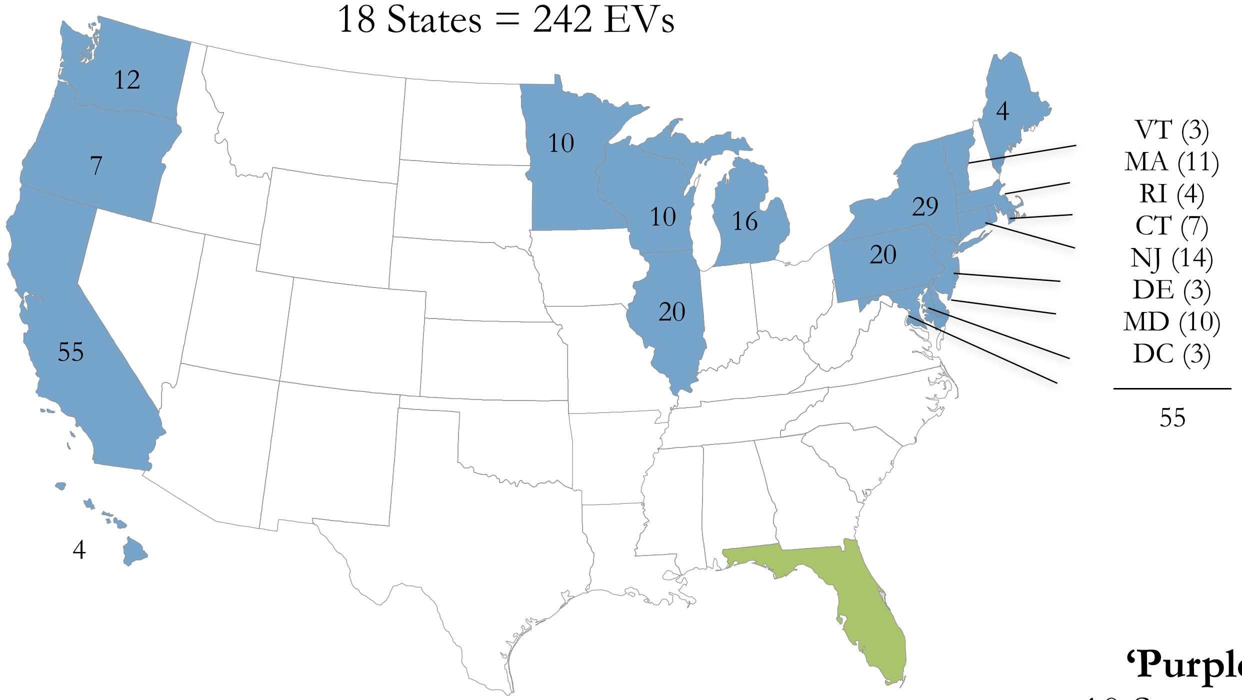
*This largely embodies the political calculus of former George W. Bush strategist and advisor Karl Rove.

538 Total; 270 Needed for Victory

"Blue Wall / Red Fence" Theory*: Democrats have won eighteen states in each of the last five presidential elections, producing a "blue wall" of 242 electoral votes on which to build the 270 vote majority needed to retain the White House. Republicans, over the same period, have erected a "red fence" of 22 states, producing 180 EVs. The net of this divide means that President Obama needs only win a combination of states producing as few as 28 EVs from among the 10 "purple" battleground states which have had mixed results since 1992. Republicans have won at least 3 out of 5 races in NC (15), VA (13), FL (29), AZ (11), and CO (9) but Democrats have had an edge in IA (6), NM (5), NV (6), OH (18) and NH (4).

