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2014 Policy Preview Call:
A Sanguine Election-Year Backdrop in Washington

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Major Topics

- 2014 midterm elections
- Need to extend the debt ceiling
- Festering next news on Obamacare
- Doc Fee Fix By Spring
- Still-low odds of immigration reform
- Farm Bill passage
- Emerging defense spending clarity
- Crude oil exports
- Tax extenders and reform
- Trade pact prospects
- Last-mile Dodd-Frank/Basel banking regs
- An imminent shift in housing finance policy

Highlights

As discussed during a Thursday, January 7, year-ahead policy preview call [mp3 replay available here], Capital Alpha sees a host of reasons why Washington should prove a benign-to-positive factor for U.S. equity markets in 2014. Broadly, these include continuingly supportive monetary policy as the Yellen era begins; increasing clarity on post-crisis banking regulation, which should gradually mitigate adverse credit conditions in the mortgage markets and otherwise lock in an acceptable if sub-optimizing new normal for large banks; a non-threatening election cycle; and an improving fiscal picture (i.e., with reduced drag from spending cuts and little suspense likely as Congress extends the debt ceiling by the end of the first quarter). Charles Gabriel's lead-off comments on these issues are at bottom, following our 2014 Policy Event Timeline.

Early on, we see limited prospects for omnibus appropriations legislation (in January) or an early-spring debt limit extension to produce worrisome headlines or suspense. Indeed, with 2014's threatened sequester and funding caps eased by December's budget deal, a bigger question may surround prospects for the debt ceiling bill to become an election-year Christmas tree (e.g., with restored emergency unemployment benefits attached). Perhaps most importantly, benign passage through this year's fiscal straits may signal to international investors that America's austerity wave, for now, has crested.

With November's elections coloring virtually everything investors will hear and see from Washington, we see several advantages for the Republicans - most notably, math, history and Obamacare - particularly in the Senate, where they face 40% odds of winning majority control. Along the way, Democrats will seek to counter by forcing votes on minimum wage and emergency unemployment benefits legislation, casting a likely-resistant GOP as insensitive to income inequality. With Republicans' already having sought to redress earlier-shutdown-related vulnerabilities by suing for peace in December's two-year Ryan-Murray budget deal, we suspect this Democratic strategy may succeed modestly in energizing its base but otherwise fall short of shielding the party from losses in both chambers. This could prove somewhat positive, incrementally, for "red stocks" in the for-profit college, energy and financial sectors (among others), but perhaps not materially so unless Republicans match the typical six-seat gain won by other opposition parties during the sixth year of a two-term presidency controlled by the other side.

Kim Monk continues to cast a wary eye on Obamacare - and there could yet be a day of reckoning for exposed managed care companies. This despite the administration's recently-more-positive spin re the Healthcare.gov website and ACA enrollment numbers. House Republicans are primed to highlight victims who have fallen through the cracks, as well as data and transparency issues. Though steadily improving enrollment could shield the program from open enrollment extensions, a focus on delaying the individual mandate will persist, particularly as we approach tax filing season. Coming next will be a spring focus on whether or not the exchange risk pools have enrolled enough healthy people (sparking or dousing concerns regarding risk pool "death spirals," 2015 rate spikes, or talk of plan bailouts).

Then will come potentially tumultuous fall implementation of the employer mandate. Though the administration delayed the open enrollment period for employers (creating a fairness issue, as others weren't similarly given relief), companies will start receiving their renewal and cancellation notices in October, sparking anger ahead of the elections. Despite nervousness among in-cycle Democrats, however, any changes will likely be implemented by regulatory agencies, rather than legislated. Meanwhile, the managed care industry, and particularly those most tethered to the fate of ACA (e.g., WLP), seem unlikely to get much relief if things go south.

Elsewhere on the healthcare front, Congress is diligently pursuing a permanent "doc fee" fix, but odds of SGR reform passage remain 45% at best, due to the heavy lift of finding $116-$150 billion in ten-year cost offsets. Even a perhaps-more-likely short term patch (through the end of 2014) would require $13 billion in cost offsets, perhaps exposing post acute providers and hospitals to related cuts.

