Thackray Market Letter

— Know Your Buy & Sells a Month in Advance —

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Market Update

In the last days of July and the beginning of August, the S&P 500 has pulled back. At this time it is interesting to see the plethora of articles defending the market and stating that the events taking place do not justify the correction. This is typical when the market turns down from all time market highs. No matter how much further the market corrects, these articles will persist. It seems that the more the market corrects, the more "buy the dips" articles are published. Seasonal investors would be wise to ignore the perpetual buy the dips mentality.

So far, the S&P 500 earnings season has gone well, with 69% of the reporting companies beating expectations, compared to the ten year average of 63% (Thomson Re-

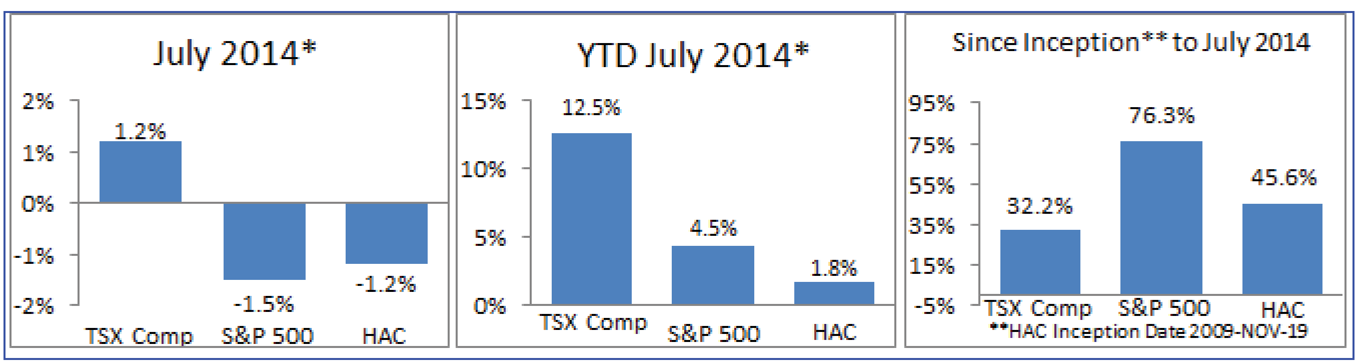
S&P 500 Technical Status

Technically, the S&P 500 is still in good shape. It still has not violated its pattern of higher highs and higher lows and is still in its trading channel that was established in 2013. For the S&P 500, support currently lies at the 1890-1900 level. The S&P 500 spent a significant amount of time at or just below this level in March, April and May. If the S&P 500 does break below this level on strong volume, the market will be in a corrective phase. If the market breaks the 200 day moving average, which is currently at 1862, more investors will move to the bearish side and bring further negative pressure to the markets. A total correction of 10% to approximately 1800 would not be out of the question. If the S&P 500 manages to turn up from the current level, it is possible that it could make it back to the top of its trading channel at the 2100 level, but a more likely scenario is for the S&P 500 to fade back down to test support once again.

Horizons Seasonal Rotation ETF (HAC :TSX)
Portfolio Exposure as of **July 31st**, 2014

Symbol	Holdings	% of NAV
	Canadian Dollar Exposed Assets	
	Fixed Income	
HFR	Horizons Active Floating Rate Bond ETF	32.7%
HBB	Horizons Cdn Select Universe Bond ETF	20.2%
	United States Dollar Exposed Assets	
	Equities	
GDX	Market Vectors Gold Miners ETF	10.0%
XLP	Consumer Staples Select Sector SPDR Fund	5.1%
XLU	Utilities Select Sector SPDR Fund	4.9%
	`	
GLD	SPDR Gold Shares	10.0%
	US Dollar Forwards (July 2014) - Currency Hedge **	-0.5%
	Cash, Cash Equivalents, Margin & Other	17.6%
	Total (NAV $115,265,776)	100.0%

** Reflects gain / loss on currency hedge (Notional exposure equals 33.8% of current NAV)



* Source: Bloomberg, HAC based upon 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.

uters, August 1st). Most of the S&P 500 companies have reported and the focus is now going to turn to the strength of the economic reports.

The economy has been expanding, albeit at a slow pace. The July employment numbers came in at 209,000 which was less than expectations of 233,000. The employment numbers have consistently been above 200,000 over the last six months, but they have not been spectacular.

Likewise the US Annual GDP growth has been improving and most recently registered a 2.4% growth rate for the second quarter of 2014. There are many other indicators to look at, but overall the economy has been improving, just not at a rapid pace.

