Cornerstone Report

Special Report **May 19, 2022**

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Topics:

- Macroeconomic Forces
- The Fed Is Steering The Ship Toward The Rocks
- Wars Are Inflationary
- Will Putin Continue To Prosecute The War?
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- The Oil Bull Market Has Likely Just Begun
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Daddy Bear Market??

As we go to press, stocks have just recently hit a new low for this bear market.

In the short run, we could be getting close to an ***inflection*** point and possible bounce, yet in the long run, the market looks like it could get much worse.

Last month's survey of the **AAII** (American Association of Individual Investors) registered 38.9% of their members polled as bearish, and only 18.9% of them were bullish, one of the lowest readings I can remember. *(Source: www.bespokepremium.com 4/14/22)*

Historically, when the numbers get this extreme, it typically means you're getting ready for a bounce. That does not, however, necessarily mean a long-term change of direction.

In other words, we may have reached an ***oversold*** extreme in the short run. Imagine pushing a beach ball underwater until it pops back toward the top. In bear markets, oversold bounces are typical, but this still looks like a bear market to me.

In fact, if you look at the overall market, ***it no longer appears to be what I would call a stealth bear***.

% Change From 52-Week High	S&P 500	Nasdaq Composite	Russell 2000
% Of Members With At Least 25% Correction	42%	72%	72%
% Of Members With At Least 20% Correction	55%	77%	82%
Average % Price Decline	-23%	-49%	-45%

Alpine Macro May 17, 2022

So far from the top, the S&P 500 has fallen 19.19%. NASDAQ and the Russell 2000 are down 29.6% and 27.8% from their respective intraday tops. The table above shows just how much carnage there has really been in this market so far. *(Source: Tradestation)*

In my estimation, the market has been appropriately adjusting for a higher level of interest rates, as well as a higher rate of inflation.

I do not, however believe that the market has adjusted for potential ***falling*** earnings.

In fact, as recently as the last few weeks, analysts on Wall Street have continued to be very optimistic, ***actually raising earnings projections for the rest of 2022 despite current challenges!*** *(Source: Bank Credit Analyst March 22, 2022)*

In other words, until now the market has been trying to assess just how bad the interest rate surge is going to end up being, how much the Fed is going to have to tighten, and how much are corporate earnings likely to soften.

In spite of the bear market, stocks do not appear to be cheap yet as we will see later.

So, to not recognize the current market as a bear at this point, to me, smacks of denial.

Macroeconomic Forces

My question is what macroeconomic forces are we likely looking forward to over the next year or so?

- ***The Russian invasion of Ukraine looks nowhere near finished and will likely intensify.*** This puts upward pressure on oil prices, materials, commodities and agricultural products, pushing inflation higher.

- ***The Fed is going on the warpath against inflation to a magnitude not seen since the 1970's.*** The Fed is "hopeful" that they can achieve a soft landing (no recession), but their track record is dubious, as we discussed in our previous special report, ***Fed Policy Mistake*** (www.cornerstonereport.com).

  Since 1965 the Fed has only engineered three soft landings out of the last 11 tightening cycles, this does not inspire great confidence in their ability to pull it off this time. *(Source: Investech February 2022)*

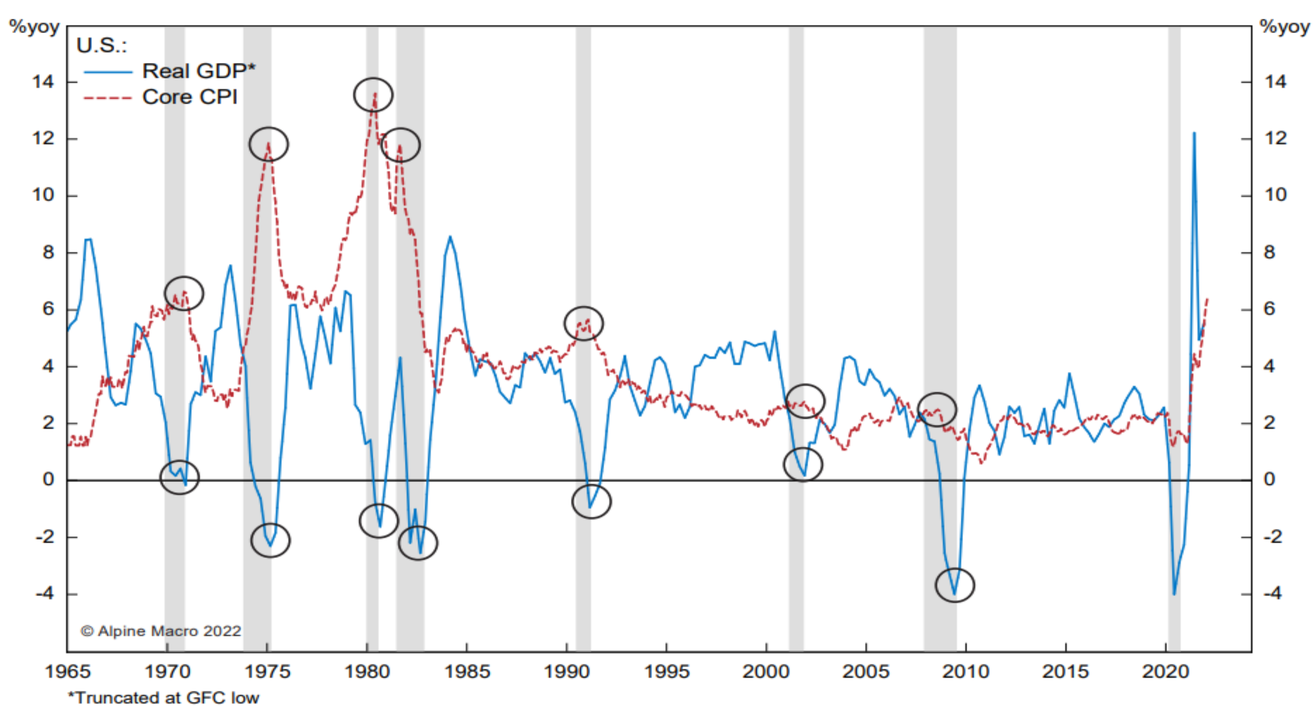
  Later we will discuss the inflation outlook, but historically, once the inflation genie has gotten "out of the bottle," it has taken a hard landing (or recession) to bring it back down. As you can see from the chart below, carefully note that every inflation peak going back to 1965 coincided with recessions.

