

Cornerstone Report

Special Report

October 5, 2022

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Topics:

- Leading Indicators
- Don't Fight the Fed
- Perfect Storm?
- Falling Earnings
- Emotions of a Bear Market

Changing the Way America Thinks About Investing.

Capitulation Coming?

The BIG question of the hour is whether or not the Fed will be able to pull off a famed “soft landing” or whether a recession is inevitable.

While you can never be certain about anything in the economic and financial realm, my conviction from January has changed.

In January, we felt like we would not have a recession, but so far we clearly are not experiencing growth in the 2nd half of this year (see *Fed Policy Mistake* newsletter January 27, 2022).

By definition, as we discussed in that newsletter, if an outside unknown shock, like Russia invading Ukraine, were to occur, it would change the equation remarkably. And it has.

At that time I was expecting what we would refer to as a mama bear market for stocks, which fit the evidence we had at the time. However, between January and May and our 2nd newsletter *Daddy Bear Market?* my views have been altered by the new events.

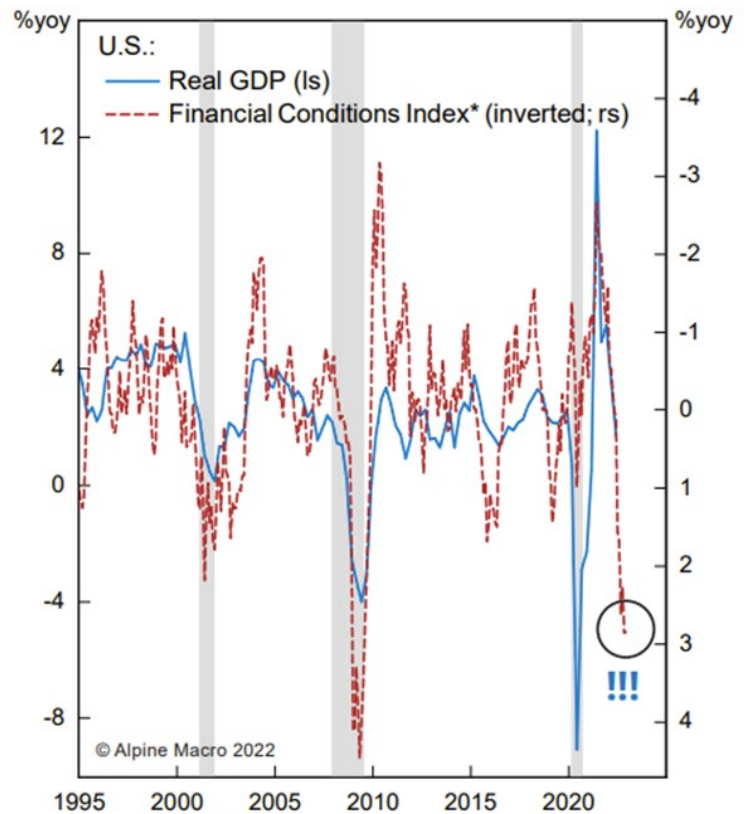
Later in this newsletter we will discuss the various types of bear markets, but for now let's take a look at the economic evidence; we will come back to the market later.

To the right you see a chart from Alpine Macro, which shows the rate of change of their financial conditions index. One of the things that people often overlook is that the **rate of change**, at times can be all important for the financial or economic outlook. In other words, it's not the absolute level of something but the **magnitude of the change** involved, which will likely give you the best clues about the future.

As you can see, there is a strong correlation between the rate of change of the tightness (or looseness) of financial policy (mostly from the Fed) and what happens next in the economy.

In addition, the financial conditions have tightened to a more extreme level than we've seen since the 2008-2009 Great Financial Crisis.

