

June 30, 2014

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Health Care - Kim Monk & Rob Smith

ACA: Hobby Lobby Supreme Court Decision Day

We see negligible impact on the health sector if SCOTUS overturns the ACA's contraceptive coverage mandate given the high levels of contraceptive and other benefits in employer-sponsored plans prior to the ACA's enactment.

The question in *Hobby Lobby* is whether the Religious Freedom Restoration Act of 1993 allows a for-profit corporation to deny its employees the health coverage of contraceptives to which the employees are otherwise entitled by under the ACA based on the religious objections of the corporation's owners. The other parts of the ACA are not challenged in this suit and thus will remain intact if the Court rules in favor of Hobby Lobby.

Some proponents of the mandate have argued that if the court rules in favor of Hobby Lobby millions of women won't have access to contraceptive coverage and employers will also drop other categories of coverage, such as cancer and psychiatric care for religious reasons. This analysis is flawed in that it ignores the fact that the vast majority of employer-sponsored health plans provided access to contraceptive coverage prior to the ACA, albeit sometimes with cost-sharing requirements that are prohibited by the ACA. And contraceptive care and services are generally available to women outside their employer-sponsored health plan through organizations like Planned Parenthood. However, some religious organizations and private companies object to the ACA's mandate to cover all forms of contraception, particularly what they consider abortifacient agents such as Teva Pharmaceutical's Plan B. Finally, employer-sponsored plans covered other categories of care on a voluntary basis prior to the enactment of the ACA, so it is unlikely they are looking for an opt-out based on religious grounds.

The ruling could have implications beyond the health sector. For this reason, most court watchers think that SCOTUS will craft a narrow ruling that only allows closely-held companies to opt out of the mandate. Companies that refuse to provide the full range of contraceptive coverage without costs sharing could be subject to millions of dollars in penalties (\$1.3 million per day for Hobby Lobby) if the Court upholds the law.

CMS Issues Exchange Auto Renewal Reg

In an effort to maintain enrollment, CMS last week published guidance allowing most individuals to continue to receive exchange coverage and subsidies in 2015 automatically.

CMS on Thursday published guidance outlining plans to automatically renew coverage for individuals enrolled in exchange plans. The agency estimates that 95 percent of current enrollees will be able to continue their coverage without taking any action. For individuals whose plans are canceled, CMS will enroll them in the closest comparable plan unless he or she opts to drop coverage or choose another plan. Some analysts are concerned that some enrollees may unwittingly lose their benefits with auto renewal if their some silver plan loses its benchmark status. People who enroll in silver-level plans who earn less than 200 percent of the federal poverty level are eligible for cost-sharing assistance in addition to premium tax credits.

Auto-renewal is a common feature of employer-sponsored health plans, but Sen. Isakson (R-GA) last week introduced legislation to repeal the ACA's auto renewal mandate for employer-sponsored plans.

Physician, Outpatient, Lab, Home Health and ESRD Rates

CMS is expected to issue several major 2015 rate proposals this week. Overall, we believe the proposals will be fairly benign, but home health could another round of cuts, and we're looking for clues on lab reform implementation.

Recent leadership changes at CMS and HHS should make for a relatively uneventful rate year for outpatient hospitals and physician services.

But if CMS sticks with its plan from last year, home health is due for another significant cut in 2015 of ~1.5%. The key question is whether intense lobbying, political pressure, and election year politics will cause CMS to pull back on rebasing for 2015 despite the fact that MedPAC asserts that the ACA cuts are modest and may not be adequate to bring payments in line with costs. CMS has responded to political pressure on MA rates, but we doubt that the home health industry will garner the same level of response. Thus, we think the best-case scenario is CMS proposes a flat to slightly negative (minus .5%) update. See our detailed note [here](#).

We do not think CMS will take full advantage of an expanded effort to crack down on overvalued physician services included in the recent SGR patch, as we discuss [here](#). CMS has used its authority in this area to go after several services, like radiation oncology and lab pathology payments, in the past. However, the savings from these initiatives are rather small but generate significant political opposition, and the new Deputy Administrator at CMS who handles payment policy and newly-minted HHS Secretary Burwell likely have larger issues to contend with.

