Thackray Newsletter

— Know Your Buy & Sells a Month in Advance —

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Written by Brooke Thackray

Market Update

No black swans in sight! Everything looks good. The economy is humming along. Earnings are finally positive for a couple of quarters in a row. Europe seems to be on the mend. The French election has reaffirmed the countries allegiance to the EU. What can go wrong?

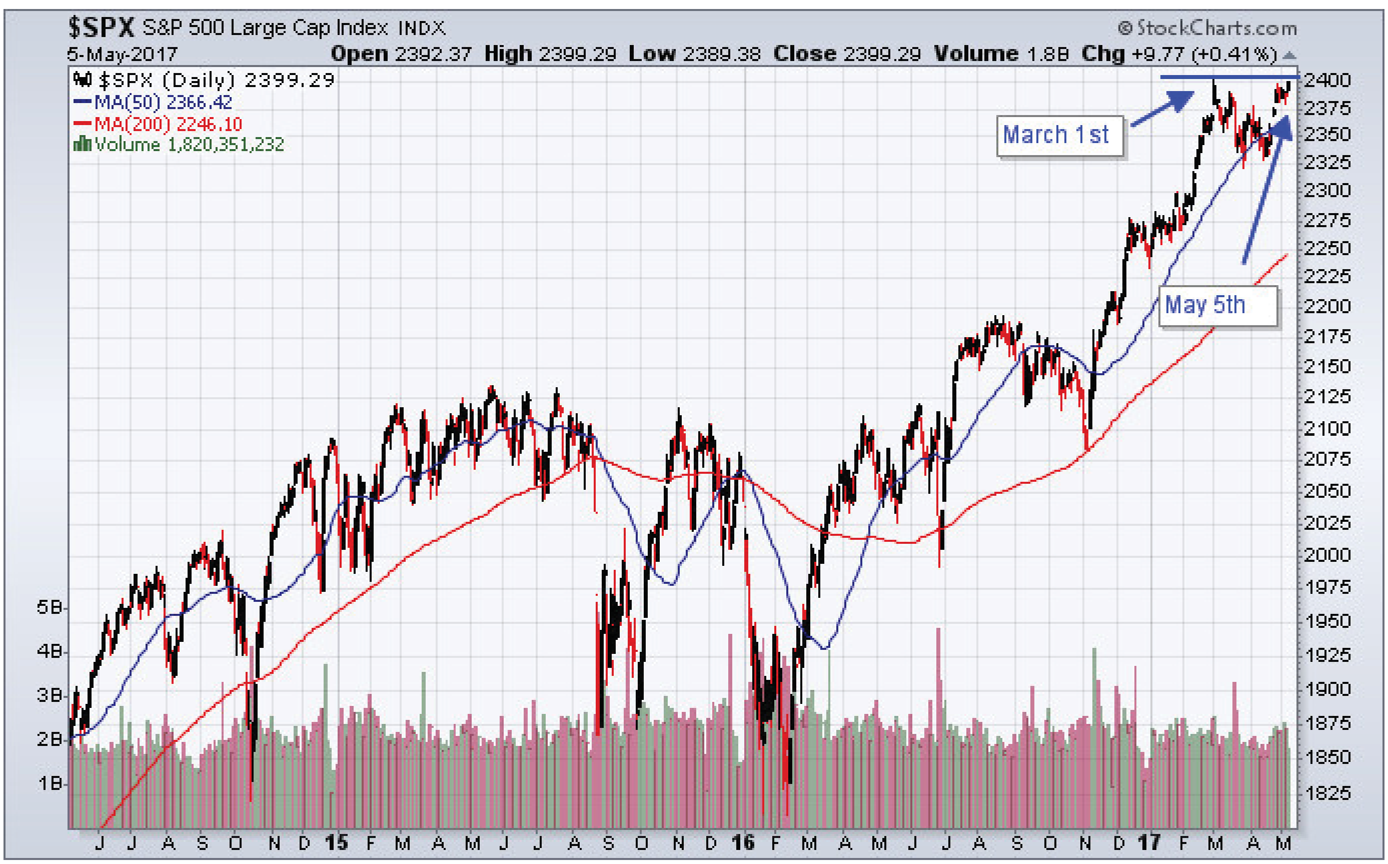
The fact that everything appears to be just great and that nothing can go wrong in the stock market, does not mean that everything is great and nothing will go wrong. The definition of a black swan event is predicated on an unexpected negative event taking place. Black swans do not announce themselves.

