Bull, Bear *Or* New Normal?

An analysis of the major trends that should impact the economy and markets for years

CORNERSTONE
INVESTMENT SERVICES, LLC

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John J. Riley
Chief Strategist
johnr@cornerstoneri.com
www.cornerstoneri.com
401-453-5550

Commentary

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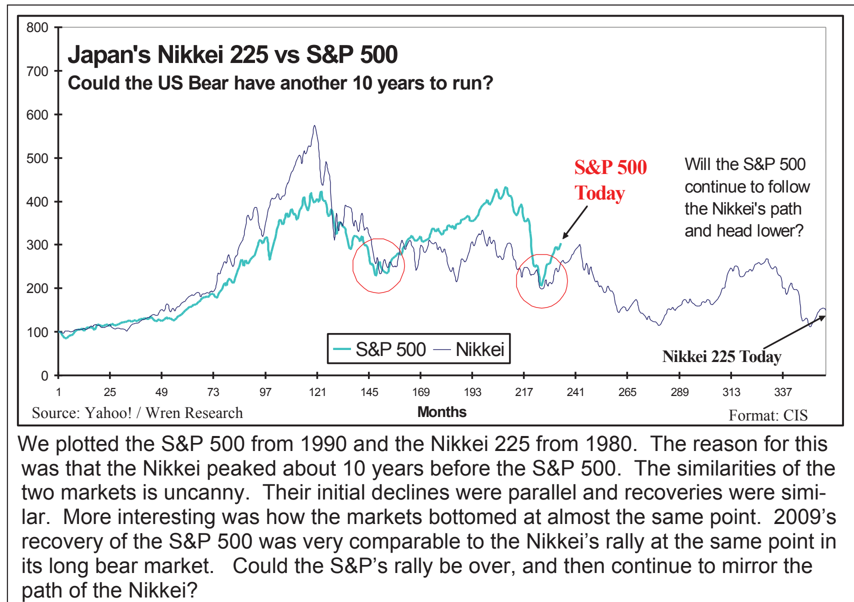
Bull, Bear, or New Normal?

Do not drink poison to quench a thirst *- Chinese Proverb*

Within any macro trend (long term), there are counter-trends (short term). These counter-trends can typically be mistaken for reversals of the long term trend. Usually, fundamentals will determine whether a counter-trend is short-term or a reversal of the macro trend.

Cornerstone (CIS) believes 2009's stock market rally was a snap-back reaction to an unprecedented perfect storm of crises in 2008. As a short-term counter-trend, which is not unusual, bear markets can have explosive rallies. The 20 year long term decline of Japan's stock market, the Nikkei 225, is a good example of a bear market with huge rallies, only to give the gain back with lower lows. When we compared the Nikkei's bear market and the S&P 500's bear market we created a surprising chart. (Right)



We plotted the S&P 500 from 1990 and the Nikkei 225 from 1980. The reason for this was that the Nikkei peaked about 10 years before the S&P 500. The similarities of the two markets is uncanny. Their initial declines were parallel and recoveries were similar. More interesting was how the markets bottomed at almost the same point. 2009's recovery of the S&P 500 was very comparable to the Nikkei's rally at the same point in its long bear market. Could the S&P's rally be over, and then continue to mirror the path of the Nikkei?

Enter 2009. While the media and Wall Street are clearly focused on a recovery and a new bull market, we see that the stock market's rally in 2009 was almost identical to the recovery rally the Nikkei had at the same point in their 20 year bear market.

I've noted where the S&P 500 is on the chart above and you may notice that at this point, the Japanese market reversed course and went into its third leg down. Their bear market resumed.

The question on everyone's mind today is will the US continue higher, or will there be another leg down to the US bear market? The Nikkei has had 10 more years (so far) of a bear market from the same point as the S&P finds itself today.

Conclusions:

This is a long report, so for those that like to read the end of the book first, our initial conclusion is that the Bullish Scenario has too many fatal flaws and is dependent on bad policy and foolish strategies, in order to be successful. It also certainly raises questions about the long term viability of the US economy.

What some are calling the New Normal is the best case scenario. Frankly, it disgusts me. It is not normal. It is the US slowly giving up Capitalism and accepting Socialism to avoid the short term pain that is a consequence of the financial excesses and irresponsibility of the previous 13 years. As Nouriel Roubini has said, "We're essentially continuing a system where profits are privatized and...losses socialized." This is not capitalism. (Howard Dean (D), Chairman of DNC from 2004 - 2009 said in a speech on 04/05/09 – "I think the debate for the new generation is instead of Capitalism or socialism is - *we are going to have both* - and which proportion of each should we have…")

The Bear Scenario, unfortunately, is the most logical and rational. Weighing the data and analyzing the charts and trends has given us an understanding of how the current circumstances can affect the future markets and economy. There will be consequences, intended and unintended, to what the Fed has done for the past 2 years that will impact the economy for years to come. CIS believes investors should prepare for the bear market in US stocks to continue, a bear in US Bonds to begin and volatility in all markets to increase. Hiding in cash or bank CDs won't be the solution though.

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As we have reiterated all along, there are many investments that we strongly believe could benefit from both the New Normal and Bear scenarios. With the proper investments and strategies, investors should be able to profit from the developments we anticipate.

Below is a recap of our expectations for asset classes going forward.
Symbol Key:

H - Hold	S - Sell/Short	S/T - Short term
O - Overweight	U - Underweight	I/T - Intermediate Term
		L/T - Long Term

Cornerstone's expectations for various asset classes

		S/T	I/T	L/T	
Currencies	**Dollar**	O	S	S	Potential S/T rally. Bear could last years, possible loss of reserve currency status
Fixed Income	**L/T US Treasuries**	O	U/S	S	Potential S/T Rally if Dollar rallies. Long term bear could last years
	L/T US Treas TIPs	O	H	H	Good hold for hedge on inflation
	L/T Muni's	U	S	S	State/local balance sheets and income continues to get worse for years
	L/T Corporates	U	S	S	Credit crisis could resume, but the Fed may not have the ability to bail it out
	L/T Junk Debt	U	S	S	Credit crunch hits Junk debt the hardest.
	S/T US Treasuries	O	O	O	Good parking place for cash
	S/T US Treas TIPs	O	O	O	Good hedge on inflation
	S/T Muni's	H	H	H	Parking place for cash.
	S/T Corporates	S	S	S	Potential for credit market lock-up too great, especially in S/T corps
	S/T Junk Debt	S	S	S	Worse for Junk debt
	Foreign Debt	U	O	O	Benefits from Dollar bear, risks of spreading financial crisis could add volatility
	Emerging Mkt Debt	U	O	O	Benefits from growing Em Mkts, spreading financial crisis could add volatility
Equities	**US**	S	S	S	Bear market rally looks to be running out of steam, bear to resume soon.
	Developed Mkts	S	S	S	Bear market rally looks to be running out of steam, bear to resume soon.
	Developing Mkts	U/S	O	O	Recovery in 2009 will likely have a pullback. This should be a buying opp
	Emerging Mkts	U/S	O	O	Recovery in 2009 will likely have a pullback. This should be a buying opp
Commodities	**Energy/Oil**	U/S	O	O	S/T Oil could pullback, long term depletion will become more of a factor
	Prec Mtls	U/S	O	O	S/T could pullback due to a Dollar rally, L/T a hedge on inflation and Dollar
	Ag	U	O	O	Beneficiary of Urbanization of Developing Countries
	Building Materials	U	O	O	Beneficiary of Urbanization of Developing Countries

Definitions of terms:
O - Overweight - Asset class we anticipate to have a higher allocation within the CIS Model portfolio. We anticipate Overweighted asset classes to out-perform.

U - Underweight - Asset class we anticipate to have a lower allocation in the CIS Model portfolio. We anticipate Underweighted asset classes to under-perform.

S **- Sell/Short** - Asset class we believe is overvalued or anticipate to have negative performance.

H **- Hold** - Asset class we don't expect out-performance from, but don't expect under-performance from either.

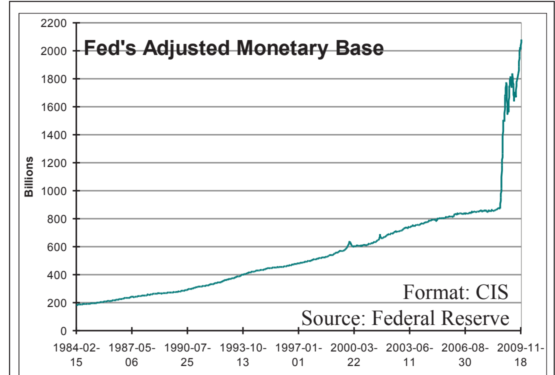
CIS allocations are not based on the S&P 500 or other market indices, but according to CIS internal research. CIS will shift asset allocations according to our internal research, short term, intermediate term and long term cycles and trends.

No guarantee in given or implied that any asset class will perform as expected.

This information is for application to CIS managed accounts and opinions may change without prior notice.

Background:

2008's financial crisis was the inevitable conclusion to the debt and derivative build-up of the previous 13 years. The Federal Reserve came quickly to the rescue of the financial system at the expense of the economy and the American people.



