# BCN ADVANTAGE: 2015 ANNUAL REPORT

| January 2016 | BCN Advantage Act/Mgmt | 100% Invested Buy/Hold | 50% Invested Buy/Hold | 100% Cash |
|---|---|---|---|---|
| Total Return: | -0.32% [1 2 3] | -2.04% [1 2] | -0.90% [1 2] | 0.25% [1 2] |
| Jan ' 97 = $100,000 [4] | $673,773 | $442,252 | $304,082 | $154,785 |
| Beta (2015): | 0.33 | 1.00 | 0.50 | 0.00 |
| Risk Adjusted Return: | 0.02% | -2.04% | -0.90% | 0.25% |

1 Performance results are based on the Fidelity Mid-Cap Fund (-3.1% for 2015), the Vanguard Index 500 Fund (1.3% for 2015), the Oakmark International Fund (-3.8% for 2015) 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.

**2015 BCN Advantage Signals**

| | Date | Market | Cash |
|---|---|---|---|
| 1 | 01/01/2015 | 25% | 75% |
| 2 | 05/01/2015 | 25% | 75% |
| 3 | 08/01/2015 | 25% | 75% |
| 4 | 11/01/2015 | 40% | 60% |
| 5 | 12/31/2015 | 40% | 60% |
| | Present | 40% | 60% |

### A Mixed Year for the Markets

For 2015, the S&P 500 declined a fractional -0.7% to 2,044, the Dow fell -2.2% to 17,425 and the Nasdaq rose 5.7% to 5,007. Stocks around the world began 2016 with one of the worst Januarys on record, as slumping oil prices, deepening concerns over China, and the Federal Reserve's first interest rate hike in a decade all combined to spook investors. The S&P 500 and Dow Industrials posted their worst weekly start ever. Most likely we are witnessing the culmination of a 14-month topping process with the S&P and Nasdaq repeatedly testing resistance (at 2,120 and 5,140 respectively) before ultimately falling back into correction – one that really began in October 2014. Be sure to see the excellent movie *The Big Short.* Having successfully navigated both the 2000 dot-com implosion and the 2008 financial collapse (and remaining steadfastly defensive for more than 2 years now), we've endured first-hand the excruciating wait – from the time we knew everything should be falling apart to the moment it actually did.

### Debt but Not Much Deleveraging

At the end of 2007 global debt stood at $142 trillion. By mid-2014 *an additional* $57 trillion had been added, and the data this year will show another record high. All the talk about deleveraging was only talk. Debt grew at a 5.3% annualized rate from 2007–2014. China's total debt has quadrupled, rising to $28 trillion by mid-2014, from $7 trillion in 2007. After being a major locomotive of international growth for decades, China is locked in a protracted slowdown. Full-year growth of 6.9%, enviable by Western standards, was China's poorest showing in a quarter century. Throughout 2015, U.S. corporations spent $1 trillion on share repurchases and dividends, most of it borrowed. Household debt grew 2.8%. Financial sector debt grew 2.9%. Corporate debt grew 5.9%. Government debt grew 9.3%.

### A U.S. Recession May be Lurking

The US economy is close to stall speed. GDP grew just 0.7% in the fourth quarter, despite 7 years of zero interest rates, $3.7 trillion of Fed money printing and $9 trillion added to our Federal debt. Global stock markets lost nearly $8 trillion in January. Remember that stocks are the only true leading indicator of economic expansion and contraction. Jobs peak after stocks and the economy have already begun to decline, with a lag of 6 - 9 months. Stocks peaked in May 2015. The weakness in the Dow Transports, down -30% from its November 2014 high, shows the U.S. could already be in recession. The index is one of the

most economically sensitive and should benefit from low oil prices. Instead it's collapsing. A repeat of 2008-09 is unlikely – but the monetary and fiscal stimulus needed to battle even a mild recession is no longer available. The Fed typically needs 3.5% of rate cuts to work its magic. The world has never seen a full-blown recession with interest rates this close to 0% in both the US and Europe.