Some would say that we are in a goldilocks scenario. The numbers are not too weak to cause a major concern and not too strong to demand the Fed to take action. Yes, this is true, but the market has already somewhat built this into its price. It is possible for the market to ride this wave for quite some time. On the other hand, it does not take much for the market to falter at this point.

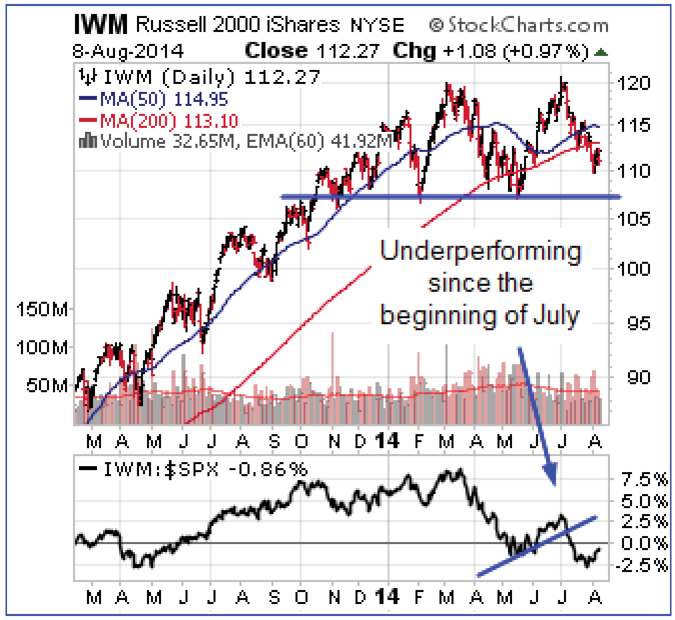
Positive economic surprises will drive the market higher and negative surprises will drive the market lower. The last statement taken by itself sounds like a fifty-fifty proposition: it is not. From a directional perspective it is true, but from a magnitude perspective, it is not. When a market is stretched to the upside and it is in the unfavorable season, the market is much more likely to respond stronger to negative news than it is positive news.

Technically Speaking

Last month I illustrated the divergence between the S&P 500 and its MACD (Moving Average Convergence Divergence), stating that the market could weaken to correct this divergence. Recently, the market has started to correct, but as I have been saying over the last few months, the market from a price pattern standpoint is still sound. The market has not violated the trend of higher highs and higher lows. It is close to breaking down below its support level, but has not done so yet.

There are more warning signs that the market may be in for more of a correction. In my May newsletter, I wrote about the two warning signs: the small cap sector underperforming the large cap sector and junk bonds underperforming higher grade corporate bonds. After updating these indicators, I will discuss how the deterioration of advancing stocks relative to declining stocks is also indicating a weakening market.

To start, in my May newsletter, I indicated how IWM was underperforming the S&P 500 and on an absolute basis was consolidating, with the possibility of breaking down. As I mentioned in the May newsletter, when the small cap sector of the market is underperforming the S&P 500, it often indicates an internal weakness for the S&P 500, as it indicates that investors are losing their appetite for risk.



Starting in May, the Russell 2000 iShares ETF (IWM) had a spurt of outperformance. It is interesting to note the sector turned down at the beginning of July, even when the S&P 500 was in an uptrend. When this phenomenon occurs, it often indicates a weakening of the broad market. IWM has not reached the low level that it did in May, but if it were to break this support level, it would indicate investors' loss of appetite for risk.

Also in my May newsletter, I illustrated how the relationship between junk corporate bonds and higher quality corporate bonds was showing a possible decrease in risk appetite. After junk bonds outperformed high quality corporate bonds for 2013, the relationship consolidated in the beginning of 2014. The JNK to LQD ratio rose briefly in June, but fell sharply in July, once again indicating an aversion to risk. Risk in the corporate bond market generally mirrors risk in the stock market. When the two markets diverge, it is often the bond market that leads the stock market. Currently, the deteriorating ratio of junk corporate bonds to higher quality corporate bonds is indicating possible further weakness ahead in the stock market.

Another indicator of "market health" that I follow is the advancing versus declining stocks ratio. This indicator helps show the breadth of the market. Very often the market can be rising and the advancing versus declining stocks ratio can be falling. When this occurs, it indicates that fewer stocks are participating in the rally. If only a few stocks are driving the market higher, it means that the market is susceptible to a correction. Currently, the advancing versus declining ratio is still healthy, but it has turned down. If the market continues to "narrow" and fewer stocks lead the market higher, investors should be increasingly cautious.

