Cornerstone Report

Special Report April 2, 2015
By: Jerry E. Tuma, MS, CFP®

2015 - The Year In Pictures

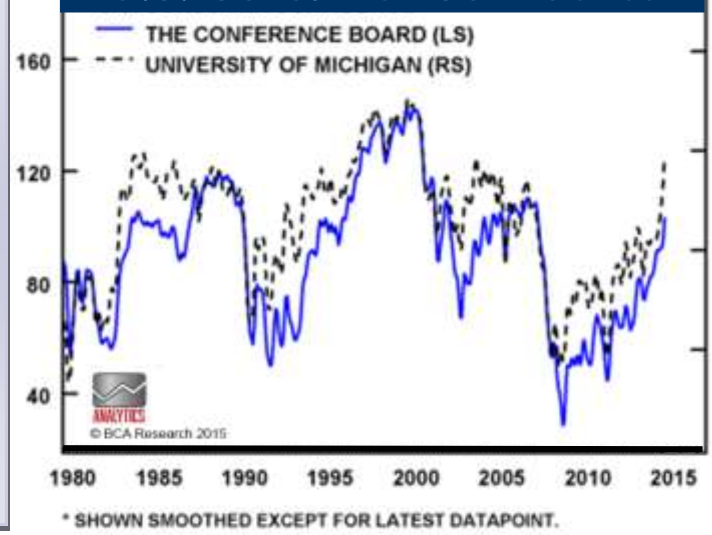
U.S. Economy—The Good

This month we want to look at the "Good, Bad and Ugly" of global finance, starting with the good—the United States. As risks continue rising globally, leverage mushrooms and geopolitical threats multiply, U.S. stocks have become very expensive (see pg. 27) and yet to some, seem the only place to invest.

The best economic news globally resides in the U.S., where consumer confidence and job openings have awakened from a 6 year hibernation.

"**Consumer confidence** bounced in January as it pushed to a new, post-recession high. Household attitudes are being lifted by falling gas prices, stronger jobs prospects and greater confidence in the broader economic outlook."[1] "Americans' confidence increased to the highest level since July 2007."[2]
(Source: 1. *The U.S. Consumer is Back*, Bloomberg Brief Economics, 1/28/15, 2. Bloomberg Consumer Comfort Index, 1/15/15)

U.S. Consumer Confidence



U.S. Labor Market

"While **wage growth** has remained weak, nominal income generated by the labor market is catching "on fire", with the private sector creating over 330k new jobs in the three months to January."
(Source: *Bank Credit Analyst*, March 2015)

NOTE: All emphasis in quotes throughout the newsletter is our own.

Jerry E. Tuma, MS, CFP®

Topics:

THE GOOD
U.S. Economy
- -Unemployment
- -Housing
- -Stocks

China
- -Housing Bubble?
- -Stock Bubble?
- -Banking Woes

THE BAD
Emerging Markets
- -Debt Bubble

Japan
- -Deflation
- -Debt Crisis

THE UGLY
European Union
Greece
Russia
ISIS/Saudi Arabia

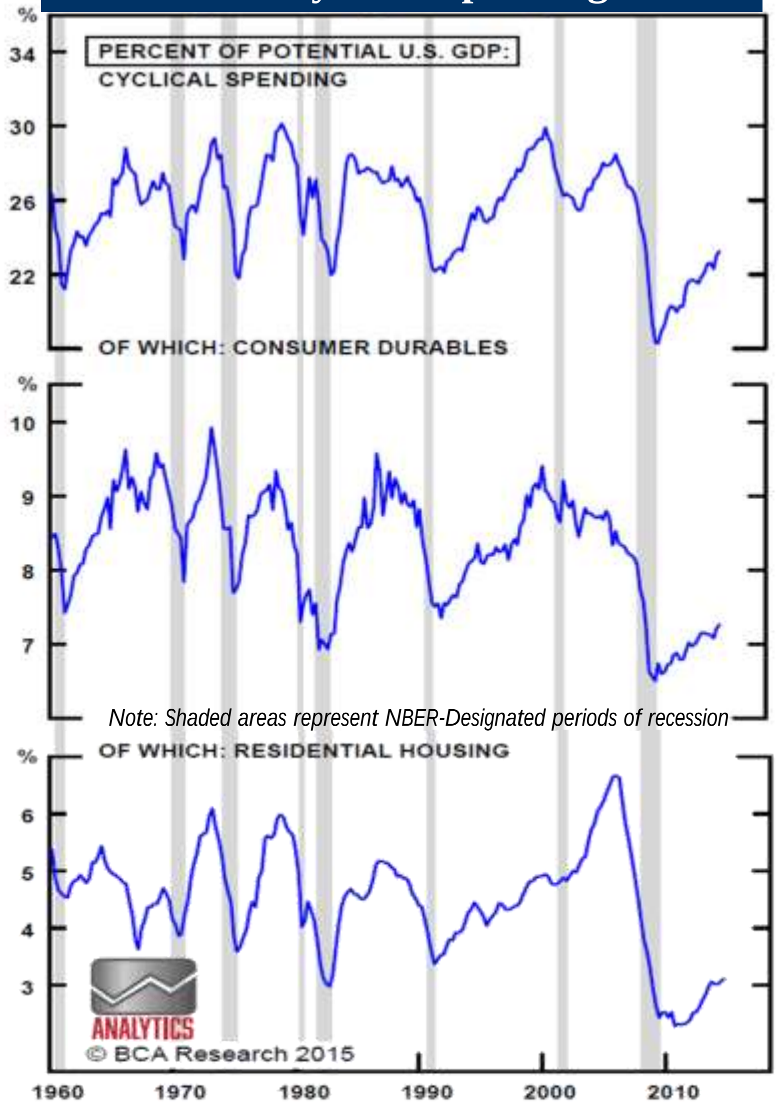
Changing the Way America Thinks About Investing.™

The chart to the right demonstrates just how slowly the U.S. economy has recovered since 2008, an aging population, weak demographics and a myriad of troubles both here and abroad have kept the recovery subdued. The worst financial crisis since the 1930's took a very deep bite out of our economy.

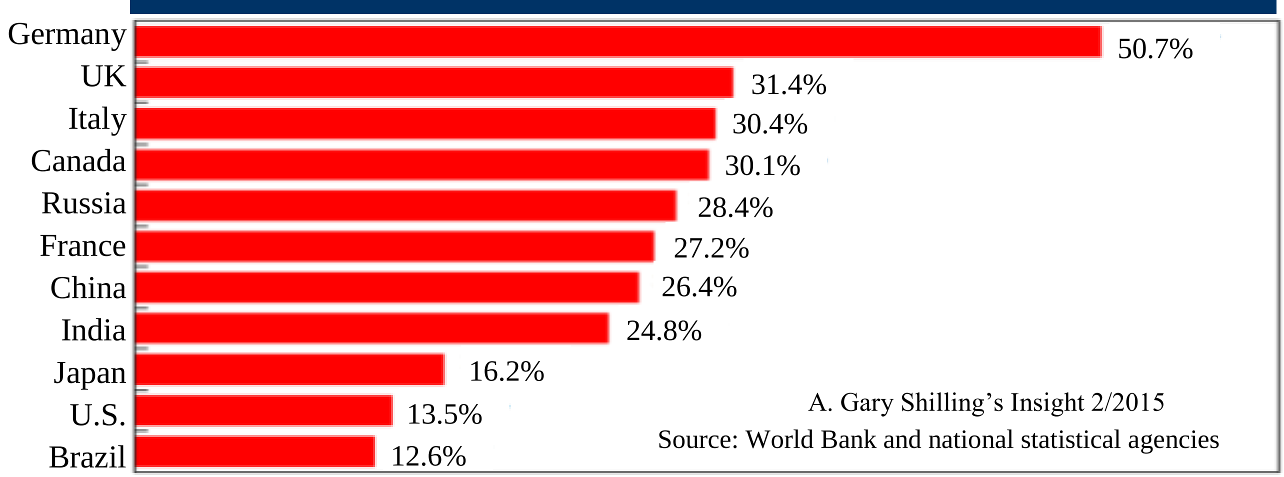
The good news is the recovery is slowly gaining strength in the U.S., but much of the rest of the world remains fragile, subject to potential major disruptions/crises or shocks, which could have a severe impact on the whole world within the next 12-18 months, in my view.

The U.S. appears less vulnerable to outside shocks compared to other countries, as our economy consists of only about 13% exports (see chart below). Thus we will likely be less impacted by any upcoming overseas challenges, compared to other countries. Yet, we will likely not be completely immune.

U.S. Cyclical Spending



2013 G-7 and BRIC Exports of Goods and Services as % GDP



Even the Great Depression recovery rate was much faster, but we were rebounding from a much deeper hole at that time.

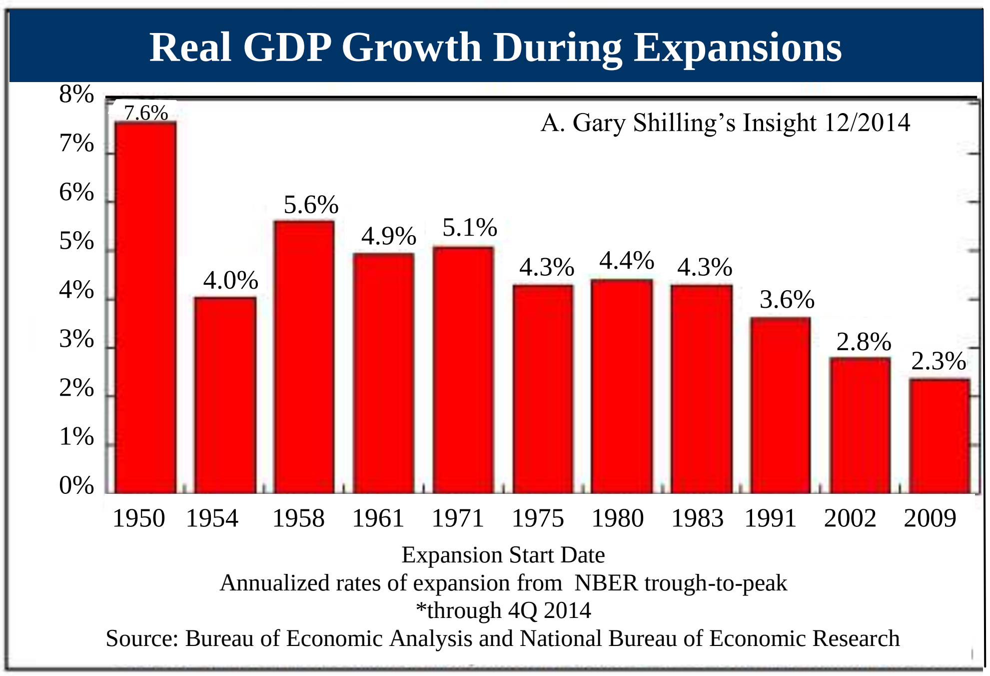
These tables demonstrate just how slow this economic recovery has been, as it has without doubt been the slowest.

Yet recovery it is nonetheless. Historic booms (real estate and sub-prime lending) led to historic busts.

Economic Recoveries

Year	Ave. Rate of Growth
1934-’37	9.4%
1983-’86	4.9%
1976-’79	4.7%
2010-’13	2.3%

Years After The Last Annual Decline In Real GDP
Copyright 2014 Crestmont Research (www.CrestmontResearch.com)
Source: Barry Ritholtz/Ed Easterling

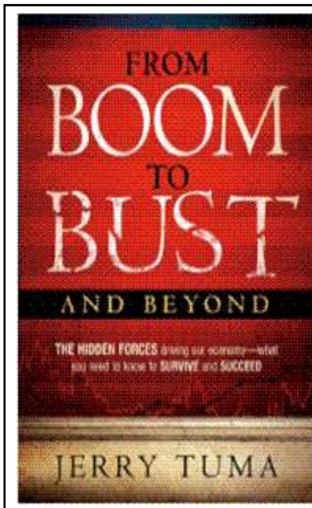


Despite best hopes to the contrary, the U.S. recovery appears unlikely to accelerate significantly due to factors previously listed such as weak demographics, deleveraging, etc.

Weak economies in Europe and Japan plus emerging markets starting to have problems, will likely contribute to ongoing slower than normal growth in the U.S.

Many factors signal potential for another major global meltdown or crash within the next 12-18 months (See “Canaries in the Coal Mine” section) due to a variety of ***overseas forces***, leaving the U.S. stock market vulnerable to unexpected outside shock.

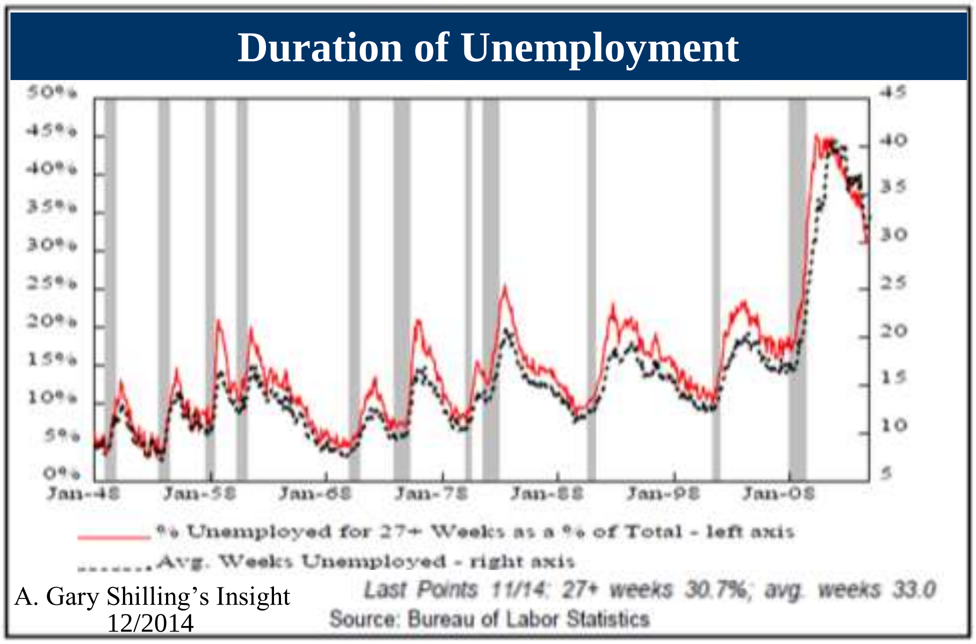
In all, the world appears a more dangerous place, and things, it appears, may be about to shift radically.



We humbly submit that our book ***From Boom to Bust and Beyond*** written in 2008-2009 is still very applicable regarding almost all of the trends discussed. Read it to understand the big picture forces at work here.

To Order an Autographed copy:
Call us at: 800-327-4285
Or
Order online at:
www.cornerstonereport.com

While longer term unemployment remains a concern, wealth has rebounded nicely as the Fed's unprecedented over $3 trillion (see pg. 5) printing press maneuver (QE or quantitative easing) combined with record low interest rates have pumped things back up, especially U.S. real estate and stocks.

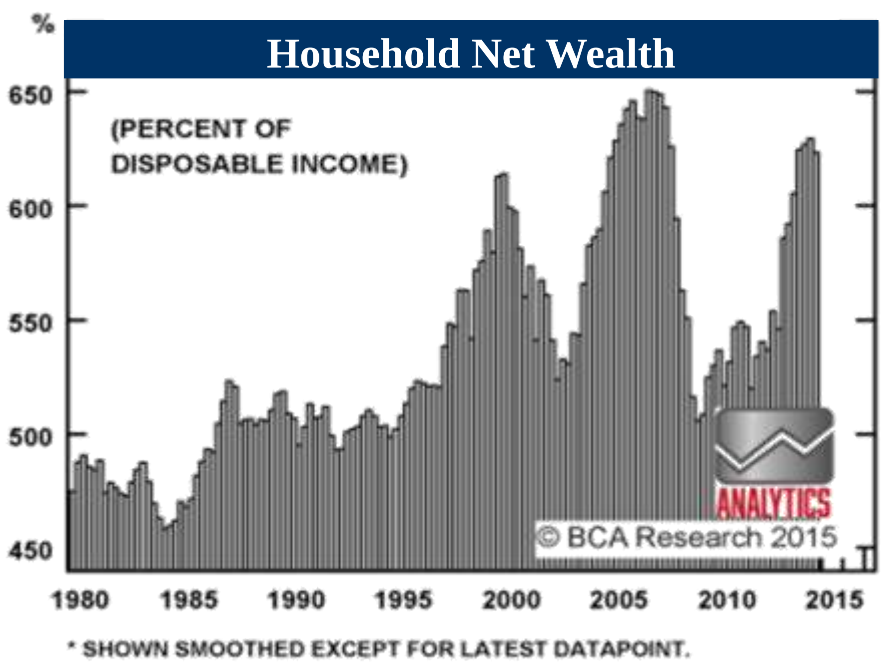


A. Gary Shilling's Insight 12/2014

This action by the Fed likely prevented another Great Depression worldwide and a complete collapse into an outright deflationary nightmare, yet has certainly not restored things to "normal".

Had the Fed simply allowed market forces to take over without massive intervention, a ***runaway*** debt deflation, a la the 1930's, would almost certainly have occurred. The rest of the world remains extremely fragile economically even now, ***after*** this historic intervention.

A runaway freight train deflationary crash would certainly have taken us into the abyss. So, while in my opinion, the Fed's massive intervention has worked so far, the bigger question is "Now What?".

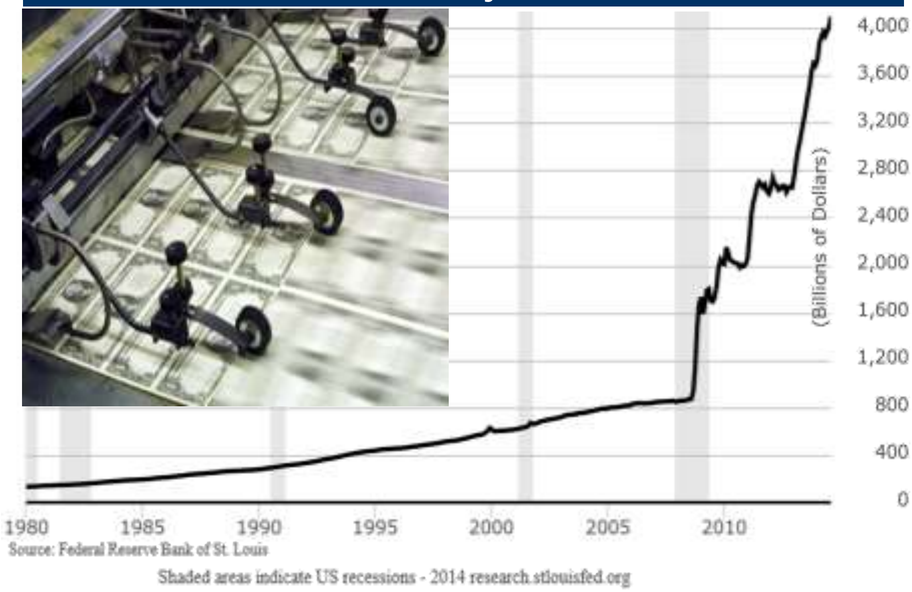


Household wealth has rebounded nicely since the crash, although this mostly affects the top 10% (some would say the top 1%). It has not filtered down effectively to most of the middle class, and certainly not to the low income households.

