BCN ADVANTAGE: 2016 ANNUAL REPORT

January 2017	BCN Advantage Act/Mgmt	100% Invested Buy/Hold	50% Invested Buy/Hold	100% Cash
Total Return:	3.19% [1 2 3]	6.32% [1 2]	3.41% [1 2]	0.50% [1 2]
Jan ' 97 = $100,000 [4]	$696,361	$470,211	$314,456	$155,561
Beta (2016):	0.40	1.00	0.50	0.00
Risk Adjusted Return:	3.19%	6.32%	3.41%	0.50%

1 Performance results are based on the T. Rowe Mid-Cap Growth Fund (6.3% for 2016), the Vanguard Index 500 Fund (11.8% for 2016), the Harbor International Fund (-0.1% for 2016) and an average money market return of 0.50%. 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.

2016 BCN Advantage Signals

	Date	Market	Cash
1	01/01/2016	40%	60%
2	02/01/2016	40%	60%
3	05/01/2016	40%	60%
4	08/01/2016	40%	60%
5	11/01/2016	40%	60%
6	12/31/2016	40%	60%
	Present	40%	60%

A Reversal of Fortune

For 2016, the S&P 500 rose 9.5% to 2,239, the Dow 13.4% to 19,763 and the Nasdaq 7.5% to 5,383. The IBD Mutual Fund Index gained only 4.7%. Stocks began 2016 with one of the worst Januarys on record, a reaction to the Fed's first interest rate hike in a decade. But markets quickly recovered as the Fed backed away from further rate increases, then remained mostly flat through October. An election night panic pushed Dow futures down 800 points and S&P 500 futures down to their -5% limit. But by morning stocks had reversed yet again, and charged ahead to close out the year 9% higher from Election Day. Despite all the excitement, the year-end rally underperformed the +10%, +14% and +13% moves in the final months of 2013, 2014 and 2015, respectively. The rally was preceded by -$228.9 billion in net outflows in U.S. stocks from January 2015 through October 2016, which raises the question of what forces have driven the major indexes to fresh all-time highs.

The sluggish US economy expanded 1.6% in 2016. Q4 missed estimates at 1.9%, and slowed considerably from the 3.5% rate in Q3. Imports grew better than 8% while exports fell more than 4%. Domestic demand in the U.S. surged, including big ticket items like houses and cars, but the strong dollar crimped exports. Core inflation rose 2.2% year-over-year, with wage growth failing to keep pace. Average hourly earnings for nonsupervisory employees declined to just 0.5%, down from 2.2% in 2015. With fewer hours worked, real income is declining. This does not bode well for consumer-spending, the fuel that drives more than two-thirds of our economic growth.

The Talked-About Stimulus

The Trump administration hopes to jolt the economy with a dose of fiscal spending, tax reform and deregulation. Vast new mega-projects will be required to significantly affect the $18.9 trillion U.S. economy – or even absorb the $1 trillion in planned infrastructure spending. A plan likely would not become law until late 2017. Kick-starting large projects from scratch takes two years to plan and design prior to construction, which suggests 2019-2020 before significant benefits filter through to the economy. Combined with estimated 9% earnings growth in 2017, lowering the top corporate rate from 35% to 20% theoretically could lift the S&P 500 to 2500, roughly 8% higher than today. But tax "stimulus" may not work that well in practice. According to the Government Accountability Office, the average tax rate paid by large, profitable U.S. corporations is 12.6%. Conservatives will push hard for revenue neutrality over worries about the nation's $20 trillion debt. As a result, there may be no real impact – and possibly *adverse* impacts on those companies currently paying less than 20% – if existing corporate deductions are eliminated to offset the tax cut. If nothing else, these are the reasons corporate tax reform could stall in Congress. Given the strong dollar, a sharp rise in Treasury rates, and faster than anticipated Fed rate hikes to curb inflation, the drag on earnings may nullify much of the talked-about proposals. Their impact may be little more than short-term "psychological" boosts.