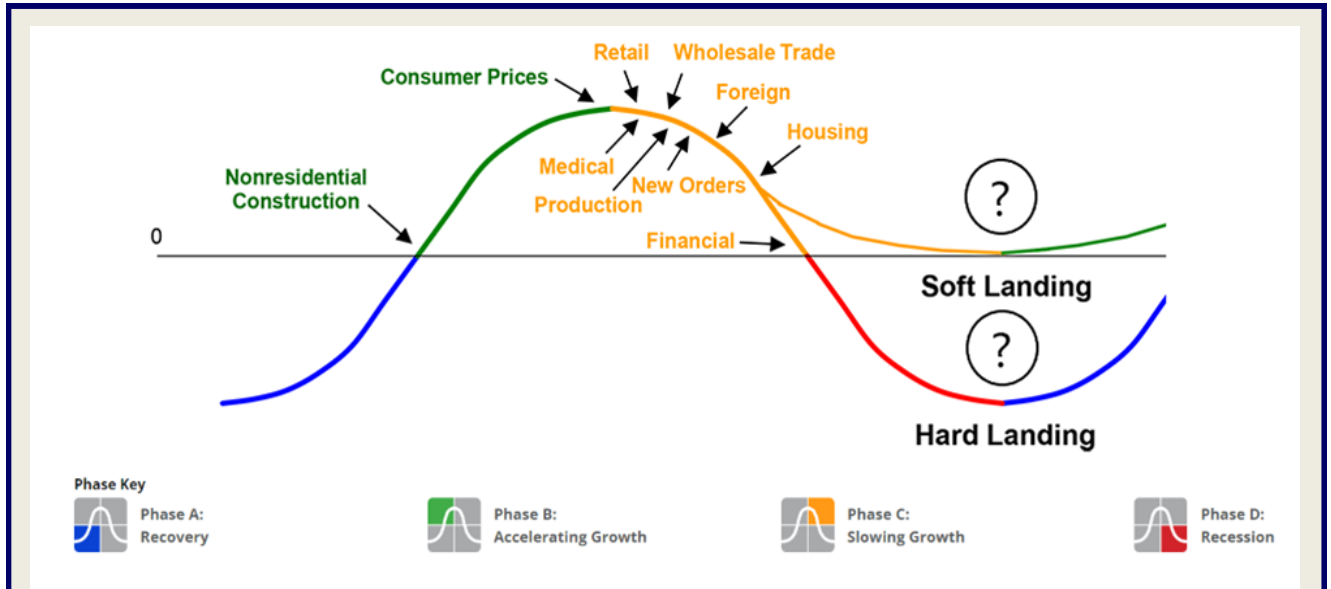
While it will probably be different this time, in my view, the red warning lights are flashing violently.



*Source: Bloomberg Finance L.P.; advanced by 3-months
Note: Shading denotes U.S. recessions

Below you see the updated version of ITR's business cycle indicator, which is updated from the one we published in January (*Fed Policy Mistake* January 27, 2022 www.cornerstonereport.com).

In January, most of the sectors of the economy were in the green section, still rising. Now as you can see most of them are in the yellow section, decelerating, but still growing. As we approach 2023, the question is will the Fed be able to pull off a soft landing, with the yellow part of the curve turning up to green, or will we go into a hard landing, into the red recession area, which is where I believe we are headed.



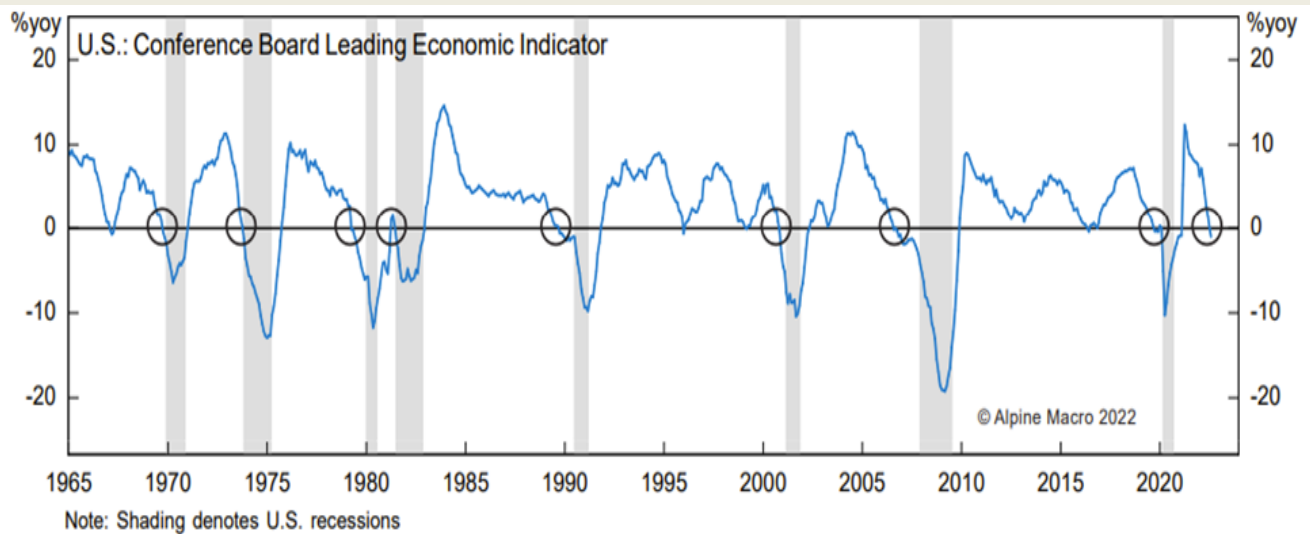
“Our overall forecast accuracy since 1985 is 94.7% at one year out. At ITR Economics, the length of time a forecast is in place is just as important as its accuracy.” <https://www.itreconomics.com/>

Below you see their latest update for their leading indicators for Q4 2022 and Q12023. As you can see they are now all in the red. **Remember**, it is most important to look at **leading** indicators of the economy, not lagging indicators, such as inflation or the unemployment rate.