- ***Interest rates continue to skyrocket.*** While this too, could be nearing a short-term extreme and inflection point, as we could see a slowing economy in the 2nd half of this year, interest rates have continued to rise unabated in 2022. Rising rates put pressure on everything from housing prices to corporate bonds, earnings and expansion. Historically, rising rates have not been positive for stock prices over the long run.

  Despite the fact that some of the more speculative stocks have crashed from their previous highs, in some ways, ***it appears that this bear market may just be getting started!***

In fact, if you look at our last special report entitled ***Fed Policy Mistake*** (published **before** the invasion of Ukraine), you'll find that we were projecting, at that time, what we refer to as a ***"mama" bear*** market.

Now it appears that we have not only started the mama bear, but the potential specter of a daddy bear may be looming (please read the special report on our website: www.cornerstonereport.com).



The Fed Is Steering The Ship Toward The Rocks

While it is entirely possible that the Federal Reserve could change its mind in time to avoid a recession, with the current political and economical pressure, that looks increasingly unlikely.

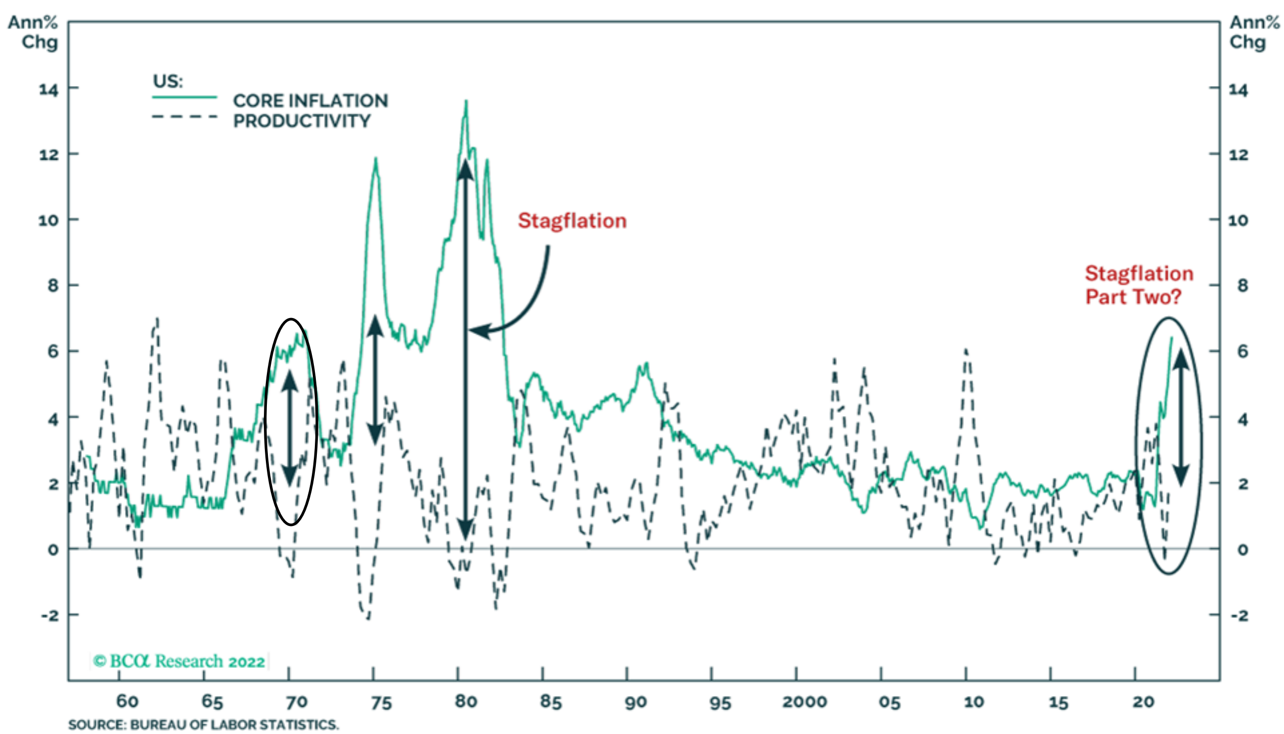
The latest table shows the Fed's projections on achieving a "soft landing" in this cycle. The analysts at Alpine Macro are calling these projections "fantasy…magical...dubious" and other superlatives.

The Fed is projecting that they can slow the economy enough to cause inflation to fall significantly, while simultaneously keeping employment and the economy strong. While anything is theoretically possible, were this to occur, it would be unprecedented in my view.

