Cornerstone Report

Special Report | **December 14, 2022** | **By: Jerry E. Tuma, MS, CFP®**

Topics:

- The Unthinkable?
- Iranian Threat
- Bear Market Continues?
- Global Oil Supply/ Demand

We're Out To Change The Way America Thinks About Investing.

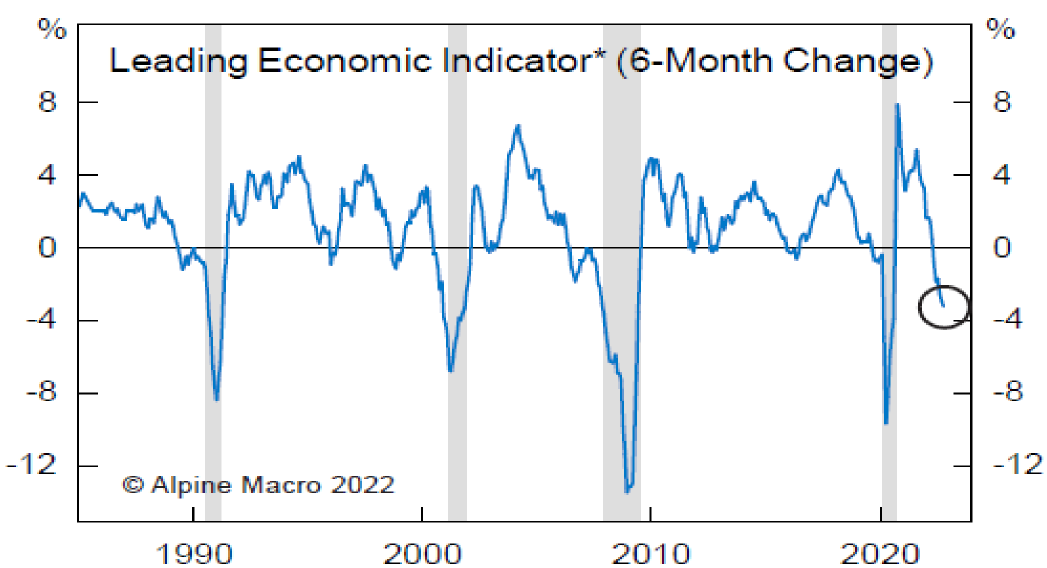
Geopolitical Peril?

This month's Special Report offers a discussion with geopolitical expert, David Asher. The economists at Alpine Macro believe he is one of the top geopolitical experts in the world. Following his comments we offer insights from our good friend, Matt Gerkin, head of the geopolitical team at Bank Credit Analyst. I think you will find both of their discussions stimulating to say the least.

David Asher offers insights from a provocative, well-informed deep thinker, long respected by the principals of Alpine Macro. David is a senior fellow at the Hudson Institute, focusing on U.S. foreign policy in Asia, global macro strategy, economic and financial policy toward U.S. state adversaries, strategic law enforcement, and high technology development. Just as relevant, he has been a macro strategist at five of the largest hedge funds in the world and had seven stints in the U.S. Government. The Russian retreat from Kherson is encouraging. But even the best-case scenario would not be a lasting peace, given the enmity between Ukraine and Russia. More generally, while everything could turn out "just fine" in the world's hot spots, David worries about potential black swans related to Russia, Iran and China. Moreover, the links between these three countries suggest war on one front increases the odds that another front will open up elsewhere. (*Source:* ***Alpine Macro*** *11/16/22)*

In the meantime, I still believe we are in a daddy bear market for stocks. Currently the market appears to be priced for a soft landing, yet the leading indicators such as the ***Index of Leading Economic Indicators***, inverted yield curve, and the ***Purchasing Managers Indexes*** continue to fall, and have now fallen to levels that have coincided with recessions in the past (see ***Capitulation Coming?, www.cornerstonereport.com***).

Remember, focus on the ***leading*** indicators which tend to lead the economy by 6 to 9 months (sometimes longer) ***not current economic numbers***. In my view, the economic ship is headed into the dock, I don't believe it's going to stop in time to avoid a recession.



*Source: Conference Board
Note: Shading denotes U.S. recessions

The current yield curve inversion is more dramatic than anytime since the 1980's (please see ***Capitulation Coming?, www.cornerstonereport.com*** for a full explanation).