All three of the above indicators are not timing tools, but they do indicate possible further weakness ahead. The market could turn around, but given the internal weakness of the market, and the fact that we are in the unfavorable period for stocks, the market at best is probably going to consolidate sideways and more than likely to correct.

What the HAC is Going On

In July, HAC outperformed the S&P 500, but underperformed the S&P/TSX Composite.

One of the major reasons that HAC outperformed the S&P 500 is the result of its defensive move to cash in mid-July. At the beginning of July, HAC was fully invested in the stock market to take advantage of the Independence Day trade and the first 18 Calendar Days In Earnings Months trade. At the onset of its broad market equity position, HAC established stop loss levels. As the market oscillated back and forth at the beginning of July, HAC was stopped out on its broad market position at various levels. Although the S&P 500 did move higher, HAC with its reduced equity position avoided the sharp correction that took place at the end of July.

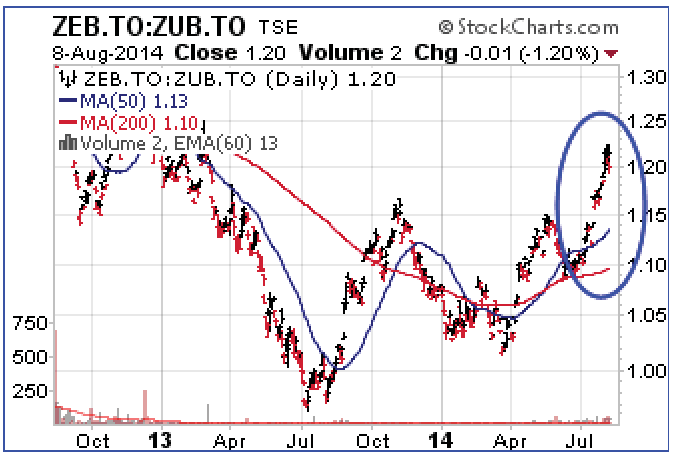
HAC also lost ground on its IBB position in July. At the beginning of July IBB started to underperform the market. At the time, a decision was made that the trade was breaking down and HAC exited the position. Unfortunately, the timing of the trade was not ideal and HAC lost ground with the trade. There is always a risk that exiting a position because of weakness will lead to a whip-saw with the position bouncing back up. Nevertheless, no apologies are needed in attempting to control risk.

Why did the TSX Composite perform so well in July, outperforming both the S&P 500 and HAC? Generally speaking, when the TSX Composite outperforms the S&P 500 it is the result of one of three sectors performing well: the gold, energy or financial sectors. These three sectors make up the bulk of Toronto stock market and by weight are all much greater than their counterparts in the U.S. Although both the Canadian and US financial sectors have a positive correlation, they do respond differently to different market conditions. In July it was the Canadian bank sector that was responsible for the TSX Composite's strong performance: it had a large positive return, outperforming the TSX Composite and the S&P 500.

The Canadian Banking Sector, represented by the BMO S&P/TSX Equal Weight Banks Index ETF (ZEB)

The U.S. Bank Sector, represented by the BMO Equal Weight U.S. Banks Hedged to CAD Index ETF (ZUB)

Canadian Bank Sector relative to the U.S. Bank Sector, represented by ZEB and ZUB



What should investors expect from Canadian banks. First of all, Canadian banks can perform well in the first half of July. Referencing the S&P GICs Canadian Bank sector, from 1990 to 2013, during the period of July 1st to July 18th, the sector has produced an average return of 1.9% and has been positive 75% of the time. This is better than both the S&P 500 and the TSX Composite. What is interesting is the relative strong performance of the sector when the S&P 500 was negative during this time period. In this time period the S&P 500 was negative eight times and only once, in 2011, did the Canadian bank sector underperform the S&P 500.

In 2013, the Canadian bank sector, after a correction that started in March, turned around to perform positively starting at the end of June as investors were expecting strong earnings reports in late August. The sector performed positively into August and continued to run up until the next earnings season. After decent earnings announcements in November the Canadian bank sector then started to fade.

This year the scenario is a bit different. The sector has already had a strong run and is in danger of correcting once the banks announce their earnings in August. Given the strength of the run in the Canadian banks, it is going to take strong earnings reports in August to drive the sector higher.

