Thackray Newsletter

— Know Your Buy & Sells a Month in Advance —

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Written by Brooke Thackray

Market Update

Powell says Federal Reserve is going to act appropriately, but are investors going to act appropriately? Hint: the risk is to the downside.

On Tuesday June 4th, Powell, at a Federal Reserve conference in Chicago, said that the Federal Reserve would "act as appropriate to sustain the [economic] expansion." Investors cheered, and drove the stock market higher on the belief that the Federal Reserve would start cutting its federal funds rate as early as June and possibly cut three times before the end of the year (CME Fedwatch Tool, https://www.cmegroup.com/trading/interest-rates/countdown-to-fomc.html).

The potential expected cuts are against a backdrop of a low employment rate 3.6% and GDP growth of 3.1% on an annualized basis. It is an unusual time for the Federal Reserve to be contemplating a rate cut(s). Historically, the Federal Reserve has waited until the economy has demonstrated that it is stumbling before cutting interest rates. Some investors are calling the potential cut(s) an "insurance cut(s)," just in case the economy stumbles.

S&P 500 - Technical Status

The S&P 500 eroded fairly consistently in May, and has rallied sharply at the beginning of June. It bounced from just below its 200 day moving average and is now is on the doorstep of its all-time high. Some investors are calling for a triple top, others are counting on the Federal Reserve to push the stock market past its previous all-time high. The recent rally in June has been on weak volume, indicating a lack of conviction, making it susceptible to a reversal. Seasonally, the stock market is in its six month unfavorable period which does not bode well for a sustained rally. The exception to this could be the stock market's historical tendency of rallying in the last few days of June into mid-July, ahead of Q2 earnings season.

Horizons Seasonal Rotation ETF (HAC : TSX)
Portfolio Exposure as of **May 31st,** 2019

Symbol	Holdings	% of NAV
	Canadian Dollar Exposed Assets	
	Equities	
HCRE	Horizons Equal Weight Canada REIT Index ETF	7.9%
	Bond	
HFR	Horizons Active Floating Rate Bond ETF	19.0%
HBB	Horizons CDN Select Universe Bond ETF	9.7%
	United States Dollar Exposed Assets	
	Short Term & Bond	
HTB	Horizons US 7-10 Year Treasury Bond ETF	25.5%
DLR	Horizons US Dollar Currency ETF	25.2%
HUF.U	Horizons Active US Floating Rate Bond (USD) ETF	1.1%
	Equities	
XLP	Consumer Staples Select Sector SPDR Fund	9.3%
	US Dollar Forwards (April 2019) - Currency Hedge **	-0.1%
	Cash, Cash Equivalents, Margin & Other	2.3%
	Total (NAV $269,402,437)	100.0%

** Reflects gain / loss on currency hedge (Notional exposure equals 63.2% 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.

To be sure, global growth continues to decline and there is potential for economic damage to occur from the ongoing trade wars. Nevertheless, the Federal Reserve's potential "preventative" actions may box themselves into a corner. Late last year, the Federal Reserve abruptly changed direction from hawkish to dovish. The abrupt change cost the Federal Reserve some credibility. Cutting rates too fast, when it is not warranted, could once again cost the Federal Reserve additional credibility.

Under previous chairpersons, the Federal Reserve shifted policy slowly with an explanation. In the third quarter of 2018, Powell took an extremely hawkish monetary policy stance. It was not that Powell was just a "hawk," he was an extreme hawk, making statements that had investors expecting a series of interest rate increases without concern for stock market levels. In late 2018, Powell reversed his stance and metamorphosed into a dove. He put the Federal Reserve on "pause," as he decreased the perceived need for further interest rate increases. Investors forgave Powell's previous "ill-beholden" hawkish stance and cheered the stock market higher.

If the Federal Reserve cuts too much, too fast, it runs the risk of over correcting. There is a lag between policy and effect, typically estimated to be one year or more. In other words the tightening policy from last year and the year before, is currently being felt. Any up coming rate cuts by the Federal Reserve will take time to have an effect. If the economy does manage to recover somewhat, the Federal Reserve's policy action could stimulate the economy at the wrong time.

