



Weekly Market Commentary



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State of the Union Preview

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Highlights

President Obama's State of the Union (SOTU), scheduled for Tuesday, January 24, is unlikely to be a big market mover.

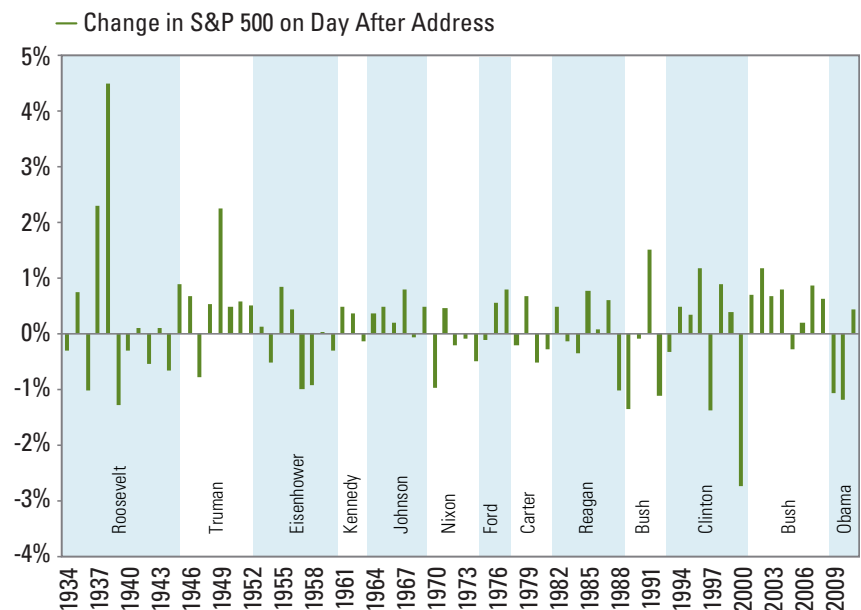
In fact, most SOTU speeches see less than a 1% move in the stock market on the following day.

However, the themes and philosophy presented may shape the market's movements in the months to come with implications for Financial and Industrial companies and oil prices.

Renewed negotiations in a divided Congress could mean more market volatility

President Obama's State of the Union (SOTU), scheduled for Tuesday, January 24, is unlikely to be a big market mover. In fact, most SOTU speeches see less than a 1% move in the stock market on the following day and the average move is only 0.14% [Chart 1]. However, the themes and philosophy presented may shape the market's movements in the months to come.

1 Stock Market Response to the State of the Union



LPL Financial, Bloomberg data 01/23/12

The S&P 500 is an unmanaged index, which cannot be invested into directly. Past performance is no guarantee of future results.

(Shaded areas indicate the Presidential term)

Rather than break new ground, the SOTU address is likely to echo the President's December 6 speech in Osawatometie, Kansas. That speech was modeled after President Theodore Roosevelt's 1910 historic address in that city on economic and social equality that led into 20th century progressivism, the central philosophy of Obama's presidency.

The many topics of the speech—and their market impacts—can be broken down in terms of what will happen, what will not happen, and what could happen in 2012.



What Will Happen

In the SOTU address, Obama is very likely to highlight the immediate need for Congress to come together to extend the payroll tax cut and unemployment insurance benefits through 2012. In December 2011, a bitterly divided Congress could not come together on how to pay for a year-long extension and so only extended them for two months. We expect Congress to further extend these stimulus measures before they expire at the end of February, but the hostile negotiations—something the markets have had a break from in recent weeks—are likely to garner attention and help to renew market volatility after a remarkably stable advance in the first few weeks of the year.

Regulatory policy, an area where the executive branch is less dependent upon Congress' leadership, will be a key part of the speech. The President is likely to highlight revamped housing programs, such as the Home Affordable Refinance Program (HARP), and announce a settlement that would end long running negotiations among Obama administration officials, state attorneys general and at least five of the nation's largest financial services companies over "robo-signing" and questionable foreclosure practices. The settlement could be good news for Financials, one of the top performing sectors this year.

