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State of the Union — This Means War!

According to the White House Office of Legislative Affairs, the President, in the 2012 State of the Union Address, laid out his blueprint for “an economy built on American manufacturing, American energy, skills for American workers and a renewal of American values.” We had hoped he would attempt to heal the rift in Congress. A few olive branches were extended but there is no doubt this was a campaign speech designed to rouse the “troops.” The speech was “Clintonesque” in that it was essentially a list of policies and programs he will feature in his re-election campaign. Most of his proposals will require bipartisan support to move forward. I believe the president knows this will not be forthcoming.

White House staff created the following summary of the key points the President was making:

- *The President believes this is a make or break moment for the middle class and those trying to reach it. What's at stake is the very survival of the basic American promise that if you work hard, you can do well enough to raise a family, own a home, and put a little away for retirement.*
- *The defining issue of our time is how to keep that promise alive. No challenge is more urgent; no debate is more important. We can either settle for a country where a shrinking number of people do really well, while more Americans barely get by. Or we can build a nation where everyone gets a fair shot, everyone does their fair share, and everyone plays by the same rules.*
- *The fact is, the economic security of the middle class has eroded for decades. Long before the recession, good*

- jobs and manufacturing began leaving our shores. Hard work stopped paying off for too many Americans. Those at the top saw their incomes rise like never before, but the vast majority of Americans struggled with costs that were growing and paychecks that weren't.*
- *In 2008, the house of cards collapsed. Mortgages were sold to people who couldn't afford or understand them. Banks made huge bets and bonuses made with other people's money. It was a crisis that cost us more than eight million jobs and plunged our economy and the world into a crisis from which we are still fighting to recover.*
- *The President has been clear that we need to do more to create jobs and help economic growth. But under his leadership and thanks to action taken by this President, the economy is growing again. The economy has added a total of 3.2 million private sector jobs over the last 22 months.*
- *American manufacturing is creating jobs for the first time since the late 1990s. The American auto industry is coming back. Today, American oil production is the highest that it's been in eight years. Together, we've agreed to cut the deficit by more than \$2 trillion. And the President signed into law new rules to hold Wall Street accountable. He stands on a solid record and tonight will lay out a blueprint that will ensure an economy built to last over the long term.*
- *For the first time in nine years, there are no Americans fighting in Iraq. We've decimated al Qaeda's leadership, delivered justice to Osama bin Laden, and put that terrorist network on the path to defeat. We've made important progress in Afghanistan, and begun a transition so*

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Afghans can assume more responsibility. We joined with allies and partners to protect the Libyan people as they ended the regime of Muammar Qaddafi.

· We cannot go back to an economy based on outsourcing, bad debt, and phony financial profits. The President intends to keep moving forward and rebuild an economy where hard work pays off and responsibility is rewarded – an economy built to last.

The President proposed several ideas in the State of the Union that would impact financial service companies if they were put into action. It is also worth noting the anti-Wall Street populist tone to the speech. I believe, if the President wins reelection, financial services will face ongoing scrutiny by the Administration. While the speech reached out on occasion to the other aisle, there was no such olive branch to Wall Street.

The President was rumored to be pushing for housing loan forgiveness. The FHFA (the regulator of Government Sponsored Entities (GSE's) such as Fannie Mae "FNM" and Freddie Mac "FRE") attempted to explain why loan forgiveness is a bad approach to solving the housing malaise. Such a program would undoubtedly have meant loss sharing for the banks. However, the President did propose, "a plan that gives every responsible homeowner the chance to save about \$3,000 a year on their mortgage, by refinancing at historically low interest rates. No more red tape. No more runaround from the banks. A small fee on the largest financial institutions will ensure that it won't add to the deficit, and will give banks that were rescued by taxpayers a chance to repay a deficit of trust." Streamlined refinancing is not new and is unlikely to happen at a scale that matters if current underwriting standards are maintained. If the President can get FNM and FRE to relax their standards and refinance loans with bad credit and/or at high loan to value, ratios this plan could happen on a bigger scale and could have a big impact. However, isn't lax underwriting part of the problem that created this mess in the first place? One impediment has been the existence of home equity lines. Perhaps the govern-

ment could coerce the banks with second liens to relinquish their right to block a refinance.

The President said that he "Will not go back to the days when Wall Street was allowed to play by its own set of rules. The new rules we passed restore what should be any financial system's core purpose: Getting funding to entrepreneurs with the best ideas, and getting loans to responsible families who want to buy a home, start a business, or send a kid to college.... So if you're a big bank or financial institution, you are no longer allowed to make risky bets with your customers' deposits. You're required to write out a "living will" that details exactly how you'll pay the bills if you fail – because the rest of us aren't bailing you out ever again. And if you're a mortgage lender or a payday lender or a credit card company, the days of signing people up for products they can't afford with confusing forms and deceptive practices are over. ... We will also establish a Financial Crimes Unit of highly trained investigators to crack down on large-scale fraud and protect people's investments. Some financial firms violate major anti-fraud laws because there's no real penalty for being a repeat offender. That's bad for consumers, and it's bad for the vast majority of bankers and financial service professionals who do the right thing. So pass legislation that makes the penalties for fraud count." These comments are noteworthy for their tone and because they harden the line on the regulatory changes. "And tonight, I am asking my Attorney General to create a special unit of federal prosecutors and leading state attorneys general to expand our investigations into the abusive lending and packaging of risky mortgages that led to the housing crisis. This new unit will hold accountable those who broke the law, speed assistance to homeowners, and help turn the page on an era of recklessness that hurt so many Americans." This is not just bad for anyone who originated mortgages in the last 10 years. Banks will need to continue to fight rear-guard actions against investigators looking for new evidence on past issues that has not been already found. I am in favor of many of these ideas on a go forward basis, but to start investigating the past again and distract resources from future growth initiatives sug-

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gests the motive is vengeance and rousing his supporters.

