

Global Political Insights

US Elections Outlook: It's Not Just The Economy, Stupid

- **We reiterate our view that President Barack Obama is likely to be re-elected November 6, with recent developments supporting our earlier call.** Obama has led in the polls all year, and history suggests that incumbent presidents who maintain their lead go on to be re-elected. The US economy, although weak, has improved from its 2009 lows, potentially insulating Obama from the anti-incumbent "Ultravox Populi" effect evident in other mature democracies experiencing a decelerating economic trend. Nevertheless, the contest will be hard-fought.
- **Ignore the pundits and partisans—think like a policy wonk.** In this paper we provide a political science-based assessment of the polls with relevant historical comparisons; an early look at side-by-side policy positions, including the limited importance of foreign policy in this campaign; and signposts to watch for. We also deconstruct the mechanics of the complex US political system for an international audience. In the weeks ahead, we are doubtful that fundraising, advertising or the televised debates will significantly alter the main trend. Similarly, fluctuations in the weekly data will have little impact at this stage of the race.
- **We note the reduced risk of an "October Surprise," as the two main external threats to the US economy—and thereby Obama's re-election—have receded.** Last week's ECB measures reduce the potential for a disorderly eurozone event in the near-term. The likelihood of an attack on Iran ahead of US elections has declined in our view, following comments from the US political & defense establishment and other changes to the political calculus, pushing the risks into the new year.
- **Prepare for a broad continuation of the political status quo. Our base-case scenario suggests Obama in the White House, Republicans in control of the US House, and Democrats in the US Senate.** But although the current political configuration has delivered limited legislative momentum, we note that the history of last-minute deal-making could bode well for pragmatic compromise, if not the comprehensive fiscal reform markets crave. We retain our longstanding optimism on eventual progress toward tax reform and continued trade agreements, regardless of the occupant of the White House.
- **Fiscal Cliffhanger? It may be the interests of both parties in Congress to go over the "fiscal cliff" temporarily, allowing legislators to vote on more favorable new legislation.** It certainly looks like this possibility has not been priced into markets. At the same time, the history of last-minute compromise could continue into the "lame duck" session between elections and the new year. But we expect no activity before the election, and subsequent cliff scenarios are highly dependent on the outcome at the ballot box and the actors leading the negotiations.

Tina M Fordham
+44-20-7986-9860
tina.fordham@citi.com

With thanks to
Matt Dabrowski

See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

Citi Research is a division of Citigroup Global Markets Inc. (the "Firm"), which does and seeks to do business with companies covered in its research reports. As a result, investors should be aware that the Firm may have a conflict of interest that could affect the objectivity of this report. Investors should consider this report as only a single factor in making their investment decision.

Contents

US Elections Amid the UltraVox Populi	3
Signposts: Key Dates for US Elections and Beyond	4
Pessimism & the "New Normal" in the US	4
A Primer on the US Elections Process	5
The Race for the White House: Close, But We Expect a Second Term for Obama	7
Obama's Year-Long Lead & Why It Matters	8
Is Obama Another Jimmy Carter? The Case of 1980	10
Is Obama Another George H.W. Bush? The Case of 1992	10
Can A President With Approval Under 50% Be Re-Elected?	11
Small Economic Gains Bode Well for Obama	12
Pragmatic Obama & Team Player Romney on the Issues	13
Can Bounces & Veeps Be Game Changers?	15
Romney Picks Paul Ryan	15
Convention Bounces Unlikely to be 'Game Changers'	16
The Presidential Debates	17
Is This Time Different?	17
Apathy and the Obama Coalition	17
The Gender Gap	18
Independents	18
American NEAP's: the Occupy Movement & the Tea Party	19
Outlook for Congress	20
GOP Control of US House Likely to Reomain	20
Toss-up for US Senate	20
More Gridlock & Obama Pragmatism on the Horizon in 2013	21
A Brief and Temporary Fall Over the Fiscal Cliff?	21
Fiscal Cliff Scenarios & Implications	22
Looking Forward to 2013	24
A Continuation of the Political Status Quo: Not Necessarily Bad News	26
Appendix A-1	27

US Elections Amid the UltraVox Populi

The 2012 American presidential election was off and running well in advance of its traditional Labor Day start. But outside the usual punditry, the campaign season has produced few surprises.

At a time when growth is sluggish, uncertainty is high and political risk is at the forefront, the US elections will be closely watched by global investors. We identified 2012 as a very political year, with a major concentration of elections in economically and geopolitically significant countries. The US race will be among the most important in a year of multiple elections and political transitions. In this paper, we adopt a political science-based approach to the current polls and political context, address what could change our assessment of a likely Obama re-election and continuation of the political status quo in the United States, and identify some of the key challenges the next US president will face.

The 2012 American presidential election was off and running well in advance of its traditional Labor Day start. But outside the usual punditry, the campaign season has produced few surprises. The momentum that surrounded the 2008 election has long since evaporated, evidenced by reduced viewership for the party conventions, and the polls have barely budged all year, with few US voters remaining undecided. Both Barack Obama and Mitt Romney have both been on the US political scene for some time now, and this race has failed to generate significant enthusiasm from voters despite the high economic stakes. Why, and how does it matter?

The US trend contrasts with the political developments in Europe, where political change and anti-incumbent sentiment has dominated, as elected leaders try to manage deep recessions and fiscal crises and a restless electorate rewards or punishes their leaders based on performance, making space for new, extreme and/or alternative political parties, which we have identified as NEAP's.

The sluggish recovery in the US economy – and it is a recovery, however slight – has created a political playing field markedly different from that of Europe.

How might the US avoid this "UltraVox Populi"? The sluggish recovery in the US economy – and it is a recovery, however slight – has created a political playing field markedly different from that of Europe, while the two-party system has reduced the space available for competing political alternatives. Voters may be relatively unenthusiastic about what is on offer, but they effectively lack choices beyond the two main parties. For Americans, the primary means of expressing anti-establishment sentiment may be staying at home

In Europe, government after government has been turned out of power over the past two years in the midst of a lingering economic malaise. But the United States has already had its share of political change, experiencing two "wave elections" in 2008 and 2010 (and in 2006 as well). In this respect, US politics may be further along the trajectory to a post-global financial crisis political "new normal."

This interplay between public opinion and the post-recession economy defines the 2012 election in the United States, and underpins our view that while the economy and jobs remain the top issues for US voters, it's not just "the economy, stupid," in the phrase famously coined by Democratic strategist James Carville in the 1992 election, that will determine this race.

This potential shift suggests that relying on post-World War II indicators and models for assessing the outcome of US elections may be of more limited utility than in the past, given that the depth and duration of the current contraction is unprecedented during this period (surpassed only by the Great Depression). With this in mind, we suggest that a close look at the polls and the prediction markets may be more useful than models that give excessive weight to economic indicators.

Signposts: Key Dates for US Elections and Beyond

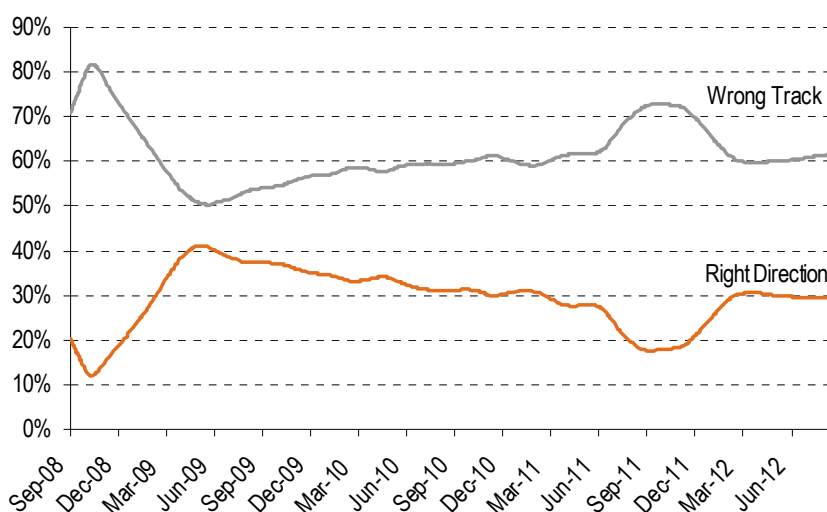
August 30	Mitt Romney accepts nomination at Republican National Convention
September 6	President Barack Obama accepts nomination at Democratic National Convention
September 30	End of government FY12, must pass budget or continuing resolutions
October	112th Congress adjourns for election season
October 3	Presidential debate in Denver
October 11	Vice presidential debate in Danville, Kentucky
October 16	Presidential debate in Hempstead, New York
October 22	Presidential debate in Boca Raton, Florida
November 6	Election Day
December	Likely "lame duck" session of 112th Congress
December 31	Tax rates expire ("fiscal cliff")
January 2	Office of Management & Budget begins sequestration ("fiscal cliff")
January 3	113th Congress convenes
January 20	Inauguration Day

Source: Citi Research

Pessimism & the "New Normal" in the US

Since the beginning of this year, around 60% of Americans tell pollsters that the country is on the wrong track, historically a potent indicator of dissatisfaction with the current presidential administration. But this pessimism isn't new to the United States. Some pollsters report 'wrong track' pluralities since 2003. With economic and political uncertainty at home and abroad, we suggest that this dissatisfaction with the status quo may signal the emergence of a "new normal" in US public opinion. A review of the public opinion data below highlights that the last time a plurality of US voters viewed the country as being on the "right track" was in the early part of the last decade.

Figure 1. Extended Pessimism in the United States Goes Back As Far As 2008



Source: Huffington Post/Pollster.com. <http://elections.huffingtonpost.com/pollster/us-right-direction-wrong-track>

Figure 2. And Further Back Than That...

Last time 'right direction' was over 50% among some major US pollsters

Ipsos	55%, May 2009
Gallup	55%, January 2004 ("satisfied")
CBS	never since 2006
NBC/Wall Street Journal	56%, December 2003

Source: The Polling Report

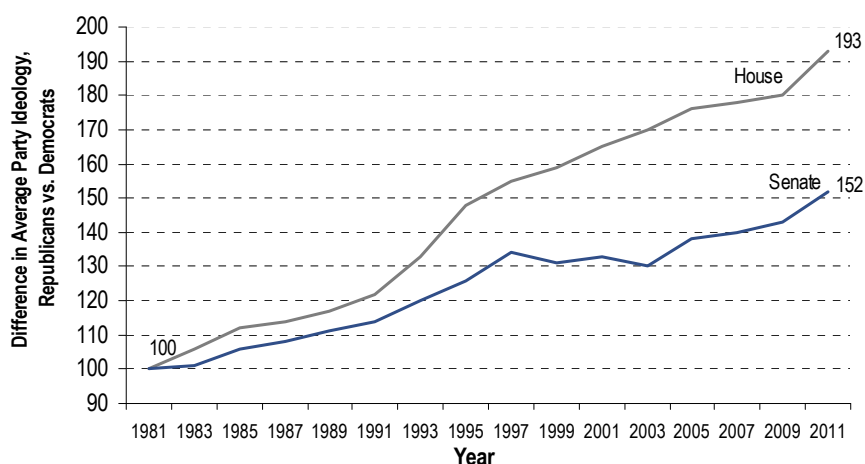
For sixty years, Americans have enjoyed a consistently rising standard of living, and this prosperity has been the root of the traditional American optimism. But in the wake of the financial crisis, the mood has changed.

Despite the negative top-line numbers, there's some positive short-term movement. Only 31% tell Pew that economic conditions are good in the US, but this is up from 18% last year.¹ This trend is to Obama's benefit.

For sixty years, Americans have enjoyed a consistently rising standard of living, and this prosperity has been the root of the traditional American optimism. But in the wake of the global financial crisis, the mood has changed. For the first time, large numbers of Americans feel that their children won't be better off than they were, marking a significant departure from one of America's most cherished notions — social mobility through hard work instead of class privilege: meritocracy.

A further shift is the increase in political polarization — the distance between the parties — currently at an all-time high, both in Congress and within the electorate. Such distance is a significant handicap in a political system designed to force compromise and reduce the power of any of the three branches of government. Could these and other factors combine to form a structural change in American public opinion?

Figure 3. Political Polarization in the US Congress At All-Time Highs (1981 Levels = 100)



Source: Professors Keith Poole & Howard Rosenthal/VoteView.com, based on aggregate roll call votes in the US Congress.

A Primer on the US Elections Process

The American president is not elected by popular vote. Instead, each state receives 'electoral votes' based on its representation in Congress.

For those unfamiliar with the US political process, we offer a quick primer. The United States is a de-facto two-party system, where the overwhelming majority of politicians are members of either the Republican or Democratic parties. All US presidents have been members of these two parties since the American Civil War.

