Cornerstone Report

Special Report | December 21, 2015 | By: Jerry E. Tuma, MS, CFP®

Jerry E. Tuma, MS, CFP®

Topics:

- Stocks Appear to have Topped
- U.S. Econo-my—Recession Next Year?
- It's All About China

Changing the Way America Thinks About Investing.™

2016 Year in Preview

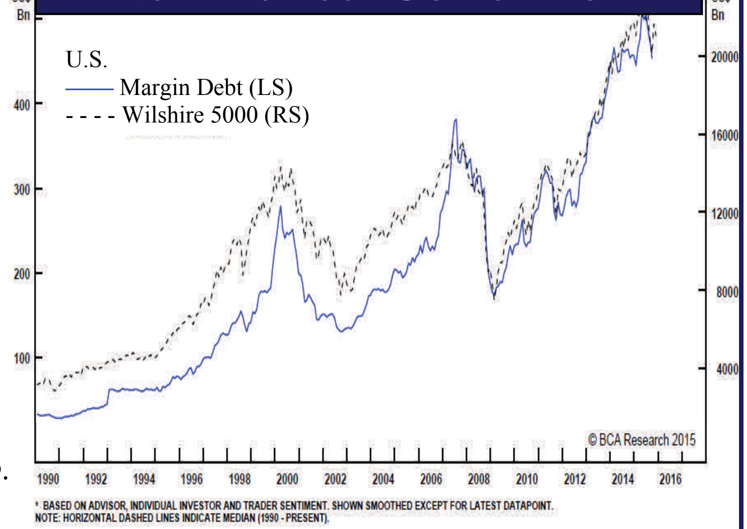
It appears that the market is in the ***process*** of topping out, probably the final stage. As I've often said, market tops are generally not an event but a process, which can take 12-18 months.

My view remains unchanged, and thus far I've seen NOTHING that doesn't align with our April Special Report entitled "***2015 Year in Pictures: The Good, The Bad, and The Ugly***." (www.cornerstonereport.com/newsletter)

Stocks Appear to Have Topped

Earnings—appear to have topped for this cycle and are now headed down. Wall Street analysts tend to ***overestimate*** earnings during a bull market, especially as you approach the top. This time appears to be no exception, but reality is that ***earnings are now falling***! Corporate earnings ***fell 3.3%*** in the 3rd quarter and are currently projected to ***fall 5%*** in the 4th quarter of 2015 (source: *S&P 500 Earnings Slumped By Most in Six Years*, *Worse to Come*, Bloomberg Brief, 11/23/2015).

Near Perfect Correlation



We have stated all year that we felt that earnings were in the process of topping. The proof is now in the pudding.

Margin Debt—also appears to have peaked. Borrowing money to buy stocks increases the ***demand*** for stocks, pushing prices higher. But remember the old Wall Street adage "trees don't grow to the sky."

Every market cycle has a ***top***. No exceptions. From everything we see currently, this appears to have occurred in July, although we won't know for certain until later.

Another adage is that "bull markets go up on an escalator, bear markets go down on an elevator." This is true in part due to leverage (margin) combined with fear. According to most studies in behavioral finance, fear is a more powerful emotion than greed.[1] (Source: 1. Why Smart People Make Big Money Mistakes, Gary Belsky, Simon & Schuster, January 12, 2010)

On the way up, investors make money faster, borrowing money, but this is a double-edged sword. ***"...margin debt is "hot money" that must be quickly unwound (i.e., position sold) when a bear market strikes in full force."***[1] Going down, losses compound twice as fast. If the July top for margin debt holds, this likely indicates the top of the market cycle is in . (Source: 1. Investech, December 2015)

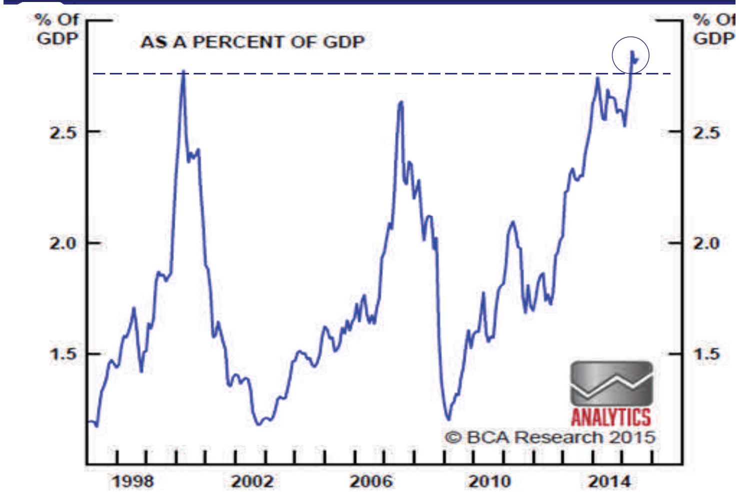
Stocks Appear to Have Topped Continued

You can also see margin debt as a % of GDP is ***actually higher than it was before the 2000 and 2008 bear markets!***

Debt levels are relative. A person making $1 million dollars a year who owes $100,000 on their home is one thing. But a person making a $100,000 a year who owes $1 million dollars on their home is an entirely different matter.