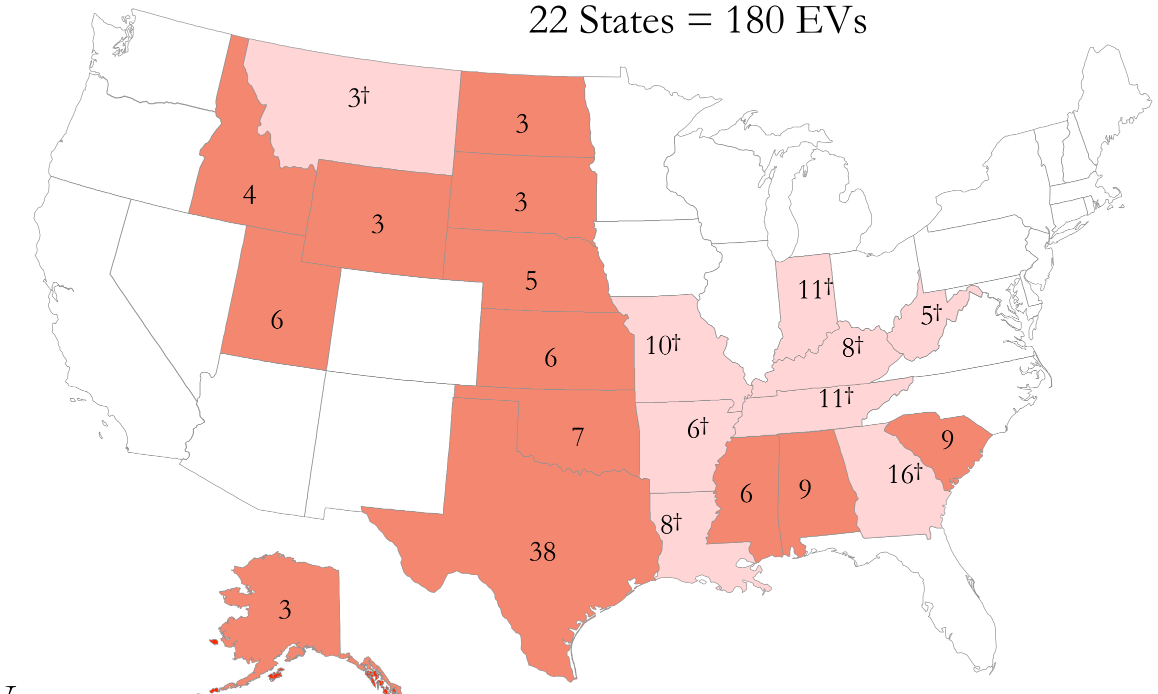
'Blue Wall'

18 States = 242 EVs



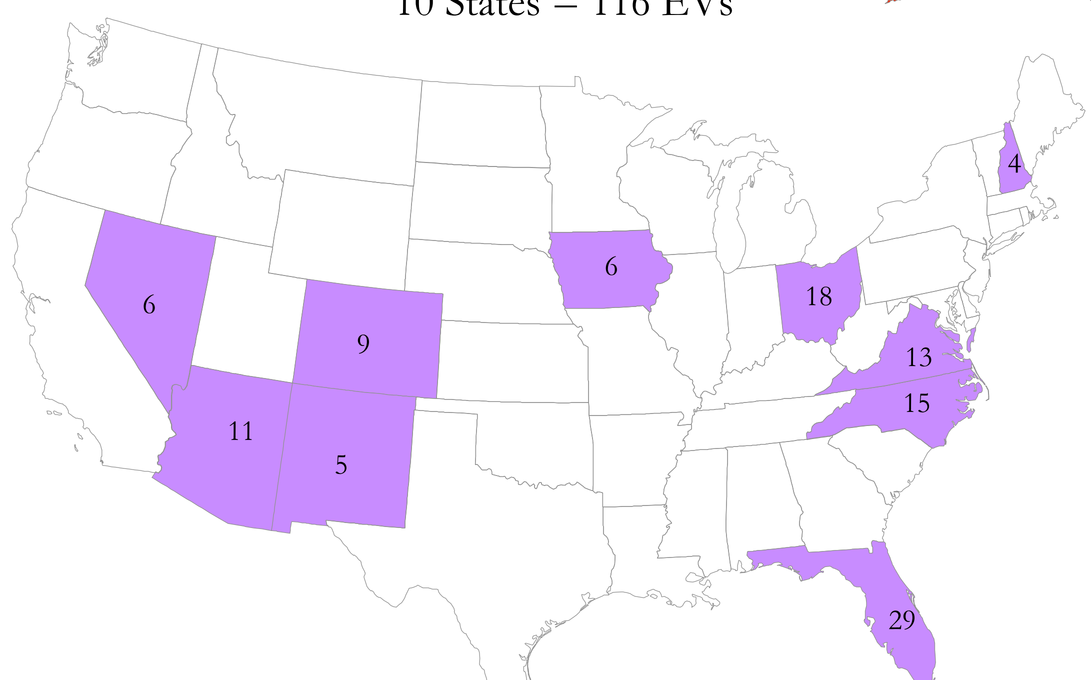
'Red Fence'

