Cornerstone Report

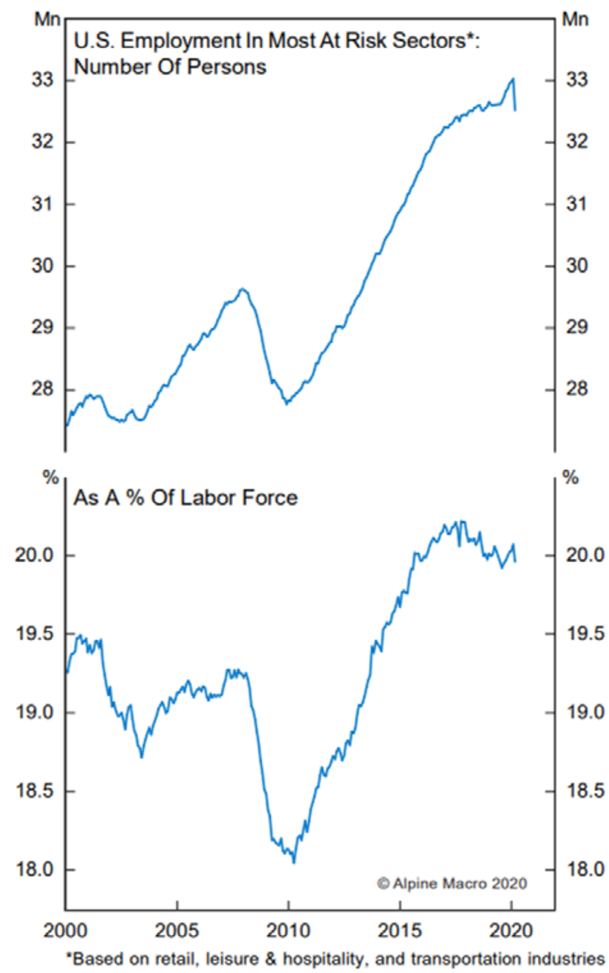
Special Report **May 19, 2020** **By: Jerry E. Tuma, MS, CFP®**

Coronavirus Recession

What a truly unprecedented season we've been through. What comes next?

First, we have the largest shutdown economically, pretty well in the history of the modern world, the fastest bear market in US history, and the largest response by the Federal Reserve and the Federal Government that we've literally ever seen. Truly unprecedented times.

The market started crashing in late February and the speed in which it crashed was truly amazing, much faster than the beginning of the 2008 crash or even 1929. But by all measures it would appear that we've started a V-shaped recovery for stocks, and likely an economic recovery starting in the 3rd quarter of 2020.



The interesting thing about this market crash is that a number of the service industries in America experienced what amounts to a laser guided missile. 7 sectors (bars, casinos, hotels, airlines, traditional retailers, coffee shops, salons) making up 20% of the workforce and some 33 million workers faced near complete shutdowns. (See chart)

Last month the unemployment rate skyrocketed to 14.7% and is still rising, with total unemployment claims at 36.5 million. If you include the broadest measure of unemployment which includes those with reduced hours who would prefer to work full time the number is now 22.8%, rivaling the Great Depression of the 1930's. (Source: Investors Business Daily 5/8/20)

Yet in spite of all this economic gloom, the stock market is on "happy pills." Which is correct, the economic gloom or the stock market? The answer in my opinion is potentially both.

The 2008 Great Financial Crisis (GFC) primarily centered around bad real estate loans including subprime mortgages, commercial mortgages and a banking system,

Topics:

- Recession
- The Federal Reserve and US Government Response
- Virus
- Potential Problem Spots
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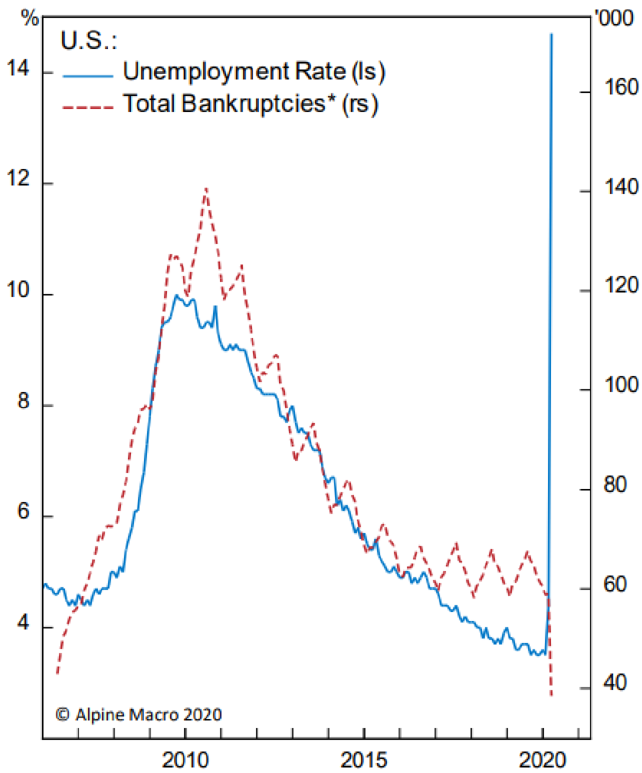
which had become over levered. Consumers had gotten deeply into debt in that cycle.

This time around consumers are in much better shape overall, having paid down their debt since 2008. In fact the US savings rate is not only much higher than it was then, but ***consumer debt service*** (interest payments) is at record lows due to extremely low interest rates. (Source: Bank Credit Analyst 4/6/20, *see below*)



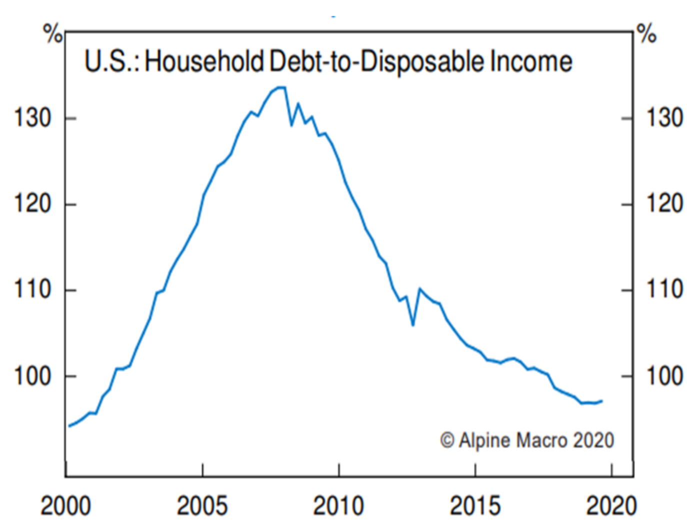
*Shown as 6-month moving average; source: The American Bankruptcy Institute

This chart shows the staggering rise of unemployment claims which has now shot up to ***36.5 million people, which is literally off the chart!!***

So consumers not involved in one of the 7 targeted areas hit most drastically by the Coronavirus shutdown are in much better shape than they were entering 2008. The banks are in much better shape overall with new lending standards and regulations instituted after the GFC, keeping banks in a more conservative position.

So if I were to use an analogy, the 2008 GFC was similar to a heart attack. The US economy at that time (and today) is the world's strongest and our stock market capitalization greatly exceeds all other countries. But in 2008 the financial system which would be like the heart and circulatory system, in essence our economic "body" had a catastrophic "heart attack".

Modern economies are fed by credit, similar to how our bodies are fed by our blood supply. If the source of our blood supply stops, our body dies. Many of our largest banks were forced into bankruptcy in 2008 and frankly I'm not sure if any of the big banks would have survived without the bailout. Therefore ***intervention*** was needed to keep the body alive.



You could be the strongest powerlifter in the world, great strength in body mass, but without blood supply you're a dead man. This is similar to our 2008 GFC financial "heart attack."

This 2020 financial attack would be more akin to a stroke. Having just walked through my wife's recent health crisis involving strokes, provides a lot of insight into this (see personal reflections). It's like the 7 economic sectors we mentioned on page one have had a stroke. While a heart attack is certainly life threatening and can be debilitating, you can also potentially fully recover and become as strong as ever.