Margin debt for stocks compared to the nation's (GDP) issues a much clearer picture, and as you can see it's at the highest point in history.

Margin Debt VS GDP

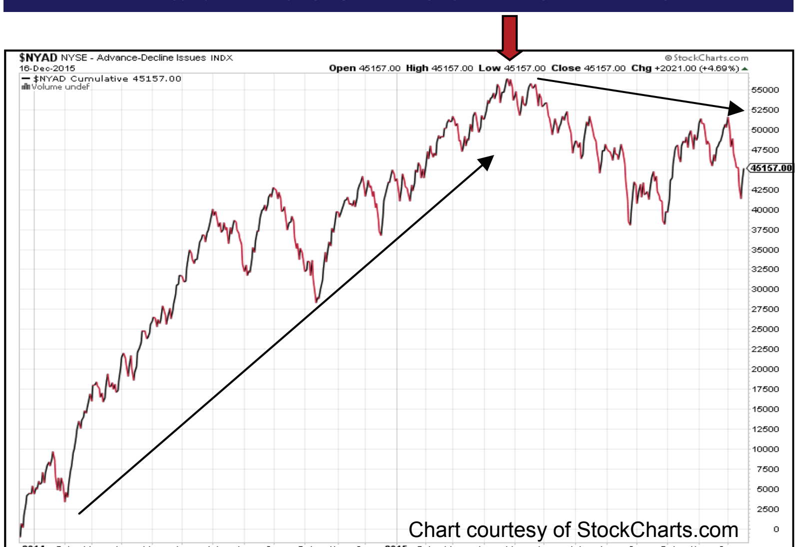


Advance/Decline Line—While past performance is never any guarantee for the markets, historically the advance/decline (A/D) line tends to peak BEFORE the stock market. This is also known as the market's breadth.

The A/D line measures the number of stocks going up (advancing) divided by the number of stocks going down (declining) measuring the ***internal*** health of the market.

In a healthy bull market, "a rising tide lifts all boats." In other words the vast majority of stocks rise right along with the bull. However, when you are at or near a major turning point and the market is in ***transition*** between the bull and the bear, the ***A/D line generally peaks first and typically gives several months warning <u>before</u> the overall market tops out***. This appears to have occurred earlier this year, as the A/D line topped out in late April, as noted by the red arrow.

Advance / Decline Line



Most stocks were rising until the end of April. Since then the market's breadth has weakened.

The Dow Jones Industrial Average, made up of 30 large blue chip stocks, peaked almost exactly a month later, May 20th. The S&P 500 peaked July 20th and the Biotech Index, which appears to be one of this cycle's "bellwether" sectors (more on this later), topped on July 21st! While this could reverse, it appears the A/D line topped in April with most of the market topping by July.

Another adage regarding the A/D line is the "troops are not following the generals." Typically late in the bull market a small number of very large, liquid "safe" stocks and/or the hottest stocks of the current cycle continue rising while the vast majority of companies decline. At major turning points the "generals" hold up or advance while the "troops" begin to retreat, typically signaling defeat for the army (stock bear market).

From my experience, when a weakening A/D line persists for a long time (and it has now persisted for over 6 months), it has typically been one of the most accurate ***indicators of an approaching bear market***.

Thus for stocks, I believe a major storm is approaching. Right now no one can guarantee how bad that storm might be, but we do know based upon history that when stocks become as overvalued as they are now, with the S&P 500 at 22.71 trailing price to earnings (P/E) ratio[1] and margin debt this high, this usually signals a major storm (NOTE: The A/D line is **not** used to measure the magnitude of the storm, but rather the ***timing*** of the storm). (See ***2015 Year in Pictures*** on our website: www.cornerstonereport.com)
(Source: 1. Markets Digest, Wall Street Journal, 12/7/2015)

From my perspective, I feel the wind, and I think I know the direction the storm is coming from. But I can't tell you exactly if the storm is one, 10 or 50 miles away. But I'm getting wet.