	2022	2023	2024	Longer Run
Real GDP Growth	2.8%	2.2%	2.0%	2.0%
Unemployment Rate	3.5%	3.5%	3.6%	4.0%
Core PCE Inflation	4.1%	2.6%	2.3%	2.0%

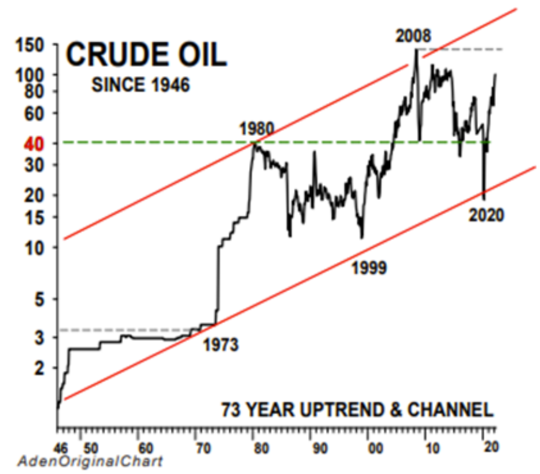
Note: Median forecasts; source: Fed Economic Projections, March 2022 Alpine Macro 2022

Below you see a chart that shows inflation over the last 60 years. You can also see that the inflation we see today so far strongly mirrors the first wave of inflation in the 1970s, which occurred between 1966-1970.



At that time, the Vietnam war was raging and President Lyndon Johnson simultaneously expanded the government's social programs, known as the Great Society (introduction of Medicare, Medicaid, etc.). Thus, government spending radically expanded during that time, and the Fed accommodated this by greatly expanding the money supply.

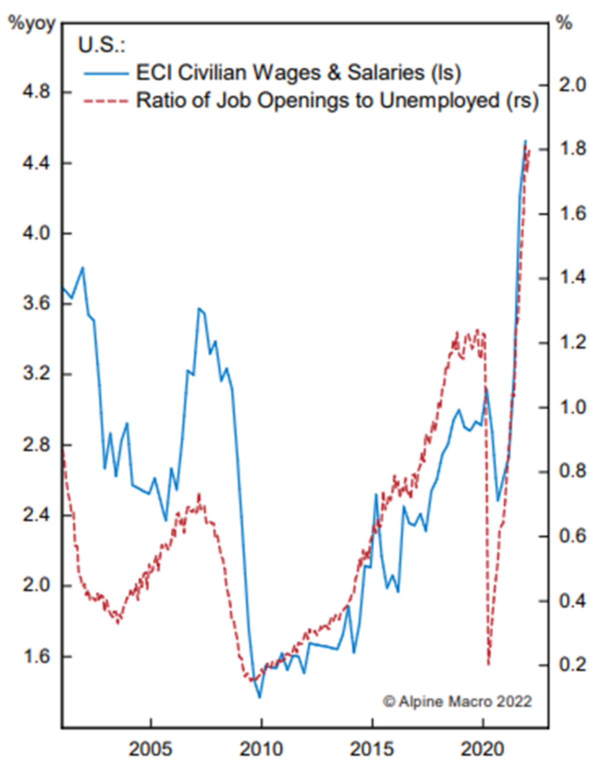
Next, we saw a second inflation wave from 1970-1974. That inflation wave was caused, in part, by the formation of OPEC and an oil embargo, which pushed oil from $2.50 a barrel up to $15 a barrel.



The third and final inflation wave of the 70's peaked in 1980, after the Iranian Revolution. Oil prices ultimately went to $40 a barrel at that time. Note that ***rapidly increasing oil prices affect virtually everything in the economy in an inflationary manner.***

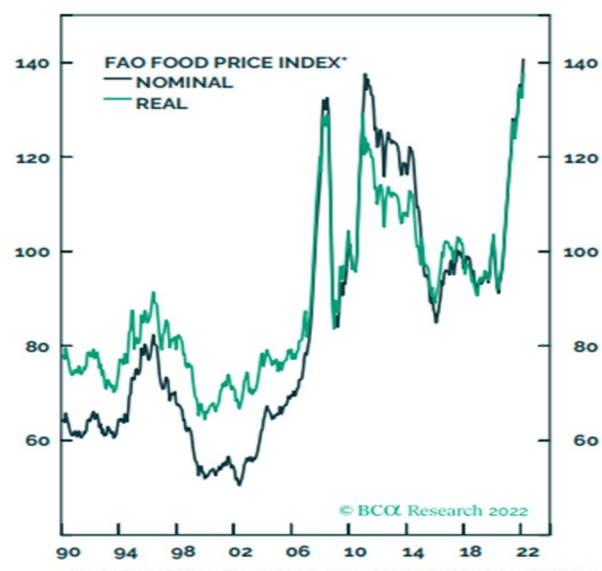
But I ask you this one question: In each case, when inflation peaked and started going down, what caused the decline? Historically, as we've shown on page 2, in each of these cases the inflation decline was caused by ***recession***.

So, for the Fed to project that we're going to "magically" see inflation fall without a recession could indeed turn out to be fanciful.



While I do agree that ***some*** of the current inflation is likely transitory in nature, with supply shut-downs, shortages, etc. due to Covid, we're also seeing skyrocketing wages, pushing prices higher for both goods and services.

Food prices have also accelerated rapidly, and will likely accelerate more as we will show in a moment.



