

Using Seasonal and Cyclical Stock Market Patterns

By Jeffrey A. Hirsch

Article Highlights

- The presidential election cycle, the best six months and January's basket of indicators are the three main calendar patterns.
- Stocks perform best during the final two years of a presidential term, with the highest returns occurring in the fourth year.
- An alternative approach to selling in May is to take a more defensive posture.

“Those who cannot remember the past are condemned to repeat it,” proclaimed philosopher George Santayana. I believe that “those who study market history are bound to profit from it.”

There are three main seasonal and cyclical patterns that have stood the test of time and consistently provide me with an edge in managing my portfolios: the four-year Presidential Election/Stock Market Cycle, the Best Six Months Switching Strategy and January's basket of indicators and trading strategies.

But first, let's get one thing straight. While I am a strong proponent of historical and seasonal market patterns, I am always mindful that history never repeats itself exactly. I have used history as a guide for navigating current market conditions and anticipating trends with quite a degree of success over the years. What we try to get Stock Trader's Almanac traders and investors to do is not necessarily follow historical patterns to a “T,” but to keep them in mind so they know when their radar should perk up.

Politics, Politics, Politics

What happens on Wall Street is inextricably linked to what transpires in Washington. For five decades, the Stock Trader's Almanac has discussed and demonstrated this phenomenon. The Four-Year Presidential Election/Stock Market Cycle is the “Old Faithful” of indicators for us.

Presidential elections every four years have a profound



impact on the economy and the stock market. Wars, recessions and bear markets tend to start or occur in the first half of the term, with prosperous times and bull markets in the latter half. This pattern is most compelling.

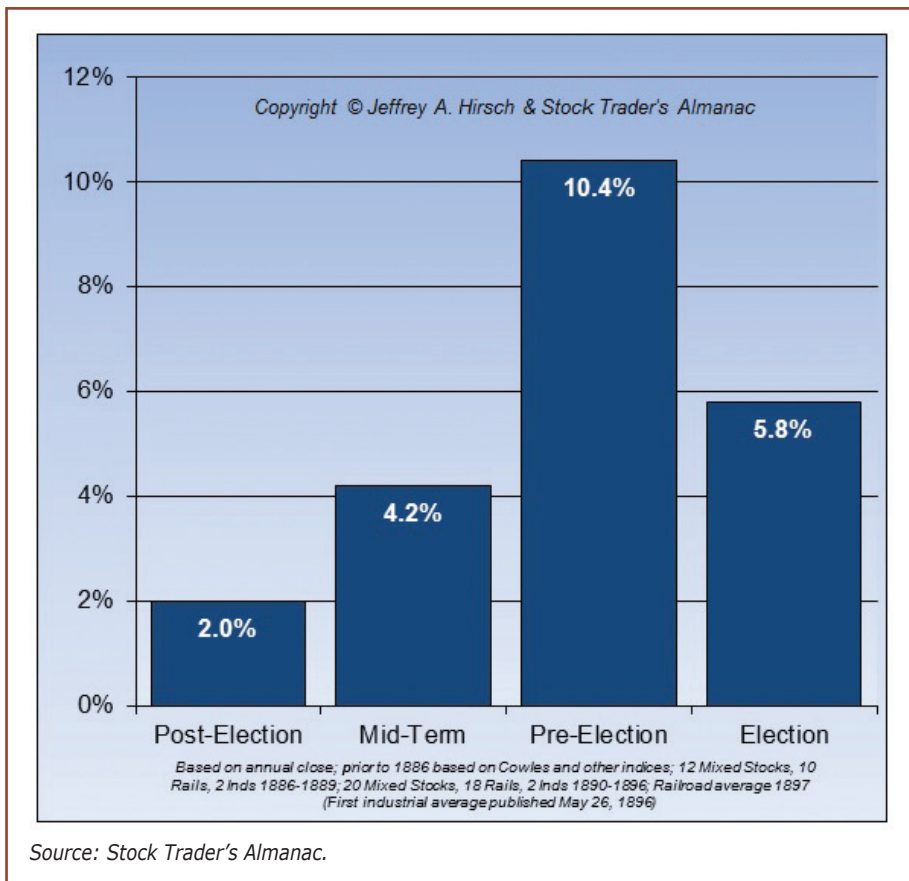
As you can see in Figure 1, the third year in the presidential term has the best performance, as there have been no Dow Jones industrial average losses in pre-election years since war-torn 1939. While pre-election years have generally had greater gains, election-year market performance has weakened, thanks in part recently to the year 2000's bear market and undecided election and the year 2008's financial crisis.

