



# ICON

## PORTFOLIO UPDATE

*April 2009*

### **ECONOMIC FORECAST REVISIONS**

Last fall, a consensus of economic forecasts predicted that the economy would hit bottom in the second quarter of 2009. Even through mid-December, a survey showed economists expecting second quarter 2009 Gross Domestic Product (GDP) to be positive. Investors, however, apparently chose not to believe in those forecasts. The stock market typically leads the economy by about six months at major turning points. While the market's November 20, 2008 low had many of the traits of market bottoms, and stock prices surged higher for a few weeks, stock prices dropped again during the first two months of 2009. Investors evidently disagreed with the economists and did not see an economic bottom forming within six months.

Over the course of this recession, economists have revised their forecasts downward and outward. As a group they were surprised by the depth and duration of the financial crisis. By mid-January, for example, a survey of 81 economists on Bloomberg News revised their GDP expectation for the second quarter to negative but still thought the third quarter would be positive and the beginning of economic recovery. In mid-March, however, economists revised third quarter GDP to negative. Investors, throughout these last months, have behaved as though the recession would be deeper and last longer than economists were predicting, thus helping to drive stock prices lower. Economists eventually revised their projections to be more in harmony with those of the average investor. In other words, many investors and economists now believe we will not see positive GDP before the fourth quarter of 2009.

### **SUSTAINABLE RALLY AND SECTOR LEADERSHIP**

From March 9 through March 26, in just 13 trading days, the S&P 1500 Index surged 23.7%. That is a sensational pace—one not seen in many decades—and begs the question as to whether the bear market is over and whether this is a sustainable rally. The answer boils down to the typical relationship between stocks and the economy. If investors believe that the economic bottom is within six months, then the move in the stock market may well signal the beginning of a rally. It is interesting to note that during this market advance, economists have revised their outlook upward. Revising expectations yet again, economists polled in a more recent Bloomberg survey are calling for third quarter 2009 GDP to be positive. Economists also revised their fourth quarter outlook higher. Encouraging economic data reported in late March that may have contributed to their upward revisions. For example, durable goods orders increased, contrary to what was expected. Consumer spending rose 0.2% in February, for its second straight monthly advance. A recent monetary and fiscal stimulus also supports the case that the economic bottom may occur sometime in the third quarter. Two measures of the money supply, M1 and M2, have been growing and spending from the fiscal stimulus package is already underway.

The sector leadership over this 13-day rally is clear. Financials have been the best-performing sector, followed by Materials, Industrials, Consumer Discretionary, and Information Technology. Each of these sectors has beaten the broad market average. The economically sensitive, cyclical nature of these sectors suggests to us that an economic recovery theme may be in the works. Lagging the market the most over this brief period were Utilities, Healthcare, and Consumer Staples. Their sector returns were positive, but nonetheless just lagged the broad market.

From an ICON valuation perspective, the conditions of March 9, 2009 qualify as a buying opportunity. On that date, the ICON average Value/Price (V/P) ratio was 1.45 for all stocks in the domestic database. Still, at least one supportive condition we like to see in the market was absent in March. Corporate bond yields have not been dropping. When corporate bond yields drop, we feel it often helps propel stock values higher and extends rallies. Yet corporate bond yields remain high and have not added support to the stock rally. As you might expect with such a sharp increase in stock prices and no accompanying drop in corporate bond yields, the overall market V/P ratio is dropping rapidly.

In sum, we believe there are two keys for the resumption of the market advance that began March 10. The first is a drop in corporate bond yields. The second condition requires investors believing that the economic bottom will take place some time during third quarter.

### **BONDS**

Since mid-2007 bond yields have reflected heightened concerns regarding issuer defaults. These concerns only accelerated when Lehman Brothers declared bankruptcy in September 2008. Credit spreads, a reflection of the additional yields required to entice investors to pur-



chase certain bonds, have remained near their extreme levels of late 2008. We find corporate bonds to be particularly appealing and U.S. Government bonds to be over-priced. Because of their unusually wide credit spreads, corporate bonds and yields in the two to six year maturity range are especially attractive to us. So far, we have found no need to reach for the riskier long term maturities or non-investment grade bonds. We expect a rally in corporate bonds eventually: we just cannot predict when investors will collectively reduce their required risk premiums and view bonds more favorably.

## INTERNATIONAL

To the day, most international markets rallied in sync with the U.S. market in late March. Japan and Hong Kong kept pace with the U.S., but most European markets did not experience as big of a percentage gain. Worldwide, as in the U.S., we believe the supportive element of declining corporate bond yields is missing. For the market advance to resume and for stock prices to move much higher, corporate bond yields need to drop. We think this is possible, but yields are not budging amid today's default concerns.

## SUMMARY

For at least the last year and a half (and possibly longer), investors and economists have disagreed about the state of our economy. Generally speaking, investors thought the recession would be deeper and longer than most economists. Gradually, and seemingly reluctantly, economists revised their forecasts downward and outward. If historical trends are any indication, we anticipate that the stock market will experience an impressive rally when investors suspect the economic bottom is six months away. That may have begun in March as there was some favorable economic news and, for the first time in many quarters, economists revised their forecasts upward for the third and fourth quarters. Currently, however, with no accompanying drop in corporate bond yields, we think this advance will be limited. In time, we expect yields to drop, paving the way for a more sustainable rally.

Prepared by ICON's Investment Committee.

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*ICON's value-to-price ratio is a ratio of the intrinsic value, as calculated using ICON's proprietary valuation methodology, of a broad range of domestic and international securities within ICON's system as compared to the current market price of those securities. To analyze intrinsic value, the ICON valuation methodology relies on the integrity of publicly released financial statements.*

*ICON's "relative strength" estimate reflects ICON's calculation of how an individual stock has performed compared to the broad stock market over a six-month period.*

*M1 is one measure of the money supply that includes all coins, currency held by the public, traveler's checks, checking account balances, NOW accounts, automatic transfer service accounts, and balances in credit unions.*

*M2 is a measure of total money supply. M2 includes everything in M1 and also savings and other time deposits.*

*Gross Domestic Product (GDP), also known as Gross National Product (GNP), is the total value of goods and services produced in the national economy in a given year. It is the primary indicator of economic growth.*

*The unmanaged Standard & Poor's Composite 1500 (S&P 1500) Index is a broad-based capitalization-weighted index comprising 1,500 stocks of Large-cap, Mid-cap, and Small-cap U.S. companies.*

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