As you can see, the various Purchasing Manager Indexes (PMI's) have also fallen into economic contraction levels (below 50), which have historically coincided with recessions.

As I stated earlier, I believe it is best to always look at the ***leading*** economic indicators, which tend to show you what will happen ahead of time.

If you only focus on the current economic statistics you will often be "a day late and a dollar short."

As we go to press, the Federal Reserve in Atlanta is forecasting economic growth of over 4% for the fourth quarter of this year. Black Friday store traffic rose 7% with sales rising 12% according to MasterCard. (Source: wsj.com)

So it is clear, that we are not currently in a recession. But that is **today**. Current economic numbers are known as ***coincident*** indicators, meaning they're telling you what's occurring today, but they don't give you a clue about what will happen in the next 6 to 12 months.

My experience has been that your best investment decisions are likely made by watching the ***leading*** economic indicators, which historically tell you what is likely to happen next year.

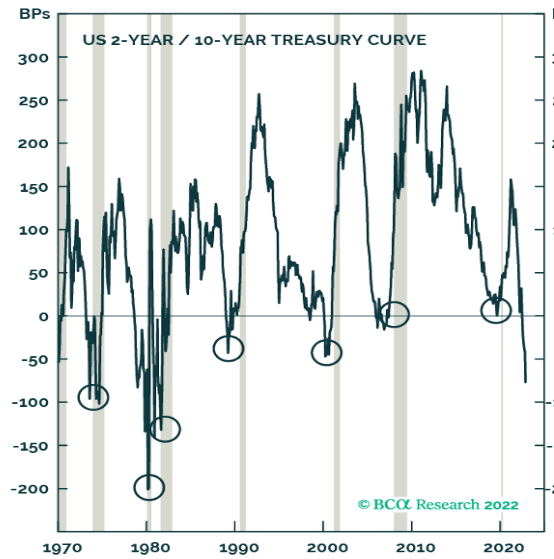
While we all know that past performance is no guarantee of future results, these leading indicators have outstanding track records. In fact, the Conference Board's ***Index of Leading Indicators*** has rarely been wrong.

So, in my opinion, the likelihood of recession next year is very high, and stocks do not appear to be priced for a recession (more on this in market section).

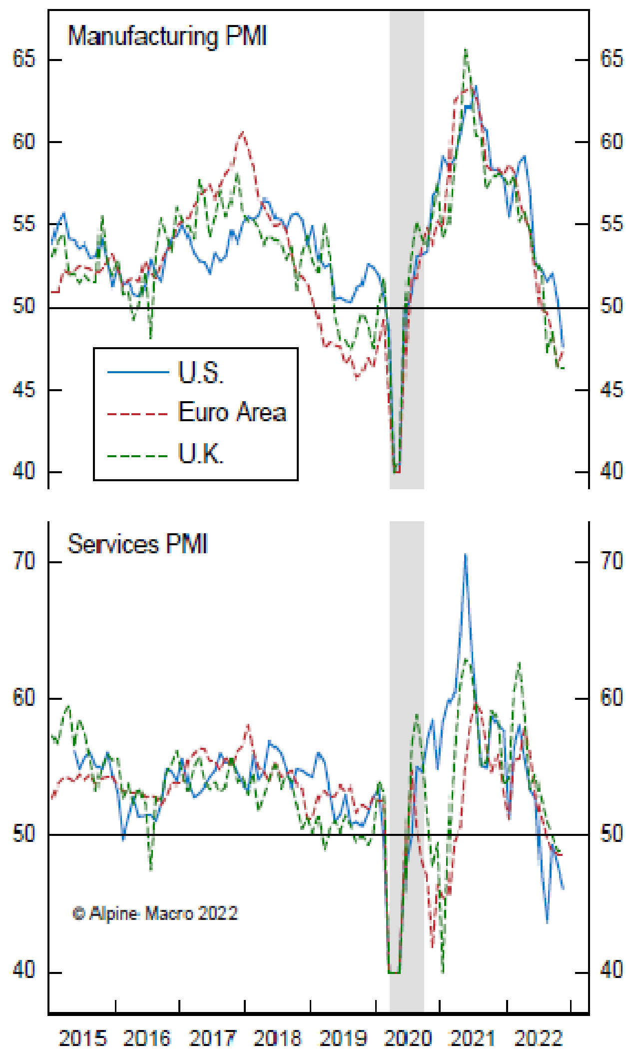
Currently earnings per share are forecast to grow 3% globally next year, whereas earnings historically have dropped an average of 15-25% in even mild recessions (see page 7). *(Source: **BCA** 12/1/22 www.bcaresearch.com)*

In sum, I still believe we are still in the midst of a daddy bear. Frequently the worst of the damage occurs in the last third of the bear market. (See ***Capitulation Coming?, www.cornerstonereport.com***)

In this case, I expect no different.