Nevertheless, this has "saved the bacon" of pension plans and 401(k)'s around the country. Another Great Depression would have been disastrous.

Inflation—Not in the Cards

Monetary Base



Inflation hawks obsessing about the potential for higher inflation due to the unprecedented “printing press” are missing the mark.

To the right you see the velocity of money, which has been steadily dropping for years and recently is falling like a rock. Even though the Fed has “printed” a lot of new money — due to fear, uncertainty, deleveraging, etc., the money supply is ***turning over at the slowest rate in over 50 years***! As long as the velocity stays low, inflation should be a non-issue.

In other words ***the pace*** of transactions has slowed radically, as many people are spending less or paying down debts.

The economic analogy would be sitting in an automobile with the engine running and the transmission in park. You can rev the engine as fast as possible, but the car isn’t going anywhere because the transmission is not engaged. Until velocity turns up, no meaningful inflation is likely, regardless of how much “printing” has occurred.

Quantitative Easing

Historically, the nation’s money supply has typically expanded somewhere between 3-6% per year in normal times. The Fed responded to the 2008 crisis with massive intervention (over $3 trillion) which is literally without precedence in U.S. history.

This could be likened to a body builder (the U.S. is still far and away the largest and strongest economy in the world) suffering a massive heart attack and needing major intervention (defibrillation or shock paddles) to survive.

Once the body builder gets back on his feet, he has the potential to heal completely, but without intervention might not have made it.

Velocity of Money—GDP to M2 Money Supply

“**Velocity of money** is the frequency at which one unit of currency is used to purchase domestically-produced goods and services within a give time period. In other words, it is the number of times one dollar is spent to buy goods and services.” (Source: St. Louis Fed, 2/27/15)

U.S. Housing—Recovering Slowly

Housing starts have slowly rebounded since the crash and are still nowhere near normal levels, despite hot housing markets in certain places like Texas and parts of California.

The U.S. and many other countries experienced unprecedented housing bubbles due to population trends (or demographics) combined with mortgage insanity such as the now infamous NINJA loans (no income, no job, no assets), subprimes and other creative inventions of the mortgage industry and Wall Street.

Thus after such an historic boom, we should expect an historic bust, which is exactly what we've seen. While healing slowly, many areas of the country are still below where they were in 2005, some ten years ago.

The U.S. housing market has followed the typical post-bubble real estate cycle.

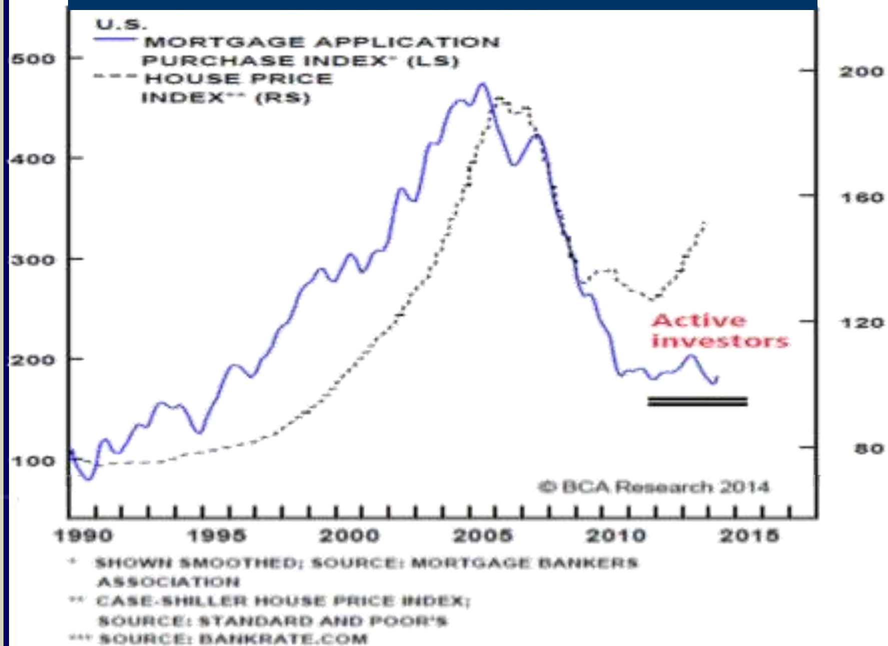
After peaking in 2005-2006, the normal pattern would be to bottom some 6 years later (2012), and that's exactly how it turned out. (Note: we pointed this out in our 2009 book ***From Boom to Bust and Beyond.*** Thanks to our friends at Bank Credit Analyst for this information).

It's truly amazing how reliably accurate human nature is, as it responds to massive herd-like emotions during speculative manias such as we experienced in many areas of the U.S. housing market.

Housing has bounced strongly off the bottom, and while certain areas of the country are hot, this is not a super strong trend nationwide.

Despite record low interest rates, **first time homebuyers** amounted to only 33% of the housing market in 2014 compared to 50% of the market in 2010. (Source: A. Gary Shilling Insight, December 2014)

New Buyers



First time homebuyers have been noticeably absent from this market, as millennials (echo-boomers) witnessed home prices plummet for the first time since the 1930's, recognizing housing is not a sure thing. Record college debt, tighter mortgage standards, reluctance to start a family during the financial crisis, and concerns about mobility should they need to change jobs have largely kept them out of the housing market.

Hedge funds made huge financial commitments to buy thousands of single family homes, which helped put a floor under the market, but also represents potential supply coming back into the market once investors decide to sell their rent homes.

Housing Immobility

"Some people can't sell because they are among those with underwater mortgages. In the second quarter, they were 17% of the total, down from 24% a year earlier and 31% at the depths of the housing crisis. Those with underwater mortgages are stuck in their houses and so are those with too little home equity to cover the down payment on a different home and the related moving expenses. Including those mortgages brings the total to 35% in the second quarter." (Source: A. Gary Shilling Insight, December 2014)

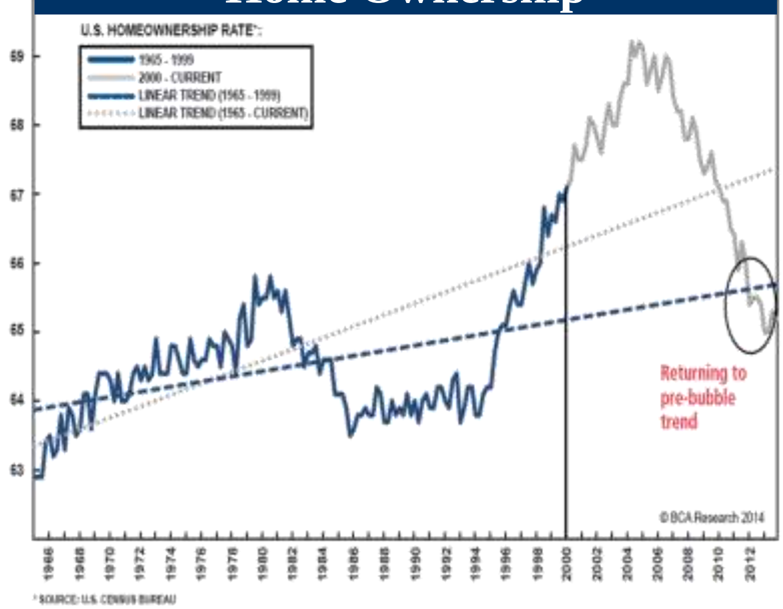
Consumers Opt to Rent, Not Buy

"Consumers continue to exhibit reluctance to own a home. Home ownership fell to 63.9% in the fourth quarter of 2014, the lowest reading since 1994. Meanwhile, rental vacancies plunged to 6.9%, their lowest reading since 1986.

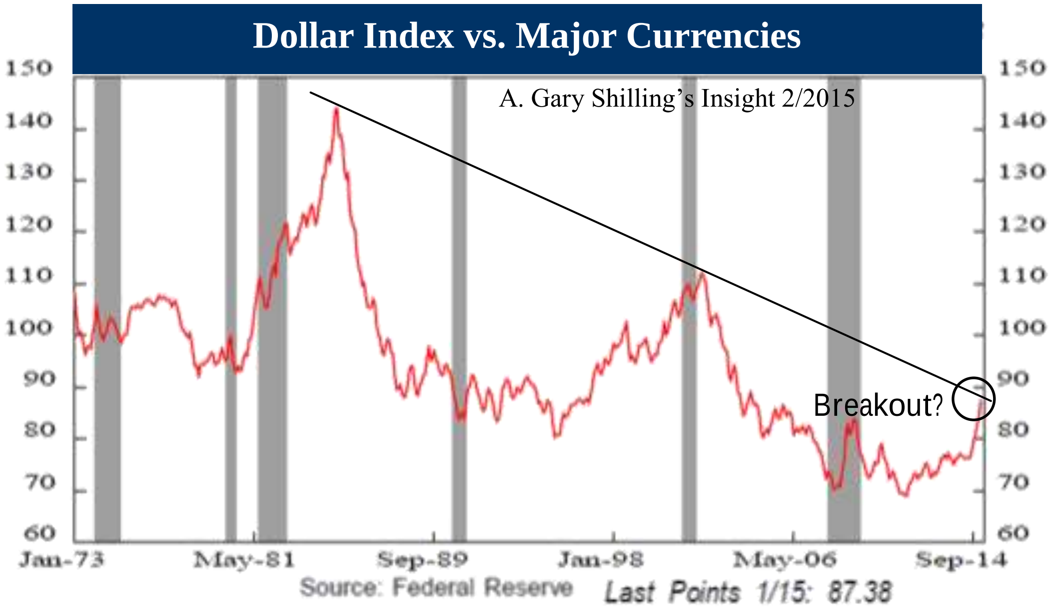
This is an extension of a trend that commenced during the 2007-09 housing crisis and economic downturn. Stagnant real incomes, widespread economic weakness and uncertainty, demographics, and the inability to get a mortgage are behind the slump in ownership rates."

(Source: *Consumers Opt to Rent, Not Buy*, Bloomberg Brief Economics, 1/30/15)

Home Ownership



U.S. Dollar—In the Land of the Blind, the One-Eyed Man is King



The U.S. dollar has been rising sharply of late, as investors worldwide worry about numerous factors. Europe remains weak and the euro looks to continue falling. With the EU restarting Quantitative Easing, interest rates in Europe have fallen to historic lows (see pg. 22 Unprecedented Times).

In contrast the U.S. Fed is talking about raising interest rates, making U.S. interest-bearing investments more attractive. Thus demand from foreign investors is pushing the dollar higher. The dollar could be on a multi-year run, possibly lasting until 2016-2017, as the U.S. remains the world's strongest economy.

We expect the dollar to eventually have its own problems due to U.S. government spending for retiring Baby Boomers. For the time being, the dollar is king and looks to remain strong for the next few years.

Dollar Vs. Yuan

China is heavily promoting their currency, the yuan (or renminbi), as a reserve currency. Simon Black reports, "China is putting up billboards advertising its currency overseas as the new choice for the world currency."[1] Yet the dollar remains king for now, as of October 2013, 81% of global transactions still use the dollar, vs. 8.66% for the yuan. The Chinese currency represented only 1.89% of global transactions as of January 2012.[2] China is gaining, but is still a long, long way off. A dollar "crisis" looks postponed until sometime next decade.

(Source: 1.The China Story, Aden Forecast, March 2015, 2.Washington Post, Swift Watch 12/20/2013)

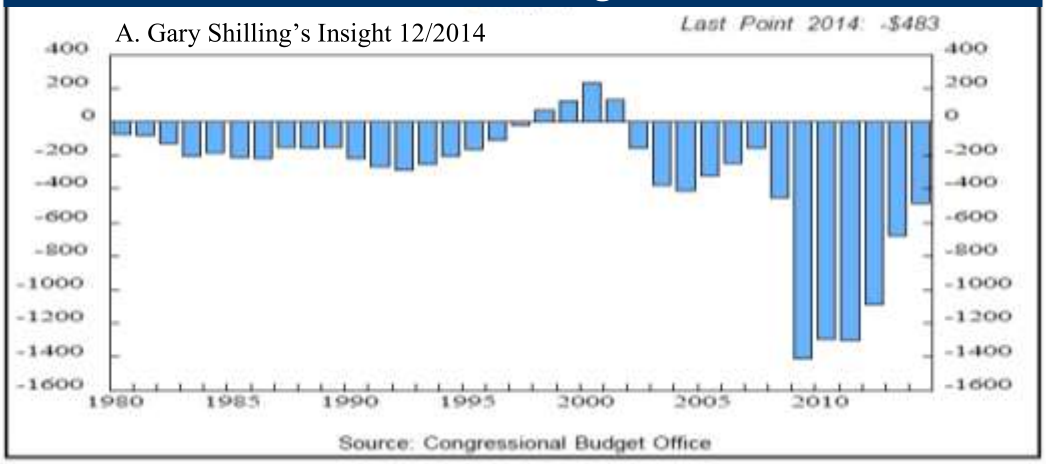
The Costly Toll of Currency Wars

"Not since the 1930s have central banks of countries around the globe so actively, and desperately, tried to stimulate their domestic economies. Confronted by a lack of domestic demand, which has been constrained by a massive debt load taken on during the boom times, they instead have sought to grab a bigger slice of the global economic pie.

Unfortunately, not everybody can gain a larger share of a whole that isn't growing—or may even be shrinking. That was the lesson of the "beggar thy neighbor" policies of the Great Depression, which mainly served to export deflation and contraction across borders. For that reason, such policies were foresworn in the post–World War II order, which aimed for stable exchange rates to prevent competitive devaluations. Almost three generations after the Great Depression, that lesson has been unlearned." (Source: *The Costly Toll of Currency Wars*, Randall Forsythe, Barrons, 2/13/15)

U.S. Deficit—Better for Now

Annual Federal Budget Balance

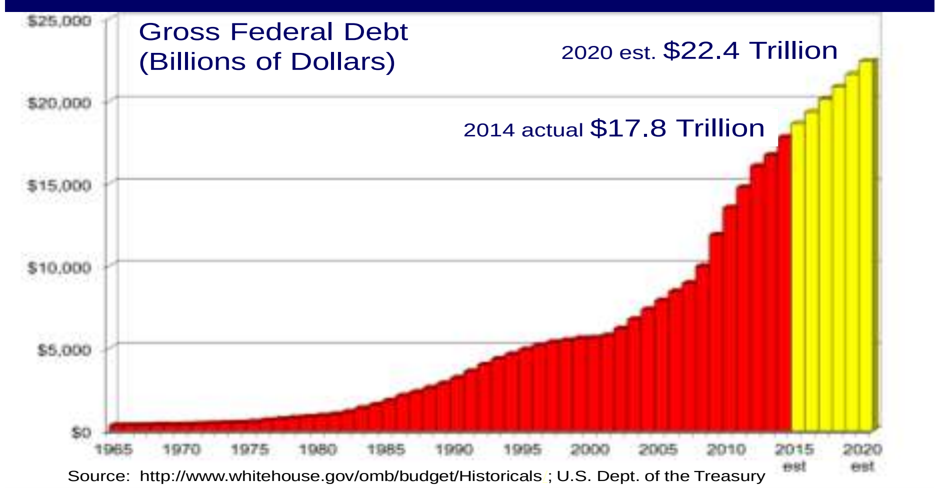


As you can see, the annual U.S. budget deficit has improved sharply, as the recovery produced increased tax revenues from corporations and individuals (profits) as well as declining expenses for "safety net" items such as unemployment insurance, welfare, etc.

Yet in coming years the deficit could skyrocket due to massive ramp-up spending for Social Security and Medicare as 76 million Baby Boomers march inextricably into retirement at the potential pace of 10,000 per day!

The 2020's are likely to see big problems for the U.S. government and U.S. dollar unless entitlement programs are curtailed sharply or revamped significantly.

Federal Debt 1965 - 2020



Entitlements

"Government spending on **mandated social programs** will rise more than 50% from $2.1 trillion this year to $3.6 trillion in 2024, potentially blowing the deficit out of control."
(Source: Thoughts From the Front Line, Mauldin 11/10/14)

Canaries In The Coal Mine

In the old days miners took canaries into the coal mines as an early warning system in the event that methane gas (odorless) leaked into the mine, as it is lethal to humans.

If a leak occurred, the canary would croak and fall off its perch, thus alerting the miners to "get the heck out of Dodge" before it was too late.

Here we are going to look at four canaries, which likely indicate that big problems appear just below the surface. Three of the four have broken bad and are indicating serious problems may be afoot for the world economy. The fourth canary looks sick but is still alive.

Lumber Prices: Breakdown or Fakeout

Copper Prices: Cyclical & Structural Breakdowns

- Lumber has not broken down but looks as if it is about to. Lumber is primarily used in commercial and residential construction. Should lumber break down sharply it would likely indicate a serious economic downturn is likely starting.
- Copper (which purportedly has a PhD in economics) may be the most accurate leading indicator of growth or contraction, and as you can see has broken sharply lower in the last couple of months. Copper is not only used in construction but all sorts of electronics and manufacturing, thus is often the most sensitive as to forewarning us about future economic trends.
- Oil prices (see next page) dropping 50% within just a few months may be indicating a large decline in upcoming demand. In each case since the 1980's, these drops have occurred ***prior*** to or during a financial crisis.
- Forward earnings estimates (2016) by S&P 500 companies are plunging. As you can see from the chart on the next page, this typically happens just before recessions. Note that forward earning projections have fallen to lower levels than had occurred in the 2000-2002 tech wreck, yet remain higher than 2007-2009.

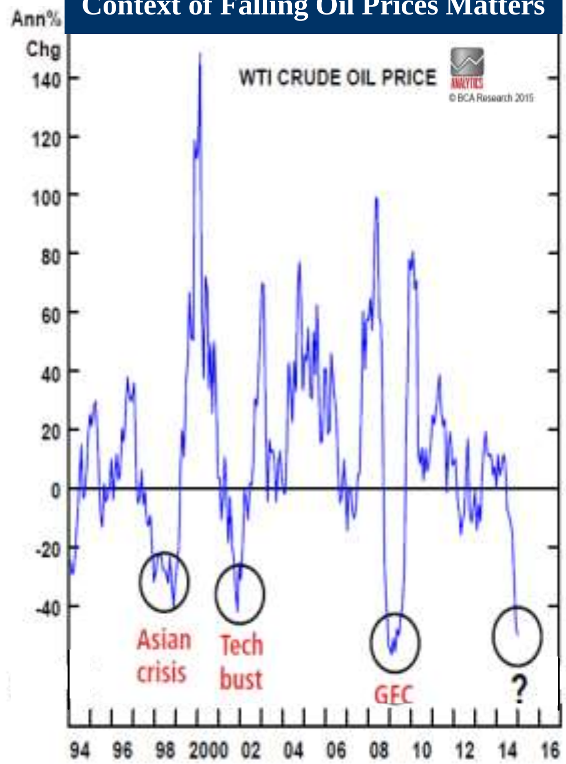
Nobel Prize winning economist Robert Shiller, PhD of Yale was amongst the few to identify the dot.com mania, and spotted the housing bubble as well.