The American president is not elected by popular vote. Instead, each state receives "electoral votes" based on its representation in Congress. Each state has two Senators and a number of Representatives proportionate to its population. California, the most populous state, has 55 electoral votes, while Wyoming, the least populous, has 3. The District of Columbia, the federal capital territory, is also given three votes. Together the 538 electors are called the Electoral College.

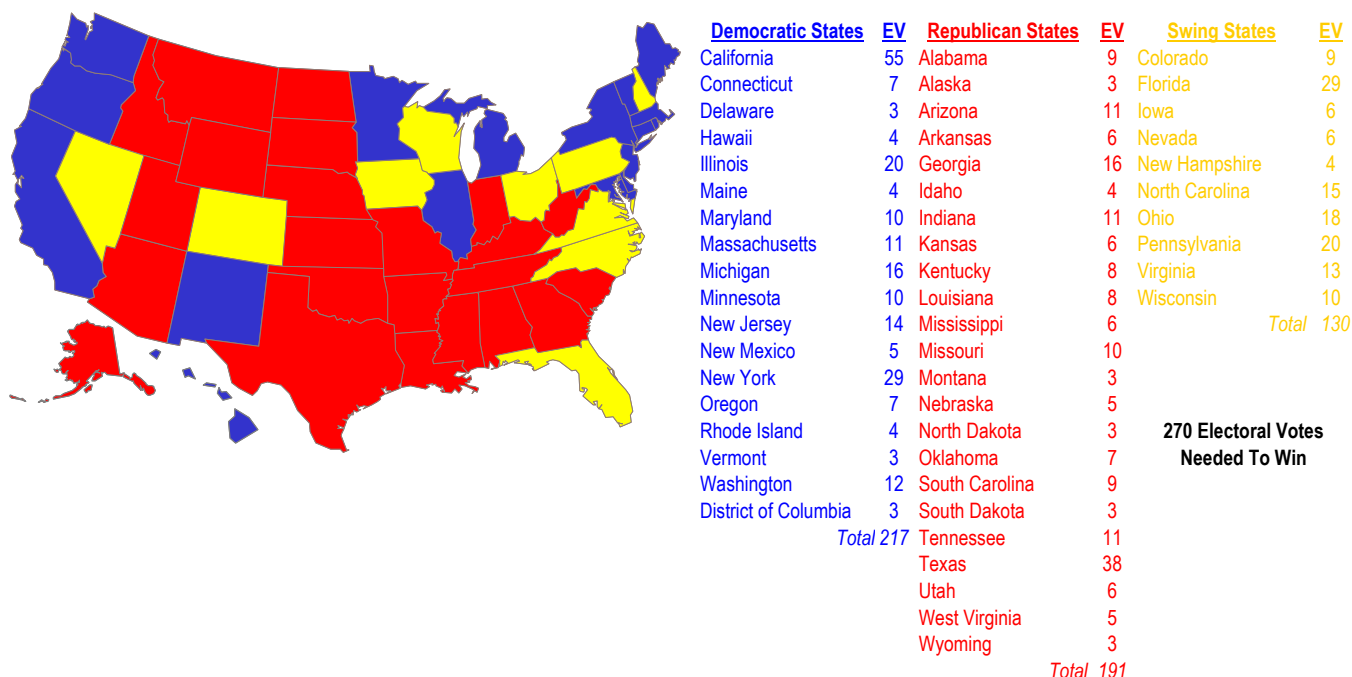
¹ Pew Global Attitudes Project. <http://www.pewglobal.org/2012/07/12/pervasive-gloom-about-the-world-economy/>

The electors cast their ballots for the winner of the popular vote in their state. Nearly all the states use a 'winner-take-all' system for electoral votes. Two states, Nebraska and Maine, allot their electoral votes using a proportional system.

First, due to arithmetic, the candidate who wins the most electoral votes (and thereby has won the most states) usually wins the national popular vote as well. But this isn't always the case. Most recently, George W. Bush was elected president in 2000 despite narrowly losing the popular vote. Regardless, despite the fifty-one race system, nationwide opinion polls which aggregate the data across the country remain useful indicators of the public mood, especially when state polls do not contradict.

Second, all states are not created equal. In the Electoral College system, some carry greater weight than others. Most states, due to geography, history or demographics, lean strongly towards one party or the other. For example, Minnesota, which is influenced by the large Minneapolis urban area and a strong labor movement, has voted Democratic continuously since 1972. Wyoming, a Western farming and ranching state, has voted Republican since 1964. States that consistently lean Democratic are nicknamed "blue states," while Republican states are nicknamed "red states." Due to these historical trends, the election is largely a foregone conclusion in these states.

Figure 4. The States and Their Electoral Votes: The Math That Elects The US President



Source: Citi Research. "Blue states" are Democratic, "red states" are Republican, and "swing states" are in yellow.

So in any given election year, only a few states are close enough to be competitive. These states receive most of the attention from the presidential candidates. Americans call these critical battlegrounds "swing states." This year, there are ten swing states: Colorado, Florida, Iowa, Nevada, New Hampshire, North Carolina, Ohio, Pennsylvania, Virginia, and Wisconsin.

This year, the Democratic Party's candidate is President Barack Obama, who seeks his second and final term in office. Obama was a law professor and a best-selling author before entering politics. He served as a community organizer in Chicago, and was elected to the Illinois state legislature and the US Senate. Obama attended Columbia University and Harvard Law School. He is 51 years old.

The Republican nominee is Mitt Romney, who is making his second run for the presidency. Romney spent his career in management consulting and private equity in Boston. He ran the 2002 Winter Olympics and was elected governor of Massachusetts. Romney attended Brigham Young University and Harvard. He is 65 years old.

The Race for the White House: Close, But We Expect a Second Term for Obama

We reiterate our base-case scenario that President Barack Obama will likely be re-elected. The effects of a major economic or geopolitical event could alter our base-case scenario, but with less than eight weeks until Election Day, time is short for this counterpoint.

We reiterate our base-case scenario that President Barack Obama will likely be re-elected, albeit by a narrow margin. The effects of a major economic or geopolitical event could alter our base-case scenario, but with less than eight weeks until Election Day, time is short for this counterpoint.

In our August mid-year global political outlook, we wrote:²

"Obama remains strong on a whole host of issues. It is notable that the consensus of US political pundits and forecasters has Obama ahead, even if slightly. Survey data highlights Obama's strong 'likability' and American voters' trust on issues such as terrorism and foreign policy....

While the relationship between economic performance and the success of ruling parties at the ballot box is taken as a given, we caution that it is not the only variable in voters' calculations. Even with the economy as the overarching issue, other intangibles have an effect. Noted US elections prognosticator Nate Silver has explored the weak relationship between economic indicators and electoral outcomes.³

This suggests to us that observers dismiss Obama's chances by looking for specific red lines in the economic indicators. Here we note that the US economy is growing, albeit sluggishly, and while fiscal pressures are considerable, they are not nearly as acute as in the eurozone. While no candidate would seek out running for election in today's current economic conditions, the modest improvement to the US economy compared to 2009 lows may be sufficient for the US public to support four more years of Barack Obama...

² Tina Fordham et al. Citi Research note. "[Mid-year Outlook: Rising Geopolitical Risks and the New UltraVox Populi Will Carry On Into 2013](#)." August 2, 2012.

³ Nate Silver. "[Which Economic Indicators Best Predict Presidential Elections?](#)" *Five Thirty Eight*. *The New York Times* online. November 18, 2011.

Substantial downside risks to the outcome of the US election come from abroad: the Eurozone crisis, a hard landing in China, and an Iranian war in the Gulf. Any of these events would have a dramatic impact on US politics. Seen this way, Obama's chances for re-election depend less on his own campaign or Mitt Romney's, than on the European policy-makers, the Chinese and the Iranians. We reiterate that the base-case scenario today is an Obama re-election, but any number of negative economic developments from abroad may change this trajectory."

An "October surprise" cannot be ruled out. The collapse of Lehman Brothers in September 2008 proved a significantly destabilizing event ahead of the last presidential contest. Yet since this assessment, the prospects for an exogenous shock from either a disorderly eurozone event or an attack on Iran have declined, following European Central Bank President Mario Draghi's announcement last week. In terms of Middle East risk, comments from senior members of the US defense establishment and President Obama cautioning that the US would not support a unilateral attack against Iran will likely postpone military action until after the elections, though we continue to believe that these pressures will resume in earnest early in 2013, while at the same time developments in Syria continue to pose a wild card challenge to regional stability.

Obama's Year-Long Lead & Why It Matters

Obama's lead is a key point. Incumbent presidents who have led their challengers all year go on to be re-elected, while incumbent presidents who fall behind are defeated. These incumbents are often behind as early as May (i.e. four months ago).

Obama continues to maintain his lead in the polls, and this year-long lead is the first leg of our base-case scenario for his re-election. Obama's lead is a key point. Incumbent presidents who have led their challengers all year have gone on to be re-elected, while incumbent presidents who have fallen behind have been defeated. These incumbents were often behind as early as May (i.e. four months ago).

American polling presents a unique case. Dozens of reputable researchers conduct surveys on a regular basis, both nationally and in individual states. The polling discipline's professional organization and a full-fledged polling media work to keep researchers honest. The large amount of data along with a sophisticated readership makes political polling in the United States the gold standard around the world, and helps to increase the confidence level in the output, compared to other countries where a small number of polls may be available for a given election and their methods potentially less rigorous.

With this in mind, given the nearly 400 polls conducted in the United States this year by dozens of polling outfits, we can gain a better idea of public opinion by not relying on any single pollster or survey. The technique, called the "rolling average," is similar to the simple moving average familiar to stock watchers.

The Pollster.com and Real Clear Politics (RCP) rolling averages take into account survey data from dozens of sources and are therefore more statistically significant than any single survey, and they also avoid "house effects," or the small biases in any individual pollster's data.

Figure 5. Latest Polling in the Swing States

Colorado	Obama +3
Florida	Obama +1
Iowa	Obama +1
Nevada	Obama +3
New Hampshire	Obama +4
North Carolina	Romney +2
Ohio	Obama +2
Pennsylvania	Obama +7
Virginia	Obama +1
Wisconsin	Obama +3

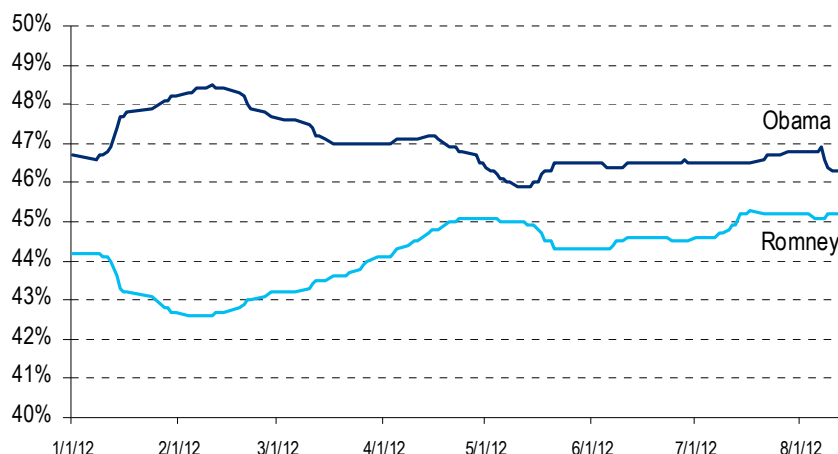
Source: Huffington Post/Pollster.com and Real Clear Politics rolling averages, accessed September 10, 2012.

The Pollster.com and Real Clear Politics (RCP) rolling averages take into account survey data from dozens of sources and are therefore more statistically significant than any single survey. Both rolling averages have Obama with a slight lead: up two points in the Pollster.com average, and four points with RCP.

Both rolling averages have Obama with a slight lead: up two points in the Pollster.com average, and four points with RCP.⁴ This trend among rolling averages result bears greater weight than any single poll, increasing our willingness to take a view that Obama will be re-elected by a nose, in contrast to observers who suggest the race is too close to call.

Obama has led Romney continuously in the RCP average since October 2011; he has never trailed Romney in the Pollster.com average. In any single poll, one can call a two-point lead a statistical tie. But in a trend of several hundred polls, we believe a consistent lead is a lead, even if it's only two points. Since the Electoral College winner almost always win the popular vote (represented by this national aggregate data), and because Obama leads in nine of the ten swing states, we believe the state-by-state vote will confirm these national polls.

Figure 6. Obama's Year-Long Lead, However Small, Points To His Re-Election



Source: Huffington Post Pollster.com rolling average, based on 420 surveys conducted in 2012, accessed on August 24, 2012, prior to party conventions.

In both modern cases when incumbent presidents lost their re-election bids, the challenger led months before Labor Day.

Of the forty-three US presidents, only nine who sought re-election have been defeated.⁵ Why is it unlikely Obama will be one of the unlucky ones? Let's examine the two cases over the past 75 years where an incumbent president has been defeated for re-election: 1980 and 1992. In both cases, the challenger led months before Labor Day. This is not the case in 2012.

