BCN ADVANTAGE: 2012 ANNUAL REPORT

January 2013	BCN Advantage Act/Mgmt	100% Invested Buy/Hold	50% Invested Buy/Hold	100% Cash
Total Return:	17.86% [1 2 3]	17.96% [1 2]	9.11% [1 2]	0.25% [1 2]
Jan ' 97 = $100,000 [4]	$580,971	$324,372	$257,570	$153,629
Beta (2012):	1.00	1.00	0.50	0.00
Risk Adjusted Return:	17.86%	17.96%	9.11%	0.25%

1 Performance results are based on the JPMorgan Mid-Cap Fund (19.9% for 2012), the Vanguard Index 500 Fund (13.4% for 2012), the Dodge & Cox International Fund (21.0% for 2012) 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.

2012 BCN Advantage Signals

	Date	Market	Cash
1	01/01/2012	100%	0%
2	05/01/2012	100%	0%
3	08/01/2012	100%	0%
4	11/01/2012	100%	0%
5	12/31/2012	100%	0%
	Present	25%	75%

A Confounding Market

For 2012, the DJIA closed at 13,104, up 7.3%, the Nasdaq at 3,019, up 15.9% and the S&P 500 at 1,426, up 13.4%. Financials were the strongest industry sector, gaining more than 26%. Of the ten S&P 500 sectors, only utilities ended the year lower, falling 2.9%.

Markets tend to do things that confound the greatest number of people. Since 2009, this meant snubbing fretful investors who have persistently bet on a market decline. Individual investors have poured nearly $210 billion into bond funds since the beginning of 2008, while yanking almost $700 billion out of U.S. stocks. In 2012 alone, investors added more than $90 billion to bonds, while pulling more than $150 billion from stocks. Over the last four years, stock investors have endured record daily price swings and three corrections of 10% or more (14 corrections of 5% or more). Daily price swings in the S&P 500 averaged 1.74% in 2008, the most for any year since the Great Depression. Price swings averaged 1.58% in 2009, the third most volatile on record. 2011’s 1.24% average was the seventh most volatile. Average daily price swings fell to 0.59% in 2012.

Improving Fundamentals

In April 2012, the median price of existing homes jumped 10.1% year-over-year, the biggest increase in more than six years. Confidence among U.S. homebuilders rose to the highest level in more than six and a half years. U.S. household net worth rose in the third quarter to $64.77 trillion, just $1.2 trillion short of the 2007 peak. Household debt fell $65.5 billion to $12.87 trillion. Part-time hiring cut the unemployment rate to 7.8% in September, although a broader underemployment rate that includes part-time workers was unchanged at 14.7%.

In June 2012, concerns were rising that the Greek elections would become a “Lehman moment” for Europe. By September, the European Central Bank agreed to launch an unlimited bond-buying program – backing ECB President Mario Draghi’s pledge to do “whatever it takes” to preserve the euro. Euro zone stocks soared in response and Spanish and Italian bond rates dropped dramatically. China's deceleration heightened fears of a global economic slowdown, but China’s economy is expected to accelerate in 2013 – to 8.2% GDP growth – coinciding with their once-a-decade political handover.

The Federal Reserve ended its December 2012 policy meeting by extending $85 billion in monthly bond purchases indefinitely. The Fed for the first time tied any increase in short-term interest rates to a substantially improved job market. The Fed will keep bank overnight lending rates near zero until unemployment falls below 6.5 percent – as long as inflation remains tame.

The S&P 500 ended the first week of 2013 at its highest level since December 2007. For the week, the S&P gained 4.6%, the Dow 3.8% and the Nasdaq 4.8%. Over $22 billion flowed into stock funds – the second-highest weekly amount on record. "Crisis fatigue has settled in," commented a market analyst. "The Armageddon investors expected never materialized."