For stock market investors, probably the biggest risk at the current time is that the Federal Reserve is not as dovish as perceived. Investors now believe that Powell is in their corner and will protect them from any downside risks and will go as far as initiating pre-emptive dovish policy to extinguish potential economic risks that might impact the stock market.

Currently, bad news is good news, which is often considered a bullish indicator. Last week's Nonfarm payrolls of 75k was dramatically less than the expected 185k. A weak Nonfarm payrolls number is a sign that the economy is slowing down, which ultimately means less earnings for companies, which indirectly affects stock prices negatively. Nevertheless, investors cheered the weak Nonfarm payrolls report and drove the stock market higher because it meant that the Federal Reserve had a increased likelihood of cutting rates.

The danger is that if Powell wants to control the euphoric feelings that investors are experiencing from the potential of interest rate cuts, and starts uttering phrases such as data dependent and patience, the stock market could react sharply to the downside. If there is one time for the Federal Reserve to help set the expectations for their actions, it is at the conclusion of their next meeting on Wednesday June 19th. We could find out shortly.

There is also a risk that Federal Reserve interest rate cuts could be ineffective in warding off the impacts of a slowing economy. Investors associate an interest rate cut with increased liquidity and soaring stock markets, but what if the Federal Reserve cuts rates and the economy continues to slow down and earnings contract. This is possible and has happened many times in the past as the economy slips into a recession.

Although the Federal Reserve has nuanced the current situation with a new phrase "act as appropriate to sustain [economic] expansion," investors would be wise to act appropriately by not blindly believing that the Federal Reserve will continue to save the day forever into the future.

In the current scenario of potential Federal Reserve interest rate cuts, the risk is to the downside. If the Federal Reserve fails to live up to its dovish expectations, the stock market could correct. If the Federal Reserve is as dovish as expected, the stock market could still correct as the Federal Reserve's previous hawkish policy could continue its restrictive impact on the stock market. In addition, maybe the US economy is slowing down and any amount of interest rate cuts may be too little, too late. Sure, it is possible that dovish Federal Reserve actions are just what is required to keep the stock market moving higher, but the risks to the downside are currently under appreciated by investors.

Seasonal bounce at the end of June into mid-July?

So far, the stock market is negative in its "Sell in May" period. A very recent rally in June has helped investors to somewhat recover from the May downwards grind, but still the stock market is negative.

In the six-month unfavorable period from May 6th to October 27th, the stock market tends to be weaker than the other six-months of the year and not produce large gains. The stock market has never ticked down day after day in the unfavorable period, nor will it ever do so. There are always rallies along the way. In fact, most of the time in the six-month unfavorable period, the stock market tends to rise. It is the large drops that often occur in this period that tend to cause the damage.

The stock market tends to have seasonal period of strength for a few weeks within the six-month unfavorable period for stocks. The S&P 500 has on average rallied from the last two market days in June until five market days after Independence Day (*Thackray's 2019 Investor's Guide*). The stock market tends to rally at this time, as investors anticipate the positive impact from Q2 earnings releases that typically start in mid-July. Of course there is no guarantee that the market will rally in this time period this year.

What the HAC is going on?

At the end of April, HAC was close to fully invested in equities. In early May, HAC reduced its equity holdings substantially and equity holdings quickly became less than 25% of the portfolio. A large portion of this cash was used to invest in both US government bonds and Canadian bonds. High quality bonds in both the US and Canada have a strong seasonal period from early May until early October. Bonds in both the US and Canada rose in value during the months of May.

In April, HAC took on a position in the consumer staples sector, as it tends to perform well relative to the overall stock market at this time of the year, into October.

Seasonal Opportunities

Consumer Staples – Outperforming

The consumer staples sector is often thought to be an uninteresting sector of the market. This is typically not a sector that the momentum traders "play" in. Over the last few years, investors have focused on growth sectors, particularly in the technology area. Nevertheless, the consumer staples sector does have a role in investment portfolios, particularly at this time of the year. If the stock market gets clobbered, it would be expected that the consumer staples sector would also fall, but not as much as the overall stock market. On the other hand, if the stock market meanders sideways over the next few months, the consumer staples sector will probably outperform.

