Merrill Lynch

STRATEGY

A Bush Re-Election and the Markets

RIC Bulletin

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The Global Private Client **Research Investment Committee** (RIC) is responsible for reviewing the disciplines and views of our macroeconomic specialists and producing targeted research with actionable ideas. We will aim to communicate our most important macro ideas and forecasts in a thoughtful, *abbreviated* format.

Highlights

Should the remaining uncounted ballots secure a Bush victory, the President is likely to continue the pro-business policies that characterized his first term. The sectors of the stock market that should benefit most are energy, selected financials, health care (including pharmaceuticals, and Pharmacy Benefit Managers (PBMs), and industrials (including defense).

We don't think that Bush's re-election would have any clear implication for the bond market. As with stocks, the fundamentals that are already in place should dominate. Still, there are a couple of aspects of Bush's policies that are somewhat bond negative: the likely extension of the favorable tax treatment of capital gains and dividends is one negative, and the possible partial privatization of Social Security is another.

The President would push to make permanent the income tax cuts of his first term. He may also try to pass a flat tax. The Alternative Minimum Tax may prove to be the vehicle for introducing a flat tax.

Table 1: President Bush and the Markets

Winners
Stock Market Sectors: Energy, Selected Financials, Health Care (including pharmaceuticals, and PBMs), and Industrials (including defense).
Losers
Municipal Bonds (initially, but not longer-term)
U.S. dollar
GSEs (e.g. Fannie Mae and Freddie Mac).
Likely Policy Initiatives
Tax cuts from first term made permanent, but....
Increasing reach of the Alternative Minimum Tax, and possibly a segue to a flat tax.
Increased scrutiny of GSEs.
Partial privatization of Social Security.

Source: Merrill Lynch.

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Refer to important disclosures on page 10. Analyst Certification on page 10.

Introduction

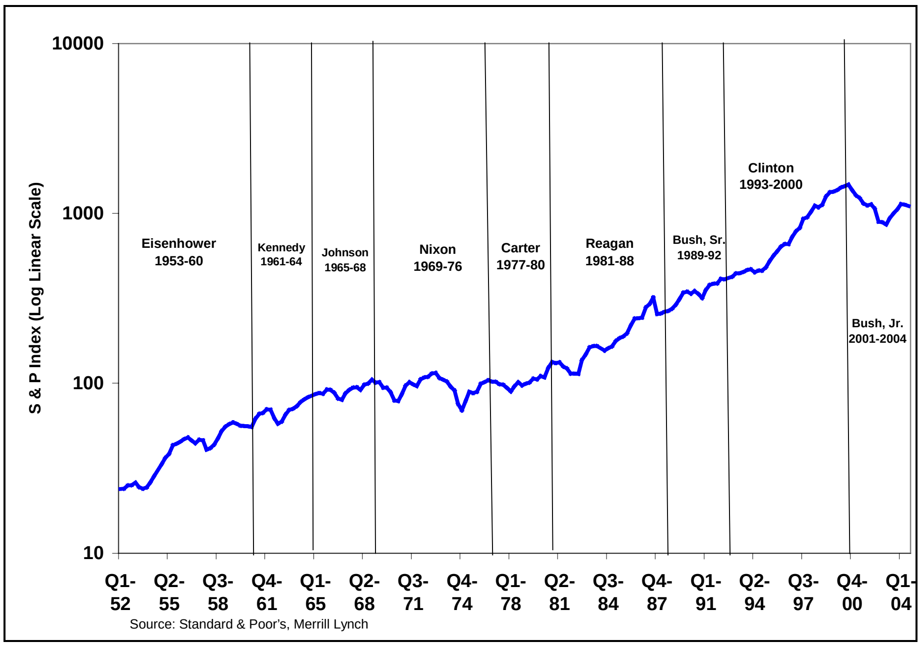
The President is one of many influences on the markets.

At the outset, investors should remember that the person who occupies the Oval Office is just one of many influences on the course of the markets. The markets' direction in the second Bush term would be shaped largely by factors that are mostly independent of the election result, such as the fundamentals facing consumers and the direction of Federal Reserve policy. Nevertheless, a President's economic and regulatory policies can still affect the relative performance of different sectors of the markets, and they will certainly have some influence on the direction of the markets as a whole.