I do not know what black swan event could take place, or even if one will occur. Maybe it is China's shadow banking system collapsing, maybe it is a military war, or even a trade war. Maybe a black swan event will not happen for

S&P 500 Technical Status

Technically, the S&P 500 is in good shape. On Friday May 5th it closed at an all-time high of 2399 (also the high for the day). On March 1st, the S&P 500 closed at 2395.96 with an intra-day high of 2400.98. In other words, the S&P 500 is at resistance. If it able to move higher than 2400 and hold this level for a few days (especially on strong volume), this would be positive.

There is also a possibility that the S&P 500 will start to struggle at this point. The S&P 500 is at all-time high levels and just starting the six-month unfavorable period for stocks (May 6th to October 27th). In this period, the stock market has historically produced bigger losses and fewer gains than the other six months of the year. Investors should be cautious at this time.



Horizons Seasonal Rotation ETF (HAC : TSX)
Portfolio Exposure as of **April 30th,** 2017

Symbol	Holdings	% of NAV
	Canadian Dollar Exposed Assets	
	Equities	
HXE	Horizons S&P/TSX Capped Energy Index ETF	10.0%
HXH	Horizons Cdn High Dividend Index ETF	9.8%
HXT	Horizons S&P/TSX 60™ Index ETF	5.8%
HSH	Horizons S&P 500 CAD Hedged Index ETF	0.8%
	Commodities	
UNG	United States Natural Gas Fund LP	3.3%
	United States Dollar Exposed Assets	
	Equities	
HXS	Horizons S&P® 500 Index ETF	50.1%
XLY	Consumer Discretionary Select Sector SPDR Fund	5.4%
	US Dollar Forwards (May 2017) - Currency Hedge **	-2.6%
	Cash, Cash Equivalents, Margin & Other	17.3%
	Total (NAV $222,088,169)	100.0%

** Reflects gain / loss on currency hedge (Notional exposure equals 78.7% 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.

a few years. It is very difficult to incorporate a black swan event into portfolio management.

From a seasonal basis, the possible occurrence of a black swan event is not taken into account, but on average the largest "drops" in the stock market have historically occurred in the unfavorable six month period for stocks (May 6th to October 27th). If the stock market were to correct in this time period and a black swan flew onto the scene, then….ouch, things could get bad.

FOMO – a virus spreading throughout the world

To me, FOMO sounds like a bacterial virus, but it is an acronym that stands for "Fear of Missing Out." The fear of missing out on stock market returns has been spreading in the investor population. There is a sense of euphoria and investors are taking their "cheap" money (low interest rates) and investing it in the stock market. When all their friends are making money, investors fear that they will be left behind. The fear of losing money is all but forgotten.

While prices are increasing, FOMO spreads faster and faster. Fundamentals do not matter, technical do not matter…nothing matters except being in the stock market. Until a negative catalyst occurs, FOMO spreads. There is no cure for FOMO, except lower prices.

I raise the issue of FOMO because the stock market can keep running on animal spirits, even during the unfavorable six-month period for stocks. Strong sustained rallies during the unfavorable six-month period are not common and usually occur after a recession or Federal Reserve intervention to increase liquidity.

Given that the U.S. is not coming off a recession, and the Federal Reserve is not planning on increasing liquidity, FOMO is not likely to power the stock market substantially higher over the next six months.