A stroke is very different. When my wife had her stroke a blood clot lodged in the basal ganglia in her brain, stopping the nerve function to the right side of her body. Her right arm and right leg would literally no longer function. Once this occurs, you have to begin a long grueling rehab process to regain use of the body parts that no longer work. This can take months or years and in many cases stroke victims never fully recover.

This is the way I feel about the current economic environment, even if we don't have another wave of coronavirus or mutation in the next year. Much of the current economy has a potential to recover as if almost nothing happened. The remaining 20% of the economy, primarily those listed on page one, ***may have to completely reinvent themselves*** and comeback in totally different forms, possibly much smaller, for the firms to survive.

With a stroke your brain has what is known as ***neuroplasticity.*** We used to think the brain was like a computer, fixed hardwiring. We now know that this is not true. The latest studies show that the ***brain can rewire itself***. So part of the recovery process of the stroke victim is attempting to the use the body parts that no longer work properly over and over again, in an attempt to ***grow*** new neuropathways to take over for the ones that were damaged by the stroke.

For our economy, this is truly an unprecedented situation where 20% of the US workforce may have to completely reprogram their jobs, companies, or industries.

Extensive surveys have shown that it is highly unlikely that the most affected of these industries will come back quickly.

For example, Macy's recently told The Wall Street Journal that it expects1/5 of normal sales volume at first. Problems include customer reluctance to return shopping, then those who do will likely spend less and serving them with new health requirements will cost more. (Source: John Mauldin 4/20/20)

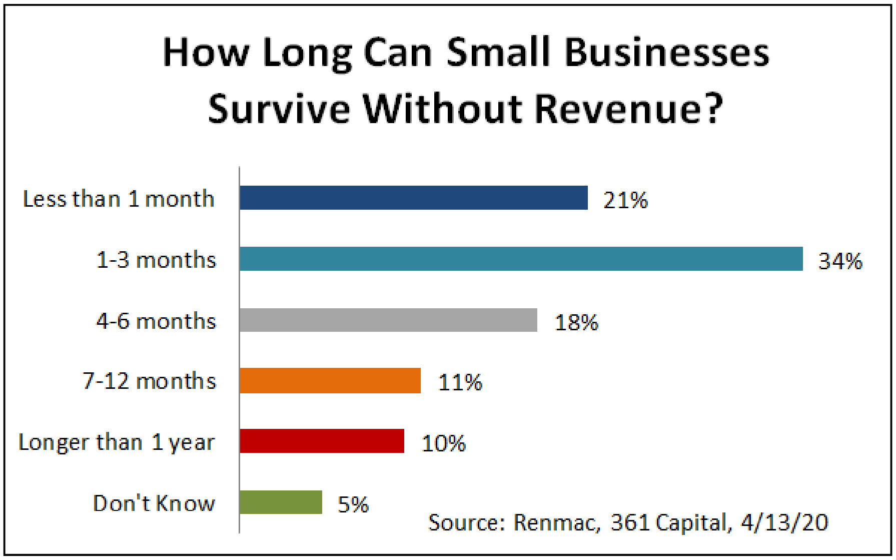
IF STAY-AT-HOME RESTRICTIONS WERE LIFTED, WOULD YOU BE COMFORTABLE GOING TO...?

	YES	NO
A BAR OR RESTAURANT	29%	71%
GET ON AN AIRPLANE	15%	85%
A LARGE EVENT	13%	87%

SOURCE: CBS NEWS, JOHN MAULDIN 4/25/20

Until there is a vaccine which can inoculate millions (which is likely some ways off) and an effective treatment program, people are not likely to return to "normal behavior" which will affect these "stroke victim" industries to the greatest degree.

So again, I ask the question, which is right, the stock market or the economic numbers and my conclusion is probably both.



There are estimated 30.2 million small businesses in the US employing 59.9 million Americans according to the SBA that means 47.3% of all employees work for a small business. This highlights the incredible dilemma authorities face. On the one hand, if they open the economy too soon, they risk reinfection. If they don't open the economy soon enough, millions of small businesses could go under. (Source: SBA & Fundera 4/18/20)

Certain parts of the economy may take years to recover just like a stroke victims painstaking years of recovery, some parts may never fully recover in their present form. Other companies, especially technology, internet, healthcare, etc. are experiencing relative boom times and will likely continue to take market share from other companies or industries.

Economist Joseph Schumpeter coined a phrase "creative destruction" which free market economic systems must go through from time to time.

When Henry Ford invented the Model T automobile and assembly line, a lot of buggy manufacturers went out of business, as the new technology replaced the old. Cars replaced horse and wagon.

Internet retail shopping was already growing at 12-14% a year compounded ***prior*** to the coronavirus recession and will likely only escalate from here. Large sports venues may not resume right away. How will this affect Major League Baseball, the NBA, the NFL, college football, especially if we get a second wave of infection, when the winter gets here (the coronavirus has a very short half-life in direct sunlight and heat but can proliferate in cold weather, *see page 6*).

So large sectors of the US economy will likely justify the V-shaped recovery for stocks while other sectors of the US economy may never recover in their present forms.

So, for this special report, what I would like to do is drill down and give you specifics on the areas that we feel have the greatest potential and areas which could face the greatest danger. Keep in mind that the US governments response both in terms of the size of the government's fiscal stimulus (PPP loans, unemployment benefits, etc.) and the Federal Reserve's "printing press" to add liquidity to the system have truly been unprecedented in both speed and size, much larger and faster than what we experienced in 2008. This gives me hope that the expected recovery could materialize soon.

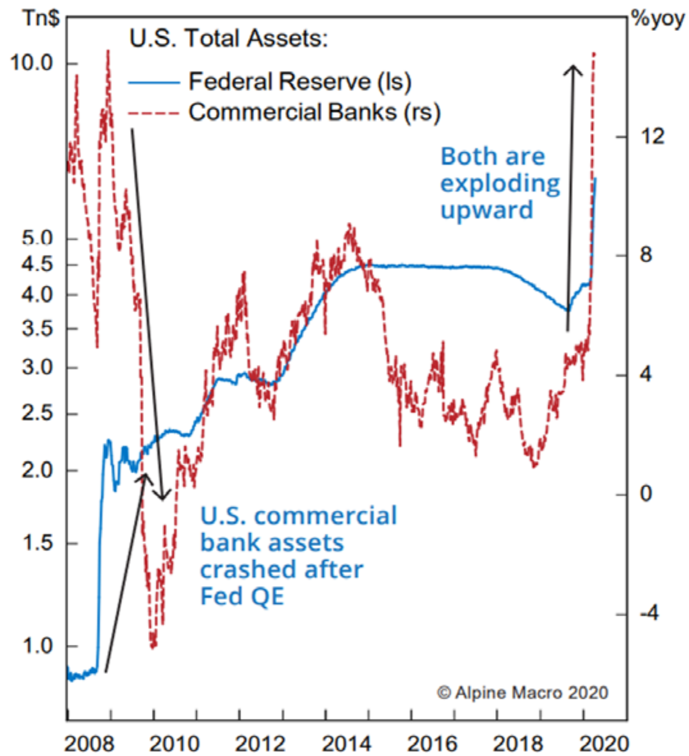
But one problem is that other parts of the world have not been as aggressive as the US and there are many potential danger spots that we will elaborate on in this report. Lets start by taking a look the size and speed of the stimulus packages in the US.