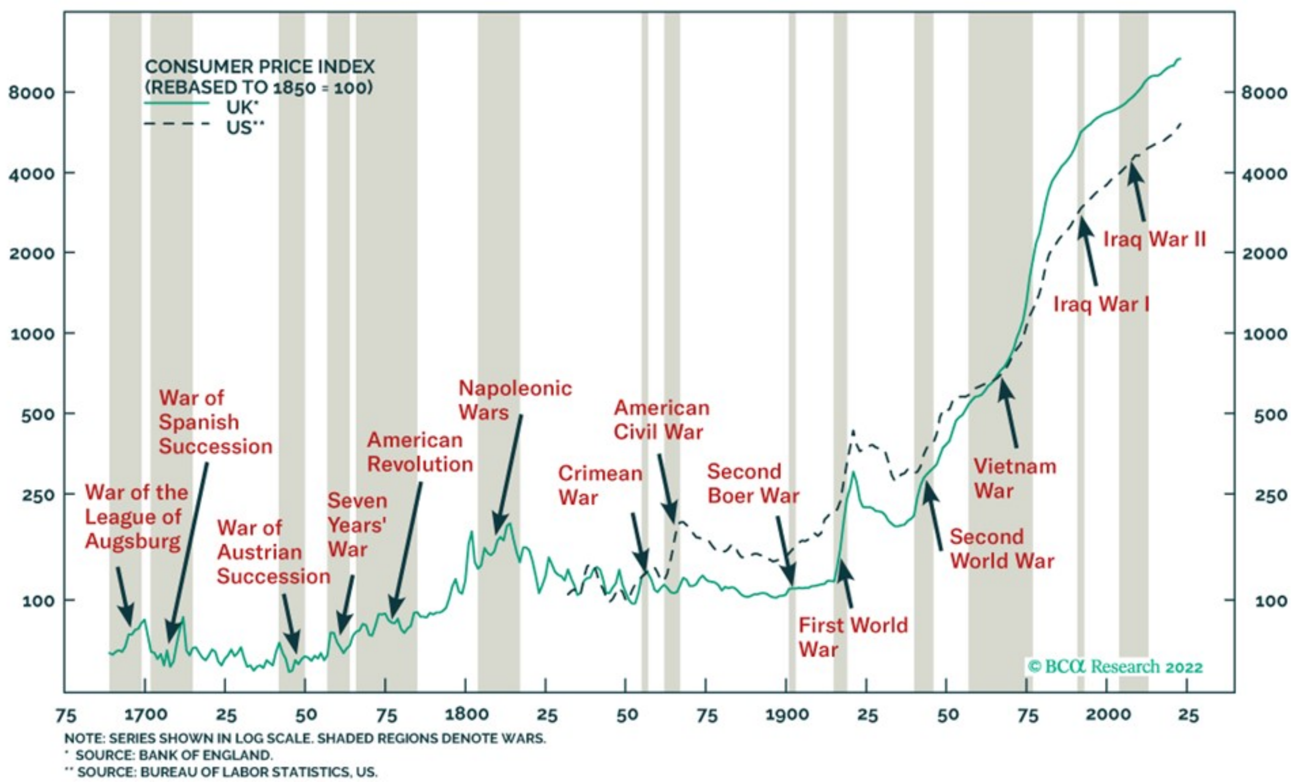
The more likely outcome in my opinion, is that a recession could hit sometime ***next year*** which should then pull inflation back down. But I also believe this is likely just the beginning of a longer-term inflationary period, which is likely to last throughout the decade.

Wars Are Inflationary

Below you see a chart showing the inflationary impact of war, going back to the 1600's. While the first part of the chart reflects Great Britain's experiences, the second half of the chart shows the United States as well.

While nothing is ever guaranteed in the marketplace, historically, wars have been inflationary. Wars chew up enormous amounts of supplies, military and otherwise. Wars put pressure on food supplies, energy, metals, and all sorts of resources, as the war causes an ***extreme*** increase in the short-term demand for certain assets.

Prior to the Russian invasion of Ukraine, suppliers of these assets did not anticipate such a radical, sudden increase in demand. This has caused price spikes to domino across the spectrum. The resource sector has thus far been one of the most resilient sectors of the market in 2022.



Inflation looks like one continuous wave over the last 100 years. If you only look at the chart above, you see continuously rising prices.

But remember that in each war we've seen since WWI, inflation has come in a succession of waves.

Thus, from a ***consumer*** standpoint it might look like an ongoing inflation wave, which it is.

But from an ***investor*** standpoint we need to focus on each ***individual wave as it pertains to the markets, as shown on page 3.***

In other words, for over 100 years now, the inflation tide has been coming in. We've not seen temporary price spikes followed by declines as before, but rather an ongoing ***inflation surge***, caused, in part by excess government spending (budget deficits) and the "printing press."

However, the tide coming in has been marked by individual waves, such as what we're seeing now. ***These waves are what the investor needs to focus on, not the tide!***

Will Putin Continue To Prosecute The War?

None of my research indicates that Putin is likely to back down. In fact, a recent Wall Street Journal article describes Putin as having a “personality defect” as one who tends to ***underestimate*** danger. In 1989, East German protesters were poised to storm the KGB compound where Putin worked in Dresden, East Germany. Pretending to be an ordinary interpreter, Putin walked out and talked the aggressive crowd down, while frantic calls to Moscow for help were left without reply, according to his autobiography.

Putin laments that the Soviet Union has disintegrated, calling it the worst geopolitical catastrophe of the last 100 years, with Moscow losing “48.5% of the Soviet Union’s population and 41% of its GDP, not counting forfeiting its global power status as America’s strategic peer.”

According to former national security advisor, Zbigniew Brzezinski, “with Ukraine, Putin has an empire, without Ukraine he does not.” *(Source: WSJ 1/20/22)*

As you can see from the enclosed map, Putin is now focusing on eastern Ukraine, including the Black Sea, which gives him greater access to the Mediterranean, as well as the area where the highest percentage of Ukraine’s oil and gas reserves are located. The Wall Street Journal recently called this “an oil heist.”

Putin clearly has designs to attempt to recreate the old Soviet Union, if possible. And while I think that’s highly unlikely, war has now come to Europe in a way we have not seen since 1945.

Putin is taking the biggest risk of his career.

SOURCE: EVAN CENTANNI AND DJORDJE DJUKIC, WWW.POLGEONOW.COM.

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Inflationary Implications of The Invasion

While Russia and Ukraine combined are not a huge percentage of the world's GDP (only 3.5% in PPP terms) there are certain key commodities they produce, that will likely have huge ramifications in Europe, the United States and the rest of the world. Shortages of metals and agricultural goods will likely reverberate across the global economy, exacerbating shortages and supply disruptions, thus fueling more inflationary pressures.