Jim Lucier sees no real prospect for significant changes in tax policy in 2014, but tumblers are falling in place to make tax reform "game on" early in the next administration (i.e., 2017). Meanwhile, bonus depreciation is gone and is not coming back; there will be no oil and gas tax increases; there is little or any risk of MLP tax changes; renewable energy tax credits are likely to be gone until the end of the year - not at all certain to come back; and other extenders, including the R&D tax credit, could possibly have to wait until a lame duck (mid-November) session to be addressed - and are also far from guaranteed, due to their $70 billion price tag.

We have become worried about Hill approval of trans-atlantic and pacific trade agreements nearing completion. Despite House and Senate agreement on how to move forward, there is key opposition from pro-labor Democrats and Tea Party Republicans - and a bill will have little hope unless the President first locks down Democratic votes for facilitating Trade Promotion Authority (TPA), the deal may not go through. Meanwhile, with particular sensitivity ahead of European Parliamentary elections in May, a deal needs to be wrapped up well before. Key signals may come in President Obama's willingness to devote political capital, possibly evidenced in the January 28 State of the Union (SOTU) address.

Crude Oil Exports Are Now in Hot Focus. While we were mostly talking scarcity and non-traditional energy sources as recently as five years ago, focus now is on an abundance of crude oil, with the U.S. to become the world's number one producer. A glut of sweet crude could plague domestic U.S. oil producers later this year, which could result in a widening price differential, a collapse in producer prices, bad news for gas and midstream transport, and an interesting situation for refiners. What had been a theoretical discussion in the past two or three years, is becoming an area where Congress is jumping in with both feet. In the meantime, however, the administration seems unlikely to move quickly.

Byron Callan Notes Imminent Granularity on DOD Budget Cuts, But a Mixed Bag, Overall, for the Defense Sector. Thanks to the December Ryan-Murray budget deal, clarity on the Defense Department's budget for the remaining nine months of FY 2014 finally seems set to emerge by mid-

January. While better than they could have been (w/o $20 billion in sequester relief from the budget deal), the numbers are still likely to produce investment opportunities, long and short. Meanwhile, spring and summer could reveal whether Congress, in reaction, aims for DOD cost savings, e.g., in a new focus on management compensation, commercial item contract issues, or contractor pensions. Along with a debate over the 2016-2019 defense spending outlook (based on the broader fiscal picture), this could potentially transform perceptions towards the industry. Separately, though geopolitics had little influence on defense stock valuations in 2013, events in Asia or a reversal of peace prospects in Iran could change that going forward.

Loren Smith predicts that the same factors that impeded movement on immigration reform will continue to block legislation in 2014, perhaps a continued relief to stakeholders in IT outsourcing companies. The key source of political frustration is how to structure the way border enforcement triggers legalization. Democrats want legalization up front, and don't want to spar with Republicans over hard metrics for border security; Republicans want certified security up front, along with a requirement that Congress come back for another legislated green light for broader reforms. We expect the impasse to last, despite recent focus on House Speaker Boehner's (R-OH) seemingly renewed interest in the issue.

Congress seems likely to pass a new five year Farm Bill reauthorization this month, or possibly February, with the result important for agriculture and machinery. Key supporters include farmers and companies such as ADM and Monsanto. Meanwhile, crop insurance could be disrupted as Congress proposes means testing for the first time ever. This could lead to a destabilization or complete privatization of crop insurance.

The House will hold a hearing on highway funding next week. The problem has been a broken funding model, as annual revenue from the federal gas tax has been less than authorized spending under enacted surface transportation bills. Nevertheless, spending is unlikely to be cut, so there be more borrowing from the Treasury. As for a notional increase in the gas tax, the delay in broader tax reform until 2017 is notably unhelpful.

We see a sobering addendum (for the GOP and would-be tax reformers) on the elections. As Loren also notes, Republicans may need to reach a 52-48 Senate majority this November in order to retain majority control (and leverage in writing tax legislation) after 2016, given that the election backdrop is likely to become more favorable for Democrats in that cycle.

Joe Engelhard notes the coming weekend rollout of final supplementary leverage ratio (SLR) proposals for large banks, one of the most important remaining elements of the Basel III reforms. We expect the international bank regulatory committee to moderate its initial proposal by, among other things, allowing greater netting for derivatives and securities financing transactions. There's also a good chance they will agree to lower the credit conversion factor for many off-balance-sheet assets. Additional moderation could come when U.S. regulators implement the rule, likely later in the second half of 2014.