NOTE: SHADING DENOTES NBER DESIGNATED RECESSION.



Source: Markit; all series truncated at 40
Note: Shading denotes U.S. recessions

The Unthinkable?

"In regard to the war between Russia and Ukraine, the U.S. government believes that there is room for negotiation, since Ukraine has effectively ceded the areas lost in 2014. That said, I assign low odds to even a temporary cessation of hostilities. Zelensky has tremendous military momentum. Putin cannot afford a continuing defeat, his military is acting like a spent force. Ergo, fighting may well continue through the winter even if Ukrainian advances slow. Zelensky wants at least a partial return of Crimean territory, but this would represent an existential disaster for Putin.

Russia may lose more on the ground, but it is winning the energy and economic war. Putin is using energy price inflation and degradation of supply capacity as a weapon system against Europe, not just the Ukraine. Their ground war is not working, but the air war with drones is causing more economic and energy infrastructure damage than the Ukrainians admit. About 50% of Ukraine's power capacity will be radically diminished or destroyed by the end of the year and these attacks can continue in the winter, with no missile defense system in place that can stop them.

The air war could get worse for Ukraine. More ***Iranian drones*** are on the way with the capability to evade the more advanced air defense systems currently being delivered by NATO to Ukraine. We should also expect Russia to use swarm-like attacks involving their own intermediate ballistic missiles that have evasive capabilities, as well as imports from Iranian and North Korean arsenals. Zelensky is publicly preparing to evacuate Kyiv if its power and energy systems are destroyed.

The odds have risen that nonconventional weapons of mass destruction could be used by Russia after the promotion of "General Armageddon", Sergey Surovikin, who used chemical weapons in Syria, and the U.S. barely opposed it. Russia also likely has capabilities they have not yet deployed especially in space - the "final frontier" for a new type of war that would affect communications, transportation, and economies.

Russia could even resort to nuclear weapons as "escalation to promote de-escalation" and to secure regime change in Kyiv by killing Ukrainian President Volodymyr Zelensky, fulfilling Putin's initial war aim." (*Source: **Alpine Macro** 11/16/22 www.alpinemacro.com)*

- "Ukraine's battlefield successes, EU energy diversification, and NATO enlargement all threaten a humiliating strategic defeat for Russia and President Vladimir Putin. If the situation deteriorates further, his personal security and regime security will be jeopardized and Russia could become a truly irrational and unpredictable global player. Putin claims that he is "not bluffing" when it comes to his threats of using nuclear weapons – signaling a low-probability, high-impact risk in 2023.

- Russia is more likely to slash oil production and cause a global oil shock than to use nuclear weapons, and it would not do either lightly, since it must retain diplomatic partners and allies. But ultimately Russia will make decisions based on its own interests – and China is not likely to halt imports of Russian and Central Asian goods. A major Russian oil cutoff could cause a global recession.

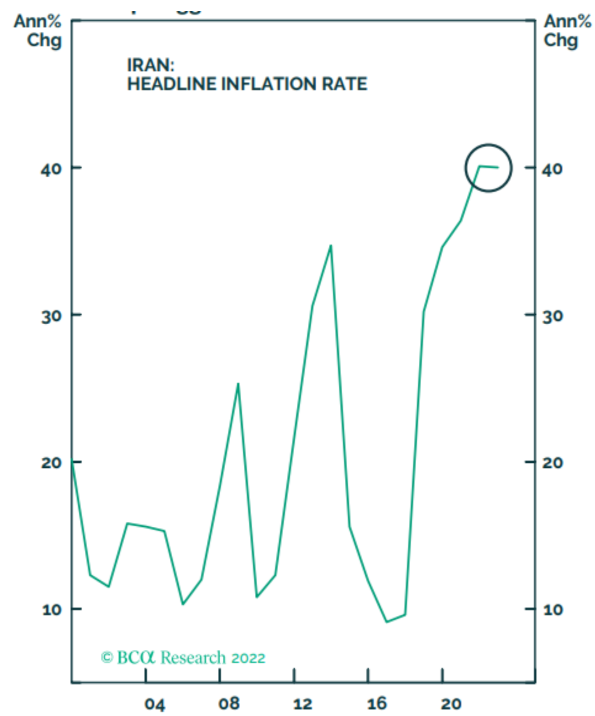
- Sweden and Finland are in the process of joining NATO, which flies in the face of Putin's career-long strategy. The U.S. and Russia have not agreed to red lines to prevent NATO enlargement from causing major new episodes of nuclear brinksmanship.