While defending his profession, Shiller notes that the vast majority of economists (and thus media) do NOT see major turning points in the economy prior to crashes. Thus the fact that we see another major crisis approaching, while others do not, should not be a surprise.

In my 35 years experience I have never seen anyone forecast all the market's zigs and zags. Yet we do have a very good track record at identifying ***major turning points*** prior to bear markets, such as in 1987, 1998, most notably in 2000. (Note: I am generally better at major tops than bottoms—we did not pre-identify the 2008 crisis).

PLEASE NOTE: This track record is not exhaustive of all market events and corresponding Cornerstone positions. Cornerstone has been both correct and incorrect as to various market-related events over the past 3 decades. Cornerstone was incorrect relative to the 2008 market correction. PLEASE REMEMBER that past performance may not be indicative of future results. A COMPLETE HISTORY OF CORNERSTONE'S MARKET CALLS IS AVAILABLE AT THE CORNERSTONE OFFICE UPON REQUEST. See page 41 for additional disclosures.

Context of Falling Oil Prices Matters



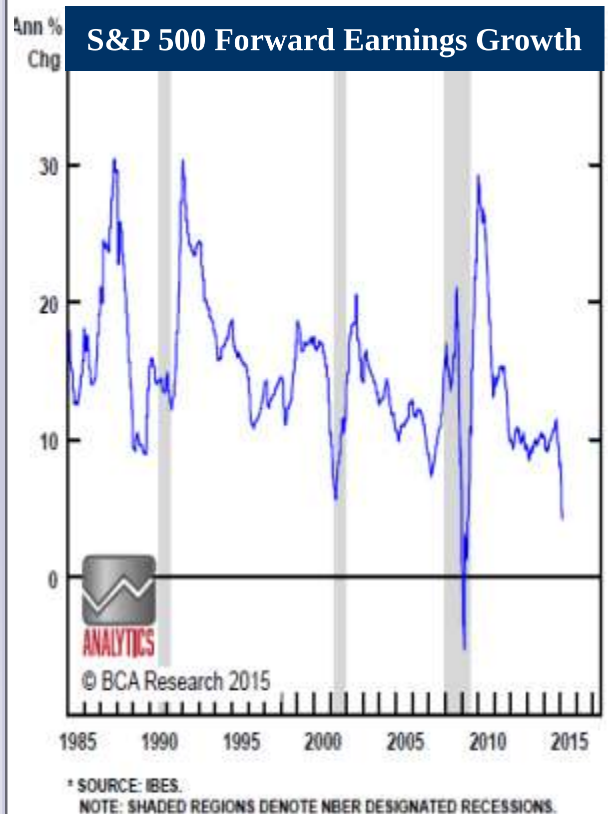
What's The Point of Economists?

"Since the financial crisis of 2007-09, criticism of the economics profession has intensified. Failure of all but a few to forecast the episode - the after effects still linger - has led many to question whether economics contributes anything to society. If they were unable to foresee something so important to people's wellbeing, what good are they?

Economists failed to forecast most of the major crises in the last century, including the severe 1920-21 slump, the 1980-82 back-to-back recessions, and the worst of them all, the Great Depression after the 1929 stock market crash. Searching news archives for the year before each of these started, I found virtually no warning from economists of a severe crisis ahead. Newspapers emphasized views of business executives or politicians, who tended to be very optimistic.

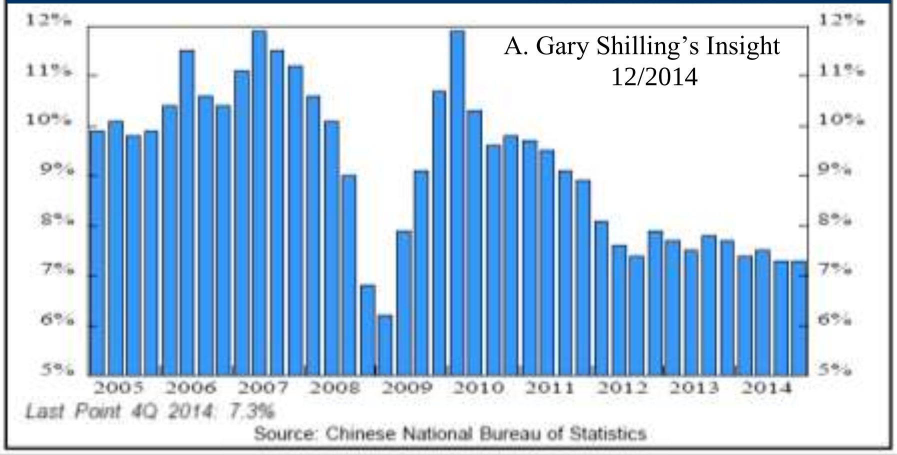
Whenever a crisis loomed in the last century, the broad consensus among economists was that it did not. As far as I can find, almost no one in the profession-not even luminaries like John Maynard Keynes, Friedrich Hayek, or Irving Fisher - made public statements anticipating the Great Depression." (Source: Things That Make You Go Hmmm, 02/01/15)

S&P 500 Forward Earnings Growth



China—Slowing, Reforming, Bubbling

Chinese GDP



Problems in China

- Slowing economic growth
- Transition from export-led to domestic driven economy
- Anti-corruption crackdown
- Shadow banking risks
- Real Estate bubble

(Source: A.Gary Shilling Insight, 2/2015)

Shadow Banking

"A big portion of [China's] shadow bank funding, including trust financing, is borrowed by property developers," said David Cui, China strategist at Bank of America. "**If there is a sharp rise of defaults by the developers**, it may cause a shock to investor confidence in shadow banking, which will raise risks of a credit crunch." The leverage ratio of Chinese companies is too great, according to Cui. "The probability of a credit crunch at some point is high," he said."

(Source: *Econochat,* Bloomberg Brief Economics Asia, 01/27/15)

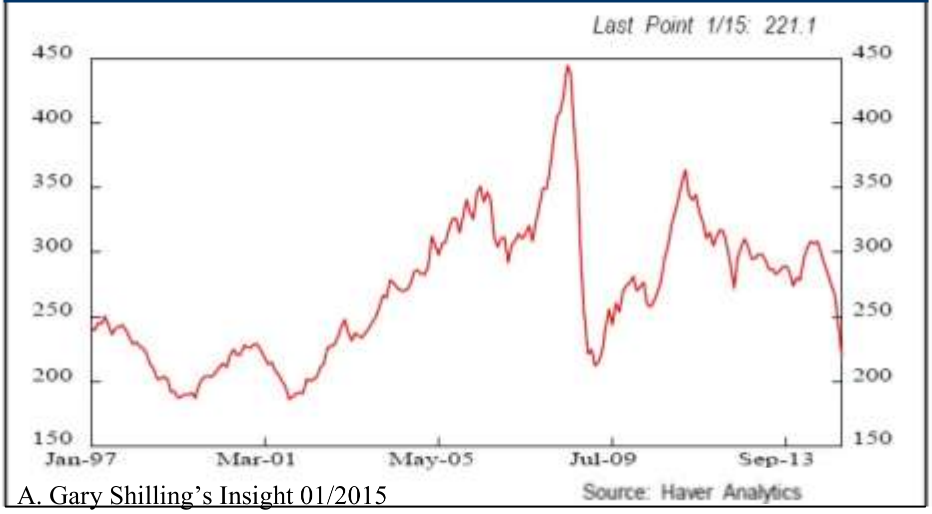
Housing Bubble Burst?

China's economy has grown dramatically over the past decades, going from total destitution under Chairman Mao to increasingly free-market-oriented. Deng Xiaoping began the economic revolution in 1978. Nobel Prize economist Milton Friedman first visited China in 1980 to consult with leaders about moving China's communist system toward free markets.

Despite massive reforms, much remains to be changed, including dominance of certain industries by state owned entities, land and housing reforms, human rights, etc. But the change so far has been stunning. A new round of reforms has now been initiated by the new premier, Xi Jinping, who has the strongest hold on the position since Deng Xiaoping. This has both good and bad ramifications. It will slow the Chinese economy short term, but will likely extend China's growth over the long run.

China is definitely slowing (no one knows if their 7% growth target for 2015 is "real" or not). The bigger issue with slowing growth in China, is not only that it strongly affects commodity prices (see next page) which hurts commodity exporting countries, but will almost certainly have a gigantic ripple effect upon the countries surrounding and supplying China. An increasing number of emerging countries have tied their economies to China's wagon. China's reforms are necessary to sustain their growth long term. Yet in the short term this could cause major disruptions.

Reuters/Jefferies CRB Index



A. Gary Shilling's Insight 01/2015

The chart to the left shows just how much commodity prices have dropped due in large part to China's slowdown, plunging to near 2008 lows.

If China's economy is truly growing at a 7% annual rate, their spending, imports, etc. (see below), do not confirm this story. No one really knows how fast their economy is growing, but the evidence shows it appears to be slowing a lot.

Category	% Change YOY
Electricity Production	**1.3%**
Yum! Same Store Sales (Taco Bell, KFC, Pizza Hut)	**-16.0%**
Casino Revenue	**-17.6%**
Imports	**-19%**
Land Sales	**-39.6%**
(Source: Bloomberg Brief China, 2/10/15)	

Corruption Crackdown

"In the past few months extraordinary revelations have appeared in the Chinese media about corruption in the highest ranks of the People's Liberation Army (PLA).

In January it emerged that no fewer than 15 generals, including a former deputy chief of the nuclear arsenal, were being investigated for graft. **Never before in China's history have so many high-ranking officers faced such charges at once.**

The lifting of the veil that normally shrouds the world's largest military force is evidence of the clout of Xi Jinping, the chief of the Communist Party, state president and, most importantly, commander-in-chief of what Mr. Xi insists on reminding officers is the party's army. No leader since Deng Xiaoping in the 1980s has held such sway over the armed forces. His purge of its highest echelons may be partly aimed at crushing potential rivals. But it is also part of Mr. Xi's campaign against corruption throughout the party and government and it has struck fear into the hearts of politicians and military officers, regardless of their loyalties."

(Source: *Lifting the Veil*, Economist, 02/14/15)

Credit Excesses

"Bottom Line: Lingering credit excesses in China and the potential for large non-performing loan losses argues for a further credit slowdown.

As a result, credit-intensive areas and in particular capital spending will weaken further. Weaker credit growth will also lead to a contraction in Chinese imports. Given the recent and expected slowdown in credit flows, China's import volumes will inevitably dip into the negative territory in the months ahead. "***The way China impacts the rest of the global economy and financial markets is not through Chinese GDP but its imports***. China's imports are leveraged to Chinese credit growth and they are bound to contract, regardless of what GDP numbers China prints. This is why in our research we have been focused much more on China's credit cycle than on GDP growth." (Source: *Key Questions on China*, BCA Research Weekly Report, 3/4/15)

Chinese Stock Market

Here you see China's stock market chart. China's stocks were a grossly overvalued bubble in 2007, and today are being fueled by an incredible borrowing binge. With real estate falling, Chinese investors have now turned back to stocks. Yet this could also prove problematic as it would certainly appear they are borrowing too much money to invest in the market.

Margin Stock Purchase % GDP

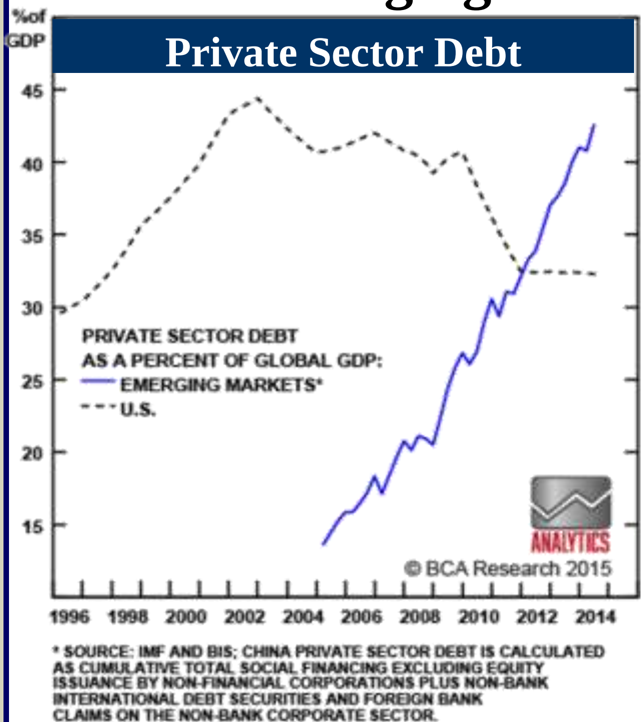
Chinese Margin Debt-New Bubble Forming?

"China's efforts to cool the growth of margin trading may curb one of the biggest drivers of the nation's world-beating equity rally: the use of borrowed money to buy stocks. **The amount of shares purchased on margin has surged more than tenfold** in the past two years to a record 1.1 trillion yuan ($179 billion), or about 3.5 percent of the nation's market capitalization. The Shanghai Composite Index has gained 37 percent in that period, including a 58 percent rally during the past 12 months that topped every other benchmark equity gauge worldwide."
(Source: *Market Calls,* Bloomberg Briefs China, 1/27/15)

China is a walking economic miracle if you look at how far they've come since the days of Chairman Mao, yet large remnants of the communist economic system remain. My guess would be they are only about 50% of the way through the process. Complete reform could take another decade or two.

Until recently, China has been the growth engine of the world, representing 45% of the world's growth as recently as the 2nd quarter of 2014.[1] However, the Chinese growth target of 7% this year appears highly suspect, and most are extremely skeptical of some of China's numbers as their GDP quarterly numbers appear 3 weeks after the calendar quarter, and are never revised despite the fact that some regions of China are only accessible by ox-cart during the rainy season.[2] In contrast, the U.S. numbers are released 1 month after the end of the quarter and are revised 2 times.[3]
(Sources: 1. Economist, 9/13/14 World GDP Growth; 2. A. Gary Shilling, 2012, A. Gary Shilling, 2014)

Emerging Markets—Debt Bubble??

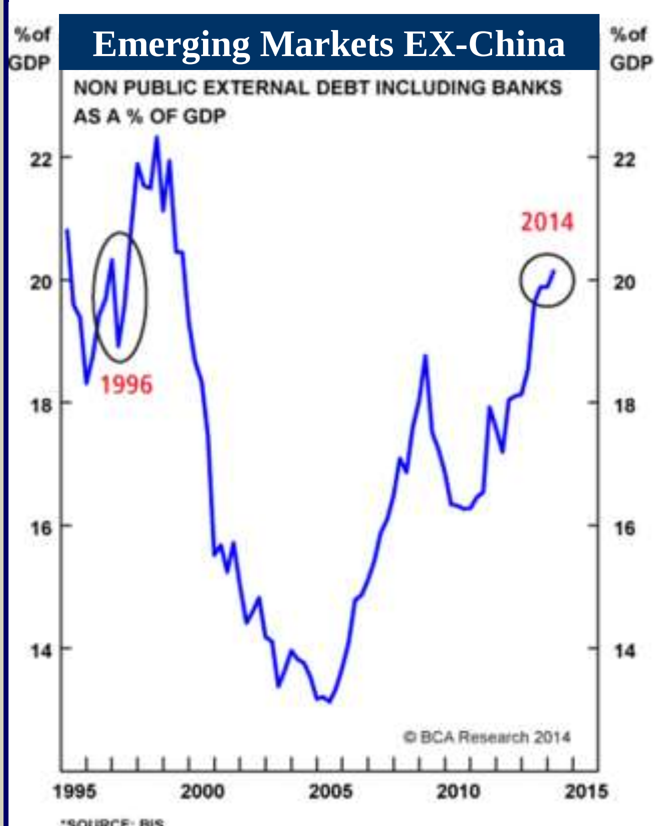


“***The speed of the rise in EM external debt since 2008 has been exponential***, and it is typically impossible to allocate such enormous amounts of credit within such a short period of time without misallocating. By capital misallocation, we refer to investment in projects that ***do not generate enough cash flow to service or repay debt***.

Contrary to investor perception, the depreciation of EM currencies (rising dollar) is more dangerous for EM debtors with foreign currency liabilities than Fed tightening and/or U.S. bond yields rising.

The EM private sector's (companies and banks) external debt levels are as high as they were before the Asian/EM crises in 1997-'98.”(Source: *EM External Debt: Why Worry?*, BCA Research Weekly Report, 2/25/15)

Private sector (non-government) debt has skyrocketed in emerging markets, such as Hungary, Malaysia, Chile, Peru, Korea, Taiwan, South Africa and others, an enormous debt binge since 2005. Will their corporations and large investors be able to repay their debts, especially if the U.S. dollar continues to rise? Individually these are small countries, but collectively they add up. In 2014 emerging market auto sales exceeded those of the United States, ***adding up to 43% of total global auto sales!***[1] (Source: 1. BCA, 2014)



One of my most vivid memories in recent years occurred in 2012 as I had the honor of sharing the speaking platform with Dr. Francis Yeoh in Jakarta, Indonesia. Dr. Yeoh was one of the ten wealthiest billionaires in Malaysia at that time. The story that stands out was when he shared about his difficulties in repaying ***dollar-denominated loans to the banks during the 1997-98 Asian crisis***. Similar to today, the dollar was skyrocketing in value versus other currencies, which helped create their economic crisis.

These emerging countries now have as much external debt as the late 1990’s, much of which is denominated in dollars, which means their debt service skyrockets if the dollar continues to rise. The difference this time is that these economies are much bigger than they were in the 1990’s, plus any repercussions will be much more significant to the world economy.

