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Monthly Insight

January and the Markets: What's the Correlation?

The ancient Romans had a god for almost everything. They even had a deity who specialized in beginnings and endings — also doorways, time, and transitions. His name was Janus, and not surprisingly, he had two faces: one looking forward and the other looking back. It also makes sense that the first month of our year, January, is named for him, since this is a time that many of us tend to look back over the previous year and also look forward to what the new year might bring.

Given the above and factoring in human nature, no one should be surprised that in the stock markets, January looms large. If you've been involved in investing for any period of time, you've probably heard of the "January effect" and the "January indicator." Conventional wisdom holds that January, as a time of transition between the old and the new, is somehow more significant than other periods in the markets. Some investors, seeking any bit of advantage they can find, place great reliance in this type of thinking. But is there any truth to either idea? Do the "January effect" and the "January indicator" really exist?

The January effect supposes that stock prices tend to rise during January as they rebound from year-end selling due to tax-loss harvesting, window-dressing by mutual fund managers, and other factors. Like many similar theories, it assumes that the markets are inefficient — that such year-end selling is "new information" that causes stock prices to move in response. First noticed by an investment banker in 1942, the supposed "January effect" has become less pronounced in recent years. Many analysts and others believe that the market has largely adjusted for it. In other words, any perceived stock price movement specific to January may have already gotten "baked in" to stock prices, which is what we would expect in an efficient market that, especially in these days of automated trading and almost-instantaneous execution, incorporates the individual purchasing and selling decisions of thousands of investors every hour. In fact, some analysts suggest that any advantage granted by the January effect is so small that transaction costs and other fees would virtually negate it.

The January indicator, sometimes called the "January barometer," stipulates that as January goes, so goes the rest of the year. But as I have noted previously, history does not bear this out as a reliable guide for investing — at least, on the downside. Going back to 1926, the S&P

500 index has been negative in January and then experienced positive returns for the rest of the year about 60% of the time. On average, the index turned in a 7% return in those years where it started in negative territory in January. In 2016, for example, the S&P 500 ended January at -4.96%. For the rest of the year, however, it showed a gain of 18%, yielding a net for the year, after the poor showing in January, of 13%. Anyone who sold their stocks in January, anticipating a down year, would have missed a major upside move.

On the other hand, a strong start in January is a somewhat more reliable indicator of a good year to follow. Nearly 75% of the time since 1946, when the market has gained more than 5% in January, it has finished the year in positive territory. On average during this period, the S&P 500 has gained about 11% for the rest of the year when it has been up in January. As a matter of fact, there have only been two years — 1966 and 2001 — when stocks dropped sharply (declining 10% or more) after a positive showing in January. It's probably worth noting that in both of these years, the markets had just experienced a multiyear upside run.

One possible explanation for the higher correlation between a positive January and positive overall year may be that bullish sentiment develops when the market appears to have upside momentum. When investors feel confident about the direction of the market, it can tend to become a self-fulfilling prophecy. On the flipside, the lower correlation between a negative January and negative year may be partially explained by the clear historical tendency of stock prices to rise. In the 72 years since 1945, stocks have finished the year lower in only 17 instances. So, it may be that a negative January is a less reliable indicator of a negative year simply because historically, stocks tend to go up more often than they go down.

To put all this in context, it's important to remember that no one — and no indicator — can consistently predict stock prices with perfect accuracy. Furthermore, it is impossible to completely eliminate all risk from any portfolio. Especially now, in this season of looking back and looking forward, this means that the most important things you can do for your investments are to reassess your asset mix, make sure you are appropriately diversified, rebalance your portfolio as needed in response to pricing movements, and ensure that your risk tolerance and your long-term strategy are still appropriate for your goals and your place in the investment life cycle.

Rather than peering into some sort of crystal ball or making decisions based on a single indicator, you should concentrate on the factors you can control. Time and again, research has shown that patient investors with well-diversified holdings will tend to do well over time. And that is why I end this newsletter with the same phrase I use in all my communications with my clients. As we work together to make 2020 the greatest year yet, my advice is still the same:

Stay Diversified, Stay *Your* Course!

One Final Note: The SECURE ACT

Late last month, Congress voted to enact the Setting Every Community Up for Retirement Security (SECURE) Act, which was signed into law by President Trump on December 21, along with the rest of the large year-end spending bill. Here's how it will impact thriving retirees. READ MORE

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