Weekly Market Commentary

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State of the Union Preview

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Highlights

- The news out of Washington had a big hand in last week's market performance and we can expect Washington to be a driver to the markets again this week with the State of the Union address and the Federal Reserve meeting on Wednesday, Bernanke's confirmation vote, and the vote on raising the debt ceiling.
- During this week's State of the Union address, we will be listening for four key areas of emphasis that have the potential to be market moving: jobs and the economy, the budget deficit, the housing market, and national security.

Early last week the stock market, measured by the S&P 500, made a new post-bear market high and a 3% gain on the year. Later in the week, several factors combined to pull stocks down by 5%:

- Several major Chinese commercial banks were "asked" by government authorities to stop new lending for the rest of the month. This raised concerns of an earlier-than-expected withdrawal of stimulus in one of the main engines of the global economy.
- The earnings season has been good, but not great, with the Financials sector dominating the first 10% of companies to report fourth quarter results. The Financials also set a mixed tone on the outlook for 2010 earnings.
- A rising anti-incumbent tone to recent elections is raising fears that Ben Bernanke may not be confirmed by the Senate this week, as his term is due to end at the end of the month. A number of Senate Democrats voiced their opposition to his confirmation last week. If he were not confirmed the appearance of outright politicization of the Fed would likely result in a negative reaction in the bond, stock, and currency markets.
- The most significant market declines during the week coincided with the proposals unveiled, and subsequently elaborated on, by the President. The proposals were targeted at the top banks, limiting growth, and compelling divestitures of profitable lines of business. The big banks led the markets lower last week, falling 5–10%.

Clearly, the news out of Washington had a big hand in last week's market performance and we can expect Washington to be a driver to the markets again this week with the State of the Union address and Federal Reserve meeting on Wednesday, Bernanke's confirmation vote, and the vote on raising the debt ceiling. We expect no material change in the statement from the Federal Reserve. We also expect Bernanke to be confirmed with enough Republican support for the former Bush administration official to offset Democrat defections. That leaves the State of the Union as the most likely market-moving Washington event of the week.

During The State of the Union, the president looks back at the accomplishments of the past year, but more importantly defines his agenda for the next year. President Obama will confront a rising frustration with the Washington status quo evident in poll results and the recent Republican Senate victory in Massachusetts. During the State of the Union address, we will be listening for four key areas of emphasis that have the potential to

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be market moving: jobs and the economy, the budget deficit, the housing market, and national security.

Employment and the Economy

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Obama is likely to cite substantial progress in the economy as evidence of success in battling the recession with the fiscal stimulus provided by the $787 billion American Recovery and Reinvestment Act of 2009, passed in the early weeks of his administration. He will likely promote another spending package targeted more specifically at job creation. Due to deficit concerns, this spending package will likely be much smaller, totaling about $150–200 billion. This could provide a boost to infrastructure-related stocks in the Industrials sector and help boost alternative energy companies including those in the Information Technology sector.

After spending much of his political capital on promoting health care reform, Obama's efforts were dealt a significant setback by Republican Scott Brown's win in Massachusetts, which was seen as a referendum on Heath Care reform. In light of this, the President will likely seek to broaden his message. The key initiatives of the administration will be framed in light of the economy. Health care, financial reform and climate change will be cited as a means of sustaining the recovery and to create a more robust economic and financial system. Based on recent poll results, the President has a hard battle to fight to make this case resonate with the American people. Therefore, it is not likely that he will get into specifics that would be market moving, but instead focus on reframing the issues in an attempt to turn around the momentum.

Budget Deficit

Proposing new spending while trying to sound fiscally responsible is a challenge. However, the President recently took action that tipped his hand on how he may try to do this in his address. On Saturday, Obama endorsed legislation creating an independent commission with the power to force Congress to vote on major deficit reduction steps this year. However, that legislation would only take effect after the November elections. Obama's statement will likely prompt the Senate to attach this legislation to this week's bill needed to raise the federal debt ceiling by $1.9 trillion. If the bill fails to gather support, he will likely use the forum of the State of the Union to announce his intention to set up such a commission with executive authority.

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The potential surprise headline is that he may preview a freeze on discretionary government spending in his fiscal 2011 budget, due to be released on February 1. Government bond yields may react negatively to the efforts to pass an increase to the debt limit, the size of any additional stimulus spending, and the limited success at putting measures in place to limit further growth in the deficit.

Housing

On Christmas Eve, the Treasury announced that despite only covering $111 billion in loses so far it would have no limit on the losses it would cover at Fannie Mae and Freddie Mac, the entities responsible for financing about half of the home loans in the U.S., for the next three years without the approval of Congress. This move suggests the administration is planning more housing assistance through Fannie and Freddie.

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Many Federal programs assisting housing are scheduled to end: the Fed's Mortgaged-Backed Securities (MBS) purchases program is scheduled to end at the end of March, the homebuyer tax credit expires in the spring (good for home purchases through April and closed by June), and the FHA and the GSEs are tightening lending standards. We doubt these will all expire without the introduction of new policies to support the housing market. Any new housing programs previewed during the State of the Union could be a plus for the homebuilders and related industries.

National Security

On the issue of national security, terrorist threats, the wars in Afghanistan and Pakistan, the removal of troops in Iraq and nuclear disputes with Iran and North Korea will be on the agenda. To be effective, the U.S. president must project a willingness to take military action if necessary. Iran, Russia, Israel, and others that believe action to resolve the current conflicts are very unlikely are testing Obama. Receiving the Nobel Peace Prize only further highlights the challenges in perception Obama faces in being tough with adversaries. Even the New York Times raised the question in a recently published an article entitled "The Label Factor: Is Obama a Wimp or a Warrior?" It is clear the president is at risk of being labeled a wimp on national security, and that can have geopolitical consequences.

Obama may back up tough talk with steps toward action, which could elevate the risk premium in oil prices and help reverse the declines of the past week or so.

When a U.S. president is on the defensive and charged with being a wimp, he tends to react. President Kennedy made a high stakes move with the Cuban missile crisis that paid off. President Carter, accused of weakness during the Iran hostage crisis, attempted an ill-fated rescue attempt. Being perceived as weak dooms a president's foreign policy. We will look closely for clues as to how Obama will react to this threat in the State of the Union address. Obama may back up tough talk with steps toward action, which could elevate the risk premium in oil prices and help reverse the declines of the past week or so.

IMPORTANT DISCLOSURES

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Investing in international and emerging markets may entail additional risks such as currency fluctuation and political instability. Investing in small-cap stocks includes specific risks such as greater volatility and potentially less liquidity.

Stock investing involves risk including loss of principal Past performance is not a guarantee of future results.

Small-cap stocks may be subject to higher degree of risk than more established companies' securities. The illiquidity of the small-cap market may adversely affect the value of these investments.

Bonds are subject to market and interest rate risk if sold prior to maturity. Bond values will decline as interest rate rise, are subject to availability, and change in price.