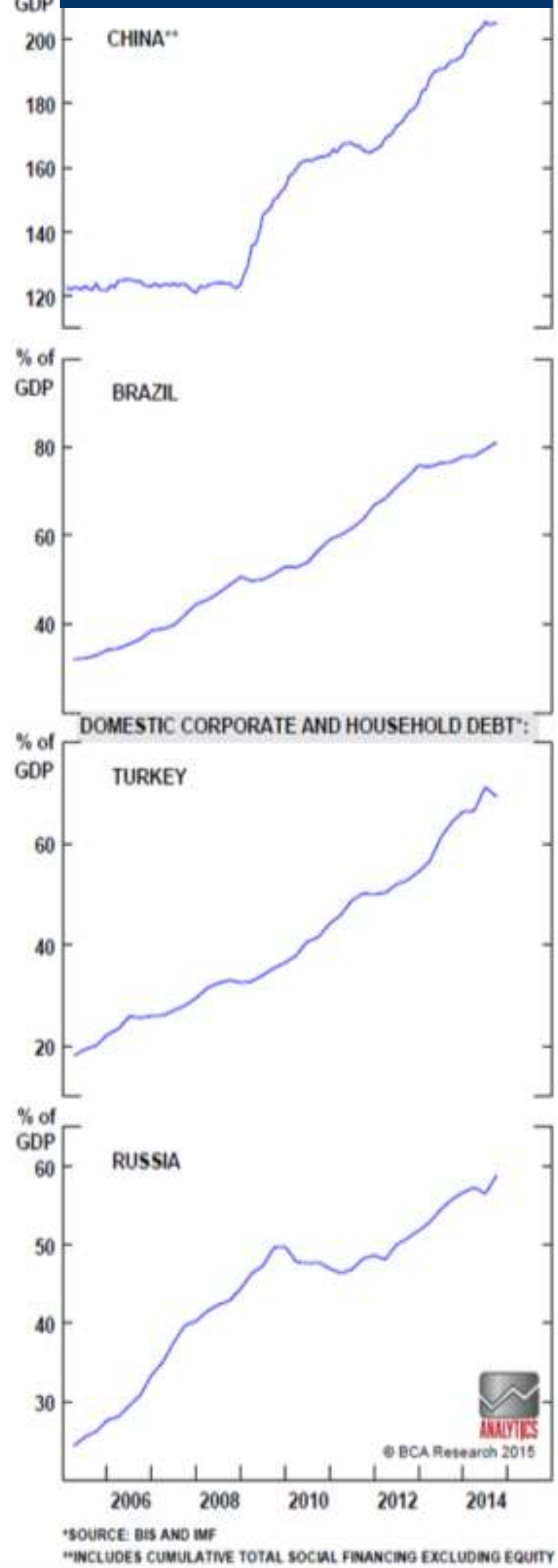
Emerging Asia Exposed to China's Credit Cycle

Emerging markets have gone on a debt binge, yet are seeing corporate profits fall across the board, likely setting up a major confrontation between their profit levels and debt service (profits falling—debt costs rising).

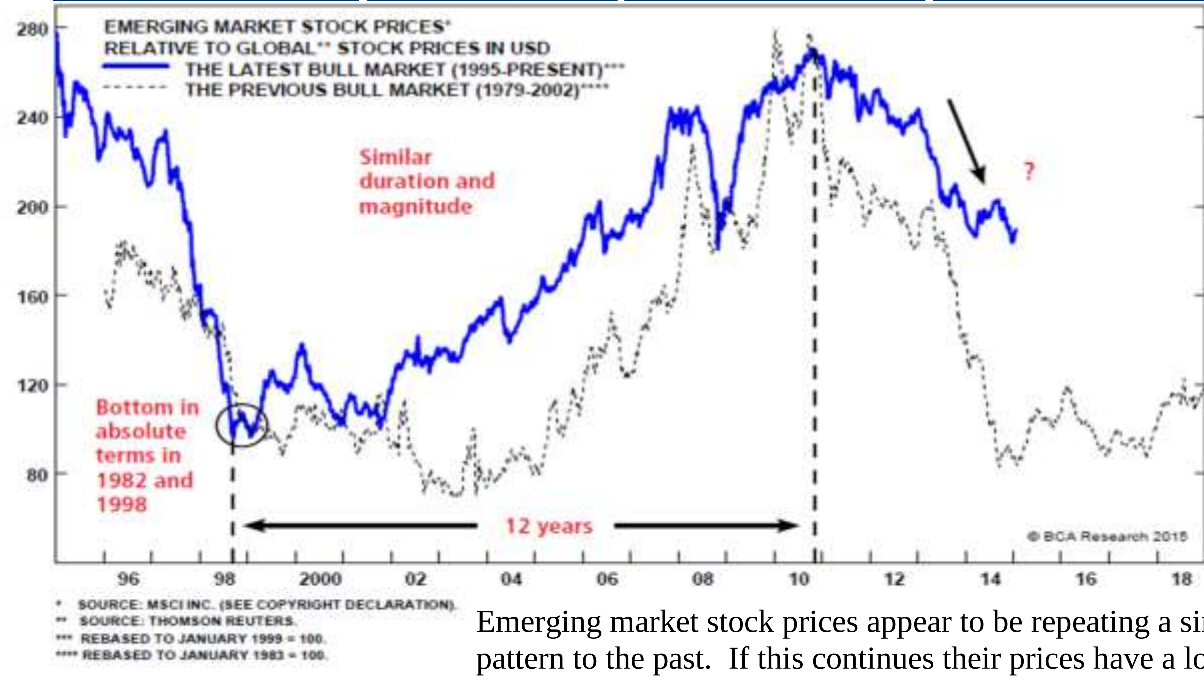
Plus, many of these emerging countries are highly exposed to China's credit cycle and slowdown, and many will experience challenges due to dependency on exports and commodities which have fallen sharply.

> "The credit boom in China and many other EMs over the past several years has given way to a credit hangover. These countries' financial systems and their debtors have to digest past credit excesses before a new credit cycle can begin.
> According to Bank of International Settlement (BIS) data, EM ex-China companies and banks have ***$2.8 trillion of outstanding foreign debt*** (bonds and loans), ***which represents an 80% rise*** from early 2009. For China, the same number is $1.3 trillion of outstanding foreign debt, a 6.5-fold rise since early 2009." (Source: *Exchange Rates Forcing Adjustment*, BCA Research EMS Weekly Report, 12/10/14)

Credit Expanded Too Fast



History Does Not Repeat Itself...It Rhymes



Emerging market stock prices appear to be repeating a similar pattern to the past. If this continues their prices have a lot further to go.

Global watchdog, the Bank of International Settlements (BIS) issued an extensive report warning that U.S. dollar-related offshore loans have soared. The BIS estimates as much as $9 trillion worth of U.S. dollar loans pose a great risk to both emerging markets and the world's financial system.[1] ***Dollar loans to Chinese banks and companies are presently rising at an annual rate of 47%***, from almost zero five years ago to 1.1 trillion. Russian external debt (mostly dollars) is up to 715 billion.[1]

In addition, "Activity in the leveraged loan markets even surpassed the levels recorded before the crisis.", with 55% of new collateralized debt obligations (CDOs) based upon leveraged loans — an "unprecedented level." CDO's were a prime culprit in the 2008 crash.[1] Ambrose Evans-Pritchard has more to say on the BIS report. (1. Source: *Dollar Surge Endangers Global Debt Edifice, Warns BIS,* Ambrose Evans-Pritchard, UK Telegraph, 12/14/14)

Dollar Surge Endangers Global Debt Edifice, Warns BIS

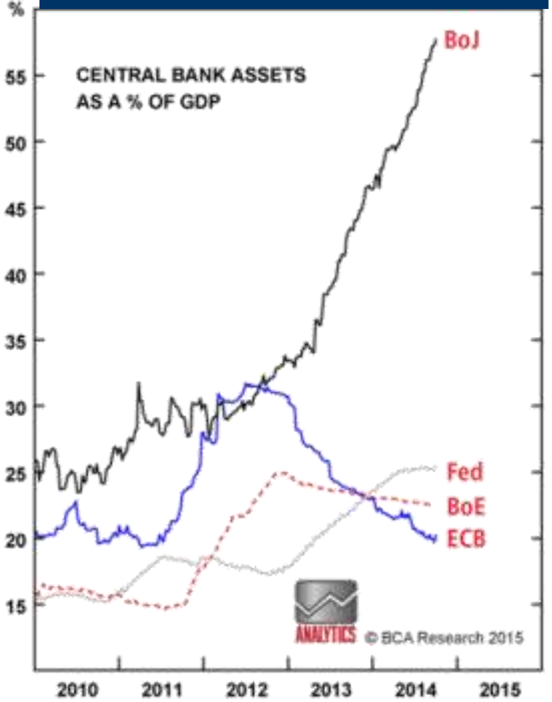
"Any tightening by the US Federal Reserve could transmit a shock through the credit systems in East Asia and the emerging world, by pushing up the dollar and thus raising the cost of borrowing. ***Dollar lending across borders has tripled to $9 trillion in a decade, some $7 trillion of this is entirely outside purview of the American regulatory system.***

The implication is no lender-of-last resort standing behind trillions of off-shore dollar transactions, increasing the risks of a chain-reaction if something goes wrong. China has ample dollar reserves to bail out its entities should it decide to do so. The jury is still out on Brazil, Russia, and other countries.

The BIS has particular authority since its job is to track global lending. It was the only major body to warn of serious trouble before the Great Recession and did so clearly, without the usual ifs and buts. It now warns that the world is in many ways even more stretched today than it was in 2008, since emerging markets have been drawn into the global debt morass as well, and some have hit the limits of easy catch-up growth." (Source: *Dollar Surge Endangers Global Debt Edifice, Warns BIS,* Ambrose Evans-Pritchard, UK Telegraph, 12/14/14)

Japan—Long Road Down

Japan Central Bank Assets



Fiscally, Japan is a basket case—***its population is actually shrinking each year!*** More people are dying than being born annually, plus the Japanese (as a culture) do not believe in immigration.

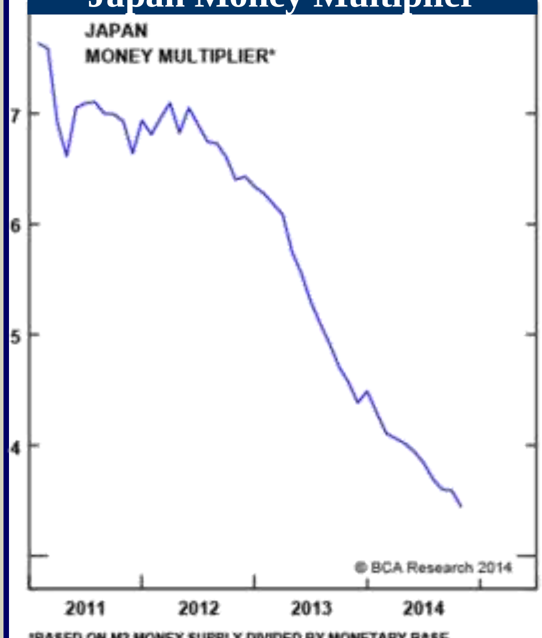
For years the Japanese were the envy of the world with a savings rate near 25% annually, and rapidly growing technology, automotive and electronics sectors, and today many of their corporations still rank amongst the best in the world. Some thought the Japanese were literally "taking over the world." Yet, in 1990 their stock and real estate bubble burst, and the crash has been longstanding and spectacular.

Today the Japanese have the highest government debt to GDP ratio in the world and they're spending down their savings as the older generation needs money for retirement and the government for social spending.

There is not enough room in this newsletter to do justice to the coming Japanese fiscal debacle. I plan on doing a Special Report on Japan within the next few months. Suffice it to say that Japan is in serious trouble long term.

The money multiplier shows how often money gets turned over inside the Japanese banking system annually (similar to the velocity shown for the U.S. on pg. 5), this simply demonstrates that as long as this continues declining, inflation will not return in any meaningful way.

Japan Money Multiplier



Despite recently printing more money (as a % of GDP) than any other nation[1] (see chart above), deflation has been the trend for Japan for over 20 years. It is truly difficult to see how they can work their way out of this without a severe crisis, probably worse than they have faced so far.

(Source: 1. *Bank of Japan Opens Floodgates*, Gavyn Davies, Financial Times, 11/2/14)

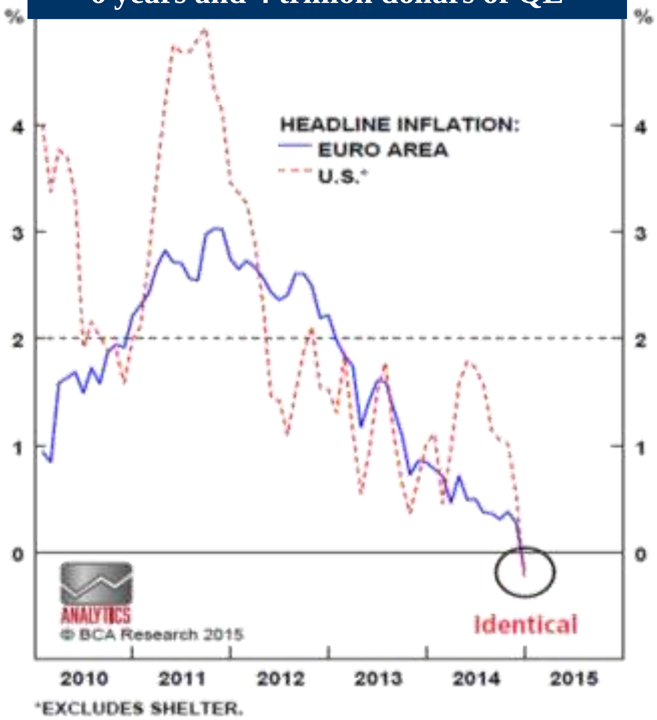
And Then There is Debt Deflation

"2013 Japan's total tax revenue fell to a 24-year low. **Corporate tax receipts fell to a 50-year low**. Japan now spends more than 200 yen for every 100 yen of tax revenue it receives. It is likely Japan will run an 8% fiscal deficit to GDP this year, but the Bank of Japan is currently monetizing (printing money) at a rate of over 15% of GDP.

But that monetization comes at a cost. The yen is already down 40% in buying power against a number of currencies, and another 40-50% reduction in buying power in the coming years is likely, in my opinion." (Source: Mauldin, Thoughts from the Frontline, 11/10/14)

Deflation—IS in the Cards

Spot the Difference: One economy has had 6 years and 4 trillion dollars of QE



Despite the fact that most analysts and economists are still expecting rising inflation, (especially in the U.S.), deflation is actually the biggest risk for the world today as we have pointed out in our seminars, radio shows and book ***From Boom to Bust and Beyond*** since 2009.

This will not remain the case forever. Inflation will not likely be a problem in the U.S. until normal velocity (turnover of money in the system) returns, as we explained on page 5. Deflation is currently in force in Japan (despite a temporary inflation bounce) and in Europe.

And while not runaway deflation like the 1930's, deflation remains a big issue as it is a central bankers' worst nightmare (Note:1930's style deflation is highly unlikely as we now have built in stabilizers to the system—i.e., FDIC insurance, unemployment benefits, welfare, etc.)

Inflation seems easier to cure. The Fed can raise interest rates and reduce the money supply. But deflation can become entrenched and self-reinforcing if consumers begin putting off making large purchases, with the expectation that prices will fall in the future.

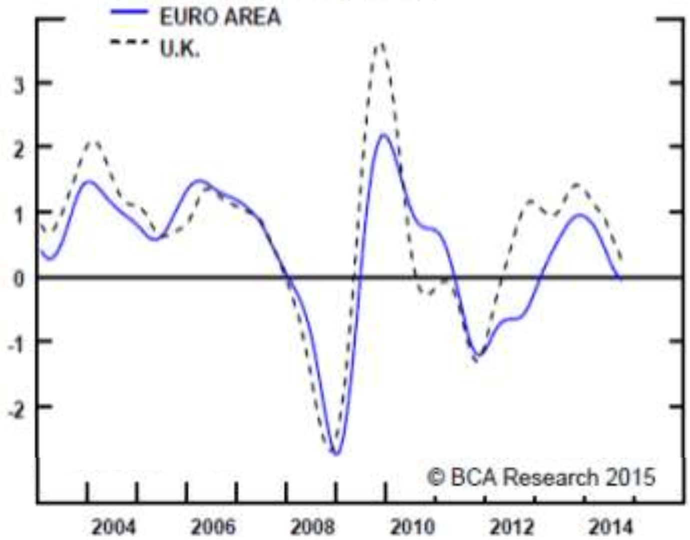
If deflationary "psychology" sets in, it can become self-fulfilling. Expecting lower prices, people delay purchases, thus leaving corporations with too many goods on the shelf. To clear the inventories corporations are then forced to cut prices, which "proves" to consumers that they were right in the first place. Thus this deflationary psychology can become a negative feedback loop, feeding upon itself over time and causing economies to slow to a crawl.

Even worse is the effect deflation has on debts. If incomes fail to rise (in a deflationary environment), previously incurred debts become more difficult to service. At the time consumers or corporations originally incurred their debts, their economies and incomes were growing rapidly. Thus they ***expected*** to be able to pay off their debts with rising incomes and ultimately cheaper dollars due to inflation. Thus as incomes rose, debts would become easier to repay. But now the world's economies are growing slowly or declining, being weighed down by excessive debt which is becoming increasingly difficult to service.

Japan has been in slow moving deflation for the most part, since 1990. Europe is entering deflation now and as you can see from the chart above, the U.S. appears headed that direction. In a "currency war" environment, where no one wants a strong currency (because it hurts the sales of their domestic corporations in overseas markets), deflation is in effect being "imported" to the U.S. as the Japanese yen and euro currencies decline.

European Union—Economic Quicksand

Leading Economic Indicator



Economic conditions in Europe may have bottomed, but many problems appear intractable, as peripheral countries (Spain, Portugal, Italy, Greece) remain stuck in low growth mode with very high unemployment rates after years of economic stimulus. Europe's leading economic indicators may be trying to bottom, yet so far remain in a declining pattern, indicating more weakness yet to come.

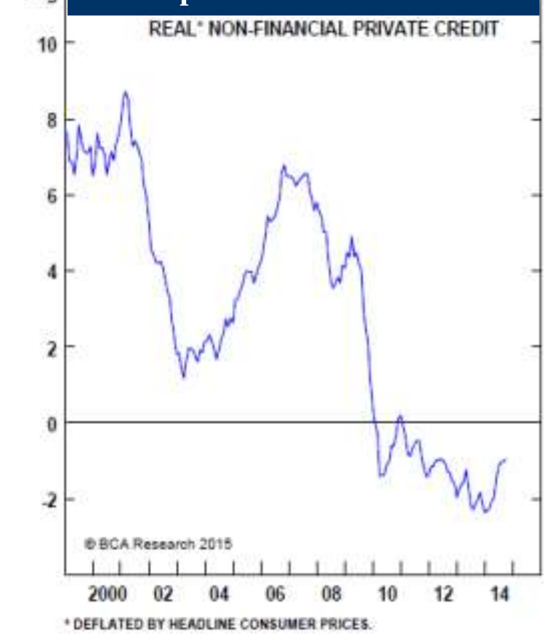
Bank credit flows appear to be improving, yet are starting from very low levels (see below). Credit flows need to greatly expand to get Europe's economy growing again.

The Euro and (Geo) Politics

- "The euro has failed to deliver on almost every economic measure its backers promised.
- German-led austerity has produced a populist backlash. New parties, such as Podemos in Spain or SYRIZA in Greece, have become political heavyweights virtually overnight.
- The European economy has underperformed for several years, with low GDP growth and high unemployment making for a toxic political brew.
- Europe's Cold War-era institutions appear to be unprepared to deal with the geopolitical threats of the 21st century, including great power conflicts with Russia."