Labs were slated to take a huge cut under a rule CMS finalized in 2013 to begin to adjust rates based on changes in technology starting in 2015. However, Congress repealed that authority in the recent SGR patch, so we expect this week's proposal to be fairly benign.

We will be looking for clues as to how the agency plans to implement the Clinical Lab Fee Schedule (CLFS) reforms included in the same SGR law that require reimbursements to be pegged to private rates starting in 2017. We will also be looking for whether the agency comments on a new pricing mechanism for advanced diagnostic tests that could benefit Exact Sciences' Cologuard if it is implemented in time, as we discuss [here](#).

Republicans Question FDA's Proposed Generic Labeling Rule

The House Judiciary Chairman and Senate HELP ranking member sent a letter to the White House budget office questioning FDA's legal authority to implement its controversial and potentially costly generic labeling proposal.

House Judiciary Chairman Goodlatte (R-VA) and Senate HELP Ranking Member Alexander (R-TN) last week sent a [letter](#) to the White House's Office of Management and Budget (OMB) questioning whether the agency has the legal authority to carry out the controversial generic drug labeling rule it proposed late last year.

As we cover [here](#), FDA wants to change a long-established rule that prohibits generics from making labeling changes to reflect new safety information unless/until its brand equivalent labeling is changed. OMB would be required to sign off on the proposal in order for it to be finalized.

Goodlatte and Alexander's letter states that language in the Hatch-Waxman law that created the generic pathway in 1984 requiring generics to maintain the same labeling as their branded equivalents "throughout the lifecycle of the generic drug product" prohibits FDA from allowing generics to make unilateral label changes.

The members also claim that FDA's economic analysis of the proposal finding it would only cost industry between ~\$4,000 and ~\$26,000 is seriously flawed given independent estimates that it would cost companies upwards of \$4 billion annually due to increased legal and regulatory oversight expenses. Finally, they contest FDA's assertion that the rule would benefit public safety since the agency has argued in the past that additional oversight of generic drug safety is unnecessary.

As we cover in our [note](#) on this topic, we believe the Administration is unlikely to finalize the generic proposal. The politics on the issue are too intense, FDA has questionable authority to move forward with it, and it could have a large impact on overall drug pricing. However, it is something the Administration could try to push through as part of the "midnight" regulation dump that typically occurs on the last days of a Presidency.

*Additional DC Coverage from Capital Alpha Partners***Macro** - Charles Gabriel and Loren Smith**Congress: House and Senate Out For Independence Day**

Policy-related news flow will be extremely light. Fed Chairman Yellen will speak at the IMF Wednesday morning, July 2, as observers await the Obama administration's next moves on Iraq.

Multi-Industry - Loren Smith**Congress Might Let Transportation Funding Slow Down**

In August the U.S. Department of Transportation will have to slow down payments by 25-30% as the Highway Trust Fund (HTF) balance falls towards zero. Congress is working on a bailout, but might not get there. For months, it's seemed likely that Congress would ultimately agree on a short-term scheme that would pump 6-9 months of cash into the HTF to allow for a post-election resolution - possibly another two-year bill. However, the solutions so far offered - principally different tax proposals - have not gotten broad traction. At this point, the possibility is quite real that Congress will leave town on July 31 for their month-long August recess without any resolution to the HTF issue. This would negatively impact companies in the construction and materials space who would see payments from the federal government to state governments slow down in some as-yet undetermined way.

Two years ago, there was a serious possibility that Congress would let the HTF run dry, only then it was more serious. Not only would payments have slowed, but programs would have expired and the federal gas tax itself would have lapsed. However, the 2012 Highway Bill extended the taxing authority through 2016 and the program authority through September 30 of this year. Payments slowing down may not be enough of a crisis to force Congress to the negotiating table.

Railroads/Crude-by-Rail: New Rules Might Wait Until After Elections

We've expected for some time that the Obama administration would unveil new rail safety rules this summer as a Notice of Proposed Rulemaking (NPRM). However, it now seems possible that the administration might choose to wait until after Election Day. Members of Congress supporting the new rules, such as Sens. Heidi Heitkamp (D-ND), Richard Blumenthal (D-CT), and John Hoeven (R-ND), would be apoplectic at such a delay. However, if the rule imposes significant economic costs - which is likely - the impact on critical Senate races is likely to influence timing. It's still possible the NPRM is issued sometime in July. If not, it probably won't be unveiled until November-December.