Leading Indicator Snapshot

	4Q2022	1Q2023	2Q2023
ITR Leading Indicator™	●	●	●
ITR Retail Sales Leading Indicator™	●	●	●
US OECD Leading Indicator	●	●	●
US ISM PMI (Purchasing Managers Index)	●	●	●
US Total Industry Capacity Utilization Rate	●	●	●

● Denotes that the indicator signals cyclical rise for the economy in the given quarter. ● Denotes that the indicator signals cyclical decline for the economy in the given quarter. ● N/A



The Conference Board's leading economic indicator (LEI) is declining. Recessions typically follow when the year-over-year change in the LEI drops below zero. **The LEI just pierced this critical level.** Alpine Macro 2022

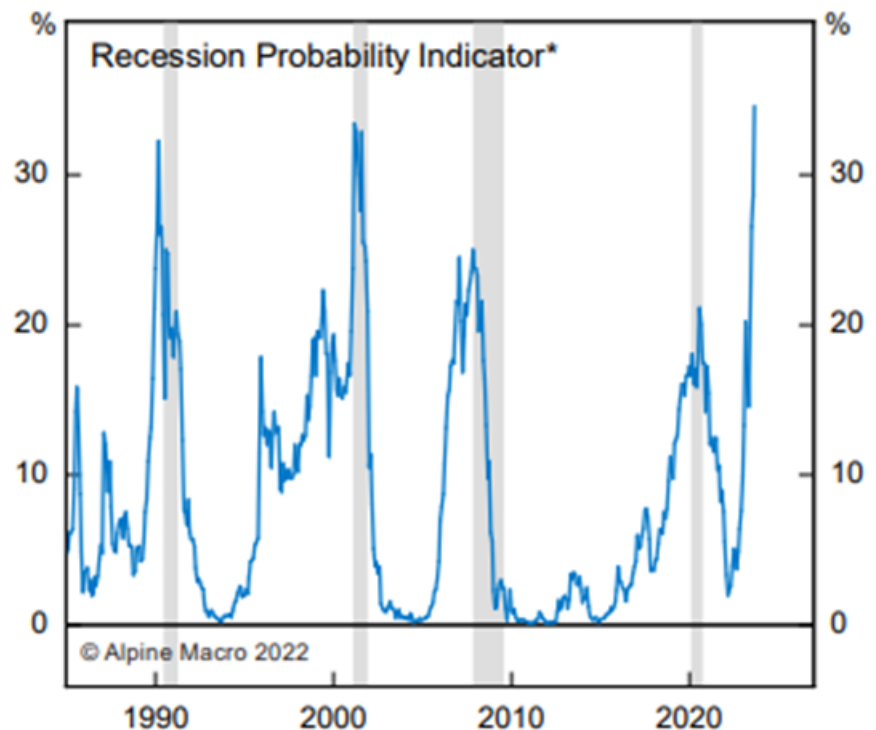
Above you see The Conference Board's leading economic indicators, and as you can see every recession back to 1970 has been preceded by a decline in this index, piercing the horizontal zero axis.

Economic data such as inflation and unemployment, are what are known as **lagging indicators** of the economy. Lagging indicators are like a caboose on a train. If you want to know where the train is headed next, watch the engine of the train to see what's coming, not the caboose.

To the right you see Alpine Macro's recession probability indicator, you can also see that it is flashing **a higher level of warning** than what we've experienced prior to previous recessions in 1990, 2000, 2008, or 2020.

On the next page you see a chart that shows one of the most accurate indicators of a coming recession that I have seen. It is known as an inverted yield curve.

Let me explain.



*Alpine Macro calculation based on FRBNY Recession Probability Indicator

Note: Shading denotes U.S. recessions

Don't Fight The Fed

With a normal yield curve, interest rates on short-term investments like Treasury Bills, which last 3 months to 2 years, should pay a **lower** interest rate, than for example, a 10-year government note. You can see this during the recovery years in the 90's, 2000's and 2010's timeframe when the 10-year interest rate shot up to 2.5% higher than the 2-year.