Sell the News?

After two elections where the pollsters got it wrong, Brexit and the U.S. elections, there is a chance that the stock market will fizzle or fade after the French election (the pollsters got this election right).

There have been too many investors betting on the outcome of the French election, expecting the stock market to rally after the election. It is not an investment strategy to bet that the stock market will go up because of an election, but many investors have followed this strategy because it has worked the last two times in a row. There is a good chance that investors will sell the news, mitigating the possibility that the S&P 500 will rise substantially above its all-time intra-day high of 2400 set on March 1st, 2017.

What to expect over the next six months

I cannot tell you if the stock market will be up or down over the next six months. Sorry. But I can tell you that the stock market is susceptible to a correction as it is "richly valued" as it enters its six-month unfavorable period. Historically, there have been very few large gains in the six-month period from May 6th to October 27th. Yes, the stock market can rally in the summer months, but overall, in the long-term from 1950 to 2016, the six-month unfavorable period has produced an average geometric loss of 0.5%. If a strong rally were to occur, it most likely would take place at the end of June and into the middle of July.

One concerning factor in equity trends is the relative performance of the defensive sectors of the stock market relative to the cyclical sectors over the last few months. The defensive sectors have generally outperformed since the beginning of the year. So, what is the big deal? When the defensive sectors outperform the cyclical sectors in the six-month favorable period for stocks (when cyclicals typically outperform), it is often an indication that the stock market is weaker than what the broad market indexes are revealing. This condition makes the stock market more susceptible to a correction than would otherwise exist.

I have recently written a report titled "Warning– Storm season ahead for stock market (May 6 - Oct 27) !" It is available at http://bit.ly/2pSs3WE. The report outlines the justification for conservative portfolio positioning over the next six months.

What the HAC is going on?

Towards the end of the April, HAC started to reduce some of its sector positions and raise cash. Overall, HAC favored the U.S. stock market over the Canadian market in the month of April.

In the transition months going into and out of the six-month unfavorable period for stocks (May and October), seasonal sectors that are not outperforming the S&P 500 typically should not be favored if they are underperforming. This year is not an exception.

A good portion of the "Trump sectors," that outperformed the S&P 500 in autumn, based upon the premise of economic expansion and reflation, performed at market or underperformed in the January to May period. This is when they typically perform well. The "Trump trade" exhausted itself in mid-December. HAC recognized this trend and as a result moved to more broad market positions compared to previous years.

Starting in January, on a relative basis, HAC did suffer from placing more emphasis on the Canadian stock market than it has in past years. On the other hand, in recent months HAC did benefit from reallocating capital to favor the U.S. equity markets.

Seasonal Opportunities

The stock markets have just entered into the six-month unfavorable period for stocks (May 6th to October 27th). In this period, there are opportunities to invest in different sectors of the market and even in the broad stock market. Nevertheless, it is the time for caution and investors should be more selective and conservative.

Energy– broken but can it mend?

The energy seasonal trade did not work this year. It had a good technical setup at the beginning of the seasonal period, but outperformance never materialized. The trade started to fall apart before the end date for the trade (May 9th). The trade showed some strength at the end of March and into the beginning of April, but it was ephemeral.

My Call: The energy trade will probably settle down at this point. Look for a good entry later in July (second seasonal period for energy).

Natural Gas– has performed well, but might be burning out

The natural gas seasonal trade started in March approximately on its seasonal schedule. The trade worked well until the beginning of April. Since that time, natural gas has pulled back slightly, but has not broken major support levels. Nevertheless, if the trade continues to deteriorate, consideration should be given to exiting the trade early.

My Call: Natural gas will probably move higher for one more rally before the end of its seasonal period. If oil were to drop in price once again, then it is possible that natural gas could suffer from spill-over sentiment.