⁴ Huffington Post/Pollster.com and Real Clear Politics rolling averages, accessed September 11, 2012. <http://elections.huffingtonpost.com/pollster/> http://www.realclearpolitics.com/epolls/latest_polls/president/

⁵ The defeated incumbent presidents were John Adams, John Quincy Adams, Martin Van Buren, Grover Cleveland, Benjamin Harrison, William Howard Taft, Herbert Hoover, Jimmy Carter and George H.W. Bush. Theodore Roosevelt also lost a subsequent run, but was not the incumbent at the time. Gerald Ford was the incumbent president on account of Nixon's resignation, so he was not seeking re-election when he lost to Carter.

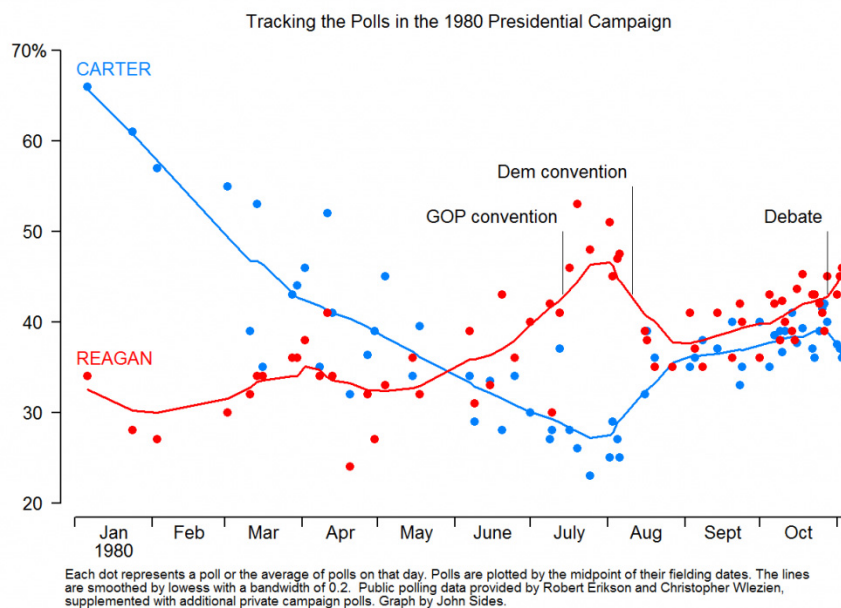
Is Obama Another Jimmy Carter? The Case of 1980

The popular misconception of the 1980 election is that Ronald Reagan surprised incumbent Jimmy Carter with a late run in the polls. In fact, Reagan led Carter as soon as he became the presumptive nominee in May.

The popular misconception of the 1980 election is that Ronald Reagan surprised incumbent Jimmy Carter with a late run in the polls. This is incorrect. In fact, Reagan led Carter as soon as he became the presumptive nominee in May, and though Carter closed some of the gap after the Democratic convention, Reagan maintained this lead for the rest of the year.

Caught between economic "malaise," the Iran hostage crisis and a vigorous challenge inside the Democratic Party from Senator Ted Kennedy, Carter's numbers began to drop early and never recovered. Kennedy lost the early Democratic primary elections but refused to drop out, and his candidacy dogged Carter until the Democratic convention in August. In the Republican Party, Reagan took the lead from George H.W. Bush after a hard-fought March primary in South Carolina, and become the presumptive nominee until after the Oregon primary in late May. He began to lead Carter in the national polls shortly thereafter.

Figure 7. Carter Trails Reagan Over Most of 1980 Campaign, Starting in May



Source: John Sides. "What Really Happened In The 1980 Presidential Campaign." *The Monkey Cage* blog, accessed August 13, 2012. <http://themonkeycage.org/blog/2012/08/09/what-really-happened-in-the-1980-presidential-campaign/>

Is Obama Another George H.W. Bush? The Case of 1992

George H.W. Bush started on top, but lost his lead to an insurgent Perot in late May — almost six months before Election Day.

The pattern was similar in 1992. A weakening economy dogged the incumbent president, George H.W. Bush. Shortly after he became the presumptive Democratic nominee, Bill Clinton took the lead from President Bush and businessman Ross Perot, and Clinton never gave it up.

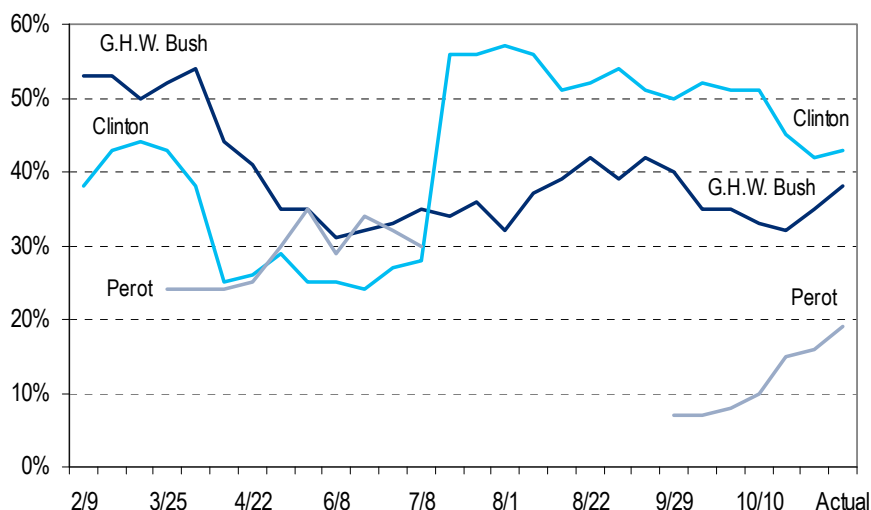
Analysts remember this election for Bush, Clinton and Perot exchanging leads in the polls. As the incumbent president, Bush started on top, but lost his lead to an insurgent Perot in late May — almost six months before Election Day. (Recall that the US is a de facto two-party system. This is last time that an independent candidate compared so favorably to an incumbent president in the polls, and it has not happened again since.) Perot's numbers were strong into June, but the

candidate lost momentum in the heat of the national spotlight and was forced from the race later on.

Throughout this period, the Democratic nomination was still contested. Clinton distinguished himself from a crowded Democratic field after the "Super Tuesday" primaries in March. But California Governor Jerry Brown also won several states, and the two traded primary victories for more than two months. In the end, Clinton finally beat Brown in the latter's own home state on June 2, and secured the nomination.

Perot's trouble with the media worked to Clinton's benefit. Clinton first led Bush in the Gallup poll the week he was nominated at the Democratic convention in July, and maintained this lead for the remainder of the campaign.

Figure 8. In 1992, Bush Sr. Loses His Lead Early & Never Regains The Advantage



Source: Gallup U.S. Presidential Election Center. Perot withdrew from the race between July and October 1992.
<http://www.gallup.com/poll/154559/US-Presidential-Election-Center.aspx>

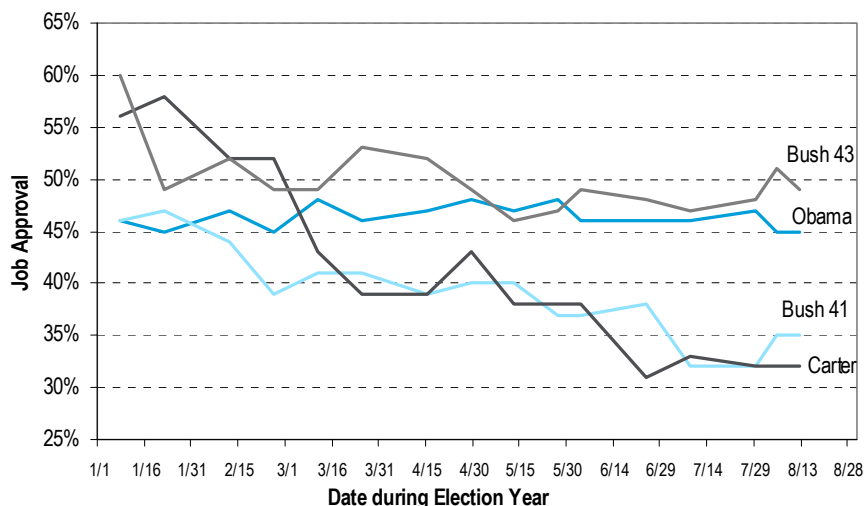
Can A President With Approval Under 50% Be Re-Elected?

Obama's job approval may be weak, but he fares better at this point than the two presidents who've lost re-election: Carter and the elder Bush.

Some analysts point to Obama's comparatively weak job approval ratings as a 'red line' for his re-election chances. However, Obama's job approval may be weak, yet he fares better at this point than the two presidents who've lost re-election: Carter and the elder Bush ("Bush 41").

Obama's approval numbers remain in the mid-40's, while by August of the election year, both Carter and Bush were in the low 30's. George W. Bush ("Bush 43"), who had the lowest campaign-season approval ratings of any re-elected president, was in the high 40's in August. Bill Clinton, Ronald Reagan and Richard Nixon were both in the low-to-mid 50's at this point in the campaign.

Figure 9. Obama's Job Approval Closer to Victorious George W. Bush Than Defeated Carter



Source: Gallup Presidential Job Approval Center. <http://www.gallup.com/poll/124922/presidential-approval-center.aspx/>

Small Economic Gains Bode Well for Obama

The second-leg of our base-case scenario is the state of the US economy which, while struggling, has improved from its 2009 lows and has not gone into reverse.

The second-leg of our base-case scenario is the state of the US economy which, while struggling, has improved from its 2009 lows and has not gone into reverse. This factor is also to the President's benefit. As Citi analysts Robert DiClemente, Peter D'Antonio and Steven Wieting wrote in August:

"Rebounds in employment and consumer spending in July have eased fears that the expansion might be at risk. Although major downside threats remain due to scheduled fiscal tightening next year and the ongoing financial crisis in Europe, the U.S. recovery is proceeding on a modest 2% track. Consumer finances have benefited from faster income growth, slowing inflation and easier credit, while signs of a modest housing rebound have become more widespread."⁶

In the ten swing states, the employed labor force has increased by almost one million jobs since unemployment was at its worst.

Another notable factor in our view is that in the ten swing states, the employed labor force has increased by almost one million jobs since unemployment was at its worst. Though we wouldn't overemphasize this type of rough measure, it points to the impact of the recovery in terms of real voters.

⁶ Willem Buiter et al. Citi Research note. ["Global Economic Outlook and Strategy - August 2012."](#) August 22, 2012. pg 16.

Figure 10. Unemployment Down In Swing States, to Obama's Benefit

Swing State	Peak Unemployment (Date)	Unemployment, June 2012	+ / - Jobs
Colorado	9.0% (October 2010)	8.3%	+ 29,000
Florida	11.4% (February 2010)	8.8%	+ 409,500
Iowa	6.3% (August 2010)	5.3%	- 2,000
Nevada	14.0% (October 2010)	12.0%	+ 10,500
New Hampshire	6.7% (December 2009)	5.4%	+ 9,000
North Carolina	11.4% (February 2010)	9.6%	+ 116,000
Ohio	10.6% (November 2009)	7.2%	+ 95,000
Pennsylvania	8.7% (March 2010)	7.9%	+ 125,500
Virginia	7.3% (January 2010)	5.9%	+ 155,500
Wisconsin	9.2% (June 2009)	7.3%	- 500
Net Jobs in Swing States			+ 947,500

Source: Bureau of Labor Statistics. Jobs figure is gain/loss in total employment since peak unemployment.

In a close election, there's no incentive for candidates to make detailed statements about policy. Any misstep could cost a candidate votes that he or she can't afford to lose.

Pragmatic Obama & Team Player Romney on the Issues

In a close election, the incentive for candidates to make detailed statements about policy is limited. Any misstep could cost a candidate votes that he or she can't afford to lose. Thus, for candidates, it often pays to be vague. This is the case in 2012, and the media has criticized both candidates for the lack of detail in their campaign platforms. Investors have been waiting to hear the candidate's positions on key areas of policy, so far mostly in vain.

So how can investors anticipate the two candidates' positions on policy matters?

Republicans took control of the US House of Representatives after the 2010 Midterm elections. In our view, Obama's reaction to the new divided political reality has implications for a resolution to the fiscal cliff. Despite the high degree of polarization between the parties, numerous instances of compromise, albeit often hair-raisingly last minute, took place.

Consider the so-called "Bush tax cuts," the focal point of the taxation debate in US politics. Opposition to the Bush package is a major talking point for Democrats, and Obama has opposed it his entire time in public life.

Figure 11. Voters View Obama Better on Security, Even Taxes; Romney Better on Economy

"Regardless of how you might vote, which presidential candidate do you trust to do a better job on each of the following issues?"