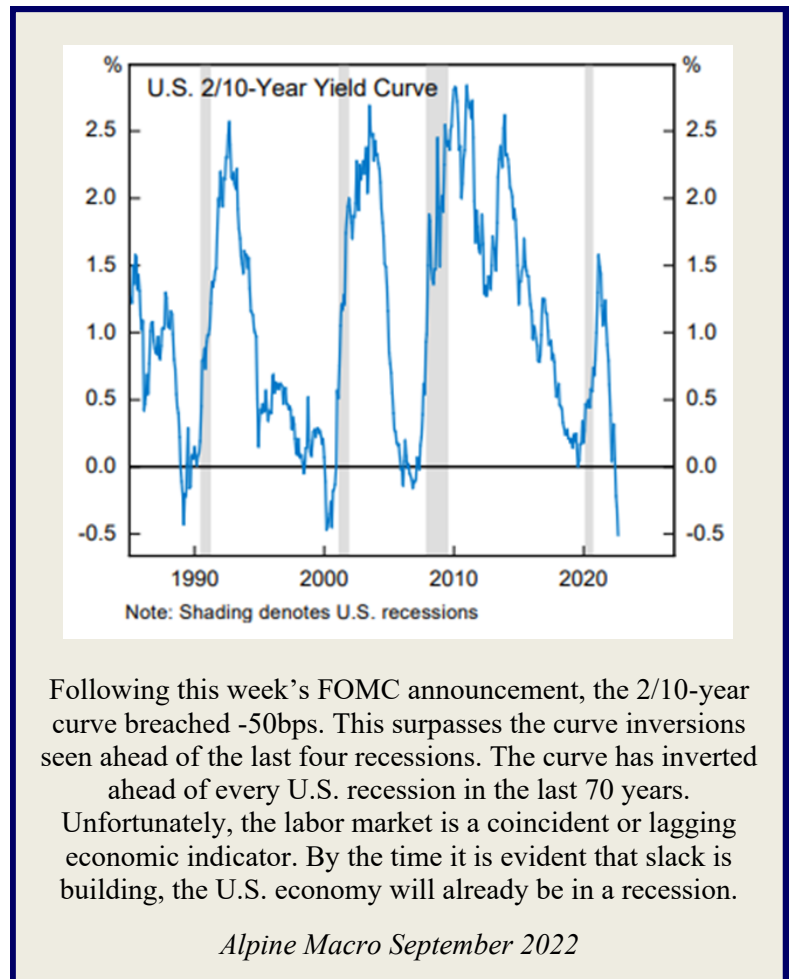
Clearly, if you're an investor and you're tying your money up for 10 years, you would expect to be paid a higher rate of interest than lets say a 2 year investment, because a 10 year investment takes longer for you to get repaid, and has a greater risk of inflation reducing your purchasing power over that time.

So, the 2-year note should normally pay less interest than the 10-year.

However, when the Federal Reserve is on a tightening rampage, like they are now, they frequently raise shorter term interest rates too far (reflected in the 2-year note). Thus, the 2-year government security actually will be paying a higher rate of interest than the 10-year, as shown in the years immediately preceding the previous recession.

This is known as an ***inverted yield curve***, it's upside down. The 2-year interest rate is now higher than the 10 year rate.

This usually means is that the Fed is raising interest rates "too far" in comparison to what longer term investors perceive the inflation risk to be. While there is no guarantee of the future, and inverted yield curve normally occurs prior to recessions. As Alpine Macro stated above, every U.S. recession in the last 70 years has been preceded by the inverted yield curve. While I only know of two instances where the yield curve has inverted without causing a recession, the vast majority of the time a recession is looming. I don't think this time will be any different.



Following this week's FOMC announcement, the 2/10-year curve breached -50bps. This surpasses the curve inversions seen ahead of the last four recessions. The curve has inverted ahead of every U.S. recession in the last 70 years.

Unfortunately, the labor market is a coincident or lagging economic indicator. By the time it is evident that slack is building, the U.S. economy will already be in a recession.

Alpine Macro September 2022

Note: For much of the remaining newsletter rather than restating what I've already said we have chosen rather to reprint excerpts from both our January and May newsletters. Please note that January newsletter quotes have a blue backdrop and the May newsletter quotes have a yellow backdrop.

If indeed the Fed has now embarked upon what appears to be an aggressive tightening campaign, the worst of the market turmoil is not likely over. From my perspective, the three most important influences the Fed has over the stock market in the short run are liquidity, liquidity and liquidity. ***Fed Policy Mistake Jan 27, 2022***

Is The Stock Market Entering The Perfect Storm?

Excerpted from the January 27, 2022 newsletter: Fed Policy Mistake?

Economically, the stock market may be entering the perfect storm.

As previously mentioned, the Omicron virus, while less severe than the previous two waves of COVID will likely produce some economic waves due to uncertainty and the potential to create more bottlenecks in the supply chain, which in turn will likely keep inflation higher.

On top of these factors, as discussed previously, we expect a slowing economy for the next 6 months. My current outlook, subject to change, is I do not expect an economic recession in the first half of the year unless there is some “unknown unknown” type of outside shock which hits the economy when already in a weakened status. Omicron, while certainly a negative for the next few months, has pretty much been factored in by the market. But the shock of the potential for a much more aggressive Fed, in addition to the other factors mentioned, will likely make it a lot more difficult for stocks to stay positive.

In addition to these economic factors, there are some major indications that the market may have reached an extreme.

1. **Valuations on stocks are absolutely at an extreme!** In the table below, you see a variety of measures for stocks which compare how expensive stocks are related to history. Of the 5 valuation methods shown, 2 of the 5 show the market at all-time highs in terms of *extreme* overvaluation. The other 3 show the market at the second highest level -- second only to the 1999-2000 dotcom frenzy.

