

BCN ADVANTAGE: 2022 ANNUAL REPORT

February 2023	BCN Advantage Act/Mgmt	100% Invested Buy/Hold	50% Invested Buy/Hold	100% Cash
Total Return: Jan ' 97 = \$100,000 ⁴	-8.68% ^{1 2 3} \$1,036,762	-21.31% ^{1 2} \$758,955	-9.64% ^{1 2} \$432,141	2.00% ^{1 2} \$172,252
Beta (2021): Risk Adjusted Return:	0.40 -8.68%	1.00 -21.31%	0.50 -9.64%	0.00 2.00%

1 Performance results are based on the T. Rowe Price Mid-Cap Growth Fund (-22.5% for 2022), the Vanguard Index 500 Fund (-18.2% for 2022), the Fidelity Diversified International Fund (-23.9% for 2022) and an average money market return of 2.00%. 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.

2022 BCN Advantage Signals

	Date	Market	Cash
1	01/01/2022	40%	60%
2	02/01/2022	40%	60%
3	05/01/2022	40%	60%
4	08/01/2022	40%	60%
5	11/01/2022	40%	60%
6	12/31/2022	40%	60%
	Present	40%	60%

The Battle Against Inflation

For 2022, the S&P 500 fell -19.4% to 3,840, the Nasdaq -33.1% to 10,467, and the Dow -8.8% to 33,147. The IBD Mutual Fund Index declined -35%. Markets suffered far and wide, including losses for U.S. stocks and bonds in the same calendar year. Vanguard's Total Bond Market Index shed more than -13%, marking its second straight yearly loss.

The Fed initially regarded pricing pressures as "transitory," resulting in a slow-footed response that included not only keeping interest rates near zero but maintaining asset purchases of \$120 billion per month. By March 2022, inflation was raging out of control with headline CPI surging 8.6% year-over-year and core CPI rising to 6.4% – highest since the infamous stagflation of the late 1970s and early 1980s.

In response, the Fed finally ended its "quantitative easing" campaign in March and announced a quarter-point rate hike. The Fed went on to deliver a half-point hike in May, four successive 75-basis point increases from June to November, and another 50-basis point hike in December. Overall, the Fed increased rates by 4.25% in just 10 months. Headline CPI peaked at 9.1% year-over-year in June 2022, but has since fallen for six consecutive months to 6.4%. Core CPI peaked in September and has fallen for three consecutive months to 5.6%. Speaking in early February, Fed Chair Jerome Powell sounded optimistic on the inflation outlook: "We can now say for the first time that the disinflationary process has started."

For the full year, GDP increased 2.1% (compared to 5.9% in 2021 – the fastest pace of growth since 1984). The U.S. economy added 517,000 jobs in January, far more than the 188,000 expected. Unemployment fell to 3.4%, the lowest since 1969, and labor force participation ticked up to 62.4%, still below pre-pandemic levels.

Breakout or Head Fake?

Equity markets have been on a tear to start 2023, with optimism fueled by the Fed's downshift to smaller rate hikes and markets pricing in rate cuts later this year. After barely a month, the S&P 500 is up +7.7%, the Nasdaq +13.6%, and the Dow +3.3%.

Is this a textbook bear market rally or the beginning of a new bull run? Morgan Stanley's top market strategist attributed recent gains to the January effect – a market theory that securities prices increase after a year-end sell-off for tax purposes.

Announced buybacks in January more than tripled from a year ago to \$132 billion, the highest total ever to start a year. Since 2011, over 40% of the market's advance is attributable to corporate buybacks. Absent share repurchases, the S&P 500 would be pushing levels closer to 2500. In November, Goldman Sachs projected buybacks to fall at least 10% in 2023, and in the event of a recession by upwards of 40% from last year's record \$1.26 trillion.