Telecom and Media - Robert Kaminski

After the broadcasters' win in the Aereo Supreme Court case last week, we run through the next policy catalysts for broadcasters. We detail these and more in [a note from Friday](#).

Broadcast Spectrum Auction: Pricing This Summer

How many stations might turn in their spectrum to the FCC in exchange for money? Proposed spectrum prices are coming this summer and the auction in mid-2015. The FCC released a 484-page order in the beginning of June describing technical and licensing rules. We are now waiting for proposed procedures that lay out opening prices and final price benchmarks. The FCC released a [detailed timeline](#) last week for the next regulatory steps. The mid-2015 guidance for the auction to be held is unchanged. The FCC also confirms what we have expected: the procedures notice could be released by the end of the summer and finalized in 1Q15. We see the incentive auction program as fundamentally flawed. In order to generate a profit for the Treasury and fund the FirstNet network, the FCC must pay broadcasters less for their spectrum than what it is worth to carriers. We think clearing 10-40 MHz spectrum is more likely than the FCC's 2010 goal of 120 MHz.

STELA Bill in Congress as Vehicle for Broadcast Items

The STELA bill is a must-pass piece of expiring legislation for the satellite industry that provides a retrans-free compulsory copyright license for DISH and DTV to import distant broadcast signals into markets

lacking or local network affiliate or out of the signal range. The STELA renewal process is relevant for broadcasters because it is a video-related bill that must be renewed before the end of 2014. In this way, it is the last train leaving the station for other, non-satellite video regulatory items to be attached. After a proposal in the House to allow MVPDs to split off retrans channels into a separate tier (since abandoned), broadcasters are watching for anything in the Senate that might materially affect retrans channels.

JSA/SSAs: M&A Overhang for Next Two Years

The FCC's new regulations attributing station ownership of JSAs for more than 15% of a station's weekly ad inventory as ownership [became effective June 19](#). Stations that would not be in compliance with the local TV ownership rule as a result (cannot own two top-four stations in the same market) have two years to unwind or seek a waiver. We are waiting for potential Congressional changes to the waiver process as part of the STELA bill. The House Commerce Committee version gives broadcasters 18 months after waiver denial to comply with the rules.

Prior to the release of JSA rules in March, the FCC released a [public notice](#) indicating that it would "closely scrutinize" any proposed broadcaster transaction that includes sharing arrangements for advertising, programming, facilities, employees, or other services with contingent financial interests. With no further public information or specifications on what the FCC might want to see changed, we see this guidance serving to increase company uncertainty and decrease clarity on timing and outcomes for deal completion. As a result, we see broadcast deals taking longer than expected.

Financials - Charles Gabriel & Joseph Engelhard

Banks: \$9 Billion BNP Settlement A Signal for Future Fines

We believe BNP's settlement, likely this week, is just the latest step in the growing politicization of bank enforcement cases. LIBOR & FX cases are likely, but there may not be enough evidence to obtain large settlements.

The investigations of BNP Paribas by the the NY Department of Financial Services and the Department of Justice into violations of U.S. sanctions law appears to be near a final agreement. As we have noted previously, we are most concerned by the apparent policy decision at the DOJ to seek maximalist criminal charges as well as the highest possible settlement amount. Given the massive amount of dollar transactions involved in the investigated trade finance and other banking transactions executed by BNP with respect to Iran and Sudan, there is at least some justification for such a large fine compared to other sanctions cases. We remain concerned, however, that the real impetus behind the DOJ's new approach to bank investigations is ultimately political. This theory may be tested by the ongoing LIBOR and FX trading investigations, in which we expect at least a few U.S. banks will be hit with similarly high settlement demands. But unless there is sufficient evidence to justify multi-billion dollar settlements, we believe it is possible that the banks, whether U.S. or foreign based, may object to any demands that are not justified by the evidence.