Chart 1 below and Table 2 on the following page provide some historical perspective. The Chart shows that the stock market has generally moved higher over time regardless of who was in office. The Table shows that over time, stocks have done better under Democratic leadership, and bonds have done better with Republicans. Moreover, bonds have outperformed stocks during Republican administrations, while the reverse has been true during Democratic administrations. The first Bush term fits this pattern, as bonds far outperformed stocks. Nevertheless, both stocks and bonds usually show positive returns over the four-year term regardless of the party.

In what follows we will assess what the apparent Bush victory may mean for the markets in the coming years.

Chart 1: The Stock Market Under Different Presidents



Source: Standard & Poor's, Merrill Lynch

Table 2: The Stock and Bond Markets and the President

President	Party	Years	Market Performance* Stocks	Bonds
Hoover	R	1929-32	-59.9%	17.9%
Roosevelt	D	1933-36	200.7%	23.1%
Roosevelt	D	1937-40	-20.2%	18.6%
Roosevelt	D	1941-44	47.9%	11.6%
Roosevelt/Truman	D	1945-48	57.2%	10.6%
Truman	D	1949-52	95.7%	5.9%
Eisenhower	R	1953-56	125.3%	5.0%
Eisenhower	R	1957-60	35.4%	7.3%
Kennedy/Johnson	D	1961-64	80.6%	14.9%
Johnson	D	1965-68	38.6%	1.3%
Nixon	R	1969-72	22.9%	19.5%
Nixon/Ford	R	1973-76	7.8%	23.1%
Carter	D	1977-80	52.0%	-4.9%
Reagan	R	1981-84	59.1%	70.2%
Reagan	R	1985-88	94.6%	79.2%
Bush, SR	R	1989-92	71.5%	56.2%
Clinton	D	1992-96	87.1%	44.7%
Clinton	D	1997-00	115.0%	38.2%
Bush, Jr.	R	2000-04	-8.5%	38.5%
Averages				
Democrat			**75.5%**	**16.4%**
Republican			**38.7%**	**35.2%**

Based on monthly data for the periods through elections. For example, the market performance for Bush, Sr. covers from the end of October 1988 to the end of October 1992. We chose these periods to capture the markets' reactions to the election results. For Bush Jr., though we began from the end of November 2000, because of the delay in finding out the outcome of that election. The figures are percentage changes for the entire period (not annualized). The stock performance is based on the S&P 500. The bond performance is based on government bonds with maturities 15 years and longer.
Source: Ibbotson Associates, Merrill Lynch

Impact on the Markets

A number of positives for the stock market would emerge from a victory for President Bush.

Bush has implemented pro-business policies.

- The President is clearly pro-business. The first Bush term was filled with business-friendly initiatives such as accelerated depreciation schedules, investment tax credits, and the tax rate cut for manufacturers.
- We believe that these sectors of the stock market will benefit from a Bush victory: industrials (including defense), health care, selected financials, energy, industrials, and insurance.
- A Bush victory, plus the continuation of Republican majorities in both houses of Congress, would raise the odds that the favorable tax treatment for long-term capital gains and dividend income will be made permanent, instead of expiring at the end of 2008, as scheduled. Preferential tax treatment of capital gains and dividends favors stocks over bonds.

We don't see a clear implication for bonds, beyond the likelihood that, from a tax standpoint, interest income will continue to be treated less favorably than dividends and capital gains. The Federal deficit may move higher, but as the experience during the first Bush term shows, deficits and interest rates do not necessarily move together. Inflation matters much more. The decline in core inflation was a powerful downward influence on bond yields during the past four years. The course of inflation will largely determine where yields go from here.

The markets did not seem to price in a Bush victory prior to the election.

We don't think the markets have fully digested the consequences of a Bush victory. Since the race was so close, the markets did not appear to have priced in a Bush victory prior to the election. For instance, higher dividend-paying shares, both common stock and the preferreds that qualify for favorable treatment, have not been outperforming other shares. Likewise, stocks have not been outperforming bonds, as we think they will in the coming months. Municipal securities might initially trade lower, to the extent that there was some expectation of a tax hike with a Kerry victory. But we see positives for the municipal market that should hold even in the absence of a tax rate increase.