The so called Buffet Tax issue of raising the effective rate for those making more than a million dollars to at least 30 percent received some attention. It would be achieved, in part, by wiping out non-charitable tax breaks and deductions for high-earners. According to the Washington Post, “*Mitch Daniels appeared to embrace a version of this idea in the Republican response, when he said the government should “stop sending the wealthy benefits they do not need, and stop providing them so many tax preferences that distort our economy.”*” The President emphasized that those earning less than \$250,000 (98% of American families) would not pay more tax.

President Obama's corporate tax reforms included a proposal for a global minimum tax to deter multinationals from sheltering their income in low-tax jurisdictions such as Ireland. I completely agree. Individuals are taxed on their global income. If “companies are people too” then they should pay a minimum tax on overseas income no matter where that income is held.

The President asked Congress to direct half the savings from ending the wars in Iraq and Afghanistan toward U.S. infrastructure. While it depends on the actual projects selected, I broadly agree with, indeed applaud, this concept. So much of the increase in government spending in recent years has failed to create the “multiplier effect” upon the economy we have discussed on several occasions. Projects that improve the transmission of information, people, goods and energy (natural gas) are vital to our future success.

Education is also key and the President discussed “*a national commitment to train two million Americans with skills that will lead directly to a job.*” A great idea that avoids offending the teacher unions etc. The reality is our education system is failing to produce the correct basic training. In part the need for retaining is a function of bad basic training. I completely agree we

shouldn't bash teachers and await more details on his comment, “*Give them (schools) the resources to keep good teachers on the job, reward the best ones.*” Notably he didn't mention what to do with the bad ones. For those of us who manage business, the only way to find the money to reward top performers is to take money away from poor performers.

On energy the President stated “*Over the last three years, we've opened millions of new acres for oil and gas exploration, and tonight, I'm directing my Administration to open more than 75 percent of our potential offshore oil and gas resources. Right now, American oil production is the highest that it's been in eight years. That's right — eight years. Not only that — last year, we relied less on foreign oil than in any of the past sixteen years. This country needs an all-out, all-of-the-above strategy that develops every available source of American energy — a strategy that's cleaner, cheaper, and full of new jobs. We have a supply of natural gas that can last America nearly one hundred years, and my Administration will take every possible action to safely develop this energy. Experts believe this will support more than 600,000 jobs by the end of the decade. And I'm requiring all companies that drill for gas on public lands to disclose the chemicals they use. America will develop this resource without putting the health and safety of our citizens.*” Accepting the devil is in the details, I am excited about this. The President must understand that prudent direction of his infrastructure programs can help this initiative tremendously. Part of the reason for the low level of natural gas prices versus those of oil is the inability to transport the gas to where it is needed.

On defense the President emphasized the current tensions with Iran: “*We will safeguard America's own security against those who threaten our citizens, our friends, and our interests....Let there be no doubt: America is determined to prevent Iran from getting a nuclear weapon, and I will take no options off the table to achieve that goal. But a peaceful resolution of this issue is still possible, and far better, and if Iran changes course and meets its obligations,*

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it can rejoin the community of nations....working with our military leaders, I have proposed a new defense strategy that ensures we maintain the finest military in the world, while saving nearly half a trillion dollars in our budget.

One of the major risks investors should be wary of in 2012 is the increased tension with Iran. I completely agree with the President that we need to reduce defense spending but disagree with him that “America remains the one indispensable nation in world affairs — and as long as I’m President, I intend to keep it that way.” I fear the reality is that to achieve the one, we need to mitigate our ambitions on the other. The President’s words on Iran are tough — we should not rule out the possibility of conflict with Iran. Tough words need to be backed up with tough action.

One of the distinguishing features of the better long-term outlook for the U.S. economy versus that of Japan and parts of Europe is our demographics. Immigration is key to that advantage. I am an immigrant and welcome the following excerpt: “We should be working on comprehensive immigration reform right now. But if election-year politics keeps Congress from acting on a comprehensive plan, let’s at least agree to stop expelling responsible young people who want to staff our labs, start new businesses, and defend this country.” I want to emphasize I have no sympathy with illegal immigration and we should step up our efforts to reduce it. However, sensible legal immigration is as key to our future success today as it has been in the past. If we recognize the skill shortage then retraining is important but the improvement in basic education reform will take time. The reality is we need immigration. The existing U.S. population is aging. More and more Americans are retiring, creating the need not just for better trained workers but a lot more of them.

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