Date	*Event*	*Sector*
Early January	Media leaks on FY 2015-19 Future Years Defense Plan (FYDP), reflecting revised budget caps subsequent to Murray-Ryan budget deal	Defense
January 6	House and Senate return	Macro
	Mel Watt sworn in as FHFA Director, supervising Fannie Mae and Freddie Mac	Mortgage/ Housing
	Senate cloture vote to begin consideration of unemployment benefits legislation	Macro
	Yellen confirmation vote	Fiscal/ Monetary
January 7	Sen. Lisa Murkowski (R-AK) expected white paper evaluating increased crude oil exports	Energy
January 10	CFPB's Qualified Mortgage (QM) Rule Takes Effect	Mortgage/ Housing
January 12	Basel Meeting - Clarity on Supplemental Leverage Ratio for Large Banks	Banks
January 15	Deadline for Passage of an FY 2014 Omnibus Appropriations	Fiscal/ Monetary
	DoD budget finalized	Defense
January 17	Oral Arguments in Fed's appeal of Judge Leon's merchant-friendly ruling against Durbin debit rules	Cards
Mid - Late January	Orderly Liquidation Authority (OLA) Rules expected from Fed	Banks
	Draft GSE reform bill expected to emerge in Senate Banking	Mortgage/ Housing
	Informal Farm Bill target	Agriculture
	Rep. Dave Camp (R-MI) could release comprehensive tax reform bill	Tax

	President Obama to nominate new FERC commissioner vice departing Chmn Wellinghoff	Energy
	State Department IG report on alleged conflict of interest in ERM Keystone XL Environmental Impact Statement	Energy
	Sens. Baucus and Hatch to introduce a Trade Promotion Authority bill; uphill chances might hinder prospects for a Trans-Atlantic Trade & Investment Treaty	Trade
Jan - March	Headlines regarding possibly negative ACA enrollment experiences	Healthcare
	Designation of auto lenders as "large participants" under the CFPB''s supervisory mandate, potentially triggering ANPR	Financials
January 22	The administration's first major wireless spectrum auction (10 MHz AWS H Block)	Wireless Telecom
January 28	State of the Union (SOTU) address	Macro
Mid-February	DC Federal Judge to rule on whether ACA subsidies can flow through state exchanges in *Helbig vs. Sebelius*	Healthcare
	Keystone XL Environmental Impact Statement expected from State Department	Energy
February 3	FY 2015 Budget Due	Fiscal/ Monetary
February 7	Statutory Debt ceiling suspension x-date	Fiscal/ Monetary
February 10	Development period for regulations concerning debt collectors to begin	Financials
February 28	Plaintiffs' reply brief due in *Perry Capital vs Jacob J. Lew*	Mortgage/ Housing

March 1	CFPB to begin overseeing large servicers of federal and private student loans	Education
	CFPB (in March) may issue white papers or ANPR's regarding payday loans, deposit advance products	Financials
Early March	Fed to announce CCAR "stress test" results	Financials
March 6-8	CPAC Meeting	Elections
March 11	Special Election - Florida (13), Young-R	Elections

Date	***Event***	***Sector***
March 14	Expiration of FCC merger review 180-day "shot clock" for AT&T/ Leap -- official approval imminent shortly before or after	Wireless Telecom M&A
Late March	Senate Energy Committee hearing on crude oil exports	Energy
End of Q1/ March - April	Extraordinary Measures Exhausted	Fiscal/ Monetary
	Debt Ceiling Bill Likely To Be Seen as Vehicle for SGR Fix, Emergency UI Extension, Tax Extenders, Medical Device Tax repeal	Fiscal/ Monetary
	Harder Deadline Approaches for Farm Bill Extension	Agriculture
	U.S. Department of Transportation likely to release rear visibility standard for cars and trucks (rearview cameras)	Autos
	Congress likely to agree on new water infrastructure/dredging legislation (Water Resources Development Act)	Infrastructure
	Viability Cutoff Point Approaches for Bipartisan Immigration Reform	Immigration