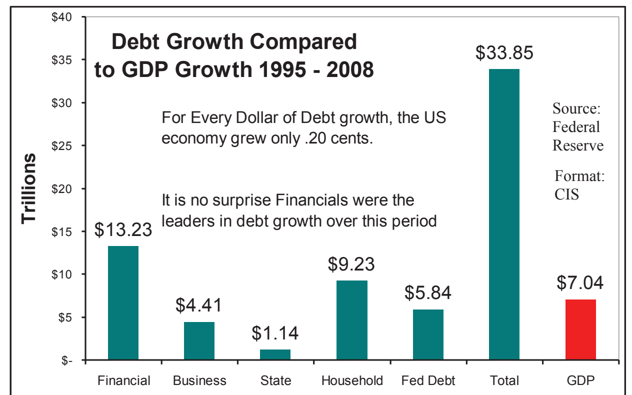
The Fed's response to the Financial Crisis was to flood the system with liquidity. The Monetary Base went up by over $1.2 Trillion, with 400 billion coming in after the recession "ended." If the recession is over, why are they still adding liquidity with such force?

CIS has been writing about these issues for years. It was no surprise when Bear Stearns collapsed, Fannie Mae failed and Lehman Brothers and other banks and brokers disappeared. A toxic mix of debt and derivatives brought down each of these institutions. They were playing in an arena with few rules and little to no oversight. Unfortunately for the rest of us, their problems helped to bring down the housing market and the economy.

From one perspective, the Fed has managed the Financial Crisis quite well. They bailed out big banks and saved hundreds of white collar, multi-million dollar jobs at the top banks and brokerages. Any wonder why they applaud the Fed's actions so loudly?

From another perspective they have failed miserably to protect the country from what started the whole thing in the first place. The economy has lost millions of regular jobs, hundreds if not thousands of small businesses have gone bankrupt and the Fed has set the US on an economic path similar to the failed fiscal trail blazed by monetary pioneers like Zimbabwe and Argentina.

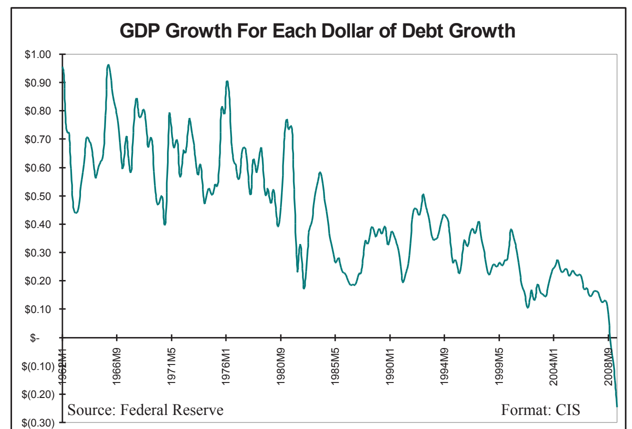
A trend that shows no sign of reversal is the liquidity the Fed has pumped into the system. Without the added liquidity, the Fed believes, and I agree, that the financial system in the US could have collapsed. They have loaned trillions of dollars to banks and brokerages and the Monetary Base has increased by over 1.2 trillion.



So how do they reverse this? How do they take all of this liquidity back out of the system, without causing it to collapse? And if the recession is truly over, why did the Fed feel it was necessary to add an addition $400 billion to the Monetary Base since the recession officially ended?

A critical factor in the Financial Crisis was the extremely high level of debt, so how does adding more debt solve this problem? This is a weakness in the fundamentals that investors should always keep in the back of their minds.

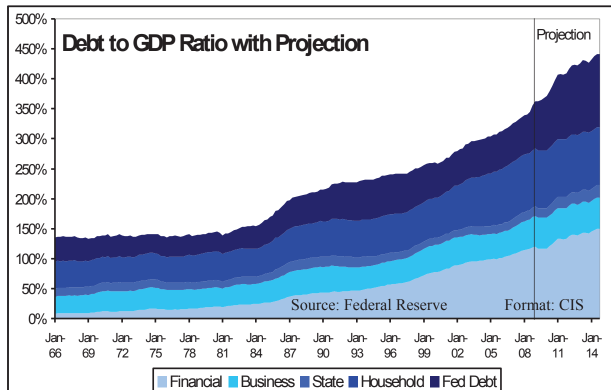
This year, the Fed has started down a path that has ruined many economies before it. They have started to monetize the National Debt. The Fed is buying Treasury bonds from the Treasury in an attempt to keep interest rates low. This also puts more liquidity into the system. They say this is a temporary strategy. (The Fed lists these actions that increased the money supply under "Permanent Open Market Operations" This should give you an idea of their intent to rein in this liquidity.)



Too much Credit, Too much Debt

Credit gets economies going, debt drags them down. Since 1995, debt growth has outpaced economic growth by almost 5:1. (Chart right) At some point debt has to be paid down, if not paid off. How does an economy do this when they are growing their debt 400% faster than the economy is growing? Worse still is that just about everything the Fed is doing to bail out the economy adds more debt!

Debt used to be called leverage. The idea was that you would borrow $100 and create $100+ worth of economic activity. But 2008/2009 has seen a unique occurrence - GDP growth relative to debt growth was negative.



For years, America has become less and less efficient with its debt. As the chart to the right shows, the amount of economic activity (GDP) generated for each new dollar of debt has been declining. From 2000 to about 2007, the US economy only grew about 0.15 cents for every $1.00 of new debt. This is terribly inefficient. It became terminal in 2008 when it went negative. Each dollar of new debt not only didn't generate any economic growth, economic growth was in reverse.

This type of death spiral predicted the credit crisis in 2008 and continues to point to future problems. It is important to remember this chart as the Government piles up more and more debt designed to re-energize the economy. The bullish camp would argue that any increase will be a positive sign, but until this chart is above $1.00 of GDP growth, debt is still growing faster than the economy.

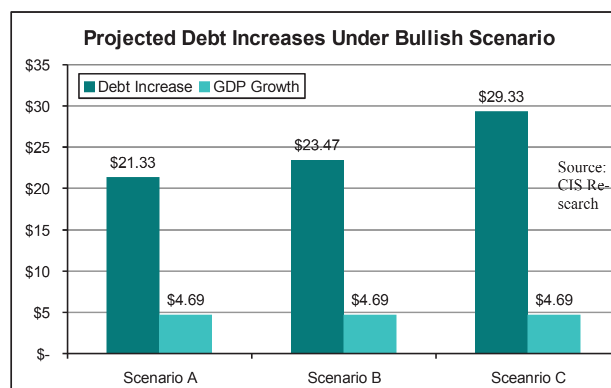
As you move forward, debt becomes a worsening drag on the economy, draining vital resources (to service the debt) that would otherwise have been used for productive purposes.

Because of this, many economists are concerned about the Debt to GDP Ratio (previous page). It shows total debt had stayed a manageable 150% for years, then moved up to just under 250%. In 1995, it really started to accelerate and now stands at almost 400% of GDP. That means the American debt mountain is 4 times larger than the largest economy on Earth.

So here is the problem: It takes *new* credit to get an economy moving. Consumers in this country live on consumer credit, corporations are used to rolling over their bank lines annually and housing is dependent on new mortgages. Is it logical to assume debt will continue to grow and that the economy will benefit from that growth?

In the Debt to GDP chart above, we projected a bearish scenario with no economic growth and 4% annual debt increase. Debt to GDP continues to climb to about 450%. Is this possible? A debt to GDP Ratio of 400% is already beyond any reasonable level. Has the United States hit its credit limit?

Credit has normally been the source of fuel for any economic recovery. This was the case in the early 1980's, late 1990's and 2002 - 2006, fueling the housing boom. We don't see how America can recover from the current economic malaise without the use of new credit.



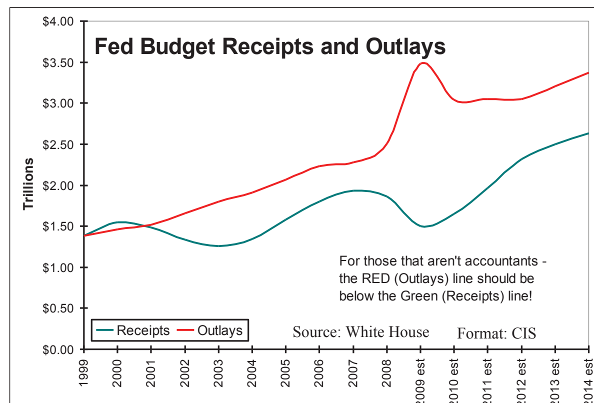
To understand a Bullish Scenario, (Chart right) we projected a repeat of the GDP growth from 2000 - 2005 and applied it to the next 5 years. The chart show trillions of dollars. We also applied the same period's debt growth. This is Scenario A. Under Scenario B we used the Scenario A GDP growth and debt growth from 2002 - 2007. Scenario C is the worst case in recent history. We applied Debt growth from 2003 through 2009 with GDP growth from 2000 through 2005. Under each scenario, debt grows about 5 times or more than the economy.

The Bullish Scenario doesn't cure the problem of too much debt. It adds to it. Is it possible to repeat any of the scenarios of the recent past?