Valuations at Bull Market Peaks

<u>Bull Market Peak</u>	<u>Trailing P/E</u>	<u>Forward P/E</u>	<u>Shiller P/E</u>	<u>Price/Sales</u>	<u>Buffet Indicator</u>
1966	17.61	--	23.70	--	0.81
1968	18.81	--	22.20	--	0.87
1973	18.73	--	18.71	--	0.78
1980	9.48	7.96	9.65	--	0.45
1987	21.23	14.19	17.68	--	0.60
1990	16.97	12.45	17.75	0.84	0.53
2000	29.98	25.79	43.22	2.35	1.59
2007	19.91	14.90	27.32	1.67	1.16
2020	29.12	16.70	30.73	2.32	1.57
Current	27.66	20.80	38.34	3.00	2.14*

*Estimated

InvesTech Research Oct 15, 2021

Robert Shiller's P/E shown above uses average earnings from the previous 10 years to smooth out the noise.

Wall Street prefers to quote projected forward earnings, the problem with this methodology, is that if we have a recession those projected earnings will vanish. Other measures, such as price to book value, and price to sales ratios are currently extreme, with the price to sales ratio the highest of all time.

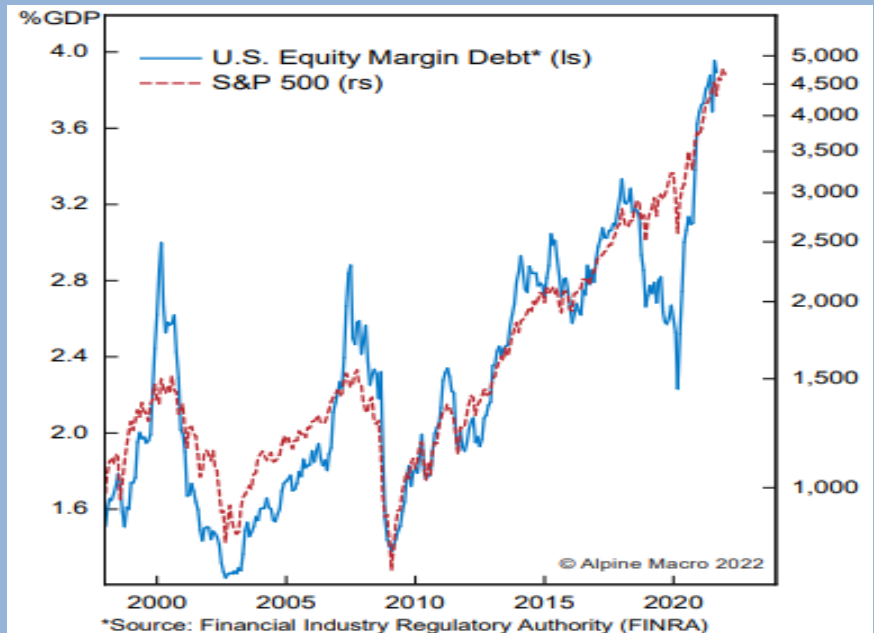
The Buffett Indicator is total stock market capitalization divided by GDP. In other words, how expensive is the market compared to the economy.

2. **Leverage in the market is extremely high!** As you can see from the chart, margin debt is the highest it's been in history as a percentage of the economy, far higher than the last two major tops in 2000 and 2007.

The problem is that, historically margin debt tends to peak ***coincident with the market***. If a bear starts with both valuations at an extreme and margin debt high, the bear tends to be a bad one.

If large numbers of margin calls start to hit the market, things will tend to snowball. Stocks going down typically creates ***forced*** selling for margined investors, as they either have to put up more cash to hold their positions or their brokerage firm will sell them out.

This forced selling pushes stock prices lower, which, in turn, produces more forced selling. If a mass liquidation starts, (think October 2008) the drop can be severe. And while a massive "daddy bear" is not our base case, you should be aware that the potential ingredients appear to be in place.



“One measure of the extreme in market sentiment is margin debt shown in chart above. The current level dwarfs the prior peaks in 2000, 2007 and 2018. Another measure of the extreme level of valuation/sentiment/speculation is the percentage of S&P 500 members with price/sales ratio greater than 10. Currently it stands at around 15%, more than double the level in 2000. Like all similar measures, these don't say much about timing but rather risks.” *Alpine Macro 2022*

3. Speculative behavior has also been at an extreme! Last year speculative behavior seemed to run almost out of control. This includes the Reddit/Robin Hood crowd, where groups of small investors circled in an attempt to make fast money, often targeting single stocks. We also witnessed the SPAC craze (Special Purpose Acquisitions Companies). These are basically shell companies created with the intent of buying a privately held company to take it public.

SPACs experienced a feeding frenzy earlier last year, and the similarities between this and the IPO's/dotcom (initial public offerings) era of 1999-2000 are amazing.

So, these market extremes, which historically have occurred either at or near market tops, are happening just as the economy looks to be slowing and the Fed is choking liquidity. All of this, could indeed produce a very rough ride for stocks for at least the first quarter of 2022 and/or beyond.

Recessions cause corporate earnings to crash and subsequently stock prices, since corporate earnings are generally the most important factor in the long run for a stock's price (a stock's valuation is primarily an extrapolation of ***expected future earnings*** for that stock).