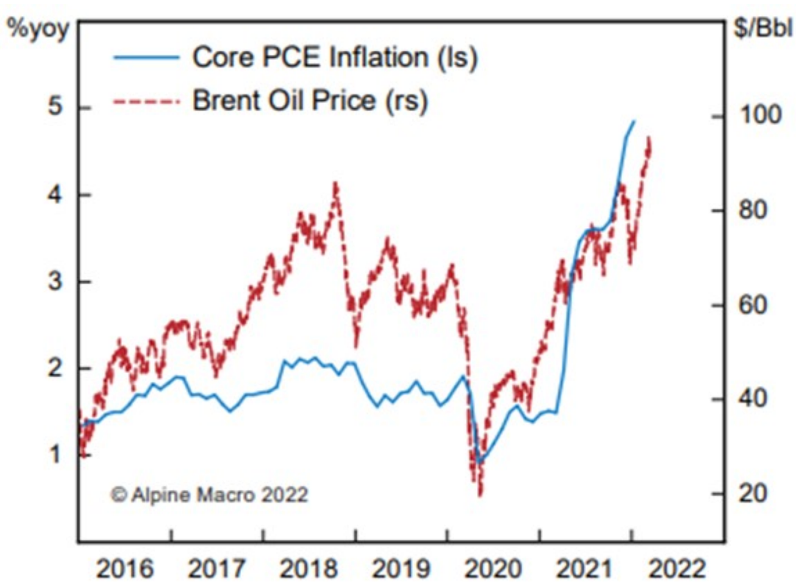
Consider:

- **Energy:** In 2019, Russia was the 13th largest exporter of goods in the world, but the 2nd largest commodities exporter (after the U.S.), and the 2nd largest oil producer, accounting for 12% of annual global output.
- **Nickel:** Russia is the 3rd largest producer of nickel accounting for 4.4% of global output. Elon Musk has stated that a shortage of nickel is the "biggest challenge in producing high-volume long-range batteries."
- **Palladium:** Russia accounts for 35.6% of global palladium output widely used in catalytic converters, electrodes, and other electronics.
- **Fertilizers:** Together, Russia and Belarus account for about 40% of global potash production, a key ingredient in potassium-based fertilizers. Russia also produces 2/3 of all ammonium nitrate, the main source of nitrogen rich fertilizers.
- **Wheat and Lumber:** Russia produces 10% of the global supply of wheat and lumber.
- **Food:** Ukraine production is dominated by foodstuffs such as corn, wheat, and seed oils. Russia and Ukraine together account for 25% of wheat exports.

The rest of the world will try to compensate for lost agricultural output. But the snag is with Russia, Ukraine and Belarus producing significant portions of the world's fertilizers, food prices will likely continue to rise, and they have already been skyrocketing.

In addition, Ukraine is a major producer of automotive wire harnesses. Volkswagen, BMW, and Porsche have all had to curtail auto production due to war-related shortages.

Also, the bulk of semiconductor-grade neon, used in high precision lasers comes from Ukraine. A dearth of this critical gas could exacerbate the semiconductor shortage. *(Source: BCA 3/14/22)*



Note the strong correlation between inflation and oil prices.

While oil prices will almost certainly fall in the next recession, the strong possibility is that they will continue to rise until then, making the Fed's job that much harder.

The Oil Bull Market Has Likely Just Begun

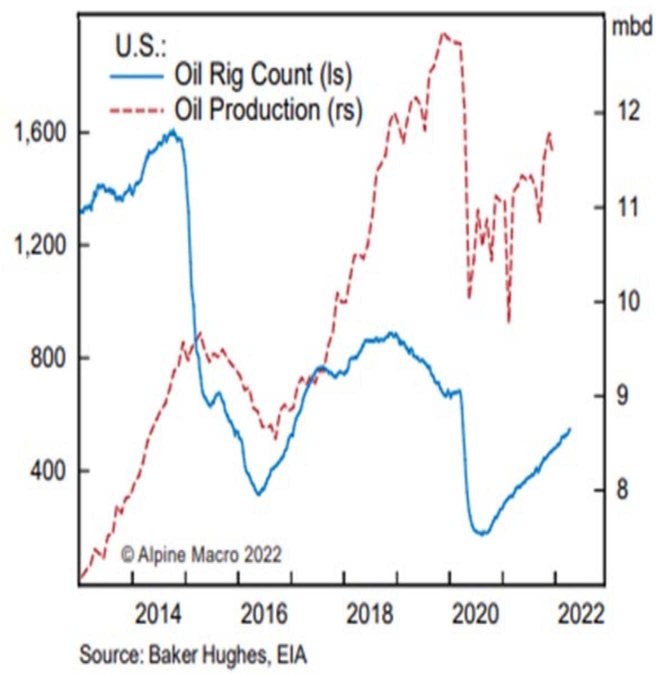
The oil embargo weapon is now being used by both sides, both the EU and Russia. Putin recently placed an embargo on Poland and Bulgaria for refusing to buy their oil imports in the Russian currency, the ruble, to get around financial sanctions imposed by the world.

Germany, the largest importer of energy in Europe is now openly discussing embargoing Russian oil and gas imports, which their economy desperately needs.