Sector Trends

Gold Bullion– Getting Ready to Shine

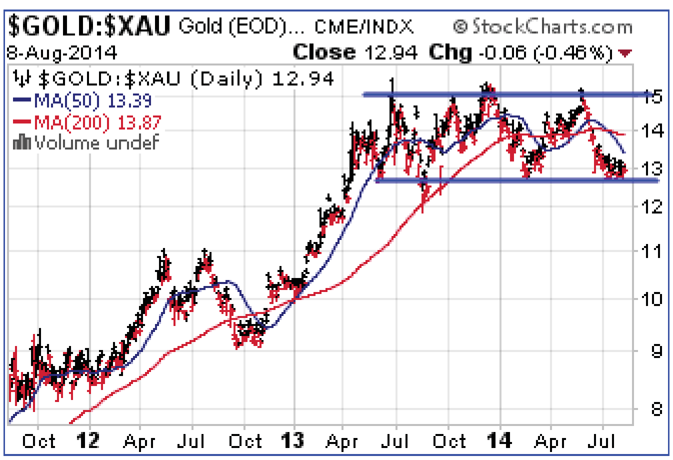
Gold has slightly outperformed the S&P 500 since the beginning of its seasonal period on July 12th and has recently been holding above the $1275 level. Given that we are still in the early stages of the gold seasonal period, this is a good thing.

There are a number of cross currents affecting gold's movement: the strengthening of the U.S. dollar and the talk of the Fed tightening is pushing gold down, but on the other hand geopolitical tensions and the realization that the Fed may soften its hawkish language are helping to push gold up. Gold always has multiple influences affecting its performance and depending on the situation it can trade off one variable much stronger than another.

The seasonal period for gold is largely driven by supply/demand imbalances that occur in the late summer months and any positive surprises tends to have a strong effect on the price. Overall, the effect of the positive surprises tends to outweigh the negative surprises, helping to push gold higher. Currently, gold has been consolidating in its trading channel and is well positioned to move higher in its seasonal period.

Gold Stocks– Is it Time Yet?

Since the end of June, the gold stock sector has been putting in time– consolidating. We are currently in the seasonal period for gold stocks to perform well. If there is one time of the year that gold stocks can perform well, it is August and September. Investors should note that gold stocks would be expected to perform poorly if the market has a severe correction. If we look back to 2011, gold stocks got hammered when the market had its major downturn. Nevertheless, gold stocks are still a favored position at this time.



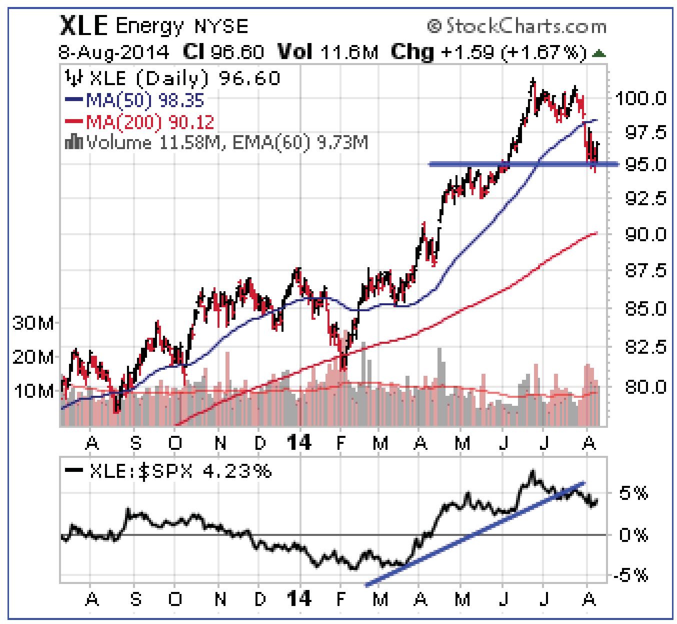
Gold stocks' performance relative to gold bullion has been consolidating and is at the bottom of its trading channel. Over the last few months gold stocks have been outperforming gold bullion. Ideally speaking it would have been better to have a setup with the gold to gold stocks ratio at a higher level. Nevertheless, the fact that the ratio is at the bottom of the trading channel does not mean that gold stocks will not outperform gold bullion. If there is one time of the year where gold stocks can outperform bullion, this is it (see Thackray's 2014 Investor's Guide, page 85).

At the end of July HAC had a fairly large position in both gold and gold stocks.

Energy– Fire Going Out or Ready to Rebound?

Given that the energy sector performed so well in its seasonal period from the end of February to the beginning of May and then continued to perform well past its seasonal period, the sector was stretched at the start of its secondary seasonal period at the end of the July.