	Barack Obama	Mitt Romney
Handling foreign policy	51%	38%
Handling national security	48%	40%
Handling health care	49%	42%
Stopping Iran from getting nuclear weapons	43%	39%
Handling taxes	46%	43%
Handling illegal immigration	43%	43%
Improving the economy	43%	46%
Reducing the deficit	38%	46%

Source: Fox News survey conducted by Anderson Robbins Research (D) and Shaw & Company Research (R). Conducted August 5-7, 2012. Sample of 930 registered voters nationwide. Margin of error +/- 3%.

http://images.politico.com/global/2012/08/120809_fox_news_poll.pdf

Yet upon entering office and facing the political realities in Congress, Obama has come to agreement with legislative leaders on extending the Bush tax cuts every year of his presidency.

Yet upon entering office and facing the political realities in Congress, Obama has come to agreement with legislative leaders on extending the Bush tax cuts every year of his presidency. Even when Democrats were in the control of both houses of Congress, Obama did not press his advantage and attempt to roll back the Bush tax cuts, something many of his fellow party members advocated.

For his part, Mitt Romney tacks close to the position of the Republican mainstream, best represented by Republicans in the US House. Congressman Tom Cole, a long-time senior Republican, told *The New York Times* about his caucus's relationship with Romney: "On the big issues — spending, taxes, what we do with the deficit — I just don't see much difference."⁷

On the issues closest to Republican hearts – fiscal policy and the economy – Romney pursues a similar combination of supply-side tax & spending cuts, and both Romney and House Republicans want to increase the defense budget. Though Romney had avoided endorsing Paul Ryan's budget plan in the past, picking Ryan as his running mate may settle the issue.

While not meant to be predictive of every policy decision or public statement, we believe this framework is a useful way to understand the two candidates on policy.

⁷ Jonathan Weisman and Jennifer Steinhauer. "G.O.P. Lawmakers and Romney Face a Delicate Tango." *The New York Times*. April 15, 2012. <http://www.nytimes.com/2012/04/16/us/politics/house-republicans-would-thwart-romney-move-to-center.html>

Figure 12. With Four Supreme Court Justices Over Age 70, Are Retirements Forthcoming?

Justice	Age	Appointed By
Ruth Bader Ginsburg	79	Clinton
Antonin Scalia	76	Reagan
Anthony Kennedy	76	Reagan
Stephen Breyer	74	Clinton
Clarence Thomas	64	George H.W. Bush
Samuel Alito	62	George W. Bush
Sonia Sotomayor	58	Obama
John Roberts, Chief	57	George W. Bush
Elena Kagan	52	Obama

Source: Supreme Court of the United States

Figure 14. Key Economic Advisers in 2012

Barack Obama	Mitt Romney
Alan Krueger	Glenn Hubbard
Gene Sperling	Greg Mankiw
Timothy Geithner	Kevin Hassett
Jacob Lew	Vin Weber

Source: National Journal

Figure 13. What's At Stake in 2012: What The Campaigns Say About the Issues

	Barack Obama	Mitt Romney
Foreign policy	"Asia pivot," "Russian reset," reducing US conventional commitments through covert operations & drone warfare. Multilateral efforts in Libya, Syria. Iran sanctions but support for diplomatic track. Afghanistan drawdown, end of Iraq War. Death of Osama bin Laden.	More vigorous support for Israel, opposition movements in Syria and Iran. Large-scale investment in military assets to project US power. Free trade agreements, Trade Promotion Authority. Confront Russia, China on geopolitics and human rights. Declare China a currency manipulator.
Taxes & the budget	Roll back Bush tax cuts on upper-income taxpayers. Restore estate tax. Passed payroll tax cut & tax credits for low- and middle-income taxpayers. Passed Recovery Act ("the stimulus").	Extend Bush tax cuts. Make permanent, 20% across-the-board cuts in personal rates. "Ryan budget" seeks long-term deficit reduction through spending caps & entitlement reform.
Corporate taxes	Lower corporate rate to 28%. "On-shoring" tax credit for corporations who move operations back to US.	Lower corporate rate to 25%. Make R&D tax credit permanent. Repeal Alternative Minimum Tax ("AMT").
Investment taxes	Allow capital gains rate to rise to 23.8% as scheduled for earners over \$250,000. Tax dividends & carried interest as earned income.	Keep capital gains rate at 15%, eliminate for low- and middle-income taxpayers. Eliminate surtax on investment income for high earners.
Profit repatriation	Worldwide minimum tax.	Territorial taxation.
Federal Reserve	Both would replace Chairman Ben Bernanke. Romney favors tighter monetary policy.	
Supreme Court retirements	Four Supreme Court Justices are older than 70 years of age	

By Sector

Defense	Take peace dividend from Iraq and Afghanistan drawdowns.	Increase defense spending to 4% of GDP.
Energy	Support renewables, strong oversight on environmental impact and permitting for oil & gas and coal. Roll back tax advantages for oil & gas. Halted Keystone pipeline.	Favor oil & gas. Account for business costs in environmental regulatory process. Expand exploration and permitting. Support Keystone pipeline, Outer Continental Shelf.
Financial	Signed Dodd-Frank.	Repeal Dodd-Frank, Sarbanes-Oxley.
Healthcare	Passed Affordable Care Act ("Obamacare").	Repeal Obamacare. Supports state-based systems, fewer mandates, medical malpractice reform.
Technology	Patent fast-tracking, investments in digital infrastructure, clean energy technology.	Investments in manufacturing-oriented spaces like fuel cells, power generation, materials science.

Source: BarackObama.com, WhiteHouse.gov, MittRomney.com, *The New York Times*, *The Economist*, Reuters, Citi Research.

Can Bounces & Veeps Be Game Changers?

Romney Picks Paul Ryan

On August 11, Mitt Romney picked Congressman Paul Ryan of Wisconsin to be his running mate on the Republican ticket.

Ryan, probably the leading figure among the fiscal policy hawks of the Republican Party, is a popular figure among the party faithful. His "Ryan budget," the leading Republican counterpoint to Obama's fiscal policy, seeks to reduce the US deficit through entitlement reform, spending caps, and a consolidation of personal tax brackets. Popular with fiscal hawks within the party, the choice of Ryan marked an effort by Romney to bolster his credentials with this wing of the party.

Democrats, for their part, oppose his budget plan's entitlement cuts and their effects on pensioners. This issue of Social Security and Medicare was once called "the third rail" in American politics, and is still potent today. In a special election in western New York State last year, Democrats successfully campaigned on this issue and won a historically Republican seat in Congress. The back-and-forth on the

Paul Ryan, probably the leading figure among the fiscal policy hawks of the Republican Party, is a popular figure among the party faithful. His "Ryan budget," the leading Republican counterpoint to Obama's fiscal policy, seeks to reduce the US deficit through entitlement reform, spending caps, and a consolidation of personal tax brackets.

Studies say that a vice-president pick has limited electoral impact, except for around 2% of the vote in the candidate's own home state. Ryan may put the swing state of Wisconsin into play for Romney.

Traditionally, the biggest single movements in the polls during the election year follow, and are the result of, the party conventions: the so-called "convention bounce."

Ryan budget could be a distraction for Romney, who wants to focus his campaign on the issues of unemployment and the economy.

Regardless, the data suggest that any "Ryan effect" will be small. Studies say that a vice-presidential pick has limited electoral impact, except for around 2% of the vote in the candidate's own home state.⁸

Ryan may put the swing state of Wisconsin into play for Romney. Pollster.com shows a 3-point Obama lead; Real Clear Politics gives Obama a 2-point lead.⁹ On the national level, Romney's new running mate has barely had any effect at all. Pollster.com analyst Mark Blumenthal, looking at the data in the aftermath of the Ryan pick, writes that there's "no significant change in the Obama-Romney race since the spring."¹⁰

Convention Bounces Unlikely to be 'Game Changers'

Both parties hold national conventions in the summer time. During the last week of August, Republicans held their convention in Tampa, Florida, where Mitt Romney and Paul Ryan formally received their nominations. Democrats gave their imprimatur to Barack Obama and Vice President Joseph Biden the following week in Charlotte, North Carolina.

With the candidates chosen long before the activists meet, modern American party conventions are less about cutting deals in 'smoke-filled rooms' than about opportunities for the parties to present their case to a national primetime audience. The decision to hold this year's conventions in two swing states reflects this calculus. No single event over the course of an election garners as much attention, both from the press and from average voters. (Indeed, it was Barack Obama's speech to the 2004 Democratic convention that made him a national figure and launched his campaign for president. At the time, Obama was an obscure state legislator in Illinois.)

Traditionally, the biggest single movements in the polls during the election year follow, and are the result of, the party conventions: the so-called "convention bounce." Observers would expect Romney to get a boost in the polls after the Republican convention, followed by a boost for Obama after the Democrats meet.

Afterward, poll numbers should return to the main trend, which in this case is a slight advantage for Obama. This means the convention season will likely have had a modest effect on what has been a very stable race all year long.

But what if the trend changes? A move toward Obama might put the race out of reach for Republicans. On the other hand, clear momentum for Romney would break the campaign out of its holding pattern. Early numbers suggest that Romney

⁸ Nate Silver. "The Overrated Vice Presidential Home-State Effect." Five Thirty Eight. The New York Times online. April 23, 2012. <http://fivethirtyeight.blogs.nytimes.com/2012/04/23/the-overrated-vice-presidential-home-state-effect/>

Nate Silver. "How Romney's Pick of a Running Mate Could Say the Outcome." Five Thirty Eight. The New York Times online. August 8, 2012. <http://fivethirtyeight.blogs.nytimes.com/2012/08/08/how-romneys-pick-of-a-running-mate-could-sway-the-outcome/>

⁹ Huffington Post/Pollster.com and Real Clear Politics rolling averages, accessed September 11, 2012. <http://elections.huffingtonpost.com/pollster/2012-wisconsin-president-romney-vs-obama>
http://www.realclearpolitics.com/epolls/2012/president/wi/wisconsin_romney_vs_obama-1871.html

¹⁰ Mark Blumenthal. "Paul Ryan Pick No 'Game Change,' New Poll Says." *Pollster.com. The Huffington Post*. August 21, 2012. http://www.huffingtonpost.com/2012/08/21/paul-ryan-no-game-change-nbc-wsj-poll_n_1820202.html

Observers should wait a few weeks after the conventions before drawing any firm conclusions. The importance of this time period can't be overstated. "If we pool the polls in the second week after the second convention for the past 15 presidential elections, no candidate who was behind has come back to win the popular vote."

received a negligible effect from the Republican convention, while the Democratic convention gave Obama a slight bump to add to his small lead.¹¹ Observers should wait a few weeks – until the second or third week of September – before drawing any firm conclusions.

The importance of this time period can't be overstated. Professors Robert Erikson and Christopher Wlezien, perhaps the US's premier researchers on election trends, write:¹²

In fact, if we pool the polls in the second week after the second convention for the past 15 presidential elections, no candidate who was behind has come back to win the popular vote.

The Presidential Debates

Three presidential debates will be held in October: in Colorado, New York and Florida. There will be a vice-presidential debate in Kentucky as well.

Like the party conventions, the debates still receive a lot of attention and press coverage. Their impact on the polls however is much less, if not negligible. Nonetheless they tend to produce some of the more memorable moments of the campaign season. Look for candidates to add detail to their economic policy packages.

Is This Time Different?

Apathy and the Obama Coalition

The core of Obama's 2008 coalition included young people, people of color, and the most educated Americans. The palpable excitement and degree of grassroots mobilization among these groups was a hallmark of that campaign, and they were a big factor in 2008's record voter turnout. Sixty-two percent (62%) of eligible Americans voted that year, the highest level since at least 1968. But the economic slowdown has hit many of these groups hard, and apathy has taken the place of the previous optimism. Unemployment among young people, for example, is twice the national average.

Voter turnout is one of the more problematic variables to forecast. Pollsters regularly ask voters if they plan to vote — known as voter intention or voter likelihood — but these numbers are less than accurate. As many as 90% of respondents regularly say they plan to vote, but as we mentioned, only 62% did in 2008.

This makes changes in enthusiasm, and therefore turnout, difficult to measure in advance. To a certain extent, each election is *sui generis*, and factors as the popularity of the candidates, the importance of the issues to the daily lives of the voters, the voter turnout efforts of the campaigns, and even the weather all have an impact on who comes out to vote.

The key components of the Obama coalition are all traditionally Democratic and should break strongly for their candidate, but most commentators would suggest

¹¹ Mark Blumenthal. "Obama Convention Bounce Confirmed in Latest Tracking Polls." *The Huffington Post*. September 10, 2012. http://www.huffingtonpost.com/2012/09/10/obama-convention-bounce_n_1870087.html

¹² Robert Erikson and Christopher Wlezien. "Party Conventions Do Matter." *Deutsche Welle* online. August 23, 2013. <http://www.dw.de/dw/article/0,,16183288,00.html>

that enthusiasm is down. While this may not be enough to substantively affect the election result, it appears safe to say that the Obama campaign is no longer the insurgent cultural phenomenon it might have been four years ago.

