BCN ADVANTAGE: 2013 ANNUAL REPORT

January 2014	BCN Advantage Act/Mgmt	100% Invested Buy/Hold	50% Invested Buy/Hold	100% Cash
Total Return:	13.35% [1 2 3]	29.75% [1 2]	14.87% [1 2]	0.25% [1 2]
Jan ' 97 = $100,000 [4]	$659,896	$422,235	$296,205	$154,013
Beta (2013):	0.38	1.00	0.50	0.00
Risk Adjusted Return:	14.24%	29.75%	14.87%	0.25%

1 Performance results are based on the JPMorgan Mid-Cap Fund (31.3% for 2013), the Vanguard Index 500 Fund (32.2% for 2013), the Dodge & Cox International Fund (26.3% for 2013) and an average money market return of 0.25%. The results may not reflect the actual performance of BCN Advantage clients. Past performance does not guarantee future results.
2 Performance results show the year-over-year change to net asset values and do not include the reinvestment of dividends (if any) other than interest earned from the money market fund.
3 Performance results are net of BCN Financial management fees.
4 BCN Financial Inc. is the registered investment advisor. Performance from January 1997 to June 1998 was provided through Quest Securities as the registered investment advisor.

2013 BCN Advantage Signals

	Date	Market	Cash
1	01/01/2013	100%	0%
2	02/01/2013	25%	75%
3	08/01/2013	25%	75%
4	11/01/2013	25%	75%
5	12/31/2013	25%	75%
	Present	25%	75%

Bubble, Toil and Trouble

"The problem with bubbles is that they force one to decide whether to look like an idiot before the peak, or an idiot after the peak." [John Hussman]

The S&P 500 rose 29.6% in 2013, its best annual performance since 1997. The Dow climbed 26.5%, its best year since 1995. The Nasdaq soared 38.3%, its best year since 2009. Good news reached full bloom in October in the form of the canceled taper, the appointment of Janet Yellen to succeed Ben Bernanke as Fed Chairman, and the end of the government shut-down. In the fourth quarter alone, the Dow rose 9.6%, the S&P 500 gained 9.9% and the Nasdaq climbed 10.7%. Q4 earnings are on pace to grow 8.9%, the best gain in two years. GDP rose 4.1% in Q3 and 3.2% in Q4. 2013 was the best year for IPOs since 2000. A total of 222 companies went public, up 73% from 2012.

Since 2014 began, equity markets have been rattled by the outlook for emerging markets, including slower growth in China, while the Federal Reserve continues to withdraw its monetary stimulus. Analysts have already pared Q1 forecasts to 4.5% for earnings and 3.2% for revenue. The Dow fell 5.3% and the S&P 500 lost 3.6% in January - their worst monthly declines since May 2012. The Nasdaq fell 1.7%, its worst month since October 2012.

To Taper or Not to Taper

Hints the Federal Reserve might slow its monetary stimulus sent stocks tumbling in May – as 10-year notes and mortgage rates spiked nearly a full percentage point. Then in September, the Fed signaled they would delay the taper, in large part because of the uncertainty surrounding the budget battles in Congress and looming government shut-down. Market participants expected the Fed would hold off until at least the spring of 2014. At their final meeting of the year, the Fed once again surprised the markets by announcing the taper would begin in January, at a rate of $10 billion per month.

The good news is that growth for the second half of 2013 topped 3.5%. But the improving numbers cannot mask this anemic expansion. The Joint Economic Committee of Congress calculates that if the pace of the recovery over the past 4 ½ years had simply held to the historical average, the economy would be $1.3 trillion larger today. The economy added just 113,000 jobs in January after closing out 2013 by adding only 74,000, the fewest in three years. The unemployment rate fell to 6.6%, the lowest since October 2008. But unemployment has fallen in large part because more than 7 million Americans have left the workforce.

The Fed has been forced to end its bond buying program more because of the dangers fraught with its ballooning balance sheet than because of real improvements in the economy. The Federal Reserve's balance sheet expanded to a record $4 trillion in December from $891 billion in 2007. The Fed now holds $1.5 trillion in mortgage-related assets and $2.2 trillion in Treasuries. Quantitative easing actively harms the economy. It leads to an unmerited redistribution of existing wealth to early receivers of newly created money, by enabling "nothing" (money from thin air) to bid for "something" (real assets & resources) before prices have been altered. It distorts interest rates and sends false signals about the economy to entrepreneurs. Scarce capital is misallocated and boom-bust cycles are set in motion. Low rates encourage spending, hiring and investing. At the same time, artificially low rates can inflate dangerous bubbles in stocks, housing and other assets.