A Fiscal Super Storm

The next brawl poses a far greater threat to markets than the imaginary "fiscal cliff" – talk of default will grow as we move into February, accompanied by concerns over U.S. credit downgrades. By definition, markets cannot be blindsided by problems everyone can see. But this time, Congress and the President cannot offer a solution that avoids recession AND satisfies the demands of the private debt markets.

Congress has already raised taxes on every working American – by rescinding the 2% reduction in Social Security payroll taxes. Under the Affordable Care Act, in 2014 businesses that employ at least 50 full-time workers must offer health insurance to employees who work at least 30 hours a week – or pay a $2,000-per-worker penalty. Employees must pay no more than 9.5% of their wages in insurance premiums, forcing employers to contribute significantly more for lower-wage workers. Nearly half of retailers, restaurants and hotels will be affected by the law. Nearly one-third of franchise owners said they plan to pare staff. "It will have a negative impact on job creation." [Mark Zandi, chief economist of Moody's Analytics].

Social Security, Medicare and Medicaid accounted for 44% of non-interest federal spending in 2012. The CBO put it this way: "With the population aging and health care costs growing faster than the economy, the U.S. cannot sustain the federal spending programs that are now in place with the federal taxes that it has been accustomed to paying." Over the last four years, federal spending has averaged $3.5 trillion, roughly a quarter of everything America produces. Only WWII rivals that level. The deficit was $459 billion in 2008. From 2009 to 2012, deficits have averaged $1.3 trillion – almost 9% of GDP. In 2009, our economy contracted 3.1%. It grew just 2.4% in 2010, 1.8% in 2011 and 2.1% in 2012. For 2013, the CBO projects 1.7% growth – a four-year recovery rate of 2%, the lowest since the Great Depression. The average four-year recovery rate is 5.7%.

Corrosion of Confidence

If Congress and the President fail to reach agreement on real fiscal reform, if they raise the debt ceiling while continuing $1 trillion annual deficits, all three major credit rating agencies (S&P, Moody's, Fitch) may downgrade U.S. debt – and precipitate a credit crisis. A downgrade by all three would compel major bond buyers (such as pensions) to either sell U.S. treasuries or stop buying future treasury debt.

$85 billion per month works out to almost exactly $1 trillion a year. A coincidence? In 2012, the Federal Reserve was already the primary buyer for over 70% of newly issued federal debt. If the U.S. continues to run deficits this massive, the Fed has no choice. There is simply not enough money on earth to continue to absorb our mountain of IOUs. The U.S. government will never technically default. But the U.S. can (and will) be perceived as a major credit risk if it plans to pay back its creditors with devalued currency. A spike to 5% in borrowing cost would increase interest payments on our $16 trillion national debt from $250 billion to $700 billion per year. A spike to 7% would increase interest payments to nearly $1 trillion per year, equal to 40% of annual U.S. federal tax receipts. With U.S. treasury yields still near historic lows, market participants are not yet considering and have not priced in the possibility of a significant spike in U.S. treasury rates – despite the consequences already seen in Europe.

The Moment Has Arrived

We are nearing the fourth anniversary of the March 2009 bear-market low, with an unmistakable correlation between "quantitative easing" and the stock-market rally. The Fed quietly began its bond-buying program in late 2008. Since the Fed doubled down in 2009, the S&P 500 has soared 120 percent. By historical standards, the current bull market at 3.8 years of age is exactly the average bull market duration of the past 80 years. Since 1929, the year following a presidential election has been the least profitable – markets have been positive only eight of 15 times, with an average return of 4.7%. And more recessions have started in the first year of a presidential term than in the remaining three years – combined. Fed intervention raises doubts about whether improvements in the economy are sustainable, or merely the result of artificial government support. Today, after $3 trillion in freshly printed dollars, the Fed has likely exhausted – prematurely – its most effective monetary policy to offset fiscal austerity. This does not bode well for 2013. We go defensive if we have a reasonable certainty of re-entering the markets at a lower buy point. That moment has arrived.

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.