

US Congressional Elections: *The more things change, the more they stay the same*

Summary and investor implications

- Our baseline assumption is that the Republicans gain control of the House of Representatives but that the Democrats retain control of the Senate by a narrow margin.
- We think the near-term economic impact of this change will be surprisingly limited in part because the legislative process has already been in near gridlock since the Democrats lost their 60-vote majority in the Senate.
- **Market impact:** Continued gridlock places the burden of providing further support to the economy mainly on monetary policy. Unless the economy accelerates more rapidly, ZIRP could persist for a long time and the case for extended QE2 is strengthened. Gridlock means that it will be more difficult to take extraordinary measures to recapitalize the financial system, should they be needed. This fattens the downside tail of the economy's distribution of outcomes.
- **Congressional bi-partisanship:** We do not expect the election to usher in a new era of bi-partisan cooperation. Instead, party lines will harden. Republicans will likely maintain their current strategy of unified opposition to President Obama's agenda through 2012. And, for those thinking of being more cooperative, the prospect of challenges from the Tea Party will have a chilling effect.
- **Regulatory uncertainty:** Nor do we expect the economy to get a big shot in the arm from a reduction in either electoral or regulatory uncertainty. The rules and regulations that will make operational the legislation of the past two years are now being written by various government agencies. This is largely independent of the election outcome. Regulatory uncertainty won't be reduced until the process is closer to completion.
- **Federal Deficit:** The election outcome will not do much to change our forecasts for the budget, either on the spending or tax side of the ledger. We expect no major new fiscal stimulus and the Bush tax cuts to be made permanent. The 2011 deficit will be on the order of USD 1.25 trillion. Even if the Republicans gain both houses of Congress, they will not be able to take a meat axe to the federal government, UK-style.

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- **Housing:** On housing and GSE reform, coming up with a plan that gives the government a role in housing but which addresses the weaknesses of the current structure is going to be an immediate challenge. The combination of a Democrat led Senate and Administration is likely to result in proposals for a well-defined, explicit role for the government in housing finance. Senate Republicans will not accept that. Expect more gridlock near-term. See our table on this report for a summary of other housing-related issues and how they will be affected by the election.
- **Energy:** In terms of energy policy, the Republicans are in a position to kill most new initiatives, but the industry still faces a number of challenges from the executive branch on the environmental and safety fronts. It will not be an easy time for energy no matter who controls Congress.

Introduction

“The more things change, the more they stay the same” are song lyrics that aptly describe the political/economic impact of the November 2 US Congressional elections.

What’s at stake? All 435 seats in the House of Representatives and one-third of the 100 Senate seats are up for election on November 2. The Republicans need to win 40 seats to gain a majority in House. Polls suggest they may take as many as 54 seats. The Senate, on the other hand, is likely to remain in the hands of the Democrats, although their majority will be cut from 59 to as low as 51. The President is not up for reelection until 2012.

The House. The majority party in each legislative chamber tends to set the overall agenda and priorities for that body. Congress works largely on a committee system. The make up of Congressional committees is adjusted to reflect the composition of the body following an election, and the majority party determines who will hold the powerful committee chairmanships. This can affect the path that legislation takes to becoming law. Tax bills originate in the House. The Speaker of the House (the presiding officer of the body) is third in the Presidential succession line, behind the President and Vice President. All in all, the prospective change in control of the House from Democrats to Republicans is a major political event.

The Senate. Even more arcane are the Senate rules around cloture, which is a vote to end floor debate on a piece of legislation. According to Senate rules, cloture requires 60 Senate votes. That means that a *minority* party, which votes as a block, can derail legislation by threatening to filibuster (a filibuster is a period of prolonged floor debate), which brings most other business to a standstill. Instead of allowing a filibuster, majority party leaders in the Senate typically don’t bring legislation to the floor for a vote unless they know they can win a cloture vote. The Democrats had a filibuster proof majority (60 votes) in the Senate prior to the loss of a seat last year. After that loss, Senate Republicans could block legislation if they voted as a block by not allowing cloture, and they tended to do this. But as far as the future goes, having already lost their

60 vote majority in the Senate, further narrowing is not a particularly politically significant event. Moreover, if the Republicans were to gain control of the Senate too, the Democrats could use the cloture rule to block their initiatives.

