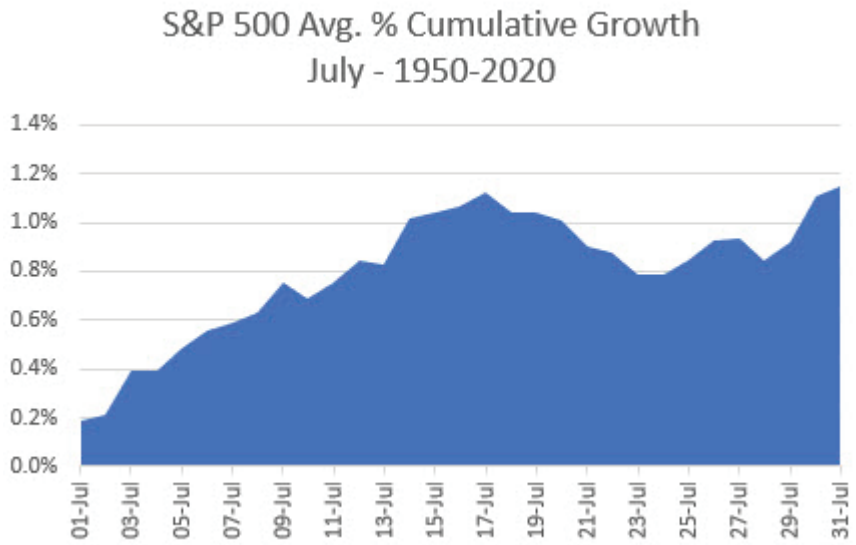
Thackray Report
Summer Rally?

June 28, 2021 Written by Brooke Thackray

If there is a summer rally in the stock market, it tends to happen in the first half of July, heading into Q2 earnings season, but investors should be extremely careful after this period, which is one weakest seasonal periods of the year.

The stock market has a period of seasonal strength from the beginning of July until July 18th. In this period, from 1950 to 2020, the S&P 500 has been positive 68% of the time and has produced an average gain of 1.0%. This trend has been persistent over the long-term and over the medium term. In this period, the S&P 500 has been positive in all of the last nine years. The main reason that the stock market tends to rally at this time is that investors tend to bid up the stock market ahead of the S&P 500 Q2 earnings season getting underway in mid-July. I have outlined this trade in my *Thackray's 2021 Investor's Guide* as the *18 Day Earnings Month Effect*.



The stock market is currently being influenced by economic reports, earnings, government free money programs and central banks keeping the "pedal to the metal" with their monetary policy.

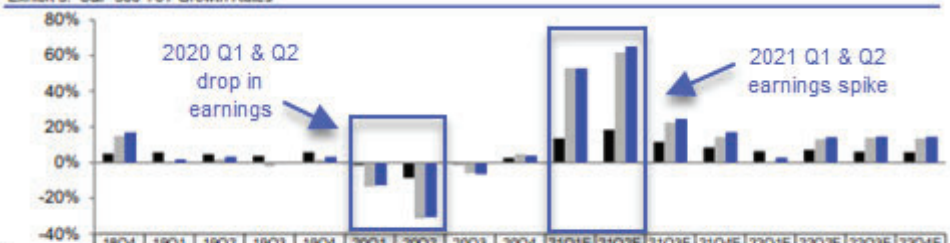
The Federal Reserve policy is a "constant" in the equation at the current time as it is not expected to raise its federal funds rate until at least late 2022 or 2023. Governments keep extending their free money programs. At some point they will have to reduce and remove many of their programs. Nevertheless, they are expected to continue to spend money at a record rate on other projects.

The economy has grown faster than expected. In the U.S. there are many states that are essentially wide open with no or very few COVID-19 restrictions. Some states and Canada have lagged with severe lock-down policies, but these places are starting to remove their COVID-19 restrictions. Overall, there is progress in getting back to something that looks like normal; however, economic reports are increasingly reporting negative surprises.

According to Citi's proprietary index of economic surprises, which measures an aggregate of economic results that are better or worse than expected, there was an initial drop in February and March 2020 and then a huge spike into autumn 2020 and then a contraction to just above zero as of late June. A drop below zero would indicate that negative surprises are outweighing positive surprises. This has not happened yet, but if it does, it could be a harbinger of the stock market reacting negatively to economic reports.

S&P 500 earnings have been better than expected as companies have benefitted from the economy re-opening. Generally, earnings have been better than expected. So far in Q1, with almost all of the S&P 500 companies reporting, 87% of the companies have reported better than expected earnings (Refinitiv, June 25, 2021). The Q2 earnings are expected to be "peak growth" on a year-over-year basis. As shown in the graph and table below, earnings are expected to grow 65% in comparison to Q2 of 2020.