In recent years Russia's domestic instability has led to foreign aggression. Assuming Putin tries to declare victory, minimize Ukraine, and stabilize the economy ahead of his March 2024 elections, Russia will remain fundamentally unstable. A decimated economy, a prolonged war (or Pyrrhic victory), and/or a manipulated election are recipes for domestic instability. Again, the Putin regime could become desperate, resulting in major negative surprises. (*Source: **BCA** 11/28/22 www.bcaresearch.com*)"

Iranian Threat

“Turning to the Middle East, do not be surprised if there is an energy war in the Gulf over the next year. Key players are emboldened to take chances at a time when U.S. influence in the region is at an unprecedented low point.

Iran has demonstrated that they can wreak havoc with Saudi energy infrastructure. In 2019, Iran attacked the Abqaiq oil processing facility, the largest in the world (4.5% of global output). Iran hit storage tanks that were replaceable but ***deliberately*** did not take out the vital cooling towers, which would have caused the facility to explode. That would not work if the same cruise missiles, which went right through the Saudi air defense, instead attacked the cooling towers. Only more advanced Patriot batteries would protect them, and these were removed early in the Biden Administration. Abqaiq could be taken offline for 6-9 months, producing a ***colossal oil shock*** that would exacerbate both inflation and recession around the world.



SOURCE: IMF WORLD ECONOMIC OUTLOOK, OCTOBER 2022.

Iranian aggression would likely cause an oil shock, unless deterrence is enhanced immediately. Iran is rapidly progressing across the nuclear threshold. The Supreme Leader, Ali Khamenei, is very sick and not long for this world. His son is likely to succeed him and has no hesitation to develop and deploy nuclear weapons. Israel has been preparing to strategically set back Iran’s nuclear weapons program. An emboldened Iran would ramp up attacks against Sunni adversaries, including Iranian retaliation against Saudi Arabia if attacked by Israel.

The Iranian authorities are more willing to use nuclear weapons than almost any country on earth. This “Armageddon mindset” could spur a dangerous response if popular protests push the regime closer to failure. The discontent is much bigger than the Green Revolution of 2010-2011, as you can see above their inflation rate is over 40% annually plus the Iranian people see what is going on elsewhere in the Gulf where orthodoxy is being moderated. The Saudis under Crown Prince Mohammed bin Salman (MBS) are opening up and modernizing rapidly. Women are driving around, barely wearing head scarves, in sports cars. People are drinking alcohol at parties.

Odds are rising of Middle Eastern instability related to Iran’s nuclear ambitions, which could cause oil prices to go vertical. Iran’s leadership, like Putin and Xi, understand that oil prices can be used as a weapons system.” *(Source: **Alpine Macro** 11/16/22 www.alpinemacro.com)*

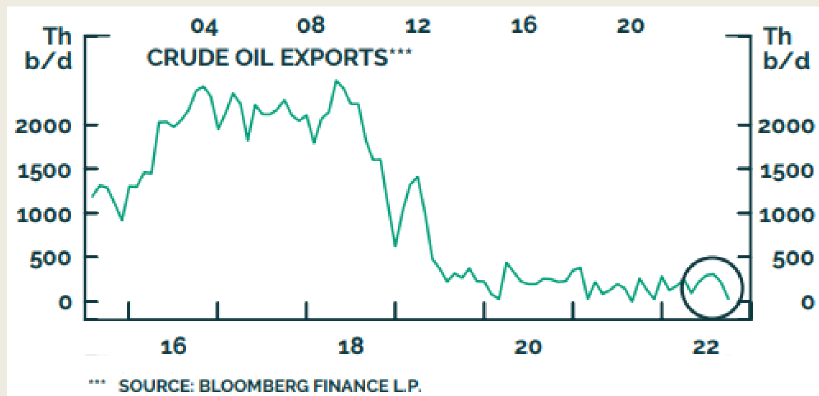
While I think that a true worst case scenario (nuclear Armageddon) is highly unlikely in the immediate future, Iran may well be up to mischief. Current supply and demand levels for oil are extremely tight and just a small nudge in one direction or the other could create huge movements in energy prices in the next year or two. More on this in the oil section.

