Is an Even Bigger Marijuana Stock Crash Coming?

Description

2018 was supposed to be the year of cannabis stocks. And in some ways it has been: the late summer cannabis rally was probably the biggest one to occur on the TSX this year, and while it has long since deflated, many pot stocks remain up year-to-date. But for investors who bought in August or later, marijuana stocks have been a losing proposition.

At the time of this writing, market leaders like **Canopy Growth Corp** (TSX:WEED)(NYSE:CGC) and **Tilray Inc** (NASDAQ:TLRY) were down as much as 48% from their 12-month highs. And some, like **Aurora Cannabis Inc**, are even down year-to-date.

I wouldn't be the first to say that cannabis stocks have been doing poorly lately. But what might surprise you is the possibility that the worst is yet to come. At least some notable investors are still betting against cannabis giants, and they may have good reason for doing so. To understand what those reasons are, we need to look at why this year's cannabis rally occurred.

A hype-driven rally

The cannabis rally that occurred earlier this year was above all a matter of hype. It was preceded by **Constellation Brands Inc's** $5 billion Canopy Growth Corp deal, which had the peculiar effect of lifting many other TSX pot stocks up with it. Prior to this, everybody had known legalization was coming, but marijuana stock prices didn't follow suit until the deal in question was made. So it was most likely the hype surrounding this deal that caused the rally. Why would investors buy into that hype? It helps to consider who specifically invested in cannabis stocks around this time.

From crypto to cannabis

It's well known that cannabis shareholders skew younger than the average. It can be inferred by the fact that the Robin Hood trading app–which has a mostly millennial userbase–has disproportionate numbers of cannabis shareholders. The same younger demographic that invested in cannabis stocks this year disproportionately invested in cryptocurrency last year.

It's therefore very likely that this year's cannabis mania was driven by millennial traders jumping from one trend to the next. Once these bandwagon riders get tired of cannabis stocks, we'll be left with more traditional investors who'll expect their shares to start producing income. And here's where we run into trouble.

Growing losses

The biggest structural problem facing cannabis stocks is the fact most are growing expenses faster than earnings. Sure, many of them have high revenue growth. But in most cases, expenses are growing even faster–Canopy's recent earnings report being a perfect case in point.

For whatever reason, cannabis companies are spending a huge amount of money for every bit of revenue growth they eke out, which means that these stocks are bleeding cash–something that investors will eventually tire of. When you add dilution of equity into the equation, it gets even worse.

Bottom line

The simple fact about cannabis stocks is this:

Their days of being buoyed by media buzz and legalization hype are over. After disappointing post-legalization returns, these stocks have probably already lost the get-rich-quick set. Eventually, they'll be left with shareholders who expect to see earnings. And after enough quarters of growing losses, we may see those shareholders abandon cannabis stocks as well, possibly leading to another crash.

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