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Letter from Washington

It has been an interesting week in America to say the least. What started out a year ago as the inevitable march toward a Clinton restoration, and the elimination of the "glass ceiling" in American politics with the election of a woman to the Presidency, turned out quite differently than expected.

While there has been a lot of breathless commentary about Obama's election representing a sea change in American politics, and a fundamental realignment between Democrats and Republicans, the facts don't necessarily support that. Obama won a convincing victory, taking 52% of the popular vote to McCain's 46%, and a crushing 364-163 in the electoral college. The electoral vote, more than the popular vote, demonstrated Obama's reach into states such as Virginia, North Carolina and Indiana that had been safely Republican for many cycles.

Interestingly the pollsters got it just about right, and there was no "Bradley effect" evident. If anything, the reverse occurred, and Obama did slightly better than polling would have indicated.

In the Congressional races though, Obama's coattails did not turn out to be as strong as the party had hoped. The Democrats picked up 20 seats in the House, giving them a 255-174 advantage over the Republicans. Election eve predictions that the Democrats might pick up as many as 30 seats in the House turned out to be overly optimistic. The gains are less impressive when the number of Republican retirements is factored in, with many of the Democrats' pick ups coming from essentially open seats.

In the Senate, the Democrats appear to have increased their lead to 57-40 with three races still undecided and in runoff or recount. The Senate Democrat leadership's hope of a 60 vote majority, required by parliamentary rules to cut off debate, will apparently not be realized.

There will be a continuing post mortem over the results but a couple of things are clear. Even with an incredibly unpopular incumbent President, two unpopular wars, and an economic crisis yielding an apparently deep recession, McCain still received 55 million votes. Voters seemed to be voting

against something (i.e., George Bush) as much as they were voting for Barack Obama.

Even though they now control both ends of Pennsylvania Avenue, it would probably be a major mistake for the Congressional leadership to interpret the election results as an ideological mandate to enact a left wing agenda.

In the US, campaigns are run largely to appeal each party's base, with just enough of the ideologically uncommitted to ensure victory. Governing, however, is a game that is played mainly between the 40-yard lines, and parties that lose sight of that and wander too far in either direction generally pay a price in the next election.

Obama ran a very skillful campaign by any standard, but especially when compared to the McCain effort. He managed to run on the promise of "change" without ever having to specify how he would accomplish any of it. The devil is always in the details, and it will be particularly difficult for Obama not to have his agenda dictated by the newly muscular Democrat majorities in the Congress. The Democrats have chafed for the last eight years over restricted spending on health care, education and infrastructure, while the administration essentially ran two wars off the books.

On the Republican side, the only graceful moment was in McCain's concession speech, and since then there has been an organized effort by his campaign staff to blame the defeat on Sarah Palin. This serves two purposes: first, if they can blame the defeat on her then they don't have to answer for running such a disjointed and disorganized effort; second, it damages her prospects for 2012. The party regulars don't like her because she was not just not from the establishment, but outwardly anti-establishment. Her primary ability was that she was able to talk over the party establishment and the media and to connect directly with the people. Unfortunately for her, once she had established that connection, what she had to say turned out to be not very helpful.

So what does all of this mean and why is it important from a defense and aerospace industry standpoint?

As with any new administration taking office, but especially in a "hostile takeover" when the parties switch, the outgoing government has done everything to enshrine its priorities and objectives into the first budget cycle. We had previously reported that the Bush administration had sped up the process so that the FY-2010 budget submission would be completed early. The Obama administration will have to live with a lot of it by default since it traditionally takes 4-6 months to get all of the mid-level political appointees in place, even with a friendly confirmation process in the Congress.

This, however is not going to be an ordinary year. The Bush administration has already pledged at least US\$1T in bailouts for the banking and credit

industry, the mortgage backed securities industry, AIG the global insurer, and potentially the automotive industry as well. That money will have to be at least partially reflected in the FY-10 budget.

That said, there will be upward pressure on defense from two primary sources. First is the need to reset the Army and Marine Corps ground elements, as well as Navy and Air Force air elements that have been used beyond service life expectations in the past eight years. If US forces are withdrawn from Iraq by the end of 2011 as candidate Obama has promised, there is an assumption that much of the rolling equipment will be left behind, either as a grant to the Iraqi security forces or as beyond economic repair --- either way it will need to be replaced. That doesn't allow for new program starts, just replacing the existing inventory.

The second source of upward pressure on defense will be personnel and medical costs. The Bush administration set a goal of expanding the number of soldiers and Marines by almost 100,000 to ease the deployment burden on the existing force, and to counter new terrorist threats that require a greater number of boots on the ground. People are expensive, but each one of those recruits is going to need housing and the individual and family infrastructure to support the expansion, not to mention additional equipment to use.

Active duty and retiree medical costs have risen 144 per cent since 9/11, and will soon represent half of the entire defense outlay.

So the bottom line is that while there will be tremendous downward pressure on defense for deficit and financial reasons, the upward pressures will not be for new systems and upgrades but for personnel and replacement equipment. The fundamental mismatch between acquisition strategy and resources that has been punted down the road for the last eight years can't be punted again.

New administrations, especially Democrats, have traditionally looked to defense as the bill-payer for social programs. This year will be no different, only we have probably arrived at the point where stretching out programs will no longer work, and the new administration will need to outright kill several major programs to have any effect. This should set up an interesting conflict between the new President, elected on the basis of "change", and the entrenched interests in the Congress that want things to remain as they are. Every major weapons system has a huge constituency in the Congress, and killing any one of them will prove very difficult.

In the short term there will probably be no major changes, but major changes are inevitable in a broken system where the acquisition strategy and the military strategy it is supposed to support grow more divergent each year.