To the right you see a table from our January 27th newsletter highlighting the magnitude of losses from the most recent bear markets (for a more full explanation on our view of the different types of bears please refer back to the January 27th newsletter on our website: www.cornerstonereport.com)

In that newsletter we discussed in depth, different types of bear markets and how they could affect investors.

Suffice it to say that we now believe that we're headed into another daddy bear market. At the time the January edition was printed, Russia had not invaded Ukraine and inflation had not become as entrenched. These factors appear to be forcing the Fed to be taking a much more aggressive stance on raising interest rates and tightening up the money supply.

S&P 500 RECENT BEAR MARKETS		
Year	% Loss*	Type
1987	35.94	Mama
1990	20.36	Mama
1998	22.45	Mama
2000	50.50	Daddy
2008	57.69	Daddy
2018	20.24	Mama
2020	35.40**	Mama
*S&P 500 Index, intraday prices DATA: Tradestation **Updated		

The above table uses the S&P 500 to measure the extent of the bear market. Please note that other indexes and individual securities may have dropped either more or less than the S&P

“Clearly, we have moved into an environment that has historically been hostile for stocks. Inflation has become widespread, the headline CPI recently hitting a near 40-year high at 7% annually. Importantly, short term inflation expectations have become elevated, and the Atlanta Fed wage growth tracker is also at the highest levels for more than a decade. There is little slack left in the economy to provide resistance to further price and wage increases. Hence, there is a significant risk that the Fed, fearing a wage-price spiral, will overdo policy restraint at a time when much of the surge in prices is due to supply constraints, which monetary policy can't do much about.” *Alpine Macro 2022*

“...stocks respond to, and are driven mainly by, the rate of change of liquidity, which has a lot to do with what the central bank does.” *Alpine Macro 2022*

In addition, the two major bear markets that we've seen in the past 40 years also had other symptoms that appeared ***before*** the bear market started.

1. Prior to the two major bear markets in the last 40 years, stocks became extremely overvalued. You can see this in both the 2000-2003 bear and 2008-2009 bear. The 2000 dot com bear market was the mother of all overvaluations for U.S. stocks, ***as stocks got more overvalued than any time in history***, even prior to the 1929 Great Depression.
2. Margin debt (investors borrow money to invest in stocks) is typically at very high levels prior to the major bear markets. The problem is that once the crash begins, accounts that have margin can lose money twice as fast as accounts where people just invested cash.

So, before both the prior daddy bear markets of my career, stocks were both overvalued and margin debt was very high. In my opinion these two factors are more important in determining ***magnitude*** of the bear market than how severe the economic downturn might be.

Recession and Falling Earnings

For the next section we're going to start with repeating material from our May newsletter. I would strongly advise you to read the entire newsletter, which deals extensively with inflation and its impact on the markets. For the time being let's just take a look at what we actually said.

Prior to May, the market's outlook was for the proverbial soft landing and now that has begun to shift to a probable recession.

During recessions, even mild ones, corporate earnings typically fall. And as we pointed out in the May newsletter up until the last few weeks, analysts had actually been forecasting rising earnings for the 2nd half of 2022 and beyond. Let's see what we said back in May.

Excerpted from the May 19, 2022 newsletter: Daddy Bear Market??

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

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

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

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

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

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

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

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

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

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

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

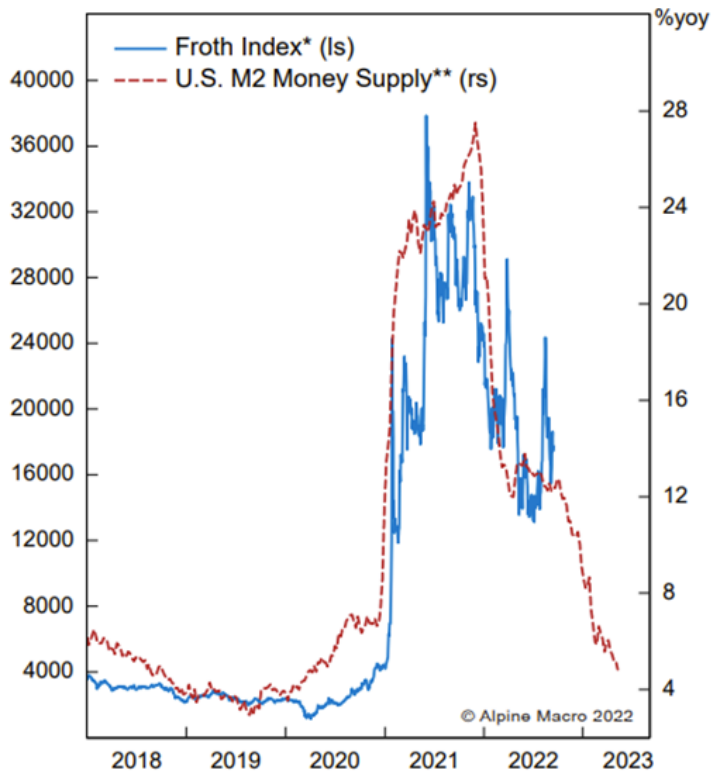
To the right you see Alpine Macro’s “Froth Index,” which is a composite made up of speculative stocks of the past. As you can see there historically has been a high degree of correlation between “frothy” stocks and the degree of liquidity that the Fed has injected into the system.