Cinderella Valuations

Back in 2007 Q3, the S&P 500 Index peaked at 1,576 and sported a price-to-earnings ratio of 18.5 times earnings. Today, the S&P 500 Index just wrapped up 2016 at 2,239, with a price-to-earnings ratio of 23 times earnings. Stock market capitalization as a percentage of gross domestic income is at its second highest level in 90 years. The price-to-sales on the S&P 500 is at its second highest in history, rivaled only by the 2000 bubble. Yet even this comparison overlooks the fact that in 2000 a relatively small subset of stocks were breathtakingly overvalued. The current speculative period has extended to virtually all risk-assets. The median price / revenue ratio of S&P 500 stocks now stands at the highest level in history.

What makes the S&P 500 truly stand out is how U.S. stocks have performed versus the rest of the world. From mid-2007 through the end of 2016, the S&P 500 Index is now more than +75% above its pre-crisis highs. Developed international markets (as measured by the MSCI EAFE Index) are still lower on a *nominal* (non-inflation adjusted) basis. The S&P 500 presently stands between 120% and 150% above historical valuation norms. Moving from 120% overvalued to 25% overvalued implies a loss of about (1.25/2.2-1=) -43%, while moving from 150% overvalued to fair value implies a loss of (1.0/2.5-1=) -60%. As Buffett likes to say, speculators are "Cinderella dancing in a ball room with no clocks." Solid earnings growth would go a long way to prevent such an outcome. For the S&P 500, 2016 Q4 would mark the end of seven consecutive quarters of annual earnings declines. The rate of year-over-year decline troughed at -15.4% in 2015 Q4 and has since been improving to just -1.7% in 2016 Q3. If the final quarter of 2016 holds up as expected, earnings would break out with a +12.9% year-over-year increase.

Maximum Front Run

Investors are scrambling to get ahead of Trump's economic proposals that many are comparing to those of Ronald Reagan. But the economic environment and potential growth of 1982 was vastly different than today (table). The U.S. stock market has been sustained all along by a steady flow of monetary stimulus (chart). As we enter 2017, monetary policy is fading at the same time that fiscal policy remains uncertain. The Fed ended “quantitative easing” more than two years ago and is now tightening. The People's Bank of China has drained $700 billion from its balance sheet since mid-2015. The European Central Bank, though still pumping, has begun to taper its asset purchase plan. And the Bank of Japan shows increasing signs of standing down.

After years of zero interest rate policy (ZIRP), the Fed has managed two 1/4 point rate hikes since December 2015. But no major economy has ever exited the ZIRP experiment successfully. In the latest report from the Institute for International Finance, global debt increased by $11 trillion in the first 9 months of 2016, hitting a new all-time high of $217 trillion. As a result, debt levels are now roughly 325% of the world's gross domestic product. There is about $1.7 trillion in cash on corporate America's balance sheets, but it’s unevenly distributed: 25 companies control more than half; 5 companies nearly a third. Corporate borrowing, spent mostly on dividends, buybacks and M&A, is at multi-year highs. Interest once earned on guaranteed CDs can now be earned only from junk bonds, whose issuance has more than doubled since the financial crisis. Credit binges are cyclical and the bigger the binge, the bigger the fall.

The current economic expansion began in June 2009, nearly 8 years ago. The longest expansion in history lasted 120 months, or exactly ten years from 1991 to 2001. It was fueled by technology advances and low inflation, falling interest rates, and massive spending on technology driven by the internet. Could this current run break the record? Perhaps, but the odds of a recession grow larger as the recovery runs longer, and no one can forecast recessions with any precision. In March 2009, we moved 100% into growth stocks. Part of our rationale then: If we're not buying stocks after they've fallen 50%, when would we? Conversely today, if an old, very expensive, highly leveraged stock market doesn’t make us cautious, what would? Yet the level of cash being held by individual investors is near record lows.

Compare that to Berkshire Hathaway, currently holding more than $90 billion in cash yielding almost nothing. Warren Buffett knows from long experience that cash protects capital. The benefits of having capital to invest at lower valuations has produced substantial outperformance over waiting for previously destroyed investment capital to recover. The BCN Advantage service offers substantial proof of the benefits of minimizing losses in actual practice. When risks begin to outweigh the potential for reward, smart investors raise cash. They buy low and sell high. When you sell high you raise cash. And you can't buy low if you don't have any capital to buy with.