I believe another major market storm with the potential to be at least a class 3, possibly a class 5 hurricane is on the way, but no one can tell you exactly when it's going to arrive. My guess would be the next 12-18 months, with the ***worst likely starting the second half of 2016***.

U.S. Economy—Recession Next Year?

The U.S. economy continues slowing and may head into recession in 2016 or 2017, but as of this writing I do not believe has the potential to be as bad as 2008. In other words, I do NOT currently believe that the U.S. economy has the potential for near systemic failure, as nearly occurred in 2008. A recession may very well still occur, combined with a severe bear market for stocks.

It is possible for the U.S. to have a ***mild*** economic downturn probably with a severe bear market, similar to what we experienced in 2000-2002. The U.S. had only a mild recession (defined as at least 2 consecutive calendar quarters of ***negative*** GDP growth), but a severe bear market for stocks, with the S&P 500 going down almost 50% and NASDAQ declining almost 80%.

Evidence of economic weakness includes ***U.S. Inventories* —** which have been skyrocketing, indicating products manufactured are sitting on the shelves. This typically happens just before recessions. Please review our "Canaries in the Coal Mine" section of ***2015 Year in Pictures*** in our April Special Report. The canaries have continued to decline (www.cornerstonereport.com).

So in sum, I do not believe that America is in major economic jeopardy similar to 2008, and in fact will likely be buffered from the coming economic storms, which I believe will primarily come from overseas, especially Asia, but I DO believe the stock market is about to experience a major bear market.

It's All About China

Since 2008 the U.S banking system has been significantly reformed, and the U.S. economy is likely to remain the anchor for the world's economy, but the U.S. has not been the primary source for economic growth in the world for some time. Remember, that China is now the second largest economy in the world with $9.3 trillion GDP vs. $16.7 trillion GDP for the U.S. (The Eurozone is made up of multiple countries).[1] "Until recently, ***China has been the growth engine of the world***, representing 45% of the world's growth as recently as the 2nd quarter of 2014."[2] (Source:1. BCA, March 2015, 2. *World GDP Growth*, Economist, 9/13/14)

As you can see from the table, everything in China has softened, with manufacturing falling off the table. China is attempting to convert from a manufacturing/ infrastructure economy to a consumer based economy, but this doesn't appear to be a smooth handoff, as manufacturing growth has essentially disappeared.

China's banking system appears to have encountered enormous problems, with Chinese bankers resorting to "extend and pretend" tactics that many U.S. bankers were forced to follow after the subprime debacle.

Chinese Growth by Industry

	Services	Manufacturing
12/31/2010	18.45%	19.2%
12/31/2011	16.84%	14.9%
12/31/2012	13.25%	6.5%
12/31/2013	13.17%	8.0%
12/31/2014	11.13%	4.8%
09/30/2015	11.94%	0.2%

A. Gary Shilling INSIGHT, November 2015

Banks Raise Dams, Fend Off Toxic Debt Crisis

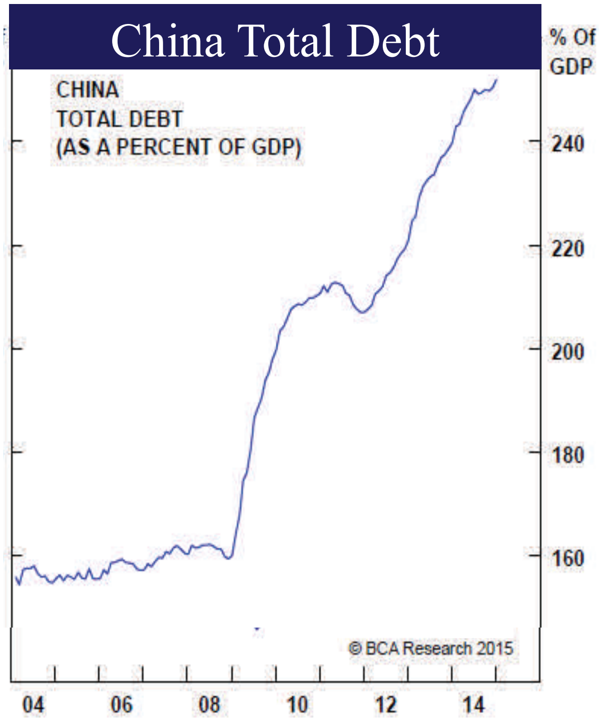
"Figurative dams and diversion canals have been popping up across China's financial landscape as banks scramble to prevent a flood of toxic debt. So far, creative engineering has helped bankers keep non-performing loans under control. Banks have found ways to sell off bad debt and roll over loans. Meanwhile, the People's Bank of China and China Banking Regulatory Commission (CBRC) are testing a new bad-loan securitization program.