### Fed Policy is Up in the Air

The U.S. added 292,000 jobs in December, well ahead of expectations. For all of 2015, the U.S. added 2.65 million jobs, down from 2014's 3.12 million but still the second-best since 1999. The unemployment rate currently holds at 4.9%. At its December meeting, the Fed raised interest rates for the first time since 2006 and signaled four additional quarter-point rate increases throughout 2016. Wall Street, though, is pricing in almost no chance of a move for the remainder of 2016, with the first increase not fully priced in until June 2017. That's a huge communication gap the Fed will have to bridge. Expectations for rising rates are putting upward pressure on the dollar, and the implications for earnings are significant. Over 30% of the revenues for S&P 500 companies come from outside of the U.S. and thus are negatively impacted by a rising dollar. Former Dallas Fed president Richard Fisher thinks the Federal Reserve is out of tools to help markets. "I don't think there can be much more accommodation," Fisher said. Fear is gripping the bond market. The yield on the U.S. 10-year Treasury note recently dropped below 1.8%.

### Oil – Cause or Symptom?

At $30 per barrel, oil prices have fallen to their lowest levels since 2003. In the 6 quarters since oil prices started to drop, U.S. GDP has averaged 2.3%, only a slight improvement over the 2.1% growth rate for the first five years of the recovery. The energy sector has lost nearly half its value after hitting record highs in 2014. Lower energy prices were expected to benefit other sectors of the U.S. economy. Now that tune has changed. December showed an unexpected drop in retail sales and a continuing fall-off in industrial output. Long-term debt for oil exploration and production exploded by 70% since 2010 to $353 billion. In December, the high-yield bond market came under pressure as worries abounded that energy-related companies would default – potentially impacting the broader markets. Standard & Poor's said its current corporate bond distress level of 29.6 percent is at its highest level since July 2009.

### A "Stealth" Bear Market

Officially, the U.S. economy has endured seven recessions over the last 50 years. In every instance except 1974, S&P 500 earnings had peaked and were in decline immediately prior. Q4 2015 earnings are on track to decline 4.1%, the biggest drop in six years and following on the heels of Q3's 0.8% dip. Revenue is headed for a 3.5% decline after sinking 4.4% in Q3. If profits finish negative, it would be the first earnings recession since the 2-year slump that began in Q4 2007. Only four sectors — telecom, consumer discretionary, financials and health care — are expected to report Q4 earnings increases. There is mounting evidence the U.S. stock market is being decimated by a "stealth" bear market. The S&P 1500 index – a broad basket of large, mid and small company stocks – shows that the average stock has fallen -26.9% from its 52-week high. Only two sectors have dodged the bear so far: consumer staples (down -18.5%) and utilities (down -14.3%). Energy stocks – the worst-performing sector – are down 52.1%.

### Looking Ahead

"The future has always belonged to those who take discipline, analysis, and the lessons of history seriously." [John Hussman].

All indications suggest a late-stage top of the third speculative bubble in 15 years, with the major U.S. indexes facing -20% to -40% declines before finally bottoming in early 2017. Stocks are collapsing for a myriad of reasons: Negative earnings, the end of QE and zero interest rates, rapidly diminishing stock buy-back plans, collapsing oil and commodity prices signaling weak global growth, an imminent U.S. recession that even if mild, comes at a time when the Fed is powerless to do much more than NOT raise rates. Central bank interventions will become increasingly ineffective as the time-tested law of diminishing returns rears its ugly head.

Central banks have waged a desperate battle against weakening consumer demand with policies that, in the long run, will only exacerbate it. By artificially lowering interest rates (through QE, ZIRP and now negative interest rates), central banks have encouraged massive government and corporate borrowing. By definition, borrowing draws otherwise future consumption forward, and in the short run does provide a brief (but unsustainable) economic boost. But then poof! All that's left is the hangover: mountains of debt with the bills coming due and no wherewithal to buy more. Global economies wake up to slackening demand and systemic long-term deflation. Without the promise of a boost from capital spending by corporations, an infrastructure program financed by the federal government, and/or reform of the tax code, there is virtually no chance that self-sustaining growth in the economy can be achieved. And none of those things are likely to happen during 2016.

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.