Thackray Newsletter

— Know Your Buy & Sells a Month in Advance —

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Market Update

Brexit Magic

The worldwide stock markets dropped on news that Britain had voted to "Leave" the EU. A two day correction was followed by a rapid rally in the stock market back to where it was almost just before the Brexit vote. Investors quickly surmised that the process of Britain seceding from the EU might not even start for two years….so why worry? The end result was that the stock market rallied and it was only a matter of days until the S&P 500 was back to pre-Brexit levels.

Investors generally look out six to nine months in the future in making their investment decisions. An event that could take place in over a year's time does not fall into the decision horizon. Although the process of seceding may fall beyond the investor's decision horizon, there is the possibility that other countries may follow the exodus parade. The problem would be particularly acute if large countries that use the euro start to put their name on the exit list. If a second country were to have a referendum, investors would probably see the bigger picture and start to factor in longer term consequences, including the possibility of the EU being dismantled to a certain degree.

Investors received an additional benefit from the Brexit outcome as it gave the U.S. Federal the chance to push out its schedule of interest rate increases. The U.S. Federal

S&P 500 Technical Status

The S&P 500 is currently (July 10th) just below its all-time high of 2131 set in May 2015. It is quite probable that the S&P 500 could move above this level as earnings season gets underway. Strong earnings could assist with keeping the S&P 500 above 2131. The test will be after earnings season gets underway and investors have a good feel for how many companies are beating expectations. This usually occurs mid-July (on average, approximately July 18th).

At this time investors should still remain cautious. The stock market may have a rally above 2131, but gains are expected to be at best nominal over the next few months.

Horizons Seasonal Rotation ETF (HAC :TSX)
Portfolio Exposure as of **June 30th** 2016

Symbol	Holdings	% of NAV
	Canadian Dollar Exposed Assets	
	Bonds	
HBB	Horizons CDN Select Universe Bond ETF	14.5%
HFR	Horizons Active Floating Rate Bond ETF	8.8%
	Equities	
HXT	Horizons S&P/TSX 60™ Index ETF	24.1%
	United States Dollar Exposed Assets	
	Bonds	
HTB	Horizons US 7-10 Year Treasury Bond ETF	9.7%
	Equities	
HXS	Horizons S&P 500® Index ETF	19.3%
IBB	iShares Nasdaq Biotechnology ETF	10.1%
XLP	Consumer Staples Select Sector SPDR Fund	10.1%
	US Dollar Forwards (July 2016) - Currency Hedge **	-0.3%
	Cash, Cash Equivalents, Margin & Other	3.8%
	Total (NAV $169,961,414)	100.0%

** Reflects gain / loss on currency hedge (Notional exposure equals 47.8% 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.

Reserve has talked tough on raising rates, but does anyone believe them anymore? Overall, they have been more dovish than expected. The Brexit outcome gives them the perfect excuse to delay raising rates once again. At some point, if they push out the possibility of raising rates too far, it will not really matter if a further delay is announced. Does it matter if the first rate rise is set for 2019 or 2020 (tongue in cheek). In fact, the futures market is placing a 10% probability that the US. Federal Reserve will add liquidity to the system in July.

On Friday July 8th, a strong nonfarm payroll report was much better than expected, and helped the S&P 500® rally to finish the day very close to its all-time closing high set in May 2015 of 2131. Despite the recent rally, over the last year and a half the S&P 500® has not really gone anywhere. It crossed the 2100 threshold on February 17th 2015 and has since zigged and zagged back and forth over the 2100 level. On June 13th, I tweeted that the S&P 500® has crossed the 2100 level a total of forty-four times. Since that time, the S&P 500® has continued to zig and zag and once again is above 2100.

Nothing has changed. I stand by my earlier assertions that the S&P 500® is going to have a very difficult time breaking substantially above its all-time high. It is possible that earnings could come in much better than expected. Current expectations are for earnings to decline 4.8% (Thomson Reuters July 8th, 2016). Even if earnings came in much better than expected, the rally will probably be short lived as global growth, including the U.S. is anemic.

At this point, the stock market is very susceptible to a correction, particularly when we get past mid-July when investors will have already priced in a lot of the effect of any positive earnings results. Despite the stock market euphoria, investors need to be cautious at this time.

What the HAC is Going On?

HAC moved up when the stock market was moving down after the Brexit vote and continued to move up when the stock market rallied.

I was travelling for business on June 23rd, heading home from Vancouver. When I got on the plane, the S&P 500® futures were positive: when I got off the plane in Toronto that night, the S&P 500® futures had crashed through the floor. I did not need to refer to a news channel to know what had happened. Fortunately, HAC only had a net exposure to equities of approximately 5% of the value of the fund. Other positions included short sell positions offset against the S&P 500® and fixed income positions. The overall strategy worked as HAC increased in value over the two negative stock market days following the Brexit vote.