Banks are working to reduce bad loan ratios. A bank employee in the southwestern city of Chengdu said many banks package and "sell" bad loans to insurance companies, securities firms and trusts. At the same time, the banks agree to buy back the debt in five to 10 years.

These agreements make a bank's "real bad-loan ratio unclear", the source said, adding that in fact "there are many ways for a bank to move bad assets off a balance sheet."

For instance, he said, some banks persuade their employees to buy property that had been used as collateral by a delinquent borrower. Others sell the assets attached to bad loans to private or state-owned companies."

Source: *Banks Raise Dams, Fend Off Toxic Debt Crisis*, CAIXIN, Things That Make You Go Hmmm, December 2015



"Managing rising debt levels to date has been a tricky affair. The key for many successful bankers has been to, by creative means, keep bad debt off their balance sheets.

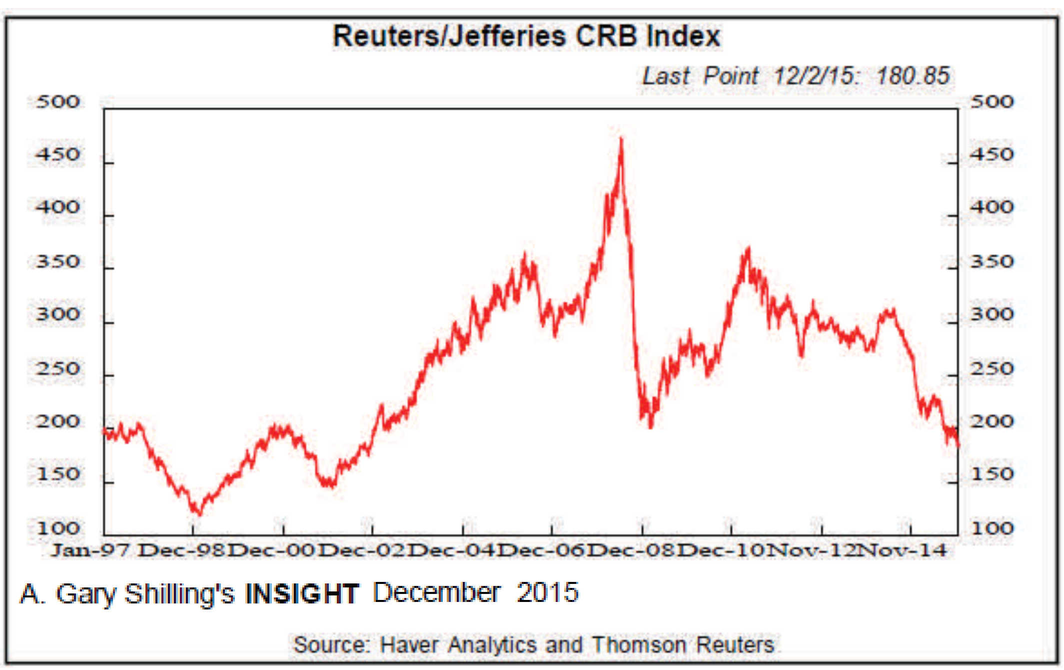
Industry sources said that some banks have let borrowers take out new loans to repay old debt. Another trick involves scaling down overdue loan levels by adjusting loan contracts or swapping assets. In some cases, banks have partnered with trusts, fund companies or asset management firms in ways that let them shift bad loans off their balance sheets and onto the partners."

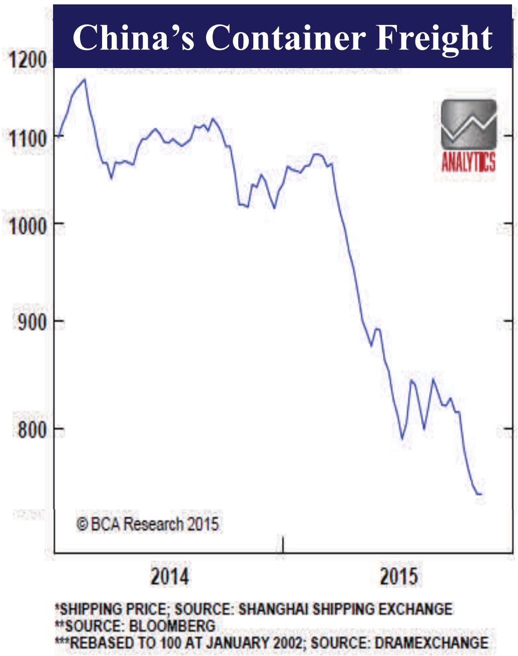
Source: *Banks Raise Dams, Fend Off Toxic Debt Crisis*, CAIXIN, Things That Make You Go Hmmm, December 2015

Meanwhile debt levels in China and other emerging economies have skyrocketed, while economic activity is slowing significantly.