Puerto Rico: Constitutional Suit v Debt Restructuring Likely to Fail

While there is significant merit to the legal challenge against Puerto Rico's new law allowing restructuring of revenue bonds, absent economic growth a default is likely.

The biggest problem with investors' legal challenge to the new Puerto Rico (PR) law that creates a mechanism for restructuring its revenue bonds is that even if they were to succeed, it may be a pyrrhic victory. It could be very hard to enforce such a decision if the relevant municipal authority does not have sufficient money to continue operating and pay back bondholders. So far, few appear to be reading the law's passages as a threat for the government obligation (GO) bonds as well. GO bonds are not included in the new law and the PR constitution provides specific protections for GO bonds against default. In the case of GO bonds, the PR constitution ensures they receive payment priority. There is no similar provision in the PR constitution for revenue bonds, and presumably that is the reason why PR authorities appear to have decided to prepare for an eventual restructuring of at least the worst performing municipal authorities.

Mortgages: Private Label Securities Proposal Welcomed, Short On Detail

A Thursday (June 26) announcement from Treasury Secretary Lew did little more than herald a solicitation of ideas on how to jump start non-agency PLS mortgages. Amid QM-opic lender/investor caution, few expect progress soon.

Mortgages: A Corker-Warren Reform-Bill "Plan B"?

On top of a *National Journal* article musing that he might be angling to run for the presidency, Sen. Bob Corker (R-TN) may soon introduce a Fannie-Freddie bill with liberal Sen. Liz Warren (D-MA).

We have noted chatter about a notional joint offering from the two senators for several weeks, expressing curiosity about any additional affordable housing-related concessions the ambitious Tennessee "deal-maker" (Corker) might make and whether the increasingly-watched progressive standard-bearer (Warren) might meet him halfway.

It's almost certain that any new template will fall short of spurring Senate floor action this summer, as there are barely two dozen legislative sessions remaining before scheduled adjournment. Meanwhile, we also find doubtful that any new outline might move the needle in the next Congress.

To begin with, minority and low income housing advocates were, in our view, cheered by the underwhelming committee vote on the Johnson-Crapo bill, which would eliminate the GSEs' affordable housing goals as part of the reform outline advanced by Corker along with moderate Virginia Democrat Mark Warner in 2013. [These groups vocally reject that the GSEs' goals were behind the crisis, and are increasingly turning up the heat on FHFA Director Mel Watt to turn them back on, administratively.] This raises the question of just how far Warren might go in response to frustrated post-vote spin from the White House (to the effect that Fannie and Freddie still pose far greater risks to housing stakeholders and taxpayers than generally perceived). We think not far.

Of even greater fascination is that Corker's efforts come amid heavy Republican anticipation of taking back the Senate. This reportedly produced back-room lobbying from Sen. Richard Shelby (R-AL) against the Johnson-Crapo bill, which: 1) he almost surely would write quite differently as the next Banking Committee chairman; and 2) might be moved even further to center-left in any deal that Corker and Warren might agree to.

As one source recently observed upon the arguable failure of Johnson-Crapo in committee, Corker was widely seen by many Hill Republicans as once again "way over his skis" - with Crapo possibly erring (politically) by following his lead. Meanwhile, the litany of episodes wherein the former Chatanooga mayor has taken stances ultimately at odds with his party caucus seemed well documented (albeit not purposefully) by the *National Journal's* Michael Catalani in a June 26 [article](#).

In early 2010, for instance, Corker infuriated Shelby and other conservatives by trying to work on his own with then-Sen. Chris Dodd (D-CT), ultimately helping to produce what became the Dodd-Frank Act. Facing a GOP Senate Banking caucus arguably more disunited as a result of Corker's free-lancing, then-ranking-Republican Shelby felt compelled to drop dozens of blocking amendments in the panel, allowing the bill to squirt through to the Senate floor. Amid burgeoning populist fever fanned by the Obama White House (which had just been burned by the initial ACA-related Tea Party rebellion that saw Scott Brown defeat Martha Coakley for then-deceased Teddy Kennedy's Massachusetts Senate seat), the final Senate version went on to carry some of Dodd-Frank's most controversial and pro-cyclical provisions, including the Durbin debit interchange amendment, the Volcker amendment, the Lincoln swaps push-out bill, and Sen. Susan Collins' (R-ME) amendment dealing with TRUPs and minimum bank capital requirements.

