BCN ADVANTAGE: 2017 ANNUAL REPORT

February 2018	BCN Advantage Act/Mgmt	100% Invested Buy/Hold	50% Invested Buy/Hold	100% Cash
Total Return:	13.64% [1 2 3]	23.66% [1 2]	12.44% [1 2]	1.20% [1 2]
Jan ' 97 = $100,000 [4]	$791,560	$581,480	$353,559	$157,438
Beta (2017):	0.53	1.00	0.50	0.00
Risk Adjusted Return:	14.35%	23.66%	12.44%	1.20%

1 Performance results are based on the T. Rowe Mid-Cap Growth Fund (24.9% for 2017), the Vanguard Index 500 Fund (21.7% for 2017), the Dodge & Cox International Fund (23.9% for 2017) and an average money market return of 1.20%. 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.

2017 BCN Advantage Signals

	Date	Market	Cash
1	01/01/2017	40%	60%
2	02/01/2017	40%	60%
3	05/01/2017	40%	60%
4	07/05/2017	60%	40%
4	08/01/2017	60%	40%
5	11/01/2017	60%	40%
6	12/31/2017	60%	40%
	Present	60%	40%

Nine Years of Gains

For 2017, the S&P 500 rallied 19.4% to 2,674, the Nasdaq 28.2% to 6,903, and the Dow 25.1% to 24,719. It's been a nine-peat: nine straight years of market gains. The U.S. stock market has returned a compound 15.5% per year over that span, growing cumulatively more than 250%.

January saw the best start since 2006. In four weeks the S&P 500 gained 7.5%, the Dow 7.7% and the Nasdaq 8.7%. Then came February. The Dow lost more than 1,000 points twice in one week, leaving the markets in a correction, down 10% from their January 26th record highs. While the headlines focused on the largest point drop ever for a single day, in percentage terms the Dow's 4.6% fall was the worst since August 2011, but only the 25th largest since 1960. For perspective, the Dow plunged 22.6% on the Black Monday crash of October 19, 1987.

On February 2nd, the U.S. employment report showed average hourly wages rose 2.9%, the biggest annual gain since 2009 and much higher than expected. Concerns suddenly intensified about inflation and the likelihood of a more aggressive Federal Reserve. A congressional budget deal that sharply boosted federal spending – on the heels of the big Trump tax cuts — pushed the 10-year Treasury yield to a four-year high of 2.88%.

Stretched Valuations

Following an "earnings recession" that spanned 2015 and much of 2016 (fallout from a 50% decline in oil prices and strong dollar), 2017 earnings were robust. For the 4th quarter, 78% of companies topped Wall Street estimates. Eighty percent beat on revenue. That's the best rate for earnings since the third quarter of 2009. For sales, it's the best since at least 2002. GAAP earnings were $110 per share, up 16% for the year, but down from a projected $122 per share at the beginning of 2017. Companies are hiking 2018 earnings forecasts on the Trump tax cuts. GAAP estimates for 2018 are a whopping $145 per share, a 32% increase. Such spectacular results would go a long way to bringing stock prices in line, but a healthy dose of skepticism is warranted.

Despite the recent 10% correction, the S&P 500 is still trading at 24 times trailing 12-month GAAP earnings. That's expensive by any measure. Valuation extremes today extend broadly across the market, in contrast to 1999 when tech companies contained a majority of the overvaluation. Price discovery is lacking, replaced in the bond markets by price insensitive central banks, and in the stock market by price insensitive corporate share buybacks and passive ETF buyers. Around $500 billion has flowed away from active managers into exchange traded funds over the past 12 months, where ETFs now account for over one-quarter of the trading volume. On January 26th, at its closing high of 2,873, the S&P 500 was trading at 26 times earnings. Back in September 2000, the S&P 500 earnings multiple peaked at 26.7, almost exactly the same level.