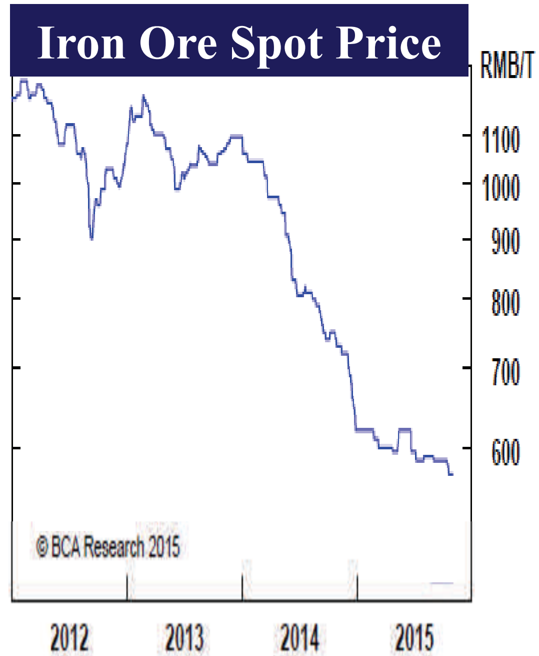
Commodities have fallen steadily since 2011, which is a big issue as China's economic growth has been primarily driven through building cities, skyscrapers, airports, hydroelectric dams and roadways, ***the largest infrastructure build-out in world history. "***It's safe to say that China has had the single-biggest buildout of infrastructure in the history of mankind."[1] (Source: 1. *China's next chapter: The Infrastructure and Environmental Challenge*, Jonathan Woetzel, McKinsey&Company, June 2013)

China has regularly experienced double digit growth rates but now the official rate is below 7%. My personal opinion is that it is probably closer to 4%. As their economic growth rate has slowed, commodity prices have consistently been sinking, which poses problems on two fronts:





China's Banking System. Many of China's "non-official" banks (known as shadow banks) became involved in creative investment schemes using inventories on commodities such as steel, or iron as collateral for loans and other "investments". This is reminiscent of the "off balance sheet financing" in the U.S. system, which blew up Bear Stearns and Lehman Bros. in 2008.



Keep in mind these are not typically China's big four "official" government owned banks (which regulators could more easily monitor) but "unofficial", off-balance-sheet financial instruments, trusts and the like that banks and other entities sponsored.
This practice appears to have become prevalent in the Chinese banking system.

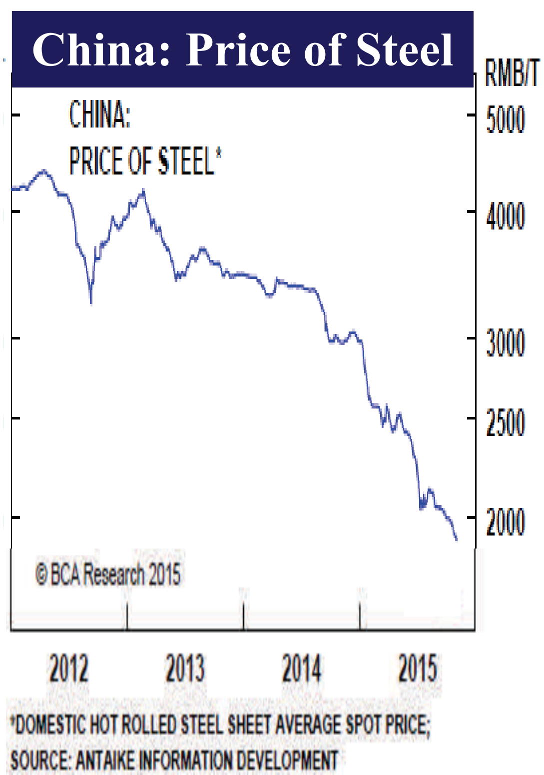
Emerging Markets. The *Economist Magazine* recently published a cover story on the ***Credit Crisis III*** highlighting:

- Part I: U.S. banks, Wall Street, Sub-Primes
- Part II: Europe, EU Banks, and Euro
- Part III: China and Emerging Markets

(Source: The Never-Ending Story, Economist Magazine, 11/14/2015)

We now appear to be entering Part III.