Should the correlation continue as I would expect, this would lead us to conclude that the bear market is hardly over.

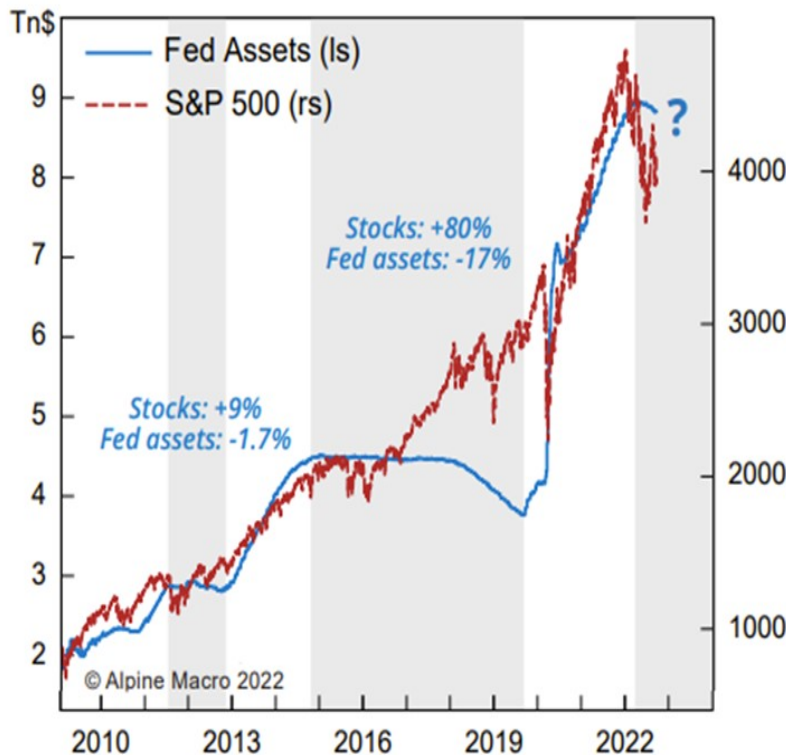
The next chart shows the Federal Reserve’s assets versus the S&P 500.

This chart, shows a high degree of correlation (although obviously not perfect) between the Fed’s “printing press” and the market.

During the beginning of the recovery from 2008-09, the Fed continuously injected enormous amounts of liquidity into the system to help avoid another depression. In the middle of the decade they stopped adding new liquidity. Stocks continued higher as the economic recovery gained strength. However, note the significant upswing in volatility for the market, especially once the Fed began as what we refer to as



*Alpine Macro calculation including Bitcoin, GME, AMC, Blackberry and Bed Bath & Beyond
 **Advanced by 40 weeks



Note: shading denotes periods of quantitative tightening (QT)

Quantitative Tightening with mama bear markets in 2018 and 2020.

Once Covid broke out, the Fed again injected enormous amounts of liquidity into they system, pushing the stock market significantly higher. Now the Fed is tightening again. You be the judge on whether this is going to cause more turmoil, as I believe it will.

My experience has been that when the Fed turns off the liquidity spigot, volatility in the stock market radically increases.

Our earnings model signals an earnings recession, with earnings expected to contract to the tune of 20% into the year-end. *BCA June 2022*

Our final chart takes another look at the market versus margin debt. Please note that we previously discussed the relationship between margin debt and the market on page 7.

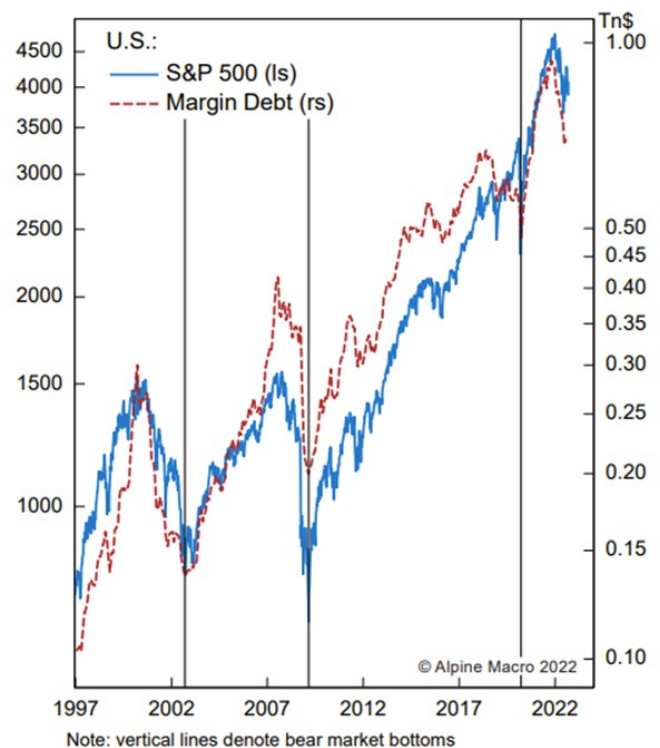
This time we are taking a look at it in a different way, not market debt as a percentage of the economy as shown on page 7 but the absolute level of margin debt versus the market.