A "hanging chad" type of event or legal challenge is a low probability for 2012 due to advances in election laws and voting technology since the controversial 2000 election, but a dispute cannot be ruled out in the event of a close race, potentially generating days of uncertainty. *The New York Times* reported that election law cases are being moving through the state & federal court systems across the country, including in swing states like Ohio and Wisconsin.¹³ At issue are rules about voter eligibility, early voting, absentee balloting, and voter identification at the polls.

Whether any of these disputes will have practical effects at the ballot box remains to be seen, but the case of the 2000 election, where the presidential election between George W. Bush and Al Gore came down to a few hundred votes in a single state and the matter was ultimately decided by the US Supreme Court, weighs on the minds of many political observers.

The Gender Gap

Commentators have highlighted Mitt Romney's trailing support among women. Recent polls show Obama besting Romney among women by no less than twelve points.¹⁴ Is this a problem for candidate Romney, or a red herring?

Although any candidate would want broad-based support among all demographic groups, it's a truism that some groups naturally lean toward one party or the other. Over the past five presidential elections, women have voted for the Democratic candidate for president by an average of 10 points, reaching as high as 16% in Bill Clinton's 1996 re-election year.

These margins make women a critical segment of any Democratic coalition, rather than a swing constituency. Historically, the gender gap has not been fatal to a Republican candidate: George W. Bush was elected president twice while losing the support of women first by 11 and then 3 points. Has this now changed in the "New Political Normal"?

Independents

The American political system has two parties, but the ultimate goal of campaigns is to win over a third group: Independents. These non-ideological and non-party loyal voters don't formally identify with either of the two parties, and are the quintessential swing voters. In general, Republicans, Democrats and Independents all make up about a third of the electorate, give or take, and partisans almost universally back their own candidate. Consequently, arithmetic suggests that the real fight is among Independents, whose numbers have grown in recent years.

Like with the overall national ballot, data on Independents is mixed. In surveys that show Obama up, he leads among Independents; in surveys that show Obama trailing, he trails among Independents as well. We reiterate that the totality of the data suggests an overall Obama lead, and this lead also extends to Independents.

Figure 15. Democrats Win Women The Past Five Presidential Elections, Exit Polls Show

Among women

	Democrat	Republican	
1992	45%	37%	Dem +8
1996	54%	38%	Dem +16
2000	54%	43%	Dem +11
2004	51%	48%	Dem +3
2008	56%	43%	Dem +13

Source: CNN/National Election Pool exit polls.

Observers should note that keeping an eye on Independents can offer insight into the dynamics underlying the campaign.

¹³ Ethan Bronner. "A Tight Election May Be Tangled in Legal Battles." *The New York Times*. September 9, 2012. <http://www.nytimes.com/2012/09/10/us/politics/legal-battles-on-voting-may-prove-a-critical-issue-in-election.html>

¹⁴ CNN/ORC survey of 1,055 adults, conducted August 22-23, 2012, margin of error +/- 3%. <http://i2.cdn.turner.com/cnn/2012/images/08/24/rel8a.pdf>

Yet observers should note that keeping an eye on Independents can offer insight into the dynamics underlying the campaign.

Independents present a real challenge for Mitt Romney. The hard-fought Republican primary took its toll on his popularity, and in January, more than half (51%) of Independents had an unfavorable opinion of him.¹⁵ Pollsters call this situation, when more voters take the negative side of a view than the position, being "upside-down." It's a problematic position for candidates.

Fortunately for Romney, his image has improved since the Republican primaries, and with it his support among Independents. This fight over Romney's image is a key priority for Republicans, and observers should expect Romney to emphasize 'humanizing' positive personal qualities, such as his marriage and family life in an effort to consolidate support.

The struggle for Independents cuts both ways. Obama's approval rating is "net-negative" with Independents – 49% disapprove to 45% approve¹⁶ — and this figure alone reminds us that Obama's re-election, while likely, will not be easy.

American NEAP's: the Occupy Movement & the Tea Party

As the global financial crisis continues, we've highlighted the emergence of "NEAP's": new, extreme or alternative political parties. In the mature democracies, traditional political actors have lost their appeal in the midst of austerity and unemployment, and a critical mass of anti-incumbent voters have gone looking for new options. Over the past eighteen months, several NEAP's have either entered parliament or expanded their representation, such as the Pirate Party in Germany, the Freedom Party in the Netherlands, and the True Finns in Finland.

The US has avoided this aspect of the UltraVox Populi in large part because of its two-party system, which restricts the opportunity for new political parties to make a splash. But the anti-incumbent mood nevertheless expressed itself in three consecutive 'wave elections' in 2006, 2008 and 2010, when historically large numbers of seats in the US Congress flipped parties, as well as in new political movements outside the party system.

On the left was the Occupy movement which, while it fielded no candidates and did not formulate a policy platform, successfully placed the issue of income inequality on the front page in the US with its "We are the 99%" slogan.

On the right, the Tea Party movement refocused the national debate on fiscal issues like the national debt, the deficit, and entitlement spending. Congress now has a Tea Party Caucus consisting of 61 Representatives and four Senators, all Republican.

Despite the initial strong showing and galvanizing effect on the Republican base, the Tea Party's appeal appears to have passed in the US and it has largely become a wing of the Republican Party, while the Occupy movement has mostly petered out. In contrast to Europe, some of the steam has been let out of the US political system, and with it the motivation to dump incumbents like Obama.

¹⁵ Elspeth Reeve. "Independents Turn on Romney." *The Atlantic* online. January 24, 2012. <http://www.theatlanticwire.com/politics/2012/01/independents-turn-romney/47793/>

¹⁶ *Washington Post*-ABC News survey of 1,002 adults, conducted August 22-25, 2012, margin of error +/- 4%. http://www.washingtonpost.com/page/2010-2019/WashingtonPost/2012/08/27/National-Politics/Polling/question_6482.xml

Outlook for Congress

GOP Control of US House Likely to Remain

In the US system, the president shares power with the legislative branch of government as well as the judiciary. This separation of powers makes the results of the Congressional races highly important to the workings of government and the future of US policy.

Republicans have a 50-seat majority in the US House of Representatives, which means that Democrats need 26 seats to take control.

In his latest update, noted US elections observer Charlie Cook lists 17 toss-up seats held by Republicans and 8 held by Democrats, for a total of 25.¹⁷ To take the House, Democrats would need to win all these seats and then some, an unlikely proposition. We were hard-pressed to find a non-partisan observer who thinks House Republicans are in trouble. Is another 'wave election' headed our way? "Don't count on it," says Cook.¹⁸

Toss-up for US Senate

With trends being well-established in the races for the presidency and the US House, the focus shifts to the US Senate. Democrats have a three-seat majority, so Republicans need to pick up four seats to win. The status quo might be fine for Democrats, who can back up President Obama in Congress and use the upper house to block legislation by House Republicans. But if Mitt Romney is elected president, control of the Senate would allow Republicans to pass large portions of their agenda.

The presidential election has a big impact here. The US Constitution makes the Vice President the president of the Senate, with the power to break tied votes. This means that a 50/50 Senate will be controlled by whichever party is in the White House.

Today, the polls suggest a close race. In our view, Democrats are slight favorites to keep control of the upper house. The saving grace for Democrats is Vice President Joseph Biden. In the event of a 50/50 tie in the chamber, Biden's vote will keep Democratic colleagues in charge. (And here we assume Biden is re-elected, as our base-case scenario suggests.)

Retirements mean that Democrats will pick up Maine, while Republicans will pick up Nebraska. Of the nine other Senate races identified as competitive, Republicans lead in seven (Arizona, Indiana, Massachusetts, Montana, Nevada, North Dakota, Wisconsin), three of which are held by Democrats. Democrats lead in four (Connecticut, Florida, Missouri, and Virginia), all of which Democrats hold.

So for Republicans to take control, they'd need to win the three Democratic races in which they currently lead (Montana, North Dakota and Wisconsin), and pick up one more. Virginia is the closest seat, a statistical tie this week.

Controversy surrounding the Republican candidate in Missouri has had a real impact on the GOP's chances. Republicans looked favored to win this race, but

In our view, Democrats are slight favorites to keep control of the upper house. The saving grace for Democrats is Vice President Joseph Biden. In the event of a 50/50 tie in the chamber, Biden's vote will keep Democratic colleagues in charge.

Figure 16. The Filibuster Explained

Senate rules allow a member to speak as long as he likes on any topic. A Senator can delay debate and stall legislation by speaking as long as he or she wants. This tactic is called a *filibuster*. It takes sixty votes – more than the usual majority of 51 – to stop a filibuster, a vote called *cloture*.

Because of the threat of the filibuster, Senate leaders work to make sure that legislation will have the support of sixty Senators before they bring it to a vote. This delays the process, and many bills are never passed.

No party has had a 60-vote majority in the Senate since after the 1978 election. Of course, Congress has passed laws since then, so the filibuster doesn't halt all legislation. Budget bills, particularly, cannot be filibustered because they are considered under a special process called *reconciliation*.

Source: Citi Research

¹⁷ The Cook Political Report. <http://cookpolitical.com/house>

¹⁸ Charlie Cook. "Wave Bye-Bye." *The National Journal*. June 22, 2012.
<http://www.nationaljournal.com/columns/cook-report/the-cook-report-wave-bye-bye-20120621>

For Republicans to take control, they'd need to win the three Democratic races in which they currently lead (Montana, North Dakota and Wisconsin), and pick up one more. Virginia is the closest seat, a statistical tie this week. Both Wisconsin and Connecticut remain states to watch.

In our view, the status quo means more of the same: a pragmatic White House cutting deals with Congress.

Barack Obama has pursued the Democratic Party's agenda while in office. But Obama also displays a pragmatic streak that has shown itself most often in fiscal policy. In our view, the continuation of the status quo means Obama is likely to continue this strategy in the next Congress.

Investors will certainly watch developments closely. The new political calculus will be a function of the combination of the margin of victory and personality of the actors in this era of limited political capital for elected officials.

While a fall over the fiscal cliff is not our base-case scenario, we flag the possibility. Political calculus works differently than market perceptions of rational behavior.

scandal has quickly taken this race out of contention, and with it the Republicans' fifty-first seat.

Paul Ryan's appearance on the Republican ticket has made a difference in Wisconsin. Recent polls have shown a close race in Connecticut as well. But both states are traditionally Democratic, and it remains to be seen how long these races may stay in play. So in our view, these poll numbers may be shallow. Both Wisconsin and Connecticut remain states to watch.

In this type of situation, we refrain from making a hard call today and suggest that the base-case scenario for now remains the status quo: Democratic control of the US Senate.

More Gridlock & Obama Pragmatism on the Horizon in 2013

In our base-case scenario, Democrats maintain control of the White House and the US Senate, and Republicans will maintain control of the US House. What are the implications for policy? In our view, the status quo means more of the same: a pragmatic White House cutting deals with Congress.

As we mentioned, Barack Obama has pursued the Democratic Party's agenda while in office. But Obama also displays a pragmatic streak that has shown itself most often in fiscal policy. The president has come to agreement with Congress on short-term fiscal policy measures every year he's been in office: the Bush tax cuts, the payroll tax extension, the debt ceiling, the "Supercommittee," and more. In our view, the continuation of the status quo means Obama is likely to continue this strategy in the next Congress.

Both Obama and Romney have said that they want to tackle comprehensive tax reform in 2013. Our interlocutors in Washington see these claims as credible, and staffers in Congress have been drawing up various pieces of reform legislation. Obviously an Obama package would look much different from a Romney package. But whether or not tax reform is on the agenda next year, much of the core agendas of both parties involve different views of fiscal, monetary & taxation policy. Investors will certainly watch developments closely. The new political calculus will be a function of the combination of the margin of victory and personality of the actors in this era of limited political capital for elected officials.

A Brief and Temporary Fall Over the Fiscal Cliff?

After the elections, investors will focus on the so-called "fiscal cliff": a combination of sudden tax and spending cuts required under current law that may push the US economy back into recession.

On the tax side, the cliff consists of the end of the so-called "Bush tax cuts" and the payroll tax cut, among others. On the spending side, a process called "sequestration" requires substantial cuts across the federal budget. All told, the cliff could add up to a fiscal contraction with 3% of US GDP according to Citi economists' estimates.¹⁹

¹⁹ Tobias Levkovich. Citi Research note. "[A Random "Cliff" Walk Down Wall Street](#)." August 14, 2012.

We do not expect progress on the fiscal cliff in advance of US elections. Both parties in Congress have exchanged rhetoric on the issue, some of which has attempted to paint their opponents as the root of the problem. These statements should be understood within the context of the election, and not as credible commitments to a negotiating position.