Greater cooperation. Some political pundits have argued that if the Republicans gain control of the House, a new era of cooperation with the President could follow. If the Republicans are no longer a minority party, they will assume a greater share responsibility for getting things done, or so the reasoning goes. We are not so optimistic. Instead, flush from their mid-term victories, the Republicans are likely be smelling victory in the much more important 2012 elections, when the Presidential as well as Congressional elections will take place. They may stay with what has so far worked: *steadfast, unified opposition to President Obama's legislative initiatives.*

And, for those Republicans who might be willing to cooperate with the Democrats, there is the Tea Party movement to consider. It has demonstrated a willingness to mount aggressive challenges in primary elections (party elections to determine candidates in general elections) to Republican candidates that it regards as being too liberal or who have been too cooperative with the Obama agenda.

The further hardening of positions along party lines could turn out to be near-term negative for the economy. Hopes of a more business-friendly fiscal agenda, if the Republicans sweep both the Presidency and Congress in 2012, could keep companies from aggressively expanding hiring and capital spending near-term.

Economic impact

Now comes part two of the lyric: *"the more they stay the same."*

We doubt that the political changes described above will have much impact on the economic landscape over the next two years. Longer term impacts -- both economic and political -- are beyond the scope of this paper, but we remind readers that the Congressional electoral victories won by the Republicans in 1994 during the first term of the Clinton presidency were substantially reversed in subsequent years, a warning that long term predictions about the course of American politics are risky.

We have been hearing many references to the halcyon period for the economy that followed the 1994 mid-term elections, but the current situation is different in many important respects. In 1994, the economy was expanding at an above-trend rate (e.g. that year, real GDP rose 3.1% on a Q4/Q4 basis and payroll gains averaged 170,000 per month). The Republicans gained control of both houses of Congress while the Democrats controlled the Presidency. Gridlock may have kept down "regulatory drag" and stopped higher interest rates on Treasuries from crowding out private borrowers. For instance, President Clinton's attempt at health care reform, which failed before the 1994 elections, was never resurrected. And, the Federal budget deficit was controlled in the years following 1994, eventually going into surplus.

Now, however, growth is now well below potential and the economy faces a large negative output gap. The data points in Figure 1 below highlight more of the differences between then and now.

Figure 1: Key date points: 1994 vs today

Variable	End Sept 1994	Latest Observation
Fed Budget % GDP	-3.7%	-9.1%
Fed Exp % GDP	20.9%	23.8%
Fed Debt % GDP	48.4%	59.7%
HHold Debt % GDP	62.2%	92.6%
Fed Funds Rate	4.8%	0 – 0.25%
Curr Acct % GDP	-1.6%	-3.0%
Trailing 3Yr GDP	0.0%	3.5%
Unemployment Rate	5.9%	9.6%

Source: Bloomberg

Reduced uncertainty. Uncertainty surrounding the outcome of the mid-term election may have been a drag on the economy in recent months, but given that Washington was already in gridlock when the Democrats lost their 60th vote in the Senate, the gains from eliminating the uncertainty associated with the election are likely to be small.

Moreover, while the future regulatory pipeline may be closed due to gridlock, legislation that has already passed on financial regulatory reform and health care is unlikely to be repealed – potentially amended but not repealed. Dodd-Frank financial legislation is a case in point. The law is now being translated into operational rules and regulations by various government agencies such as the SEC and the FDIC. This process is largely independent of the outcome of the upcoming election. While Congressional oversight may intensify following the election, regulatory uncertainty won't be reduced until the rule writing process is complete. The same is true for health care legislation, where uncertainty will be gradually reduced by clearer implementation of the present law rather than by the legislative process in the new Congress.

That said, below is our analysis of key areas of the economy and how they are likely to be affected by our baseline political scenario, ie that Republicans gain control of the House but not the Senate. We stress that given the power the Republicans already have in the to block legislation in the Senate due to the 60-vote rule on cloture, many of the outcomes discussed below are not as contingent on the election results as might be supposed.