Stock Market Winners and Losers

Historically, the performance of different sectors under Republican administrations has largely gone against the conventional wisdom. According to Richard Bernstein, our Chief Quantitative Strategist, since 1980, the following sectors are among those that have done better under Republican leadership than Democratic leadership: auto parts and equipment, foods, department stores, retail composite, textiles, and waste management. Also, consumer stocks tend to outperform industrial stocks during Republican administrations, as was the case during the first Bush term.

This time around, we think that energy, selected financials, health care, and industrials (including defense) will benefit most from the Bush victory.

- **Energy**

Arctic drilling should benefit energy companies.

Energy companies are likely to see less regulation and more production under a second Bush term than they would have under a President Kerry. Among Bush's policy proposals that are likely to benefit energy companies are: the construction of the Alaskan natural gas pipeline, efforts to develop 1% of the Arctic National Wildlife Refuge, and funds for clean coal technology.

In addition, the climb in the price of oil has spurred increased capital expenditures by the major companies and by independent exploration and development companies. If Arctic drilling were to be allowed, it might still take a few years before oil is actually extracted, but **oil service** companies should begin to see increased revenues in the years before production actually begins.

- **Financials**

Increased scrutiny of the GSEs.

A Bush victory would mean different things in the financial sector. The **Government Sponsored Enterprises** (**GSE**s, e.g. Fannie Mae and Freddie Mac) will likely come under increased scrutiny. We think that the Republican Congress will assign a new regulator, and impose stricter capital requirements than those that are in place now. That is likely to be a positive for GSE debt: we don't see a risk to the AAA rating of the existing senior debt. Regulatory changes may pose more problems for GSE equities, although we maintain our buy rating on shares of Fannie Mae and Freddie Mac.

Tort reform should benefit insurers.

Insurers might benefit under the President's proposal for increased tax credits for low-income families to buy health insurance, and tax deductions for the purchase of long-term care insurance. Insurance companies should also benefit from the likely tort reform legislation from a Republican congress and administration.

Banks and brokerages might benefit if Mr. Bush succeeds in implementing partial privatization of Social Security. Even so, other fundamentals, such as new issuance and the shape of the yield curve, are likely to be more important to their prospects.

Increased R&D spending and fewer new regulations should help health care companies.

Health Care

President Bush has proposed a number of initiatives that could help the health care industry. Among them are doubling the budget for the National Institutes of Health, and substantially increasing funding for Research and Development, and the National Science foundation. He has also pledged to fight for medical liability reform, which should help contain the growth in the prices paid by HMOs.

Pharmaceuticals and **Pharmacy Benefit Managers** (PBMs) should also benefit with a Bush victor to the extent that the market had been pricing in a Kerry victory. The Bush re-election would relieve worries about possible price controls on drugs, and also ease the threat of re-importation and increased competition from generic drugs. Pharmacy Benefit Managers, which negotiate large volume contracts with drug companies and retail pharmacies and can offer prescription drugs at lower prices, would also benefit from efforts to control health care costs.

A larger military budget should help defense companies.

Industrials

Defense companies should benefit from a larger military budget under a re-elected President Bush. NASA is also likely to see increased funding. Also, a large range of manufacturers likely face less potential asbestos liability than they would have under a Kerry Administration.

Tackling Taxes

Table 3: Key Expiring Provisions of Tax Law

2006
Taxpayers no longer have the option of deducting state sales taxes.
Temporary increase in AMT exemption amount expires.
2009
Long-term capital gains taxed at a maximum rate of 28%, and dividends taxed as ordinary income instead of a 15% maximum rate.
2011
Income Tax Rates Revert to pre-2001 levels
– Top bracket becomes 39.6%, 10% bracket goes away.
– Child Tax Credit reverts to $500 from $1,000.
Estate tax resurfaces.

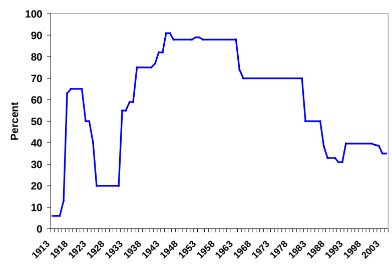
Source: Joint Committee on Taxation, Merrill Lynch.