	FDA to Propose regulation of e-cigarettes	Tobacco
	Fed to propose capital and/or margin requirements for securities financing transactions (SFTs)	Financials
Q1/Q2	D.C. Circuit Court of Appeals decision expected on Verizon appeal of FCC net neutrality rules	TMT
	Expected release of revised media ownership rules	Media
March 25	SCOTUS to hear oral arguments in two cases of businesses challenging the ACA's contraceptive coverage mandate	Healthcare
March 31	End of ACA Open Enrollment	Healthcare
	SGR/Doc Fee Patch Expires	Healthcare
	Fannie Mae to announce multi-billion-dollar remittance to USG; GSE "x-date" reached	GSEs/ Mortgage/ Housing
Q2	Fed to issue final capital rules for SLHCs with more than 25% insurance assets	Financials
April 5	Afghan Presidential Elections	Defense
May	Proposed regulation for prepaid cards targeted	Cards
May 22-25	Elections for the European Parliament (setting up a de facto deadline for TTIP)	Trade
May 30	Health plans must submit rate filings for 2015 exchange coverage	Healthcare
Spring	SEC follow through with final response to Franken amendment	Credit Rating Agencies
June	Final Decision on Keystone XL pipeline, with litigation expected to follow any approval	Energy

Mid - June	ACA SCOTUS watch; SCOTUS watch on CSAPR and Greenhouse Gas Regulation	Healthcare ; Energy
	Iran nuclear deal(?)	Defense
	Oral Arguments in FHFA vs BankAmerica/Merrill Lynch	Mortgage/ Housing/ Banks
June - July	CFPB may issue white papers or ANPR's regarding overdraft loan programs	Financials
	CFPB may issue final rule re auto lenders	Financials
July 22	GOP Senate primary runoff, Georgia	Elections
Q3	Basel Committee to propose net stable funding ratio (NSFR)	Financials
	Fed to propose enhanced prudential standards for systemic U.S insurers	Financials
August 19	Wyoming (Enzi vs Cheney) and Alaska (Begich vs ???) primaries	Elections
Q4/Fall	Court ruling in Dissident Retailers' Appeal Against Judge Gleeson's approval of class action swipe fee settlement(?)	Cards

Date	***Event***	***Sector***
Q4/Fall	FDA to propose menthol cigarette regulations	Tobacco
	Expected presentation and approval of state-level public safety broadband network plans (opting-out of $7 billion federal FirstNet program)	Telecom Equipment
	Expected FCC wireless spectrum auctions totaling 70 MHz	Wireless Telecom

September 30	2012 Highway Bill expires. Congress likely to pass an extension rather than a new Highway Bill	Infrastructure
October	Plan renewal notices start to go out to employer groups with likely big rate jumps	Healthcare
November 4	Election Day	Elections
November 11	Possible first day for a lame duck session of Congress, with outstanding tax issues hanging in balance	Macro/Tax
November 15	2015 ACA Open Enrollment begins	Healthcare
December	International Association of Insurance Supervisors to mandate minimum "backstop" capital requirements for systemic insurers	Insurance
By Year End	U.S. banking regulators to propose application of SIFI Buffer to U.S. banks	Banks

Overlying Theme: Benign Net Effect From Election-Wary Washington
Charles Gabriel - Capital Alpha Partners
Our goal this morning is to give you a feel for the policy-related timeline and Washington outlook in 2014. Hopefully you've seen our related three-page "Preview" chart that was attached to the email invitations the past two days. It intersperses important dates like the President's January 28 State of the Union address, the now-delayed February release of the federal budget, and key primaries and other events heading up to Election Day with the most important regulatory, legal and legislative developments we see coming in all our major industry areas. It points to a very front-loaded calendar- I commend it to your attention.

We also want to leave you with a theme or two, so I will talk from high up to set the stage, then ask Kim Monk to discuss Obamacare and the need for a doc-fee fix by April. From there, Jim Lucier can discuss energy and taxes, Byron Callan defense, and Loren Smith immigration and the emerging Farm Bill. After that, also available for questions will be Joe Engelhard on banking and insurance regs, Rob Smith on cigarettes or beverages, and Robert Kaminski on telecom.

My overarching observation is that we see four key reasons why Washington should prove a benign-to-positive factor for the equity markets this year,

including continuingly supportive monetary policy, clarity on regulation, a non-threatening election cycle, and an improving fiscal picture.