The Federal Government to the Rescue!

The government has taken on the responsibility of bailing out the financial system and the US economy. So far they seem to have bailed out the financial system and the banks. Time will tell on the economy.

Can WE really afford to do this? This leaves a bigger question - Who will bail out the Government if they fail?

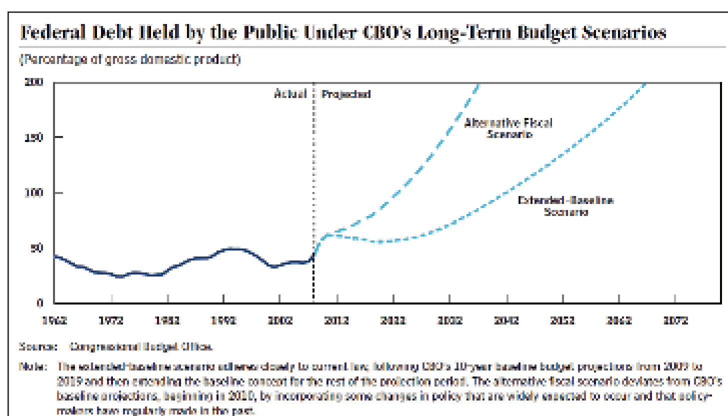


We are not the only ones concerned. The Director of the Congressional Budget Office (CBO), who would normally be expected to paint a positive picture, recently reported the following:

"Under current law, the federal budget is on an unsustainable path—meaning that federal debt will continue to grow much faster than the economy over the long run." - Douglas W. Elmendorf, Director CBO, The Long-Term Budget Outlook, before the Committee on the Budget, United States Senate, July 16, 2009

So far in 2009, the Federal Government is receiving less income at a time when expenditures are skyrocketing. The chart to the right shows the Federal Governments's Receipts vs. Outlays for the past ten years along with the White House's projections. The picture doesn't get much better in the future. The White House expects to see income significantly lower than expenses for as far as they can project.

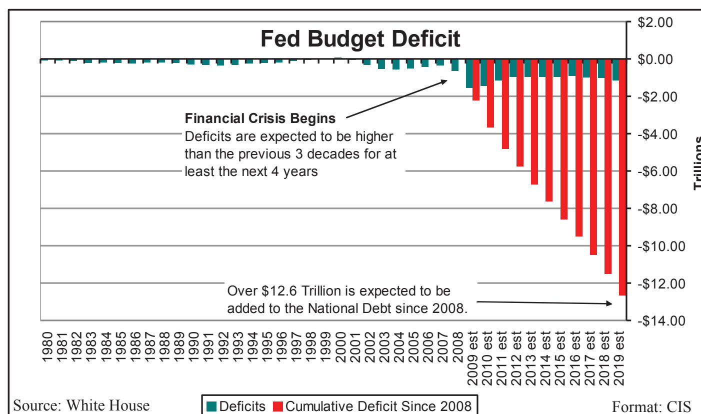
Shadow Government Statistics is an independent research group that applies accepted accounting principles to government statistics and the budget. They also use the "old" formulas for economic indicators such as CPI and GDP, giving a much more accurate picture. The recently wrote in a report on hyper-inflation:



"...if the government were to raise taxes so as to seize 100% of all wages, salaries and corporate profits, it still would be showing an annual deficit using GAAP accounting on a consistent basis. In like manner, given current revenues, if it stopped spending every penny (including defense and homeland security) other than for Social Security and Medicare obligations, the government still would be showing an annual deficit. Further, the U.S. has no potential way to grow out of this shortfall." - HYPERINFLATION SPECIAL REPORT (Update 2010) Dec 2, 2009 Shadow Government Statistics

Running deficits during a recession is supposed to be the Government's formula for recovery. However, the White House expects these deficits to last for 10 more years. Do they expect the recession to last that long?

The CBO sheds some light on the long term prospects. The chart to the right shows Federal Debt rising to 200% of GDP. This is Federal Debt alone, not including Consumer, Corporate or Financial. It is an unsustainable, destabilizing trend. Even the CBO's best case scenario shows Federal Debt growing from here, albeit at a slower pace.

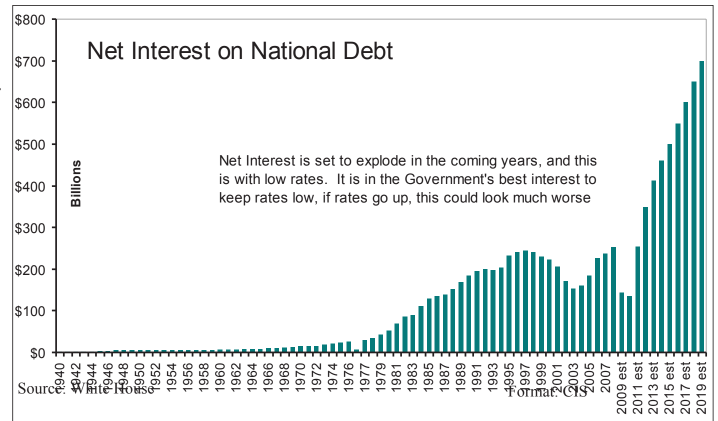


After running an almost $2 trillion deficit for 2009, the White House projects deficits of about $1.50 Trillion for 2010 declining to under $1 trillion in a couple of years. While politicians may applaud this, and pat themselves on the back for "fiscal restraint," it is still a massive deficit, larger than anything prior to 2008.

Ignored is the cumulative effect of these deficits. (Chart right) Based on White House estimates, an additional $12.5 trillion will be added to the National Debt since the Financial Crisis began in 2008. This more than doubles the National Debt.

CIS

Is it any wonder why countries around the globe are calling for the US Dollar to lose its reserve currency status? The Government is steadily weakening the Dollar with every Dollar of debt they pile up.



Even more scary is the interest on the National Debt. The chart to the right shows what the cost to the Government will be in future years, based on White House estimates. By 2014, about half of the Budget deficit will be from Interest Expense. By 2019, a majority of the Federal Budget deficit will be interest on the debt.

What happens if rates go up over the next few years? The interest expense could double. How can they reduce the interest expense? They need to reduce the National Debt. There is no prospect of that happening any time soon.

In an attempt to keep interest rates low, the Federal Reserve started buying Treasuries from the US Treasury. This is the monetization of the debt many economists and strategists, including CIS, have feared and warned about. It is a path that once started down, is difficult to exit. The result is money being printed out of thin air to pay for the bonds being bought by the Fed from the Treasury. This weakens the Dollar and erodes its value.

In the Second quarter of 2009, the Fed purchased almost half the net new bonds issued. This was a record and especially timely since both foreign and household buyers decreased purchased by about 40% from the first quarter, according to the Flow of Funds report for Q2, 2009.

Countries around the world, especially China, have voiced concerns over the massive amount of debt and printing of Dollars that the Fed is engaged in. Whispers are turning into shouts about the potential for a US Treasury default. Officially, the US has never defaulted and never will. That is what Obama told the Chinese on his visit recently and is the party line at the Treasury and Federal Reserve.

But looking at these charts, with expenses heading higher and income having no chance of catching up for years and years, debt growing uncontrollably and interest expenses climbing, would you loan money to the Government? If it weren't for the full faith and credit f the US Government backing the Treasury and the US Dollar, no one would lend them anything.

Technically, the government is insolvent. If it were a company, it would get a junk rating. (As of this writing, Moody's has changed their view on US debt from Resistant to Resilient and said the US "may test the boundaries of their AAA sovereign ratings due to deteriorating public finances.") No prospects of positive earnings and its key assets - the Dollar as reserve currency and its own full faith and credit are in jeopardy.

At this time next year, what everybody knows is going on could be official, the Dollar loses its reserve currency position. Many Countries, especially China, are conducting international trade in other currencies. Oil countries are using Euros and China is using its own currency for many transactions with its neighbors.

"China's president Wen Jiabao admits he's "definitely worried" that the banana republic known as the United States will default on its debt. And it probably will--although not in the way Wen fears." - Henry Blodget, China terrified US Will Default on Debt, 03/13/09

Something else may happen as soon as next year, (maybe later, depending...). I believe this is one of the other reasons the Fed was buying Treasury bonds last year, in preparation of what I think is possible. This is speculation, but I'm not alone, as Dr. Marc Faber, Jim Rogers and several other strategists

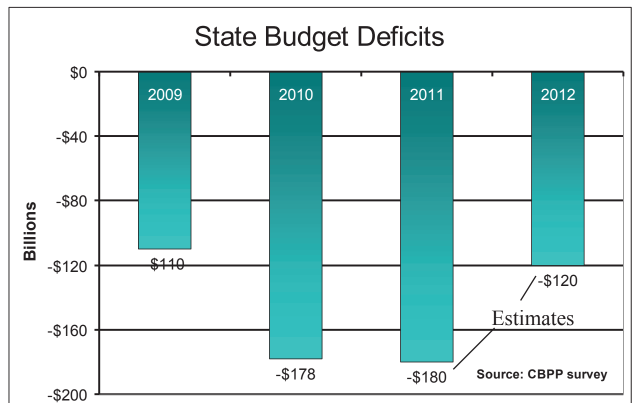
believe it is not only possible, but likely. I believe the US could have a limited default on its bonds, maybe as soon as next year.