In a second term President Bush might straddle two goals with regard to taxes: make the tax law changes of his first term permanent, and simplify the tax code.

Key elements of the tax packages passed during the Presidents first term are set to expire in the coming years. (See Table 3 above.) These "sunset provisions" were imposed in order to contain the long-term cost projections of the tax law changes. As things stand:

- Beginning in 2009, long-term capital gains and dividends will no longer be taxed at a maximum rate of 15%. For those in the top tax bracket, that amounts to an increase in the tax rate to 28% on capital gains and to 35% on dividends. We expect Congress to make this tax law change permanent.

Chart 2: Top Marginal Tax Rate

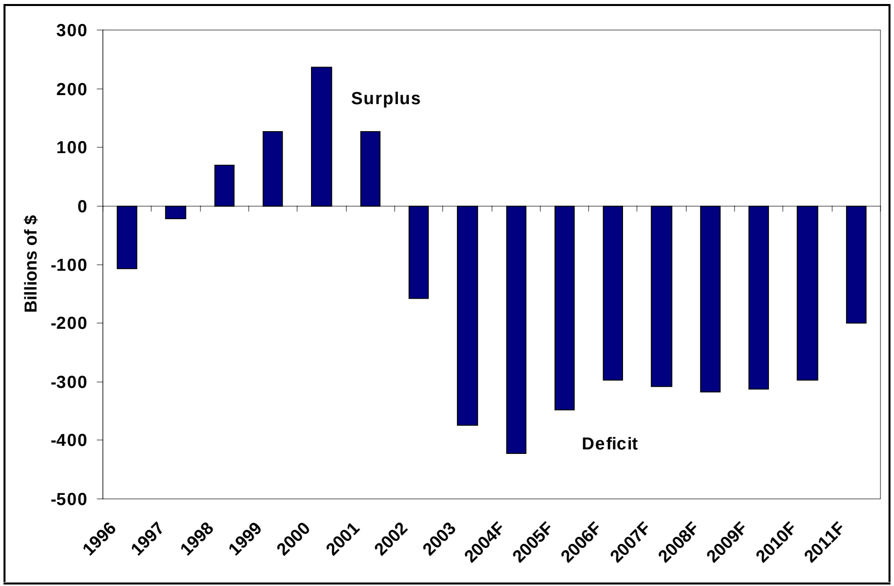


Source: Treasury Department.

- Beginning in 2006, taxpayers will no longer have the option to deduct state sales taxes instead of state income taxes, a choice that was granted as part of legislation passed in October 2004.
- Beginning in 2011, income tax rates will return to pre-2001 levels.
- The estate tax is scheduled to phaseout by 2010, but return in 2011.

A re-elected President Bush would push to make the tax law changes permanent. Because he will have a Republican Congress, and the real hit to the budget from the sunset provisions will not begin for another four years, we believe that the President will succeed in getting most of the full package made permanent. Nevertheless, the likelihood that budget deficits will be large in the coming years (see Chart 3) should create some pressure to raise revenue from sources other than marginal tax rate increases.

Chart 3: Federal Budget Balance



F= Forecast
Source: Congressional Budget Office.

Tax simplification may take priority over tax cuts under the existing system.

The President may also turn his attention to a second goal: simplifying taxes. Ironically, the way to do that may be through what has become the most controversial part of the tax law, and one that has expanded far beyond its original intent: the Alternative Minimum Tax.

Coming to Grips With the AMT

Once a footnote in the income tax system, the AMT is on its way to surpassing the ordinary income tax as a source of revenue for the federal government. The AMT was introduced in the late 1960s as a mechanism to make sure that wealthy people could not avoid paying their "fair share" of income taxes. Since then the reach of the AMT has extended far beyond that.