Figure 17. Only A Few Key Figures Will Be Players in Fiscal Cliff Negotiations

Democrats

President Barack Obama
Nancy Pelosi, House Democratic leader
Harry Reid, Senate Democratic leader
Sander Levin, House Ways & Means ranking member
Max Baucus, Senate Finance chairman

Republicans

Speaker John Boehner
Mitch McConnell, Senate Republican leader
Dave Camp, House Ways & Means chairman
Orrin Hatch, Senate Finance ranking member
Source: Citi Research

For better or for worse, Congressional leaders are neither economists nor market strategists; they don't approach their problems from the perspective of the markets. That's why going over is a real possibility; both sides can vote for a "clean bill."

A continuation of the status quo suggests a continuation of the status quo: more deal-cutting. The question from our perspective is the timing: on this side of the cliff in December, or on the other side in January?

As mentioned, our expectation is that if we have the same players as in the past three years' previous piecemeal deals, we'll have similar results.

The economic case against the fiscal cliff is convincing, and for that reason few investors expect it: surely elected officials would not inflict such damage on the still-fragile US recovery? But for policymakers, the political case is something entirely different. While a fall over the fiscal cliff is not our base-case scenario, we flag the possibility. Political calculus works differently than market perceptions of rational behavior.

Furthermore, we do not expect progress on the fiscal cliff in advance of US elections. Both parties in Congress have exchanged rhetoric on the issue, some of which has attempted to paint their opponents as the root of the problem. These statements should be understood within the context of the election, and not as credible commitments to a negotiating position.

After the election on November 6 comes the 'lame duck' session of Congress, which meets between then and the swearing-in of the new Congress on January 3. Outgoing legislators, some of whom won't be returning to office, will meet to work on last-minute bills.

As with the other fiscal policy deals over the past four years, only a few key players will be involved in fiscal cliff negotiations. These include the leaders of both parties in the House and Senate and the leaders of the tax-writing committees. We've included a table of some of these key figures.

Negotiations will occur behind closed doors. If a deal can be cut, leaders will cut a deal that can pass both chambers and be signed into law. Observers shouldn't look to the regular order of business – parliamentary procedure, second and third readings, the filibuster, "reconciliation" and the like — for ideas on how it may play out. If there's a deal to be cut, they'll cut it.

Our view of the motivation of Congressional leaders is that they're concerned less about winning, than avoiding losing. Republicans don't want to vote for tax increases, and Democrats don't want to vote for spending cuts. Going over the cliff will allow them to avoid both. For better or for worse, Congressional leaders are neither economists nor market strategists; they don't approach their problems from the perspective of the markets. That's why going over is a real possibility; both sides can vote for a "clean bill."

Whatever one thinks of the Obama administration, it has a three-year record of cutting fiscal deals with Congress (payroll tax, debt ceiling & the Supercommittee, Bush tax cuts), however piecemeal and short-term. A continuation of the status quo suggests a continuation of the status quo: more deal-cutting. The question from our perspective is the timing: on this side of the cliff in December, or on the other side in January?

Fiscal Cliff Scenarios & Implications

The elections will determine the leadership and therefore the players in Congress, and thereby the final result. Our base-case scenario is Obama-Boehner-Reid (the status quo) as the leadership players, but Obama-Boehner-McConnell (a Republican victory in the Senate) is certainly a possibility, as is a victorious Romney in the White House.

As mentioned, our expectation is that if we have the same players as in the past three years' previous piecemeal deals, we'll have similar results. It stands to reason that having different players – because Republicans took the White House or the Senate or both in the elections – will result in different outcomes.

Should Romney win, timing becomes important, as the new president wouldn't take office until January 20, twelve market trading days after sequestration begins.

A Republican sweep may mean that the GOP, fresh from victories at the polls and looking to put their own stamp on a fiscal cliff solution, will hold off until January for its own fix. Timing becomes important, as the new president Romney wouldn't take office until January 20, twelve market trading days after sequestration begins. (And January 20 is a Sunday, which could push 'day one' activities back 24 hours.)

Citi projects as many as three million lost jobs in the US if Congress fails to act. In July, Steven Wieting wrote: "A number of forecasters including ourselves have estimated a four percentage point reduction in U.S. output as the most likely path for activity in 2013 if the large tax increases and spending cuts are put in place at the start of the year in line with current law."²⁰

It's clear to us that this risk is not priced into markets.

It's clear to us that this risk is not priced into markets. Citigroup ICG conducted a survey of institutional clients in July, and less than half (45%) thought a solution to the crisis was likely. A full 56% of North American clients thought a deal was unlikely.

Figure 18. Citi Institutional Clients Talk Fiscal Cliff

In your opinion, how likely do you think each of the following scenarios is to happen?	Likely	Unlikely
"The upcoming change in leadership in China will proceed smoothly."	76%	15%
"An agreement among European leaders on banking union will improve the outlook for resolving the Euro zone crisis."	59%	38%
"Greece will leave the Euro zone within the next 12 months."	50%	47%
"U.S. political leaders will agree on a solution to the so-called 'fiscal cliff' by the end of 2012."	45%	46%
North American clients only	42%	56%

Source: Citigroup ICG survey of 440 institutional clients, conducted July 3-13, 2012. Margin of error is +/- 5%.

Even more concerning is the potential cost for such a short-term maneuver. Citi's Chief US Equity Strategist Tobias Levkovich has written:

"Going over the cliff could lead to a 15%-20% drop in stock prices, assuming a full fix (the so-called 'grand bargain') to fiscal imbalances between November 6 and December 31, 2012 seems extremely unlikely and thus it is not being considered just yet (even as it might need to occur in 2013). But failing to address the nearer term cliff issue later this year would most probably cause a substantive decline in economic activity, with commensurate earnings hits and market weakness."²¹

An ongoing stock market correction might make going away for Christmas more difficult for those legislators who would prefer going over the cliff.

²⁰ Steven Wieting. Citi Research note. ["Event Study: Both Pain and Gain in U.S. Fiscal Tightening."](#) July 16, 2012.

²¹ Tobias Levkovich. Citi Research note. ["A Random 'Cliff' Walk Down Wall Street."](#) August 14, 2012.

The most likely political solution during the December lame duck session of Congress is the bare minimum required to avoid the cliff, with the major decisions pushed off to the new Congress.

The most likely political solution during the December lame duck session of Congress is the bare minimum required to avoid the cliff, with the major decisions pushed off to the new Congress.

This difference over the Bush tax cuts has been one of the definitional disputes between the two parties for a decade, and remains the chief sticking point. Yet seeds for a future compromise are evident. Recently, both chambers cut a deal on a "continuing resolution" for September, ending the risk of any government shutdown this year. On the Senate side, Max Baucus and Orrin Hatch agreed on extensions to the research & development tax credit. Both sides said the deal demonstrates that cooperation is possible on the fiscal cliff.²² Baucus, a Democrat, and Hatch, a Republican, will both be key figures in fiscal cliff negotiations in the lame duck session.

Beyond the tax cuts, there is also significant pressure in both parties to resolve sequestration cuts to the defense budget. Citi's defense & aerospace analyst Jason Gursky has written that the most likely result is a "face-saving deal for both sides" that still reduces defense spending but back-loads the cuts:

"This allows Democrats to say they protected non-defense spending & allows the GOP to say they saved DoD from what the SecDef has described as the 'doomsday' scenario."²³

This jives with our assessment that policymakers are less concerned with winning than avoiding losing.

Looking Forward to 2013

Looking to the issues, foreign policy often takes a backseat to domestic policy in presidential campaigns, and 2012 is no exception. But the next president can certainly be expected to have his share of foreign policy challenges.

Calendar year 2012 will end in four months, but politics will not. Political risk will continue in the new year, and with it new challenges for investors across the world.

Our chief equity strategist Tobias Levkovich has written that challenger victories create better returns in the markets.²⁴

"History argues that investors should root for the challenger, irrespective of party. The debate over who is better for the stock market, a Democrat or a Republican, can be somewhat distracting even as the data shows better returns under Democrat Presidents over the course of their terms. However, challenger wins provide more insight as they typically generate a much stronger S&P 500 gain, on average, in the subsequent year and over the full term, regardless of party affiliation...

A Romney victory may benefit several industries such as Energy, Health Care, Defense, Utilities and Financials... Obama's re-election would be more supportive of alternative energy, generic pharmaceuticals, technology and entertainment."

Looking to the issues, foreign policy often takes a back seat to domestic policy in presidential campaigns, and 2012 is no exception. But the next president should certainly have his share of foreign policy challenges. This week's violence in

²² Steven Sloan. "Max Baucus, Orrin Hatch Strike Deal On Business Tax Package." *Politico*. August 1, 2012. <http://www.politico.com/news/stories/0812/79252.html>

²³ Jason Gursky. Citi Research note. "[Sequester Playbook & the Way Forward](#)." June 13, 2012.

²⁴ Tobias Levkovich. Citi Research note. "[Tuesday Tidings](#)." August 31, 2012.

Benghazi, where the US ambassador was killed, and in Cairo underscore the extent to which such developments are tests for US leaders.

The prospect of conflict with Iran remains an elevated concern. Although we place a low probability on an attack before the election, headline risk should continue into the new year, especially in 1H 2013. We doubt that either a re-elected Obama or newly-elected Romney will be keen to seek political support from across the aisle and expand the US deficit in order to undertake another conflict in the Middle East. Either will likely struggle to find the requisite political capital to do so, and prefer to focus on domestic economic matters.

The new US president would still need to address any challenges in both Syria and Iran, regardless of preferences. The use of chemical weapons by the Assad regime, or threat that Syria's stocks could fall into the hands of rogue actors, could quickly internationalize the conflict, potentially drawing the US and other regional actors in.

As we have previously noted, government action is constrained in an era of debt crisis. The two-fold restriction – first from fiscal policy in the age of austerity, and second from voters who may reject incumbents based on performance – can be expected to hamper European efforts to dig a path out of the recession.

Meanwhile, Europe's sovereign debt crisis continues. As we have previously noted, government action is constrained in an era of debt crisis. The two-fold restriction – first from fiscal policy in the age of austerity, and second from voters who may reject incumbents based on performance – will hamper European efforts to dig a path out of the recession. The next US president will watch European developments carefully, though he will likely have little practical help to offer.

Three critical elections in the new year – in Germany, Italy and Israel – highlight the totality of the political risk environment. The possibility of changes in government will create uncertainty on the one hand, and jockeying for position on the other. This uncertainty presents a challenge both for US policymakers and for investors.

It is notable that anti-China sentiment, one of the few true bipartisan issues in the current US political context, has failed to have much of a presence in the campaign, save a promise from Mitt Romney that he would "name China a currency manipulator on day one" that we do not expect he would deliver on.

Likewise on US policy toward Russia, we think broad adherence to the "reset" agenda is likely in the event of a second term for Obama, bearing in mind Secretary Clinton's recent visit to Moscow and the suggestion that Cold War-era Jackson-Vanick legislation could be rescinded in light of Russia's recent WTO accession. For his part, Romney has named Russia the US's "number one geopolitical foe." Citi's Russian equity strategist, Kingsmill Bond, has written about the market implications of this view.²⁵

Given the state of the US economy, such restraint reinforces our view that despite occasional rhetoric designed to pander to the candidates' respective bases, both Romney and Obama adhere to the centrist foreign policy that has dominated the latter part of the post-Cold War era. The additional variable of a new slate of Chinese leaders will add to the uncertainty in US-China relations.

²⁵ Kingsmill Bond. Citi Research note. "[Russia and the US election](#)." August 29, 2012.

Figure 19. Probabilities of an Israeli Attack on Iran, August 29, 2012

Citi Research	Intrade	Israel Democracy Institute	The Atlantic Iran War Dial
25%	27%	33%	40%
"Before US elections" Citi Research note. ²⁶	"Before December 31" Prediction market. ²⁷	"Will soon launch an attack, even without the cooperation of the US" (Very/moderately high chances) Survey of Israelis, July-August 2012. ²⁸	"In the next 12 months" Panel of U.S. experts. ²⁹

Source: Citi Research

A Continuation of the Political Status Quo: Not Necessarily Bad News

In the 1990's, Democrat Bill Clinton worked with the Republican Congress and Speaker Newt Gingrich to pass balanced budgets and a major welfare reform package. Of course, this cooperation was not without its hiccups, including a government shutdown and an impeachment proceeding.

As we mentioned, both parties plan to consider comprehensive tax reform in the next Congress. The issue of the US debt ceiling will also return.

While gridlock may persist in the next Congress, divided government needn't be the death knell of legislation. In the 1990's, Democrat Bill Clinton worked with the Republican Congress and Speaker Newt Gingrich to pass balanced budgets and a major welfare reform package. Of course, this cooperation was not without its hiccups, including a government shutdown and an impeachment proceeding. Yet policymakers in both parties often remember this era fondly.

As we mentioned, both parties plan to consider comprehensive tax reform in the next Congress. Packages may take shape by the summertime. While an Obama plan would look much different from a Romney plan, and likely neither plan would get through Congress without some level of amendment and compromise, investors proceed with uncertainty.