No Alternative to Stocks

At 4 years, 11 months this bull market is already one of the longest since the Great Depression. Looking at the S&P 500 back to 1932, the average bull market duration is 3.8 years. Of 16 bull markets over the past eight decades, only three prior to this one lasted more than 5 years. The S&P 500 has gone 850 calendar days (from October 2011 through January 2014) without a correction of 10% or greater, the 5th longest stretch in the last 50 years.

The investing public’s market timing is notoriously bad. And right now, they’re piling into stock mutual funds at the most furious rate in 13-years. Advisors polled by Investors Intelligence reached the lowest percentage of bears since 1987. The percentage of bullish advisors rose to 61.6%, the highest in six years. At the October 2007 top, the percentage was 62%. The spread between bulls and bears reached 46.4 percentage points at the beginning of 2014 – for the fifth straight week higher than October 2007. Advisors now have 98.3 percent of their clients’ portfolios allocated to stocks (exposure to equities averaged 72 percent during 2013) and margin debt is at record highs – exceeding $445 billion and far eclipsing 2007 levels. Overall, the S&P, Nasdaq and Dow are simultaneously reaching major trend line resistance in an environment of peak optimism.

The Problem is Earnings

“Risk increases substantially as the trend ages,” writes Goldman’s chief strategist David Kostin. “The longer the bull market goes on, the higher the excesses become and the more painful the drawdown will be on the other side.” Key metrics indicate stocks are at least 40% overvalued: Cyclically adjusted price-earnings ratio (current P/E is 25x vs. 15x average). Market cap to revenue (current ratio of 1.6 vs. 1.0 average). Market cap to GDP (double the pre-1990s norm). Record corporate profit margins are the direct result of Federal transfer payments (food stamps, disability benefits, unemployment benefits, student loans and direct welfare benefits) that have continued at emergency levels five years into the economic recovery. Corporations are enjoying stable demand (reflected in flat revenues) without having to hire or pay increasing wages and benefits. So while stock PRICES are merely lofty when compared with current earnings, the danger is that EARNINGS ARE IN A BUBBLE financed by unprecedented monetary and fiscal stimulus.

Forecast for a Perfect Storm

Coming to you in 2014: Higher interest rates, reduced monetary stimulus, reduced fiscal stimulus and reduced discretionary spending (as consumer dollars are redirected toward mandatory health insurance premiums and out-of-pocket deductibles). All the while high paying jobs continue to be replaced with part-time, temporary and contract jobs that pay lower wages or lower benefits or both. Median annual household income has fallen $2,535 since the recession “officially” ended in June 2009 – and the labor participation rate continues to languish at levels not seen since the 1970s. Each percentage increase in Treasury rates will add $170 billion per year to the interest paid on our national debt.

The Eurozone crisis is not over. Their fiscal problems have yet to be resolved and their unemployment is staggeringly high and still rising. Eurozone governments have set aside almost no money to make good on their promise to recapitalize ailing banks after a health check later this year. "The risk of a hard-landing of the Chinese economy is not negligible," observes Societe Generale. "The most likely trigger is that Beijing's gradual deleveraging plan gets out of control, which would lead to shadow banking failures, a liquidity crunch and financial market turmoil."

Secular bear markets bottom at P/E multiples below 10x and typically require three major corrections over a period of at least 17 years. If historical relationships hold, we face a concluding 40% to 60% peak-to-trough drawdown that would not be reversed until at least the end of 2016. Our discipline to move to cash (when risks outweigh rewards) allows us to become fully invested after declines (as we did in 2009). It’s worth remembering that prior to our decision to go defensive in early 2013, we remained 100% invested in stocks for 30 consecutive months and for all but a handful of months since this rally began in March 2009. These markets are every bit as dangerous as 2000 and 2007. There is no way to sugarcoat it. We are about to enter a period that could be worse than 2008. This time around, stocks, bonds and real estate could all fall in value – perhaps precipitously. In other words, there may be no place to hide other than cash, today’s most despised asset.

As always, we look forward with great optimism. We appreciate your faith and confidence. And we are eager to apply the lessons learned for your benefit.