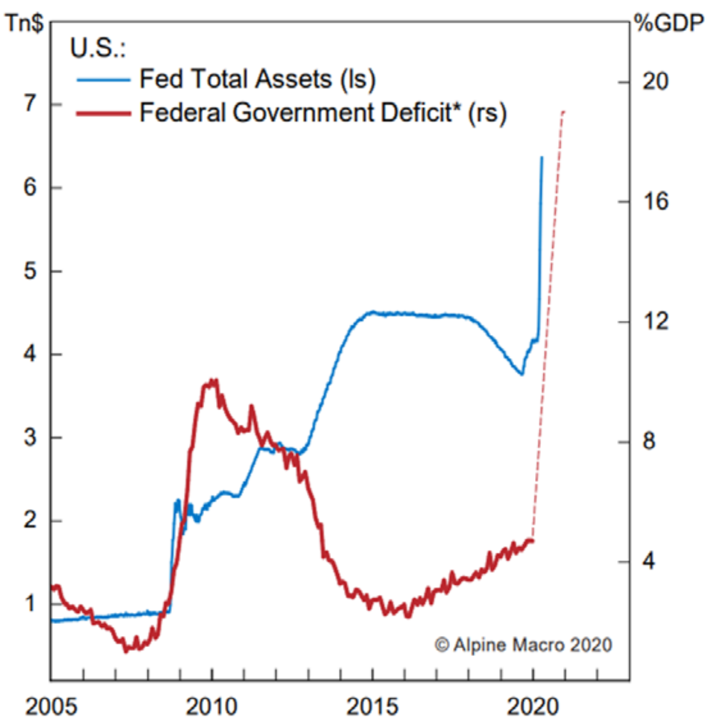
The Federal Reserve and US Government Response

To the right you see a chart showing the reserves the Federal Reserve has been "printing" as well as bank loans, both of which are exploding upward. Bank Credit Analyst projects the Fed's balance sheet will expand quickly to $11 trillion up from $3.8 trillion just a few months ago, almost tripling in size!

At the risk of sounding repetitive, this is truly an unprecedented expansion of monetary reserves, which for the time being will not likely cause inflation, but probably will down the road. You also see in the chart the explosion of commercial lending which is the exact opposite of what happened in 2008.

Remember that in 2008 bank lending and liquidity shrank rapidly, sending us into a heavy deflationary spiral. Today, corporations preemptively tapping into their credit lines (just in case we need the cash) combined with the SBA (Small Business Administration) loan program has created an enormous explosion in credit for the US economy. Much of this added liquidity is pouring into US financial assets primarily the stock market.





*2020 forecast based on Goldman Sachs report

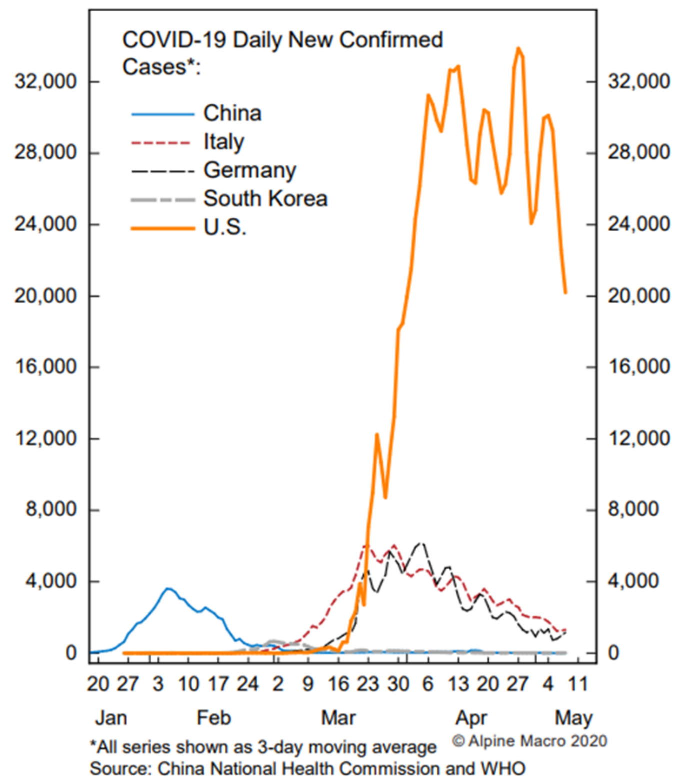
Thus for those industries not directly shutdown by the quarantines, you could make the case that this could be a solid recovery starting in the 2nd half of this year and going into 2021.

In addition, the bailouts, SBA program, etc. will cause the Federal budget deficit to balloon, possibly hitting as high as 20% of the economy (GDP) this year, far surpassing the 2008 GFC. (Source: Bank Credit Analyst 5/5/20)

As I mentioned, I do not believe that either the Fed's "printing press" or the Federal government's budget deficits will be inflationary in the short run, but I believe they will be HIGHLY inflationary later in the 2020's. More on that in future newsletters.

Virus

While it certainly appears that the coronavirus infection into has peaked in America and other countries, and I know that our pharmaceutical companies, health providers and universities are frantically working to develop a vaccine and other treatments, it may be sometime before these are commercially available in adequate quantities.



Remember, there are some 330 million people in America alone and over 7 billion in the world. While all of these will not immediately need vaccines or treatments, a significant number will, in order to stop the virus and this involves an enormous outflow of treatments and vaccines.

Therefore, part of the assessment of the Coronavirus, needs to be potential for a second wave or mutation. The Spanish Flu of 1918-1919 experienced 3 distinct and different waves as the virus mutated.

In fact, a new report from Las Alamos National Laboratory indicates that they believe that the Coronavirus has ***already*** mutated, into a new "dominate strain spreading across the US, which appears to be even more contagious." (Source: CNBC 5/5/20)

It appears that the new strain began spreading across Europe and has become the dominant strain now affecting the world, which is potentially problematic considering there are more than 100 vaccines being developed to prevent COVID-19. The new strain appears to be less deadly but more contagious.

While the stock market may be experiencing a V-shaped recovery in many sectors, I have never felt that the ***economy*** would have a V-shaped recovery but more like a checkmark. Since the coronavirus is very sensitive to heat, it makes sense that the infection rates for the northern hemisphere as we approach summer, when combined with social distancing, would greatly decline.

According to Homeland Security's website "***sunlight*** reduces infectious virus to undetectable levels after just 3 minutes to exposure to the solar equivalent of midday sun on a sunny day in the middle latitudes of the US. No light produced no decay in the viruses half-life."

As a matter of fact, one survey from health care providers showed literally zero infections that could be traced to outdoor behavior. In other words, it appears that 100% of infection occurs indoors from close quarters (source: 361 Capital 5/5/20).

Personal Reflections

By Ramona Tuma

I love my early morning time spent with God. This has happened since the day after my stroke, sometimes waking me up from a dead sleep.

The first time was the morning after the stroke. I felt like the Lord assured me that this would be really tough, but I would reach the other side. I would never be the same, I would be transformed by it, and so would my family, and not to fear the process.

I have always dealt with extreme fear, but this process took it away, all fear is gone.

This morning I had almost this exact type of time with God.

The world has had a stroke.

Each person's stroke is different. Some never wake up, others recover quickly. Some recover but are never the same.

I felt led not to fear the process. There is a way through the process, the key is obedience. Some days won't be easy, some days you will say - na uh! Not going to do it. But then you will do it because it's necessary.

None of us will be the same, but if we follow in His steps we will be better, as Melania says "we will be best."

As I write this I keep seeing the picture of me sitting at a table, two laundry baskets in front of me. One was filled with foam squares, the other empty. My task was to transfer the squares from one basket to another. My emotions were at the highest level of frustration, ever. It was an impossible task; so easy before, now a monumental test.

Everything in me wanted to scream and bash those baskets off the table, but I couldn't even do that.

It was my moment to decide to obey the process. I could rebel and go back to my bed and stay there, or I could go through the process, little knowing how much more would be required of me. I stayed.

Now I am amazed at what my precious right hand can do, it is not the same. After a long hard day of therapy I would talk to my hand, thank it, love it, tell it that it was going to make it. It did, it does. But it's not the same, life is different, but different is richer.

I still get mad, frustrated, I cannot fold anything straight, but then I remember when I couldn't pick anything up.

Why this long illustration? Again, early morning time with God.

The way out will have bumps in the road, there will be days we cry out and wonder, "What the heck!" But there will be a way out, if we do what the old song says, "trust and obey, for there's no other way, to be happy in Jesus, but to trust and obey."

The joy of the LORD is my strength!

