Thackray Newsletter

— Know Your Buy & Sells a Month in Advance —

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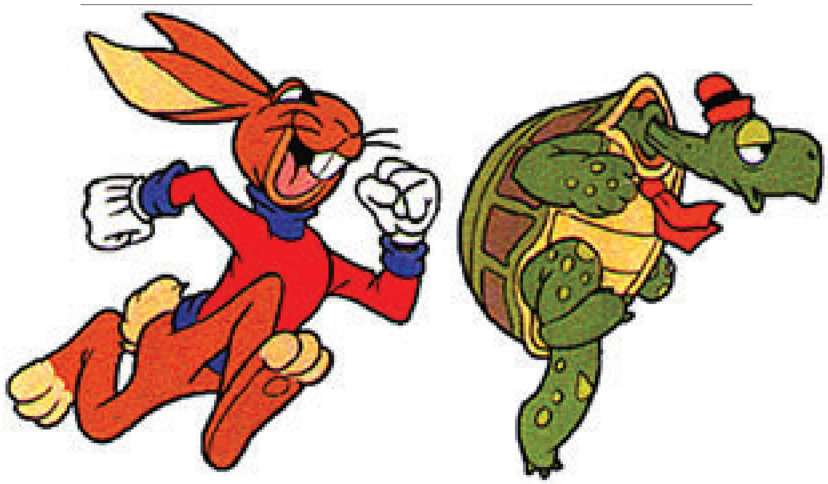
Market Update



The Tortoise and the Hare (Turtle and Rabbit) Fable encapsulates current investor expectations of the economy getting back to some sort of "normal." Some investors believe that the economy is going to recover quickly with central bank and government help, others believe that it is going to be a long slow process.

There will be better times ahead, but how we get there and what the future looks like is driving the stock market at the current time.

I am sure that everyone is tired of hearing how the stock market is a forward looking mechanism. As the economy has suffered in the Covid-19 crisis, the media has constantly reminded us that investors are looking past the self-imposed economic shutdown to a not so distant future when almost everyone will be back at work and the economy will once again be operating smoothly.

Saying that the stock market looks forward by six or nine months is a nebulous concept. It is often used as an excuse to justify the valuation of the stock market on a qualitative basis. Sometimes it is important to parse out the elements to try and grasp if investors are being too optimistic or pessimistic in their judgement of the future.

S&P 500 Technical Status

Is the S&P 500 going to be able to break above the 2900-3000 level in the near future?

After a strong rally since March 23, the S&P 500 has managed to climb back to its resistance level of 2900-3000. Given that it has been at these levels quite a few times over the last two years, it could be difficult for it to break above this level. It broke above 3000 in 2019, but then sharply corrected. Given the recent large decline in the S&P 500, its 2900-3000 resistance level is now back in play. Of course it is possible for the S&P 500 to break above 3000 and continue on to new highs. The odds of this happening in the short term are low.

In 2015 and 2016, the S&P 500 had trouble breaking above and staying above 2100. It was not until the 2016 election that the S&P 500 was able to march higher.

Given that we are now at a major resistance level for the stock market and we have just entered the six-month unfavorable period for stocks, investors should be cautious.

Horizons Seasonal Rotation ETF (HAC : TSX)
Portfolio Exposure as of **April 30,** 2020

Symbol	Holdings	% of NAV
	Canadian Dollar Exposed Assets	
	Equities	
	Equities	
HXT	Horizons S&P/TSX 60™ Index ETF	26.4%
HXCN	Horizons S&P/TSX Capped Composite Index ETF	18.3%
	Commodities	
HUN	Horizons Natural Gas ETF	3.0%
	United States Dollar Exposed Assets	
	Equities	
HXS	Horizons S&P 500® Index ETF	35.0%
XLP	Consumer Staples Select Sector SPDR Fund	5.0%
	US Dollar Forwards (May 2020) - Currency Hedge **	-0.1%
	Cash, Cash Equivalents, Margin & Other	12.3%
	Total (NAV $255,078,477)	100.0%

** Reflects gain / loss on currency hedge (Notional exposure equals 18.9% of current NAV)

The objective of HAC is long-term capital appreciation in all market cycles by tactically allocating its exposure amongst equities, fixed income, commodities and currencies during periods that have historically demonstrated seasonal trends. The Thackray Market Letter is for educational purposes and is meant to demonstrate the advantages of seasonal investing by describing many of the trades and strategies in HAC.