22 States = 180 EVs



'Purple Maze'

10 States = 116 EVs



Obama Defends

- Colorado (9)
- Florida (29)
- Iowa (6)
- Nevada (6)
- New Hampshire (4)
- New Mexico (5)
- North Carolina (15)
- Ohio (18)
- Virginia (13)
- Pennsylvania (20)
- Michigan (16)
- Wisconsin (10)

Total Votes: 151**

Republicans Defend

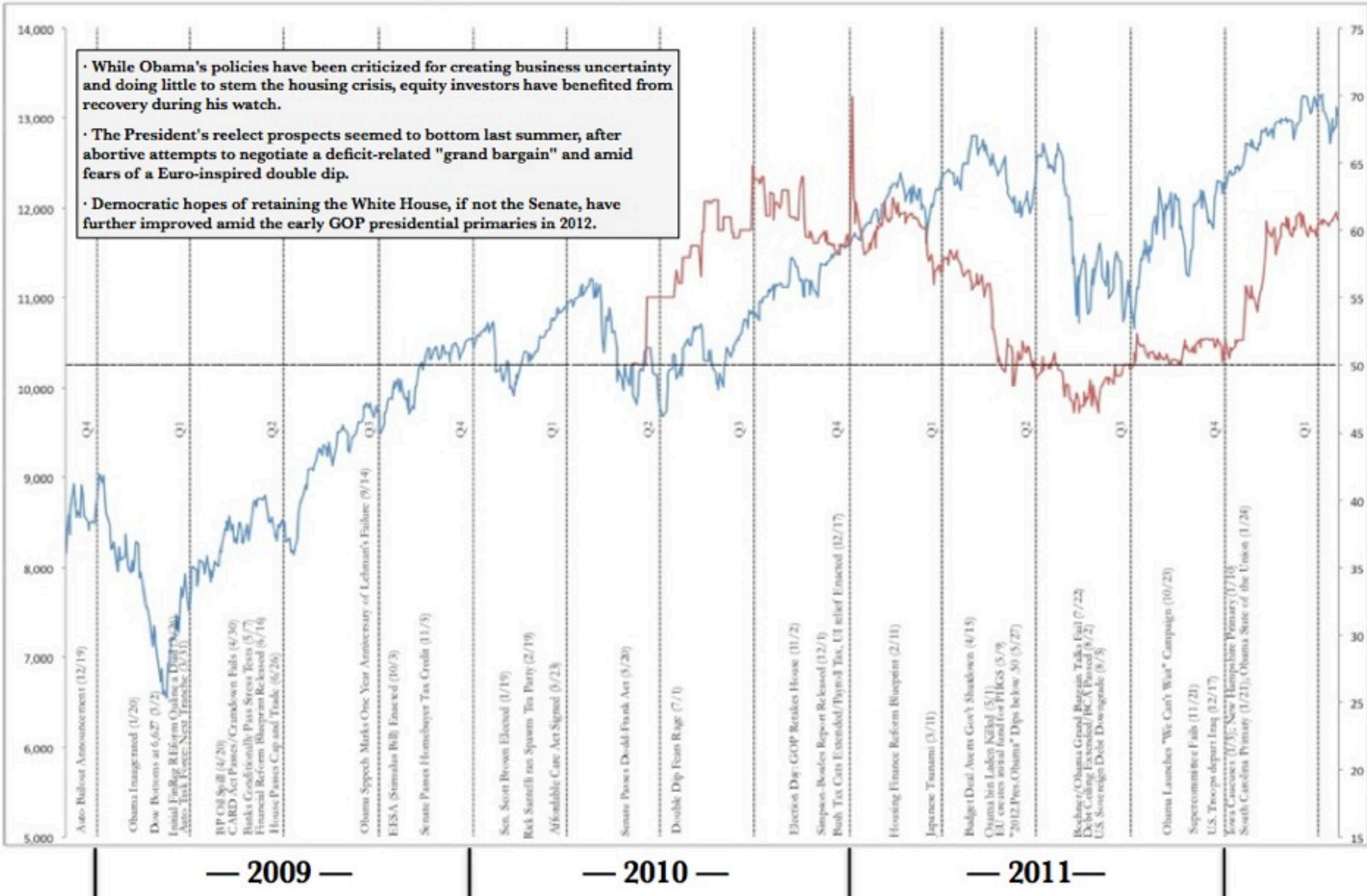
- Arizona (11)