It is still possible that the sanctions will be vetoed and revised. But with Germany changing its position and now willing to embargo oil, it is only a matter of time before the majority of the EU cuts off Russian oil imports. BCA 5/5/22

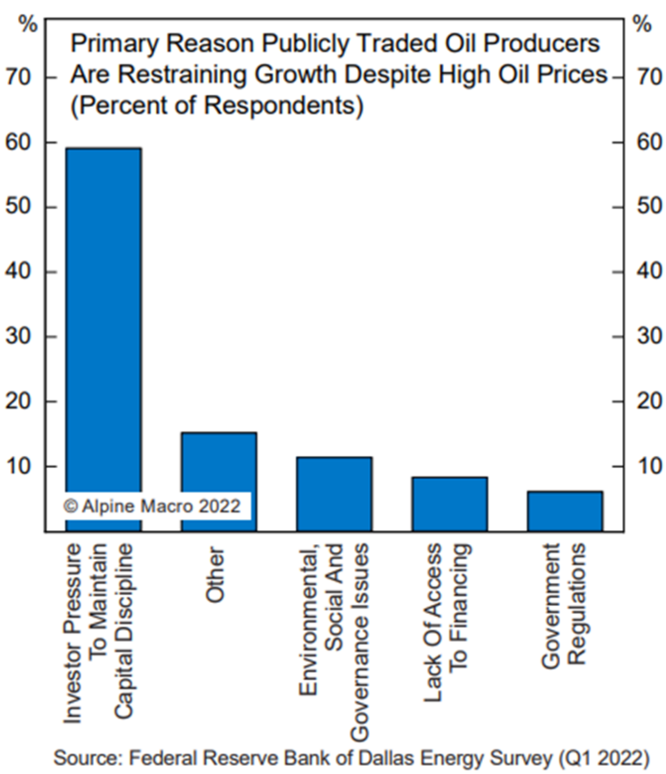
Unless there is a miracle and the war ends quickly, this looks to be a protracted war with ***heavy duty*** inflationary implications, as skyrocketing oil prices put inflationary pressure on just about everything.

In the following chart you see the recent price of oil and the muted response of the U.S. oil industry in terms of the amount of drilling taking place in the U.S.



The ongoing political environment has a lot to do with this, as the so called ESG movement (Environmental and Social Governance) is calling on institutions, banks, etc. as well as the existing oil companies to cut back on their drilling.

Rather than focusing on finding more oil, they are instead focusing on distributing more cash as dividends and/or share repurchases while turning their attention to alternative energy.



In fact, Exxon Mobil (which recently lost 3 of their board seats to activist hedge fund ***Engine No.1***) has decided to reduce their budget significantly over the next couple of years, cutting their drilling budget from $22 billion in 2019 to $16 billion in 2022. *(Source: WSJ Dec 1, 2021)*

The ***very outspoken*** new board members have "chastised" the company for recklessness in terms of "wasting corporate money" by drilling more oil wells as the world moves toward alternative energy.

To the right you see a chart showing the latest stats we have on global supply and demand for oil. As you can see, demand has almost completely recovered from the 2019 peak prior to Covid, yet new supply is not being added at the same rate.

It seems that emerging markets like India, Indonesia, South Africa, Turkey, etc., are not as worried about climate change as much as the media and liberals in America are.

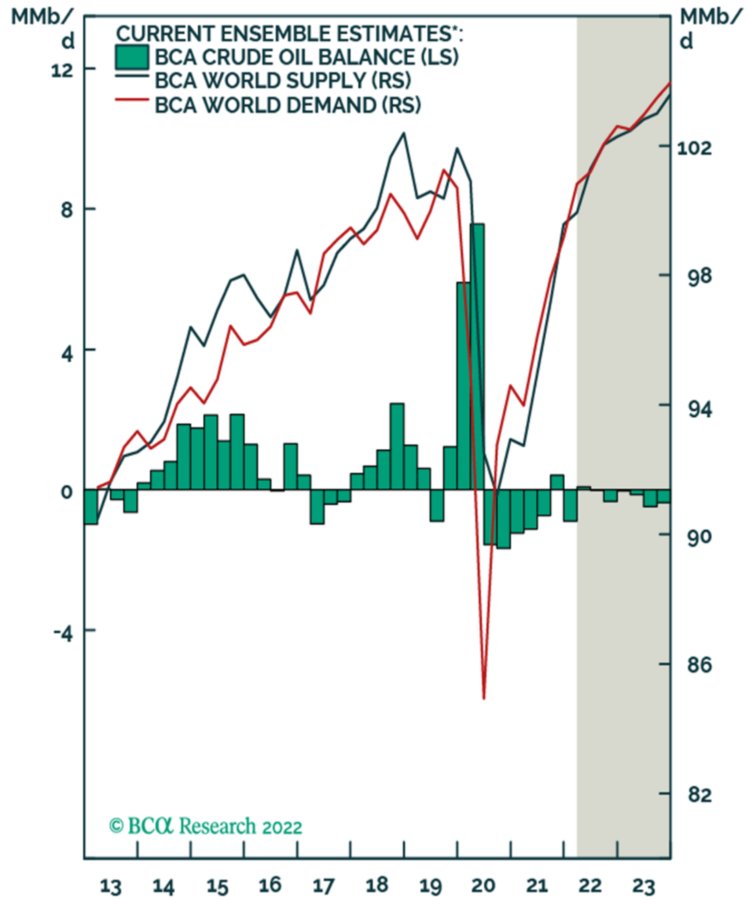
In fact, many of the citizens of these emerging markets, are starting to make a lot of money (compared to their previous living standards) and one of the first discretionary items they tend to buy is a car. In many instances this serves as a status symbol, that they have "arrived."

Remember that over ***50% of global energy demand*** comes from China, India (over 3 billion people combined) and the rest of the emerging markets.

These emerging economies are ***hyper*** accelerating in their energy usage and are nowhere near maturity phase. Like adolescent boys entering their growth phase, the emerging markets will likely be an insatiable source of demand for the coming decade. *(Source: Bank Credit Analyst May 2022)*

So, the likelihood continues to be very strong that global energy demand continues ratcheting higher throughout this decade, despite wishful thinking of the far left.

Alternative energy sources are not even remotely close to replacing petroleum-based sources of energy in the near term.