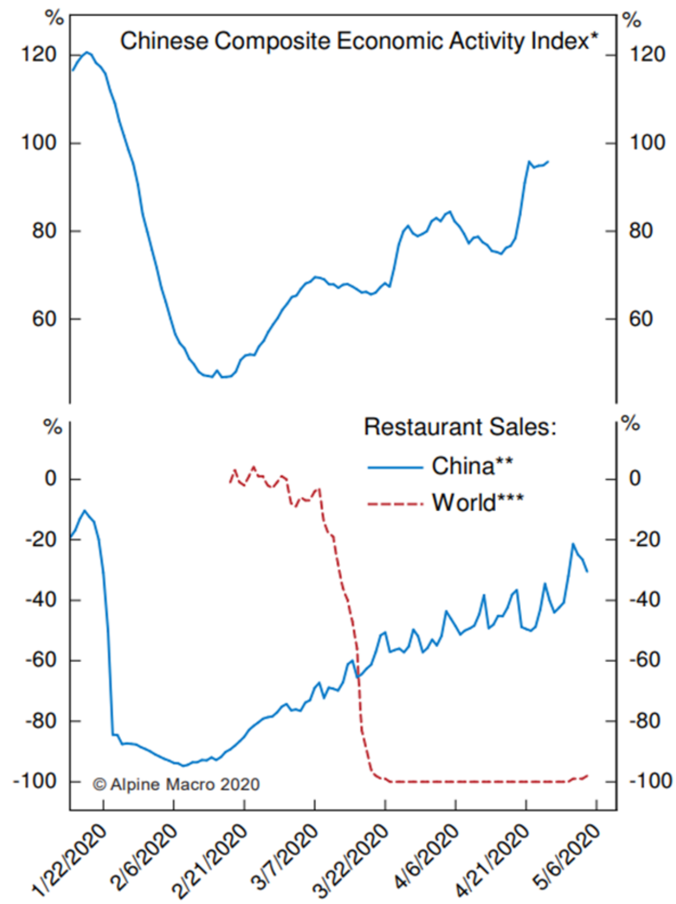
China

As the epicenter of the global outbreak, perhaps its somewhat fitting that China experienced its first outright recession in over 40 years since the death of Mao.

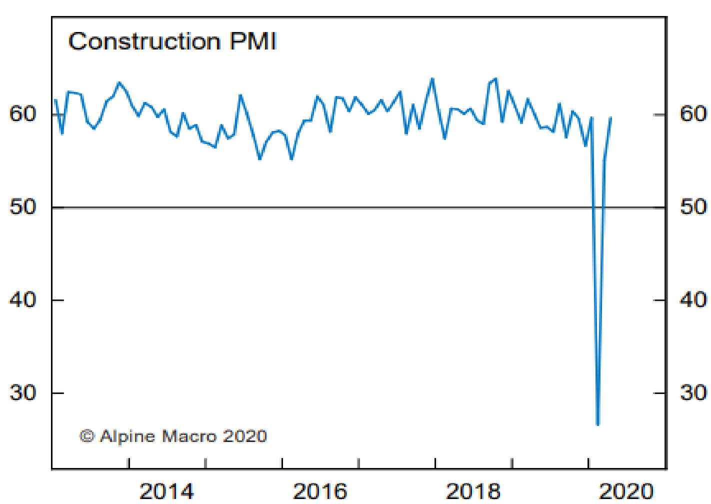
Retail sales in China plunged over 20% in the first few weeks of the pandemic, yet stimulus from the Chinese government, as well as easing of the pandemic lockdown has caused the recovery to start in China. (Source: Bank Credit Analyst 4/24/20)

Yet things have not "normalized." Reports from Alpine Macro's China analyst indicate that while most people are going back to work, they're wearing masks and typically going home for lunch, and they are not going out in the evenings. So while this is better than a complete shutdown, there's a lot more room for recovery in China. (Source: Alpine Macro 5/6/20)

Great stimulus has been fed into the system by Chinese authorities. Yet there is still room for more. In 2008 stimulus amounted to 20% of their GDP, whereas this round has only amounted to 10% of GDP, yet recovery is started to show up in property markets as well as some of their manufacturing. (Source: Bank Credit Analyst 5/1/20)



*Average of major six power plant coal consumption, property transactions, national steel inventory and labor migration; 2020 vs 2019, adjusted for Chinese lunar new year
**Restaurant orders relative to January 1, 2020; source: Hualala
***Seated dinners relative to the same day of the week in the previous year; source: OpenTable



Source: China Federation of Logistics & Purchasing

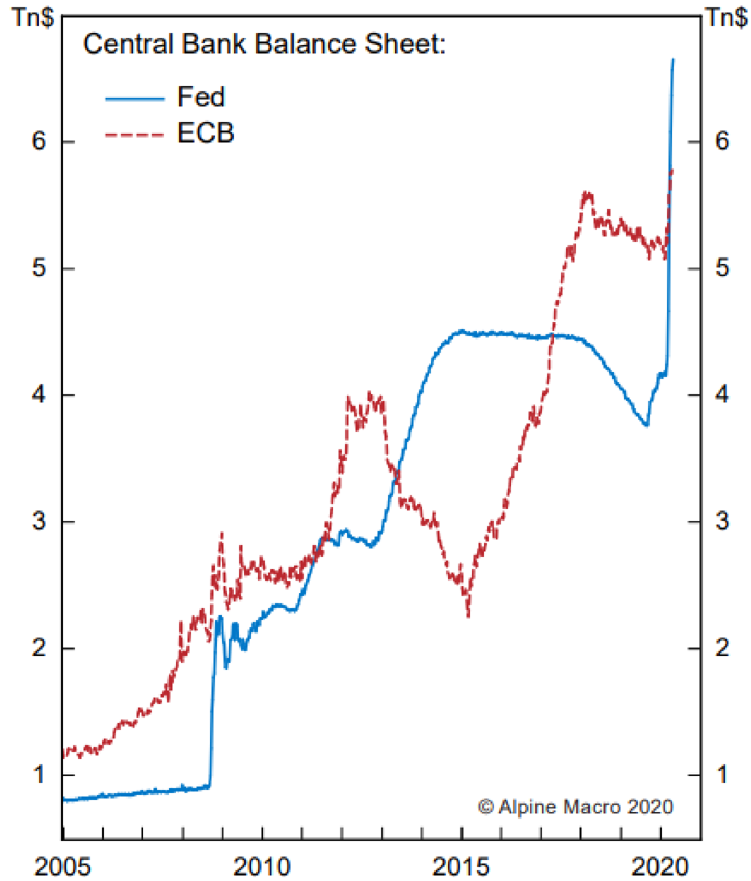
So in some ways you could say that there is the beginning of a V-shaped recovery in some areas yet it is more likely to be like a checkmark when we stand back and look at it in a couple of years.

Potential Problem Spots

Europe

Recently ECB president Christine Lagarde stated in a press conference that the magnitude of this shock demands "ambitious and coordinated fiscal response" as she implored European finance ministers to adopt a "joint approach" toward those most affected by the crisis. (Source: Bank Credit Analyst 5/1/20)

The next chart shows the response of the Federal Reserve vs the European Central Bank in terms of "money printing" and you can see the response since the beginning of this year from the US has been 4-5 times greater than the EBC, with the Fed adding much more liquidity.



The one thing that Lagarde needed to add was that the ***speed*** of the response is extremely important and the bureaucrats that run the Euro area are certainly not known for speed.

In fact, the 6 month increase in European bank flows amounts to an underwhelming $70 billion, compared to a record high $660 billion in the US and $550 billion in China. (Source: Bank Credit Analyst 5/5/20)

The problem is that not only has the Euro areas fiscal and monetary stimulus been tepid in comparison to the United States, but there are many areas of the Euro economy which never fully recovered from the previous crash in 2008, especially Spain and Italy, which have been hit very hard by the Coronavirus.