My Call: The consumer staples sector will probably moderately outperform the S&P 500 over the next few months.

Gold – Shining brightly, but may pause

The seasonal period for gold starts on July 12th and ends in October 9th. In my May newsletter, I stated that it was probably to early for gold as June can be a volatile month. Of course, gold can rally at any time and that is exactly what has happened since late May.

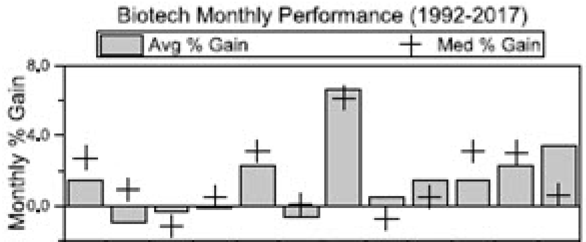
As interest rates have been falling, gold has increased in value as the relative cost of owning gold has decreased. The fact that gold has rallied just before its seasonal period, does not mean that it will not rally in its seasonal period. Currently, it has become overbought on a momentum basis, with the RSI having a reading over 70. Given that gold sits just under its resistance level of $1350, it is possible to see gold consolidate at the current level without further positive catalytic actions.

My Call: Gold will probably pause at the current level. If interest rates move lower, gold could continue its move higher. The seasonal period for gold starts shortly and gold could be volatile coming into its seasonal period. Nevertheless, gold will probably break above the current resistance level of $1350 and move significantly higher at some point before the end of its seasonal period in early October.

Biotech – Sector on doorstep of seasonal period

...One of my favorite seasonal trades

Biotech seasonal period: June 23rd to September 13th.



	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec
Avg. % Gain	1.5	-1.0	-0.3	-0.1	2.3	-0.6	6.7	0.4	1.4	1.4	2.3	3.4
Med. % Gain	2.7	0.9	-1.2	0.5	3.1	0.0	6.2	-0.7	0.5	3.1	3.0	0.6
Fq %>0	62	54	46	54	69	50	81	46	54	54	58	58
Fq %>S&P 500	54	50	35	38	69	50	85	58	62	46	46	46

The biotech sector seasonal trade is one of my favorite trades. It has worked with persistence since 1992 and has strongly outperformed the S&P 500. As biotech conferences start to roll out at this time of the year, investors are attracted to the sector. On a monthly basis, July has by far been the best month of the year for the biotech sector. Its performance stands above the rest of the months of the year on an average, median, positive frequency and frequency of outperformance relative to the S&P 500. The graph above is from *Thackray's 2019 Investor's Guide, page 70*.

Technically, the sector is setting up well just before the start of its seasonal period. On an absolute basis, it is at the bottom of its trading range. Relative to the S&P 500, it has recently been consolidating which is often a good technical setup just before the start of a seasonal period.

My Call: The biotech sector will probably start to outperform the S&P 500 very shortly and continue to outperform the stock market in the month of July. Its outperformance will probably taper off early, in August.

Health care – Healthy consolidation

After strong outperformance relative to the S&P 500 in the second half of 2018, and then underperformance in 2019 until late April, recently, the health care sector has been showing strength compared to the broad stock market. The health care sector is currently in its strong seasonal period, which lasts until August 2nd before a temporary reprieve.

On May 9th, I was a guest on BNN Bloomberg Market Call. My comments on the health care sector are included in the clip of my top picks here:

My Call: The health care sector will probably continue to outperform into the beginning of August.

Oil (WTIC) – getting pummeled... but could be setting up for next seasonal period

The price of oil is getting "pummeled" as investors fret over the possibility of a recession reducing the demand for oil. Sure, the fundamental case for oil is considered to be strong by some analysts, but a strong fundamental case does not mean that the price of oil will increase. In the past, we have seen oil drop precipitously despite strong fundamentals.