Measures to stimulate job growth are unlikely to be funded

What Will Not Happen

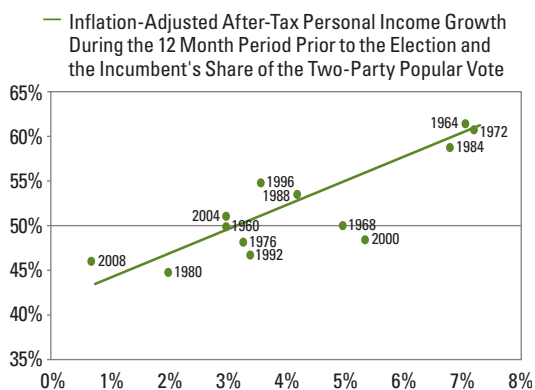
The President is likely to call for increased infrastructure investment in the U.S. economy, including school construction, roads and bridges, and high-speed rails. Congress is unlikely to appropriate the funding to meet the President's call on these items. Companies in the Industrial sector have performed well so far this year, but do not appear to be pricing in increased domestic infrastructure spending.

Job growth is key to the President's re-election chances. As you can see in [Chart 2](#), inflation-adjusted, after-tax income growth of about 3% appears to be the threshold for incumbents to get 50% of the popular vote. Currently, this measure of per capita income is only growing at 0.1%.

While factors other than jobs have a bearing on the election, job creation may be the key measure by which Obama's presidency will be judged. However, much like infrastructure initiatives, measures to stimulate job growth presented in the SOTU are unlikely to be funded.

The President will likely address eliminating the so-called Bush tax cuts for higher earners, especially those making \$1 million or more a year. In addition, given the recent attention to Mitt Romney's tax filings, the President may call for applying income taxes to carried interest. With the President due to release his budget on February 6, he may also address overseas corporate tax breaks. However, with the House in Republican hands, none of these tax proposals will pass this year.

2 3% Income Growth is the Key to Getting Re-elected



Source: LPL Financial, Bloomberg Data 01/23/12



What Could Happen

This SOTU may foreshadow the President tilting his focus away from domestic politics to foreign affairs over the course of 2012. In doing so, he is shifting from the area where the President is institutionally weak (domestic policies) to the place where the President is institutionally strong (foreign policy). A Congress divided into two houses, a Supreme Court, and the states limit the President dramatically in domestic politics. However, the Constitution and American tradition give the President tremendous power in foreign policy. The President will surely highlight the U.S. withdrawal from Iraq and the winding down of the war in Afghanistan. Another foreign policy matter that may move the oil markets will be his discussion about Iran and the potential impact of U.S., Japanese, and European sanctions on Iranian oil.

Obama's re-election strategy may be one of opposition to Congress. Essentially, this was Bill Clinton's strategy in 1996 with a Republican Congress and it worked. Going into opposition against Congress could energize the President's base, but that base is in the low to mid-40s. By itself, this may not be enough. Instead, over the next 10 months, Obama's strategy may be to shift from the domestic aspects of the presidency where he is weaker to the stronger part, foreign policy, where a president can generally act decisively without congressional backing.

The critical issue for post-Iraq war foreign policy may be the U.S. relationship with Iran. An often rumored "October" surprise is the idea of attacking Iran's nuclear facilities. But a precise strike can be messy since it carries the risk of Iranian retaliation in the Strait of Hormuz through which a meaningful percentage of the world's oil travels. An approach with less chance for global economic disruption is a generalized air campaign against both Iran's nuclear and military sites. But, in our view, starting a war is a huge risk. Setting aside all other considerations, from a political point of view, it would alienate Obama's political base, many of whom supported him because he would not undertake the unilateral military moves of his predecessor. This is not intended to imply President Obama would consider starting a war for political ends, but merely to show that even if it were a consideration it is unlikely to be a successful strategy.

The President could make a grand diplomatic outreach gesture toward Iran

However, there is another foreign policy option, one that would appeal both to Obama's political philosophy and to his political situation: pulling a Nixon. In February 1972, the last year of his first term as he ran for re-election, President Richard Nixon visited China in a grand diplomatic gesture even while Chinese weapons were being used to kill American soldiers in Vietnam. In another interesting parallel that rings with echoes of the themes of Obama's SOTU address, President Franklin Roosevelt did the same thing with the Soviets in 1941. A diplomatic engagement with Iran would seem to appeal to the President and his political base and rejuvenate some of the energy around a theme that helped him win the election in 2008.

We will be listening to the SOTU for clues as to the President's foreign policy initiatives. If the President were to pursue this foreign policy choice, it may have the effect of sharply lowering oil prices—and help to stimulate



the U.S. economy—as geopolitical risk fades and added supply returns with the potential for a lift of the long-running embargo that has blocked critical parts and equipment needed to ramp up Iranian oil output. While a gesture by no means guarantees a resolution, the markets may welcome news of a potential arrangement with Iran.

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