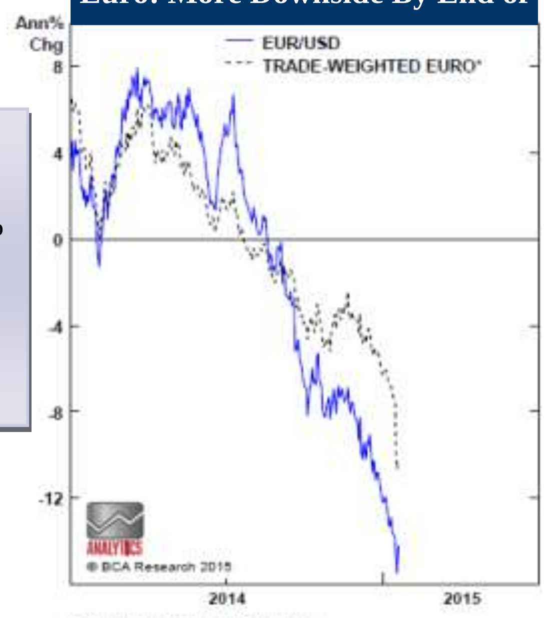
(Source: BCA Research Geopolitical Strategy, 2/2015)

European Demand Remains



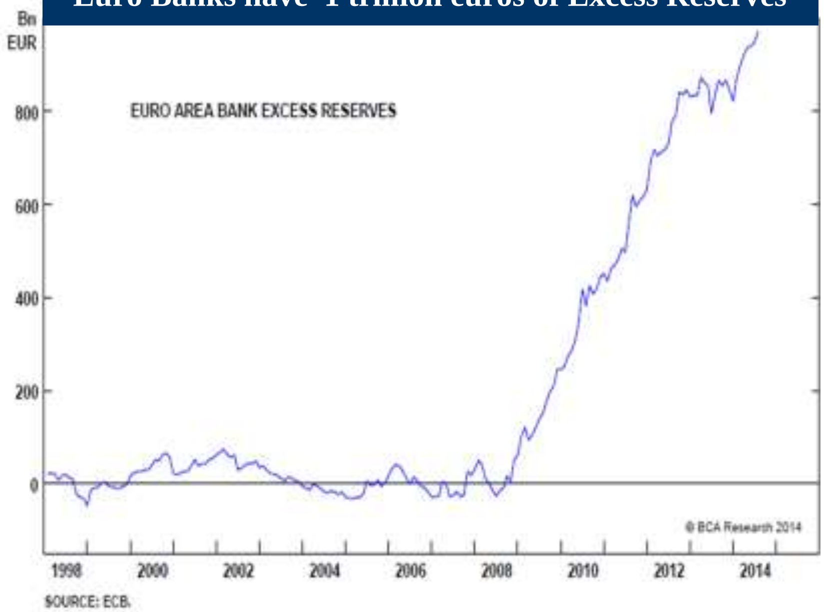
"Goldman Sachs predicts the euro to decline another 30% by 2017."
(Source: Hedge fund Manager: It's a 'truly scary time', Lawrence Delevingne, 3/16/15)

Euro: More Downside By End of



You can lead a horse to water but...

Euro Banks have 1 trillion euros of Excess Reserves



Euro area bank reserves have been climbing since the 2008 crisis. This is telling us that there is deficiency in one of two areas, or both.

Either businesses are reluctant to take out new loans, as they're overindebted thus are more concerned about survival and servicing existing loans than taking out new debt, or banks are reluctant to loan because their present loan portfolios are impaired. Thus they are slowly ridding their books of bad loans before considering new lending. Especially hard hit in recent years have been small-to-medium sized businesses in Europe.

The ECB And The Emperor's New Clothes

"Once people realize that monetary policy has no credible transmission channel into the real economy, even this ability to influence inflation expectations through psychology and bluster becomes severely compromised.

Europe's most important Finance Minister, Germany's Wolfgang Schäuble, spoke the uncomfortable truth. The emperor isn't wearing any clothes. ***"'To be quite frank, I don't think ECB monetary policy has the instruments to fight deflation. Liquidity in markets is not too low, it is even too high" .***

The ECB's decision to become lender of last resort to sovereigns in 2012 was a genuine game changer because it removed a binding liquidity constraint for the weaker (but solvent) sovereign borrowers.

But today, there are no binding constraints which the ECB can remove. Policy interest rates are at the zero bound, sovereign bond yields (in both the core and periphery) are at record lows."

(Source: BCA Research, 9/14/14)

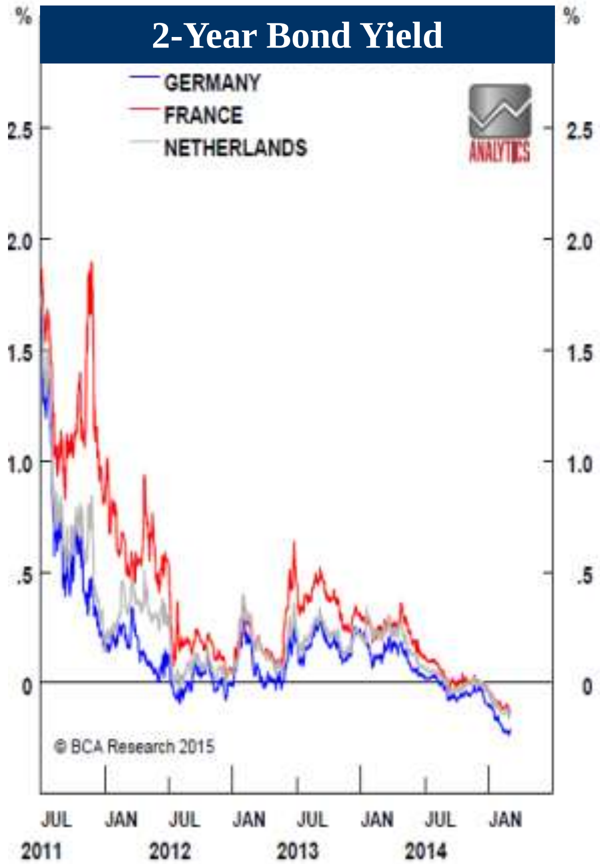
"Paola Subacchi at Chatham House is dubious about the chances of the ECB's latest stimulus effort. "At best, QE will help assuage some ***deflationary fears*** and provide some oxygen to the peripheral countries by keeping under control the costs of serving their public debt," she writes. "But it is unlikely that QE will make a significant difference in terms of economic growth."

(Source: *What We're Reading*, Bloomberg Economics Europe, 1/28/15)

Geopolitical Risks

"78 year old banker Jacob Rothschild used his chairman's statement in the RIT Capital Partners 2014 annual report to outline his concerns, saying that on top of a "difficult economic background" investors face "**a geopolitical situation perhaps as dangerous as any we have faced since World War II**". He said this was a result of "chaos and extremism in the Middle East, Russian aggression and expansion, and a weakened Europe threatened by horrendous unemployment, in no small measure caused by failure to tackle structural reforms in many of the countries which form part of the European Union". Then, he listed the major dangers as the slowdown in China's growth and a possible over-valuation of shares."

(Source: *Rothschild: 'Investor's face a geopolitical situation as dangerous as World War II'*, Richard Dyson, UK Telegraph, 3/4/15)



Unprecedented Times

"Low rates have been used to keep their currencies weak because in this era of currency wars, no country wants a strong currency and low interest rates make a currency less desirable. The problem is, things are going overboard. Currently, for instance, interest rates are below 0% in Japan, Germany, Switzerland, France, Belgium, Austria and Denmark.

Now here's the shocker… **This is totally unprecedented in world history**. In fact, reviewing the book, ***A History of Interest Rates***, there has ***never*** been a time when interest rates were below zero in the major countries.

With the brief exception of Swiss interest rates in the 1970s, we're talking about 800 years! Through the Dark Ages, the Renaissance, the Industrial Revolution, the Great Depression, great wars and much more, the world has never seen a situation like the current one. We are literally in uncharted waters and aside from the obvious, the eventual outcome, repercussions and effects are totally unknown because this has never happened before." (Source: The Aden Forecast, February 2015)

EU Deflation

"Euro-area producer prices continued to fall in December, even when corrected for a decline in energy prices. **The headline index fell 2.7 percent year over year in December**, after a 1.6 percent drop in November." (Source: *Overnight*, Bloomberg Brief Economics, 2/3/15)

Accentuate the Negative

"A guaranteed loss. That is what investing in bonds at negative yields implies: those who buy the bonds will get back less than they paid even after interest is taken into account. Yet government bonds of various maturities in as many as ten countries are selling at negative yields. Why on earth would bond investors, the "masters of the universe" once famed for intimidating governments, be willing to accept such a lousy deal?

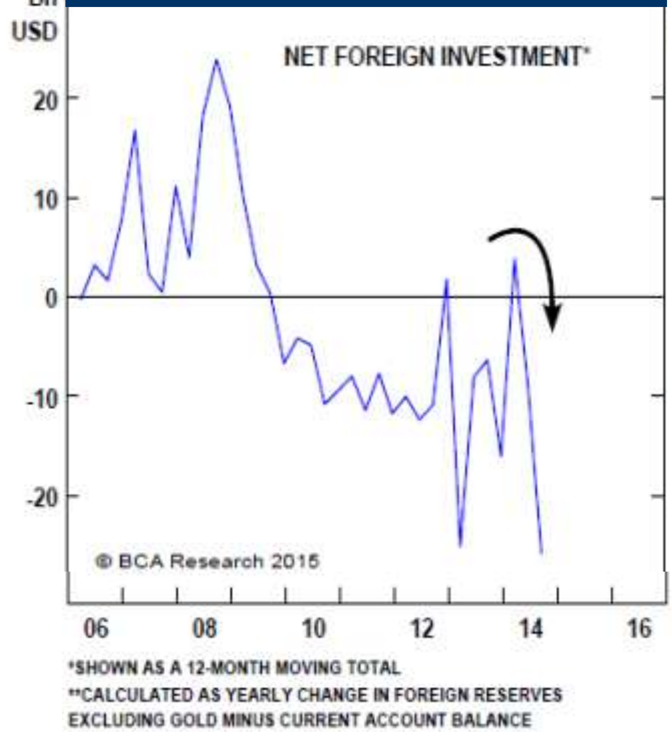
One obvious reason is fear, or at least caution. In the depths of the financial crisis in 2008, when the safety of the banks seemed in doubt, short-term Treasury bills offered negative yields and investors were happy to take them. (Holding physical cash is impractical, given the sums involved.) Now, with some uncertainty about what might happen to banks were Greece to leave the euro, investors may decide it is worth accepting a negative yield of 0.16% on two-year German bonds. "In effect you're paying a 16-basis-point custody fee for keeping your money safe," says David Lloyd of M&G, a fund-management group.

In other words, investors are willing to lose a little to make sure they don't lose a lot. But it is harder to see this as an explanation for negative yields on longer-term debt, such as Switzerland's ten-year bonds. You would have to be quite depressed to conclude that no asset on the planet would make any money at all over the next decade." (Source: *Buttonwood:*, The Economist, 1/24/15)

Russia—Catastrophe in the Wings??

Ruble Trouble

Russia: Capital Outflows are Pervasive



As the value of the ruble falls compared to the dollar, foreign capital continues to flee, making it increasingly difficult for Russian firms to service their debts and to stay in business.

Fleeing foreign capital has not only become pervasive but jeopardizes the very existence of some firms, as this creates a huge capital shortage.

"Carl Weinberg, chief economist at High Frequency Economics has Russia on his mind. 'What scares me the most is Russia. As we continue to impose sanctions on Russia and disfranchise that country from the world financial system, **Russia has less and less to lose from reneging on its foreign debt**, which right now totals about $670 billion (now $715 billion). We also run the risk that with commodity prices and oil prices falling, Russia may be pushed to a place where even if it wants to repay and service all its debt, it might not be able to, because its foreign-exchange reserves are dropping,' he said."
(Source: *Economist Notepad*, Richard Yamarone, Bloomberg Brief Economics, 12/23/14)

Russian Loans

"For a domestic (Russian) corporation that has to pay off a dollar loan, the cost of paying off that loan has doubled over the last year. If you borrowed $1,000 at 5 percent a year ago starting from a Russian corporation, today you owe more than twice the same amount of rubles. **In other words, instead of 33,000 rubles, you owe 66,000 rubles today, plus interest—100 percent plus on that loan**. And that is going to be debilitating for companies in local-currency terms.

Right now, they need high interest rates to stabilize the currency, but high rates will kill the economy. They're in a situation where they're really stuck. They've suffered an awful, catastrophic shock in their balance of payments from the combination of oil prices and sanctions. And there's just not a good way out of that, that I can see. I can't imagine a policy remedy that could undo either of those things, let alone both.
(Source: *Keene's Corner*, Carl Weinberg, Bloomberg Brief Economics, 12/18/14)

EU/Russia Geopolitics

"In Brussels and other EU capitals, the fear of Vladimir Putin is becoming palpable. The mood has changed in a matter of weeks from one of handwringing impotence over Ukraine to one of foreboding.

The anxiety is encapsulated in the sudden rush to Moscow by Germany's Chancellor Angela Merkel and France's President François Hollande. To senior figures closely involved in the diplomacy and policymaking over Ukraine, **the Franco-German peace bid is less a hopeful sign of a breakthrough than an act of despair.** "There's nothing new in their plan, just an attempt to stop a massacre," said one senior official.

Carl Bildt, the former Swedish foreign minister, said a war between Russia and the west was now quite conceivable. A senior diplomat in Brussels, echoing the broad EU view, said arming the Ukrainians would mean war with Russia, a war that Putin would win.

Announcing the surprise mission to Kiev and Moscow, Hollande sounded grave and solemn. The Ukraine crisis, he said, started with differences, which became a conflict, **which became a war, and which now risked becoming "total war"."**

(Source: *Fear of Vladimir Putin grows in EU Capitals Amid Spectre of 'Total War',* Ian Traynor, The Guardian, 2/6/15)

It would not surprise me to see Putin temporarily back off in terms of military excursions, in a two steps forward one step back approach, with the hope of reducing or ending economic sanctions from the EU this coming July. Yet in the long run Putin definitely remains expansionist.

"But until Friday Merkel had never gone to Moscow. Only a few weeks ago she vetoed a summit in Kazakhstan with Putin because she believed there was no point negotiating with someone she no longer trusted.

The broader economic sanctions in force against Russian banks and companies are more serious. They lapse in July unless extended by all EU governments.

Putin is increasingly seen as a reckless gambler who calls bluffs and takes risks, and is inscrutable, paranoid and unpredictable. Trying to work out what he wants is guesswork. The Europeans sound scared.

For Europe it is becoming clear that the real nightmare is not Ukraine, but Putin's Russia."

(Source: *Fear of Vladimir Putin grows in EU Capitals Amid Spectre of 'Total War',* Ian Traynor, The Guardian, 2/6/15)

Kidnapped by the Kremlin

"Some in the West will argue, let Mr. Putin keep the Crimean peninsula, it has a Russian-speaking majority and was anyway part of Russia until 1954.

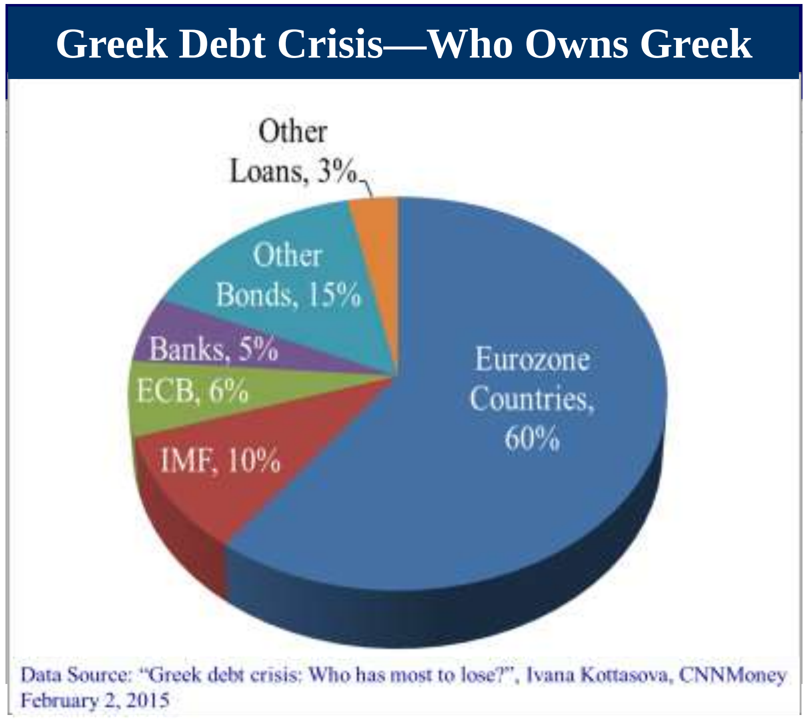
But the justification Mr. Putin claims for sending in troops is not Crimea's unique history, but the principle that **the Kremlin has a duty to protect Russians and Russian-speakers wherever they may be—the logic that Hitler used when he seized parts of Europe in the 1930's.** If the West implicitly accepts this line, Mr. Putin will have a pretext for intervening to protect Russians scattered across the former Soviet Union, from Central Asia to the Baltic.

So do not bet on Mr. Putin being content to stop at Ukraine. In 2008 he fought Georgia to assert control of Abkhazia and South Ossetia. He has said that the collapse of the Soviet Union was the 20th century's greatest geopolitical catastrophe. He is armed with a self-proclaimed mission to rebuild the Russian empire and now with a pretext to intervene abroad. Mr. Putin poses a grave threat to his neighbors.

(Source: The Economist, 3/8/14)

Greece—Is the Word

With the election of the new far left, socialist prime minister, Alexis Tsipris, the Greeks have voted that they are sick of economic depression and German "austerity" policies. Great Depression level unemployment and other woes, have hardly improved as we near the 7 year anniversary of the great financial meltdown, and has proven that Germany's (and the EU's) prescriptions have not worked.



Unfortunately, Greece is between a rock and a hard place, on one hand they do not have the financial wherewithal to leave the euro and convert back to their own currency (the drachma), which would likely fall like a rock similar to Russia's ruble. This would almost certainly impose additional financial hardship. On the other hand it's difficult to see how they can survive if they stay in the euro (see Greenspan quote below).

Nevertheless, Tsipris got elected on the platform of throwing off the German taskmasters to escape this modern day debtor's prison, while promising to restore all sorts of social programs which the country simply cannot afford.