*Ron Brownstein of the *National Journal* has been credited with coining this phrase, which has also become embedded in election analysis from AEI.

† Mixed results in last five elections but leaning Republican and not viewed competitive (78 total).

Obama's First Three Years

From Hope, to Peril, to a 60% Gain on the Dow



The Presidential Race in 2012: Where We Stand

Odds for President Obama to be Reelected: 55%; Electoral College Projection: 241 R, 297 D

	Likely Democrat 60-80%	Leaning Democrat 51-60%	Leaning Republican 51-60%	Likely Republican 60-80%
States carried by Obama in 2008	Delaware (3) Maine (4)[1] Minnesota (10) New Jersey (14) Oregon (7) Washington (12)	Colorado (9) Michigan (16) New Hampshire (4) New Mexico (5) Nevada (6) Ohio (18) Pennsylvania (20) Virginia (13) Wisconsin (10)	Florida (29) Indiana (11) Iowa (6)	North Carolina (15) Nebraska's 2nd CD (1)[1]
States carried by McCain in 2008			Arizona (11)	Missouri (10)

Source: Capital Alpha estimates

Currently safe Democrat: CA (55), CT (7), DC (3), HI (4), IL (20), MA (11), MD (10), NY (29), RI (4), VT (3)
Currently safe Republican: AK (3), AL (9), AR (6), GA (16), ID (4), KS (6), KY (8), LA (8), MS (6), MT (3), ND (3), NE (4)[1], OK (7), SC (9), SD (3), TN (11), TX (38), UT (6), WV (5), WY (3)

2008 result, adjusted for reapportionment: 359 D, 179 R. (As a result of the 2010 census, states that supported Barack Obama in 2008 lost a net of six electoral college votes to the other states.)

Numbers in parentheses indicate electoral college vote value.

[1]Maine and Nebraska divide their electoral college votes by congressional district, with the statewide winner getting two additional votes

2012 Senate Outlook: GOP Net +3

Capital Alpha Partners LLC

Seats at Stake: 23 D[1]; 10 R

	Likely Democrat 60-80%	Leaning Democrat 51-60%	Leaning Republican 51-60%	Likely Republican 60-80%
Seats Now Held by Democrats	**Connecticut** Joe Lieberman[1,2] **Minnesota** Amy Klobuchar **New Jersey** Bob Menendez **Washington** Maria Cantwell	**Florida** Bill Nelson **Hawaii** Daniel Akaka[2] **Michigan** Debbie Stabenow **New Mexico** Jeff Bingaman[2] **Ohio** Sherrod Brown **Pennsylvania** Bob Casey **West Virginia** Joe Manchin **Wisconsin** Herb Kohl[2] **Virginia** Jim Webb[2]	**Missouri** Claire McCaskill **Montana** Jon Tester **North Dakota** Kent Conrad[2]	**Nebraska** Ben Nelson[2]
Seats Now Held by Republicans		**Maine** Olympia Snowe[1,2] **Massachusetts** Scott Brown	**Nevada** Dean Heller **Indiana** Dick Lugar[3]	**Arizona** Jon Kyl[2] **Texas** Kay Bailey Hutchison[2]