Biotech– Upcoming potential

After poor performance in 2015 and the beginning of 2016, the biotech sector has performed at market. On an absolute basis, the sector has had a series of higher lows and has formed a bullish ascending triangle.

The sector is benefitting from Trump slogging through his initiatives, trying to get them implemented. At this time investors are of the mind that Trump may leave the biotech sector alone as it is too far down the list. As a result the sector has shown signs of improving.

The ideal setup for the biotech sector trade would a pullback before the start of the seasonal period (June 23rd).

My Call: The biotech sector will probably perform at market until the beginning of its seasonal period.

Consumer Staples– Seasonal sector, but it is expensive

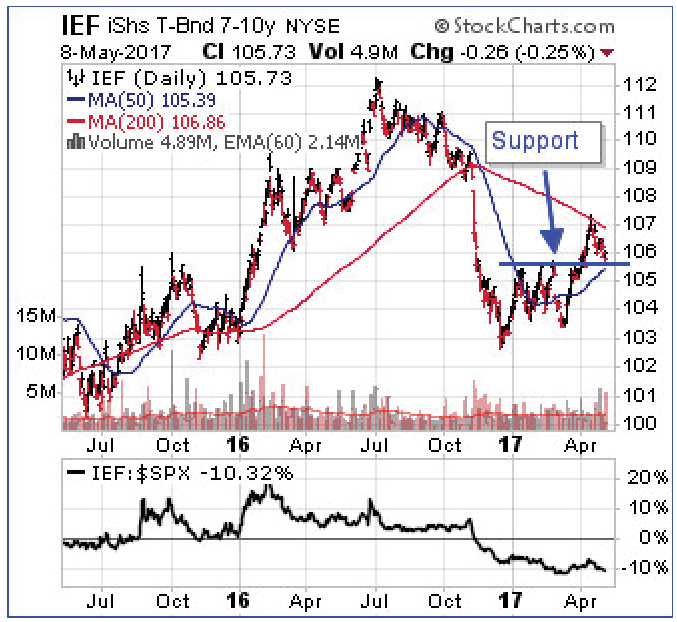
The consumer staples sector initially underperformed the S&P 500 after the U.S. election in November 2016. As investors have faded the "Trump trade," since the beginning of the year, the sector has outperformed the S&P 500. Recently, the sector has underperformed the S&P 500 as investors have moved back into some of the "Trump sectors." Although the consumer staples sector is in its seasonal period, it is expensive, trading at a forward P/E of 20.3 (Yardini Research May 8, 2017). The consumer staples sector is considered a low growth sector, but investors tend to push up the P/E when they are concerned about the stock market.

The consumer staples sector is still susceptible to a correction if the stock market corrects. The fact that it is a defensive sector does not mean that it will not decrease in an overall market correction. This is particularly true since the valuation for the sector is quite "rich."

My Call: The consumer staples sector will probably perform at market. A better opportunity to enter this sector could be on the horizon if the stock market were to correct.

Government bonds– Seasonal sector, but the sector hasn't shown signs of "kicking in yet"

Government bonds typically perform well from the beginning of May until the beginning of October. The sweet spot for the trade is in August and September. The sector performed well in March, as the North American equity markets corrected. Recently the sector has pulled back as some of the economic data has been more robust than expected and the stock market has stabilized.



My Call: Government bonds will probably stabilize and start to outperform equities shortly after the equity market shows any signs of weakness. Overall, government bonds are expected to produce a gain in their seasonal period.

Gold– In the spotlight, but now is not the "seasonal time"

Gold bullion is a sector that is not in season, but I thought I would write about the sector given the amount of interest in the subject.

After starting the year on a positive note, gold bullion has corrected twice and has performed approximately at market. On an absolute basis, the sector is still in its trading channel, but it is trading below its 200 and 50 day moving averages. Other than trading through its key averages, technically gold bullion has not broken down. If it were to trade below $1200, this would not be good.