HAC went from a position of net 5% in equities to approximately 64% in equities on Tuesday June 28th. This was done to take advantage of the tendency of the stock market to perform well a few days before Independence Day and into the first part of July because of the Earnings Month Effect. The end result is that HAC printed a new all-time high at the beginning of July.

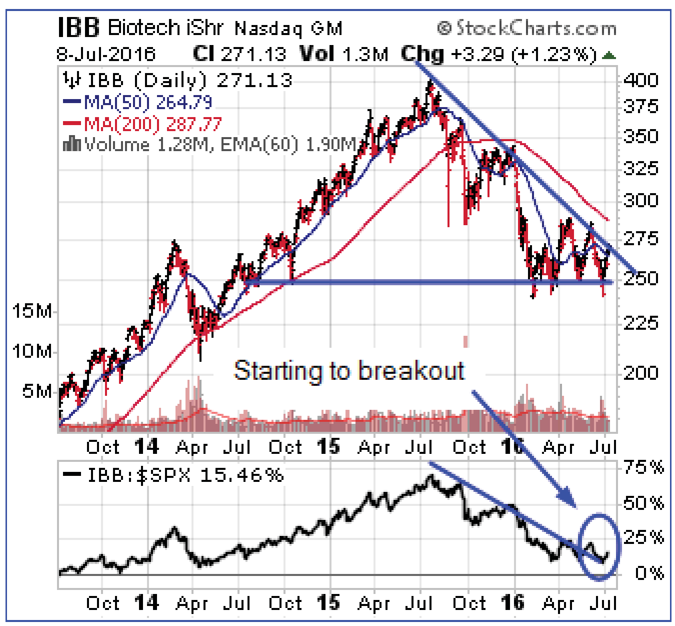
The Independence Day Trade/Earnings Month Trade is not a long-term investment strategy. HAC will be looking to reduce its equity positions– upon stock market weakness.

Seasonal Opportunities

Biotech– Seasonal period from June 23rd to September 13th

The biotech sector has been underperforming since last July, but has recently come to life in its seasonal period. On a relative basis, it has started to outperform the S&P 500. On an absolute basis, it has been positive, but a break above its down trend line would be reassuring.

Investors should watch for this sector to come under pressure if the topic of drug prices becomes an election issue. If this were to happen and the sector started to underperform the S&P 500, investors should consider exiting the sector.



My Call: The biotech sector will outperform the S&P 500 over the next month and start to weaken in mid-August.

Consumer Staples– Seasonal period from April 23rd to October 27th

The consumer staples sector has been performing very well as investors are questioning the strength of the stock market rally. The sector has also benefited from investors chasing yield. As interest rates decrease, the higher yielding consumer staples stocks have increased in price. The sector now sports a P/E of 22, which is high for a low growth sector, but in an environment of low interest rates, and concern over market valuation, investors are willing to pay a premium.

My Call: In its seasonal period, the consumer staples sector will provide moderate outperformance compared to the S&P 500 over the next three months.

Investors should be careful with the consumer staples sector, if interest rates start to rise as the "safe" haven advantage of this sector may not overcome the negative effects of higher interest rates.

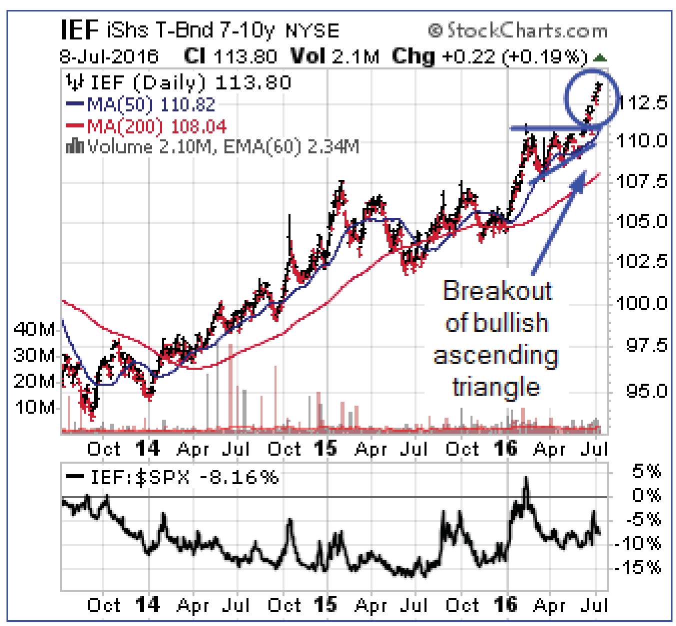
Utilities– Seasonal period from July 17th to October 3rd

The utilities sector has been the top performing major sector in the S&P 500 this year. Similar to the consumer staples sector, the utilities sector has benefited from investors seeking safety and yield. The utilities sector has one additional benefit in relationship to lower interest rates, in that the sector is highly reliant on debt which means that lower interest rates substantially reduces the cost of doing business. The utilities seasonal period is at our doorstep. Although the sector can still perform well, most of the gains have probably already been made and investors should be conservative in their allocation.

