Weekly Market Commentary

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Investor's Guide to the 2014 State of the Union Address

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Highlights

President Obama's State of the Union (SOTU), scheduled for Tuesday, January 28, is unlikely to be a big market mover. But three areas of the market may see some impact.

Last week the stock market slid 2.6%, reacting negatively to some mixed readings on global economic growth along with pressures on emerging market countries associated with the Federal Reserve's (Fed) tapering of its bond-buying program. While we believe global economic growth is improving, the data rarely strengthens in a straight line. We continue to believe these "scare markets"—temporary pullbacks driven by growth concerns, rather than bear markets driven by a broadly deteriorating environment for the economy and profits—may be more common this year as volatility rises from the business cycle low point reached last year. Although it can be painful to see markets fall for any reason, it is somewhat comforting that the vicissitudes of Washington politics are not the driver of the decline.

President Obama's State of the Union (SOTU), scheduled for Tuesday, January 28, 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].

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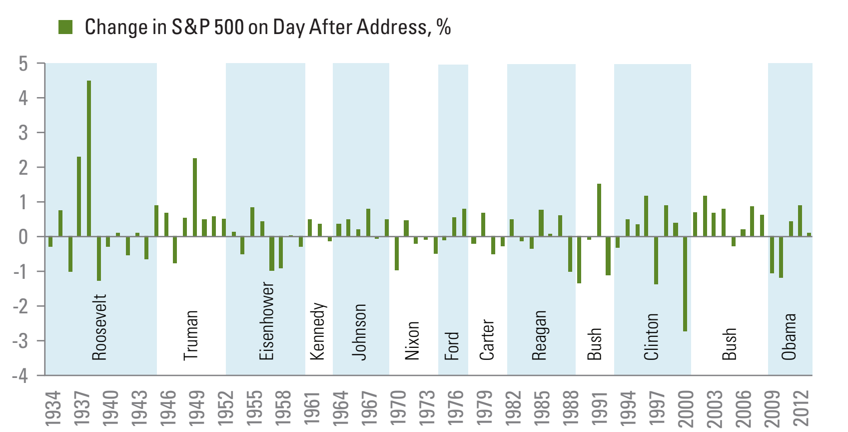
1 Stock Market Response to the State of the Union



Source: LPL Financial Research, Bloomberg data 01/27/14

Shaded areas indicate the Presidential term.

Past performance is no guarantee of future results.

The S&P 500 is an unmanaged index which cannot be invested into directly. Unmanaged index returns do not reflect fees, expenses, or sales charges. Index performance is not indicative of the performance of any investment.

Key Themes

In his SOTU address on Tuesday, President Obama will present key themes that may impact certain sectors. While income inequality (including raising the minimum wage and extending emergency unemployment insurance benefits) and health care reform will likely be important themes, they are likely to have little market impact, since the broad provisions are well known and have been debated among market participants for some time. The three areas that we will be listening for with potential to impact the markets are reinstating tax cuts, energy independence, and housing finance.

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- **Reinstating tax cuts.** Any mention from the President on a push to reinstate the tax cuts that recently expired would be welcome news for stocks in the industrials sector. Reinstating the tax benefits of accelerated depreciation and the research and development tax credit in an effort to promote growth and jobs could be a boost to capital goods producers in the industrials sector.
- **Energy independence.** Any favorable talk about energy independence could be a plus for the producers and refiners in the energy sector. Alternatively, an emphasis on climate change and tough regulations on coal use by utilities may pressure railroads. However, the impact may be limited, as railroads are already seeing weak coal volumes — historically a very large portion of carload traffic — but this is rapidly being replaced by liquid fuels.
- **Housing finance.** The President may provide some insights on housing finance reform along with specific measures to expand housing credit availability and to compel banks to expand refinancing opportunities for existing borrowers. While the talk is unlikely to affect housing stocks, some mortgage-heavy banks could be impacted.

Another topic that could move markets is the upcoming February 7 expiration date for lifting the debt ceiling. Given the bipartisan cooperation to pass the budget a few weeks ago and the fact that the debt ceiling was ultimately lifted last fall with 87 Republican votes in the House, the Treasury bill market is showing little to no signs of stress over this deadline. We also expect cooperation to lift the limit before extraordinary measures to meet U.S. obligations run out in late February or early March, although this could be sooner or later depending in part on daily tax payments and refunds.

However, another showdown like the one last October could be an unwelcome shock to investors. The Republican response to the SOTU and leaks from the Republican Party retreat later this week may offer an indication of whether the Republicans intend another fight. It is worth noting that Congress goes on recess from February 13 – 24, which may provide some impetus to get a deal done in the next two weeks.

Competing Drivers

Every President has had both gains and losses in the stock market on the day following their SOTUs. This year's move, up or down, may not have anything to do with the themes discussed. In fact, the move on the day after the SOTU has not only been small, it is often unrelated to the themes presented by the President. For example:

- The biggest post-SOTU decline was in 2000, when the SOTU focused on the prosperity of the booming markets and economy. Strong readings on economic growth and inflation were reported the following day, making more aggressive Fed rate hikes likely and prompting a pullback in the market as stocks neared the peak of the internet bubble.
- The biggest post-SOTU gain was in 1991, when the SOTU focused on the unfolding first Gulf War. However, the stock market posted a gain as more evidence emerged that the economy was nearing the end of a recession, the Fed was preparing to cut rates by 50 basis points the following day, and positive earnings results were reported from key technology companies.

We continue to forecast 10–15% gains for the stock market in 2014 driven by stronger growth, but accompanied by higher volatility.

This week, the Fed meeting, earnings reports, economic data releases, and global developments are likely to be at least as important as the SOTU in determining market direction. We believe the state of the stock market is favorable. As outlined in our *Outlook 2014: The Investor's Almanac*, we continue to forecast 10–15% gains for the stock market in 2014 driven by stronger growth, but accompanied by higher volatility. ■

Quantitative easing is a government monetary policy occasionally used to increase the money supply by buying government securities or other securities from the market. Quantitative easing increases the money supply by flooding financial institutions with capital in an effort to promote increased lending and liquidity.

INDEX DESCRIPTIONS

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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