At the end of July, HAC had foregone the minor seasonal period for the energy sector that lasts from July 27th to October 3rd. This does not mean that HAC will not participate in the trade, but HAC will ideally look for the sector to turn around before stepping into a position.

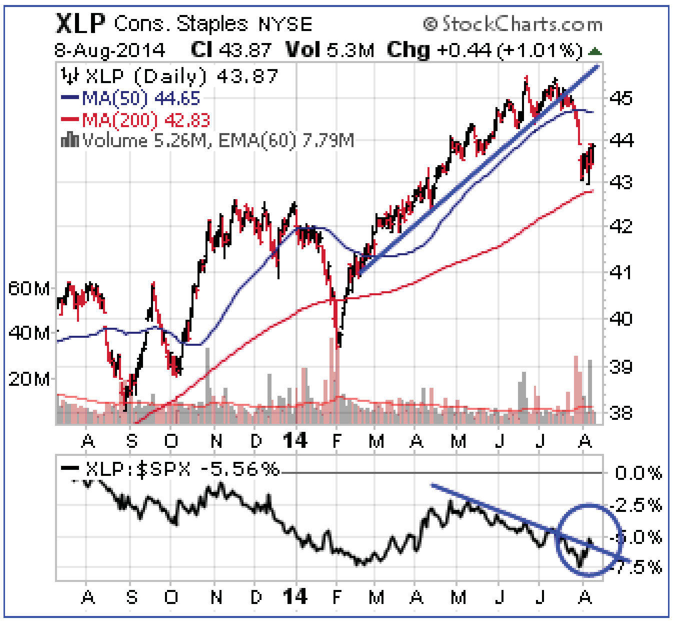


Initially, the geopolitical tensions caused an extra premium in the barrel of oil, but this effect has slowly been fading. Investors seem to have become desensitized to the geopolitical events and as a result, the sector has pulled back. Obviously, if the geopolitical tensions ramp up significantly, this would help to push the energy sector up once again. Also, if the worldwide economy were to show significant growth this would also translate into higher oil prices.

Consumer Staples– Weaker than the Market, But Good Times Ahead

The consumer staples sector tends to outperform the consumer discretionary sector starting in late April and into late October. Within this period, the consumer staples has in interim period where it does not perform strongly- mainly June and into July. Given the weak technical picture of the sector in early June, HAC cut its exposure to the sector in half. Reducing the weight of the sector has proved to be fortuitous as the sector has underperformed the S&P 500.

As the market has corrected recently, the consumer staples sector has started to outperform the S&P 500. If the market continues to perform poorly, look for the consumer staples sector to outperform. Even if the market continues to rise, the sector has corrected enough to represent good value in its seasonal period. The risk to this sector is if the emerging markets start to suffer again, as the consumer staples sector has a large exposure to emerging markets.



Government Bonds– Seasonal Sweet Spot Just Started

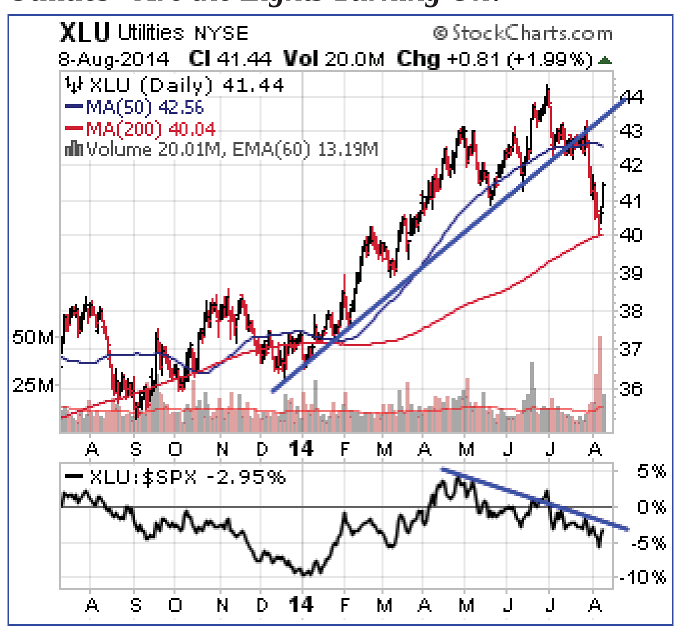
Last month, I used the sub-title that the seasonal sweet spot for the government bond sector was just ahead. At the time, government bonds were performing positively. The good news is that the sweet spot for both U.S. and Canadian government bonds has just started at the end of July. Despite the increased discussion in the media about rising interest rates in the future, from a seasonal stand point, this is the best time to own bonds (up until October 3rd). If the economy weakens, look for less talk from the Fed about raising interest rates in the future, which would help government bonds.