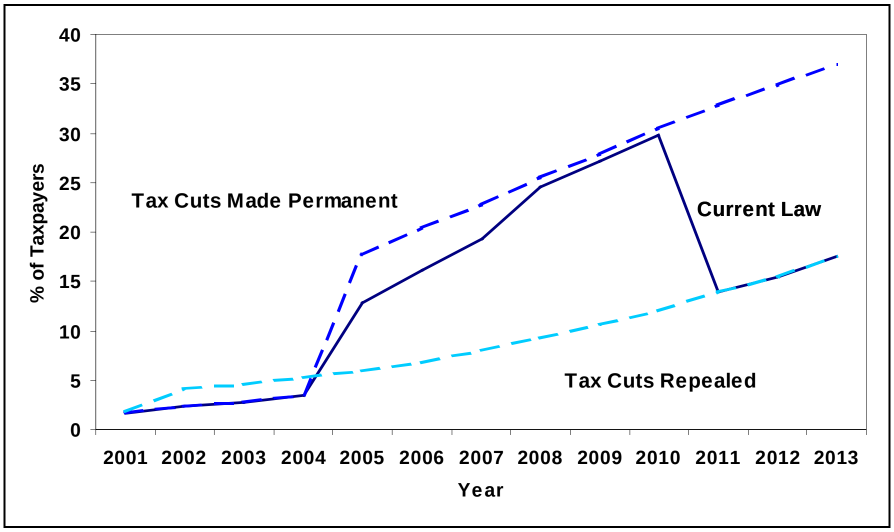
The AMT is essentially an awkward and accidental version of a flat tax. The AMT allows fewer deductions than the normal system, but has only two statutory rates: 25% and 28%. Taxpayers are allowed to exempt a certain amount of AMT income from taxation. The first $175,000 of income beyond that amount is taxed at 25%, and the rest is taxed at 28%. But, the phaseout of the exemption amount at high-income levels can make the effective marginal tax rate as high as 35%. In an attempt to contain the reach of the AMT, Congress has raised the exemption amounts temporarily, but this has had little impact on most taxpayers.

Taxpayers are liable for the higher of the tax rates computed under the normal system and the AMT. The tax cuts during the Bush years, plus the fact that the AMT cutoff points are not indexed for inflation have pushed more people into the AMT in recent years. In effect, the AMT reduces the extent of the tax cuts that were enacted during the President's first term.

More people are facing the AMT.

Chart 4 shows estimates of the prevalence of the AMT under different assumptions about tax law changes. If current law holds and tax rates return to pre-2001 levels in 2011, the reach of the AMT will expand steadily through 2010, and then falloff sharply. If the tax cuts are made permanent after 2010 the incidence of the AMT will rise steadily beyond then. Conversely, an immediate repeal of the Bush tax cuts would derail the expansion of the AMT, as more people would then face higher taxes under the normal system.

Chart 4: The Incidence of the AMT Under Different Tax Assumptions



Source: Tax Policy Center

The AMT will hit middle income people more than the very rich!

The incidence of the AMT varies greatly by income level. (See Table 4 below.) Presently, the tax is concentrated in the upper income brackets, but that will change. According to estimates by the Tax Policy Center, by 2010 nearly three-quarters of those with incomes of $75,000 -$100,000 in 2002 dollars will fall under the AMT. That figure exceeds 90% for those with incomes between $100,000 and $500,000. Ironically, the incidence of the AMT is smaller for income levels above $500,000, the income bracket that was the target of the AMT when the system was introduced.

Table 4: Who Will Face the AMT?*

	% Facing AMT	
Income Level(2002 $)	**2005**	**2010**
$0- $50,000	<10%	<10%
$50,000-$75,000	9%	37%
$75,000- $100,000	27%	73%
$100,000- $200,000	54%	92%
$200,000- $500,000	83%	96%
$500,000- 1,000,0000	27%	49%
> $1,000,000	19%	24%

* Does not include the effect of the recent increase in AMT exemption amount for 2005. The figures for 2005 may be slightly overstated as a result, especially for the lower income brackets.
Source: Leonard E. Burman, William G. Gale and Jeffrey Rohaly: "The AMT Projections and Problems," *Tax Notes,* July 7, 2003.

Despite widespread opposition, it will be difficult to make major changes to the AMT: the tax simply brings in too much revenue. In fact, Congressional estimates show that by 2008 it would be more costly to scrap the AMT than the normal system.

The AMT can't be scrapped, but it might be used as a framework for tax simplification.