Given that China has largely been the engine of world economic growth for some time, commodity-dependent countries, including Canada, Australia and South Africa, are likely to continue to suffer. Plus most Asian economies (which are closely linked to China's economy) are likely to suffer as well.



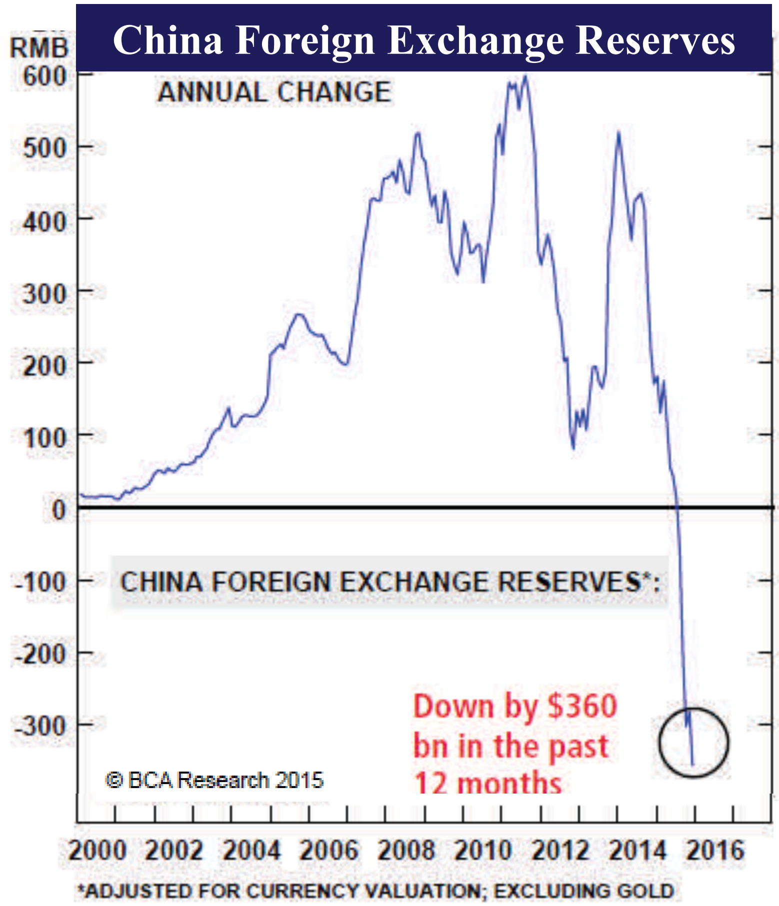
Believe it or not, the European banking system (which is still very fragile from Part I and II) provided much of the financing for China and other Asian economies. I do not believe that China will collapse, but a major shake up is process.

The question is, how long and how deep?

The answer is no one really knows and Chinese government officials certainly aren't going to tell anyone. Problems appear to go very deep and will almost certainly take years to work off.

"China's foreign exchange reserves excluding gold have dropped by $360 billion from a year ago, after adjusting for the currency revaluation effects. Such a large drop in international reserves and the growing current account surplus suggest that capital outflows remain enormous."[1] (Source: BCA, Emerging Markets Strategy, 12/9/2015)

If capital outflows are any clue, investors appear worried as well. While the Chinese government certainly has enough money to bail out their banks, the credit bubble in China will have to be detoxed, and this will likely take years, not months.



In sum, everything I see points to another major storm involving the stock market, probably of historic proportions. This includes China, most of the emerging economies and probably Europe.

This may not be a storm that you want to ride out.

Dollar Surge Endangers Global Debt Edifice, Warns BIS

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

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

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

Patterns of History

I previously mentioned "bellwether" stocks and/or sectors of the market. Besides China's stock bubble (see ***2015 Year in Pictures***), market sectors such as biotech and social media have been the darlings of this cycle.

Historically, each bull market exhibits similar characteristics. While nothing is perfect, as you can see on page 9, the patterns of history tend to repeat themselves to a remarkable degree. We originally used these charts back in the early 2000's, demonstrating to investors just how similar each pattern has been.

