

BCN ADVANTAGE: 2021 ANNUAL REPORT

February 2022	BCN Advantage Act/Mgmt	100% Invested Buy/Hold	50% Invested Buy/Hold	100% Cash
Total Return: Jan ' 97 = \$100,000 ⁴	8.48% ^{1 2 3} \$1,134,596	17.88% ^{1 2} \$964,442	9.44% ^{1 2} \$478,264	1.00% ^{1 2} \$168,844
Beta (2021):	0.40	1.00	0.50	0.00
Risk Adjusted Return:	8.48%	17.88%	9.44%	1.00%

1 Performance results are based on the T. Rowe Price Mid-Cap Growth Fund (15.1% for 2021), the Vanguard Index 500 Fund (26.4% for 2021), the Dodge & Cox International Fund (11.0% for 2021) and an average money market return of 1.02%. 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.

2021 BCN Advantage Signals

	Date	Market	Cash
1	01/01/2021	40%	60%
2	02/01/2021	40%	60%
3	05/01/2021	40%	60%
4	08/01/2021	40%	60%
5	11/01/2021	40%	60%
6	12/31/2021	40%	60%
	Present	40%	60%

An Illusion of Market Stability

For 2021, the S&P 500 gained +26.9% to 4,766, the Nasdaq +21.4% to 15,645, and the Dow +18.7% to 36,338. Marking an important divergence: the IBD Mutual Fund Index lagged +13.5% for the year.

The U.S. economy grew 5.7%, its strongest performance since 1984. Unemployment ended 2021 at 4.0%, with labor participation increasing to 62.2% and average earnings rising 5.7% year-over-year. The bond market was caught off guard by the 467,000 jobs created in January, despite expectations for an Omicron impacted report. 30-year fixed mortgages increased to 3.69%, the highest since January 2020 and well above the 2.73% average for 2021. The nation suffered over 450,000 deaths attributed to COVID, up 27% despite more than 205 million Americans being fully vaccinated. But the worst of the economic disruption is probably over, with business activity expected to rebound as the Omicron wave subsides.

January 2022 saw the S&P 500 fall more than 5%, its worst start since 2009. The Dow declined more than 3%, while the Nasdaq shed about 9%, nearly matching 2008 for its worst start ever. Guidance – or lack thereof – has been the biggest red flag. Streaming giant Netflix plunged 21.8% after serving up a tepid outlook. Meta Platforms, the social giant formerly known as Facebook, cratered 26.4% as investors reacted to its Q1 forecast. With the drop, Meta shed \$237 billion in market cap – the biggest one-day wipeout in U.S. stock market history.

Five companies (Facebook, Apple, Amazon, Microsoft, and Google) account for one-quarter of the market capitalization of the entire S&P 500. Apple is worth \$2.8 trillion, Microsoft \$2.4 trillion, Google \$1.8 trillion, Amazon \$1.6 trillion, and Facebook \$876 billion. Thanks largely to ETFs and the overweight inflows into these handful of stocks, an illusion of market stability is not surprising. The small cap Russell 2000 has been a canary in the coal mine for much of the past year, lagging the S&P 500 by 25 percentage points – its worst 12-month relative return since 1999. 46% of Nasdaq companies are down at least 50% from their 52-week highs. Not since 1999 have so many stocks been cut in half while the Nasdaq held near its peak. Historically, when at least 35% of stocks are down by half, the Nasdaq has been down by an average of -47%.

That 70s Show

Consumer prices surged an annual 7.5% in January, the biggest jump since 1982. Core PCE, the Fed's preferred inflation gauge, is at 4.7%, more than double their 2.0% target. The rate of change in Core PCE over the past year is the second fastest on record, exceeded only by 1974 – 1975. For the first time since 1974, over half of small businesses expressed their intent to raise prices. Today's tight labor market increases the possibility that inflation will become entrenched via a wage-price spiral. Fed Chairman Powell recognized the danger during his Senate confirmation, when he stated that a smaller labor force "can be an issue going forward for inflation, probably more so than these supply-chain issues." The specter of inflation has futures markets pricing in a full percentage point of Fed rate hikes by August, and the equivalent of six quarter-point moves in 2022.

The Fed's attention has turned squarely toward inflation, a battle they haven't had to fight in roughly four decades. And suddenly, investors may no longer be able to count on the Fed coming to the rescue at the first sign of trouble. That guarantee – widely assumed on Wall Street – is known as the "Fed Put." In late 2018, a 20% decline prompted the Fed to quickly reverse policy. As COVID spread in March 2020, the S&P 500 collapsed 33% and the Fed responded with 2-years of near-zero interest rates and \$120 billion per month in additional "quantitative easing."

Though the Fed could temporarily suspend rate increases if markets fall this time, they'll be much less likely to swiftly reverse course by cutting rates and ramping up QE. Not if inflation is still raging. As a result we could see a series of rolling corrections: declines of 10% or more but without the corresponding V-recoveries investors have grown so dependent on. This is particularly true given that a -30% decline in the S&P 500 and a -40% drawdown in the Nasdaq would "merely" return these indexes to their pre-COVID highs.

Global Headwinds

Rising tensions with China over its increasing aggression towards Taiwan, and direct conflict with Russia over its looming invasion of Ukraine would undoubtedly cause major disruptions in global markets – all the more so if both unfold in tandem.

The collapse of China's largest real estate operator, Evergrande, could trigger a crisis similar in magnitude to Lehman Brothers – a bankruptcy that heralded the beginning of the Great Recession nearly 14 years ago. But the problem doesn't stop there. Since 2013, China has used a unique system of local government financing vehicles to stimulate economic growth through infrastructure improvements. Today, many of these LGFVs are at risk. Goldman Sachs estimates that outstanding debts for LGFVs could be well over \$8 trillion - roughly 52% of the China's GDP. China's central bank is cutting rates and pumping cash into their financial system at the same time other global central banks are preparing to raise rates in the battle against inflation.

Understanding the Danger

Back in 2016, Powell clearly understood the danger: "... it's plausible to me that rates will have to remain very low for a very long time to achieve stable prices and full employment, but that such low rates will drive excessive credit growth and create irresistible upward pressure on asset prices, including real estate prices. I'm thinking of a situation in which a broad range of asset prices are moving up well beyond what fundamentals would justify." He did it anyway.

Interestingly, Powell has yet to specify when the Fed will begin reducing its nearly \$9 trillion balance sheet – now 40% of U.S. GDP. Draining liquidity from "quantitative tightening" poses the most significant risk to U.S. markets, all the more so when there are clear signs the economy is slowing. Expectations are for GDP to grow 4.0% in the first and second quarter of 2022 and then slow to 3.3% and 2.5% in the third and fourth quarters. Mere talk of rate hikes has already pushed the front end of the yield curve higher, but the long end of the curve is low, flattening the curve – a classic precursor of recession.

The effectiveness of Fed policy can only be evaluated once the policy has gone full cycle. Cutting rates to zero, holding them there for years, and creating trillions in debt through quantitative easing will prop up an economy. That much has been established. But can that stimulus be reversed, and that liquidity be drained, without pushing the economy into recession – one deeper and more damaging than any that preceded it? The S&P 500 took 7 years to reach a new high from 2000 to 2007 after a 51% decline between March 2000 and October 2002, and 6 years to notch a fresh high from 2008 to 2014 after a 58% loss between October 2007 and March 2009. Have we entered another period when investors will be happy to have been largely out of the market? We believe so – because we will have saved money by being out – while reducing risk and volatility on the round trip. Our definition of a successful bear market call.

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.