Cornerstone Report

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Chaos or Shake up?

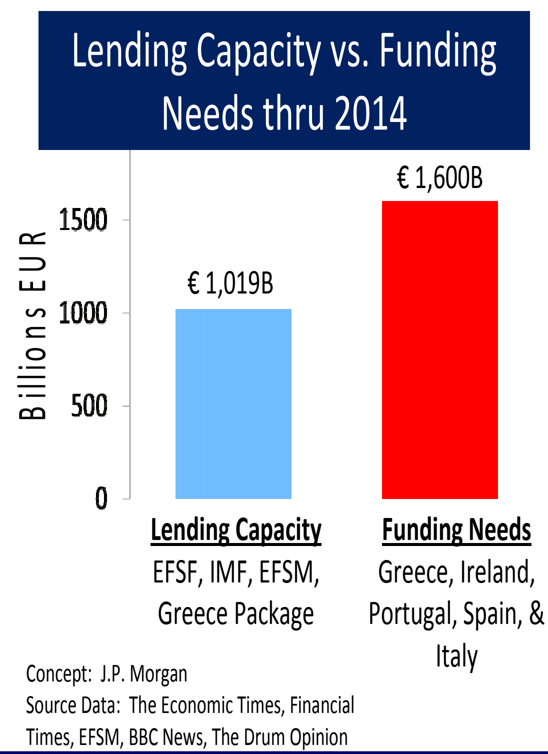
August 12, 2011

The events of the last few weeks have been truly amazing! Last May I stated both on radio and at our conference that I felt something had shifted, and that a top of significant importance had occurred in the market. I wasn't sure it was THE top, but it looks to be that way right now. The global economy currently faces assaults on multiple fronts.

First, the European "Greek tragedy/comedy" has now moved to Italy, the world's third largest debtor (yes, I said third largest). ***Only the U.S. and Japan have more debt outstanding than this tiny little country about the size of the state of California!*** Furthermore, cross-pollination of lending in Europe now jeopardizes other countries, as banks in other European nations (especially France) are heavy owners of Italy's debt.

A bailout of Italy could cost upwards of $1.4 trillion, far more than the current European bailout fund has available. With a total of $2.6 trillion, Italy's debt equals 120% of its' GDP (1).

I'm reminded of Milton Friedman's famous prediction that the Euro (as a currency) would survive its first recession, but not its second. This could well be happening.



Second, is what Bank Credit Analyst recently referred to as the "clown show in Washington." Standard and Poors, after badly missing the implications of the sub-prime debacle, seems determined not to miss the ball this time.

Beset by debt woes including .40 cents of deficit for every $1 of government

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spending, lawmakers cannot agree upon how to fix the problem, and the poisonous vitriolic debate leaves you wondering how they could ever come to terms, as both sides are on polar opposites in terms of their perspective on how to fix the problem. So, a short term band-aid was put on the mess, prompting S&P's downgrade.

I can't fault S&P for their outlook considering the "Grand Canyon" sized deficits coming at us as 76 million Boomers move slowly, steadily into the retirement system - - if you call 10,000 Boomers per day hitting Medicare slow. But, S&P's timing was certainly exquisite, exquisitely BAD considering that this announcement came at a time when the markets were already in turmoil due to the European and the Washington debt sideshows.

Third, we're now seeing a significant slowdown in the global economy, as China, in particular, slows hoping to avoid a hard landing. The world doesn't appear to be in recession (yet), but a slowdown is certainly in place, and global sales are having an outsized effect on U.S. multinational corporations. Currently almost 50 percent of sales for S&P companies are generated abroad (2).

> **"Bank of America Merrill Lynch analysts said emerging markets will account for 80 percent of global growth in 2011."**
> Caroline Valetkevitch - Reuters 12-21-2010

Finally, U.S. GDP growth was revised downward yet again. GDP, estimated to have grown by 1.9% in the 1st quarter of 2011 was revised downward to .36. That's POINT 36, just above break even. Second quarter GDP was estimated at 1.28% (but could be downgraded later as well).

Historically, if the economic growth rate drops below 2% during a recovery, as you can see in the next chart, it's almost always on the way to recession (2012 or 2013 here we come??). Yet, this time it could be premature as Bernanke and Co. may well announce another "stimulus" plan to stabilize the markets and buy some time. Europe will keep boiling as well.