Fed in a Box

The yield on the benchmark U.S. Treasury 10-year note is 2.83%, more than double the multiyear low of 1.37% set in July 2016. Up to a certain point, rising yields are seen as the barometer of a robust recovery. But if yields rise too far, too fast, it sets up a policy conundrum. If the Fed withdraws transparency (decides to stop allowing the markets to have a say in how policy develops) on the way to leaning aggressively hawkish, they risk hiking too fast, flattening the yield curve, and pushing the economy into recession. If the Fed sticks to a gradual pace (allowing the markets to fully price each hike), they risk falling behind which, if inflation pressures build, would force the Fed to play catch-up after the curve aggressively steepens.

The current fed funds range is 1.25% - 1.50%, with three quarter-point hikes priced in by December. But consider the changing landscape: In the U.S., the administration has just passed a deficit-funded tax cut and budget-busting spending bill, piling fiscal stimulus atop an overheating economy at a time when the Fed is trying to hike. Past a certain point, inflation would force central banks to end their reflexive relationship with markets. No more "Fed Put." They would need to lean against inflation irrespective of what that would entail for risk assets. 26x earnings may not seem unreasonable so long as the Fed has your back. But absent faith in continued Fed accommodation and intervention, stratospheric valuations no longer look appetizing.

Quantitative Tightening

Combine suddenly higher rates with massive outstanding debt (both government and corporate) and you have a recipe for disaster. Hand in hand with $21 trillion in Treasury debt, upwards of $13 trillion of non-financial business debt is currently outstanding (compared to just $4 trillion in 2000). A 2.5% rise in yields would amount to $325 billion of increased interest expense – about 25% of current non-financial business profits before tax.

Even before a deal to boost spending on defense and domestic programs, Treasury was expected to issue nearly $1 trillion in debt this year, nearly double last year's total. Add to that the Fed's commitment to shrink its balance sheet by $600 billion annually, beginning in October 2018. For the first time ever, both the Fed and Treasury will be dumping massive amounts of public debt on the bond market – $1.8 trillion in FY 2019 alone. The double whammy of government debt coupled with Fed "quantitative tightening" could spark a "yield shock" – even in the absence of inflation. As we learned during the EU debt crisis of 2010, bond investors are enticed by high yields only so long as rates are seen as stable or poised to go lower. But what if perception shifts? And bond investors become fearful that rates will not only rise, but rise rapidly. Demand even for sovereign debt can disappear overnight, creating a vicious cycle. This is what we saw in Europe before the banks stepped in.

Looking Ahead

The yield curve has inverted ahead of every recession in the past 40 years. The lag is usually 12 months or more, so recession is not likely on the horizon for 2018. But bull markets end well before a recession rears its ugly head – when everything seems perfect: low unemployment, strong earnings, high profit margins, high capacity utilization, near record output, stock market indices at record highs.

Repatriation of overseas cash by U.S. multinationals could bring $2 trillion back to the U.S, much of it used to buy back company stock. Corporate repurchases totaled $570 billion in 2017, and are expected to reach $590 billion in 2018. Stocks should rally, lifted by those share buybacks and strong earnings. But we fully expect the lows set by this current pullback to be retested, probably no later than October as the Fed and other central banks accelerate their quantitative tightening. 10-year yields rising above 3% may set the stage for sharp declines. And the "Fed Put" may not be available the next time markets take a sustained tumble.

This current market selloff could be the beginning of a more serious correction, but it's too early to tell. If the ensuing rally fails before making a new market high, subsequent declines will become increasingly more dangerous. We are already positioned for a decline as severe as -25%. But we definitely do not want to commit further to growth stocks until the pattern of this current selloff becomes clear. For us, deep corrections become buying opportunities, because we have the financial ammunition (defensive cash) to buy aggressively once the markets bottom.

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.

BCN Financial Inc. is the Registered Investment Advisor

We are required to offer Form ADV Part 2 to our clients each year. Contact BCN Financial for a copy.