In 2013, meanwhile, "Corker wrote a border-security amendment that pushed an overhaul of the immigration system through the Senate against conservative opposition," Catalani added. He more recently cast procedural votes along with Democrats to advance a minimum-wage bill and student-loan legislation — "both Democratic election-year priorities. And now, he's working with Sen. Chris Murphy of Connecticut on a long-shot plan to shore up the depleting Highway Trust Fund and offering a plan that would hike the gas tax."

In short, along with a low rating from conservative groups like Heritage Action, the engaging and energetic Corker may be earning a reputation as a John McCain-like maverick. But his leadership role on GSE reform may already be reaping diminished returns.

Rating Agencies: Franken's Time?

Perhaps pressured by Democrats worried about Sen. Franken's (D-MN) at-risk Senate seat, the SEC may soon follow through with benign new rating agency rules calling attention to the former comedian's related (DFA) amendment.

The *Wall Street Journal* [flagged](#) a perhaps imminent SEC announcement last Wednesday (June 25). Meanwhile, we listed the issue as one of our [Trending Ten](#) catalysts last Friday.

Our expectation has been that, while the Commission will devote much of its effort to bolstering protections against conflicts of interest between analysts' rating efforts and companies' marketing (e.g., through bolstering of Rule 17g-5 to encourage unsolicited ratings), a slightly more provocative package of reforms could mirror the Europeans' adoption of forced-rotation rules. We doubt much, if any, material effect, regardless.

Education - Charles Gabriel

Prop school stocks mostly stabilized amid volatility last week, even as 12 Democratic senators piled onto COCO's recent woes and House and Senate education committees signaled directly opposed stances on ED's Gainful Employment proposals.

As we noted during our June 19 [Spotlight Call](#), we expect Corinthian College's funding problems to prove unique, with perhaps a troubled institution or two to follow but most others surviving. With at least some hope of modest regulatory relief from a more Republican 114th Congress, this could empower those schools emerging as innovators to further adapt to the new paradigm slowly gripping the entire higher ed sector.

Last week's events were remarkable, nevertheless, in that they represented the equivalent of a pre-July 4 shoot-out, ahead of the encroaching August recess and scheduled adjournment in early October.

Long-time industry nemesis Sen. Richard Durbin (D-IL) co-authored a June 25 [letter](#) urging Education Secretary Arne Duncan to "protect students while continuing to hold Corinthian Colleges, Inc. accountable, including immediately prohibiting them from enrolling any new students."

The letter goes on to starkly cast COCO's fate -- but to project opportunity along with associated risks for related institutions' attendees: "After failing to provide required data to the Department of Education about its practices, including falsifying job placement data used in marketing claims to prospective students and allegations of altered grades and attendance, Corinthian has now agreed to sell or close its campuses across the country. This places the company's 70,000 current students at risk, but also presents the opportunity to find better educational opportunities for these students. The for-profit college is currently under investigation by 20 states, the Consumer Financial Protection Bureau, the U.S. Department of Justice, and the Securities and Exchange Commission."

Meanwhile, Senate HELP Chairman Tom Harkin (D-IA) proposed a stricter 90-10 rule and marketing restrictions for prop schools in a draft Higher Education Act (HEA) reauthorization [bill](#) introduced the same day. And the Republican-led House Education & the Workforce Committee followed the next day by rolling out three separate bills comporting with a broad [white paper](#). As we've expected, the GOP majority calls for, among other things, repeal of the Obama administration's emerging "Program Integrity" rules, dealing most notably with outcomes-based "Gainful Employment" criteria that for-profit vocational schools would have to adhere to in order to stay eligible for Title IV student aid.

Under a section dubbed "Promoting Innovation, Access, and Completion", the EWF white paper focused more surgically on "Eliminating Overly Burdensome Federal Regulations."