Exhibit 5. S&P 500 YoY Growth Rates



	18Q4	19Q1	19Q2	19Q3	19Q4	20Q1	20Q2	20Q3	20Q4	21Q1E	21Q2E	21Q3E	21Q4E	22Q1E	22Q2E	22Q3E	22Q4E
Revenue	5.1%	5.7%	4.7%	3.9%	5.8%	-1.4%	-8.7%	-0.9%	2.7%	13.5%	18.4%	11.7%	8.5%	6.4%	7.2%	6.2%	5.8%
Net Income	15.0%	-0.8%	2.0%	-2.3%	1.6%	-13.6%	-31.4%	-6.0%	4.8%	53.1%	61.9%	22.6%	14.4%	0.3%	13.0%	13.9%	13.6%
Earnings	16.9%	1.6%	3.2%	-0.3%	3.1%	-12.8%	-30.6%	-6.5%	3.8%	52.8%	65.1%	24.4%	17.0%	2.6%	14.1%	14.4%	14.3%

The high growth rates of Q1 and Q2 are somewhat of an inverse of the poor results in Q1 and Q2 in 2020. It is interesting to see outsized strong growth rates for 2022. The rates are more than a simple bounce back from the COVID-19 pandemic. They are probably too optimistic and could indicate a possible environment for a weaker stock market down the road. Another topic for another day.

In the short-term, investors are very bullish on the Q2 earnings season. This year, the start of the Q2 earnings season could get an additional boost from the US banks which are generally the first large companies to report earnings as the season gets underway. In the fourth week of June, the Federal Reserve announced that all of the US financial institutions that it performed a stress test on, passed as expected. What is significant this year is that the US banks have been regulated to put the payment of dividends on hold. It is now expected that some of the US banks will start to announce dividend resumption in Q3. This is positive news and could motivate investors to bid up the markets coming into their earnings reports and help boost the overall markets.

A primer on seasonality

A lot of investors believe that the best time to invest is a sector is after the positive news is released. Seasonal investing does not work in this manner. Typically, the best time to invest in a sector of the market or the market occurs in the lead up to the positive news. It is based on the premise that it is best to "get in before everyone else" and "get out before everyone else." In other words, seasonal investing is based on taking advantage of investor behavior. Sure, the sector of the market or the market can keep rising on an "excellent" event, but the real juice for the market is typically before the event takes place.

For earnings months (January, April, July and October) the main rally in the stock market takes place on average until the eighteenth day of the month, as the earnings season gets started. Even if reported earnings are decent after the eighteenth of the month, the stock market tends not to respond substantially to the upside. Seasonal investing somewhat mirrors the adage, buy the rumor and sell the news. It is often wise to exit on the doorstep of the news being announced, or as the news is announced.

Positive seasonal trend into earnings

Currently, we are just about to start, a period in the summer months when the stock market typically performs well. If there is a summer rally, this is when it is most likely to occur. Despite being in the six-month unfavorable period for stocks that lasts from early May to late October, the stock market still tends to perform well in the first half of July. There are a number of positive drivers that could drive the stock market higher in the first half of July, including positive expectations for earnings. From a seasonal perspective, historically it has been best to be in the market towards the end of June and to exit around the eighteenth day of July, or before if the market starts to have its momentum erode.

Negative influences to follow potential summer rally- Danger Zone starting July 19

The period after Q2 positive earnings season starts (after July 18) could be a very difficult time for the stock market. Once the Q2 earnings season gets underway, investors will start to look ahead to Q3. In Q3, on a year-over-year basis, earnings growth is expected to decrease substantially. Although it is expected, a miss to the downside of lower expected growth could push the stock market sharply lower. This is particularly true as the earnings are very optimistic.

In addition, the Producer Price Index (PPI) is rising at a much faster rate than the Consumer Price Index (CPI). This typically means that companies are having difficulty passing on cost increases, which means translates into lower profit margins. This will potentially start to show up in Q3 earnings. This is a large risk to the stock market in the future and I will address it in more detail in future writings.

There is another large risk to the stock market that has not been talked about or priced into the market: the US debt ceiling which takes effect at the end of July. Over the last number of years, this has been a non-event for the stock market. The reality of the situation was that it was hard for the US to cut spending with so much of it being non-discretionary. This year the situation is very different, with so many free money programs and such a high percentage of the current deficit being discretionary, there is a lot to fight about and an acrimonious debate between the Republicans and Democrats could spill over into the market with negative investor sentiment.

On a seasonal basis, investors need to be particularly careful from the second half of July onward. Sure, the banks could come out with stronger than expected earnings and positive

announcements about initiating their dividends in the near future, but this sugar high could wear of quickly as excitement about earnings fades and other factors have a greater influence in driving the stock markets. This is particularly true as on a seasonal basis. The worst two contiguous months of the year for the stock market, on average, August and September, are on the near-term horizon after a potential summer rally. Any summer rally that could take place in the first half of July could be fleeting (transitory).