BCN ADVANTAGE: 2018 ANNUAL REPORT

February 2019	BCN Advantage Act/Mgmt	100% Invested Buy/Hold	50% Invested Buy/Hold	100% Cash
Total Return:	-5.15% [1 2 3]	-8.56% [1 2]	-3.27% [1 2]	2.02% [1 2]
Jan ' 97 = $100,000 [4]	$751,316	$531,711	$341,996	$160,616
Beta (2018):	0.60	1.00	0.50	0.00
Risk Adjusted Return:	-5.15%	-8.56%	-3.27%	2.02%

1 Performance results are based on the Fidelity Mid-Cap Stock Fund (-6.5% for 2018), the Vanguard Index 500 Fund (-4.5% for 2018), the Dodge & Cox International Fund (-18.0% for 2018) and an average money market return of 2.02%. 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.

2018 BCN Advantage Signals

	Date	Market	Cash
1	01/01/2018	60%	60%
2	02/01/2018	60%	60%
3	05/01/2018	60%	60%
4	08/01/2018	60%	40%
5	11/01/2018	60%	40%
6	12/31/2018	60%	40%
	Present	75%	25%

A Down Year for the Markets

For 2018, the S&P 500 fell -6.2% to 2,507, the Nasdaq -3.9% to 6,635, and the Dow -5.6% to 23,328, breaking a streak of 9 straight years of market gains. The IBD Mutual Fund Index declined -9.1%. The average hedge fund lost 6.7%

The S&P 500 dipped into official bear market territory, declining by as much as 20.2% during the worst December since 1931. Still, this may turn out to be the shortest-lived bear market in history, as the infamous “Fed Put” is back in effect.

GDP grew at the fastest rate since the 2008 recession, the unemployment rate fell to its lowest level in nearly fifty years and corporate profits increased by more than 25%. Meanwhile, the Fed nearly doubled short-term rates to 2.5% and accelerated “quantitative tightening”.

The “Fed Put” is Back On

Fed policy will be the single most important factor in market performance. The balance sheet of the Federal Reserve peaked at roughly $4.5 trillion in January 2015 and has now contracted to $4.175 trillion. During that time, the Federal Funds rate was raised from 0% to an upper range of 2.5%. In October 2018, the Federal Reserve started to roll off $50 billion per month, precipitating the worst quarter for stocks since 2008.

Jerome Powell struck an entirely different note on January 30th, 2019, as he essentially capitulated across the board: “The Fed will now be patient in regards to interest rates.” Suddenly, the balance sheet unwind wasn’t on “autopilot” any more. Markets are no longer expecting 2-3 rate hikes from the Fed this year. They are expecting zero rate hikes or possibly even a rate cut. And “almost all participants” supported announcing an end to the balance sheet normalization process this year. The FOMC originally believed the balance sheet runoff could last until 2023.

The ability of the Fed to bail out markets today is much more limited than it was in 2008. Then, the Fed's balance sheet was only $915 billion, and the Fed Funds rate was 4.25%. Today, unemployment is 4%, not 10+%. Corporate debt is at record levels. The

government is running $1 trillion deficits during an expansion. The economy is extremely long in a growth cycle, not emerging from a recession. Such an environment could make further interventions by the Fed less effective.

Debt is Always the Problem

It's difficult to overstate the influence Fed policy has on markets. America has never been so indebted. Therefore, rates don't need to return to past levels to have a detrimental impact on the economy. Total debt today (public and private) is roughly $69 trillion. This includes state, local, federal, corporate and household. At the peak in 2008, total debt was roughly $54 trillion. Debt that is not self-funding is future consumption brought forward. Because of the Fed's decade-long measures to artificially suppress interest rates and flood the system with excessive liquidity, we have enjoyed consumption and growth that cannot happen in the future.

The U.S. national debt was $21.867 trillion at the end of 2018, an increase of $11.3 trillion over the last 10 years. Since 2000, Federal spending has increased by 132%, but Federal tax revenue has increased by just 63%. At well over $500 billion, debt servicing now equates to about 13% of Federal spending.

Total corporate debt has swelled from $4.9 trillion in 2007 as the Great Recession was just beginning to nearly $9.1 trillion mid-way through 2018, surging 86%.

U.S. households are collectively $19.26 trillion in debt, a new record: Credit card debt: $1.06 trillion. Auto loan debt: $1.22 trillion. Student loan debt: $1.58 trillion. Mortgage debt: $15.4 trillion.

Margin debt, specifically, will act like the proverbial foot on the accelerator during future market declines: Margin debt ballooned to $669 billion at the peak in May 2018, up 60% from its pre-Financial Crisis peak in July 2007. Since May, margin debt has plunged by $114.6 billion.

Markets are Facing Headwinds

S&P 500 earnings increased more than 26% in 2018 but are expected to grow less than 8% in 2019. Global growth Is less synchronized. The international stock index EAFE has been negative in 5 of the last 11 years, including a -14.2% drop in 2018 as trade tensions with China intensified. Market structure is one-sided and worrisome. A tenth of a percent of the stocks in the world comprise 15% of world market capitalization. Apple's recent stock plunge unnerved markets across the globe. When Apple peaked at more than $1 trillion in market capitalization, its stock was worth more than the entire stock markets of 54 countries.

Investors have been draining money out of U.S. stocks to the tune of nearly a quarter of a trillion dollars. At the same time, U.S. corporations have poured a record $1 trillion into share repurchases. As the Fed rolls $50 billion per month off its balance sheet, the onus for absorbing Treasury issuance falls to markets. The more issuance at a time when the Fed is pulling back, the less liquidity available for risk assets. Meanwhile, Fed hikes drive up the yield on cash, making it viable as an asset class for the first time in a decade. Last year, cash outperformed 90% of global assets.

Oil has gotten crushed since the high reached in October. The price of oil ended 2018 at $45.41, crashing 45% from its high of $76.41 a barrel, marking one of the sharpest oil declines in history. The average interest rate nationwide on a 30-year fixed rate mortgage was 4.55% at the end of 2018. The record low national average was 3.31% in November 2012.

Strategy for 2019

With the Fed acting to support asset prices, the decline that began last October is probably no longer the start of a bear market, but rather the conclusion of a significant correction. Since 1928 there have only been four cases of consecutive down years: 1929-1932, 1939-1941, 1973-1974, 2000-2002. And stocks have been higher in the 12 months following every midterm election since 1946.

The Fed's 180-degree policy shift will likely prolong the economic expansion, making a recession unlikely until mid-2020. But while we recognize the possibility of new highs, this remains a high-risk, late-stage bull market. Always keep in mind that markets never collapse when things look bad. Quite the contrary.

Expect a tough back-and-forth struggle as the S&P 500 makes its way back to 2,800. At that level, the S&P 500 is exactly 20x it's trailing 12-month (2018) earnings. Since 1978, the average TTM P/E for the S&P 500 has been 20.2. But if the bulls can regain control and push prices back above the November highs, then the "bear market" correction of 2018 will officially be dead. The path will then be open for another potential run to 2,940 and new all-time highs.

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.