# Weekly Market Commentary

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## Investor's Guide to the State of the Union Address

Jeffrey Kleintop, CFA
Chief Market Strategist
LPL Financial

### Highlights

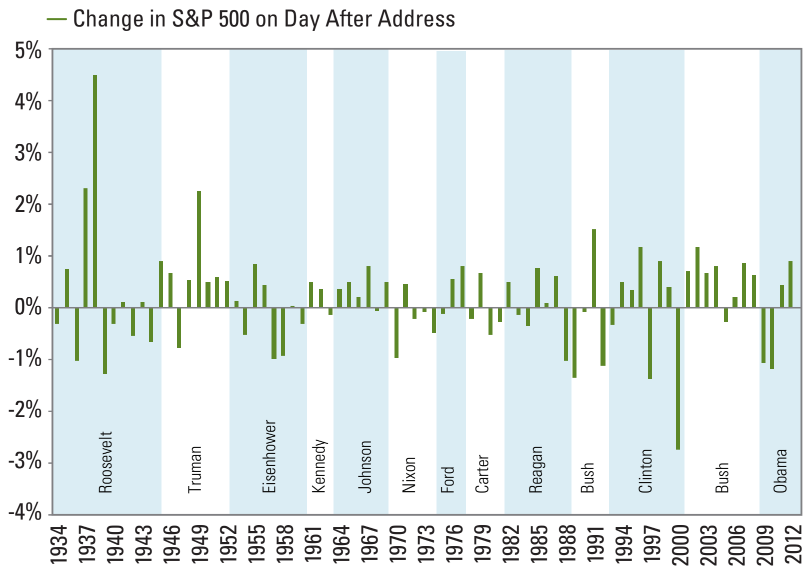
President Obama's State of the Union, scheduled for Tuesday, February 12, is unlikely to be a big market mover. However, two major themes that we will be listening for with potential market impacts: the fiscal cliff and energy independence.

Fiscal cliff-related comments hold potential consequences for defense, consumer discretionary, and high dividend-paying stocks.

Comments on energy independence could lead to a bounce in clean energy stocks that soon fades. Talk of the elimination of tax breaks for the exploration and production companies in the energy sector could act as a negative.

President Obama's State of the Union (SOTU), scheduled for Tuesday, February 12, 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 0.15% [Figure 1].

1 Stock Market Response to the State of the Union




Source: LPL Financial, Bloomberg data 02/11/13

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)

In his SOTU address on Tuesday, President Obama will present key themes that may impact certain industries and asset classes. While gun control and immigration will likely comprise important themes, they have minor market impact. The two major themes that we will be listening for with potential to impact the markets are: the fiscal cliff and energy independence.

### Fiscal Cliff Part II

Early in his speech, the President will be forced to talk about the fiscal cliff part II. There are three remaining components to the fiscal cliff that are yet to be resolved: the sequester taking effect March 1, the government shutdown set for March 27, and the debt ceiling to be hit on May 19.

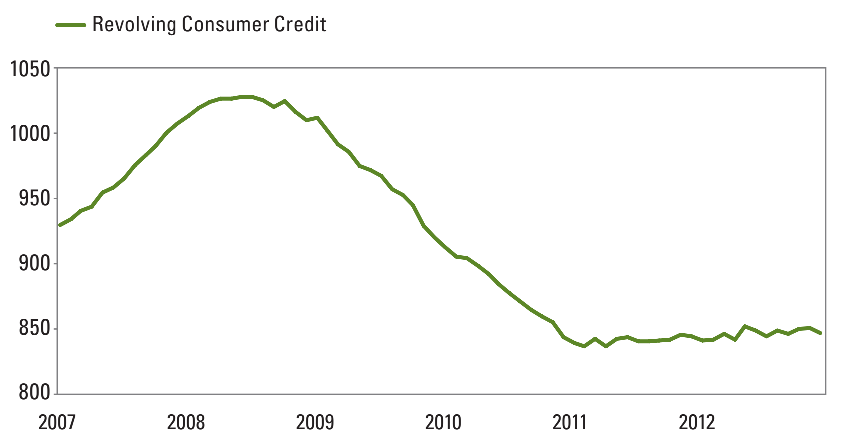
- The President will likely restate his recent comments about replacing the spending cuts that kick in on March 1, known as the sequester, with some combination of tax increases and spending cuts. However, this has little chance of passing the House after Republicans supported tax increases in the first fiscal cliff deal. The Congressional Budget Office estimates that the fiscal drag from the sequester in 2013 would be about $85 billion, or about 0.5% of gross domestic product (GDP.) This adds to the roughly 1.5% drag on the economy from the fiscal cliff tax increases that went into place January 1. That is a materially negative impact for an economy that registered a contraction in the fourth quarter and is on track for only sluggish growth in the current quarter.

  Comments that suggest the President is open to mitigating the defense cuts in exchange for cuts elsewhere, rather than tax increases, may be a positive for the markets—especially for stocks in the defense industry, which have been pulling back lately as the cuts have loomed. Unless changed, defense spending (other than for military personnel) will be cut by around 8% across the board, while nondefense funding that is subject to the automatic reductions will be cut by between 5% and 6%.