Investors are looking way in to the future in order to justify current valuations in the stock market.

Investors initially stepped into the stock market in late March because it was an opportunistic low. Many believed that they were taking advantage of once in a "lifetime deals," and the Federal Reserve would make sure that they did not get hurt. If that were true, it is no longer true given the markets rapid rise since March 23rd.

Now, we are at a reality check time. Companies that were in good shape two months ago are starting to seek bankruptcy protection. The are a large number of businesses that are going to be fighting to stay alive, despite central bank and government assistance.

Restaurants survive on thin margins and are constantly going out of business in good times. As the economy reopens, restaurants will find it very difficult, with lower occupancy limits and people being reluctant to dine at restaurants. Many restaurants will close their doors.

It is not just restaurants, but many other businesses will suffer a similar fate. The knock-on effect is what starts economic deterioration. With fewer people working in the service industry, there will be fewer people buying household furniture, cars etc. The slowdown in a few sectors multiplies through the economy.

There is generally a positive relationship between the between those investors that feel the economy is going to get on its feet quickly (the hares) and those that believe the Federal Reserve and governments are going to be effective in stimulating the economy with their massive stimulus programs. In comparison, there is a positive relationship between those that feel the economy has a long slow road ahead (tortoises) and those that feel the stimulus packages may not be as effective as most perceive.

It is a real stretch to say that in nine months (the time typically quoted for the stock to look forward to economic conditions) that the US unemployment rate will return to 3.5% and GDP will be back to its previous levels. There are so many jobs that will not be coming back in the short-term. It takes time for new businesses to start. Last week, the Nonfarm payroll report printed a number of 20.5 million more people unemployed in April. It is a huge number, but a lot of investors took solace in the fact that 80% were temporarily laid-off. This may not be quite as it seems. Companies strapped for cash are probably inclined to claim temporary layoffs so that they do not have to pay severance.

In order to believe that the stock market is undervalued, an investor has to believe that central bank and government actions will be effective in stimulating the economy and more than make up for the economic damage that Covid-19 has caused... at some point in the next year or two.

Government actions so far, although much of it needed, has been in the form of transfer payments to help individuals and companies survive the Covid-19 crisis. It is not really stimulus. It is meant to replace some of the wages and income lost that have been lost during the pandemic. In fact, a lot of the money being passed out is causing a misallocation of capital by keeping zombie companies alive that should have gone out of business a long time ago.

Once the coronavirus settles down, expect the government to announce massive fiscal packages of spending. Although this will be a form of stimulus in the short-term, over the long-term it potentially could create problems.

Central bank interference since the last bull market has created a moral hazard, whereby investors believe that any economic and/or stock market decline will be counteracted by the central bank. This has allowed investors to look further into the future, more than the traditional six to nine months and create a case that central banks will make sure that the economy is on a steady footing. In the past, investors believed that central banks would mitigate economic damage (soften the blow), not stop it.

Today, investors believe that the job of the central bank is to stop any economic downturn from ever happening. In other words, the business cycle should not exist. As a result, investors have developed a sense of confidence that has allowed them, in times of economic uncertainty to look further than the traditional six to nine month period in anticipation of better times ahead. Their sense of confidence has allowed them to look out one or even two years, counting on better economic times to move the stock market higher in the present time.

I call this "moral hazard duration risk."

The problem with an overconfidence in the belief that the Federal Reserve will be able to save the economy in a year or so, is that it creates an increase in tail risk. If the economy does turn down and the Federal Reserve is not able to arrest its fall, then the collapse in the stock market could be bigger and more painful.

It is all about the narrative

As the economy opens back up, most stories in the media will probably have a positive spin, but over time that may change. Just the other day, Reuters published an article about Disney opening up its Shanghai Park in China. I found the order of facts interesting. The article was titled:

Shanghai Disneyland tickets sell out as park prepares to re-open (Reuters May 8, 2020).

https://www.reuters.com/article/us-health-coronavirus-disney-shanghai/shanghai-disneyland-tickets-sell-out-as-park-prepares-to-re-open-idUSKBN22K0N6

The title gives you the impression that there is overwhelming demand to pay to get into the park. It is not until you read almost the whole article that it reveals that the Disney park is operating at 30% capacity: It is not making money at that level. The test will be once the park opens up to significantly more people.