There is a danger that if the economy does improve above expectations that the chatter will increase on rising interest rates to the point that it will have an impact on the bond market. So far the bond market is holding up well, even with investors bantering around the possibility that the Fed will raise rates shortly around the corner. The strength of the bond market should be respected and investors should go with the seasonal trend.

Using the iShares 7-10 Year Treasury Bond ETF (IEF) for U.S. government bonds, government bonds are in an upward trend over last few months (Canadian government bonds have also performed well). IEF has just broken through resistance and is poised to reach $106.

At the end of July, HAC had a position in a bond ETF.

Utilities - Are the Lights Turning On?



The utility sector has corrected since its peak in June and suffered a sharp decline in July as the broad market was trying to move higher. The sector has broken its uptrend, but has more recently bounced of its 200 day moving average.

Earlier this year the sector had become overbought outside of its seasonal period. It put in a strong positive performance as investors were becoming defensive and fixed income was appreciating in price. Quite simply, the sector had become stretched to the upside and corrected as investors moved back to a risk on mode. The sector has just started its seasonal period and looks to bounce over the next two months as the markets struggle forward.

HAC entered into a small position in XLU towards the end of July.

Fertilizer Sector– Not Growing So Far

The fertilizer sector starts its seasonal period in late June, but the sweet spot of the trade occurs in September. Towards the end of June the sector looked poised to perform well. The sector was unable to break above its resistance level and has turned down. At this time it is best to wait for the sector to show sustained performance before entering into a position.

HAC, at the end of July did not hold any fertilizer stocks or ETFs.

The Short Side of the Market

Transportation– Short Opportunity

The transportation sector is often used to measure the health of the economy and stock market. The basic rational is that if the economy is performing well, industry should be busy, shipping materials and products and therefore the transportation sector should be performing well. In 2013, the transportation sector outperformed the S&P 500 for most of the year. In 2014, the sector has outperformed the S&P 500 once again, but has recently started to turn down. The seasonally weak period for the sector is from August 1st to October 9th. In this time period, from 1990 to 2013 the sector has produced an average loss of 4.5% and was only positive 35% of the time.

Industrials– Still More Room to go Short

The industrial sector has a very similar rhythm to the overall market: when the market is rising, it tends to outperform and when the market is declining, it tends to underperform. Of course there are exceptions and an exception occurred in June when the S&P 500 was rising and the industrial sector was moving lower.

XLI is currently at its 50 day moving average and it has broken its uptrend and is underperforming the S&P 500. Although this sector will do well on positive days, look for this sector to underperform in the summer months.

Consumer Discretionary– Short Opportunity for August and September, But be Careful

After a strong run in 2013, the consumer discretionary sector underperformed the S&P 500 at the beginning of this year. A lot of the underperformance was the result of poor retail sales because of the bad weather around the Christmas holidays and the start of the New Year. In May the sector broke its downtrend of underperforming the market. At the beginning of July the sector had trouble breaking resistance and has turned down below its 50 day moving average. Investors have to be careful because XLY could get support at its 200 day moving average and challenge its resistance level at $67.50. If it is successfully able to do this, the sector could have some upside.

Last Minute Thoughts

Investors expect the market to move up over time. They are correct in their expectations as historically, the markets have risen over time. There are certain sets of conditions that are more conducive to market increases and others that lay the ground work for poor market returns. I have seen different metrics used to determine if it is best to avoid the market or to stay invested. At one time a lot of investors used to work with a system that would decrease their equities if the market had a P/E ratio above 20. With markets rising above this level in the 1990's and moving higher, investors looked for other metrics for timing. Today, I see a lot of investors focusing on sentiment indicators. My investment discipline is focused on seasonal analysis, which has worked over the long-term and across different market and economic conditions. Like any other investment discipline, it is not perfect, but it has provided solid returns on a risk adjusted basis over time.

Over the long-term, August and September have not been favorable months for the stock market. There are exceptions. Typically, when the market performs strongly at this time, it is because of a bounce after a major market correction, an economy that is unexpectedly expanding rapidly or the Federal Reserve increasing liquidity into the markets. Currently we have none of these conditions. Yes, the market still might move upward, but history does not favor this scenario. Seasonal investors should remain cautious for the next two months.

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