Greek Haircut Needed

"It would take a significant debt reduction to put Greece on a stable trajectory. According to calculations by Bloomberg Economics, ***the nation would need a 48% haircut*** on its 315 billion euros of public debt (as of the end of 2013, according to the Eurostat) to bring its debt-to-GDP ratio down to the euro area's average." (Source*: Greece Stares Down Troika With Weak Hand*, Bloomberg Brief Economics Europe, 1/27/15)

Greenspan Sees a Greek Exit

"I don't see that it helps them to be in the euro and I certainly don't see that it helps the rest of the euro zone," Greenspan said in a radio interview with the BBC on Sunday. ***"I think it's just a matter of time before everyone recognizes that parting is the best strategy."*** (Source: *Greenspan sees Greek Exit from Euro as Just a Matter of Time*, Bloomberg, 2/8/15)

"Scary" Greece

"We've been looking at Greece and it's very scary. It's hard to find anything very good in Greece. Not only that we should see problems with youth unemployment, but now we've got problems with 25 to 29 year-olds, and they were young in 2008 and they are really being impacted. And we sat and tried to look at deep analysis of the Greek youth labor-market problem and ***basically concluded the best thing that any young Greek could do was move***. I mean it's literally as bad as that." (Source: David Blanchflower, *Keene's Corner*, Bloomberg Brief Economics Europe, 1/30/15)

The biggest risk may well be the Greek banks, which have seen significant outflows and face the potential for a banking crisis sooner rather than later. Reports of Greek shipbuilders (one of their largest industries) moving money out of Greek banks, is a big concern.

One way or another, either the Germans, the EU and IMF will have to give, or Tsipris and Syriza will have to give, there is no way they can both get what they want, and the Germans (and Eurozone) hold all the cards. While no one on either side wants to see catastrophe, Europe has been slowly preparing for the eventuality of a Greek exit for several years. The bigger issue is not the 315 billion euros the Greeks owe (which is largely unrepayable), but rather the potential precedent it would set for Portugal, Italy, Spain and Ireland to renegotiate their debts, which are much bigger.

The latest deal between Greece and its creditors kicked the can down the road until June, but things could get quite interesting in the second half of the year. The moment of truth approaches.

Syriza Campaign Pledges

"The new government said it would **raise the minimum wage by 30%, rehire thousands of government employees, end the government's privatization program, raise pensions and aid for the poor**. It also demands a restructuring of Greece's bailout loans of €240 billion. Many fear that Greece will run out of cash and default on her foreign loans by July or August when the €6.7 billion owed to Eurozone central banks is due. That could lead to Greece's withdrawal from the euro as she loses access to central bank liquidity, huge economic dislocation in Greece, massive writeoffs for creditor countries and lasting destabilization of the eurozone. Furthermore, if Greece departs, the question becomes, who's next? Portugal? Spain? Italy?" (Source: *Global Outlook: Falling Commodity Prices, Deflation & Universal Currency Devaluations: Greece*, A. Gary Shilling's Insight, February 2015)

Time to Watch Greece Again

"They (Syriza) want to see a restructuring of Greek debt, which frankly is the only way possible for Greece to get out of its current long-lasting depression. A 175% debt-to-GDP ratio, without a central bank willing to purchase all that debt, simply does not qualify as a working business model. In the background is ***the collapsing Greek economy, which has shrunk by 25% in the past five years, while youth unemployment hovers at a staggering 50%. Prescription drug prices have gone up 30%; unemployment benefits end at 12 months; and the long-term unemployed lose access to state health care***. Already, Greek taxpayers are delaying payments in anticipation of Syriza's promised abolition of property taxes.

The populist proposals made by Syriza will not fix any of the underlying structural problems and will likely make them even worse. There is simply not the money to do what they want. Undoing economic and labor reforms will put any future growth, which is the most important need, even further out of reach." (Source: Mauldin, Thoughts From the Frontline, 1/26/15)

U.S. Stocks—Still Advancing (for now)

Advance-Decline Line

To the left you see the advance-decline line (A/D) which measures the number of stocks rising divided by the number declining. Historically, the A/D line begins to fall <u>before</u> (!) the market, serving as an effective early warning system.

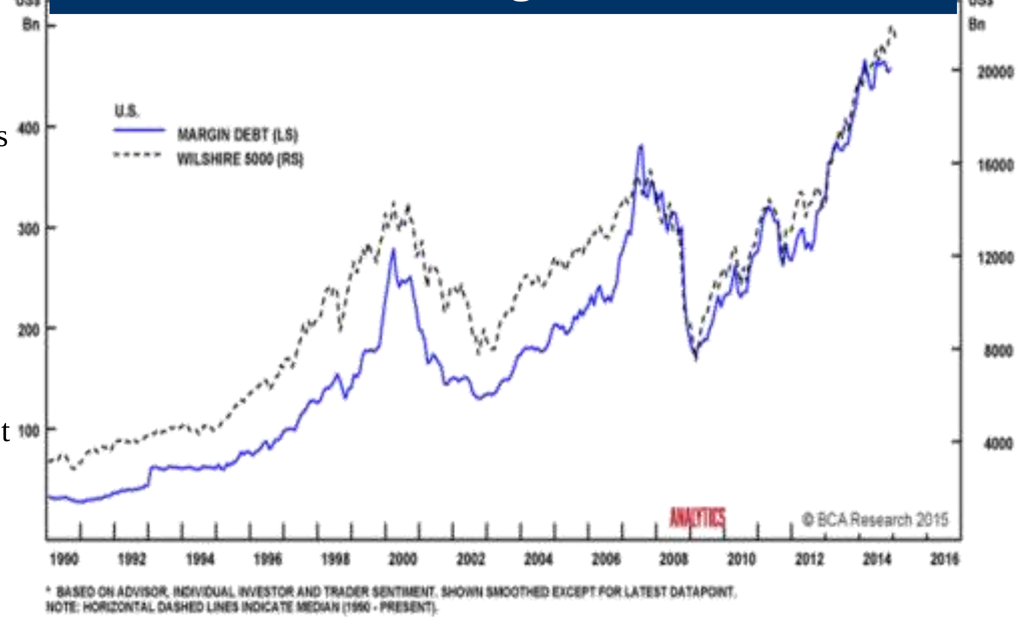
Past performance is no guarantee, but you can see that the A/D line has previously led the way prior to bears.

At present the A/D line is still rising, indicating more upside potential for the market over the next few months as it generally peaks several months before the stock market. BUT keep watching!

Margin debt (borrowing to buy stocks) traditionally leads the market as well. Once a market peak occurs, falling stock prices force additional selling, as margin investors lose money much faster than non-leveraged investors due to the debts involved.

Though margin debt peaked last February, it remains high. Margin debt as a % of GDP (the economy) it is just as high as the previous two market peaks in 2000 and 2007.

U.S. Margin Debt



Projected forward earnings for 2016 are falling sharply as U.S. corporations expect headwind next year, not the least being a rising dollar which is crimping their foreign earnings and hurting overseas sales. In addition, the rising dollar hurts U.S. companies **domestic** sales as consumers change their preference to cheaper imported products.

As you can see below, historically once earnings peak and begin falling, this is typically a ***precursor*** for a soon to be followed recession, as stocks typically pick up the economic slowdown ahead of time.

Earnings Expectations Will Deteriorate Fur-

* SOURCE: IBES.
NOTE: SHADED REGIONS DENOTE NBER DESIGNATED RECESSIONS.

"The market is sending a number of warning signals. Leadership is narrowing, **with just 5 stocks accounting for most of the rise in the NASDAQ so far this year**. Margin debt remains elevated and merger and acquisition activity is picking up." (Source: Bank Credit Analyst, March 2015)

Why U.S. Multi-Nationals Face Stiff Headwinds from Dollar

"Just five months ago a product selling for a $1000 U.S. dollars would have cost a European 745 euros. Today that same item would cost them 900 euros. **That is a 21% price hike in just 5 months!"** (Source: *Why U.S. Multi-Nationals Face Stiff Headwinds from Dollar,* Business Insider, Myles Udland, 1/28/15)

Energy Woes

"Earnings in the S&P 500 may be as much as $6 a share lower than analysts forecast, due to oil prices, according to Savita Subramanian at Bank of America. "***The direct impact to profits in the energy sector and energy-related companies in the industrials sector far outweighs the positive impact on the consumer sectors,***" Suzuki said. "The positive impact for other sectors is actually pretty muted." (Source: *Market Calls*, Bloomberg Brief Economics, 1/8/15)

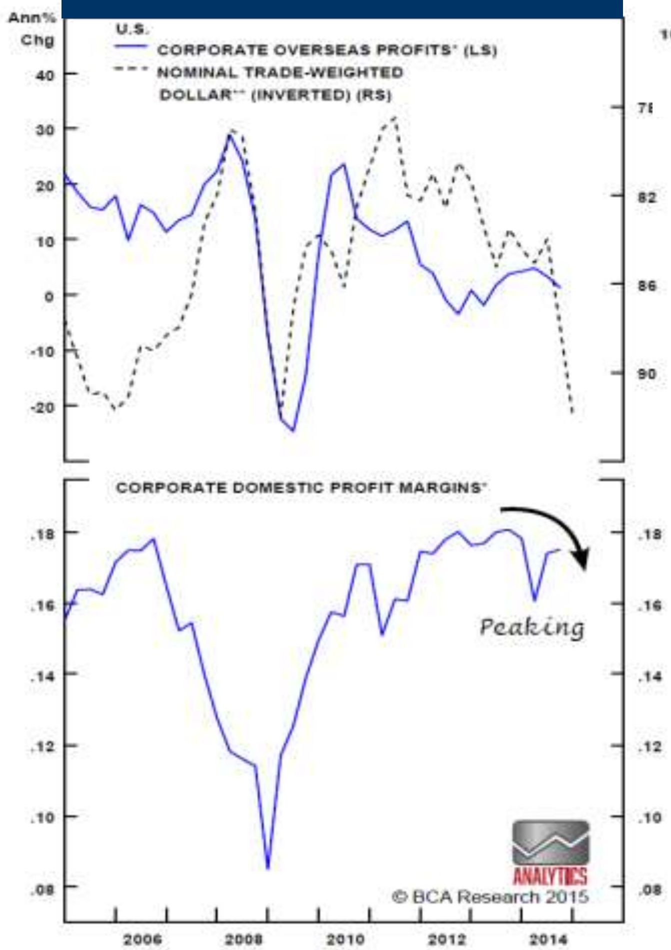
Why It's Late in the Bull Market

"Excesses always develop in an aging bull market, especially with market traders and speculators. Margin debt, or the amount of money borrowed to buy stocks on margin, is one important gauge of excess – both psychological and monetary. As pointed out in the past, it represents "hot money" that must be quickly unwound (i.e., positions sold) when bear market losses start to mount.

After rising rapidly between 2012-14, margin debt peaked in February last year and just fell again in January (*see page 27 in this special report*). It indicates that speculators and traders are starting to unwind their leveraged positions. ***The problem is that past peaks in margin debt have led or coincided with the start of past bear markets.*** (Source: *6 Compelling Reasons Why It's Late in the Bull-game...and why "Risk Management" is so important right now*, Investech Research, 3/6/15)

Since the crisis in 2008, foreigners have been piling into U.S. stocks, as earnings have been rising rapidly, and the U.S. economy has recovered faster than most others. However, earnings appear to now be topping, and could soon decline in earnest as shown below. Historically, when the U.S. dollar strengthens U.S. multinational corporations earn less profits.

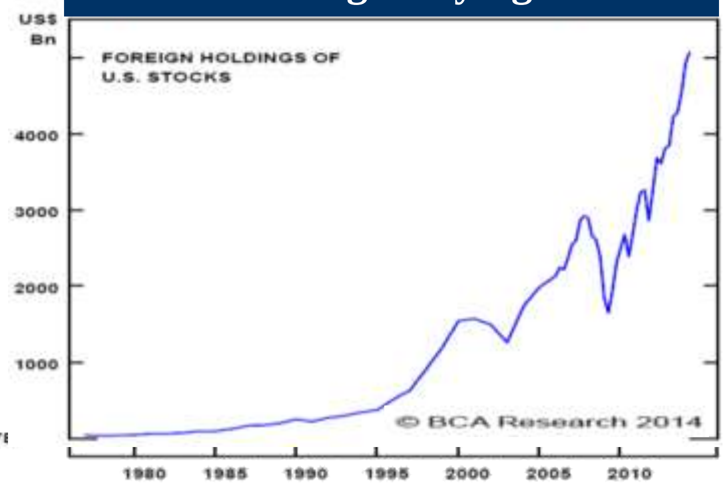
A Less Favorable Picture for U.S. Profits



* BASED ON CORPORATE PROFITS WITH INVENTORY VALUATION AND CAPITAL CONSUMPTION ADJUSTMENT.
** SOURCE: J.P. MORGAN CHASE & CO.

"***The S&P 500 has traded inversely to the dollar over recent years, and has become increasingly negatively correlated***. As a growing share of revenue and profits for U.S. companies comes from overseas."
(Source: *U.S. dollar strength continues to impact U.S. multinationals*, Jeremy Schwartz, Wisdom Tree, 2/17/15)

Foreign Buying



* BASED ON THE WILSHIRE 5000.

S&P 499?

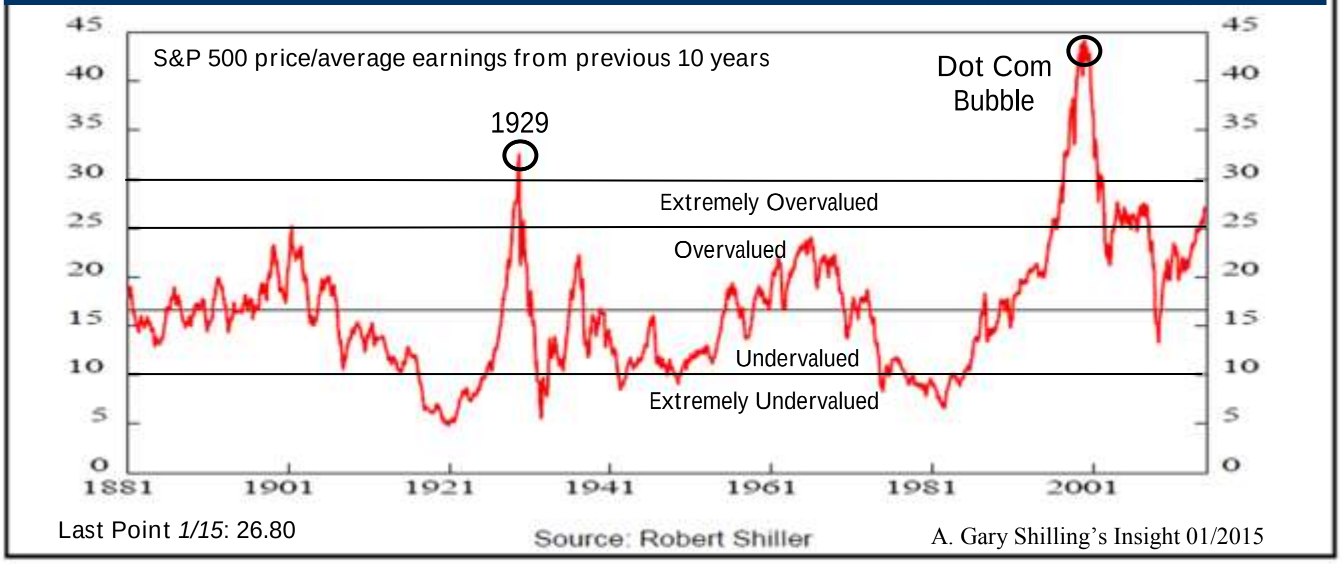
"Earnings haven't been giving stocks much lift of late. Jim Bianco writes, the tepid 4.1% year-over-year earnings growth for the S&P 500 in the fourth quarter projected by Bloomberg is overblown. **According to FactSet data, half that gain came just from Apple (APPL) "The S&P 499" (S&P 500 less Apple) has a growth rate of less than 2%.**"(Source: *Up & Down Wall Street*, Barrons, 2/16/15)

"Valuations in the U.S. are clearly no longer favorable, ***the strong dollar will erode foreign earnings, and domestic margins are already as high as they can get."***
(Source: *2015 Themes: Fortresses, Kingdoms, Bloodbaths…*,BCA Research, January 2015)

"American corporations, as represented by the S&P 500, aren't that American. ***Over 40% of sales come from outside the country*.**"
(Source: *Economic Upturn Has Downside*, Wall Street Journal, 10/6/14)

"**Indiscriminate buying** is occurring even as dedicated equity investors fret about the sustainability of earnings momentum."
(Source: *Bank Credit Analyst*, March 2015)

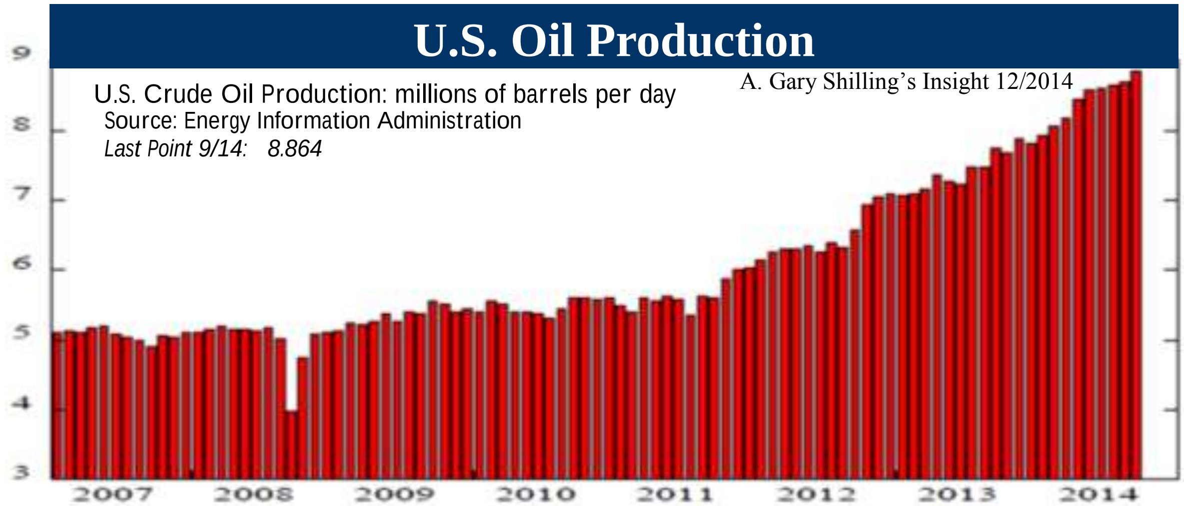
Cyclically-Adjusted Stock Price-to-Earnings Ratio



Robert Shiller, PhD and Nobel prize winner from Yale (mentioned previously) created his own price to earnings ratio (P/E) in an attempt to separate out some of the market "noise." In doing so he calculates the P/E ratio using the previous ten years' earnings. As you can see from his indicator the U.S. market has now moved into extremely overvalued territory as it has rarely done in the past. The P/E ratio is an excellent measure of risk, but not a good tool for timing as risk can stay elevated for some time.