I can envision inflation getting away from the Fed, with rates heading well into the double digit area. The Dollar collapses 20% or more and interest rates spike up. In an effort to restore faith and confidence in the bond market, the Fed and Treasury simply agree not to have any interest paid on the over $1 trillion of Treasuries the Fed holds. They may even go so far as to delete, forgive, or erase the principal. However you want to put it. (To my accounting friends that say this isn't possible, look at everything that the Fed, Treasury and Administration have done in the past 2 years that wasn't possible and even illegal.) They would put a ribbon on the strategy and sell it to the public and especially the foreign holders of US debt, (if there are any left), as part of an austerity program designed to protect their investment in the US.

It would immediately improve the Debt to GDP ratio, although it might be a bit of a damper on the US economy. With foreigners less likely to want to lend money to a deadbeat, they may also have an aversion to the products we would like to sell them.

A US debt default is possible, but not likely. The timing will probably be tied to inflation or long term interest rates getting out of control. The Treasury defaulting on debt held by the Fed, if it occurred at all, would probably follow a spike of inflation or a spike in long term interest rates.

The important trends that are in place are that income will stay substantially below expenses at the Federal Government level. This will lead to more debt building up and interest expenses climbing rapidly. This combination will make it more and more difficult for the Government to give the economy a boost through stimulus programs (which I expect more of).



Not to be left out....

The Federal Government isn't the only ones suffering from a lack of income. Many states are running deficits, which by law, they are not allowed to do. The chart to the right shows that the cumulative deficits among the fifty states may bottom in 2011, but still be about $120 billion in 2012. This translates into trouble for many states as they scramble for income and shed expenses.

We have all heard about California's problems, but there are many more states to worry about. The Center for Budget and Policy Priorities monitors the fiscal condition of the states and reports that many are in big trouble. They estimate 48 states will have budget shortfalls for 2010. And 2011 won't get any better.

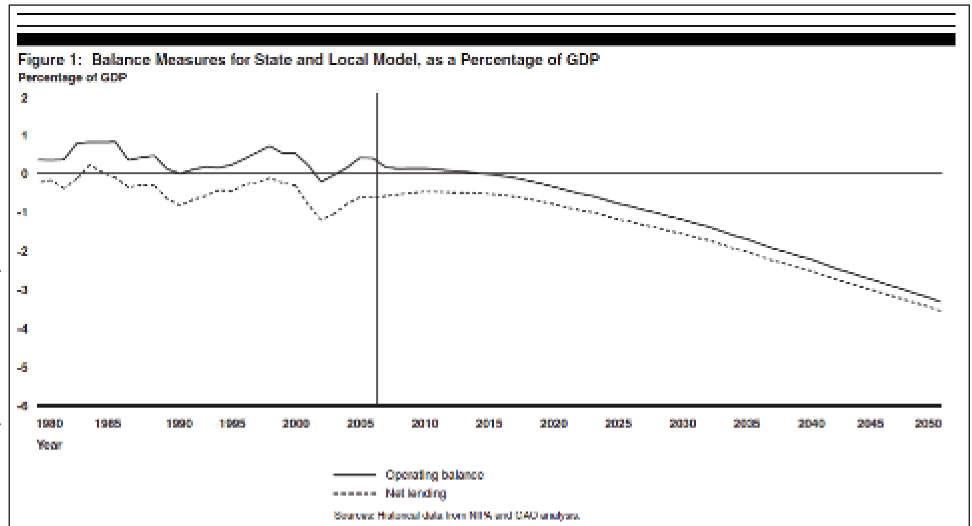
States in Fiscal Peril	Least Like California
California	Wyoming
Arizona	Nebraska
Rhode Island	Iowa
Michigan	Texas
Oregon	N. Dakota
Nevada	Montana
Florida	Pennsylvania
New Jersey	S. Dakota
Illinois	W. Virginia
Wisconsin	
From - Beyond California States in Fiscal Peril The PEW Center on the States 11/09	*From -* Beyond California States in Fiscal Peril The PEW Center on the States 11/09 Appendix

The PEW Center on the States has done some in-depth research into the fiscal condition of the states and has determined which states are most like and which are least like California. For investors, the possibility of default on some state bonds and local bonds is very real.

The Rockefeller Institute reports: *"This year, and 2010, will bring more taxes, more fees, more "cuts" in spending – and more borrowing and budget gimmicks"* as ways states and locals will try to handle their fiscal problems. They go on to report that 45 states experienced a revenue decline with 12 states having declines in revenues of over 15% for the first quarter of 2009.

The Rockefellar Institute also expects the states to be hit hard by any national healthcare program. *"A national health plan likely means* ***more****costs for the states, not less –remember Medicaid was sold as relieving states, but it didn't turn out that way!"*

As a money manager, I can report that the pricing in the municipal bond market is mirroring the chaos in the statehouses across the country. We are getting pricing on bonds that are shocking. Normally, bonds trade as a percentage of par. Par being 100% of the face value. So if a $1,000 bond is trading at 99, the cash price is $990.



Many times, the spread between the bid and ask is about 0.25% to 0.50%. This means that if you own a bond, you wouldn't be surprised to sell it for a lower price than you might buy it. Usually about a quarter to a half a percent less. Most bonds are still trading with narrow spreads like that. But many are trading with spreads of 5% or more. So some bonds are selling for 5% less than what you would pay to buy the bond. An investor could take a 5% haircut on selling the bond. This is because the buyers want to be paid for the increased risks in some bonds. The lower the bond price when bought, the higher the yield and yield to maturity.

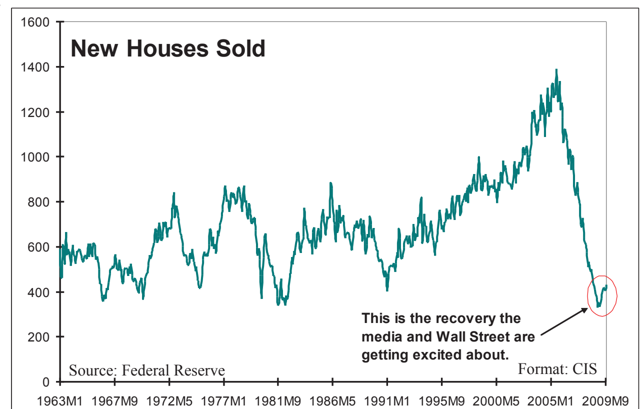
Is this a short term phenomenon or a long term trend that investors should address? The GAO (General Accounting Office) has done research on the states and has determined that they are in a terminal downtrend with regard to balances. Relative to GDP, the states and locals are heading into a decline for as far as they could calculate. (out to 2050.) (Chart above right)

This is a long term trend that spells trouble for municipal bond investors. It adds to the debt trouble that the Federal government is piling on to the economy. Investors shouldn't wait until 2050 to do something. Remember, we are already seeing bad pricing in muni's.

How can this trend be reversed? Expenses need to be cut. Less services from the government means less jobs. This would add to the unemployment that scored a perfect record with all states showing job losses this year.

Unfortunately for the states, according to the Rockefeller Institute, much of the pressure on their budgets over the next decade will come from Medicaid. There is very little they can do about that.

Income also needs to rise dramatically, but according to the Rockefeller Institute, 71% of local tax revenue is from real estate. After the huge decline in the past 3 years, no one expects real estate to go back to the previous highs any time soon. With still rising homeowner defaults and a commercial real estate sector on shaky ground, it would appear this source of income could decline for some time. Add on top of that the potential for real estate re-valuations to come in lower, reducing the base for property taxes. (Yes, contrary to what we have all seen, property taxes can actually decline!)



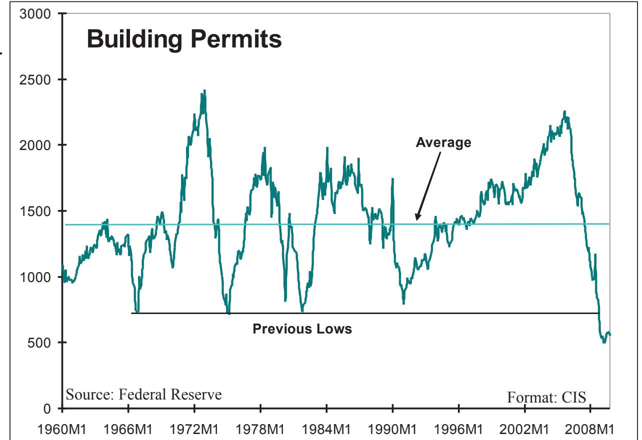
Real Estate

Unless you live in a cave, you know that real estate has collapsed over the past 3 years. The decline was widely predicted and years in the making. The collapse is probably over, but that doesn't mean the decline is over. Real estate may drift lower for a while, with spurts here and there, but nothing sustained.

Understanding why real estate went stratospheric will help you understand why that is not likely to happen anytime soon.