Manias By Decade

1960's	**Technology**
1970's	**Gold, Oil**
1980's	**Japan**
1990's	**Tech and Dotcoms**
2000's	**Real Estate**
2010's	**Biotech, Social Media, China**

(Source: Jerry Tuma)

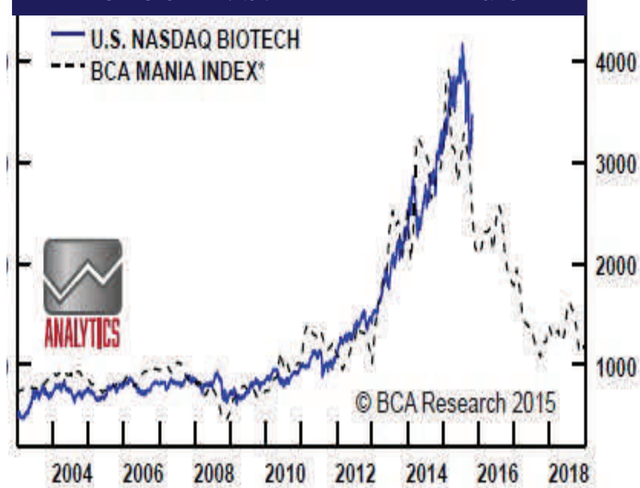
Housing Index

In each case, regardless of whatever the mania (or bubble) of each respective bull market, the pattern starts with a rapid rise, then becomes a straight up exponential move, culminating with what is referred to as a "blow-off" top.

In each case the respecting market moved to ridiculous extremes, topped, then attempted to regain the top. ***Once that subsequent rally failed,*** the price bubble collapsed, moving down generally at least 50%, but often as much as 90% (the bigger they are the harder they fall). It typically it takes years to recover, ***if indeed recovery ever occurs.***

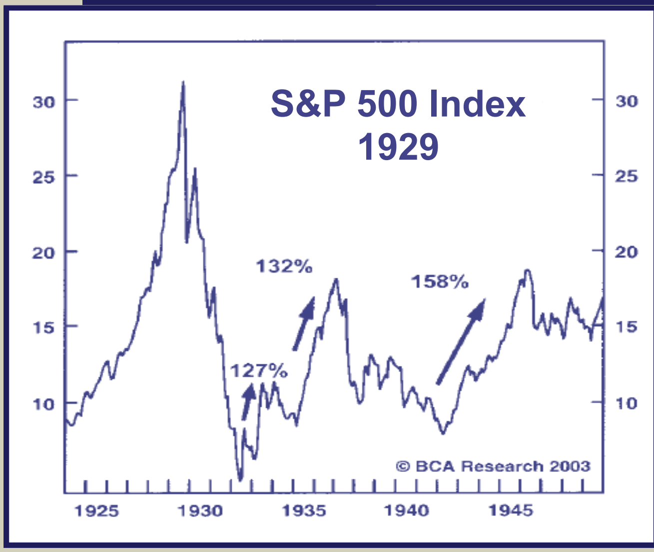
Japan has still NEVER recovered back to its old high. Gold took 28 years, NASDAQ 15 years. The Dow in 1929 took almost 25 years to recover.