One of our favorite charts in terms of timing is the monthly MACD, as it has historically done an excellent job of identifying the major tops prior to bear markets. As you can see from the indicator, the monthly MACD tends to peak early, telling us when the market begins to lose momentum. Typically, ***once it has started to fall decisively***, it marks the end of the bull market. As you can see, the monthly MACD at present looks as if it is in the process of topping out, but as yet has not turned down. This would likely indicate that the bull market for stocks is living on borrowed time, yet may still have further to run. No indicator is perfect, and it's obvious from the chart that there are occasional fake-outs, yet a decisive cross-over and decline by the MACD and its moving average has historically done an excellent job of identifying the bulk of the move for both bull and bear markets.

Oil

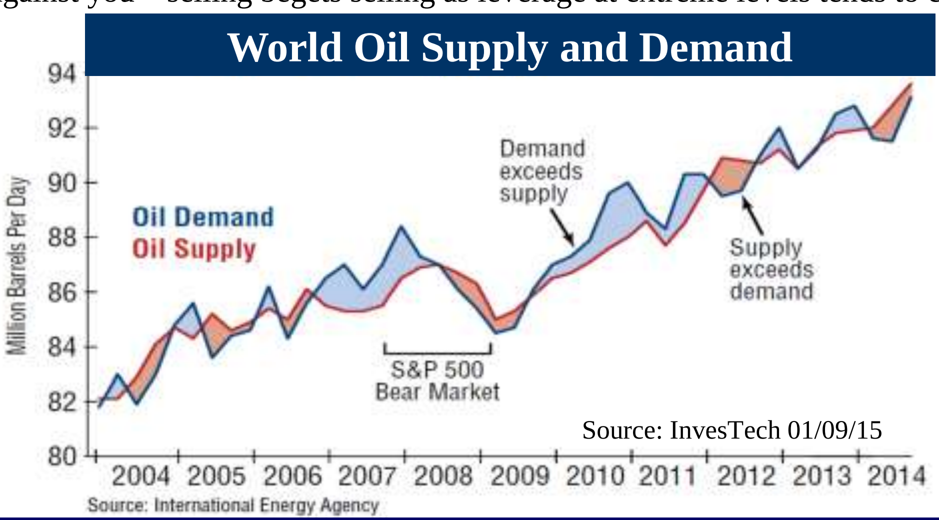


Despite oil production surging from 6 million barrels per day (BOD) in 2012 to almost 9 million today in the U.S., ***the world's supply/demand equation is not far out of balance,*** and the U.S. is still importing over 25% of its daily energy needs.[1] (Source: 1. Energy Information Administration, Nov. 2014)

Media bombardment to the contrary, the world's oversupply is rather small. This is nothing like the oil bust of the 1980's, when supply exceeded demand by approximately 22% (60 million BOD demand vs. 73 BOD supply),[1] a 13 million BOD surplus. Current world oversupply is estimated at somewhere around 1 1/2-2 million BOD, hence somewhere around 2% oversupply.[2] (Source: 1. BCA, July 2013, 2. *Oil Prices: Four Experts Size Up the Energy Market*, Barrons, 2/14/15)

If the world's energy consumption continues to rise (oil demand is <u>still rising</u>, as more people are driving cars in emerging markets)— they would likely soak up the surplus within, at most, 2-3 years at the current rate. With this being the case, then why have oil prices fallen so far, so fast? Two reasons come to mind.

1.) Leverage. While stats are not readily available on this—the likelihood is high that hedge funds, oil producers, big banks, or all of the above were way too highly leveraged in oil last year. Leverage (borrowed money) in oil markets has a history of becoming extreme, and once the market starts falling against you—selling begets selling as leverage at extreme levels tends to come unwound very quickly.



How Much Excess Oil?

"Jerry Swank: We are not talking about massive oversupply. The world consumes 92 million barrels a day, and there's an oversupply of 1.5 million to two million barrels a day."

(Source: *Oil Prices: Four Experts Size Up the Energy Market*, Barrons, 2/14/15)

Rumor has it that some extremely big banks were way overleveraged in commodities, especially oil. Thus once prices started falling—forced selling of oil positions kept hitting the market over and over again, as each new level of decline produced increasingly larger losses and more pain until excess leverage levels were finally washed out. It looks to me like oil market equilibrium will find itself soon.

2.) Saudi Arabia. Borrowing from the 1980's playbook, Saudi Arabia decided to pull the rug out from under highly leveraged marginal producers in the U.S., to reduce competition for market share.

They've certainly accomplished their first objective, falling oil prices, but they may have overplayed their hand. ***Right now, production from U.S. shale producers continues rising***—a trend likely to continue until at least this fall, due to projects already in the pipeline. So, in the short run oil prices will remain under pressure. No meaningful reduction in U.S. production is forthcoming, at least not for awhile.

But Saudi Arabia also had geopolitical cards to play, and as a matter of fact this may have been their primary motivation (see Oil Geopolitical Risks pg. 33). Thus the world finds itself with much cheaper energy (for a time) yet the very act of disrupting the supply/demand imbalance may indeed be what creates major supply risks (terrorism, war) as Middle East participants become increasingly desperate.

ISIS hates the Saudis (despite also being Sunni) because they view the Saudis as apostate. The Saudis fear Iran's increasing influence and power within the region and may actually be more interested in hurting Iran than U.S. shale producers. Thus increasing instability in the Middle East as long as oil stays low, creates an environment ripe for supply disruptions, which would then cause oil prices to spike.

Thus this short-term crash in oil prices, which could last 12-18 months, possibly longer, creates even more potential for geopolitical problems in the region, which could actually undermine the current supply/demand structure and bring great pressure back to the supply side of the equation, ultimately forcing prices much higher.

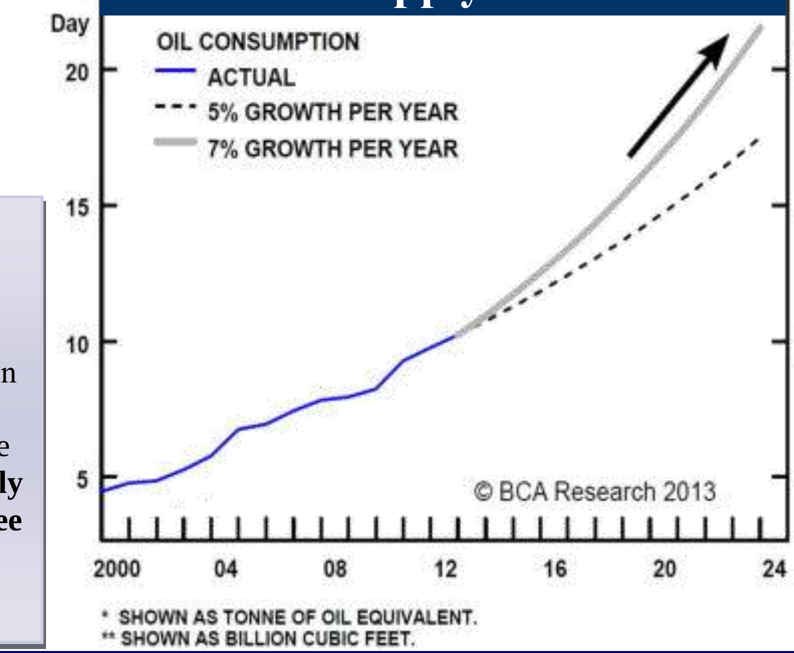
In all, despite increasing U.S. supply, over the long run, oil prices are likely headed much higher, as longer-term growth of oil demand greatly exceeds increasing supply. Despite debt related problems in the short run, emerging markets are still emerging and they all want to drive cars.

Over and Under

"Oil companies are struggling, they just don't have the cash flows to invest at $50 and therefore, you're going to see a correction on the supply side. It's a question of how long it takes for that to happen. Everyone is talking about a U-shaped curve now, **so a longish bottom and then a really bad under-supply problem in two to three years.**"

(Source: Keene's Corner, Bloomberg Brief Economics, 2/10/15)

World's Supply & Demand



Oil Geopolitical Risks

ISIS

"ISIS emerged from the ideology of the Muslim Brotherhood, the first post Ottoman (1300-1900 AD) Islamist group dating back to the late 1920's in Egypt. It adheres to global jihadist principles and follows the hard-line ideology of al-Qaeda and many other modern-day jihadist groups."

ISIS aims to return to the early days of Islam, rejecting all innovations in the religion, which it believes corrupts its original spirit. It condemns later caliphates and the Ottoman Empire for deviating from what it calls pure Islam, and seeks to revive the original Wahhabi project of the restoration of the caliphate governed by strict Salafist doctrine. Following Salafi-Wahhabi tradition, **ISIS condemns the followers of secular law as disbelievers, putting the current Saudi government in that category.**"

(Source: *Islamic State of Iraq and the Levant*, Wikipedia, 2015)

	Sect
ISIS	Sunni (Wahhabi)
Saudi Arabia	Sunni (Secular)
Iraq	Mostly Shia
Iran	Shia

Webster's defines a caliph as "a successor of Muhammad as temporal and spiritual head of Islam." Thus caliphate would be the caliph's empire, and ISIS desires their caliph to rule over all the Middle East.

In other words the goal is to create a religious empire governing the entire Middle East with the strictest adherence to the most radical views of Islam.

ISIS vs. Saudi Arabia vs. Iran

"***Saudi Arabia and Iran are engaged in a regional proxy war across the region***. In Syria and Iraq this war has evolved into two major civil wars, but there are battles of various intensity raging in Yemen, Lebanon, and Bahrain. Since 2011, Saudi's strategy has been to support Sunni freedom-fighters, insurgents, and militants against any Iranian Shia allies. This strategy has failed and backfired spectacularly. In Syria, President Bashar al-Assad remains in power. In Iraq and Syria, the ***fundamentalist Islamic State (ISIS) militants now threaten not just Sunni civilians, but Saudi Arabia itself.***

In late 2014, Saudi Arabia decided to shift its tactics and use the price of oil as a weapon. **Our view has always been that oil prices were Saudi Arabia's 'nuclear option', to be used in extreme circumstances**. It would appear that those circumstances are in place. Saudi Arabia cannot allow Iran to dominate a stable, Shia-controlled Iraq.

The only weapon that Saudi Arabia has available in its arsenal to prevent the emergence of an Iranian-dominated Iraq is oil prices. If we compare Saudi Arabia and Iran on all the usual measures of geopolitical power, Iran wins in every category but one. It has a favorable geography (it is an impregnable mountainous fortress and it controls the Straits of Hormuz), healthy demographics, an educated population, a strong conventional military, and an indigenous technological know-how. Saudi Arabia's only advantage is its ability to withstand economic pain.

Low oil prices make life difficult for Iran and increase instability in neighboring Iraq. While the Islamic State insurgency may very well fizzle out in 2015, there is no evidence that the broader Sunni insurgency will abate. And as oil revenue decreases, various sectarian factions in Iraq have all the more reason to battle for control over vital oil transportation and production facilities. Iraqi oil production will struggle to break through the 4 million barrels per day ceiling without foreign investment, which is difficult to attract amid a Sunni insurgency." (Source: *Middle East: Multipolarity and Oil Prices*, BCA Research, January 2015)

Oil Price Needed to	
Iran	$140
Venezuela	$121
Russia	$115
Iraq	$106
Saudi Arabia	$93
Libya	$90
Source: *OPEC's Price Crunch*, Wall Street Journal, 10/10/14	

To the left you see expert estimates as to what each country needs in order to break even for their respective government's budgets. Some say Iran needs $140 a barrel, some $120 a barrel (see below) but the bottom line is that each of these countries needs much higher oil prices than we see at present.

My concern is, given that the supply and demand levels are so close together at present, and that dangerous radical regimes could get desperate, that geopolitical supply risk, especially in the Middle East (not discounting Russia), ***could be about to become extreme***. At no time since the invasion of the Persian Gulf in 1990 have I felt concern over geopolitics. Today, I believe risks of this type may be the highest we have seen in our lifetimes.

"The real **straw that broke the camel's back** was when Saudi Arabia discounted the price of its own crude in October; then other OPEC members also discounted. Around Thanksgiving, the market thought OPEC would cut production by 500,000 barrels to support the price of oil. But it didn't, and oil prices fell further." (Source: *Oil Prices: Four Experts Size Up the Energy Market*, Gibson Cooper, Barrons, 2/14/15)

"The current rout is distinguished from the crash in 1986—which left crude trading below $25 a barrel for four years—**because OPEC countries today have almost no spare capacity**."
(Source: Market Calls, Bloomberg Brief Economics, 2/6/15)

Terror Attacks—Supply Risks

"Oil production in Iraq has reached a decade high of 3.9 million bbl/day in January, but we expect supply risks to emerge there as well. Recent setbacks for the Islamic State (ISIS) militants will motivate the group to diversify away from conventional warfare – at which they are actually horrible – and into terrorism, which is their forte. ***The switch to attacking oil production and transportation facilities in Iraq therefore makes sense.***

Saudi Arabia is not just trying to stall the growth of new oil production in the U.S., it is also looking to weaken its primary rival in the Middle East – Iran. From the Saudi perspective, the growing Iranian influence in Iraq, Syria, Lebanon, Bahrain, and now Yemen with the success of the Shia al-Houthi rebellion, is a concern. But their main concern is Iranian influence in Shia-dominated Iraq and the possibility that the latter's oil production could take off, creating a powerful Shia bloc within OPEC.

Degrading Iran's influence is a long-game and one that can be accomplished with $70/bbl oil as much as with $40/bbl. True, the latter is more painful for Iran, but it is also painful for Saudi Arabia and its allies. Iran's budget break-even is around $120/bbl, which means that even if oil rallied by another 30% from today's level, to say $75/bbl, Iran would still be under serious fiscal pressure.

We therefore do not want to be myopic. Yes, geopolitics matters. But Saudi Arabia can accomplish its long-term geopolitical goals even if it were to undergo a serious rally. ***We therefore continue to observe supply risks in countries like Libya, potentially Algeria, Iraq, Nigeria, and Venezuela."***
(Source: *Energy: Are Oil Prices Bottoming?*, BCA Research Geopolitical Strategy, February 2015)

Gold—Bottoming Soon?

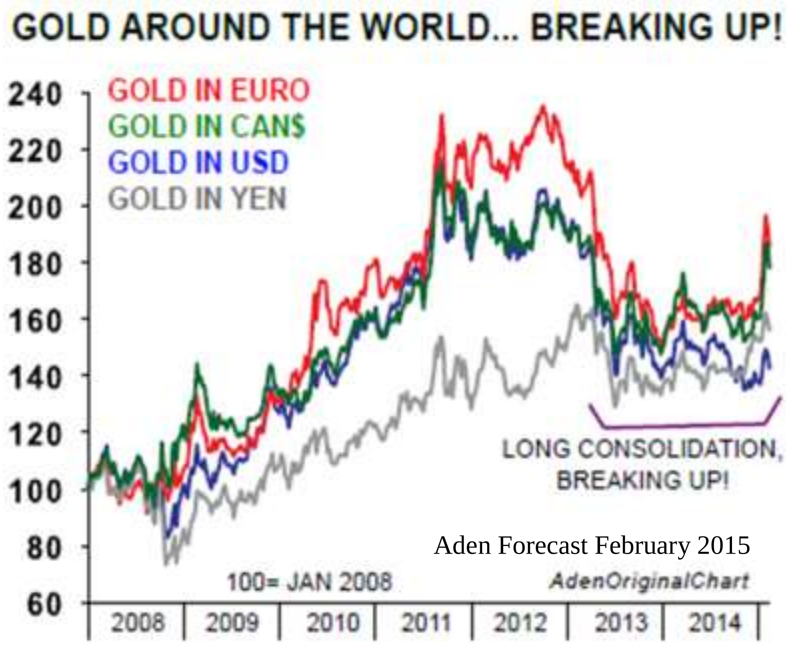
Gold Demand Growing

"Gold demand continues to grow with the central banks. China being one key buyer, as they quietly accumulate massive amounts of gold. Plus Germany continues to repatriate more of its gold. **And more countries continue to call in their gold**. They want it in their own country.

Greek and Russian investors have also turned to gold as a safe haven. Financial uncertainty has attracted many gold buyers over the years.

Plus, when gold is manipulated, it's indirectly saying there's plenty of demand to keep it up. Rigging the gold price and precious metals is now coming into the spotlight. The Wall Street Journal reported that U.S. officials are investigating over 10 major banks for possibly rigging this market."

(Source: Aden Forecast, March 2015)



Gold priced in other currencies besides U.S. dollar have bounced sharply, signaling a possible reversal overseas. Gold prices in the U.S. will remain under pressure as long as the dollar is strong, but could benefit from geopolitical and currency issues discussed below.

Gold is the only item that can be characterized as an investment, an "alternative" currency and a precious metal. Longer term, I believe gold prices will likely go much higher as potential concerns about Baby Boomer retirement funding in the U.S. as well as other industrialized nations, are increasingly likely to "print money" to pay for government sponsored retirement plans. In addition geopolitical issues combined with strong demand from Asia will likely put gold back in favor.

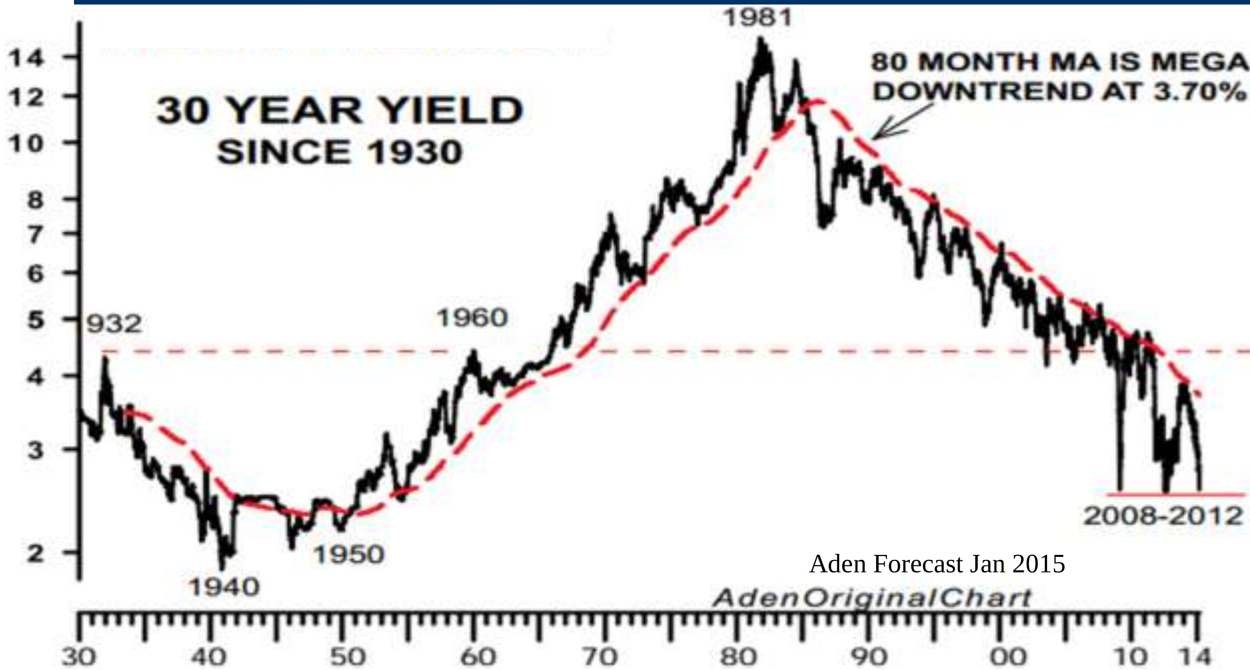
In the short run, gold prices remain under pressure as the dollar's present strength has pushed the price of gold lower for U.S. based investors. 2015 could see a bottom as gold prices (in dollars) have held up well considering just how strong the dollar has been. Both geopolitical issues (Russia, Oil) and potential currency crises overseas (EU breakup?, Yen crash?) ***could cause gold to strengthen in spite of the dollar's rise***, as it is still viewed as "real money" in many circles, especially Asia.

