



The Real Reason Why I Won't Touch Cannabis Stocks With a Barge Pole

Description

Speculation has taken complete control of the marijuana market, and as gamblers continue to bet on who's next to partner up with a well-established behemoth, the incredible amount of euphoria could turn to fear and disgust in a matter of minutes, as we saw with **Tilray** and its boom-and-bust moves made in a single trading session.

As we head into an environment where recreational weed is legal at the federal level, many pot investors are expecting more than perfection when it comes to the first round of post-legalization quarterly results. They're expecting a blowout surprise, and anything short of this will result in disappointment that'll rattle the entire industry.

Expectations are unfathomably unrealistic

The bar keeps getting raised, and although many pundits agree that there's going to be a huge supply shortage in the months following legalization day, I believe investors are overestimating the length of this supply shortage window. After this window closes, the marijuana market may not reach a slow and steady equilibrium, as some analysts think will happen. I believe the market could see a profound oversupply of cannabis that could result in a glut and a cutback to production, similar to what we've witnessed with oil sands operators over the past few years.

Regulators have set the stage where marijuana will be nothing more than a commodity. And with no way for producers to differentiate themselves, marijuana will be a commodity that'll fall in price from the get-go.

Now, if regulators allowed for product differentiation, it'd be a completely different story, and **Canopy Growth** ([TSX:WEED](#))(NYSE:CGC) would likely become a standout player in its industry. But regulations aren't going to be lax. Regulators could put forth stringent measures together with strict enforcement proceedings with severe penalties for firms that play outside the rules.

Don't rule out a violent post-legalization correction for 2019

Cannabis is a cash crop. Everybody's jumping on the opportunity to get rich off the green rush. As this

happens, the opportunity will eventually cease to exist — perhaps a lot sooner than many of us anticipate, as opportunistic arbitrageurs keep piling into the space until the possibility of economic profit dries up.

Consider how many up-and-coming pot producers are popping up on Canada's venture exchanges. There are plenty more private firms that are going to go live, and, as you'd imagine, they're all going to be turning on the taps on production, or, in the case of cannabis, they're going to be growing like there's no tomorrow to fulfill a supply shortage window that may be closed in a matter of weeks, not months.

As all cannabis producers operate at full capacity, the marijuana market equilibrium will likely be reached, only to be passed as supply heavily outweighs demand. How many non-cannabis smokers do you know are waiting for legalization before they before chronic users?

Thus, many cannabis firms are going to continue to grow at full capacity well after a market equilibrium is reached. That's going to cause the price per gram of cannabis to plummet more violently than many analysts are expecting. Some pundits believe that the price per gram will subtly drop year by year.

Given the sheer number of new cannabis producers combined with [household growth](#) (and grey market distribution) of cannabis, we could realistically witness cannabis glut at a time when many investors thought there wouldn't be nearly enough cannabis on the market.

If cannabis is kept as a mere commodity, we'll eventually reach a point where it'll be as profitable to grow cannabis as it would any other crop. And unless all of today's Canadian cannabis producers put the brakes on or go out of business, we could see the price per gram of marijuana fall below \$5 by 2020.

Foolish takeaway

The economics of the marijuana market scares me. Investors who are paying up +200 times sales for some of the marijuana producers are going to be in for a very rude awakening when the cannabis correction finally hits. If product differentiation were possible, things would be different, but in the meantime, I'd exhibit caution before [judgement day](#), unless you're fine with high-stakes gambling.

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Author

joefrenette

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