As we stated on page 7, margin debt can be dangerous in bear markets because it can result in forced liquidations as investors have to come up with more money to hold their positions, otherwise known as a margin call.

As you can see from this chart, margin debt appears to have peaked for this cycle. But in my opinion it's highly unlikely it's been washed out of the system, as normally happens if this is a daddy bear market as I expect.

Thus, I believe we are headed for a likely recession late this year and early next year. In my opinion this has NOT been fully factored into the market.

Should this turn out to be the case, corporate earnings will likely fall significantly and will likely take stock prices with them. In sum, I do not believe the bear market is over and I believe stock prices are likely to fall significantly more than they have.



Emotions of a Bear Market

Historically speaking, the daddy bears tend to have 3 distinct emotional phases.

Phase 1 we call the **denial** phase. In spite of the fact that the bear market has started, typically investors and the media are emotionally in denial and do not recognize the bear at first. In my view, this occurred in the first quarter of 2022.

Phase 2 of the bear is usually the **recognition** phase. In this phase investors slowly wake up to the fact that we are actually in a bear market and the media recognizes this as well. Wall Street typically usually uses a 20% decline as a rule of thumb before a bear market becomes “official” and this happened in the 2nd quarter of 2022.

However, if this is truly a daddy bear, as I believe it is, there is normally a **third emotional phase** of the market called **capitulation**. The capitulation phase is normally where investors start to freak out.

Studies have shown that when investors are faced with the prospect of loss, the part of the brain that processes this is the part of the brain that causes them to want to flee (Source: **Your Money & Your Brain** Jason Zweig)

If we go into the capitulation phase over the next few months, that is usually when declines in the market steepen radically.

Chronologically the capitulation phase may only be about 1/3 of the actual duration of the bear, but historically it is not uncommon to see as much as half of the price damage occur. In other words, if this does turn out to be a daddy bear market, based on historic precedent, the damage may be only half done.

The following factors reinforce this:

- The Federal Reserve is indeed on a *very aggressive* tightening campaign, the likes we have not seen since the 1970's stagflation era.
- When the Fed is aggressively tightening monetary policy (i.e. raising interest rates, squeezing the money supply and selling their assets into the market to soak up liquidity), this has proven to be *very challenging* for stocks historically.
- A recession looks increasingly likely either late this year or early next. Recessions are typically not good for stocks unless and until the market believes that the worst is over. I don't believe we are there yet.
- *Stocks were historically overvalued* prior to entering the bear. This typically means that the magnitude of the bear market will likely be more severe.
- Record amounts of margin debt have been and are still in the system. This tends to lead to potential landslide levels of forced selling, which frequently happen in the final capitulation phase.

In all, I personally see more difficult sledding ahead for the stock market. While certainly no bear market lasts forever, I would recommend you pay close attention to these facts and adjust your portfolio accordingly.

Wall Street has another slogan which I believe is appropriate here, "the Fed normally tightens until something breaks." We do not know at this point what might "break" in the system, but we do know that this is frequently how things turn out as often times the pendulum of change tends to swing too far.

As we go to press, we are currently seeing a rally, which I believe to be a rally in the ongoing bear market.

As shown in the enclosed charts, it is not unusual to have large bounces within the context of an ongoing bear market.

In fact, if you will look at the enclosed chart of the 2000-2002 daddy bear, there were 8 rallies where the market bounced at least 5% before heading lower and 3 rallies of almost 20% or more, before finally closing down 49% on the S&P from start to finish. (Source: Tradestation)



The 2007-2009 bear market saw 12 rallies of over 5%, with the biggest bounce being 24%, before finally closing down 57% at the end of the bear market.

(Source: Tradestation)

While no one can be certain, my best educated guess is that we may be seeing another one of these bear market rallies as we go to press.

While inflation and interest rates may be trying to top out for this cycle, remember that monetary policy typically affects the economy with a lag, most often 6-9 months.

So far, the Fed has shown little desire to relent on the inflation battle, with chairman Powell even mentioning Paul Volcker and his epic battle with inflation in the early 1980's.

It looks like it will take a lot more tightening, and almost certainly a rise in unemployment (recession) to pull inflation down to the Fed's target range. I see little chance of that happening immediately.

So far, we have seen 5 bounces of more than 5% since this bear started in January. (Source: Tradestation)

The sum total of all of my research leads me to believe that the worst is not over yet.

I have a hard time believing that all of the current and coming challenges have been fully factored into this market.

I think that we probably have another major down leg to go.



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