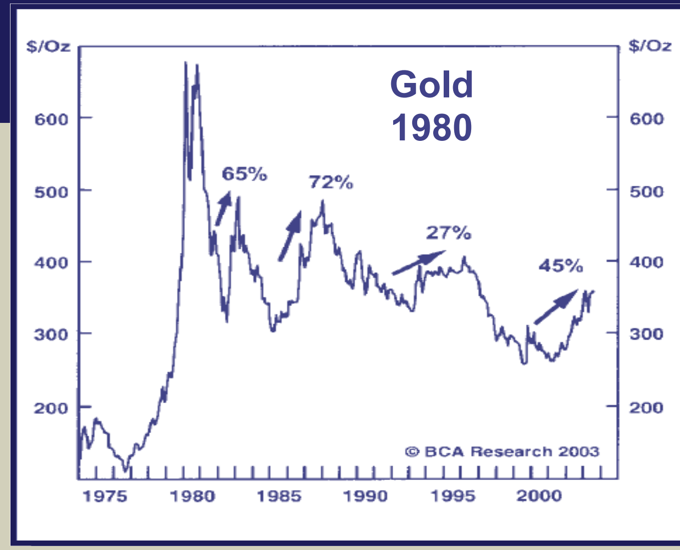
Biotech vs. Mania Index

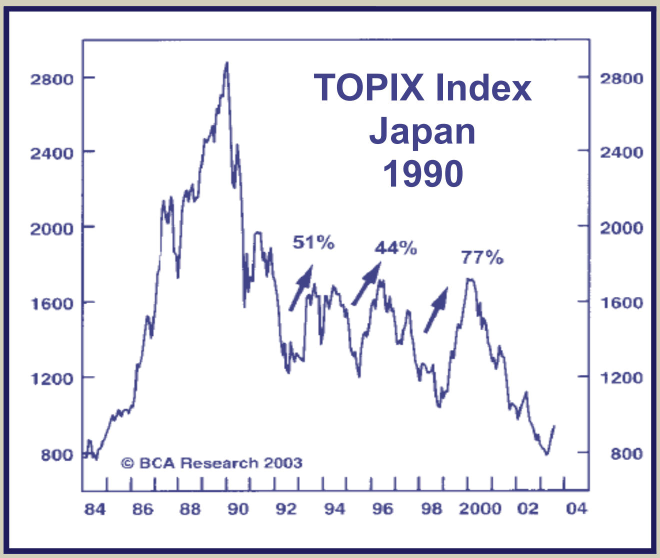


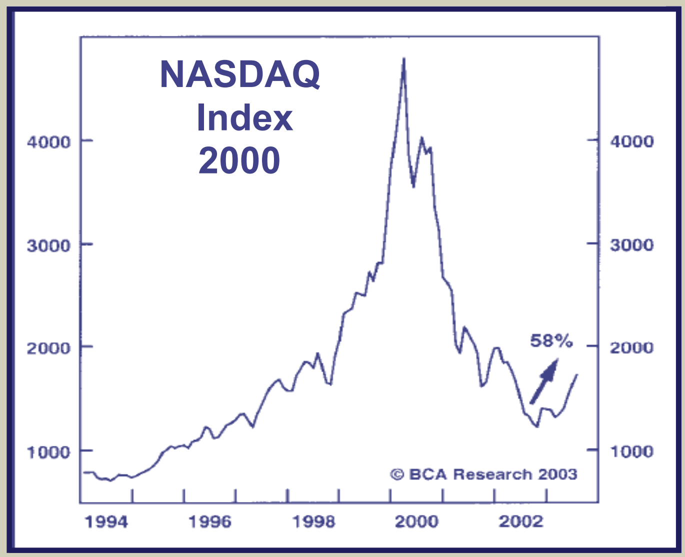
* REGRESSION USING PREVIOUS BUBBLES IN THE NIKKEI, NASDAQ, GOLD, SILVER, THE S&P 400, THE US$, TAIWANESE EQUITIES, NICKEL AND COCOA PRICES.

Previous Manias 1929-2000









* Based on fitted values +/- 2 standard deviations from a regression on the Japanese Nikkei 225 index in the 1980s, gold in the 1970s and the S & P 400 in the 1920s.

Each of these charts show remarkable consistency of pattern, despite different time frames and countries.

Human emotions involving greed and "get-rich-quick", combined with leverage, can be dangerous as they play out in the marketplace.

Beware the bubble!

> "History doesn't repeat itself exactly but it rhymes."
> -Mark Twain

Patterns of History Continued

As we've said, patterns of history tend to repeat themselves.

So what should we learn from this? Each cycle normally has a darling or "bellwether" sector(s). Biotech (see chart) and China (2015—not shown) appear to have already peaked (in July) and are following the familiar pattern.

In every bull market I am familiar with, at least one sector became the darling, rose exponentially, then crashed. What does this tell us about the current cycle? This probably means that the current bull market is living on borrowed time.

Virtually every sign that we have historically used to identify major tops looks to be in place, except for a handful of social media stocks, which may not have peaked yet but likely will soon. While the market is still not far from its all time high I believe its momentum has shifted.

Proponents of behavioral finance have studied the history of bubbles extensively (see ***Contrarian Strategies*** by David Dreman). In experiments, they have discovered that investors tend to repeat similar mistakes again and again, creating bubble after bubble after bubble. However in each cycle, the sector or bubble area of the market ***rotated to a different sector***.

Burned by technology and dotcoms (2000) investors moved to housing (2006). Burned by housing, investors moved to China, biotech or social media (2015). In each case, to quote the late Yogi Berra's son Dale, "the similarities are different."

The pattern of trading looks almost identical but the ***sector*** of the market shifts. Once the current mania's darlings have topped out (as biotech and China appear to have), the bull market has generally either peaked or is very close. My guess would be that social media stocks will likely top soon if they haven't already — possibly by January.

The lesson of history is:

1. Expensive stocks PLUS
2. Lots of Margin Debt PLUS
3. Mania / Bubble Stocks = Really BIG bear market.

End of story.

"That which has been is what will be, that which is done is what will be done, and there is nothing new under the sun." *Ecclesiastes 1:9*

(Source: New King James Version, 1979, 1980, 1982, Thomas Nelson, Inc.)

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

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

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

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

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

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

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

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

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

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

David McCord, CMT,
Contributing Editor