My Call: The utilities sector will consolidate in July and then slightly outperform the S&P 500 in August and September.

U.S. Government 7-10 yr. Bonds– Seasonal period from May 6th to October 3rd

Before the start of the seasonal period for government bonds, the sector was forming a bullish ascending triangle. HAC bought an initial position in the sector at the start of the seasonal period and increased its position when the breakout from the bullish ascending triangle occurred.



My Call: U.S. government bonds will provide moderate returns in August and September.

Canadian bonds - Seasonal period from May 5th to October 3rd

Canadian bonds have been performing well since the start of their seasonal period in May. HAC bought an initial position at the start of the seasonal period and increased its position after the sector broke above resistance.

My Call: Canadian bonds may soften a bit in July due to their strong run, but they are still expected to provide positive performance in August and September

Gold– Seasonal period from July 12th to October 9th

My Call: Gold will probably back fill at this point, but is still expected to provide positive performance in August and September.

In my last newsletter I stated that given gold was overbought before its seasonal period, and that gold tends to perform poorly in June, it would be best to hold-off entering the sector early. Unfortunately, the powers driving gold ahead of its seasonal period pushed it up substantially. Gold quickly went through its resistance barrier of $1300 and now has resistance sitting not too far overhead at $1400.

The fact that gold has done well ahead of its seasonal period does not negate the gold seasonal trade, although it might mean that the gains in gold's seasonal period may not be as large.

Gold miners– Seasonal period from July 27th to September 25th.

Gold miners have been performing exceptionally well as investors have latched onto the sector as a gold leverage play. The sector is close to the resistance level of $31. As a result, investors would be wise to wait until the start of the seasonal period for gold miners before entering into a position in the sector.

My Call: Gold miners will probably back fill at this point, but the sector is still expected to provide positive performance in August and September. Investors should be cautious with this sector, if a large correction in the stock market occurs, more than likely gold miners will also perform poorly.

Energy– Seasonal period from July 24th to October 3rd

The energy sector has a minor seasonal period from July 24th to October 3rd. This period is not nearly as strong as the primary seasonal period, from February 25th to May

9th. As a result, the current seasonal period is less attractive and if the trade is entered a smaller allocation should be considered. Currently, the energy sector is at its resistance level and West Texas Crude is just below $50. For both the energy sector and crude oil, a large move above the current levels is going to be difficult. Rig counts are moving up in the U.S., increasing supply. It is just a start, but if the trend continues, this will put a damper on the price of oil.

Recently, oil has been trading with international economic news. Even though the U.S. released a nonfarm payroll report that was much greater than expected, the overall trend around the world is slower growth. Release of further slowing growth could put a damper on the prospects of the energy sector at this time.

My Call: The energy sector will provide nominal returns at best over the next few months. It is susceptible to a correction if weaker than expected economic numbers are released on a global basis.

Short Sells (for pair trades)

Small Caps (Short Sell)

The small cap sector tends to perform poorly in July as investors prefer the larger more stable sectors of the market in the middle of the six month favorable period for stocks.

The small cap sector has been outperforming the S&P 500 since the bottom of the stock market in February. The route has been lumpy as the small cap sector has outperformed in rapid rallies and underperformed in pull-backs. Given that the sector is now at resistance, it is susceptible to underperformance if the stock market starts to correct.

My Call: It is difficult to determine if small caps are going to underperform as the sector is currently at resistance. If the stock market starts to correct, small caps will probably underperform. If small caps continue to outperform, then a short sell position will be considered to have failed.

Consumer Discretionary– (Short Sell)

The consumer discretionary sector is currently at resistance and has been performing at market. The sector tends to underperform the S&P 500 in the summer months making it a good short sell candidate.

My Call: The consumer discretionary sector has been performing at market. Look for weakness before entering into a short sell position.

Materials– Underperforming

The materials sector has been showing signs of breaking down. The sector is mostly made up of chemical companies which tend to perform poorly in the summer months.

My Call: The materials sector is likely to underperform as it has already broken its upward trend line on a relative basis and the material sector tends to lag at this time of the year.

Brooke's Rant

I don't blame the Britons

If I were a Briton and had to vote, I would probably have voted "Leave." Note: I lived in Scotland in my youth and have visited the Britain a number of times.