Source: Capital Alpha estimates

Currently safe Democrat: CA, DE, MD, NY, RI, VT[1]
Currently safe Republican: MS, TN, WY, UT
[1] Sens. Joe Lieberman (CT) and Bernie Sanders (VT) campaigned as Independents, but caucus as Democrats; they are counted here as Democrats. In Maine, former Gov. Angus King, an independent, is likewise expected to caucus as a Democrat, should he be elected.
[2] Retiring.
[3] Defeated in primary.

2012 Gubernatorial Outlook: GOP Net +1

Capital Alpha Partners LLC

Current Distribution: 20 D, 29 R, 1 I[1]

	Likely Democrat 60-80%	Leaning Democrat 51-60%	Leaning Republican 51-60%	Likely Republican 60-80%
Seats Now Held by Democrats	**Delaware** Jack Markell **Vermont** Peter Shumlin	**Washington** Christine Gregoire[2] **Missouri** Jay Nixon	**Montana** Brian Schweitzer[2] **New Hampshire** John Lynch[2] **West Virginia** Earl Ray Tomblin	**North Carolina** Beverly Perdue[2]
Seats Now Held by Republicans			**Indiana** Mitch Daniels[2]	

Source: Capital Alpha estimates

Currently safe Democrat: None
Currently safe Republican: ND, UT
[1] Lincoln Chafee of Rhode Island
[2] Retiring.

Early 2014 Senate Outlook: GOP + 3

Seats at Stake: 20 D; 13 R

	Likely Democrat 60-80%	Leaning Democrat 51-60%	Leaning Republican 51-60%	Likely Republican 60-80%
Seats Now Held by Democrats	**Delaware** Chris Coons **Iowa** Tom Harkin **Michigan** Carl Levin **Minnesota** Al Franken **New Hampshire** Jeanne Shaheen **New Jersey** Frank Lautenberg **New Mexico** Tom Udall **Virginia** Mark Warner	**Arkansas** Mark Pryor **Colorado** Mark Udall **Louisiana** Mary Landrieu **Montana** Max Baucus **North Carolina** Kay Hagan **South Dakota** Tim Johnson **West Virginia** Jay Rockefeller	**Alaska** Mark Begich	
Seats Now Held by Republicans			**Maine** Susan Collins	**Kentucky** Mitch McConnell **Tennessee** Lamar Alexander **Texas** John Cornyn

Source: Capital Alpha estimates

Currently safe Democrat: IL, MA, OR, RI
Currently safe Republican: AL, GA, ID, KS, MS, NE, OK, SC, WY

Seats at Stake: 10 D; 24 R

	Likely Democrat 60-80%	Leaning Democrat 51-60%	Leaning Republican 51-60%	Likely Republican 60-80%
Seats Now Held by Democrats	**California** Barbara Boxer **Washington** Patty Murray	**Colorado** Michael Bennet **Nevada** Harry Reid		
Seats Now Held by Republicans			Illinois **Mark Kirk** New Hampshire **Kelly Ayotte** Pennsylvania **Pat Toomey** Wisconsin **Ron Johnson**	**Arizona** John McCain **Florida** Marco Rubio **Kentucky** Rand Paul **Indiana** Dan Coats **Iowa** Chuck Grassley **Missouri** Roy Blunt **North Carolina** Richard Burr **Ohio** Rob Portman

Source: Capital Alpha estimates

Currently safe Democrat: CT, HI, MD, NY, OR, VT
Currently safe Republican: AK, AL, AR, GA, ID, KS, LA, ND, OK, SC, SD, UT

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