Take Iran Threats Seriously

Meanwhile the U.S. and Iran have so far failed to agree to a strategic détente. Unless domestic social unrest forces Supreme Leader Ali Khamenei to accept President Biden's offer, a new crisis will emerge in the Middle East. As things stand, Iran could conceivably construct a deliverable nuclear device in as little as two years, setting a clock on potential Israeli unilateral military action. Iran is likely to sabotage Middle Eastern energy infrastructure to warn the U.S. not to let Israel attack. If recession occurs next year, then oil shocks will add to volatility. *(Source: **BCA** 11/28/22 www.bcaresearch.com)*

Iran could launch attacks across the Middle East ***imminently*** according to Saudi and U.S. officials. The U.S. and Iran failed to agree to a strategic détente this year, opening the way for Iran to reach nuclear breakout capacity and Russia to increase military cooperation with Iran. Iran's domestic social unrest is threatening the regime during a critical period, in which leadership succession looms. The regime has already shown willingness to react aggressively abroad.

Supreme Leader Ayatollah Khamenei said on November 2 that Iran is still planning to retaliate for the U.S. assassination of military commander Qasem Soleimani. Meanwhile news reports claim that Iran is planning to launch attacks imminently against Saudi Arabia, prompting higher military alert levels for the U.S, the Saudis, and other regional states. Saudi officials specifically warned that Iran could attack Saudi or Iraqi oil infrastructure to distract from domestic instability. The U.S. National Security Council pledged the U.S.'s willingness and ***ability to defend Saudi Arabia*** and other regional partners against aggression.



As you can see, Iran's primary source of income, crude oil exports have fallen precipitously with sanctions over nuclear ambitions for this country viewed as the world's nuclear pariah.

Still the rumors should be treated seriously because Iranian aggression is expected: Iran's national and regime security is deteriorating at home and abroad.

At home, political opposition is taking advantage of a looming leadership succession. Khamenei is 83 years old and lacks a succession plan. His failure so far to rejoin the 2015 nuclear deal, achievement of nuclear breakout capacity, and decision to supply drones and missiles to Russia for its war in Ukraine all put Iran on the path of conflict with the United States and its allies.

The trigger for social unrest was the death of Mahsa Amini at the hands of the regime's "morality police" on September 16, only 4 days after U.S.-Iran talks faltered. Her death prompted the prime-age population, who make up 62% of the population, to take to the streets where they have been violently repressed by security forces.

With the U.S. political parties now sharing a united front against Iran, and Tehran's regime besieged by a restive population and hostile psychological operations via social media, Khamenei has little choice but to court Russian and Chinese alliance and confront the U.S. and the West.

Most likely the purpose would be to send a warning to the United States. Attacks would disrupt oil supply and signal that a global oil shock will ensue if Iran is attacked, whether through the Strait of Hormuz or Iraq or elsewhere. *(Source: **BCA** 11/2/22 www.bcaresearch.com)*

Bear Market Continues?

As we go to the press the market has had a nice rally off of the October lows. While clearly I could be wrong about this, my view is still that we're in an ongoing bear market, which will graduate from a mama bear to a daddy bear, likely in 2023. For a more full understanding of the different types of bears see our newsletter ***Capitulation Coming?***, *www.cornerstonereport.com*.

The chart you see below shows the S&P 500 since December of last year. As you can see, in spite of periodic bounces, if you draw a line across the tops you clearly see a pattern of declining short-term tops, which is typical in a bear market. Another demarcation for bears is what we call the 200 day moving average. To calculate this you average the price of the market for the previous 200 days and plot that above or below the market. Everyday you throw the oldest day out and put in the new day, thus the average ***moves*** as you go through time. So, a 200 day moving average will always be showing you the most recent 200 days.

