ICON OUTLOOK
MARKET MOVES 8.10.2011

The Cavalry is on the Way, Again

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Four years ago, in August 2007, the Federal Reserve (FED) lowered the discount rate 50 basis points. Under normal circumstances, 50 points is an aggressive move that would have injected reserves into the banking system, promoted bank lending, and fueled growth in the M1 money supply (that is, currency plus demand deposits). In general, however, banks were unable to make loans due to bad assets and loans on their books.

In late 2008 and early 2009, we boldly told investors and advisers "The monetary cavalry is on the way." We were referring to the growth in the money supply after the FED and U.S. Treasury Department had finally unlocked the banking system. We offered the monetarists' view of economics that with the money supply growing, an economic recovery would follow. Monetarists subscribe to the view that the money supply directly determines the future strength of the economy. Two and a half years later, as of June 30, 2011, Gross Domestic Product (GDP) is 5.0% higher than it was during the market bottom in the second quarter of 2009. In spite of the panicked selloff we've seen in the first days of August, the S&P 1500 Index is still 77% higher through August 8, 2011 than it was at its low of March 9, 2009 (and that's even after the index's nearly 7.0% decline on August 8).

After getting a disappointing GDP figure for the second quarter of 2011, investors sold stocks in fear of slow growth or even GDP slippage. From ICON's perspective, the cavalry is on its way again, subsequent to the success of the FED's recent program, QE2. As seen in the graph at right, the FED has boosted annual M1 growth to the 15.0% range, which ICON (and the monetarists) believes is a powerful boost to the economy.

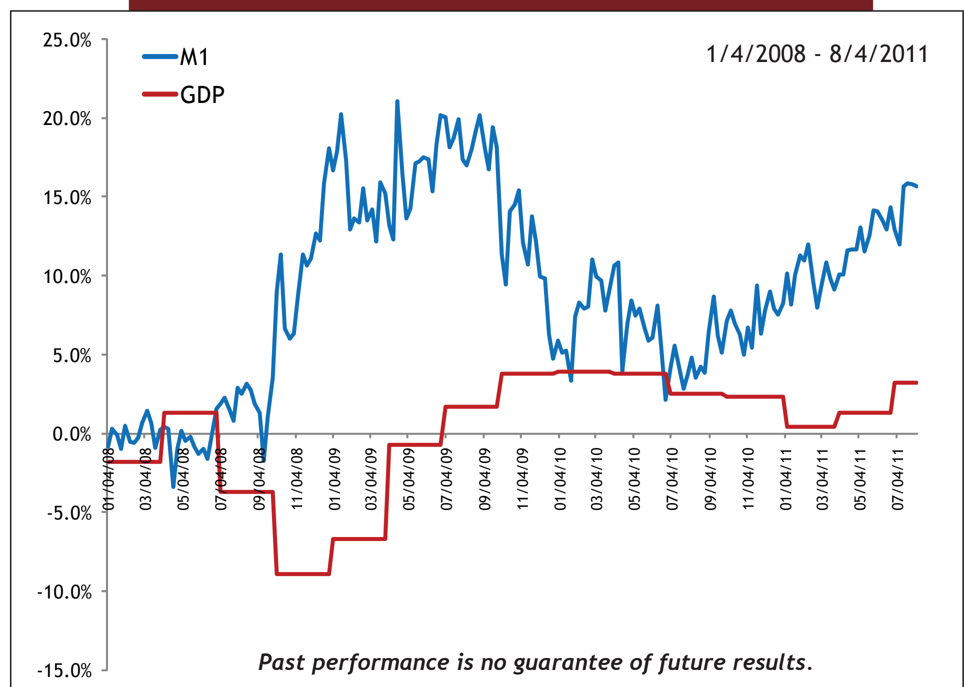
Notice the recent relationship between M1 and trailing GDP. In late 2008 and into early 2009, M1 grew rapidly reaching a high in the 20% range. The economy then followed, emerging out of a recession in mid-2009 and experiencing its peak growth in first quarter 2010. From the fall of 2009 through the summer of 2010, the FED let the growth drop back to a historically normal rate near 5.0%, perhaps incorrectly thinking it had provided a stimulus sufficient to allow the recovery to morph into an expansion. As we know now, the recovery was fragile and had not picked up the necessary momentum.

GDP, although still positive, slowed through first quarter 2011 in response to the slower M1 growth. Since 2010, the growth rate in M1 has steadily increased. We believe this increase will stimulate the economic recovery. In fact, we already see improvement as real GDP increased from a 0.4% pace in the first quarter to a 1.3% pace second quarter. A Bloomberg survey of economists shows a consensus forecast for third quarter 2011 of 3.2%.

SUMMARY » A MONETARIST'S GUIDE TO THE ECONOMY

The FED has used M1 correctly in the past, and this strategy led to a significant recovery off the lows we saw in 2009. We expect that the stock market retreat we've experienced in July and August — driven by fears of a GDP slowdown or slippage and the S&P's unfortunate downgrade — will prove to be temporary and misguided. We expect that once again, in its quiet, behind-the-scenes way, M1 growth will boost the economy.

M1 52-WEEK CHANGE & GROSS DOMESTIC PRODUCT



Past performance is no guarantee of future results.

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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.

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.

Gross Domestic Product (GDP) 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.

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