We begin with positive clarity on monetary policy, with Janet Yellen confirmed yesterday, and committed to the same policies as her predecessor Ben Bernanke. Some would note that handoffs to new Fed chairmen have typically been fumbled by the markets, as with the exploding cigars initially handed Paul Volcker in '79, Alan Greenspan in '87, and Ben Bernanke in 2009. But we've already seen investors adjusting, well enough, to a 3% 10-year and 30% higher 4 1/2 percent mortgage rates - and the markets so far having rallied into the onset of tapering. In the absence of glaring fiscal woes or other imbalances, the QE dismount, or having to deal with associated bubbles, doesn't yet seem too daunting. To be sure, accelerated Fed tapering could prove problematic, should market exuberance become irrational and the economy were to take off - but that hardly seems tangible enough to worry about yet. Meanwhile, the offsetting prospect of a strengthening dollar should remove currency risk for foreign investors, perhaps finally prompting global flows into U.S. equities and out of bonds.

The second part of the story will be about regulatory clarity, particularly for U.S. banks. There, Dodd-Frank mandates, legal risks, and Basel bank-capital rulings that have contributed to an adverse credit environment will keep dribbling out into the second half. Nevertheless, Joe Engelhard and I would argue that banks are just about to emerge from the extra inning rulemaking caused by the London Whale scandal - and the legal settlements that took so long to get started may peak with the BankAmerica-FHFA mortgage agreement before mid-year. Meanwhile, we think that the resulting Volcker rule, higher bank SIFI buffers and liquidity and leverage ratios will prove profit-dampening to the industry (note the Journal's feature story this morning on Goldman's decline in trading revenue) - certainly more so than when they emerged from the last major reregulation cycle after the thrift and banking crises in the '90s. But not in a way that should preclude reversion to a new normal that will prove doomsayers wrong about the banks, and allowing them to power GDP growth trending back toward a respectable 2 1/2 to 3 percent.

Another key trend in the financial space will see the CFPB gain momentum as it moves toward supervision of non-bank student loan servicers and new rules for auto loans, payday loans, debt collectors and prepaid cards. We think the auto loan story will be most interesting, given bipartisan Hill pushback and the fact that auto dealers, themselves, were exempted from regulation under Dodd-Frank. For the most part, we would argue that the CFPB, under Richard Cordray, has been open and fair, as best witnessed in its Qualified Mortgage rule that will heavily shape mortgage lending when it takes effect this weekend. Still hanging out there, however, is Fair Lending exposure - really at the heart of the auto loan struggle. And lenders can adhere to the QM, or other regulatory mandates, but still be sued if it results in disproportionately few loans going to poor or minority borrowers. The only cure for this "disparate impact" risk seems to be time, or a shift in administrations.

Meanwhile, further helping the housing sector could be the swearing in of Mel Watt to head the FHFA yesterday. As we have written, while it will

unlikely do much to juice the last mile of the now defunct refi wave, or perhaps even to spur more activity via Fannie-Freddie principal forgiveness, Watt's new thrust at the agency will likely put less near-term priority on raising fees and reducing loan limits in order to shrink the GSEs and bring back private capital in favor of an alternative focus on assuring borrower access to credit. This may frustrate would-be GSE reformers, and will unlikely help the cause of legislating a Fannie-Freddie phase out (to the relief of junior preferred stakeholders), but it will also provide a net plus for the mortgage, housing and home improvement sectors. (We see a potentially wild ride for shareholders in the Fannie-Freddie preferreds, by the way.)

A third key ingredient is a non-threatening election outlook. We see neither side likely to make enough gains to sharply shift the balance, but it is shaping up as a year likely favoring Republicans. And in dampening the populist regulatory and tax impulses of the White House and Hill progressives this prospect should be fine for the markets. As our old friend Mark Melcher famously used to write about, "Blessed Gridlock."

Democrats are arguably wearing leg weights in the form of the President's Bush-like low-40s approval ratings, growing dislike for ObamaCare, and the tradition of the party in the White House losing seats, particularly in mid-term congressional elections in the sixth year of a two-term presidency. They are also defending more Senate seats, with the class of 2008 facing reelection - and 7 or more are in red states, where Obama lost to Mitt Romney in 2012. Meanwhile, the average pickup in the last five "sixth-year itch" midterms was 6 Senate seats - just enough to shift control to the Republicans, if they can duplicate.