The way this tends to be useful, is that it frequently works very well as a demarcation line to delineate between a bull market and a bear market. While we all know that past performance is no guarantee of future results, historically it has been very accurate in providing a tool to help investors differentiate between bulls and bears.

So, historically speaking, when you're in a bear market the current price of the market is typically below the 200 day moving average, which makes sense because the current price in a bear market is falling, thus the previous 200 days will mostly be higher than the current price. So historically when the market is below the 200 day moving average for a significant period of time, that usually means you're in a bear market.

The inverse is true in a bull market, where the current market price is usually above the 200 day moving average. When the market is in a bull market, it usually remains above where it had been previously, thus while no indicator is perfect, it has done a pretty good job, based on my experience of differentiating between bulls and bears.

As you can see from the chart, while the S&P has bounced above the 200 day average a couple of times, it has been failed to stay above it, meaning the bear market has resumed.

It is entirely possible that the market could go above the 200 day moving average for a while, even in this current rally, but I believe the bulk of the evidence lends itself to the continuation of the bear, and the "mama bear" that we've seen so far likely will gravitate toward a daddy (***See Capitulation Coming?***, *www.cornerstonereport.com*).

One thing to remember is that the price of a stock tends to be an extrapolation of the expected future earnings of a company. Add up all the companies together and extrapolate all those future earnings expectations and that will tend to show the likely trend of the market ahead. Remember as we stated in the beginning of the newsletter, look at the leading indicators not the current data.

As we stated in the beginning of the newsletter, the odds of recession in 2023 have continued to increase. So, the question investors should be asking themselves is that if we do have a recession, what will happen to earnings?

In my opinion, over the long-term, earnings are the most determinant of stock prices. Most of everything else is the market attempting to interpret how the Fed, the economy, and other factors will likely affect corporate earnings and thus stock prices.

Currently, analysts are projecting earnings per share growth of 3% globally for stocks next year. All year long, earnings expectations have been falling, but in my view, still have not fallen enough. According to Bank Credit Analyst, historically, earnings have fallen between 15-25%, even in ***mild recessions.***

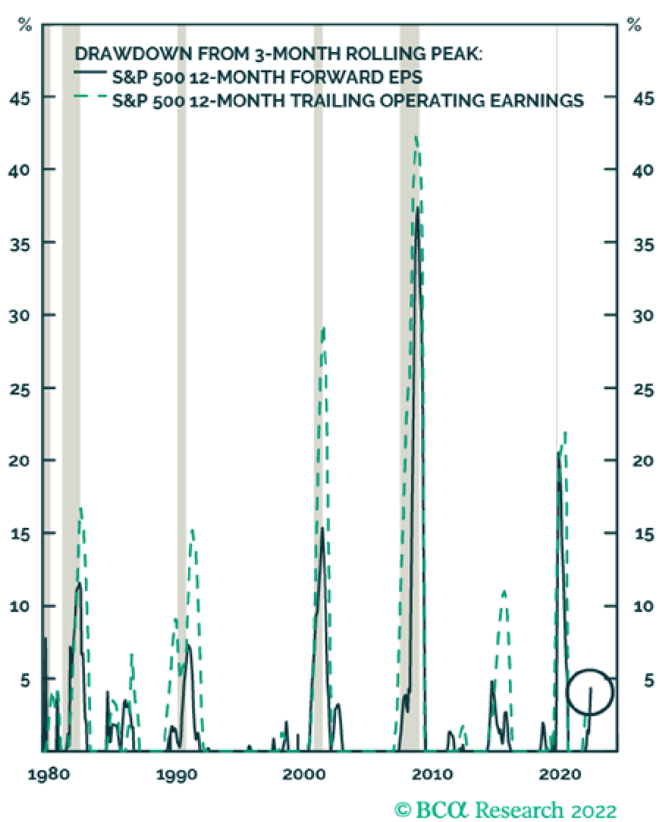
So, if the stock market is currently priced to anticipate 3% earnings growth next year and we end up in a recession, the market is going to have to reprice itself, likely significantly to accommodate a 20-25% drop in earnings. Mind you I said a ***drop in earnings***.

To the right you see a chart showing the most recent recessions and how much earnings fell in each case. While past performance is no guarantee of future results, if I end of being right about next year being a recession, you can clearly see the danger for the market and why it might end up being a daddy bear.