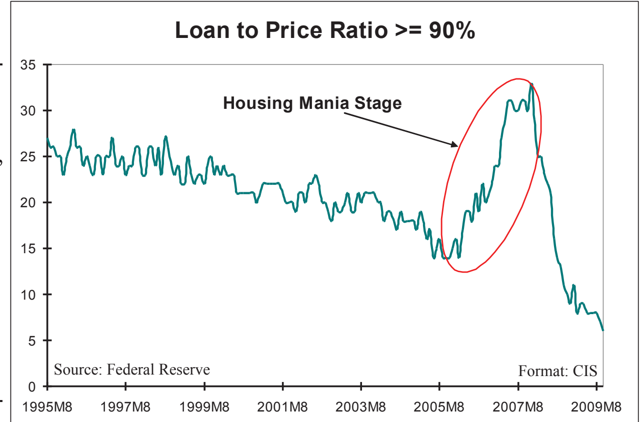
CIS

Simply put, easy money was the culprit. Banks and mortgage brokers gave mortgages to just about anyone with a pulse. And why not? They securitized them, sold them off and let the investors worry about them. (The banks got themselves into trouble by then investing in the worst of the loans and trading derivatives on them. But that is a different issue.)



As you can see by the charts to the right the decline has been steep with little to no reversals until this year. But the reversals hardly qualify as an end to the decline or even a bottom. Unfortunately it will take some time to determine if real estate has bottomed because banks have been skewing the numbers by selling some of their foreclosed properties. The numbers are not firm, but surveys of banks indicate that many of them are holding back on much of their foreclosed inventory so as not to send the market down further.

Hard numbers we do know indicate that foreclosures are still growing. The Mortgage Bankers Association reports that almost ten percent of all homeowners are at least one month behind on their monthly payments for the third quarter of 2009. 14.41% are either delinquent or in foreclosure according to the Association. As unemployment worsens or even plateaus, delinquencies and foreclosures are expected to rise.

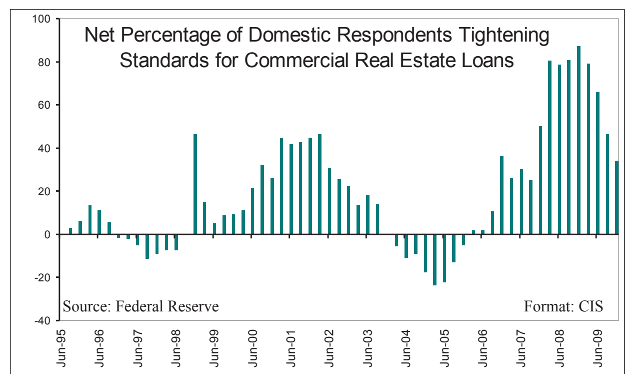


Even if unemployment were to improve, it is highly unlikely real estate will recover to pre-collapse levels for years if not decades. This is because the engine of the real estate boom is gone. The easy money that drove prices up is no longer available. As the chart to the right shows, loans with less than 10% down skyrocketed from 2005 through 2007. This was one of the reasons for the boom, and the bust. People that couldn't afford the down-payment were being given mortgages. Is it really any wonder why they fell behind on their mortgages?

The other shoe...

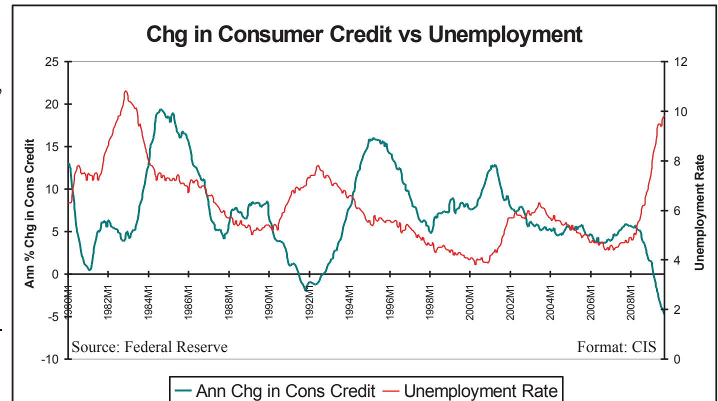
The commercial real estate market, already in decline, may turn nasty in the coming months as highly leveraged deals are not able to get re-financed and incomes from rentals are dropping along with higher vacancies. Wilbur Ross recently commented:

"I have felt for quite some time that the same reckless lending that characterized the subprime mortgage business in residential was also characterizing what had gone on in commercial real estate in the mid-2000s. You had properties being bought at a 3% cash-on-cash yield. You had properties being financed at on such an aggressive basis that the lenders had to give them an advance – several years worth of interest – because there wasn't enough cash coming from the properties even to pay the interest. And the theory was that rent rolls would go up, occupancy would go up, and eventually the property would grow its way into paying interest. Well now that clock is ticking – rents haven't gone up, they've gone down; occupancy hasn't gone up, it has gone down; and capitalization rates that people require from properties have gone up. So everything is going in the wrong direction, and I think we are going to see quite a lot of tragedies in that sector." - Wilbur Ross, 11/09 CNBC interview. Wilbur Ross is president of WL Ross & Co. - A corporate turnaround and restructuring company



Research analyst Jonathan Habermann from Goldman Sachs reports that he doesn't expect to see any kind of recovery of rents or vacancies until the end of 2012, if not later. The US Treasury reports that of the $3.4 trillion of commercial real estate debt, $1.4 trillion is due by the end of 2012, as reported by Karen Mazurkewich of the Financial Post.

Banks have been tightening standards for a few years, according to surveys done by the Fed. The chart to the right shows that even though the chart appears to be declining, in the most recent quarter, 40% of banks were still increasing their standards for Commercial Real Estate loans. This chart will have to go negative (showing banks are relaxing standards) for an extended period if the wave of re-financings expected over the next couple of years are to go smoothly.



Don't count on the Consumer

The Fed has relied on the consumer's insatiable appetite for shopping to bail the economy out of several slow-downs and recessions in recent years. American shoppers gladly obliged, running up consumer and mortgage debt to all-time highs.

But discipline is being forced on Americans, whether they want it or not. The days of homeowners using their home equity as an ATM are over, thanks to declining home prices. Similarly, rising unemployment has put a damper on Consumer Credit use. The chart to the right shows for the first time in decades, consumer debt is actually declining. If unemployment stays high, which we expect it will, you could see Consumer Credit continue to decline. This is actually a positive sign long term, but it means one of the primary drivers of an economic recovery may be sitting on the sidelines for a while.

Basic Error

One of the foundational tenants in the monetarist's world view is that low interest rates spur on economic activity. This is because low interest rates entice consumers and businesses to borrow at a low price. They then go and use the cheaply borrowed dollars to buy goods and services and keep the economy moving forward.

But this theory disregards the role of the lender. As we discussed in ***Risk Costs*** (Jan, 2008), low interest rates do not encourage lending. High interest rates encourage lending.

A lender puts his money at risk. They want to be compensated appropriately for that risk. If you were to lend $1,000 to a friend that owned several profitable businesses, you could feel reasonably sure that you would get the money back. But if you lent $100 to your lazy good-for-nothing brother-in-law, know you are never going to see that money again. One loan had little risk, one had great risk.

If you were to charge interest, you would probably charge your brother-in-law a much higher rate to compensate you for the higher risk you are taking. It is the same with bonds. Higher rate bonds are usually higher risk. As a bond buyer, you are also a lender. And as a lender you want to be compensated accordingly.

Since the Summer of 2007, and especially since the summer of 2008, economic risks have risen substantially, but interest rates have declined. What incentive does a lender have to putting his money to work?

Bond buyers have been flooding the bond market pushing prices higher without any understanding of the long term risks. But key lenders, the banks, have been sitting on their cash. In fact, according to the Flow of Funds report, there has been a reduction of about $1 trillion of loans in the first 6 months of 2009. The banks aren't lending, they are reducing their exposure to debt as a lender.

The surprise here is that the Chinese get it and Bernanke doesn't. Former Morgan Stanley Asian Economist Andy Xie now based in Shanghai, stated on December 8, 2009 in an article in Bloomberg that the Fed was prescribing "poison" for the US economy by keeping rates so low. He went on to say "There is a Chinese saying that one could quench the thirst by drinking poison..." Bernanke's actions were "marginal considerations" that will help short-term growth and employment, instead of focusing on the "soundness of the system."

Impact

So what does all of this have to do with investors and the stock market?

We believe the financial crisis is not over. There will be long term effects felt by the economy and there will be consequences for both the excesses that caused the crisis and the actions taken by the Fed to solve the crisis. These trends are in place and the realization of the impacts are not likely to be derailed. What this means is that short term counter-trends, short term good news will not be able to turn the direction of the trends.

Bullish Scenario

The bullish scenario maintains the economy will snap back to pre-crisis activity. The stock market will recover fully into a new stronger advance. Interest rates will stay low and the real estate market will come back, and with that the consumer will back to their old spending habits. The Dollar's demise will have been greatly exaggerated as it recovers and advances to new highs. The Government's programs will have gotten the economy over the hump and the banks that were lent trillions by the Fed will return all of the taxpayer's money, allowing the Fed to drain off the trillions in liquidity previously injected into the system. Fannie Mae, AIG and GM will be spun off into private companies again and flourish on their own. Investors that stayed the course in their stock funds will be greatly rewarded by the markets rising to new all-time highs.