- The continuing resolution funding the government expires on March 27 and could prompt a government shutdown (though certain essential components like the armed forces will continue to operate). While tax collections will be reaching their seasonal peak as the April 15 deadline approaches, tax refunds processed by the IRS may take much longer than usual and could cause consumer spending to drop and negatively impact stocks in the consumer discretionary sector. In 2012, the average tax refund check was nearly $3,000, all together totaling $175 billion. The drag on incomes could be felt since consumers have lacked the confidence to fund spending with credit cards in recent years [Figure 2]. During the previous two government shutdowns, it was short-lived. It lasted five days in November 1995 and was followed by 21 days in January 1996. As long as talks are proceeding, we expect another continuing resolution to be

As long as talks are proceeding, we expect another continuing resolution to be passed to fund the government for a few more months or until September 30 to avoid a lengthy shutdown.

2 The Pulse of Consumers' Credit Card Fueled Spending Is Flat Lining




Source: LPL Financial, Federal Reserve 02/11/13 passed to fund the government for a few more months or until September 30 to avoid a lengthy shutdown.

- While the debt ceiling has been pushed back to May 19, it will soon be upon us again. If no further action is taken before May 19, the Treasury will once again resort to extraordinary measures to allow the government to continue operating. As precursor to restating these negotiations, President Obama will likely talk about a "balanced package" of spending cuts and tax increases to reduce the deficit and need for additional borrowing. With the potential for additional tax rate increases on the horizon, high dividend-paying stocks and municipal bonds (given the potential elimination of some deductions) could react negatively, which may present a buying opportunity.

These fiscal cliff issues leave little likelihood that other recurring themes in the President's SOTU address see any legislative action that otherwise could impact certain asset classes. For example, the President is likely to again tout the need for greater infrastructure investment—a potential positive for some stocks in the industrial and materials sectors were it to actually take place. Another example is a new program to modify underwater mortgages that could act as a negative for mortgage-backed securities, if implemented.

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## Energy Independence

The President is likely to highlight the need for U.S. energy independence, noting the increasing domestic oil and gas production and voicing his continued support for sources of clean energy. Given their dependence on federal support programs, the stocks of producers of wind, solar, and other clean energy sources often tend to be volatile around the SOTU addresses in recent years—sometimes seeing a big bounce that soon fades.

Regarding traditional sources of energy, investors are unlikely to hear anything on natural gas or coal that may turn around slumping coal stocks, but probably nothing that would accelerate their decline either. However, the President will likely highlight energy tax incentives for elimination known as the "percentage depletion allowance" and "expensing of intangible drilling costs." These incentives exist to encourage small companies to produce oil from marginal wells that become profitable with the tax breaks. These marginal wells are old or small wells that do not produce much oil individually, but in total constitute most of the U.S.'s domestic oil and gas production. The percentage depletion allowance was eliminated in 1975 for the major oil companies, and their ability to expense intangible drilling costs expensing is very limited. Therefore, the potential elimination of these tax breaks would be unlikely to have a major negative effect on the major companies in the energy sector. However, the exploration and production industry of the energy sector could be negatively impacted, were these incentives to be eliminated, which we doubt will happen in 2013. ■

## IMPORTANT DISCLOSURES

The opinions voiced in this material are for general information only and are not intended to provide specific advice or recommendations for any individual. To determine which investment(s) may be appropriate for you, consult your financial advisor prior to investing. All performance reference is historical and is no guarantee of future results. All indices are unmanaged and cannot be invested into directly.

The economic forecasts set forth in the presentation may not develop as predicted and there can be no guarantee that strategies promoted will be successful.

Stock investing involves risk including loss of principal.

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Municipal bonds are subject to availability and change in price. They are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rates rise. Interest income may be subject to the alternative minimum tax. Municipal bonds are federally tax-free but other state and local taxes may apply.

Mortgage-Backed Security (MBS) is a type of asset-backed security that is secured by a mortgage or collection of mortgages. These securities must also be grouped in one of the top two ratings as determined by a accredited credit rating agency, and usually pay periodic payments that are similar to coupon payments. Furthermore, the mortgage must have originated from a regulated and authorized financial institution.

Mortgage-Backed Securities are subject to credit, default risk, prepayment risk that acts much like call risk when you get your principal back sooner than the stated maturity, extension risk, the opposite of prepayment risk, and interest rate risk.

Investments in specialized industry sectors have additional risk such as credit, regulatory, operational, business, economic and political risk which should carefully be considered before investing.

Consumer Discretionary Sector: Companies that tend to be the most sensitive to economic cycles. Its manufacturing segment includes automotive, household durable goods, textiles and apparel, and leisure equipment. The service segment includes hotels, restaurants and other leisure facilities, media production and services, consumer retailing and services and education services.

Energy Sector: Companies whose businesses are dominated by either of the following activities: The construction or provision of oil rigs, drilling equipment and other energy-related service and equipment, including seismic data collection. The exploration, production, marketing, refining and/or transportation of oil and gas products, coal and consumable fuels.

Industrials Sector: Companies whose businesses manufacture and distribute capital goods, including aerospace and defense, construction, engineering and building products, electrical equipment and industrial machinery. Also, companies that provide commercial services and supplies, including printing, employment, environmental and office services, or provide transportation services, including airlines, couriers, marine, road and rail, and transportation infrastructure.

Materials Sector: Companies that are engaged in a wide range of commodity-related manufacturing. Included in this sector are companies that manufacture chemicals, construction materials, glass, paper, forest products and related packaging products, metals, minerals and mining companies, including producers of steel.

## INDEX DEFINITIONS

The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries.



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