At some point, investors will become tired of hearing the positive spin of stores and businesses are reopening. It is just the way it works. People get tired of hearing the same story over and over. The media typically complies and either puts a different spin on the news or moves on.

Over-time articles could "flip the narrative," You won't have to read to the end of the article to find out that things are not all rainbows and sunshine. Also, as more and more businesses claim bankruptcy, the articles will start to examine the Covid-19 cost to society and the economy. In turn, this could lead investors to question their assumptions of a robust economy on the near term horizon.

The stock market has had a strong rally since March 23. A lot of investors believe that it has developed an inertia and will keep rallying unless something bad happens. Narratives change gradually and then quickly. Investors tend to hold on to their existing perception of the market despite the narrative changing. In other words, trying to time narrative changes on how the valuation of the stock market is perceived is very difficult.

Seasonals have not gone away

Seasonally, we have entered into the weaker six month period of the year for the stock market. Despite the previous correction and then a rally, the seasonal trends are still valid.

In the six-month period from May 6 to October 27, the S&P 500 has historically had very few large gains. From 1950, the S&P 500 has rallied 10% or more eight times in this six month period. Each instance occurred as the economy was coming out of a recession. This is not the case right now. The economy may be picking up, but we are not coming out of a recession. In comparison, the S&P 500 in the other six-month period, from October 28 tho May 5, has rallied 10% or more, twenty-eight times. Big difference. In other words, the risk-reward relationship of a long position in the stock market at this time of the year is not favorable compared to the other six-months of the year.

What the HAC?

In April, HAC was substantially invested in equities. HAC maintained a focus on broad market equities. In mid-month, HAC took an initial position in the consumer staples sector. HAC also held a small position in natural gas.

Seasonal Opportunities

Consumer Discretionary

The consumer discretionary sector has a strong seasonal period from October 28 to April 22

The consumer discretionary sector has performed well relative to the S&P 500 largely because of Amazon. Investors have been attracted to the sectors of the stock market that are benefiting from stay-at-home activities, including on-line shopping.

Investors are going to be judge the strength of the business re-openings with the consumer discretionary sector. Specifically, investors will be looking at retail sales, auto sales and shopping trends.

Overall, given the seasonal trend of the consumer discretionary sector underperforming the consumer staples sector into October, it is probably better to favor the consumer staples sector.

> My Call: The consumer discretionary sector will probably underperform into early July.

Consumer Staples

Consumer staples sector has a strong seasonal period from April 23rd to October 27th

The consumer staples sector outperformed the S&P 500 when it was declining sharply in February and March. The sector performed well on a relative basis because investors were attracted to defensive sectors as markets plummeted. In addition, the higher dividend yield of the consumer staples sector became relatively more attractive as interest rates fell. The sector was also boosted by strong sales in the food retailing sub-sector.

The sector corrected, relative to the S&P 500, when the market rallied starting in late March. At the current time, the consumer staples sector is close to the same relative value compared to the S&P 500 as it was 2019. Given that we have started the seasonal period for the consumer staples sector, it is considered a preferred sector over the next few months.

> My Call: Consumer staples will probably perform better than the S&P 500 until early July, before the next earnings season starts.

Industrials

The industrial sector has a strong seasonal period from January 23 to May 5

The industrial sector has finished its seasonal period in the red relative to the S&P 500. This sector typically does not perform well at this time of the year.

> My Call: The industrials sector will probably continue to underperform the S&P 500 until late September.

Materials

The materials sector has a strong seasonal period from January 23 to May 5

The materials sector has finished its seasonal period in the red relative to the S&P 500. This sector typically does not perform well at this time of the year.

My Call: The materials sector will probably underperform until early November.

Utilities

Utilities have a strong seasonal period from March 8 to September 20

As the stock market was declining in February and March, the utilities sector, declined, but not nearly as much as the S&P 500. The sector benefited from the move into defensive sectors and falling interest rates, which makes the higher dividend rate from the utilities sector more attractive.

As the stock market rallied in late March into April, the utilities sector underperformed. Currently, the relative valuation compared to the S&P 500 is back to 2019 levels.

The utility sector typically performs well if interest rates are declining in a fairly stable market. If the stock market is declining sharply and interest rates are falling, government bonds are typically the preferred investment.