There are a few problems with the Bullish Scenario. First of all, where will the "fuel" for the economy come from? Real estate is not likely to come close to the pre-crisis levels for decades. This is because mortgage lenders are increasing their requirements and standards. We won't be seeing 120% mortgages again for a very long time! And if there isn't the buying mania pushing home prices higher and higher, then Americans are not going to be able to tap their home equity lines for spending money.

If unemployment stays high for an extended period, consumer debt will probably continue to decline. The economy won't be able to count on consumers to spur it on.

Commercial real estate is also going through a period of tightening standards and declining values. The big concern for commercial real estate is over the next couple of years. The economy could head into recession again if too many companies are not able to roll their debt and instead default.

Local and state governments are busy trying to bail themselves out of their own fiscal problems. Cutting services and raising taxes are not a formula for economic stimulus. The potential for default by one or more states and several counties and cities is high and it will take a long time for these municipalities to right their fiscal ships.

One of the battle cries from the bullish camp is that companies have learned their lessons and the cost cutting over the past year will pay huge dividends. For a newbie, this sounds logical. I, on the other hand, am a crusty old broker and I don't buy it at all. The reason is simple. Wall Street has been claiming that companies have been on cost cutting campaigns for the past 10 years. GM is the perfect example of a company that was perpetually in restructure mode. They were always cutting costs and re-arranging the deck chairs on the Titanic. It didn't help.

With interest rates held low by the Fed, who will be lending money? As we have already spelled out, lenders lend when they get properly compensated. This means the economy needs higher rates, not low rates.

As it is now, the Fed is setting interest rates for mortgages below market levels to keep housing afloat. Without the Government's backing, how could Fannie Mae ever go private again? It wouldn't be able to make a go of it because it doesn't have the ability to charge rates below market rates. They couldn't make it during the biggest real estate boom in modern history, how can anyone expect them to make it during normal or slow times?

The Federal Government has put trillions of dollars into the economy over the past eighteen months and has gotten little in return. GDP growth for every dollar of new debt is negative. While we don't expect that to stay negative for long, we also don't expect to see the numbers rise much higher than the poor numbers from the past few years. So how can the Fed pull back all of the bailout money and decrease the Monetary Base back to pre-crisis levels? If the implementation of the funds had almost no impact, doesn't that mean the removal might have catastrophic effects, unleashing deflation? They filled a hole in the economy with cash. If they take that cash back, what then fills the hole?

The Federal Government is already projecting budget deficits higher than anything pre-2008 ever approached. In order to narrow the gap, spending would have to be cut, (not going to happen), or taxes would have to rise substantially, (which may happen), but have a very negative impact on the economy.

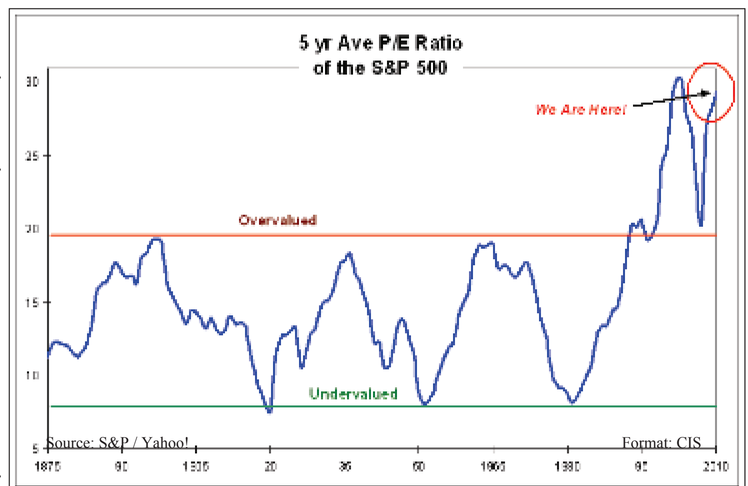
The Chinese have warned the US that we need to control our budget deficits and get our fiscal house in order. This means reducing debt, not growing it. But growing it is exactly what the White House expects, to the point where the National debt will double over the next decade.

But the Chinese are the lenders to America and they have a trillion or so of our Treasuries and gobs of our Dollars. The US Dollar is in jeopardy of losing its Reserve Currency status sooner rather than later. Many countries, the UN, the IMF and World Bank are looking for an alternative. With all of the Dollars printed by the Fed floating around the Globe and the mountain of debt created to bail out the system, the Dollar has been damaged and its value eroded.

To save the Dollar, the Budget deficit would have to become a surplus, the money supply would have to contract substantially and the mountain of Treasury debt would have to come down. None of these is possible. The Dollar, therefore, is doomed.

This comes back to the stock market. If the economic fuel is gone, how can anyone expect the stock market to perform? If those in charge of the economy decide to add more stimulus packages and the economy does get a bit of a boost, does that change any of the fundamentals trends that we have addressed? No, it would just add more debt to an already overburdened economy.

The Bullish Scenario ignores the problems of the economy and the trends that are already in place. It needs a magic wand to clear up the debt problems without any negative effects to the economy.



Lastly, the Bullish Scenario ignores the current valuation of the stock market. The stock market prices in events in the future. Sometimes it prices in perfection. Let's suppose that all of the above were solved, the debt problem blew away like dust off a table with no ill effects to the economy. The stock market is still overvalued based on historic P/E ratios.

The stock market's 5 year average P/E is in the high 20's, almost at all-time highs. Bull markets start when P/E ratios are in single digits, not the high 20's.

If nothing else puts a hole in the bullish scenario, this should. Buying at high p/e's in the hopes of the p/e going higher is a dangerous game. One that investors should have learned not to play after 2000 and 2008.

New Normal

The New Normal is a term coined to make a lousy economy sound good. It makes as much sense as saying your car with a flat tire isn't a problem, it is the New Normal, and then driving on it anyway. The New Normal accepts the Government as activist in the economy on both macro and micro levels. Takeovers of private companies like GM are suddenly considered a good thing. Setting pay limits on

employees of private companies is considered noble. Interventions in the stock and bond market are believed to be the government's duty.

The New Normal is slow growth, if at all. Growth will come from the government, through programs and stimulus packages. It will have more regulations and less capitalism. Public/private partnerships will be needed to "save" various industries including newspapers, housing, autos, banks, insurance companies (except those put out of business by the healthcare reform).

A comparison with China makes things clear. The US is a capitalist country racing to embrace socialism as a way to save itself from the downside of capitalism. The government is setting itself up as the savior of the population making everyone more and more dependent on the generosity of the government..
A government big enough to give you everything you want is a government big enough to take from you everything you have. - Gerald Ford

China, in contrast, is a communist country embracing capitalism as a way to grow itself, become stronger and empower its population to be less dependent on the government.

The New Normal in the US will be marked by the economy just muddling along, the stock market in a trading range of a few thousand points and interest rates kept artificially low. The Fed heads will wonder why the economy hasn't gotten going, not realizing the anchor low rates are to growth at this part of the cycle.

The government will be forced to take a more active role in the markets to keep the Dollar from complete collapse and keeping the bond market from imploding. States will require heavy bailouts from the Federal government and with the money will come strings to make sure they play ball.

This, unfortunately is the scenario I suspect we all should get used to. The activists in the Fed and Treasury are determined to prove their theories are correct and will manipulate the markets to achieve their goals.

Luckily, the New Normal will not extend overseas. It will have no control over commodities or developing countries. In the New Normal, the rest of the World will have the opportunity to race ahead. Developing countries will grow much faster and they will cause the consumption of raw materials, oil and Ag products to accelerate.

Bearish Scenario

This isn't doom and gloom, it is reality. The debt levels built up have to be dealt with. Debt is part of the reason the financial crisis started and it is the reason it will get worse. As we have demonstrated in this report, debt levels are unsustainable. There must be a period of de-leveraging - a reduction of debt. This can either come by way of a strategy or the markets. If it is strategy, there may be some control and minimal damage to the economy. If it is by way of the markets, all bets are off.

Choices

The Federal Reserve and Treasury have added trillions to the national debt and are projected to double it in the near future. The growth of the debt is not being matched by economic growth. What this means is that we are falling further and further in a hole. To get out of a hole, the first thing you have to do is stop digging. They haven't learned that lesson yet.

There are several ways to solve a debt problem.

1 - Pay off the debt - This is obvious. Unfortunately, it is also impossible. The Federal Government is running deficits. Interest alone is expected to be over 50% of the deficit by the end of the decade. If they were to attempt this, they would have to slash spending and raise taxes. Neither of these is helpful to an economy. The result would be a perpetual economic malaise for years. As the study from the Shadow Government Statistics show, this still wouldn't be possible, even if they taxed us 100% on all income, because the deficits are so large.

2 - Default on the debt - Almost every country, at one time or another, has defaulted, with the exception of the US. I'm not advocating this strategy, but it is like tearing a band-aid off quickly. It hurts a lot for a short time, but it is over quickly. The US has been following Banana Republic economics for the past few years, debasing its own currency and loading up on debt. These strategies have lead to defaults in other countries.