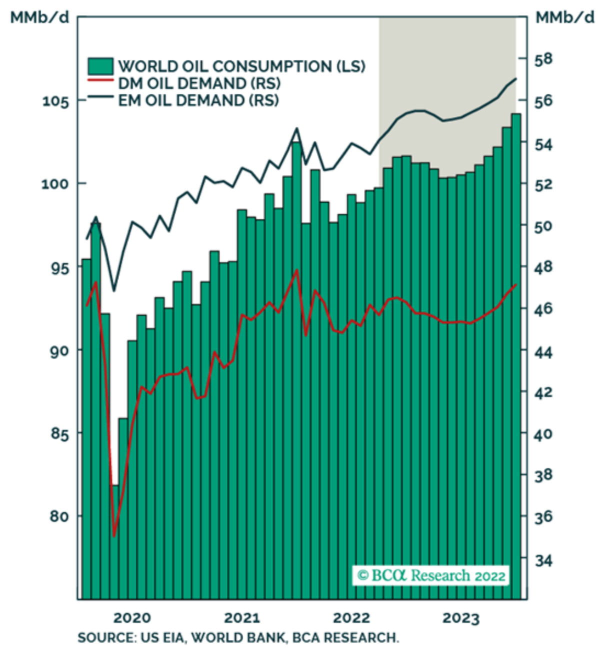
As you can see, the very short lived Corona Virus recession in 2020 (which caused a mama bear market), earnings dropped more than 20%, whereas the 2000 and 2008 bear markets, were much more severe.

In fact, in light of these factors and the likelihood of recession next year, Bank Credit Analyst is projecting the S&P 500 to fall somewhere between 3100-3300 in a recession, a drop of another 17-22% from current levels. Keep in mind that soaring energy stocks plus some defensive stocks have cushioned the blow for the 500 stocks in the S&P 500, masking the degree of carnage in the overall market thus far. Many stocks are down much further. Should BCA prove to be right, this would definitely qualify as a daddy bear.

As we discussed in ***Capitulation Coming?,*** historically speaking prior to daddy bears, the market had reached levels of extreme overvaluation, extreme margin debt (both of which existed in ***spades*** prior to the bear starting), but the final nail in the coffin, so to speak, was typically a recession. So, a very overvalued stock market, extreme margin debt ***plus*** recession combined, typically produce a daddy bear.



Global Oil Supply/Demand



To the right you see a chart showing the world oil consumption. As you can see, world demand crashed during the Covid crisis, from just under 100 million barrels a day (green bars left axis) to just over 80 million barrels a day during the crisis.

Now, world demand has not only completely recovered but is now moving to all time highs.

Another important note in this chart, is that they show the emerging markets oil demand (EM oil demand black line right scale). As you can see, the emerging markets of the world (China, India, Indonesia, etc.) are now making up not only the majority of the oil demand for the world, but also growing at a much faster pace than the developed markets (U.S., EU, Japan). The developed markets are shown with the red line.

Regardless of how optimistic green energy proponents would like to be, one fact you cannot deny is that global demand for oil is steadily rising, and has been rising rapidly for the last decade and will likely continue to rise sharply due to the emerging markets buying and driving cars.

The latest statistics we have show that China has gone from 70 cars per thousand people to approximately 205 cars per thousand people in the last decade. Bank Credit Analyst is projecting that China could match South Korea's penetration for cars within the next 5 years or so. South Korea presently has approximately 450 cars per thousand people. Remember China has ***1.3 billion people***.

As much as I hate to disappoint green energy adherents (and I personally have no problem, in fact, favor alternative energy over the long-run), we have to be realistic here.

The 1.3 billion people in China are not particularly worried about climate change. When they start making enough money to qualify for middle class status in China ($10,000-15,000 per year), one of the first things they want to do is buy a car.

In the last 15 years, China has experienced the most massive buildout of infrastructure in world history, building out hydroelectric dams, airports, high-speed rails, and highways at the greatest rate in history. The communist regimen's "command economy" actually started building the highway infrastructure prior to the Chinese citizens buying cars en masse.

Thus the long term supply and demand picture shows emerging markets like China, India, etc., likely driving world oil demand significantly higher over the decade.