Fiscal policy and the federal budget

Gridlock is already in the forecast. While the mid-term elections may lead to a shift in the political landscape, we believe the immediate economic and budget implications are relatively small and we think most market participants agree. For instance, only 2.3% of the economists surveyed by Blue Chip Economics expect the Bush-era tax cuts to be allowed to expire.

No new spending initiatives. In terms of budget specifics, we do not expect any major new fiscal policy initiatives, such as a second large stimulus package. The deficit in FY 2010 widened to \$1.29 trillion (or 9.1% of GDP), while federal debt as a percentage of GDP climbed to around 60%, both post-war highs. These results will significantly limit the policy flexibility of both the incoming Congress and the Obama Administration in the next two years. While massive purchases of Treasury debt by the Fed may make funding additional fiscal stimulus relatively easy, the American public and the Congress appear to have no appetite for a further expansion of the government sector and are extremely leery of any action (including tax cuts) that might lead to even larger budget deficits in the future. Thus, we see little chance of a major fiscal initiative aimed at boosting growth being proposed in the wake of the elections.

On the other hand, even if the Republicans were to gain control over both houses of Congress, they will not be able to take a meat axe to federal government spending, UK-style. They won't control the Presidency, and they won't have the votes to overturn Presidential vetoes. Nor will they have likely have enough votes to invoke cloture in the Senate.

Tax cuts. Bush tax cuts likely to be extended even for upper income earners. The one major issue that will be addressed in the wake of the elections is the Bush tax cuts, which are set to expire on December 31, 2010. The provisions set to sunset include the 10% tax bracket (which reverts to 15% in 2011), lower tax bracket rates of 25%, 28%, 33% and 35% (which rise to 28%, 31%, 36%, and 39.6%, respectively), a 15% top tax rate for long-term capital gains and dividends (which moves to 20% for capital gains and 39.6% for dividends), and the phase-out of itemized deductions and personal exemptions for higher-income earners. In addition, the expanded child tax credit reverts back to \$500 from \$1,000, and the Making Work Pay tax credit that was part of the 2009 American Recovery and Reinvestment Act expires at the end of 2010. Also, the estate tax, which was repealed in 2010 (the result of legislation enacted in 2001) is scheduled to return to its pre-Bush level on January 1, 2011.

The CBO estimates that the expiration of the individual income tax provisions alone would boost Federal revenues by more than \$300 billion in FY 2011 and FY 2012 combined (much of the impact from the increase in income tax rates would be reflected in higher payments in early 2012). However, the President has proposed that only the tax cuts on individuals making more than \$200,000 per year (and married couples filing jointly earning more than \$250,000) be allowed to expire. In addition, most have assumed that the top tax rate for both capital gains and dividends will be capped at 20%, and that the rise in the estate tax will be less than currently slated. We believe that the boost to Federal revenues as a result of these changes would be relatively small, perhaps between \$100 billion and \$150 billion (in part because we assume that the increase in taxes on upper income earners, many of which are actually small business owners, would lead to somewhat slower growth).

Assuming the Republicans take the House and make significant gains in the Senate, there is unlikely to be a compromise on the Bush tax cut issue (i.e. Republicans will insist that all tax cuts be extended). Thus, RBS now expects that all of the Bush tax cuts will be extended for between one and three years, perhaps after the new Congress starts in late January, or possibly during the lame duck Congressional session. The release of the recommendations of the Bipartisan National Commission on Fiscal Responsibility and Reform due in December could provide Democrats and the Administration with sufficient cover to extend all of the cuts (the President can say the Commission's recommendations should be reviewed before any changes in tax policy are instituted).

The budget. We have already incorporated the baseline outcome for the election, as well as expectations for a less hostile fiscal environment generally, into our forecasts, so that such a development would not lead us to meaningfully alter our 2011 GDP forecast or FY 2011/2012 budget projections.

Our current budget forecasts call for a \$1.25 trillion deficit in FY 2011 and a \$1.1 trillion deficit in FY 2012, assuming all of the Bush tax cuts are extended. Our estimates would not change materially if the tax cuts on upper income earners were allowed to expire. In a world of \$1 trillion+ projected deficits, even a \$150 billion increase in revenues would represent a rounding error. Similarly, with respect to growth, our forecast for a slight pick-up in real GDP growth from roughly 2.5% Q4/Q4 in 2010 to around 3% in 2011 assumes no income tax increases. If the top income tax rate went up next year, we would shave our 2011 GDP estimates modestly, perhaps by one-quarter of a percentage point.