There are questions, of course, about whether Republicans can snatch defeat from the jaws of potential victory by nominating unelectable Tea Party candidates as they did in 2010 and 2012 - and we'll see evidence of this in key primaries and even a Florida special election late winter and early spring. It also remains to be seen whether Democrats might gain traction with their counter messaging on income inequality, which the President will try to hammer home in an event today just as Republicans likely block consideration of an extended unemployment benefits bill in the Senate.

We're skeptical how much relief or cover these factors can provide, however, so for the most part the trend will be slightly rightward. And the variables to watch will be the president's popularity, GDP, and the generic ballot, which is currently about even. We *do not* see passage of a minimum wage increase, by the way, though the debate to begin in the HELP committee next month could be interesting.

Odds are that Republicans gain a few seats in the House, adding to their 17-seat margin - no more than 10% odds that Nancy Pelosi could be returned as speaker. Meanwhile, we'd put 40% odds on Republicans' retaking the Senate: They seem likely to take three open Democratic seats that will be vacated by retiring Democrats in West Virginia, Montana, and South Dakota. But they would still have to win three more from four vulnerable Democratic incumbents in Arkansas, North Carolina, Alaska, and Louisiana in order to win the net six needed for majority control, while also guarding against

surprise losses of their own in Kentucky or Georgia - and we wouldn't bet on that.

Meanwhile, if we're wrong, and a conservative wave emerges after all, this should marginally boost a still lopsided list of red stocks, including the banks and financials, for-profit colleges, and much of the energy sector - even while we acknowledge that Obamacare has arguably made the reddest of our red stocks in 2012, the managed care industry, almost blue for this cycle, along with the defense sector, which needs another leg in the austerity cycle (that might accompany a GOP Senate) like a hole in the head.

Fourth and finally, and perhaps most important, is the fiscal story, where the austerity drive that took root after the 2010 mid-terms has arguably plateaued, giving way to less fiscal drag over the next 12 months - and perhaps renewed allure among foreign investors, who know austerity's shortcomings all too well. Long-term deficits have been reduced by $2.5 trillion or more over the past three years, based on the discretionary spending cuts and long-term sequester threat locked in by the 2011 Budget Control Act and the tax hikes enacted to avert the fiscal cliff a year ago. True, We've seen a nothing done on entitlement reform, where our biggest spending problems lie; and achieving $2 trillion plus in savings only via the one-third of the budget that is annually appropriated, or controllable, is untenable. But as long as Congress further chips away at long-term spending when it inevitably feels compelled to ease future sequesters, they'll be 80-90 percent of the way there toward the Simpson-Bowles challenge of cutting $4 trillion in 10-year deficits.

Most importantly, thanks to the front-loaded intensity of last fall - the 16-day government shutdown that saw Republicans dip ten points relative to the Democrats in the generic ballot - the House GOP essentially sued for peace in the Murray-Ryan budget deal adopted in December. That deal raised post-sequester discretionary spending caps for both 2014 and 2015. As a result, Congress this week and next still has to come to terms on a hoped for omnibus appropriations bill to live within a more lenient $1.01 trillion cap for FY 2014 and fund the government after January 15. But the odds this will prove suspenseful are low.

That leaves the residual challenge of extending the debt ceiling by early spring - which seems highly unlikely to produce suspense or negative headlines about a possible government shutdown or U.S. debt default. Indeed, the biggest questions, in our mind, may be not so much whether Republicans will demand a dollar-for-dollar offset for extending the $17.3 trillion limit past November's elections - we doubt it. . . But rather whether, as the last helicopter leaving Saigon, so to speak, the debt ceiling bill might become a vehicle for an SGR or Medicare "doc fee" fix, extension of the R&D tax credit and some $70 billion in other expiring tax provisions, or "extenders", a retroactive reinstatement of emergency unemployment benefits, or a medical device tax repeal or other ObamaCare-related tweak. The doc fee seems the most certain add-on, but I'll let Kim weigh in on that; meanwhile, unemployment benefits seem unlikely to pass unless a $26 billion offset is found.

In any event, the notion of default will likely seem remote. And the quote of 2013, in my opinion, was Senate Republican Leader McConnell's observation, after the shutdown, that there's "no education in the second kick of a mule." With Obamacare's messy rollout having clearly angered the public, the GOP has now more than recovered what it lost last fall, and has taken a hippocratic oath that should serve investors well.

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