Ordinary citizens of most European countries see the EU as an out of control bureaucratic wasteful bully. They feel disenfranchised from the European government and believe that their own country has no say in European policies. They believe that the EU is a group of elite individuals dictating for their own self interest. EU citizens also believe that the EU has become a monstrosity that is too large and too deaf to initiate any meaningful change.

One of the touch points for European citizens and how they view the EU is through the abundance of really stupid laws the EU keeps passing. In North America, we do not read about the wastefulness of the EU; such as, imported bananas have to have a certain curvature to be accepted for import, cucumbers have to be straight, you cannot eat your pet horse, children under eight cannot blow up balloons etc. There are hundreds of these anecdotal stupid laws. If you are looking for a night of fun, I am sure an internet search on "EU stupid laws" would provide a few hours of fun. The point is that European citizens have to live with this bureaucratic oversight.

There is a cost to staying in the EU. The ordinary citizen knows that the "stupid EU laws" somehow translates into higher costs for everyone. As the British found out in the referendum campaign, there is also a huge cost of transfer payments to the EU, somewhere in the neighborhood of a net 150 million euros a week is transferred to the EU from Britain. As the people struggle in their daily lives and see the wasteful bureaucracy they wonder if it is worth staying in the EU.

So why has the ordinary citizen supported the EU? They believe that despite all of the short comings of the EU, there is some nebulous benefit that goes along with easy access to other markets and labor mobility. Somehow, they are better off together with other countries than on their own.

The media has portrayed Britain as making a terrible mistake in its decision to leave the EU and focuses on the current cost of their decision, including a drop in the British pound and house values. The argument is somewhat one-sided as the costs to staying in the EU are not considered. There is no question there is going to be some short-term pain leaving the EU, there was always going to be short-term costs. It is the long-term costs that should be considered.

The arguments for "Remain" and "Leave" are debatable with the current structure of the EU. If the EU was a productive economically viable long-term institution, then I might be swayed to the "Remain" side of the debate. The problem is that the argument for "Remain" is built on the assumption that the EU is a healthy entity that will exist into perpetuity. When this assumption is taken away, the argument for "Leave" gets a lot stronger. My support for the "Leave" side rests not on the current state of the EU, but rather the distinct possibility that the EU will disintegrate sometime in the future.

If you believe that the EU is a failed institution, like I do, the equation to "Remain" or "Leave" changes and it makes sense to leave before the EU implodes. The EU cannot exist in its current state. Aside from its dogmatic bureaucracy, it is built on a faulty structure. It is not possible to have a bunch of countries share a currency without fiscal unity. Not that a common fiscal policy (one government controlling taxes and expenditures) is the right way to go. It is just that a common monetary policy alone will ultimately crash and burn. The financial crisis of 2008/2009 tested the European structure, but there are still great challenges ahead. Although, the troubled European countries are not making headlines, the underlying problems are still simmering. All that it will take is a global recession to bring the problems to the forefront. If people think that Europe is solving its problems, they are fooling themselves.

The EU finds it very difficult to enforce fiscal rules on its countries. Sure, countries are not supposed to run more than a 3% deficit (LOL as my kids say). In this day of large governments with a matching tax and spend attitude, almost all of the European countries are running more than a 3% deficit. The EU can make all the fiscal rules it wants, but they are not enforceable.

EU countries are acting in their own best interests, defying EU laws without consequence. The problem is that a moral hazard situation is being created. The countries feel that the EU ultimately "has their backs" if things go wrong. It is the EU's best interest to make sure that its constituents survive. If countries run into financial trouble it is typically best for the EU to bail them out. Small countries such as Cyprus and Greece are exceptions as they can be bullied into submission and used as examples to deter other countries from following a profligate path. Large countries such as Italy and Spain are a different matter entirely, because their demise would affect the very fabric of the EU. Predictably, large EU countries believe that they have an EU "put option." They believe that if they run into difficulty, they can "put" or give their problem back to the EU, which will then provide help to solve the situation.

It is possible that the EU could change, but not likely. They will of course utter words of comfort, but a large government bureaucracy has a life of its own and meaningful changes are unlikely. If other countries start to leave the EU, at some point, it could become a race out the door. If this is the case, it is best to be one of the first countries to leave.

Britain was already half out the door because they were using their own currency. Many years ago, when Britain was joining the EU, I remember all of the arguments that were made as to why Britain should use the euro instead of the pound….better access to markets, seamless business etc. Obviously, Britain has been much better off not being part of the EMU (European Monetary Union). Britain's foresight to keep the pound as their national currency has stood them in good stead. In the recent Brexit vote, the British have stated many different reasons to leave the EU, such as sovereignty and immigration control. Ironically, their "Leave" decision could be serendipitous, as the best reason to leave might not be the benefits of independence, but rather benefit of avoiding the EU's demise.

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