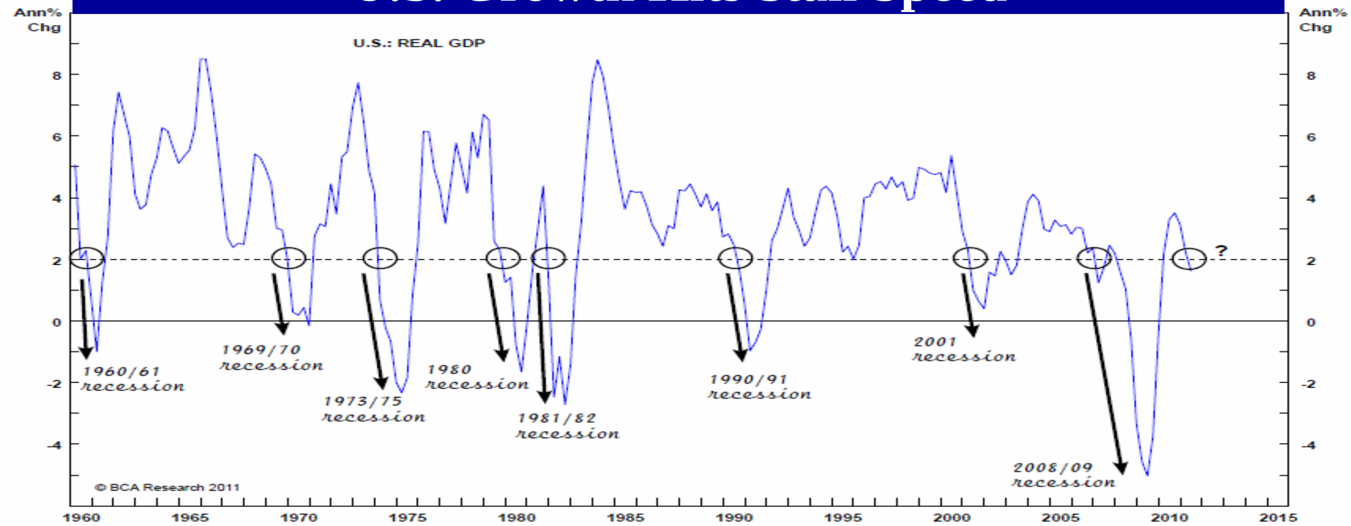
GDP REVISIONS:	Projected	Revised
2010-4th QTR	3.1%	2.35%
2011-1st QTR	1.9%	0.36%
2011-2nd QTR	3.3%	1.30%

Source: Mauldin 7-29-11

U.S. corporate profits (except for financial companies – the Achilles heel of our economy) remain very strong, but again, most of this is due to emerging markets, which are slowing. In all, none of this adds up to a shiny picture. Should a recessionary relapse occur, those profits will likely evaporate anyway. (Remember, the stock market often serves as a leading indicator of the economy, usually 6-12 months in advance.)

Barring a *massive* print job from the Fed, it's going to be difficult for the economy to restart, especially now that Federal government spending (one of the only sources of economic stimulus in the country) is set to slow next year. Reduction in spending by the federal government next year will negatively impact the economy as cited by a recent article in the *Wall Street Journal*. According to sources at Goldman

U.S. Growth Hits Stall Speed



Sachs, the economy will likely take a 1.5% hit from government cutbacks next year if the Bush payroll tax cuts expire at year end. But Moody's has indicated that they may follow Standard and Poor's downgrading the U.S. credit rating if they ***don't*** allow them to expire. Talk about between a rock and a hard place.

For long term fiscal solvency, the government must cut spending. Yet, if it cuts spending and that softens the economy, this threatens to put us back into recession. In a recession, budget deficits get larger because there are less tax revenues coming in and more entitlement spending going out, like food stamps and unemployment. Then if deficits get larger, this likely lowers our credit rating. This is a vicious circular problem. Unfortunately, our country has been painted into a corner and there are no easy solutions.

Yet, this market currently has a "feel" to it similar to 1998. 1998 was NOT the beginning of the 2000-2002 recession, just a pre-shock. The failure of a large hedge fund (Long Term Capital Management) took the market down 20% almost overnight before stabilizing. Then, as per Greenspan's arrangement, a bailout occurred, the market bottomed and the crisis was halted (for the time being). 1998 was NOT the big one, but just a precursor, a warning, if you will. The real bear market and recession hit 18 months later. This is what I think my gut is telling me.

While the world's financial situation is infinitely more complicated and desperate this time, with many of the problems appearing intractable (U.S. national debt, Euro woes) the bottom line is that big bailouts buy time.

While it won't *solve* any of these problems, it could serve to kick the can down the road a year or two, at least until the 2012 elections. My real concerns start around the 2013 - 2015 window, as a tsunami of financial dominoes appear to be lining up for that period of time.

In all, expect more volatility until bailouts (both our Fed and Europe) occur. Right now I expect them to stabilize the situation in the short run while solving none of the problems long term. In all, expect more volatility.

(1) *Wall Street Journal* 8-10-11 and the *Economist* magazine 7-14-11
(2) McClatchy - Washington Bureau, March 28, 2011

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