We suspect that the President will use the AMT as a framework for simplifying the current system. The goal would be a system with fewer deductions, and a lower marginal tax rate than under the normal system. Still, getting there will not be easy, as previous attempts at both a flat tax and consumption-based tax have shown. Among the problems are deciding which deductions to continue to allow. For example, it would be hard to scuttle the home mortgage and charitable deductions. Also, politically, it would be difficult to avoid the charge that the switch to a flat tax benefits high-income people more than low-income people.

Regardless of how successful the President might be in simplifying the tax system, it seems nearly certain that some version of the AMT is here to stay and that its reach will grow. That leaves investors with this unhappy truth: you may face a lower tax rate, but not necessarily in a way that you want. If you fall under the AMT, you have fewer deductions, and by definition you are paying more than under the regular system.

A flatter tax could decrease the appeal of munis versus taxable bonds, but the impact is not likely to be large. For example, under the 28% top statutory AMT rate, a 10-year AAA-rated municipal G.O. presently yields 50 basis points more than the after-tax yield on a Treasury security.

Other Considerations

New leadership at the Fed and other important regulators.

Mr. Bush would also have a big hand in determining the course of **regulatory and monetary policy**. Fed Chairman Greenspan must step down by January 2006. President Bush would appoint his successor as well as possible new leaders at the SEC, FDIC, Comptroller of the Currency, and possibly the Treasury Department.

Who might a re-elected President Bush tap **to succeed Mr. Greenspan at the Fed**? The top candidates appear to include two former heads of the Council of Economic Advisors—Martin Feldstein and Glen Hubbard, as well as current Fed Governor Ben Bernanke. In any event, President Bush is likely to appoint someone who shares Greenspan's anti-inflation resolve.

The President might also push for **partial privatization of Social Security**, although this will undoubtedly meet with strong opposition. Currently, all of the assets held by the Social Security Trust funds are Treasury securities. Partial privatization would shift some of these assets to equities, which would be another aspect of the Bush presidency that would favor stocks over bonds.

A Bush victory would probably add to what we believe are already important downward influences on the **dollar**. The Bush Administration has not been a strong verbal supporter of a strong dollar, and market forces stemming from the large current account are likely to push the greenback lower at least through the first half of 2005.

Conclusion: What to Do

We would see a Bush victory as a slight positive for the stock market and a slight negative for the bond market. That said, other factors are clearly more important in setting the direction for both markets.

We highlight the sectors that we think would benefit from a Bush victory in the Table on the cover page. From a policy standpoint, a re-elected President Bush may leave his mark by making the tax cuts from his first administration permanent, and, particularly if that initiative does not succeed, by moving to a flat tax. The most likely route to that would be through the existing Alternative Minimum Tax.

Here are some investment recommendations for a second Bush Administration. Keep in mind that your investment decisions should be based on your risk tolerance and investment goals.

- Hold on to large capitalization **pharmaceutical** shares. We recommend that new commitments to this sector be among European drug manufacturers. We also recommend Pharmacy Benefit Managers (PBMs).
- In the energy sector, we recommend **oil drillers and service companies**, along with companies involved in **exploration and production**.
- Among industrials, our chief recommendation is **defense** stocks.
- **Life and health insurers** are the most likely to benefit from the proposed tax incentives to purchase health-care related insurance.
- In the taxable bond market, we recommend moving down in quality to get extra yield, and emphasizing **three-to-seven-year** maturities. We also recommend a 3% allocation to inflation-linked securities, especially the Treasury **TIPS.**
- We recommend a heavy concentration towards **municipal securities** in bond portfolios for those in the 28% federal tax bracket and higher. Our favored maturity range for munis is 5-to-15 years.

Analyst Certification

We, Thomas Sowanick, Michael Hartnett, Philip Fischer, Martin Mauro, David Wilson, Cheryl Rowan, Millicent Citron here by certify that the views expressed in this research report accurately reflect our personal views about the subject securities and issuers. We also certify that no part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or view expressed in this research report.

Important Disclosures

Investment Rating Distribution: Global Group (as of 30 September 2004)

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Buy	1095	44.05%	Buy	374	34.16%
Neutral	1207	48.55%	Neutral	333	27.59%
Sell	184	7.40%	Sell	37	20.11%

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