There is good news from a seasonal perspective: Oil tends to increase in value from late July into early October based upon the heating season demand that takes place in autumn. Although this seasonal trend is not nearly as strong as the seasonal trend from late February to early May, it is noteworthy. The late July to early October trade seems to work best if the price of oil has been pummeled leading into the seasonal trade. This is currently the case and oil could set up well for its next seasonal trade.

US Government bonds – What happened to the bond bear?

Recently, US government bonds have rallied sharply as yields have dropped. It was not that long ago 10-year US Treasuries were yielding 3.2% (October) and so many people were screaming that the bond bull market that started in 1981 was over. Recently, 10-year Treasuries have been yielding just over 2.1%. This has been a rapid move and it is possible that treasuries may pause at this point. The sweet spot to the US government bond trade occurs in August and September.... so there may be more good times ahead.

On May 9th, I was a guest on BNN Bloomberg Market Call. My comments on US government bonds are included in the clip of my top picks [here](#):

My Call: US government bonds will probably proceed moderately at this point with stronger returns in August and September.

Utilities – Consolidating

On an absolute level, utilities have been rallying since early in the year. Relative to the S&P 500, the sector has been trading in a consolidation box. Recently, the sector rallied in May as interest rates fell. The sweet spot for the utilities trade occurs in August and September.

My Call: The utilities sector will probably pause at this stage, before resuming its outperformance in August and September.

Canadian REITs – Consolidating

Canadian REITs have a seasonal period that lasts from May 20th to September 20th.

Canadian REITs have been consolidating relative to the S&P/TSX Composite Index since late 2018. Recently, the sector is in the top end of its trading band after outperforming the broad stock market index. If the broad stock market stumbles through an environment of falling interest rates, Canadian REITs would be expected to hold up fairly well. If on the other hand, the stock market corrects sharply, Canadian REITs could correct sharply along with the stock market.

My Call: The Canadian REIT sector will probably continue to outperform the Canadian stock market until late September.

Short Sells

Small Caps – Substantially off September High and Underperforming

The small cap sector is well-off its September high and is underperforming the S&P 500. On a seasonal basis, the small cap sector tends to underperform the large cap sector for most of the month of July. At this time, investors are focused on the strength of the Q2 earnings of large cap companies. As a result, small caps tend to underperform large caps for most of July.

My Call: Small caps will probably moderately underperform large caps for most of July, particularly if the US dollar weakens relative to global currencies.

Currency Corner

CADUSD - Next seasonal period in late August

On a seasonal basis, the US dollar has just finished its period of seasonal strength in late May. It carried its momentum into June, but recently the Canadian dollar has been showing improving relative strength. The next seasonal period of strength for the Canadian dollar is in late August.

My Call: The Canadian dollar will probably moderately underperform relative to the US dollar over the next few months.

Brooke's Rant

Poloz the Unpredictable

In his tenure as the Bank of Canada Governor over the last six years, Poloz has flipped and flopped in his monetary policy approach with decisions that sometimes seem out of synch with what is going on around the world and the Canadian economy. Sometimes, I have perhaps been too hard on him and his lack of clear communications. He has a difficult job, especially since Bank of Canada messages are compared to the "text" of the Federal Reserve in the US.

Previous to the age of the internet and the religious following of communications of the Federal Reserve chairperson, perhaps Poloz's policy announcements would not have come under such scrutiny and all would have been fine.

Overall, Poloz has maintained a dovish stance, probably more than the markets expected. In a recent communication to the public, he maintained that Canada was on a fairly solid economic footing and gave little credence to the world wide economic slowdown taking place. He was more hawkish than expected.

Do not necessarily take Poloz at his word. In 2015, Poloz out of the blue shifted to a very dovish stance in monetary policy. He caught almost everyone off guard. The same phenomenon may take place once again if the Canadian economy shows signs of eroding. He may become dramatically more dovish very quickly.

Although the Bank of Canada maintains an independent stance from the federal government, a federal election is taking place in October and the Bank of Canada will probably be reticent to make abrupt moves just before the election date, given the decision may be seen as political. In other words, if Poloz is going to become dramatically more dovish in the future, it will probably be soon.

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