We believe it is possible for the Treasury to partially default on its debt and get away with it. The trillion or so that the Fed has bought from the Treasury is almost the same as moving money from one pocket to the other. (To my accountant friends, I know it isn't, but go with me on this...) So since they are both playing for the same team, the Treasury could default on its debt with the Fed and reduce debt levels immediately. It could do it by defaulting on the interest owed or outright principal default.

The impact would be quick and earth shaking, literally. Countries around the world would wonder if they are next and would dump US Treasuries quickly. The US Dollar would collapse and the plan would work as the Fed buys up Treasuries on the open market adding them to the pile of defaulted debt.

I said this scenario is possible, I don't think it is likely. It would take a very brave leader at the Fed to pull this off and last I saw, Paul Volker, the last good Fed Chairman, was being hidden from the public by the Administration, due to his disagreements with them.

3 - Inflation - This appears to be the most likely scenario, but one the Fed would never admit to. Never before in history has a government pumped up its money supply the way this country has. And when a country has increased its money supply too much, it always resulted in inflation. By letting inflation run, the debt gets paid off with inflated dollars. Also, a declining currency brings inflation. Foreign goods become more expensive and commodities go up in price.

The result is higher interest rates domestically. This would put an end to any hope of a sustained real estate recovery. This would put a damper on economic growth. And it would not be good for stocks as companies battle rising costs and declining demand squeezing profits. (See the 1970's US stock markets)

At the top of the cycle is when things get interesting. Debt to GDP levels would be much lower, and at that point, lenders would start to come back into the system. Remember our contention is that lenders want high rates to compensate them for the risks. They are not going to jump on the first sign of rising rates, but they will come back when rates are peaking. Where would this be? In the teens? Maybe higher?

4 - Hyper-inflation - This is a bad derivative of inflation, and it is a real risk. Hyper-inflation is when inflation gets out of control, sending inflation rates up huge amounts (20%+) each month. This is when the markets take the strategy out of the Fed's hands and run with it.

The dollar would collapse, interest rates would go sky high. The economy would be frozen. Gold would go through the roof and commodity prices would be un-touchable. Unemployment would hit new highs and forget about a real estate recovery with such high interest rates.

Some analysts believe the stock market would also rally. They point to recent history in countries like Zimbabwe where they experienced hyper-inflation over 1 million percent. Their stock market also went up zillions of percentage points.

This may be true, but from a risk management standpoint, I would rather ride my bike down a clean flat road than one I know has broken glass all over it. I might get through unscathed, but why bother with the additional risks of the stock market? The easier play for hyper-inflation is gold and commodities and shorting the US Dollar. As Jim Rogers had to explain when he said the US stock market could go to 15,000, it didn't matter what stocks do because gold and commodities will be up many times more due to hyper-inflation.

Doomsday Scenario - Deflation

I am sure deflation is what keeps Ben Bernanke up nights. He has become famous for his strategies for fighting deflation. (Deflation: Making Sure "It" Doesn't Happen Here - Ben Bernanke, Nov 21, 2002)

Nothing survives deflation. Real estate collapses, stocks crash and many corporate bonds default. Many municipalities would have trouble paying their debts, so defaults would be expected there too. Cash won't earn anything, but it becomes worth more domestically as it continues to buy more goods each day.

Some have said the Dollar would rally under a deflationary scenario, but I don't see how. Why would anyone from outside the US want to buy into a country who's economy is doing so poorly? Domestically, the Dollar would rise in value relative to goods and services, but currency traders are international. They would be buying into a country whose stock market, real estate and bond markets are in disarray.

Long term Treasury bonds would theoretically be a good buy under deflation, but thanks to deflation working in reverse of inflation, our Debt to GDP Ratio would get much worse, making Treasuries less attractive. This would eventually force rates higher to attract buyers.

The current evidence suggests two things. One - With Bernanke's strategies, we have avoided deflation, for now. His infusion of trillions of dollars into the system ensured that deflation would be held in check after last years financial crisis. The financial system has been saved, although it is now a ward of the state, dependent on government money.

The other implication from the evidence is much more chilling. If the Fed has pumped trillions, some estimates from Bloomberg are as high as $9 trillion including off-balance sheet transactions, into the economy, why hasn't the economy responded better? Just how bad was the deflationary hole Bernanke filled with all of that liquidity? And if they start to remove the liquidity too soon, might they accidentally push us into deflation?

Cornerstone's position on deflation is that if it were to happen, it would be contained to the US and maybe Europe. (With Bernanke at the helm of the Fed, we don't see how deflation would be possible, but...) It would actually be a combination of deflation and hard asset inflation. This is because China, India and the other developing economies, would suffer a bit from declining trade with a deflationary West, but are increasing their trade with each other. Certain trends such as urbanization are in place. Deflation in the US isn't going to stop a family from rural areas of western China making the move east to the cities for a better life.

On the first page of this report, we overlaid the S&P 500 with the Nikkei 225. There are striking parallels and these similarities have many analysts predicting that the US will suffer the same deflationary fate as the Japanese. They have been in a 20 years deflationary bear market. 20 years after its peak, the Nikkei is still down about 75%.

There are fundamental differences though. The Japanese had a high savings rate, the US is a nation of spenders. They had a strong currency, ours is weak. They were net exporters, we are net importers. Their government also dragged their feet while the Fed acted quickly to stave off deflation. These differences, along with others, are what will help the US avoid deflation, for now.

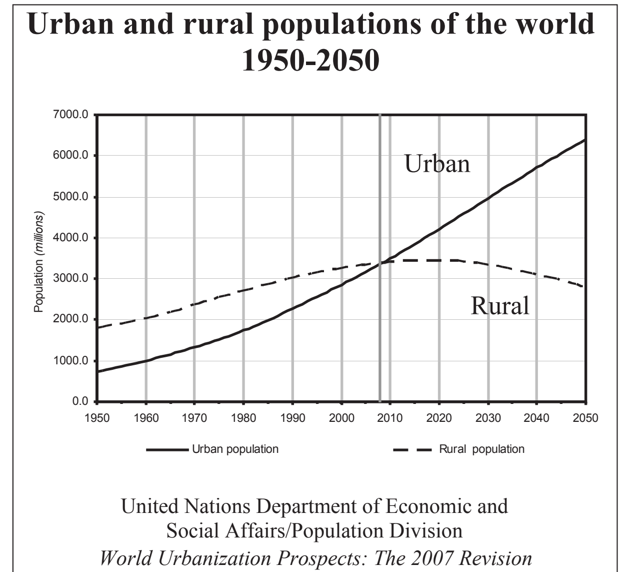
As for the stock markets? I wouldn't be at all surprised if the S&P 500 continues to mirror the Nikkei 225. That would mean at least 10 more years of a bear market with the stock market testing the March 2009 lows.

Positive Trends

There is always a bull market somewhere. In virtually all the scenarios, the growth of capitalism globally will continue (except in the US and Europe). There are several macro trends that are unlikely to change any time soon.

Urbanization

The UN estimates that today, for the first time in history, more people live in cities than in rural areas. There is a global shift in population going on that brings with it a myriad of investment opportunities and growth potential. Urbanization brings with it higher consumption of virtually every hard asset and the need for improved infrastructure and services. As the chart to the right shows, the UN expects this trend to continue for decades.

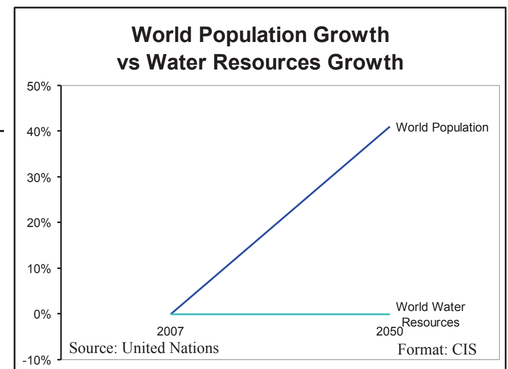


United Nations Department of Economic and Social Affairs/Population Division
World Urbanization Prospects: The 2007 Revision

Water

Peak Water is more important than peak oil and much easier to control. We don't have to mine for water. It is all around us. But the world doesn't have enough clean, potable water for its population. Urbanization and industrialization of emerging countries is putting a strain on water sources, actually ruining many of a country's sources of clean water through pollution and over use.

Fresh water represents about 2.50% of the earth's water. Of this, only a fraction is available for human consumption. Developing countries are in need of water purification and pollution controls. This isn't a short term need. It will be an ongoing battle for clean water as millions move from rural areas to cities in the coming decades. Battle is not a word used accidentally as the UN is concerned tensions between countries that utilize the same water source could start to rise.