Indeed, Spanish stocks are at the lowest level in comparison to the rest of the EU since 1996 and their banks are heavily exposed to Latin American emerging economies. (Source: Bank Credit Analyst 5/5/20)

Emerging Markets

Emerging markets (excluding China) appear to have run smack dab into the "perfect storm." Not only are they experiencing ***greatly reduced demand for their exports*** from both China and the United States but their currencies have been crashing compared to the US dollar. Countries such as South Africa, Mexico, Colombia, Russia and Turkey have seen their currencies fall 15-25% compared to the US dollar in the past 2 months. (Source: Bank Credit Analyst 4/23/20)

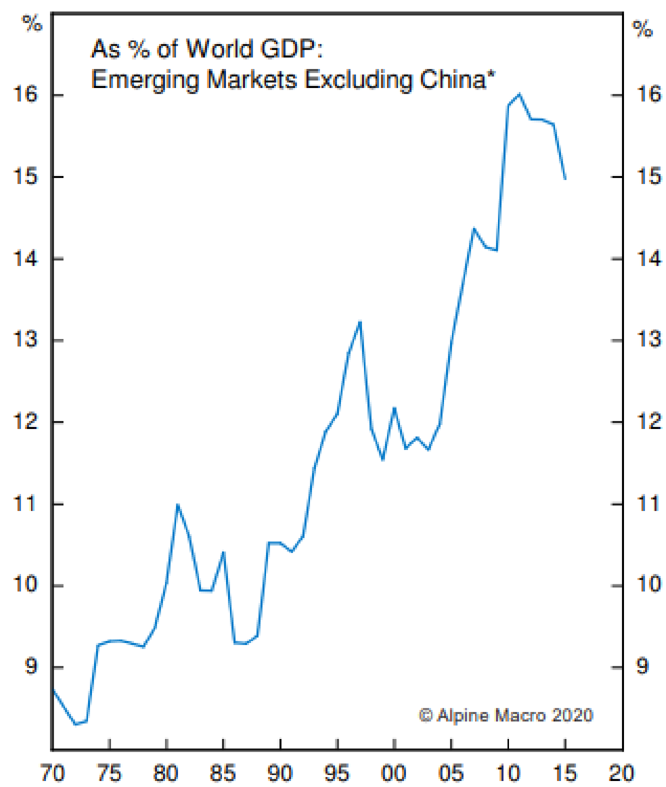
In addition, with the global panic there have been ***record financial outflows*** from these emerging markets as investors have "run for the hills" with ***significantly higher outflows from these emerging markets than what we saw in 2008.*** (Source: Bank Credit Analyst 4/23/20)

In addition, since many of these countries have weak, still developing financial systems, a high percentage of the bank debt in these countries is denominated in US dollars. This means that if their currency falls in value 20% against the US dollar due to the "flight to quality" induced by the panic, not only will their interest payments rise by 20% but their ***principal*** on the loans will rise as well. Developing countries typically have between 50-100% of their imports invoiced in US dollars. (Source: Bank Credit Analyst 4/23/20)

Lastly, much of the banking system in the emerging markets was already filled with problem loans due to the lending boom that occurred in the last decade. Due to this fact, the average bank loan rate in the emerging markets is 12%. (Source: Bank Credit Analyst 4/23/20)

Keep in mind that these emerging markets are not inconsequential in terms of the overall world economy. As you can see, excluding China, they make up about 15% of global GDP.

So in sum, previously greatly weakened banking systems, very high interest rates, plunging currencies and weak exports make emerging markets a great candidate to experience very difficult times and turmoil over the next 2+/-years.



*Includes Indonesia, India, Malaysia, Philippines, Taiwan, Thailand, South Korea, Hungary, Poland, Turkey, South Africa, Brazil, Chile, Colombia, Mexico and Peru

"Over the next two years, there may well be numerous defaults on Emerging Market (EM) private debt and perhaps even sovereign (country) debt.

The EM private debt market is limited and dominated by foreigners. These countries don't have much capacity to deal with the virus." (Source: Alpine Macro 4/22/20)

Stocks

As we go to press the stock market has seen a furious rally off the bottom.

Just like the economy, parts of the stock market have been doing great with some stocks actually hitting new highs, especially stocks revolving around the internet, internet retail, telecommunications and healthcare. NASDAQ is near an all time high.

Other parts of the market are struggling greatly. This would include transportation stocks, restaurants, etc. In other words areas that have been most affected by the quarantine.

The real question is what comes next. There are several possibilities.

1. This could be a new bull market (unlikely).
2. This could be a continuation of the previous bull market.
3. This could be a market rally prior to having another down leg.

For reference, I would recommend you go to our website and read ***Goldilocks and the Three Bears*** which deals with 3 different types of bear markets, baby bears, mama bears and daddy bears. Right now, I lean toward the 3rd scenario, a rally prior to another down leg.

While obviously none of this can be guaranteed, historically speaking when you have a new bull markets the leaders of the ***prior*** bull market are **not** leaders in the new bull market. This is presently not the case, as Facebook, Amazon, Microsoft, Apple and Google remain amongst the top performing stocks in this market, just as they have been for most of the last decade. So, in my opinion, this is clearly not a new bull market, but likely a continuation of the previous bull.

On a big picture basis, the market often tends to reflect seasons similar to what we see on the calendar. In Texas, we need a good hard freeze in the winter to kill the bugs, otherwise they overrun you in the summer time. Just as winters have a healing effect on nature, the market tends to go through spring, summer, fall and winter. Historically it takes ***time*** to cleanse the excesses from the prior bull market.

Bank of America analysts reported that never before in the US history has a bear market lasted only 2 months when accompanied by a recession. And this recession is turning out to be a doozy, approaching Great Depression unemployment rates in the near future. (Source: Dow Jones Company 4/7/20)

Excesses of speculation, margin debt, initial public offerings (IPO's) that are money losers, are all characteristics of previous market tops, and these all occurred during this cycle in 2018-2020. I personally do not think it's possible to cleanse the excess of an 11 year bull market in only 2 months.

The most likely scenario in my opinion is that this "continuation" will experience another down leg before 2022. So I believe that scenario #3 above is the most likely ultimate outcome.

There is no way to predict ahead of time what could cause the 2nd down leg but as you've read in this report so far there are plenty of candidates. Emerging markets, Europe, a virus mutation and/or another round of infection all could easily effect another down leg.

In many ways this bull market has most closely resembled the 1990's bull. That bull market started just after Saddam invaded Kuwait and set a thousand oil wells on fire, then topped out with the NASDAQ and Dotcom tech bubble. In total the bull market lasted right at 10 years.

The tech bubble started to burst in late 1999 and early 2000, but the 10 year bull market was not completely cleansed of the ***excesses until October 2002.*** The economy had been slowing in 2001, but the recession was triggered by 9/11. ***By early 2002 the economy had already begun a recovery,*** but the worst of the bear market was still ahead, with the final down leg occurring between June and October ***after*** the recovery had begun.

What caused this?

Historically, every bull market has its set of bad actors. In June of 2003, MCI/Worldcom and Enron went bankrupt due to accounting scandals with Enron taking one of the largest accounting firms in the country, Arthur Anderson, down with it.

As Warren Buffet is fond of saying you never know who's been swimming without their clothes on until the tide goes out.

Well today, the tide has definitely started to go out. The problem is that it's too early to tell who the bad actors for this cycle are going to be, but you can almost guarantee that there are likely plenty of them out there. Where they surface has yet to be seen.

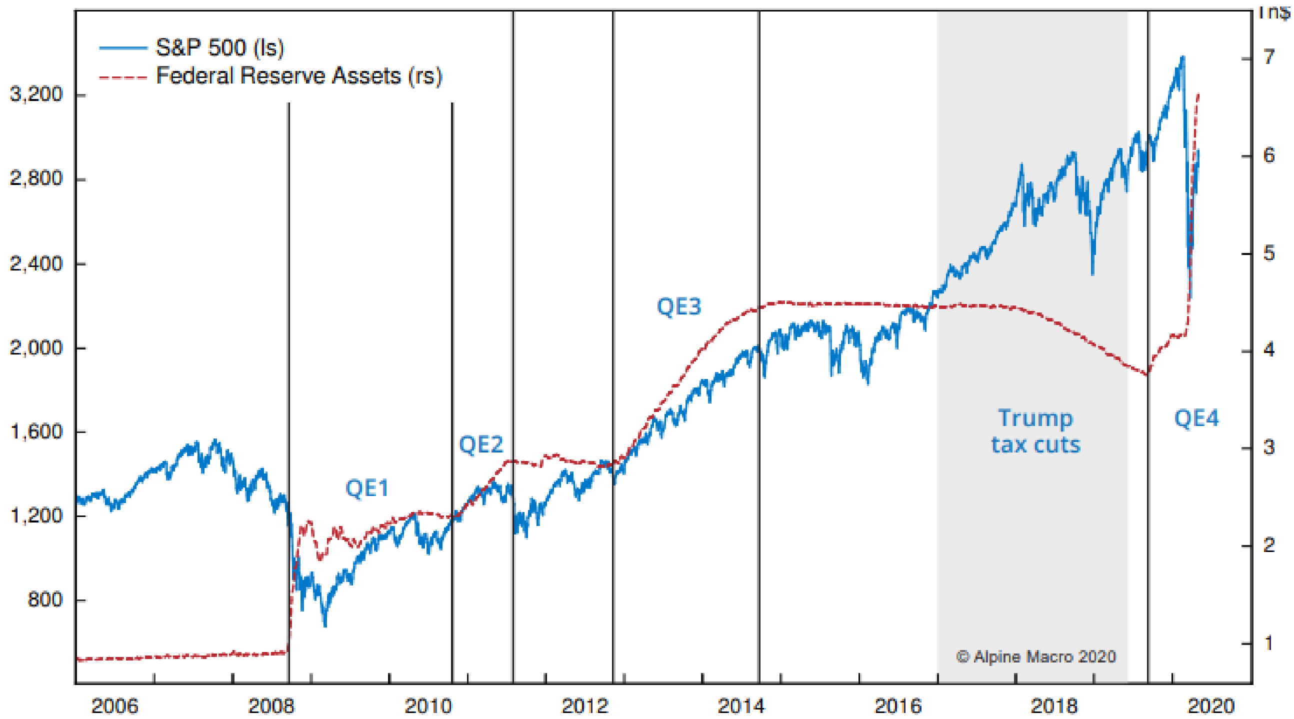
Companies can get away with a lot for a while, living on their reserves, until they can't anymore. This is what I expect we will be seeing in the next year or so. This is why I lean towards scenario #3, another major down leg, likely with the mama bear we've seen so far morphing into a daddy bear. But at the moment the stock market is living on happy juice.