Impact of Election on US Agency debt and MBS Markets

The highest probability outcome is Republicans will control the House of Representatives and Democrats will have a majority of seats in the US Senate. Democrats tend to favor an explicit role for the government in housing finance, and Republicans favor privatization. While Republicans are likely to use the next few years to set up for the 2012 presidential election by going on record against a government role in housing, the reality is that the 2010 election is unlikely to have a major impact on the current and future role of housing finance. There will be a lot of hearings, proposals and alternatives but unless there is an unlikely bi-partisan compromise, it will all be headline risk. At some level, both political parties recognize the need to maintain housing market stability. There are two issues that need to be addressed – the fate of the current GSEs and the future role of the government in housing finance. Both will be painfully slow to resolve. A new framework is likely to be legislated only gradually, over many years.

The accompanying table highlights the current status of the GSEs and other main topics related to housing finance reform as well as where we see the Democrats, Republicans and Administration positioned on these topics. These topics include the current structure of the GSEs, future of the housing finance market, GSE mortgage guaranty business, GSE retained portfolios and loan modification programs.

Figure 2: Election Outcome: Where do the parties stand on the topics?

Topic	Current Status	Democrats	Republicans	Administration
Future Structure of GSEs	FNM and FRE put into conservatorship under the FHFA on Sept 2008. Currently a 3-tier system: (1) GNMA for Veterans and low-income borrowers, (2) GSEs providing capital to mortgage lending (3) private lending	Support continued government role but need to define future role for government involvement. Support continued conservatorship throughout the process of creating a new housing finance framework: GSE debt and MBS would remain supported by the government even in a wind-down situation	Privatize as much as possible: abolish GSEs, shrink GNMA role. Would support a plan to conclude conservatorship over the next several years.	Required by Dodd-Frank to release proposal on the future housing finance market by the end of Jan 2011; likely to support a government role
Treasury Support of GSEs	Treasury Preferred Stock Purchase Agreements (PSPAs) provide unlimited support through 2012. Following unlimited support, the available draws revert back to the remaining capacity on the 12/09 amendment of \$274 bn combined.	Although not yet discussed, we could imagine support for a reduction in the 10% preferred stock dividend paid to Treasury or excluding the preferred dividend payments to the U.S. Treasury from the PSPA limits. Could also delay the implementation of fees required to pay the UST per the PSPAs.	Do not have authority to amend the PSPAs without support of Treasury FHFA, and GSEs, therefore no change.	Wouldn't allow any reduction of support of GSE's over concern of disrupting housing market.
GSE Retained Portfolios	\$810 billion limit for each by end of 2010 from \$900 billion limit EOY 2009, declining by 10% per year	Likely to have no impact	Could set limit to decrease by 10% of year-end portfolio size, resulting in a more rapid decrease in the portfolios.	Unlikely to support faster reduction of portfolios
GSE Debt	No explicit backing, but is supported through the Treasury PSPAs. Debt outstanding is decreasing in line with retained portfolios.	Likely to have no impact	Likely to have no impact	Administration crafted the PSPAs which reinforce Treasury support, decrease the retained portfolios, therefore decreasing Agency Debt Outstanding. Likely to stand behind GSE debt regardless of the GSE reform outcome.
MBS GSE Guaranty	GSEs unconditional guaranty of Agency MBS, linked to Treasury support of the GSEs	Likely to support an explicit guaranty of Agency MBS, similar to GNMA	Likely to support eventual wind-down of government support of the housing market through the GSEs	Would like to explicitly guaranty Agency MBS but concerned over optical impact on balance sheet and how it relates to funding of the Treasury
GNMA/HUD/VA	Full-faith and credit of the U.S. Government	Support for expanded role through GNMA	Support status quo only	Could possibly support for expanded role of GNMA in the future of housing finance
Conforming Loan Limits in High Cost Areas	\$729,750 extended through Sep 2011	Likely to support extending higher loan limits depending on the pace of the housing market recovery	Likely to allow high cost limit to revert to \$625,500 and eventually to reduce to normal conforming limit (currently \$417,000)	Bi-partisan support for current high-cost area loan limits but in a Republican-controlled Congress, the reversion to \$625,500 could be supported by the administration, depending on the state of the housing market and to the extent private lending revives
High LTV Refinances by GSEs	HARP allows refinances of responsible borrowers up to 125% LTV, expires June 30, 2011	Likely to support extension of date and expansion of eligibility	Do not support extension or expansion of HARP	Administration likely to support expanding its HARP program
Government Modification Programs	HAMP, FHA Short Refinance, etc. allows loan modifications and principal reductions	Overall support of modification programs including principal forgiveness, cramdowns	Support winding down existing programs; do not support principal forgiveness or cramdowns	Does not support mandatory principal forgiveness due to moral hazard and other issues
Universal Low Rate Mortgage	Does not exist	Very weak support of government-backed low rate loans	Absolutely do not support non-credit-based loans	Very unlikely to support universal low rate mortgage; support improved underwriting standards