My Call: The utilities sector will probably outperform the S&P 500 until late September.

Health Care

The health care sector has a strong seasonal period from May 1 to August 2

The health care sector has benefitted from the Covid-19 crisis both from increased demand for products and services and increased investor interest in the sector because of the role that the sector has played in trying to deal with the crisis.

The health care sector has outrun the S&P 500 for quite some. Although it is still expected to perform well relative to the S&P 500 in its seasonal period, the outperformance could be fairly moderate.

My Call: The health care sector will probably moderately outperform the S&P 500 until late July.

Biotech

The biotech sector has a strong seasonal period from June 23 to September 13

The biotech sector has benefited from the Covid-19 crisis. Over the last couple of years, the biotech sector has underperformed the S&P 500. With the current crisis, investors have started to focus on the biotech sector. The biotech sector has also benefited from increased demand for future products to deal with the coronavirus, including vaccines and viral medications.

On a technical basis, the biotech sector started to outperform the S&P 500 in late January, well before the start of its seasonal period. When this happens, it is often best to wait for the seasonal period to start, rather than trying to establish an initial position early.

My Call: The biotech sector will probably outperform in the near future, particularly in the month of July.

Oil

Oil has a strong seasonal period from February 25 to May 9

Oil did not perform well in its seasonal period, which just finished. Large exogenous events can overcome any seasonal trend, particularly with commodities. The next seasonal period of strength for oil starts in late July. This seasonal period tends to be a relatively minor seasonal trend, but still worth consideration.

My Call: Oil will probably trend slightly down, over the next few months.

Energy

Energy has a strong seasonal period from February 25 to May 9

Recently the energy sector has been rallying off better than expected inventory levels and supply curtailment. The positive trend could quickly recede if oil demand is not as robust as expected during the business re-opening cycle. On a seasonal basis, it is best to wait for the next seasonal period for the energy sector that starts in July.

My Call: The energy sector will probably underperform the S&P 500 until July.

Natural Gas

Natural gas has a strong seasonal period from March 19 to June 22

Natural gas has been performing well largely based upon favorable weather patterns. It has also received a boost from expectations of oil companies curtailing their production of oil, which results in some curtailment of natural gas output as it is often a bi-product of oil production.

Natural gas has broken its downward trend line that started in late 2019 and has been fairly stable recently.

My Call: Natural gas will probably increase moderately over the next month.

Gold

Gold has a strong seasonal period from July 12 to October 9

The seasonal period does not start for a while, but given that I have received quite a few questions on gold, I thought I would make some initial very brief comments.

Technically, gold is in an up-trend. From a trading channel perspective gold is attractive at the lower boundary of approximately $1650.

Gold has been receiving a lot of attention as central banks print up buckets of money. The inflation-deflation debate will be getting a lot of print in the near future as the economy is slowing down and at the same time central banks have been printing money.

Without any substantial policy announcements by the Federal Reserve, gold at this point is not expected to have a substantial run until closer to its seasonal period.

My Call: Gold will probably start to outperform in the next month and continue to perform well until September.

Gold Miners

Gold miners have a strong seasonal period from July 27 to October 3

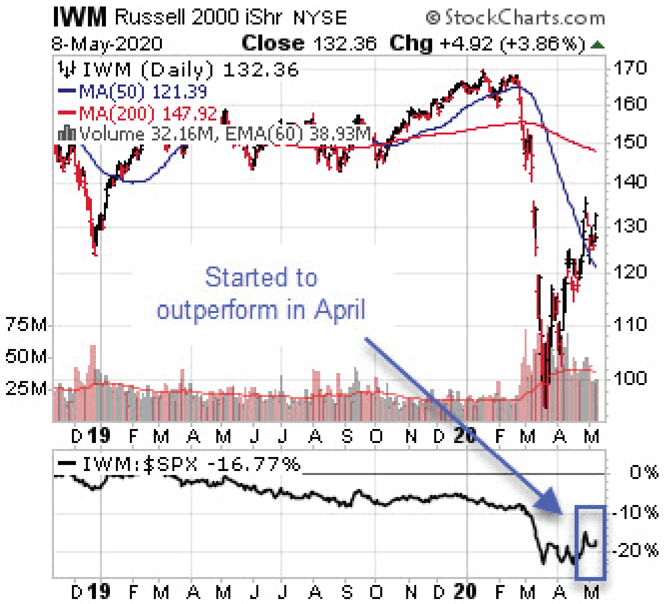
Gold miners have been performing well on an absolute basis and relative to the S&P 500. As gold has shown some stability and the stock market has rallied, gold miners have benefited outside of their seasonal period.