It read:

"Beginning in 2010, the Department of Education released several regulations purportedly to improve the integrity of student financial aid programs. Two of these so-called "program integrity" rules expanded federal authority into areas historically reserved for states and institutions. A third regulation would impose federal cost controls on institutions and make it more difficult for disadvantaged students to receive a postsecondary education. Taken together, these regulatory schemes will impede innovation, usurp the authority of decision-makers at the state and institutional levels, and hurt some of the nation's most vulnerable students.

"Leaders in the higher education community, the federal court system,¹⁸ and a bipartisan coalition of congressional members have firmly rejected these regulations.¹⁹ The federal government should not be used to unjustly penalize institutions preparing individuals to succeed in the workforce. Furthermore, the right of each student to attend the institution of his or her choice must be protected."

Separately, the House Republicans also pledged to prevent the administration's proposed federal government rating system for all colleges:

"Members of the committee are deeply concerned about the Postsecondary Institution Ratings System (PIRS) being developed by the Department of Education. This is an attempt by the administration to rate institutions based on access, affordability, and student outcomes. The administration is then expected to tie these ratings to an institution's eligibility to participate in federal financial aid programs. While we must increase transparency, it is not the role of the federal government to impose a one-size-fits-all formula that arbitrarily rates institutions, especially when we know that selecting a college or university is a uniquely personal decision for each student and family. The PIRS will unfairly judge our nation's diverse colleges and universities, restrict consumer choice, confuse families, and limit postsecondary options for low- and middle-income students. Rather than implementing an arbitrary ratings scheme that attempts to dictate students' needs, the federal government should provide useful information so students can make the best possible decision."

Our bottom line continues to be that we would expect worrisome 90-10 changes to be rejected by a Republican-led HELP Committee, under likely Chairman Lamar Alexander (R, TN). Such changes would continue to be opposed by House Republicans, in any event, so the for-profit industry would seem at least somewhat insulated regardless of election outcomes this November. Meanwhile, we would also anticipate resistance to the administration's broader higher ed "scorecard system" (i.e., the PIRS) to be used by the GOP as a leveraging tool in negotiations with the White House.

Defense - Byron Callan

Main Defense Catalysts for 2H 2014

We have low expectations for Congress to pass a defense appropriations bill before Sept. 30, despite best efforts to return to regular order. With no new appropriations for FY15, at least one or more continuing resolutions are likely. We see this as business as usual so it's not catalytic for defense stocks, so long as there is an FY15 appropriations act by early spring 2015.

The NATO Summit may provide a floor on European defense spending and see some defense decisions. The August run-up to the NATO Summit in Wales on Sept. 4-5 or the Summit itself could see two possible catalysts. One is some sort of declaration that defense spending shouldn't be cut further in Europe. We are not hopeful, however, for a resounding reaffirmation of sped up progress towards 2% of GDP for defense and investors need to pick through how much new spending could go for readiness and training and how much could actual benefit defense contractors.

The other catalyst could be announcements or decisions on ballistic missile/air defense programs by Turkey and Poland. Raytheon may be the best positioned for these programs but there is potential of an upset in

Poland by Lockheed Martin/Airbus MEADs. If MEADs is selected by Poland and support is committed by Germany and Italy, Raytheon's Patriot franchise would face a new competitor.

The mid-term election will provide a better read on when FY15 could be completed and should inform FY16's prospects. We see the mid-term Congressional elections in the U.S. as a gating factor for defense expectations with investors starting to pay much more attention to election implications in September. Capital Alpha currently has an out-of-consensus call that there is a 55% probability that Democrats retain control of the Senate.

We've believed that defense stocks could perk up if it appears more likely that Republicans could gain control of the Senate. The belief rests on the notion that Republican control could further sharpen foreign policy debates with the White House and suggest potential for more bellicose action.

Defense Week Ahead

CSIS is holding a June 30 event on "An Assessment of Russian Defense Capabilities and Security Strategy" and another July 1 event on "The Joint Multi-Role Technology Demonstration." JMR aims to advance vertical lift and so in a slow news flow week, may be of interest to BA, TXT, UTX and other helicopter primes and suppliers.

Other Noteworthies:

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Contact [Rich Linville](#), [Tom Butler](#), or [Courtney Oldham](#) for further details about Capital Alpha's research. MP3 replays of our past calls are also available upon request.

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