Our next chart shows the fluctuations of the S&P 500 vs the Fed's "printing press" where they buy assets like government bonds, mortgage backed securities, and recently high yield securities to prop up the system and add liquidity.

This practice started in late 2008 prior to the end of the bear market. The Fed started running the "printing press" months before the bottom in 2009. As you can see there is a strong correlation between the stock market and the "printing press."

In each case the Fed started a new program (QE1, QE2, etc.) and each time the stock market rallied as the Fed added liquidity into the system. As you can see the Fed started taking liquidity out of the system in 2018 and 2019, which is part of what caused the mama bear in 2018.

To Infinity And Beyond



Now the Fed has essentially declared "open-ended" stimulus from their printing press. Bank Credit Analyst recently projected the Fed's balance sheet to balloon to over $11 trillion over the next several months. So in the short run, the market is living on happy juice.

This reminds me of the famous experiment with Pavlov's dogs, who were fed every time the bell rang. Soon the dogs learned the pattern and would begin salivating as soon as they rang the bell, whether they were fed or not. The market has learned that when the Fed prints money it gets fed.

In the short run, I think it is highly likely that stocks continue to rally for now, but I am not taking this for granted. What happens when we start the fall election cycle, which will be absolutely brutal, plus the potential for another Coronavirus mutation next winter. So if I'm guessing, I think we have a rally that lasts 9 months possibly longer, but I would be prepared for the potential for another major down leg in 2021.

In fact our favorite economic forecasters, the Beaulieu brothers of ITR, which currently has the highest success rate in the nation on forecasting the economy, are forecasting economic growth in 2021, followed by another economic downturn in 2022.

I simply don't believe the excesses from an 11 year bull market have been cleansed out of the system. But for now enjoy the ride, don't fight the Fed and remember that the trend is your friend. But all of this could change as soon as this fall or winter.

Bonds

Right now, I have a hard time believing that traditional buy and hold bond accounts are going to serve as a source of stability/safety for portfolios as they have over the past 30+ years.

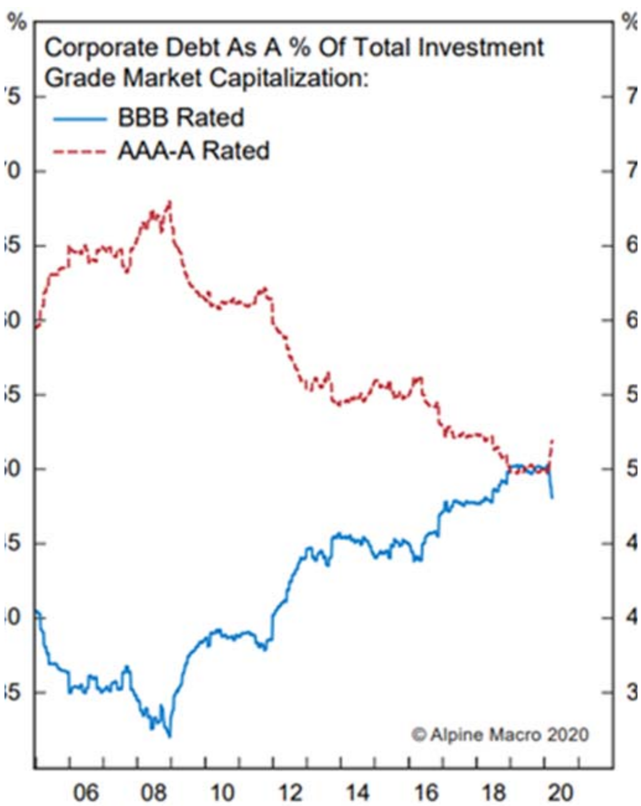
In the following table from Bank Credit Analyst you can see the potential for returns for the 10 year US government bond at various interest rate assumptions. As the table states, if the yield on 10 year bonds were to ***drop all the way to zero*** (from 0.64% currently) this would likely produce a positive 6.1% return from current levels. (Source: LendingTree.com 5/15/20)

If interest rates rise, the 10 year government bond will produce ***negative returns,*** which Bank Credit Analyst estimates at a ***–13.3% if rates on the 10 year government just go back up to 2%.*** Obviously significantly worse losses would occur if rates rise more than that, or if the bonds were a longer duration.

Total Return of 10-Year Government Bonds at Different Target Rates

Target Rate	US
2.0%	-13.3%
1.5%	-8.4%
1.0%	-3.6%
0.5%	1.3%
0.0%	6.1%

Source: Bank Credit Analyst 5/1/20



Source: BofA Merrill Lynch

Corporate bonds could also cause some issues as well. We are currently sitting at the highest level of BBB bonds in US history, and in a weak economy many of these bonds will likely be downgraded as you can see in the chart. (Source: Alpine Macro 2020)

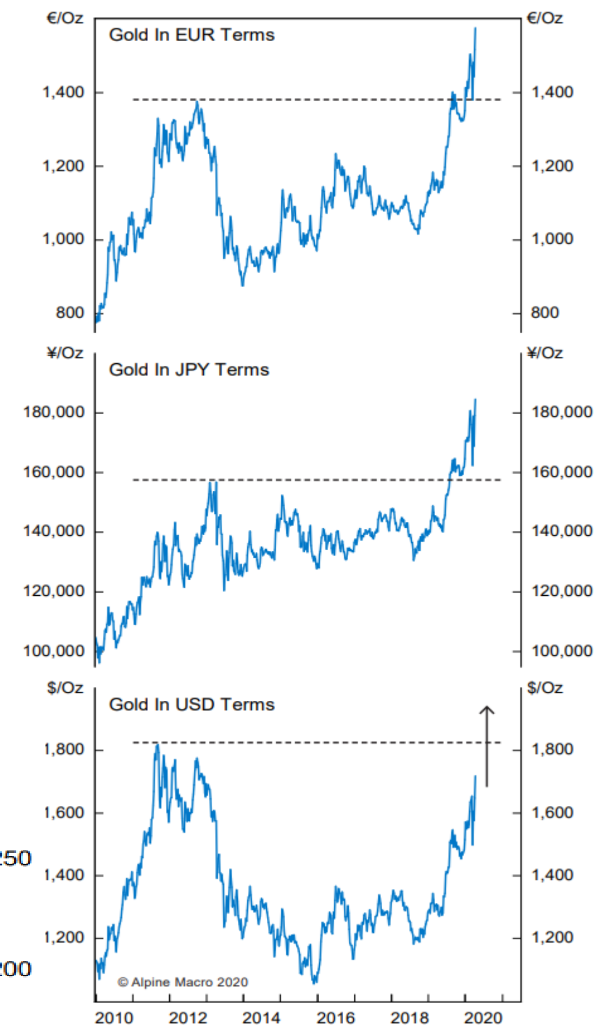
The big issue with this is that a lot of large investment firms like insurance companies, banks, and certain investment funds, by charter cannot invest in bonds below BBB, and many BBB firms are being downgraded. While the Fed has pledged to backstop the high yield bond market in terms of issuers being marked down from BBB to BB there's not a lot of support below that and many companies will likely see their credit rating fall even further depending upon how severe the recession becomes.

