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Markets lose ground in January

Will the year follow suit?

January 29, 2010 – Stock markets ended January with a dull thud, losing considerable ground in the first weeks of the year. For avid devotees of market patterns and cycles, this is not good news, and point to a history of sub-par market performance in the 12 months following a January loss. Other observers argue that a temporary pullback was only to be expected given last year's awe-inspiring gains from bear market lows last March, and that a phase of profit-taking is inevitable before the next leg up. Who's right?

There is some compelling research that suggests weak January performance typically heralds weaker annual performance. The research, conducted by Ned Davis Research, looks at US stock market performance from 1900 through 2009. In years when the Dow Jones Industrial Average has dropped in January, the DJIA rose a median of only 0.28% over the rest of the year. That compares with a median increase of 10.4% when the Dow has closed up for January.

Of course, "median" simply means "mid-point," with half the returns higher and half lower than the median. While not necessarily a predictor, a lower median return overall does seem to indicate an increase probability of suppressed returns following January weakness, even though "suppressed" may mean a 15% annual gain, versus, say, a 25% gain in a year when stocks closed higher in January.

A good example of this can be found in the year just passed. In January 2009, the Dow Jones Industrials lost 8.8% month over month – and then proceeded to sink to a low of 6,440 in March, for a 26% plunge since the end of 2008. Looking back at the grinding pessimism of those days (less than a year ago now!), it seemed that the January weakness pattern was about to take hold with a vengeance. Except it didn't. That March low marked the bottom of the bear, and the Dow surged, to end 2009 with an 18.8% annual gain. Global stock indexes followed suit. So apparently, 2009 fell well into the above-median range for returns in a year displaying marked January weakness.

The point is that it's possible to make statistics jump through hoops. The financial and economics forecasting business is infamous for this kind of stuff (even more so than so-called climate "scientists" are, some of whom apparently have been going a step further and inventing data to support outlandish theories of global warming), so it can be a very

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dangerous thing to predicate investment policy on putative "patterns" in market history – without first double-checking the data and the assumptions.

Now, with January's books closed on less-than-stellar stock market performance, it might help to put things into a bit of context.

January's market pullback can't be blamed on any particular downside earnings surprises either in Canada or the US. Quarterly corporate earnings have actually been meeting or exceeding expectations. The consensus forecast for TSX stocks is a 43% increase in operating earnings for 2010. And the consensus on Wall Street is for about a 30% boost in profits this year for S&P 500 stocks.

Revenues, too, are expected to start pulling their weight on bottom-line performance, even though concern lingers that earnings growth, especially in the US, is still largely being fuelled by sharp cost cutting over the past 18 months. That shouldn't be as much of an issue in Canada, as growing international demand is helping to kick-start top-line revenue growth in Canada's all-important resource sectors.

Similarly, it's not easy to see the economy as a being proximate cause of market weakness. Canada's gross domestic product expanded for the third straight month in November, rising 0.4% month over month, as mining, oil and gas, and wholesale trade contributed to the reading that outpaced most projections. The figure puts Canadian GDP on track to post a robust 4% rate of growth for the fourth quarter overall.

South of the border, the US economy grew 5.7% in the fourth quarter, the fastest rate in six years, according to preliminary numbers released by the US Department of Commerce last week. Granted, some 3.4 percentage points of that growth arose from a slower rate of inventory contraction, as demand revives and factories get assembly lines going again. It's a little bit of numbers game (see comments on statistics and hoops above), because US inventory levels are still contracting – just not as quickly as they did earlier in 2009. But even taking the inventory measure out of the picture, fourth-quarter growth still came in at 2.2%, with consumer spending up 2% and business investment up a net 2.9%. Okay, it's not a lot to crow about, but it's solid, meaningful growth – pretty much as expected following a deep, nasty recession, and not a reason for markets to get nervous.

Interest rates? No real indication of trouble on that front yet, either, as both the Bank of Canada (two weeks ago) and the US Federal Reserve Board (last week) held policy rates steady, at 0.25%, showing no inclination to begin raising rates before the middle of the year (BoC) or for an "extended period" (Fed). The only shadow was cast by the Bank of Canada, which warned that Canadian productivity performance has been relatively disappointing, that government support and stimulus continue to be outsized contributors to economic activity, and that US consumer spending remains fragile.

Fiscal problems currently facing some members of the European Union might well be causing some nervousness in markets. Greek/German government bond spreads continue

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to widen as Greece faces increasing fiscal difficulty and denied it was seeking Chinese funds as a lifeline. Similar troubles are brewing in Spain, Portugal, Ireland and Italy. European markets continued to retreat, while the euro came under increasing pressure as foreign investors turned to the dollar and snapped up US Treasurys.

Fiscal problems besetting the weaker eurozone members are symptomatic of a wider problem, now that the banking crisis has become a government debt problem. Investors are beginning to weigh the extent to which global monetary accommodation and government support and stimulus have been responsible for the outsized stock-market advance from last March's low. The question now becomes whether corporate earnings growth will be sustainable as all that stimulus is removed, excess liquidity dries up, and rates start inching higher.

With those uncertainties at top of mind, it's no wonder that investors looked to lock in some profits. The S&P/TSX Composite Index lost 2.2% week over week, as of Friday's close, and ended the month down 5.5% from December's closing level. The Dow Jones Industrial Average ended the month with a weekly loss of 1.0% and a monthly loss of 3.5%. The broader S&P 500 Composite Index declined 1.6% on the week, and ended January with a 3.8% monthly loss.

Stock markets are said to look six to eight months down the road. If so, January's bout of profit-taking may be signalling a slower pace of economic growth in the second half of the year. But, statistically, that doesn't necessarily mean stock markets will be any lower at the end of the year then where they started.■

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