PRATO CAPITAL

The January Effect
And Other Seasonal Indicators

January 2022

It's a new year and there are headlines about the January Effect and the January Barometer. Are there any real benefits for investors with these January indicators or any of the other seasonal indicators?

January

The financial media outlets use terms like the 'January Effect,' and 'January Barometer' with little discussion of what is meant or how accurate either of these indicators may really be.

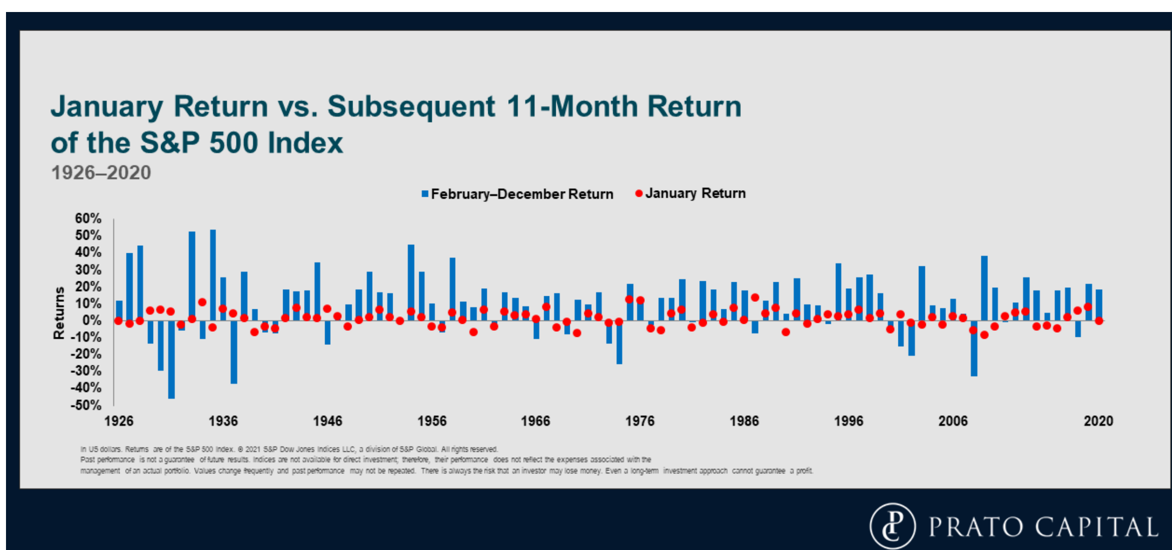
A theory was introduced in the 1940s that returns for the month of January were greater than those of other months and most noticeably greater within small-cap stocks. This is what is now called the "January Effect." When we look at a stock index that includes large and small-cap stocks like the Wilshire 5000, January is not the month with the highest returns. Over the past 50 years, the month of April has returned almost .5% more than January. And both November and December have also seen higher monthly returns than January[1].

The January Barometer refers to a theory that how stocks perform during the first month of a new year is a signal for how the stock market will perform over the next eleven months. In other words, if the return of the S&P 500 in January is negative, this would predict a declining stock market for the remainder of the year, and vice versa if returns in January are positive.

Chart 1 below shows the annual returns of the S&P 500 since 1926, indicated by a blue line, along with the returns during the month of January of those years, indicated by a red dot on those lines. Looking at this chart, it is difficult to see any pattern that shows January being a predictor of future stock market returns. When January had positive returns, the S&P 500 had positive returns for the rest of the year almost 60% of the time. But this isn't an indication about the month of January. The S&P 500 had positive annual returns 71 out of the last 96 years, 75% of the time. And looking over the past 20 years, January has had negative returns 11 times, and only 3 times the rest of the year was negative for the S&P 500.

1 Wilshire Associates, Wilshire 5000 Total Market Index [WILL5000IND], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/WILL5000IND, December 23, 2021.

Chart 1: January vs Subsequent 11 Month Returns of the S&P 500



Other Seasonal Indicators

A line from the novel "Pudd'n Head Wilson" by Mark Twain led to what is known as the "Mark Twain Effect", *"October. This is one of the peculiarly dangerous months to speculate in stocks. The others are July, January, September, April, November, May, March, June, December, August, and February"*. This theorizes that October is a bad month for stock returns (what about the other 11 months mentioned?). The bear markets of 1929, 1987, and 2009 either started or continued into the month of October. But, over the past 50 years the returns of the Wilshire 5000 had an average positive return for the month of October, and in 2021 returns were over 6%.

In our June 2021 newsletter, we discuss another seasonal saying often used in the media – "Sell in May and go away". This saying suggests that stock market returns are negative during the summer months but the saying originated centuries ago in London when bankers went away for the summer and were not able to manage a portfolio from the English countryside. There can be negative outcomes for portfolios if investors make investment changes based on a phrase like "sell in May and go away". This past summer of 2021, an investor would have missed an 8.3% gain in the S&P 500 in just the months of June, July, and August.

The Santa Claus Rally describes the theory that stock markets rise on the trading days after Christmas and into the first few days of January. We discuss this in our December 2018 newsletter. Over the years, the Dow Jones Industrial Average has risen almost 3 out of every 4 years during this period. Although this happens about 75% of the time, it does not happen all the time.

Conclusion

Using a month or a day of the calendar as an investment strategy may sound like a way to get an edge when investing. The reality is much more obvious. Stock prices do not go up or down because of the day or the month. And investors can do real and lasting damage to their portfolio by following these "indicators".

At Prato Capital, we like to use history as a guide when we look to what the future may hold for our clients. Rather than trying to beat the market based on hunches, headlines, or indicators, at Prato Capital Management we remain disciplined and use strategies based on 100 years of market history. History has shown that many of the catchy phrases used concerning the stock market and trying to predict future returns appear to be all for show with little substance to back them up. Long-term investors are best served by ignoring these indicators.

“You can observe a lot by just watching.” – Yogi Berra.