Source: RBS

The next step in the process is Treasury's road map for reform that must be submitted to Congress by the end of January 2011, as required by the Dodd-Frank law. The first aspect of this will be to define the desired role of government in housing finance followed by a framework for the future, including a plan for the legacy entities. We expect any new model to address the faults in the current structure while maintaining the benefits of the existing model. The combination of a Democrat led Senate and Administration is likely to result in proposals for a well-defined, explicit role for the government in housing finance. Senate

Republicans will not accept that role for government which, again, means an unlikely bi-partisan compromise is the only answer.

Energy and Utilities

The Energy and Utility Industries have had a difficult two years dealing with the Democratic-controlled Legislature and Executive branches, mainly due to implementation of several new restrictive environmental and operational regulations. Additionally, the negative publicity resulting from the Macondo accident in the Gulf of Mexico has led to additional restrictions and compliance costs. Though the apparent legislative death of H.R. 2454 (the "cap and trade" act) and the probable takeover of the House by Republicans may have many industry participants breathing a sigh of relief, we would caution that the Administration and various Governmental Agencies such as the Environmental Protection Agency (EPA) and the Occupational Safety and Health Administration (OSHA) may have the flexibility to implement an agenda outside of Congressional mandates and/or desires but fulfilling the ultimate environmental goals of the Obama Administration.

There are a number of air, water, solid waste and financial reform regulations and proposals currently pending. The ultimate outcome of these proposals and regulations is unknown, but if several outlier proposals are implemented, it could likely result in significantly higher operating costs for the Energy Industry. There could be potentially crippling rules and regulations in the utility segment (coal plant remediation), oil service segment (additional inspections and safety equipment), exploration and production segment (potential ban and restrictions of shale drilling onshore), MLP and pipeline segment (more frequent inspections of pipelines), and refining segment (additional safety and ultra-low sulphur diesel "ULSD" requirements).

We foresee the likely implementation of EPA regulation regarding CO₂ emissions, new restrictions on coal ash storage and disposal, further EPA, DOE and DOI restrictions on the processing, storage and transportation of hazardous or non-hazardous materials used in the Energy Industry, new clean air mandates limiting the emission of SO₂, Nox, mercury, CO₂ and other emissions. For example, we believe that the EPA will seek to shut down, via the Clean Air Act, older coal-fired plants within the next two years which could lead to, at minimum, the permanent reduction of approximately 45GW of power or 4% of total U.S. electricity supply. The highly regarded North American Electric Reliability Corporation (NERC) issued a very compelling white paper highlighting many of these aggressive EPA proposals and actions. In the worst case, the NERC notes that EPA rules, all of which are new and fairly obscure (such as regulation of water intake structures to regulate mercury emissions), could affect all coal-fired plants, which supply 53% of U.S. electricity and could lead to the permanent reduction of almost 8% of U.S. electricity supply. This would be particularly negative for the coal generation heavy Mid-West and Northeast utilities and could hamper the economic recovery in those regions. Additional restrictions and regulations may lead to brownouts and power shortages as well as higher energy (e.g. gasoline) prices that would limit any economic recovery and is a risk we would highlight in the Energy and Utility space.

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