The issue of the US debt ceiling will also return. A comprehensive tax package may take care of the issue, but the question remains whether Congress will act on major legislation before the debt ceiling is hit. The cycle of the previous years may repeat itself: crisis and brinkmanship, followed by a short-term deal.

We also continue our long-standing optimism on bilateral trade agreements, witnessed most recently by clearing the way for Russia's entry to the WTO, and tax reform, the latter highly contingent upon the outcome of the elections.

With all this in mind, the new US political normal may not be a tale of sound and fury in terms of the pace and scale of legislation produced or ambitious reform attempted. Nevertheless, the machinery of government can continue to rattle on, with just-in-time compromise measures reached, albeit at the last-minute and without much foresight. In an era of political muddling through, such a scenario could provide a modest amount of comfort, compared to the alternative.

²⁶ Fordham, Tina et al. Citi Research note. "Mid-year Outlook: Rising Geopolitical Risks and the New UltraVox Populi Will Carry On Into 2013." August 2, 2012.

²⁷ Intrade. "U.S. and/or Israel to execute an overt air strike against Iran before midnight December 31, 2012." Accessed August 29, 2012. <http://www.intrade.com/v4/markets/contract/?contractId=750356>

²⁸ Israel Democracy Institute. "The Peace Index: July 2012." August 8, 2012. <http://www.peaceindex.org/indexMonthEng.aspx?num=244&monthname=July>

²⁹ Goldberg, Jeffrey. "Odds of War With Iran Increase to 40%." *The Atlantic* online. August 29, 2012. <http://www.theatlantic.com/international/archive/2012/08/the-odds-of-war-with-iran-increase-to-40-percent/261724/>

Appendix A-1

Analyst Certification

The research analyst(s) primarily responsible for the preparation and content of this research report are named in bold text in the author block at the front of the product except for those sections where an analyst's name appears in bold alongside content which is attributable to that analyst. Each of these analyst(s) certify, with respect to the section(s) of the report for which they are responsible, that the views expressed therein accurately reflect their personal views about each issuer and security referenced and were prepared in an independent manner, including with respect to Citigroup Global Markets Inc and its affiliates. No part of the research analyst's compensation was, is, or will be, directly or indirectly, related to the specific recommendation(s) or view(s) expressed by that research analyst in this report.

IMPORTANT DISCLOSURES

Analysts' compensation is determined based upon activities and services intended to benefit the investor clients of Citigroup Global Markets Inc. and its affiliates ("the Firm"). Like all Firm employees, analysts receive compensation that is impacted by overall firm profitability which includes investment banking revenues.

For important disclosures (including copies of historical disclosures) regarding the companies that are the subject of this Citi Research product ("the Product"), please contact Citi Research, 388 Greenwich Street, 28th Floor, New York, NY, 10013, Attention: Legal/Compliance [E6WYB6412478]. In addition, the same important disclosures, with the exception of the Valuation and Risk assessments and historical disclosures, are contained on the Firm's disclosure website at https://www.citivelocity.com/cvr/eppublic/citi_research_disclosures. Valuation and Risk assessments can be found in the text of the most recent research note/report regarding the subject company. Historical disclosures (for up to the past three years) will be provided upon request.

NON-US RESEARCH ANALYST DISCLOSURES

Non-US research analysts who have prepared this report (i.e., all research analysts listed below other than those identified as employed by Citigroup Global Markets Inc.) are not registered/qualified as research analysts with FINRA. Such research analysts may not be associated persons of the member organization and therefore may not be subject to the NYSE Rule 472 and NASD Rule 2711 restrictions on communications with a subject company, public appearances and trading securities held by a research analyst account. The legal entities employing the authors of this report are listed below:

Citigroup Global Markets Ltd

Tina M Fordham

OTHER DISCLOSURES

For securities recommended in the Product in which the Firm is not a market maker, the Firm is a liquidity provider in the issuers' financial instruments and may act as principal in connection with such transactions. The Firm is a regular issuer of traded financial instruments linked to securities that may have been recommended in the Product. The Firm regularly trades in the securities of the issuer(s) discussed in the Product. The Firm may engage in securities transactions in a manner inconsistent with the Product and, with respect to securities covered by the Product, will buy or sell from customers on a principal basis.

Securities recommended, offered, or sold by the Firm: (i) are not insured by the Federal Deposit Insurance Corporation; (ii) are not deposits or other obligations of any insured depository institution (including Citibank); and (iii) are subject to investment risks, including the possible loss of the principal amount invested. Although information has been obtained from and is based upon sources that the Firm believes to be reliable, we do not guarantee its accuracy and it may be incomplete and condensed. Note, however, that the Firm has taken all reasonable steps to determine the accuracy and completeness of the disclosures made in the Important Disclosures section of the Product. The Firm's research department has received assistance from the subject company(ies) referred to in this Product including, but not limited to, discussions with management of the subject company(ies). Firm policy prohibits research analysts from sending draft research to subject companies. However, it should be presumed that the author of the Product has had discussions with the subject company to ensure factual accuracy prior to publication. All opinions, projections and estimates constitute the judgment of the author as of the date of the Product and these, plus any other information contained in the Product, are subject to change without notice. Prices and availability of financial instruments also are subject to change without notice. Notwithstanding other departments within the Firm advising the companies discussed in this Product, information obtained in such role is not used in the preparation of the Product. Although Citi Research does not set a predetermined frequency for publication, if the Product is a fundamental research report, it is the intention of Citi Research to provide research coverage of the/those issuer(s) mentioned therein, including in response to news affecting this issuer, subject to applicable quiet periods and capacity constraints. The Product is for informational purposes only and is not intended as an offer or solicitation for the purchase or sale of a security. Any decision to purchase securities mentioned in the Product must take into account existing public information on such security or any registered prospectus.

Investing in non-U.S. securities, including ADRs, may entail certain risks. The securities of non-U.S. issuers may not be registered with, nor be subject to the reporting requirements of the U.S. Securities and Exchange Commission. There may be limited information available on foreign securities. Foreign companies are generally not subject to uniform audit and reporting standards, practices and requirements comparable to those in the U.S. Securities of some foreign companies may be less liquid and their prices more volatile than securities of comparable U.S. companies. In addition, exchange rate movements may have an adverse effect on the value of an investment in a foreign stock and its corresponding dividend payment for U.S. investors. Net dividends to ADR investors are estimated, using withholding tax rates conventions, deemed accurate, but investors are urged to consult their tax advisor for exact dividend computations. Investors who have received the Product from the Firm may be prohibited in certain states or other jurisdictions from purchasing securities mentioned in the Product from the Firm. Please ask your Financial Consultant for additional details. Citigroup Global Markets Inc. takes responsibility for the Product in the United States. Any orders by US investors resulting from the information contained in the Product may be placed only through Citigroup Global Markets Inc.

Important Disclosures for Morgan Stanley Smith Barney LLC Customers: Morgan Stanley & Co. LLC (Morgan Stanley) research reports may be available about the companies that are the subject of this Citi Research research report. Ask your Financial Advisor or use smithbarney.com to view any available Morgan Stanley research reports in addition to Citi Research research reports.

Important disclosure regarding the relationship between the companies that are the subject of this Citi Research research report and Morgan Stanley Smith Barney LLC and its affiliates are available at the Morgan Stanley Smith Barney disclosure website at www.morganstanleysmithbarney.com/researchdisclosures.

For Morgan Stanley and Citigroup Global Markets, Inc. specific disclosures, you may refer to www.morganstanley.com/researchdisclosures and https://www.citivelocity.com/cvr/eppublic/citi_research_disclosures.

This Citi Research research report has been reviewed and approved on behalf of Morgan Stanley Smith Barney LLC. This review and approval was conducted by the same person who reviewed this research report on behalf of Citi Research. This could create a conflict of interest.

The Citigroup legal entity that takes responsibility for the production of the Product is the legal entity which the first named author is employed by.

The Product is made available in **Australia** through Citi Global Markets Australia Pty Ltd. (ABN 64 003 114 832 and AFSL No. 240992), participant of the ASX Group and regulated by the Australian Securities & Investments Commission. Citigroup Centre, 2 Park Street, Sydney, NSW 2000. The Product is made available in Australia to Private Banking wholesale clients through Citigroup Pty Limited (ABN 88 004 325 080 and AFSL 238098). Citigroup Pty Limited provides all financial product advice to Australian Private Banking wholesale clients through bankers and relationship managers. If there is any doubt about the suitability of investments held in Citigroup Private Bank accounts, investors should contact the Citigroup Private Bank in Australia. Citigroup companies may compensate affiliates and their representatives for providing products and services to clients. The Product is made available in **Brazil** by Citigroup Global Markets Brasil - CCTVM SA, which is regulated by CVM - Comissão de Valores Mobiliários, BACEN - Brazilian Central Bank, APIMEC - Associação dos Analistas e Profissionais de Investimento do Mercado de Capitais and ANBID - Associação Nacional dos Bancos de Investimento. Av. Paulista, 1111 - 11º andar - CEP. 01311920 - São Paulo - SP. If the Product is being made available in certain provinces of **Canada** by Citigroup Global Markets (Canada) Inc. ("CGM Canada"), CGM Canada has approved the Product. Citigroup Place, 123 Front Street West, Suite 1100, Toronto, Ontario M5J 2M3. This product is available in **Chile** through Banchile Corredores de Bolsa S.A., an indirect subsidiary of Citigroup Inc., which is regulated by the Superintendencia de Valores y Seguros. Agustinas 975, piso 2, Santiago, Chile. The Product is made available in **France** by Citigroup Global Markets Limited, which is authorised and regulated by Financial Services Authority. 1-5 Rue Paul Cézanne, 8ème, Paris, France. The Product is distributed in **Germany** by Citigroup Global Markets Deutschland AG ("CGMD"), which is regulated by Bundesanstalt fuer Finanzdienstleistungsaufsicht (BaFin). CGMD, Reuterweg 16, 60323 Frankfurt am Main. Research which relates to "securities" (as defined in the Securities and Futures Ordinance (Cap. 571 of the Laws of Hong Kong)) is issued in **Hong Kong** by, or on behalf of, Citigroup Global Markets Asia Limited which takes full responsibility for its content. Citigroup Global Markets Asia Ltd. is regulated by Hong Kong Securities and Futures Commission. If the Research is made available through Citibank, N.A., Hong Kong Branch, for its clients in Citi Private Bank, it is made available by Citibank N.A., Citibank Tower, Citibank Plaza, 3 Garden Road, Hong Kong. Citibank N.A. is regulated by the Hong Kong Monetary Authority. Please contact your Private Banker in Citibank N.A., Hong Kong, Branch if you have any queries on or any matters arising from or in connection with this document. The Product is made available in **India** by Citigroup Global Markets India Private Limited, which is regulated by Securities and Exchange Board of India. Bakhtawar, Nariman Point, Mumbai 400-021. The Product is made available in **Indonesia** through PT Citigroup Securities Indonesia. 5/F, Citibank Tower, Bapindo Plaza, Jl. Jend. Sudirman Kav. 54-55, Jakarta 12190. Neither this Product nor any copy hereof may be distributed in Indonesia or to any Indonesian citizens wherever they are domiciled or to Indonesian residents except in compliance with applicable capital market laws and regulations. This Product is not an offer of securities in Indonesia. The securities referred to in this Product have not been registered with the Capital Market and Financial Institutions Supervisory Agency (BAPEPAM-LK) pursuant to relevant capital market laws and regulations, and may not be offered or sold within the territory of the Republic of Indonesia or to Indonesian citizens through a public offering or in circumstances which constitute an offer within the meaning of the Indonesian capital market laws and regulations. The Product is made available in **Israel** through Citibank NA, regulated by the Bank of Israel and the Israeli Securities Authority. Citibank, N.A. Platinum Building, 21 Ha'arba'ah St, Tel Aviv, Israel. The Product is made available in **Italy** by Citigroup Global Markets Limited, which is authorised and regulated by Financial Services Authority. Via dei Mercanti, 12, Milan, 20121, Italy. The Product is made available in **Japan** by Citigroup Global Markets Japan Inc. ("CGMJ"), which is regulated by Financial Services Agency, Securities and Exchange Surveillance Commission, Japan Securities Dealers Association, Tokyo Stock Exchange and Osaka Securities Exchange. Shin-Marunouchi Building, 1-5-1 Marunouchi, Chiyoda-ku, Tokyo 100-6520 Japan. If the Product was distributed by SMBC Nikko Securities Inc. it is being so distributed under license. In the event that an error is found in an CGMJ research report, a revised version will be posted on the Firm's Citi Velocity website. If you have questions regarding Citi Velocity, please call (81 3) 6270-3019 for help. The Product is made available in **Korea** by Citigroup Global Markets Korea Securities Ltd., which is regulated by the Financial Services Commission, the Financial Supervisory Service and the Korea Financial Investment Association (KOFIA). Citibank Building, 39 Da-dong, Jung-gu, Seoul 100-180, Korea. KOFIA makes available registration information of research analysts on its website. Please visit the following website if you wish to find KOFIA registration information on research analysts of Citigroup Global Markets Korea Securities Ltd. <http://dis.kofia.or.kr/fs/dis2/fundMgr/DISFundMgrAnalystPop.jsp?companyCd=A03030&pageDiv=02>. The Product is made available in Korea by Citibank Korea Inc., which is regulated by the Financial Services Commission and the Financial Supervisory Service. Address is Citibank Building, 39 Da-dong, Jung-gu, Seoul 100-180, Korea. The Product is made available in **Malaysia** by Citigroup Global Markets Malaysia Sdn Bhd (Company No. 460819-D) ("CGMM") to its clients and CGMM takes responsibility for its contents. CGMM is regulated by the Securities Commission of Malaysia. Please contact CGMM at Level 43 Menara Citibank, 165 Jalan Ampang, 50450 Kuala Lumpur, Malaysia in respect of any matters arising from, or in connection with, the Product. The Product is made available in **Mexico** by Acciones y Valores Banamex, S.A. De C. V., Casa de Bolsa, Integrante del Grupo Financiero Banamex ("Accival") which is a wholly owned subsidiary of Citigroup Inc. and is regulated by Comisión Nacional Bancaria y de Valores. Reforma 398, Col. Juárez, 06600 Mexico, D.F. In **New Zealand** the Product is made available to 'wholesale clients' only as defined by s5C(1) of the Financial Advisers Act 2008 ("FAA") through Citigroup Global Markets Australia Pty Ltd (ABN 64 003 114 832 and AFSL No. 240992), an overseas financial adviser as defined by the FAA, participant of the ASX Group and regulated by the Australian Securities & Investments Commission. Citigroup Centre, 2 Park Street, Sydney, NSW 2000. The Product is made available in **Pakistan** by Citibank N.A. Pakistan branch, which is regulated by the State Bank of Pakistan and Securities Exchange Commission, Pakistan. AWT Plaza, 1.1. Chundrigar Road, P.O. Box 4889, Karachi-74200. The Product is made available in the **Philippines** through Citicorp Financial Services and Insurance Brokerage Philippines, Inc., which is regulated by the Philippines Securities and Exchange Commission. 20th Floor Citibank Square Bldg. The Product is made available in the Philippines through Citibank NA Philippines branch, Citibank Tower, 8741 Paseo De Roxas, Makati City, Manila. Citibank NA Philippines NA is regulated by The Bangko Sentral ng Pilipinas. The Product is made available in **Poland** by Dom Maklerski Banku Handlowego SA an indirect subsidiary of Citigroup Inc., which is regulated by Komisja Nadzoru Finansowego. Dom Maklerski Banku Handlowego S.A. ul.Senatorska 16, 00-923 Warszawa. The Product is made available in the **Russian Federation** through ZAO Citibank, which is licensed to carry out banking activities in the Russian Federation in accordance with the general banking license issued by the Central Bank of the Russian Federation and brokerage activities in accordance with the license issued by the Federal Service for Financial Markets. Neither the Product nor any