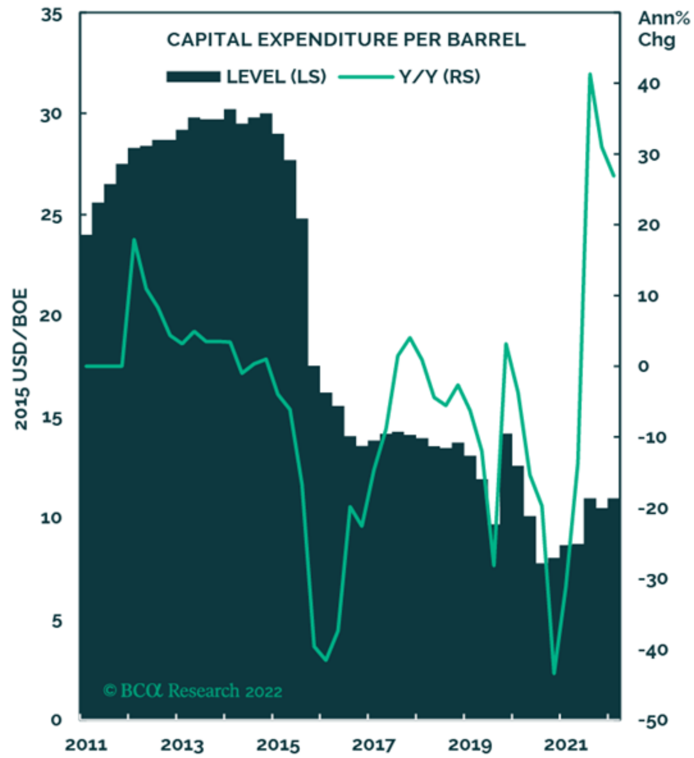
As citizens of these formerly undeveloped nations become developed nations, they're able to see on the internet and social media what other people around the world are experiencing and ***they want it!***

Thus, there is likely to be an insatiable demand for oil from these emerging markets at least through the end of this decade, probably well beyond, and there is no way, in my opinion, that alternative energy sources can reasonably meet this demand.

So the demand for oil over the next decade plus, will likely keep growing rapidly.

What about the supply?

To the right you see a chart showing capital expenditures for oil and gas companies over the past decade or so. As you can see, the amount of capital flowing into finding new oil and gas reserves has radically declined since the early 2010's. Part of this, in my opinion, is due to two bear markets for oil (2014 and 2020) plus media, social, and political pressure to stop "global warming" or climate change.



SOURCE: US EIA
NOTE: BOE=BARREL OF OIL EQUIVALENT. THE US EIA DID NOT PROVIDE DATA FOR Q4 2015

But what green proponents don't seem to understand is that the more they "punish" or discourage the traditional oil and gas industry, the more they are actually enriching energy companies and investors.

Ironically, energy policies, which I believe are bad for our country, can actually be potentially beneficial for us as investors.

World demand will likely continue rising, a pretty safe assumption given that almost a third of the world's population is moving toward developed nation status. They will likely be buying millions of cars over the next decade plus. So by discouraging oil and gas investments, green energy proponents could actually be creating a potentially incredible opportunity.

All of this points to the likelihood of rising oil prices over the long-run, but when you factor in potential geopolitical disruptions this could actually blow the top off of oil.

Robert Ryan, Senior Analyst for Bank Credit Analyst has projected a range of potential outcomes next year. Even assuming a mild recession he's projecting $115 a barrel due to supply and demand factors in 2023. However, the range of possibilities is higher than anything I can remember in my 41 year career.

In a severe recession (like 2008, which is neither their or my base case) and absent any geopolitical problems, he projects $50 a barrel next year. However, if there are any significant geopolitical problems next year with oil, he is projecting oil could easily go over $200 a barrel.

While I am certainly not an advocate of polluting the earth, as we are called to be God's stewards of the earth, the push towards alternative energy, while it may be the best move possible over the long-run, can simply not get there in my opinion on a time scale that will suit left wing radicals.

50 years from now, oil may be like whale oil, completely obsolete. But any rational analysis in my mind shows that this is likely decades away, not years away and the harder that the far left pushes on this issue the more likely oil investors will be rewarded.

Wishful thinking, utopian-type realities which some on the left have as their world view, in my view, do not lead to ***Smart Money*** investments.

Rational analysis based on the facts, are more likely to produce investing prosperity in the long-run.

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