This is the reason that we are only recommending tactical (non buy and hold) bond strategies at this time.

Since March high yield bonds have experienced a sharp rally due to the Fed backstopping high yield ETF's plus recently downgraded credits, which had fallen from BBB to BB. However, more issues may be coming as the recession takes a firmer hold.

Gold

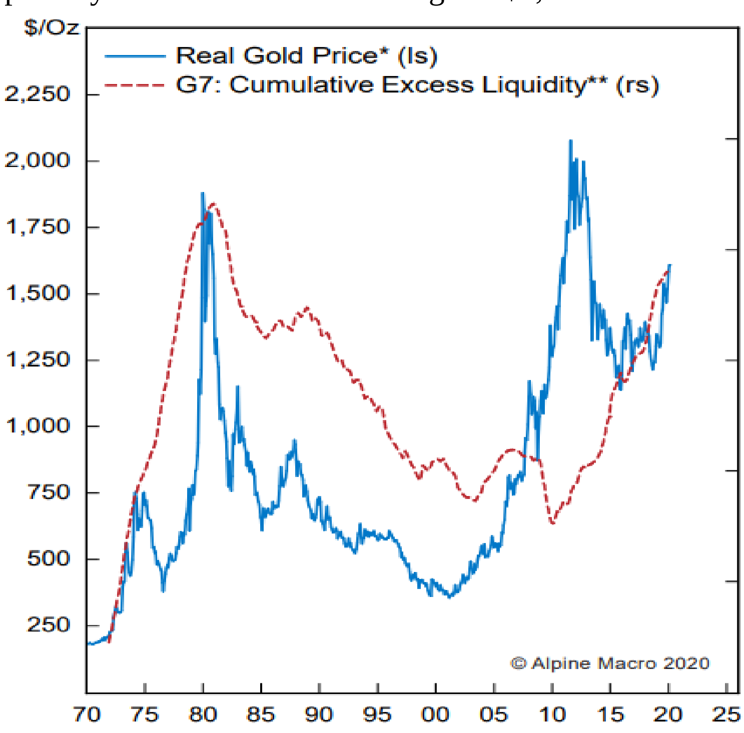
Gold has proven to be one of the most stable stores of value during this recession, falling briefly during the liquidity crunch part of the market crash and then bouncing back strongly after that. To the right you see the price of gold in various currencies. And while gold has not yet hit an all time high in comparison with the US dollar, it is at ***new highs*** versus the Euro and the Japanese Yen.



At the end of the day all of this currency debasement (printing press) is likely to benefit gold dramatically. The last time we had high inflation rates was in the 1970's and gold was one of the premier investments of that time. The same could be shaping up for the coming decade.

The next chart shows gold versus excess liquidity. As you can see there is a strong correlation between the price of gold (adjusted for inflation) and the various G7 countries "printing presses."

I view it as highly unlikely that this liquidity wave will end any time soon and could push gold into the stratosphere especially if it breaks the old US high of $1,900 an ounce.



*Deflated by U.S. core PCE deflator
**Calculated as G7 GDP growth rate minus average of short term rate and 10-year government bond yield; rebased to January 1975 = 100

"This is a perfect environment for gold to take center stage. Fanatical debasement of money by all of the world's central banks, super-low interest rates and gold mine operation and extraction issues (to a large extent to the pandemic) should create a fertile ground for this most basic of all money and stores of value to reach its fair value, which we believe is literally multiples of its current price."

(Source: 361 Capital, Elliot Letter, 4/16/20)

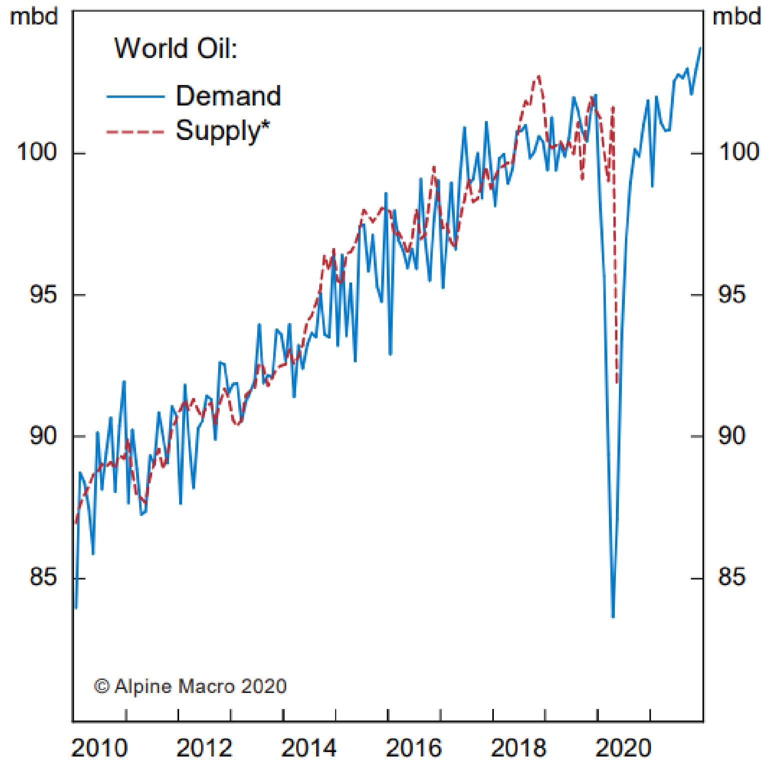
Oil

Oil has experienced a double whammy this year, with the combination of an ill advised price war between Saudi Arabia and Russia, creating excess supply, plus a gigantic decrease in demand due to the coronavirus recession, almost simultaneously.

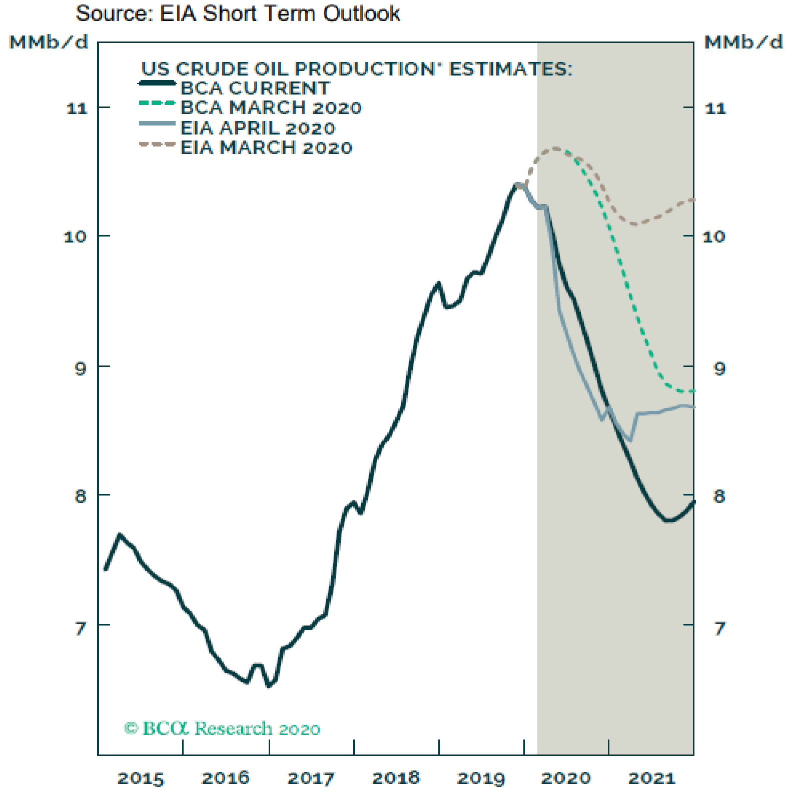
To the right you see a chart showing just how deep the plunge in demand has been, with an estimated 25-30 million barrel a day drop due to the recession. Best estimates are that approximately 65% of oil demand comes from a combination of passenger cars, road freight, buses, maritime, and aviation transportation. (Source Mewbourne Oil Company & Rystad Energy March 2020).