information contained in the Product shall be considered as advertising the securities mentioned in this report within the territory of the Russian Federation or outside the Russian Federation. The Product does not constitute an appraisal within the meaning of the Federal Law of the Russian Federation of 29 July 1998 No. 135-FZ (as amended) On Appraisal Activities in the Russian Federation. 8-10 Gasheka Street, 125047 Moscow. The Product is made available in **Singapore** through Citigroup Global Markets Singapore Pte. Ltd. ("CGMSPL"), a capital markets services license holder, and regulated by Monetary Authority of Singapore. Please contact CGMSPL at 8 Marina View, 21st Floor Asia Square Tower 1, Singapore 018960, in respect of any matters arising from, or in connection with, the analysis of this document. This report is intended for recipients who are accredited, expert and institutional investors as defined under the Securities and Futures Act (Cap. 289). The Product is made available by The Citigroup Private Bank in Singapore through Citibank, N.A., Singapore Branch, a licensed bank in Singapore that is regulated by Monetary Authority of Singapore. Please contact your Private Banker in Citibank N.A., Singapore Branch if you have any queries on or any matters arising from or in connection with this document. This report is intended for recipients who are accredited, expert and institutional investors as defined under the Securities and Futures Act (Cap. 289). This report is distributed in Singapore by Citibank Singapore Ltd ("CSL") to selected Citigold/Citigold Private Clients. CSL provides no independent research or analysis of the substance or in preparation of this report. Please contact your Citigold/Citigold Private Client Relationship Manager in CSL if you have any queries on or any matters arising from or in connection with this report. This report is intended for recipients who are accredited investors as defined under the Securities and Futures Act (Cap. 289). Citigroup Global Markets (Pty) Ltd. is incorporated in the **Republic of South Africa** (company registration number 2000/025866/07) and its registered office is at 145 West Street, Sandton, 2196, Saxonwold. Citigroup Global Markets (Pty) Ltd. is regulated by JSE Securities Exchange South Africa, South African Reserve Bank and the Financial Services Board. The investments and services contained herein are not available to private customers in South Africa. The Product is made available in **Spain** by Citigroup Global Markets Limited, which is authorised and regulated by Financial Services Authority. 29 Jose Ortega Y Gasset, 4th Floor, Madrid, 28006, Spain. The Product is made available in the **Republic of China** through Citigroup Global Markets Taiwan Securities Company Ltd. ("CGMTS"), 14 and 15F, No. 1, Songzhi Road, Taipei 110, Taiwan and/or through Citibank Securities (Taiwan) Company Limited ("CSTL"), 14 and 15F, No. 1, Songzhi Road, Taipei 110, Taiwan, subject to the respective license scope of each entity and the applicable laws and regulations in the Republic of China. CGMTS and CSTL are both regulated by the Securities and Futures Bureau of the Financial Supervisory Commission of Taiwan, the Republic of China. No portion of the Product may be reproduced or quoted in the Republic of China by the press or any third parties [without the written authorization of CGMTS and CSTL]. If the Product covers securities which are not allowed to be offered or traded in the Republic of China, neither the Product nor any information contained in the Product shall be considered as advertising the securities or making recommendation of the securities in the Republic of China. The Product is for informational purposes only and is not intended as an offer or solicitation for the purchase or sale of a security or financial products. Any decision to purchase securities or financial products mentioned in the Product must take into account existing public information on such security or the financial products or any registered prospectus. The Product is made available in **Thailand** through Citicorp Securities (Thailand) Ltd., which is regulated by the Securities and Exchange Commission of Thailand. 18/F, 22/F and 29/F, 82 North Sathorn Road, Silom, Bangrak, Bangkok 10500, Thailand. The Product is made available in **Turkey** through Citibank AS which is regulated by Capital Markets Board. Tekfen Tower, Eski Büyükdere Caddesi # 209 Kat 2B, 23294 Levent, Istanbul, Turkey. In the **U.A.E.**, these materials (the "Materials") are communicated by Citigroup Global Markets Limited, DIFC branch ("CGML"), an entity registered in the Dubai International Financial Center ("DIFC") and licensed and regulated by the Dubai Financial Services Authority ("DFS") to Professional Clients and Market Counterparties only and should not be relied upon or distributed to Retail Clients. A distribution of the different Citi Research ratings distribution, in percentage terms for Investments in each sector covered is made available on request. Financial products and/or services to which the Materials relate will only be made available to Professional Clients and Market Counterparties. The Product is made available in **United Kingdom** by Citigroup Global Markets Limited, which is authorised and regulated by Financial Services Authority. This material may relate to investments or services of a person outside of the UK or to other matters which are not regulated by the FSA and further details as to where this may be the case are available upon request in respect of this material. Citigroup Centre, Canada Square, Canary Wharf, London, E14 5LB. The Product is made available in **United States** by Citigroup Global Markets Inc, which is a member of FINRA and registered with the US Securities and Exchange Commission. 388 Greenwich Street, New York, NY 10013. Unless specified to the contrary, within EU Member States, the Product is made available by Citigroup Global Markets Limited, which is regulated by Financial Services Authority.

Pursuant to Comissão de Valores Mobiliários Rule 483, Citi is required to disclose whether a Citi related company or business has a commercial relationship with the subject company. Considering that Citi operates multiple businesses in more than 100 countries around the world, it is likely that Citi has a commercial relationship with the subject company.

Many European regulators require that a firm must establish, implement and make available a policy for managing conflicts of interest arising as a result of publication or distribution of investment research. The policy applicable to Citi Research's Products can be found at https://www.citivelocity.com/cvr/eppublic/citi_research_disclosures.

Compensation of equity research analysts is determined by equity research management and Citigroup's senior management and is not linked to specific transactions or recommendations.

The Product may have been distributed simultaneously, in multiple formats, to the Firm's worldwide institutional and retail customers. The Product is not to be construed as providing investment services in any jurisdiction where the provision of such services would not be permitted.

Subject to the nature and contents of the Product, the investments described therein are subject to fluctuations in price and/or value and investors may get back less than originally invested. Certain high-volatility investments can be subject to sudden and large falls in value that could equal or exceed the amount invested. Certain investments contained in the Product may have tax implications for private customers whereby levels and basis of taxation may be subject to change. If in doubt, investors should seek advice from a tax adviser. The Product does not purport to identify the nature of the specific market or other risks associated with a particular transaction. Advice in the Product is general and should not be construed as personal advice given it has been prepared without taking account of the objectives, financial situation or needs of any particular investor. Accordingly, investors should, before acting on the advice, consider the appropriateness of the advice, having regard to their objectives, financial situation and needs. Prior to acquiring any financial product, it is the client's responsibility to obtain the relevant offer document for the product and consider it before making a decision as to whether to purchase the product. With the exception of our product that is made available only to Qualified Institutional Buyers (QIBs) and other product that is made available through other distribution channels only to certain categories of clients to satisfy legal or regulatory requirements, Citi Research concurrently disseminates its research via proprietary and non-proprietary electronic distribution platforms. Periodically, individual Citi Research analysts may also opt to circulate research posted on such platforms to one or more clients by email. Such email distribution is discretionary and is done only after the research has been disseminated via the aforementioned distribution channels. Citi Research simultaneously distributes product that is limited to QIBs only through email distribution.

The level and types of services provided by Citi Research analysts to clients may vary depending on various factors such as the client's individual

preferences as to the frequency and manner of receiving communications from analysts, the client's risk profile and investment focus and perspective (e.g. market-wide, sector specific, long term, short-term etc.), the size and scope of the overall client relationship with Citi and legal and regulatory constraints. Citi Research product may source data from dataCentral. dataCentral is a Citi Research proprietary database, which includes Citi estimates, data from company reports and feeds from Reuters and Datastream.

© 2012 Citigroup Global Markets Inc. Citi Research is a division of Citigroup Global Markets Inc. Citi and Citi with Arc Design are trademarks and service marks of Citigroup Inc. and its affiliates and are used and registered throughout the world. All rights reserved. Any unauthorized use, duplication, redistribution or disclosure of this report (the "Product"), including, but not limited to, redistribution of the Product by electronic mail, posting of the Product on a website or page, and/or providing to a third party a link to the Product, is prohibited by law and will result in prosecution. The information contained in the Product is intended solely for the recipient and may not be further distributed by the recipient to any third party. Where included in this report, MSCI sourced information is the exclusive property of Morgan Stanley Capital International Inc. (MSCI). Without prior written permission of MSCI, this information and any other MSCI intellectual property may not be reproduced, disseminated or used to create any financial products, including any indices. This information is provided on an "as is" basis. The user assumes the entire risk of any use made of this information. MSCI, its affiliates and any third party involved in, or related to, computing or compiling the information hereby expressly disclaim all warranties of originality, accuracy, completeness, merchantability or fitness for a particular purpose with respect to any of this information. Without limiting any of the foregoing, in no event shall MSCI, any of its affiliates or any third party involved in, or related to, computing or compiling the information have any liability for any damages of any kind. MSCI, Morgan Stanley Capital International and the MSCI indexes are services marks of MSCI and its affiliates. The Firm accepts no liability whatsoever for the actions of third parties. The Product may provide the addresses of, or contain hyperlinks to, websites. Except to the extent to which the Product refers to website material of the Firm, the Firm has not reviewed the linked site. Equally, except to the extent to which the Product refers to website material of the Firm, the Firm takes no responsibility for, and makes no representations or warranties whatsoever as to, the data and information contained therein. Such address or hyperlink (including addresses or hyperlinks to website material of the Firm) is provided solely for your convenience and information and the content of the linked site does not in anyway form part of this document. Accessing such website or following such link through the Product or the website of the Firm shall be at your own risk and the Firm shall have no liability arising out of, or in connection with, any such referenced website.

ADDITIONAL INFORMATION IS AVAILABLE UPON REQUEST