From a seasonal basis, the seasonal period for gold bullion does not start until mid-July. Although we are getting close to this time period, June and the beginning of July can be extremely volatile. Now is not the preferred time to enter the sector.

It is interesting that gold bullion has pulled back as the U.S. dollar has also pulled back relative to world currencies. If the U.S. dollar were to improve its relative performance, gold would probably suffer.

My Call: Gold bullion will probably continue to correct over the next month and a half. In this time period, it will probably be extremely volatile and could challenge the $1200 mark. Better opportunities probably lie ahead.

Canadian dollar– April seasonal trade...not good

The Canadian dollar typically performs well relative to the U.S. dollar in the month of April. In the first half of April, the trend held up, but once oil started to collapse and Trump started to tweet his “anti-Canadian” messages, the Canadian dollar corrected. It broke a key support level of $73.75. Over the last few days, the Canadian dollar has been on a wild ride, up and down as traders have moved positions in their oil investments.

Unfortunately, just because the Canadian dollar has corrected does not mean that it will bounce back because it is good value. In fact, the likelihood of this happening is greatly diminished as the Canadian dollar tends to perform poorly in May and into June.

My Call: The Canadian dollar will probably underperform over the next two months, especially if the price of oil continues to slide.

Brooke’s Rant

“Risky Risk” Parity Funds (pun intended)

Risk Parity funds could be the catalyst that pushes a correction further down the pain scale. Generally, this “latest and greatest” investment methodology is based upon the parameters of creating a portfolio of equities and bonds that has an equivalent risk level to a broad-based index such as the S&P 500® (not all risk parity funds are built the same way and some do not include leverage).

Okay, so how do you create a portfolio with the same risk as the stock market and include assets that have historically had less risk than the stock market? Answer: leverage. Yes, leverage. In order to create a risk parity portfolio, a risk benchmark for the broad market must be created in order to set risk levels (let’s hope the algorithm is correct).

There is no set standard for establishing the risk of the stock market, so it is left open to interpretation. Once the risk level of the stock market has been artificially established, a mix of stocks and bonds (some risk parity funds use other asset classes as well) is determined. If no leverage is used, then there would be less risk than a straight equity portfolio.

Bonds have historically had less risk than the stock market (we will get to that one in a minute). The solution to solve the situation of a balanced (stock and bond) portfolio having less risk than the equity markets is to leverage up the bond portfolio in order to increase the risk. This allows the total risk of the stock and bond allocations to be equal to the stock market.

Ummm. Did I miss something. Hold on, do bonds and stocks move together? With all this talk recently of how higher interest rates (lower bond prices) are good for the financial sector, it is easy to forget that higher interest rates provide an alternative investment choice for stocks and therefore can have a negative impact on stock prices.

Why raise this point?

Risk parity funds are largely built on back tested data in the last few of decades. Interest rates peaked in 1981 and long bonds have performed extremely well since. So, if leverage were used on bonds during the bond bull rally from 1981 and equities were added into the portfolio, of course the end result would have a strong profile of risk adjusted returns. But in a world of rising interest rates, the results would probably have been substantial different, as the risk parity portfolio would have dramatically underperformed the stock markets.

Here is the problem. A large number of investment managers are using the same basic risk parity strategy. As of September 2015, there was approximately $500 billion in risk parity funds, not including leverage (Financial Times, September 24th, 2015). Today, the number is even higher. If the stock market were to correct, and investors started to pull their money out of risk parity funds, then this would cause huge selling of assets by the risk parity funds. Unwinding leverage can drive prices down fast. People tend to forget this truth. With a large group of managers using a crowded trade, the situation would be that much worse.

The good news is that on a seasonal basis, bonds tend to perform well from May until the beginning of October. It is possible that risk parity portfolios might get a reprieve, but it doesn't take away the overall risk that is not properly factored into the risk parity equation. After all, at some point interest rates may increase, so all that back tested data from a falling rate environment will be useless. Oops.