However, as the old saying in the oil patch goes, “the cure for low oil prices is low oil prices.” Combined supply cuts from Russia, Saudi Arabia and the rest of OPEC of some 10 million barrels a day, plus the shutting down of wells in the US and greatly reduced future drilling, will likely rapidly return the oil market back to equilibrium in relatively short order.

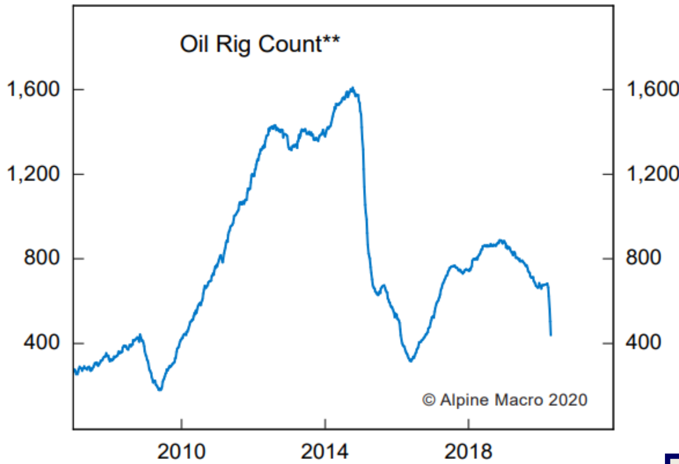
To the right you see the latest estimates from Bank Credit Analyst, which show a reduction in US crude oil production from almost 11 million barrels a day down to under 8 million within the next 12 months or so.



*Estimates and forecast based on latest OPEC+ agreement
Source: EIA Short Term Outlook



* LOWER 48, EXCLUDING GOM.
NOTE: SHADED AREA DENOTES FORECASTS.
SOURCE: US EIA, BCA RESEARCH.



**Latest data point is April 13, 2020. Source: Baker Hughes

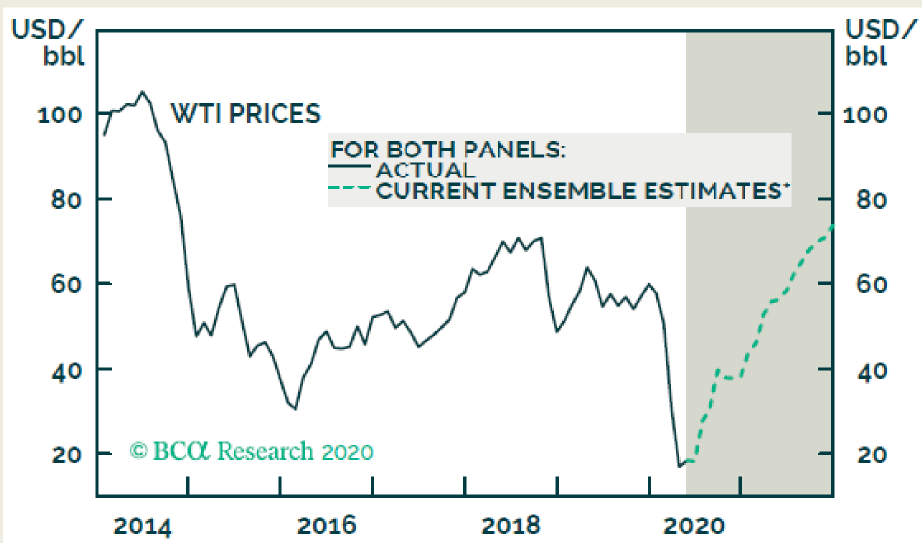
The oil rig count which shows new drilling activity in the US has already fallen 50%, and as you can see from the following chart from Bank Credit Analyst, output in the shale area will likely fall precipitously, squeezing new supply like never before.

All this projects to take an enormous excess supply of oil over the next two quarters and reduce it to big deficits by the end of this year or early 2021.

In addition there is a massive decline in offshore drilling activity (deep water gulf) around the globe. Remember that offshore oil production accounts for approximately 50% of global oil supplies.

"Investors should prepare for new offshore activity to effectively halt from here as we see the lowest levels of new capacity additions since 1999, fewer than 20 new projects, and the 'backlog' of production under construction - i.e. 'in progress' future supply - falling to levels not seen since 2009."

(Source: 361 Capital, Bernstein, 4/27/20)



* REFLECTS THE PROBABILITY WEIGHTING SCHEME OF OUR FORECAST.
NOTE: PRICES ARE MODELED AS A FUNCTION OF FUNDAMENTAL VARIABLES.
SHADED AREA DENOTES PROJECTIONS.

"It is highly likely, in our view, OPEC 2.0 will be the direct beneficiary of the massive fiscal and monetary stimulus of the DM and EM economics—oil being a derived demand that depends on the income available to firms and households. This means the odds of seeing $80/bbl Brent is more likely than not next year." (Source: Bank Credit Analyst 5/7/20)

Conclusion

In all, the Coronavirus recession is obviously taking a huge bite out of our economy. And while I prefer to remain optimistic, especially over the long term, I simply cannot get over concerns about the specter of the potential relapse and/or mutation of the virus late this year or next winter.

These words of caution are largely reflected by our friends at ITR Economics and it shows the potential for a relapse, which could short circuit the recovery.

Currently ITR Economics has the #1 economic forecasting record in the country and their base projection is the recovery starts in the 2nd half of this year and 2021, followed by a relapse to weak economics in 2022. But as Brian Beaulieu explains, a mutation or significant relapse will ultimately push the recovery further down the road, probably several calendar quarters. (Source: ITReconomics.com)

"There is the potential for a second wave of the coronavirus that is significant. We have yet to see any report that assigns it a probability. There is the potential that governments will intervene and close down parts of the economy again."

"If there is a second wave of sufficient magnitude to create reasonable consternation (coinciding with a particularly nasty influenza season might qualify), governments may respond by shutting down swathes of the economy again."

"If the compound risk comes to be reality, the effect on our forecasts will be to push out the timing by one to two quarters. Instead of beginning to walk away from the recession in 4Q20 as measured by GDP, the fourth quarter would represent the resumption of decline or at best an extension of the "crawl" built into the 3Q20 outlook. The timing of the other aspects of the economy, from housing , to capital goods new orders, to nonresidential construction, would likely be delayed accordingly." (Source: ITR Economics 5/15/20)

So, as I mentioned in the stock section enjoy the ride while it lasts. Unprecedented amounts of both financial stimulation (from the US Fed and its global cohorts) and the US federal government are certainly producing a "sugar high" for the market. Emotionally, sheer terror has given way to cautious optimism. And while many remain skeptical, the bottom line is that we're seeing a strong rally.

But again I have big concerns about the 2nd half of this year and next winter. As I stated before this election cycle is likely to be the most vicious at least in modern history, which is unlikely to make stock participants happy given that the stock market hates uncertainty. How likely is it that President Trump gets reelected given an historic recession and significant job losses in many of the "red states."

While Biden may not be a formidable candidate, demographically America has been moving further to the left for over a decade. What happens if Biden appoints Michelle Obama as his running mate. This might be a tough combination to beat in light of the deep financial uncertainty. And certainly veering left at this point in the economic cycle is hardly a positive.

In addition, the history of these incredible viruses leaves us with a lot of potential for another big wave, not just a small resurgence. As Brian Beaulieu mention earlier if there's a large second wave, huge portions of the economy could get shut down again which would absolutely derail the recovery.

Finally as I mentioned in the stock section it is hard for me to believe that an 11 year bull market run will be cleansed in less than 2 months. Normally the longer the bull market runs, the longer the bear market runs to correct the excesses.

So for the short run enjoy the ride, but I recommend you stay on red alert for the 2nd half of this year and 2021.

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Cornerstone Financial Services, Inc.
4851 LBJ Freeway, Suite 1175
Dallas, TX 75244

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

David McCord, CMT,
Contributing Editor