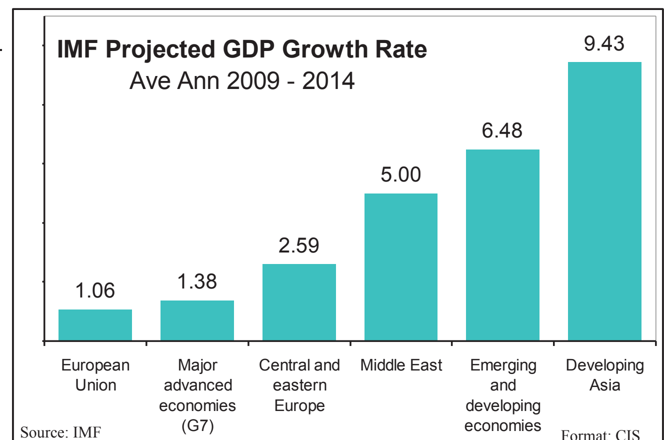
The chart to the right shows that while the world's population is expected to rise about 40%, water resources are expected to see zero growth. This means the need for desalinization and water purification is going to get more and more extreme going forward.

Economic Growth

While the West is wrestling with its fiscal mess, the rest of the world will be actively engaged in growing their economies. The IMF has projected that economic growth in the developing world will far outpace the major advanced economies like the US and Europe.

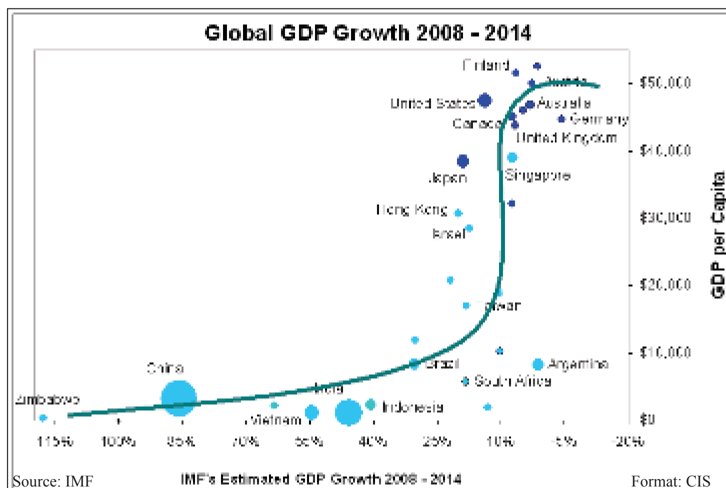
This means opportunity for investors. But they won't be without their thrills. Emerging markets and developing economies can go through wide swings. Double digit gains and losses are commonplace. The long term prospects are great, but the ride will be wild.

An economic slowdown in the US will have some impact on developing economies, but with China leading the way, they have focused on increasing trade with each other so that according to the IMF, almost half of all exports from developing countries is to another developing country. In other words, they are growing their trade with each other and becoming less dependant on the US as the consumer of last resort.



As you can see on the "S" chart to the right, countries like China, Vietnam and India have a long way to go for both GDP growth and GDP per capita to catch up to the mature economies like Germany and the US. Due to the high populations, the growth of GDP per person growth will have an enormous impact on the over all economic growth of these countries. The West has no chance to have the multiplier effect these countries will have as their economies grow.

The multiplier effect flows down to almost all natural resources and hard assets. This is why commodities like oil and copper are so important for investors.

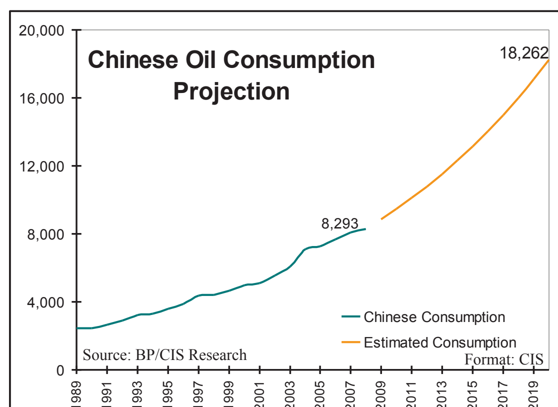


Oil

Industrialization and urbanization is leading to higher and higher consumption of oil. The chart to the right shows China's actual consumption and projected consumption based on current trends. Their consumption should more than double in ten years.

But consider this: John Hess (President of Hess Oil) in a speech he gave on 10/20/2009, said the US has "1,000 cars per 1,000 people. China has only 10 cars per 1,000." It doesn't take a rocket scientist with a fancy calculator to figure out that an increase to 100 cars per 1,000 people in China would make oil consumption explode and the chart would be a very low estimate. With the millions of people moving to the cities in China, 100 cars per 1,000 is not unreasonable to assume.

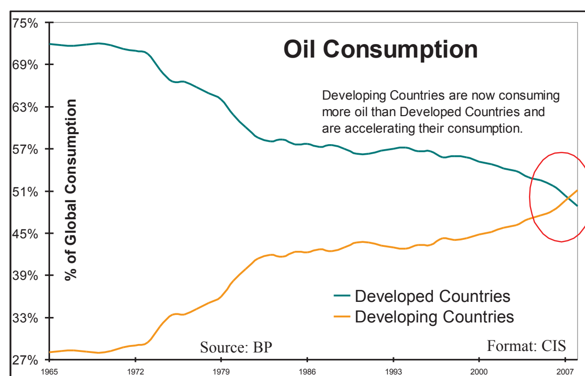
The chart below shows that for the first time ever, developing countries are consuming more oil than developed countries. Plus, the trend of their consumption is rising much faster than that of the developed countries. The concerns about economic slowdown in the West leading to lower oil consumption are offset by higher consumption in the emerging economies. This is a trend that should continue for many years if not decades.



Combine that with the 6% - 8 % annual depletion of oil supplies as reported by the IEA and you can see why oil and other energy investments have excellent long term prospects.

Gold & the Dollar

Another trend that seems inevitable is the downward spiral of the US Dollar. It isn't. It is not a trend that will last decades. The Dollar's decline is the result of poor fiscal policies in the US and will probably be replaced as the World's reserve currency sooner rather than later. Too many countries want this to happen for it not to happen. So the duration of the Dollar's decline may be limited by its replacement as reserve currency. After, the world will not have a use for the Dollar so it will trade like any other unimportant currency. It will have its ups and downs but they will be irrelevant to the global economy. By the time the Dollar is officially replaced as the world's reserve currency, most of the major players will have already reduced or eliminated their Dollar holdings.



The depth of the decline is a different matter. This will be a function of Washington's policies, market conditions and global demand for commodities. To see the Dollar drop 20% overnight wouldn't surprise me. To see it grind 25%, 35%, 50% lower over 2 or 3 years wouldn't surprise me either. Could the Dollar go to zero, disappear? There is nothing today that indicates that is a possibility.

Because of the Dollar's limited future decline duration, we believe gold has limited upside duration (Measured in years, not months). Gold is a good hedge on the US Dollar. But once that hedge isn't needed, its usefulness as an investment will be diminished. I didn't say eliminated. Gold may very well play a useful role as an inflation hedge or hedge on global political unrest, among other purposes.

Gold's potential upside has been widely reported in the news. With no verifiable valuation matrix, the value of gold could go just about anywhere. Inflation adjusted, gold is estimated to be worth anywhere

from $2,000 to $2,500/oz today. That doesn't mean it will hit it or not, or go well beyond it to $5,000 as some are predicting.

We don't play that game. We don't make price predictions. We will use gold and gold miners as hedges on the Dollar and for other purposes as long as they make sense. If that means gold goes to $1,500 or $5,000 we can't begin to guess.

Conclusions:

This report reviewed some of the various potential outcomes to the US markets and economy. The Bullish Scenario relies too heavily on investors having faith that everything will work out in the face of mounting debt. We don't believe the Fed has a magic wand that can make the debt disappear without any consequences.

The New Normal is the most likely scenario and one that could make investing in the US very problematic. The increases in regulations and dependence on government intervention would force money managers to have to not only understand economics, but to try to second guess and anticipate the Fed's heavy hand controlling the markets. Old investment rules might not apply anymore as the Fed goes about manipulating domestic markets to fit their agenda.

The Bearish Scenario is the most logical, it fits with basic economic rules and is rational. If the New Normal were to fail, this is the scenario investors better be ready for.

Spin the Globe

None of these scenarios matter for investors that realize the global economic world is shifting east. Beijing is the new center of capitalism, not New York. Investors that focus on developing economies, commodities and hard assets will not have to concern themselves much with the condition of the US markets and economy..

While the US is flirting with debt at 400% the size of its economy, the Federal Reserve reports that developing countries average debt load is only 50% of their economies. We are relying on them to lend us the money we need to keep our heads above water.

The unrelenting movement of millions of people all over the globe from rural areas to cities is a trend that will have long term effects on commodities, oil, markets and the way we view our own country.

Investors that rigidly stick to the old way of doing things in America - buy n' hold, US bonds, muni's and equity mutual funds - should expect to find themselves going upstream against a flood coming the other way.

Going with the flow is going to be a much smoother ride for investors and probably much more profitable.

Questions, comments, further information,
to set up an appointment or request forms, call: Toll Free:
1-888-277-5968
(outside Rhode Island)
Providence Office:
(401) 453-5550
Dallas Office:
(972) 563-8990

Email:
johnr@cornerstoneri.com

Cornerstone Investment Services, LLC
245 Waterman St, Ste 301
Providence, RI 02906

www.cornerstoneri.com

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