



# Portfolio Update

## September 2007

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### Domestic Market Commentary

After declining during the last few days of July, the stock market went sideways in early August and then sunk to a short-term low on August 15, 2007. The market rebounded from that low but faltered in the final days of August.

Sell-offs during the last month have been related to defaults in the mortgage market, especially among lower quality, higher risk loans. Many hedge funds and mortgage companies that had taken those higher risks are now facing severe losses. Some of the selling is related to redemptions and/or margin calls but we believe some of it may be an overestimated view by investment bankers as the losses in hedge funds are very "close to home." Because of that proximity, we think the problem seems more serious to them than it really is. Losses among hedge funds and investment bankers are insignificant to the ICON view of the stock market. We believe another reason for the recent selling is the concern that the mortgage defaults will put a damper on the economy.

The most important event in August, in our estimation, related to a move by the Federal Reserve (the Fed). The Fed has three tools for implementing monetary policy: open market operations, discount operations, and changing reserve requirements, roughly in order of increasingly dramatic effect. In mid-August, the Fed announced a 0.5% cut in the rate charged at the discount window, a reduction that encourages Federal Reserve member banks to borrow. Their borrowing injects reserves into the banking system.

The amount of demand deposits that a bank can carry is limited by the amount of reserves a bank has. When reserves are injected into the banking system, more demand deposits can be created which means an increase in the money supply. So, this move is a powerful easing of monetary policy.

Based on our experience, the Fed eases monetary policy when it perceives a problem, such as a recession, a potential recession, or a situation that may cause a slowdown in the economy. An increase in the money supply is generally a powerful tool to fix whatever is ailing an economy. It is slow, but historically, it usually has worked. The recent reduction in the discount rate will inject reserves, expand the money supply and, in our opinion, prevent an economic slowdown caused by the subprime mortgage problem.

Easing monetary policy is not a bailout for institutions that got burned by mortgage lending. Increasing the money supply is not a subsidy. It is a broad economic stimulant that is expected to find its way into consumer spending on housing, autos, and non-durable items.

There are many sayings and rules of thumb on Wall Street that sound good but just do not work for us. There is at least one, however, that we believe in: "Don't fight the Fed." When the Fed eases, we believe it is prudent to own stocks; when they tighten monetary policy, stocks likely have to fight a headwind. With a value-to-price ratio (V/P) of 1.20 at the mid-August low (1.15 at the end of August) and the Fed easing, we believe that owning stocks makes sense, and we continue to keep the ICON portfolios fully invested.

It is normal for investors to focus on the current problem or not have faith in the power of an increased money supply. The market could be in for a choppy advance as skeptics use up-days as an opportunity to sell.

### Identifying a Theme Change

Our focus is to determine the industry and sector leadership that will emerge from here. We believe the market advance over the last few years through July 2007 had a theme. Generally, leading industries came from the Energy, Materials, and Industrials sectors. Now, however, we are seeing two conditions forming that our experience indicates are typical of theme changes: volatility and new industries near the top of our V/P rankings.



It is still too early for our system to tell, but it's possible that industries in the Financials and Consumer Discretionary sectors could emerge as the new leaders. They have worked their way toward the top of the V/P rankings. In our experience, these sectors historically have benefited from Fed monetary easing. It is often difficult for our system to discern future market leadership during turbulence, so clear theme identification may take awhile.

#### **Bond Market Commentary**

Long-term bonds have continued to rally as yields have dropped. We are gradually shifting toward long-term bonds, not because we are betting on Fed easing, but simply because of our V/P and relative strength readings. The yield curve has steepened, making the longer term end more attractive to us.

#### **International Market Commentary**

Hong Kong and China stand out as two country markets that are behaving differently than the U.S. Otherwise, most international markets are experiencing the same pattern and turbulence as our domestic market. Given the recent retreat, valuation readings are slightly more attractive outside the U.S. As we are doing with the U.S. market, we are watching to determine whether new industry and sector leadership will emerge internationally.

#### **Summary**

The combination of good bargains, the Federal Reserve easing, and declining interest rates mandates that we be invested with an expectation that the market will rise over the next year. There is the possibility of a leadership theme change, but it is too early for our calculations to tell. We intend to ride through this choppiness and implement reallocations if new potential leadership becomes apparent.

Prepared by ICON's Investment Committee.

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