

January 15, 2008 – The “January Effect”

The stock market has had a rough start in 2008 with all of the major indices in the red. The S&P 500 index finished down 5.3% for the first five trading days of this year. There is no single best index to track when identifying how the overall market is performing but the S&P 500 is one of the most important since it represents about 2/3 of the valuation of the entire US stock market. In addition, approximately 48% of the S&P 500 company’s earnings come from overseas so it is a diverse index.

Do the first five trading days of the year or the entire month of January act as an “Early Warning” of things to come for the entire year? To help answer this question we look at a study called, The January Barometer, created by Yale Hirsch in 1972. Yale studied how year-end returns in the stock market compared to both the first five trading days of the year and the entire month of January. It turns out, the results are quite predictive. It is felt, the basis for the predictive ability comes from the fact that many important events occur in January: new Congress convenes, annual budgets are presented, the President gives the “State of the Union” address and sets goals for the country.

First Five Trading Days of the Year

Since 1950, there have been 36 up first five trading days followed by full year gains 31 times (86% correlation). There have been 21 times the first five trading days were down followed by full year losses only 10 times (48% correlation) and full year gains 11 times.

Therefore, when the first five trading days are up, there is much better chance the entire year will be up. When the 1st five trading days are down, it is far less accurate at predicting the full year performance. If we combine the statistics, the 1st five trading days predict, with 71% accuracy, if the entire year will be up or down (Greater than +/- 5%. Less than 5% in either direction is considered a flat year). Overall, a good barometer of things to come.

January

Since 1950, the entire month of January has had a 75% accuracy rate in predicting if the full year will finish up or down. This means, if January finished up for the month, the full year also finished up for the year (by greater than +/- 5%) 75% of the time. If January finishes down, the full year is likely to finish down.

Down January’s are especially accurate at predicting trouble ahead in the stock market. Every down January since 1950 was followed by a decline or flat year in the stock market. Except for 1956, all down January’s resulted in a decline in the stock market of, on average, -12.6%. (1956 was affected by President Eisenhower’s heart attack in 1955 that created doubt if he could run for re-election in 1956.)

As of this writing, for the year the S&P 500 is down 5.7% and the technical picture is deteriorating. Only 4 of the last 57 years ended January with a loss of greater than 5.7%. With this in mind, January has been an accurate harbinger of things to come. Bull or bear markets do not conveniently begin and end at the end of years, so most bottoms occur throughout the year. So monitor the price and volume action of the market and watch how the month of January ends. Look for signs of significant turning points before putting valuable capital to work in this higher risk environment.

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