We prefer to maintain a small insurance position as a hedge against inflation likely down the road, but also potential geopolitical disruptions and/or currency issues, regardless of short term price fluctuations. I think eventually gold prices will go to several thousand dollars per ounce, probably late this decade or in the 2020's. The available stock of gold supplies above ground pales in comparison to the trillions of dollars of "paper" fiat currencies sloshing around in the world. Over time, we think the negative perceptions of gold will change radically and push gold prices much higher.

Sometime over the next several years we expect gold prices to move back to new all time highs, yet in the short run the price remains under pressure. But remember gold tends to be very volatile and can move a lot in a hurry.

Bonds

Bond Mega Trends



Above you see the mega trend for interest rates on the 30-year bond. As you can see, interest rates have been falling since 1981 and appear to be bottoming out, as shown in the 2008-2012 time frame. Thus, rates could now be hitting all time lows for several decades.

On the other hand, you can see that in the 1930's and up until the beginning of WWII, 30 year yields actually fell even further. And though we are not forecasting a return to the 1930's runaway deflationary scenario as central banks the world over will likely "print, print, print" whenever necessary, a glut of savings globally combined with a scary world situation could result in another flight-to-quality scenario as investors globally flee into the dollar. **If this occurs, believe it or not, interest rates could actually fall even lower than the 2008-2012 bottom!** This remains to be seen.

Much of what happens from here (EU-Greece, Spain, Italy, Portugal, Russia, Middle East, Oil, etc.) will be based upon political, geopolitical or military decisions, which by definition cannot be predicted ahead of time. They can and should be evaluated as potential risks, yet cannot be predicted as they are based upon as yet to be made human decisions.

So on the one hand, interest rates could be bottoming out seemingly "forever". If so, rising interest rates longer term would be pure poison for bond investors. On the other hand, deflationary and geopolitical risks could force another flight-to-quality surge, with foreigners fleeing to United States investment assets, some of which will inevitably flow into U.S. bonds, thus pushing rates even lower– (unbelievably) to truly once in our lifetime levels. We are certainly facing unprecedented times.

Conclusion—Point of Maximum Optimism?

Stocks appear to be nearing the point of "maximum optimism", a phrase coined by the late investing legend Sir John Templeton. Bear markets have not been outlawed, they follow bull markets as surely as winter follows fall (**Note: We are <u>not</u> bearish on the market at this moment, but believe the moment of truth is fast approaching!**).

By May we will be sitting on the 3rd longest running bull market since 1932.[1] In all but one case, in the bear markets that followed, stocks lost at least half their gains. ***It would not surprise me if this bear market loses more than half*** (similar to 2000 and 2007), due to extreme levels of overvaluation and leverage.

Stock Market Risk Levels are Very High.

- **Margin debt** has again reached extremes. This means built-in selling pressure once the market reverses. Margin compared to GDP has only been this high in two prior instances, just before the 2000 and 2007 bear markets, and in ***each of those cases the market lost virtually all of its prior gains.***[1]
- **The market is very overvalued**. The more overvalued the market becomes, the more susceptible it is to another mega bear. Extreme overvaluation levels lead to much more radical corrections on the downside. At present the price to sales ratio is 73% above the median for the last century, the price to book value ratio is very high, and we've only seen Shiller's P/E ratio (pg. 30) at these levels three previous times in the last century.[2] Other valuation measures such as Tobin's Q indicate that stocks are extremely expensive.[3]

In terms of **market sentiment** (emotion) we have also reached extremes. ***Remember that historically things tend to look best just before a bear market***!

- The market has not experienced a 10% correction for three consecutive years (2012, 2013, 2014). Volatility this low has not occurred within the last 130 years![4]
- The number of bearish investment advisors has reached the lowest level since 1987, just before the Crash indicating that complacency (which always occurs at the top) has set in (see inset).

Advisors Too Optimistic

"Sentiment among investment professionals has seldom been more optimistic and less bearish. Investors Intelligence's Survey reveals only 14.1% bears for three consecutive weeks. These ultra-low readings, along with one week of 13.3% bears last September, represent the fewest "bears" since 1987, shortly before the Crash." (Source: *6 Compelling Reasons Why It's Late in the Bull-game...and why "Risk Management" is so important right now*, Investech Research, 3/6/15)

Earnings appear to have peaked for this cycle, leaving stocks very vulnerable.

Globally, **liquidity** is still driving the market higher. We also know that historically, bear markets tend to occur when people ***least expect it***. "Maximum optimism" is built upon years of rising markets and tends to emotionally suck investors into complacency, extreme risk taking and leverage. All signs in today's market point to the symptoms that are generally associated with major market tops.

With **the Fed having discontinued QE** (for now) and the dollar rising, this will put increasing stress on emerging market's debt levels, which will likely come back to our shores to haunt us. It is highly doubtful that the U.S. economy can remain an island of prosperity by itself when virtually every other major economic region is experiencing hard times or stress.

(Source: 1. Investech, March 2015, 2. BCA, Aug 2014, 3. BCA, July 2014, 4. Aden Forecast, January 2015)

Economically, recession is not yet in the cards and may not be. If I were just looking at the United States in isolation, I would make the case for continued recovery, picking up momentum over the next two years. However, globalization has increasingly caused our country to be interwoven into the fabric of the rest of the world. ***With 14 of the 23 advanced OECD countries experiencing falling consumer prices (deflation) you must conclude that times are far from normal***.[1]

U.S. recessions are typically caused by the Federal Reserve hitting the monetary brake too hard, forcing interest rates too high (pushing short-term rates above long term rates), thus creating a recession. This will almost certainly not happen this time, **as the Fed has yet to raise interest rates at all in this cycle, and are only discussing raising rates by a mere 1/4 of 1% (25bps).** In other words, unlike 2008 where U.S. problems (sub-prime loans and banking) sank the rest of the world, the next crisis seems likely to originate overseas.

It is possible that the U.S. avoids recession altogether, or experiences a mild recession due to overseas shocks, but if enough shocks strike sequentially (like dominoes falling) the U.S. will get hit as well. The U.S. economy may be insulated from overseas problems, (which appear to be approaching from a multitude of sources—perfect storm?) but the U.S. will be affected if the storm is severe enough. ***Stocks are especially vulnerable due to over-valuation and leverage***.

China, is the second largest economy in the world with $9.3 trillion GDP vs $16.7 trillion GDP for the U.S.[2] and is rapidly liberalizing their system. Reforms include combining the Shanghai and Hong Kong stock markets, making up one of the largest stock markets in the world. But short-term, problems in banking, finance, real estate and land are likely to create big issues.

Long-term structural reforms in China will extend the Chinese "miracle", as their growth will still likely be amongst the world's strongest until the mid-2020's. However, short-term fallout from banking and real estate woes will cleanse their system, yet will also reduce their growth (possibly significantly) and could send tsunami like negative economic waves toward other Asian countries and other emerging markets that produce commodities in support of China's growth.

China remains a major player and will rival the U.S. for world dominance economically within a decade or so, but short-term their problems could create havoc in many parts of the world.

Why I'm Very Optimistic about the United States

Despite challenges that the U.S. will face over the coming years, possibly severe challenges— particularly the funding of the aging Baby Boomers as they hit the American retirement system (Social Security, Medicare, etc.) — I am very optimistic about the United States long-term.

The U.S. has proven to have a much more dynamic system vs. its overseas competitors, and has certainly rebounded into a much stronger position ***despite the fact that we were the primary cause of the 2008 financial crisis.*** Globally, investors are "voting with their feet", moving more and more of their assets into the United States, which should help keep U.S. interest rates low as money moves into fixed income, and will help elevate other U.S. assets (stocks and real estate). While this certainly will not rule out corrections, and bear markets, over the long-term this is an exciting trend for those of us that live in the U.S.

(Sources: 1. BCA, March 2015, 2. List of Countries by GDP, Wikipedia 3/4/15)

Looking at our closest economic competitors, we find that the U.S. has decisive advantages.

U.S. vs. Europe—Europe has a completely dysfunctional financial system, without a central governing body over bank assets (like our FDIC) or a system-wide bank insurance system. Each country has its own set of tax-and-spend fiscal policies, and while they do have a common currency, without a fully integrated financial governance system, the current system presents major challenges.

In addition, despite a number of countries having very strong economies (such as Germany and other northern EU countries), socialism is rife in Europe. ***In terms of the percentage of a country's economy made up of government spending, 16 of the top 17 in the world are located in Europe***.[1] The ideals our U.S liberals love to spout off are proving not to work so well in Europe after all. Europe's system has government too big and labor laws too stringent.

Demographically the EU is much weaker than the United States. Economic systems need ***youth*** to be healthy long-term — as the youth create innovation and provide the primary sources of growth to economies as they start families, buy houses, etc. Europe's generation of young people is much smaller than the U.S. Positive demographics are potential prosperity for the future, and Europe is getting older at a much faster rate.

Japan is a fiscal basket-case long-term, facing HUGE demographic problems as their society continues getting older and older, putting great strains on their government's finances.

The Japanese are a very hard working, extremely disciplined and efficient people. Japan still contains some of the best corporations in the world, but longer term they face the potential for continual decline as a result of their population, if a miracle does not occur. Culturally they are radically opposed to immigration, thus their aging population creates almost insoluble problems for them. For example, there are **currently more females over age 85 than under age 5,[2] as Japanese are getting married at increasingly older ages, thus having fewer and fewer children**.

China—China will likely rival the U.S. in terms of total economic size (GDP) within a decade or so at the present rate. While they remain a major source of long-term economic growth for the world, they need massive restructuring including:

- Corruption—which despite the present crackdown is still widespread.
- Financial Liberalization—which though started has a long way to go.
- Modernization—parts of the country, rural and western area, remain largely undeveloped.
- Transition—China's transition to a consumer based economy from a low wage manufacturing economy will not be easy, plus housing, real estate and banking challenges.
- China doesn't have any well developed retirement systems in place.

China has been the primary source of growth globally for the last 10 years. Yet, ***the concern is whether or not China will grow rich before it grows old.*** China's one child policy will eventually create issues (although at least a decade away) as they face a similar situation to Japan's, only to a lesser degree. China's population under age 20 has decreased significantly.[2] So in total, China may likely one day have a bigger economy but they also have four times as many people, and on a per capita or per person basis I don't see them catching up in the foreseeable future.

(Source: 1. 2013 Index of Economic Freedom, The Heritage Foundation, 2. U.S. Census Bureau, International Database)

India—India is obviously a huge country and based on pure population will likely be the most populous by 2030. Yet they are way, way, behind everyone else in terms of free market economic reforms.

India has GREAT demographics which again is potential for future prosperity, and despite very strong growth in the last several years has many systemic problems which will have to be revised for India to reach its ultimate potential.

- Systemic corruption is endemic throughout the system. Their present prime minister Modi, is a reformer and is tackling these issues, but there is a lot to be tackled.
- Massive structural changes must be made in governance to ensure the economic growth and business development as **India remains one of the world's worst places to conduct business according to various surveys, ranked 142 out of 189 for doing business in 2015**.[1]
- In addition to business barriers, their primitive caste system (which is starting to break down) creates unnecessary barriers to economic growth, prosperity and free markets. In the U.S. we are taught from birth that all men are created equal, meaning equal opportunity. In India this is not true. Social norms have created unbreakable artificial ceilings at each level of the caste system, benefiting mostly the elite. While education, international trade and the emergence of western corporations, (plus emerging Christianity) are starting to break these structures down, this is likely a multi-decade process.

So, despite the challenges America is likely to face over the next decade or two, I remain an optimist about America's future . I do not believe the pessimists, that America is doomed to go the way of the Roman Empire. As we have seen in the recovery since 2008, no other country has our unique combination of strengths. We have the most dynamic free market economic system, a strong and growing population with healthy longer term demographics, despite abortion taking a huge bite out of future prosperity (54 million aborted people = 54 million fewer jobs, homes, etc.)

Significant structural changes MUST be made within the next decade or so for America to go beyond and be prosperous through the 21st century. But remember, the challenges we face in life often are designed to show us our weaknesses, to point out what is wrong and thus needs to be fixed or reformed. Believe me there are many challenges ahead. However, as I survey the landscape of the world economy and look at America's potential challengers for economic dominance, no one else comes close.

So despite the challenges we will face, I'm a long-term optimist about America's future. We need to take on our issues head on and fix or reform them, yet I believe America's future looks bright.

To close I would like to quote author Jim Collins in his latest book ***Great by Choice***. Collins' previous books on top U.S. corporations entitled ***Built to Last*** and ***Good to Great*** were landmark best-sellers.

In Collins' new book he chose to study corporations that not only survived but thrived under very difficult circumstances. Collins decided to study performance in adverse environments because, as he stated: "**We believe the future will remain unpredictable and the world unstable for the rest of our lives and we wanted to understand the factors that distinguish great organizations, those that prevail against extreme odds, in such environments...those that don't merely survive but prevail." [2]**

The world today is unlike anything we have experienced. We would all like to go back to "normal" times but that is not in the cards. Rather, focusing on how to not only survive but hopefully to thrive in extreme circumstances is, I believe, what we must do. Always remember, challenging times create potential opportunity and the most challenging times historically have created the greatest potential for opportunity. (Sources:1. Doing Business—World Bank Group, 4/2/2015 2. *Great By Choice*, Jim Collins)

The Cornerstone Report is published by Cornerstone Financial Services, Inc., a Registered Investment Advisor.

The opinions and statements made within this newsletter should not be construed, directly or indirectly, as an offer to buy or sell any securities mentioned herein. Principals and/or agents of Cornerstone Financial Services, Inc. may or may not have positions in any securities or investments mentioned herein. Due to volatility within the markets mentioned, opinions are subject to change without notice. Statements and opinions are based upon sources of information believed to be reliable; however, accuracy and completeness cannot be guaranteed. No assurance can be made that recommendations contained herein will be profitable or will be equal to past results. Past performance is no guarantee of future results.

This newsletter is designed to provide general economic and market information and should not be construed to comprise individual or specific counsel concerning investment, tax or legal considerations. Material discussed herewith is meant for general illustration and/or informational purposes only, please note that individual situations can vary. Therefore, the information should be relied upon when coordinated with individual professional advice. Please consult your financial advisor(s) for specific advice pertaining to any and all areas of financial planning.

Please remember: Past performance may not be indicative of future results. Different types of investments involve varying degrees of risk, and there can be no assurance that the future performance of any specific investment, investment strategy, or product made reference to directly or indirectly in this newsletter (including the investments and/or investment strategies recommended or undertaken by Cornerstone Financial Services) will be profitable, equal any corresponding indicated historical performance level(s), or be suitable for your portfolio or individual situation or prove successful. Due to various factors, including changing market conditions, the content may no longer be reflective of current opinions or positions. Moreover, you should not assume that any discussion or information contained in this newsletter serves as the receipt of, or as a substitute for, personalized investment advice from Cornerstone Financial Services, Inc. To the extent that a reader has any questions regarding the applicability of any specific issue discussed above to his/her individual situation, he/she is encouraged to consult with the professional advisor of his/her choosing. A copy of Cornerstone's current written disclosure statement discussing our advisory services and fees is available for review upon request. A complete history of Cornerstone's market calls is available at the Cornerstone office upon request.

All technical analysis and resulting conclusions and observations are based upon historical chart formations and patterns. Therefore, observations are a function of each analyst's interpretation of the charts—and also a function of mathematical probabilities. In effect, technical analysis is a study in probabilities. What happened x number of times in the past per a particular chart pattern does not mean it will always recur in the future. It logically follows that historical precedent does not guarantee future results.

**Global or international investing involves special risks, such as currency fluctuation, political instability, and different methods of accounting and different reporting requirements.*
**MACD is the difference between a security's 26-day and 12-day exponential moving averages.*
** The S&P 500 is an unmanaged index comprised of 500 widely-held securities considered to be representative of the stock market in general. You cannot directly invest in the S&P 500 index.*
** The NASDAQ Composite Index is an unmanaged, market-weighted index of all over-the-counter common stocks traded on the National Association of Securities Dealers Automated Quotation System. You cannot directly invest in the NASDAQ Composite index.*

* The Russell 2000 is an unmanaged index comprised of 2000 smaller company stocks and is generally used as a measure of small cap stock performance
* The Dow Jones Equity REIT Index is a capitalization-weighted index composed of 114 US listed Equity real Estate Investment Trusts (REITs) comprising 95% of the equity REIT investable universe
* Small Cap stocks may be less liquid and subject to greater price volatility than large cap stocks.
* Sector investing may involve a greater degree of risk than investments with broader diversification.
* Investing in securities involves risk including the loss of principal invested. Past performance is no guarantee of future results.
* The price of commodities, such as gold, or oil is subject to substantial price fluctuations of short periods of time and may be affected by unpredictable international monetary and political policies. The market for commodities is widely unregulated and concentrated investing may lead to higher price volatility. In addition, investing in commodities often involve international investing in emerging markets, which involve significant risks. Please consider all of these risk factors before making a decision to invest in any product.
* Investments in real estate have various risks including the possible lack of liquidity and devaluation based on adverse economic and regulatory changes. As a result, the values of real estate may fluctuate resulting in the value at sale being more or less than the original price paid

For investment advice or portfolio review, call (800) 327-4285. There is no charge or obligation for initial consultation. Jerry Tuma, David McCord, and other representatives of Cornerstone Financial Services, Inc., (CFS), are registered representatives of and offer securities through Independent Financial Group, LLC., (IFG), a registered broker-dealer, member FINRA/SIPC. Advisory Services offered through Cornerstone Financial Services, Inc. (CFS), a Registered Investment Advisory firm. CFS and IFG are not affiliated entities.

Cornerstone Financial Services, Inc.
14901 Quorum Dr. Suite 785
Dallas, TX 75254

Jerry E. Tuma, MS, CFP®,
Senior Editor

David McCord, CMT,
Contributing Editor