*REFLECTS THE PROBABILITY WEIGHTING SCHEME OF OUR FORECAST
NOTE: SHADED AREA DENOTES FORECASTS
SOURCE: US EIA, OPEC, BCA RESEARCH

If Russia's production is curtailed by roughly 1mm b/d this year and next year due to sanctions, we estimate Brent prices could reach $120/bbl. Losing 1.8mm this year and another 700k b/d next year could push Brent prices above $140/bbl.

On the back of this collateral damage from the cut-off of Russian oil and gas exports, we would expect inflation and inflation expectations to take another leg up.

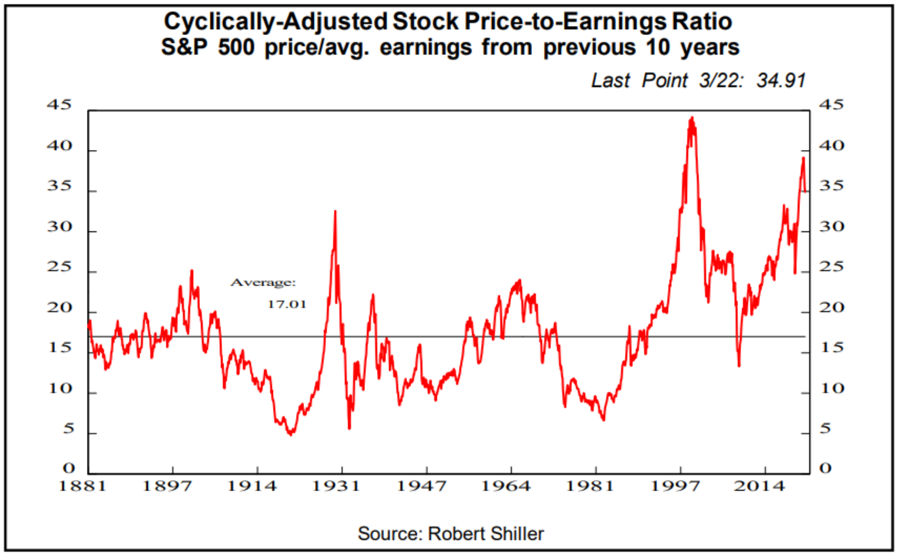
BCA 5/5/22

This is likely a movement that will be measured not in years, but in ***decades***.

Thus, I believe we are headed for a ***chronic state of undersupply*** for the world economy for oil and gas throughout the rest of the 2020s. While anything can happen, current supply and demand projections appear to project higher demand throughout the decade.

Are Stocks Cheap Enough Yet?

To the right, you see a chart showing the Shiller PE Ratio for the U.S stock market.



As we demonstrated in our last special report, stocks have been, in some cases, ridiculously expensive recently (see ***Fed Policy Mistake*** p.8, www.cornerstonereport.com)

Over the past few decades, valuations on U.S. stocks have tended to ratchet higher. This, is in part because of their higher performance compared to many other asset classes, but also because interest rates have fallen to historic lows.

In fact, a recent study by Bank Credit Analyst, in studying international bond yields, stated that in Great Britain, interest rates had fallen to the ***lowest levels in over 800 years!***

Falling interest rates have historically been an excellent booster for both stocks and bonds. But if I'm right in my concerns, and inflation becomes the big story of this decade, this will likely change.

Note: The Shiller PE Ratio (Nobel prize winning economist, Robert Shiller of Yale) compares stock market earnings over the past decade. By using average earnings from the previous decade, the goal is to factor out short-term market "noise," and give investors a better big picture outlook.

In fact, in the first quarter of this year, stocks and bonds BOTH fell simultaneously for the first time since the 1970's. *(Source: WSJ May 3, 2022)*

The vast majority of this generation has primarily witnessed interest rates falling and stocks rising over the long run, punctuated by occasional bear markets, some of which were severe (2000 & 2008).

But if you look back at the 70's decade, both stocks and bonds tended to perform poorly.

The Dow Jones Industrial Average hit 1000 for the first time ever in 1966. I first entered this industry in 1980, prior to stocks hitting their long-term bottom in 1982 at 777. Stocks experienced a 16-year sideways market, punctuated by 4 distinct bear markets, one of which was the worst, at that time, since the 1930's (1974).

Bonds on the other hand, for the most part, had poor performance throughout the entire decade as generally speaking, long-term bonds go down in value when interest rates go up.

Thus, if this current bout of inflation is indeed the ***first leg of an inflationary decade***, as I think it will be, traditional asset allocation models will likely need to be significantly revamped, as I don't believe the traditional models, which have primarily focused on results over the past 40 years of falling interest rates, will stand a chance of being as profitable this next decade.

Below you see a chart showing NASDAQ's recent decline. As you can clearly see there's been a significant drop since the high on January 3rd, in fact as we go to press *NASDAQ has erased all the gains back to August 2020!*

As is often the case in bear market rallies, NASDAQ bounced up to the 200-day moving average in early April, and failed to continue rising from there as noted with ↓.

A similar pattern occurred in early 2008, with the market dropping sharply during the first quarter, ***then rebounding up to the bottom of the 200-day*** moving average. But then it failed to follow through.

While I'm not saying this necessarily means we're facing another 2008 catastrophe, as I don't believe the financial system is anywhere near the fragile state it was in back then, historically, bear markets tend to have certain behavior and patterns.

Last year saw a ***high degree of speculative activity*** including such ballyhooed events as Robin Hood going public (now down 70%). Special purpose acquisition companies (SPACS) were very hot, (raising a lot of money to buy companies) plus we saw a gigantic proliferation of margin debt (see ***Fed Policy Mistake*** p.9).