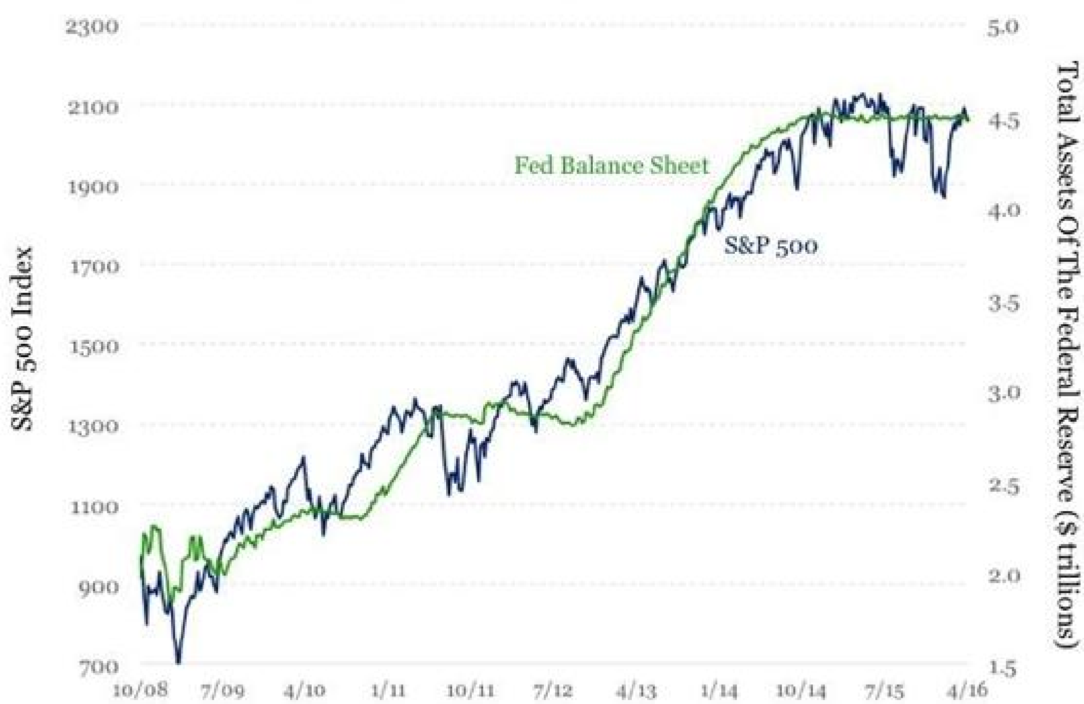
Looking forward, we realize that patience is waning as stocks move higher. One quarter does not make a trend, but if downward pressure continues to build on S&P 500 valuations (from the 2016 Q3 peak of 24 x earnings), we will move more aggressively into stocks – likely 70% by summer. But don’t be surprised if a significant market correction occurs before then.

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.

1982 vs 2017

	1982	Today		1982	Today
Fed Funds Rate	18.00%	0.50%	Annual Inflation Rate (CPI)	8.00%	1.60%
10 Year Treasury Yield	15.00%	2.30%	Personal Savings Rate	10.00%	5.00%
Mortgage Rate	16.25%	3.87%	Labor Force Participation	64.00%	63.00%
Household Debt to Income	62.00%	130.00%	S&P 500 - CAPE10	7	26
U.S. Government Debt to GDP Ratio	30.00%	105.00%	S&P 500 - Median Price to Sales Ratio	.50x	2.20x
Total U.S. Debt to GDP Ratio	.90x	3.60x	Median Age Baby Boomers	26	60
Productivity Growth	2.00%	0.25%	Global Trade Barriers	Falling	Rising

Stocks & The Fed's Balance Sheet: Intertwined



Source: Gerring Capital Partners, U.S. Federal Reserve