BCN ADVANTAGE: 2019 ANNUAL REPORT

February 2020	BCN Advantage Act/Mgmt	100% Invested Buy/Hold	50% Invested Buy/Hold	100% Cash
Total Return:	20.77% [1 2 3]	27.00% [1 2]	14.51% [1 2]	2.02% [1 2]
Jan ' 97 = $100,000 [4]	$907,602	$675,275	$391,618	$163,858
Beta (2019):	0.75	1.00	0.50	0.00
Risk Adjusted Return:	20.77%	27.00%	14.51%	2.02%

1 Performance results are based on the Fidelity Mid-Cap Stock Fund (25.4% for 2019), the Vanguard Index 500 Fund (31.3% for 2019), the Oakmark International Fund (24.2% for 2019) 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.

2019 BCN Advantage Signals

	Date	Market	Cash
1	01/01/2019	75%	25%
2	02/01/2019	75%	25%
3	05/01/2019	75%	25%
4	08/01/2019	75%	25%
5	11/01/2019	75%	25%
6	12/31/2019	75%	25%
	Present	75%	25%

An Extraordinary Decade Draws to a Close

For 2019, the S&P 500 gained +28.9% to 3,231, the Nasdaq +35.2% to 8,973, and the Dow +22.3% to 28,538. The IBD Mutual Fund Index rose +29.59%. Over the decade, the S&P 500 gained more than +250%, the 80th percentile for rolling 10-year periods.

The longest economic expansion on record is well into its 11th year. Job gains averaged 200,000 per month in the second half of 2019, with an additional 225,000 jobs added in January. At 3.6%, the unemployment rate is sitting near half-century lows. Employment gains have been broad-based with wages rising, particularly for lower-paying jobs. Labor force participation by individuals in their prime working years is at the highest rate in more than a decade. But productivity growth, the main engine for higher wages and living standards, has been subpar throughout this economic expansion.

Recession Fears Have Waned but Not Disappeared

With the uncertainty of U.S. / China trade negotiations and the Brexit standoff, the S&P 500 plunged to a major low of 2,351 on December 24, 2018 before beginning a V-shaped reversal that finally achieved a new record high on May 1, 2019. The indexes spent several months consolidating before rallying again in October.

Widely watched yield curve inversions had many on Wall Street fearing recession. Downside pressures were especially felt in the manufacturing sector, which was also related to the escalation in the U.S.-China trade war. The Fed began ratcheting the Fed funds rate lower in August. By the end of 2019, rates had been cut three times.

Historically, whenever the 10-year treasury yield slips below the Fed funds rate (as happened in 2019) the Fed is too restrictive, and the economy is in danger of slowing down. At 1.57%, the 10-year Treasury rate is once again dangerously close to the effective Fed funds rate of 1.55%. If the U.S. economy continues to outperform its global counterparts, the U.S. will continue to import disinflation and force the Fed to keep cutting rates. But slowing global growth could eventually throw the U.S. into recession.

Fed Policy Continues to Move the Markets

Following his semiannual report to Congress in February, Jerome Powell explained why the Fed is "not comfortable" with inflation running persistently below their 2% objective: "We would have less room to reduce interest rates to support the economy in a future downturn, to the detriment of American families and businesses."

The Fed has no interest in raising interest rates anytime soon. Not without higher inflation. Meanwhile, Wall Street is assigning a 65% probability for at least one more quarter-point rate cut in 2020. And the Fed is once again expanding its balance sheet, adding $400 billion in the past four months alone.

By chasing investors out the risk curve and down the quality ladder, central banks create voracious demand for corporate bonds. The proceeds from much of that debt issuance have been plowed into stock buybacks. Financial engineering at its "finest." Corporate buybacks have been the largest source of U.S. equity demand over the past decade, as retail and institutional investors have been net sellers of U.S. stocks for most of this bull market. Overleveraged corporations will likely curtail buybacks when the next recession hits, a factor that would intensify any downturn.

Valuations Are Once Again Extended

2019 was driven by multiple expansion rather than earnings growth, as the trailing 12-month P/E for the S&P 500 has now ballooned to 24.5 (vs. 20.2 on average since 1978). High valuations are not predictive of market tops but do indicate risking risk for a 20% or greater market correction. By way of comparison the S&P 500 peaked at 26.7 in September 2000 – on the eve of the dot-com implosion. The so-called "Buffett Indicator" is the ratio of the total stock market to GDP. Its level at the end of 2019 was double its seven-decade average and higher than any other year with one ominous exception – 1999, at the top of the internet bubble. Worth noting, Buffett has built up Berkshire Hathaway's cash pile to a record $122 billion.

The sustained rally since October has caused many investors to worry that a "bubble" or "melt-up" is underway. From the October 2, 2019 closing low of 2,887 the S&P 500 has gained 17%, close to matching the 18% rally in January 2018. But we're not seeing the excessive enthusiasm that accompanies the final stages of a blow-off rally. The latest AAII survey showed that bullish sentiment among its members is 41%, just above the long-term bullish average of 38%.

What Could Trigger the Next Major Decline?

The most likely cause of the next major stock market decline will be the Fed's delayed or perceived inadequate response to even a mild economic downturn. Little firepower is left in most of the developed world for QE to have more impact. Global central bank balance sheets have grown from roughly $5 trillion in 2007 to $21 trillion, equivalent to the size of the entire U.S. economy. More than $15 trillion of debt has already been issued at negative interest rates. Short of buying stocks outright (as Japan has done), there are few levers left for central banks. And fiscal stimulus would arrive too late to avoid the damage to asset prices.

The Brexit transition lasts until December 31, 2020, during which the UK must negotiate a new trade deal with the EU. The 11-month timeline is incredibly tight, not just for the government but also for businesses. And the UK must strike new trade deals with other nations to ensure trade isn't disrupted when the world stops treating Britain as a de facto EU member.

Fallout from the coronavirus in China could spill over to the global economy. Despite the seriousness of the health threat, U.S. equity markets have so far taken news pertaining to the outbreak in stride. Given the experience with SARS in 2003, economic disruptions will likely be temporary, but we continue to monitor the effects of the epidemic closely.

Strategy for 2020

The two pillars of the vaunted "Goldilocks" economy are (1) reasonably robust growth and (2) subdued inflation. Wall Street consensus expects S&P 500 companies to grow earnings-per-share by 8% on top of revenue growth of 5%. In the absence of Fed rate hikes, only corporate bankruptcies and actual defaults would cause a dangerous increase in U.S. borrowing costs, an unlikely event so long as earnings and revenues continue to grow.

Notably, the ISM manufacturing PMI rose to 50.9 in January, representing the highest level in six months and the first indication of expansion in the manufacturing sector after five consecutive months of contraction. Since 1999, a move back above 50 in the ISM exports index has coincided with an average of 18% earnings growth for S&P 500 companies.

Assuming inflation remains anchored – and there's every reason to believe it will – "Goldilocks" could be in the driver's seat again in 2020. But we're keeping a close eye on valuations. As the S&P approaches 3,500, a trailing 12-month P/E above 25x will be cause for concern. Yet another Fed pivot to hiking interest rates seems unlikely (especially in an election year), but market internals (most notably corporate earnings) remain especially critical this late in the economic cycle. Signs of deteriorating earnings will certainly push us into a more defensive stance.

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.