In bear markets, margin debt serves as potential "pent up" selling pressure. This is because once the market penetrates certain levels, margin call selling becomes forced, and reinforces the already downward spiral. As we pointed out in ***Fed Policy Mistake***, high levels of margin debt typically precede major bear markets.

While history never repeats itself exactly, as Mark Twain reportedly said, "it often rhymes."

Based on my study of previous bear markets, there have historically been ***three primary*** characteristics which tend to cause a mama bear to morph into a daddy bear — normally characterized by a 50% +/- decline in the market.

Two of the three characteristics that historically have appeared before most daddy bears are already with us.

First would be unprecedented levels of ***overvaluation.*** As we demonstrated in our previous special report, we have been at some of the highest levels of valuation in market history based upon price/earnings ratio, price to sales ratios, etc.

The **second** characteristic that historically occurs before most daddy bear markets is high levels of leverage. As we pointed out in our previous special report, margin debt was roughly twice as high compared to the economy (GDP) as was seen prior to previous daddy bears. *(Source:* ***Fed Policy Mistake*** *p.8-9, www.cornerstonereport.com)*

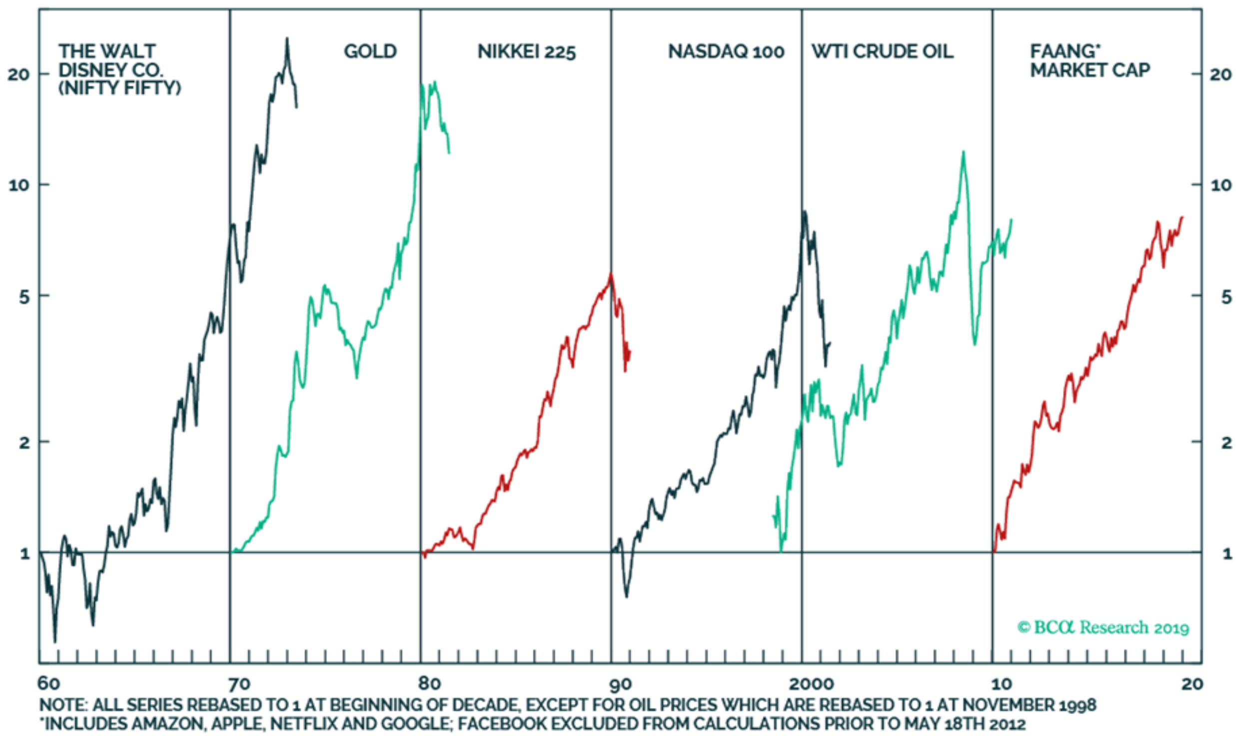
The **third** ingredient, which has tended to change a mama into a daddy bear, historically has been a recession. Prior to the Russian invasion of Ukraine — with the war and subsequent inflationary pressures — I was expecting a slowdown in the economy this year and next, ***not a recession***.

However, I always say that I reserve the right to change my opinion later ☺. And while it is entirely possible that the Fed could change course and still avert a hard landing, this looks increasingly unlikely. We will have to wait and see.

So, in conclusion, I feel like the very long bull market that we experienced from 2009 to 2021 is over. This likely means two things.

First, it means that we are almost certainly not finished cleansing the system of the excesses of both speculation and debt that built up during the long bull market. Historically, I believe it to be unrealistic that in just over one calendar quarter, we have cleansed the excesses built up over the previous 12 years.

Secondly, it likely means that once the bear is over and we start another bull cycle, the next big winners are likely to be completely different than what was seen in the previous cycle. In fact, if you look at the chart below, you'll see that these trends tend to run for very long periods, but so far at least, each decade tends to have a completely different set of winners, which we refer to as trophy stocks.



While it is too early to predict which sectors of the market place could produce the next round of trophies, my suspicion is that it will revolve around things that tend to prosper from inflation, which could include things such as oil, food or other physical resources.

While we always know that past performance is no guarantee of future results, and that history never repeats itself exactly, a wise man, who in his day was probably the richest man in the world, Solomon once said "there is nothing new under the sun. What has been, has been before." *(Ecclesiastes 3:15)*

History tends to repeat itself because human nature never changes and human nature tends to produce repeatable behavior over very long-term periods of time.

It looks to me like a repetitive pattern is reoccurring, similar to what was seen prior to other major "daddy" bear markets. The next year or two could be quite interesting.

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