Are financial markets misreading the Fed? Higher equity prices and falling bond yields have complicated the Fed's task. Since mid-October (the most recent stock market lows), the 10-year Treasury yield has fallen 50 basis points from its high of 4.25%. Continued resiliency in the labor market takes pressure off the Fed to reverse course. The Fed will raise rates until financial conditions tighten enough to slow the economy and the labor market. Tightening financial conditions occur when rates increase, the dollar strengthens, spreads widen, implied volatility rises, and stock prices fall.

Timing the Fed Pivot

Market participants are expecting not only a pause in rate hikes (after a final quarter-point increase in March) but rate *cuts* beginning as early as November this year. That is not what the Fed is signaling. Asked how long it will take for inflation to return to the Fed's 2% target, Powell said the process, "is going to take quite a bit of time, and is not going to be smooth."

In December, the Fed increased its terminal rate to 5.1%. The message was clear: not only will they not be cutting rates in 2023, they are willing to accept a more severe economic slowdown and higher level of unemployment than initially projected. Any CPI reading that comes in hotter-than-expected will likely cause the Fed to raise rates more than what the markets have priced in.

And merely pausing rate hikes isn't going to reverse the damage already baked into the economy. The problem with rate hikes, as always, is the lag effect. It takes about nine months on average for the impact of a Fed rate increase to fully work its way through the economy. As Powell stated in November: "Monetary policy affects the economy and inflation with uncertain lags, and the full effects of our rapid tightening so far are yet to be felt. History cautions strongly against prematurely loosening policy. We will stay the course until the job is done." Cutting rates too soon could spark a second bout of inflation, similar to what happened in the 1970s.

Will We Avoid Recession?

There remains considerable uncertainty about the direction of the economy. "If we look at market pricing so far this year, it's not even pricing in a soft landing. It's pricing in takeoff. It's priced for perfection." [BlackRock global chief investment strategist Wei Li, February] The S&P 500 is currently trading more than 18 times estimated earnings for 2023, historically a level only seen during bubble periods. Earnings cannot, over the long term, outgrow the economy. As such, stocks remain vulnerable to significant repricing in the event of recession. As of February, S&P 500 earnings are expected to grow 11.5% year-over-year. Compare that to 2008, when earnings collapsed by -40%.

The Conference Board's Leading Economic Index declined in December for the tenth consecutive month. Over the past six months, the index has shrunk 4.2% — the fastest six-month decline since the beginning of the pandemic. Treasury yields have been inverted since July 2022. The current spread between 10-year and 2-year treasury notes is at 40-year extremes of nearly 80 basis-points. All ten of the previous recessions dating back to 1955 have been preceded by an inverted yield curve. All ten were preceded by tight monetary policy and Fed rate hikes. Small businesses employ roughly 50% of the nation's workforce. The NFIB survey posted a sharp drop in December, indicating that small business owners are not optimistic about 2023. "Dealing with the fallout" of weak business conditions includes layoffs and terminations, wage cuts, inventory reduction, and reduced capital expenditures.

A 5% Fed funds rate is exceptionally high for the American economy. The cost of borrowing is rising significantly and will continue increasing as the effects of tighter monetary policy filter through the economy, leading to a slowdown in spending, GDP, and corporate profits. Without a doubt, spiraling interest expense on our \$31.4 trillion national debt creates a massive challenge for the Fed. From a low of \$400 billion during fiscal 2015, interest paid nearly doubled to \$724 billion in fiscal 2022 and is set to eclipse \$1 trillion by the end of fiscal 2023 in October. The Fed is desperate to return inflation to low levels, even at the risk of recession.

The Fed has barely begun to reduce its balance sheet — by a mere \$45 billion per month — from its all-time high of more than \$8.9 trillion. Once this current cycle of rate hikes has ended, will the Fed then begin to accelerate quantitative tightening? And even if the Fed continues this very moderate reduction of its balance sheet, can markets climb in the absence of the massive injections of liquidity the Fed has provided over the last 15 years - since the Great Financial Crisis of 2008? The era of near zero interest rates, ultra-low inflation, and trillions of quantitative easing was an anomaly — and it's ending.

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.