



Have Canadian Cannabis Stocks Reached Their Peak?

Description

Shares of **Aurora Cannabis Inc.** ([TSX:ACB](#)), **Canopy Growth Corp.** ([TSX:WEED](#)), **MedReleaf Corp.** ([TSX:LEAF](#)), and **Aphria Inc.** ([TSX:APH](#)) have punished speculators who jumped in at the wrong time. And unfortunately, I think this pain is going to become even more severe in the year ahead, as we inch closer to legalization day because of a less-favourable environment that has been severely downplayed by many analysts. Moreover, the pundits who are, in fact, bearish on the industry have oftentimes simply dismissed cannabis stocks, referring them as a bubble and not really shedding too much light on the potential triggers that could cause the bubble to pop.

Furthermore, I believe many [disappointing scenarios](#) could end up playing out in the legalization era, as investors are way too optimistic at this point. I've been quite accurate about calling where cannabis stocks were headed over the short term in the past, including calling [2017's cannabis correction](#), [the bottom to that correction](#), and the [most recent 2018 pullback](#). I'm now calling for extreme investor caution after legalization day, since the stakes have been raised such that the risk/reward trade-off no longer makes sense, even for a short-term thinker.

Not only are cannabis stocks severely overvalued after last year's parabolic surge, but there are two other major headwinds that could send could cause cannabis shares to implode to levels where a return to peak would be out of the question (think a +80% decline).

First, the black market may be a lot more insidious than analysts believe it'll be. When it comes to black market, most people think of a shady drug dealer who has laced their product with goodness knows what. However, a different type of black market, I believe, will serve as a massive headwind that could derail pot stocks at these levels.

Various provinces are allowing people to grow their own cannabis plants at home. PEI, for example, is slated to allow residents to grow up to four pot plants. The yield from these plants is more than enough for an average household. As such, I believe many recreational and medical cannabis users would rather grow their own or buy from a friend or colleague who happens to be growing, especially since the prices will be substantially lower than the \$8-10 per gram that's projected to be sold legally. This type of black market would consist of average citizens and potentially "illegal" dispensaries growing

and distributing cannabis products for prospective buyers.

Second, government regulations that aim to keep cannabis out of the hands of minors will, ironically, end up exacerbating the proliferation of the black market. The lack of branding for legally produced cannabis will hold back firms like Canopy, which could have garnered pricing power in the legal weed space with Tweed- and Snoop Dogg-branded cannabis products (smokables, edibles, topicals, etc.)

The stage is set where cannabis will be nothing more than a commodity and a tonne of up-and-coming producers will, in time, flood the market with cannabis in the years following legalization. And given the black market could theoretically meet the much-anticipated post-legalization supply shortage, I think cannabis stocks are akin to TSXV-traded venture mining firms and are thus uninvestable for long-term thinkers.

Bottom line

Positive (or negative) developments drove stock prices last year, but this year, all eyes will be on the legalization day (slated for summer 2018) and the first round of post-earnings quarterly results, which will likely serve as judgement day. I think these results won't be as astronomical as many believe they'll be.

As such, a very sharp decline could be in the cards. I would not touch any cannabis stocks at these levels unless you're comfortable with losing 100% of your investment. In addition, should a rally occur before legalization day, I'd treat it as an opportunity to do some trimming such that you're playing with the house's money.

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