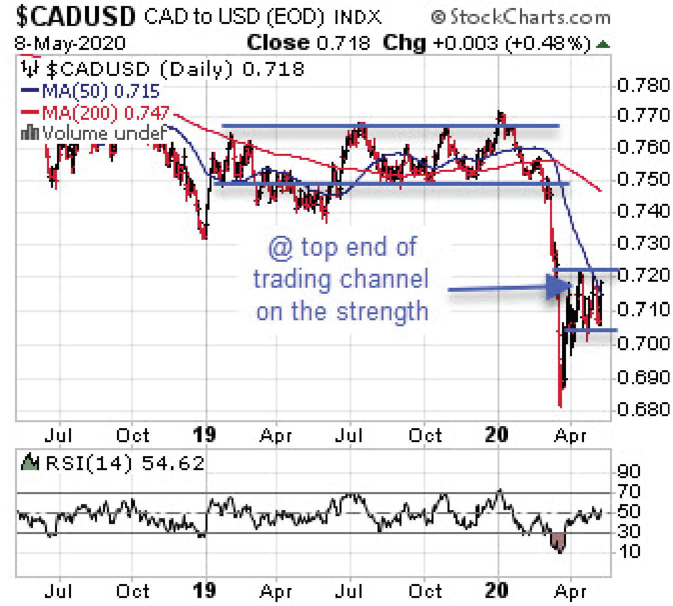
The risk with gold miners at this time is that if the stock market corrects sharply, and gold is not moving up substantially in price, gold miners will probably correct in price.

Small Caps

Small caps have a strong seasonal period from December 19 to March 7

The small cap sector is not in its seasonal period, but nevertheless it is an important sector to follow to understand how investors perceive the current risk environment.





Overall, the sector has been underperforming in the last few years. The sector corrected sharply and underperformed the S&P 500 in February and March. Recently, the sector has started to show some strength relative to the stock market, however; this could change relatively quickly, particularly as small caps tend to be weaker than the S&P 500 in the summer months.

My Call: The small cap will probably start to underperform in the very near-future and underperform over the next few months.

Currencies

CADUSD

The Canadian dollar tends to underperform the US dollar in May.

Oil is just one of the factors affecting the value of the Canadian dollar relative to the US dollar. If oil were to decrease in value, then this would put downward pressure on the Canadian dollar. Of course, this may or may not happen, but given that oil has finished its seasonal period, it is something to monitor.

At the same time, if the stock market were to correct sharply, it would probably also put downward pressure on the Canadian dollar as the US dollar is considered a safe-haven asset.

On a technical basis, the Canadian dollar is at the top end of its trading range. Given that it is in a period of seasonal weakness relative to the US dollar, the Canadian dollar is favored to decrease within its trading range or head lower.

My Call: The Canadian dollar will probably underperform past its seasonal period of weakness in May and continue to underperform over the next few months.

Brooke's Rant

Flicking a switch– Really?

Last week on a major business network, I heard a guest state that the "US economy should be in good shape once we flick the switch to restart it." Yup, it is that easy. All that we have to do is go over to the wall and flick the light switch (sarcasm).

Below is the binary light switch which we are accustomed to seeing in our everyday lives. It is either on or off.

We are not powering up the economy from "0" to "100." In it is not a flick of the wrist. I know, the TV guest probably did not mean it that way. But clearly, the guest meant that the re-opening of the economy was going to be "big" and that there would be no looking back.

Nope! Probably the best way to think about the re-opening of the economy is a dimmer switch. You know, the one that you can turn up slowly and then turn faster or slower until you reach the right spot to create the ideal lighting for the mood (economy).

I fear that the experience of re-opening the economy might be like my spouse and me sitting down for dinner. I turn down the light dimmer: she turns it up. I turn it down: she turns it up. And then we negotiate. I am hoping that the re-opening of the economy does not play out like our dimmer actions.

But an old fashion on-off light switch, the economy is not. Let's hope that we can somehow turn "on" the economy at the right time and pace to balance economic needs with people's health.