How the Government Manipulates the Economy to Stay in Power

In an effort to gain reelection, presidents tend to take care of most of their more painful initiatives in the first half of their term and “prime the pump” in the second half so the electorate is most prosperous when they enter the voting booths. The “making of presidents” is accompanied by an unobvious manipulation of the economy. Incumbent administrations are duty-bound by their parties to retain the reins of power. Incumbent administrations during election years try to make the economy look good to impress the electorate and tend to put off unpopular decisions until the votes are counted.

After the midterm congressional election and the inevitable seat loss by his party, the president during the next two years jiggles fiscal policies to get federal spending, disposable income and Social Security benefits up and interest rates and

Figure 1. DJIA Average Annual Percentage Gain (1833–2012)



inflation down. By Election Day, he will have danced his way into the wallets and hearts of the electorate and, it is hoped, will have choreographed four more years in the White House for his party.

Post-Presidential Year Syndrome

Subsequently, the “piper must be paid,” producing an American phenomenon that we have coined the Post-Presidential Year Syndrome. Victorious candidates rarely succeed in fulfilling campaign promises of “peace and prosperity.”

Most bear markets began in such years—1929, 1937, 1957, 1969, 1973, 1977 and 1981. Our major wars also began in years following elections—the Civil War (1861), World War I (1917), World War II (1941) and the Vietnam War (1965). Post-election 2001 combined with 2002 for the worst back-to-back years since 1973–74. (These were first and second presidential term years). We also had 9/11, the war on terror and

the build-up to confrontation with Iraq.

Global financial calamity and the Great Recession sent the second-worst bear market for the Dow to its ultimate low in post-election 2009. Less severe bear markets occurred or were in progress in 1913, 1917, 1921, 1941, 1949, 1953, 1957, 1977 and 1981. Only in 1925, 1989, 1993 and 1997 were Americans blessed with peace and prosperity in the post-election year.

Bottom-Picker's Paradise

Practically all bear markets began and ended in the two years after presidential elections. Bottoms often occurred in an air of crisis: the Cuban Missile Crisis in 1962, tight money in 1966, Cambodia in 1970, Watergate and Nixon's resignation in 1974 and threat of international monetary collapse in 1982. But crisis often creates opportunity in the stock market. In the last 13 quadrennial cycles since 1961, nine of the 16 bear markets bottomed in the

midterm year. (A good number of these midterm bottoms occurred during the worst six months.)

A 50% Dow Gain From Midterm Low to Pre-Election High

In the last 13 midterm election years (second year in the presidential term), bear markets began or were in progress nine times; we experienced bull years in 1986, 2006 and 2010 (1994 was flat). But by the third year (the pre-election year), the administrations' focus shift to “priming the pump.” Policies are enacted to improve the economic well-being of the country and its electorate.

From the midterm low to the pre-election year high, the Dow has gained nearly 50% on average since 1914. A swing of such magnitude is equivalent to a move from 10,000 to 15,000. The puniest midterm advance, 14.5% from the 1946 low, was during the industrial contraction after World War II. The next four smallest advances were: 1978 (OPEC–Iran) 21.0%, 1930 (economic collapse) 23.4%, 1966 (Vietnam) 26.7% and 2010 (European debt) 32.3%.

It's also important to note the concentration of midterm lows: six in January and four in October, plus four secondary lows in 1962, 1974, 1978 and 1998. On the flip side, the greatest concentration of pre-election year highs has been in December, with nine occurring in the last month of the year and six on the last trading day of the year.

Best Six Months Strategy

There is no such thing as a perfect trading strategy, but our Best Six Months Switching Strategy has an undeniable track record. The Best Six Months strategy is basically the flip side of the old “sell in May and go away” adage. It comes from an old British saw, “Sell in May and go away, come back on St. Leger Day.” Established in 1776, the St. Leger Stakes is the last flat thoroughbred horserace of the year and the final leg of the English Triple Crown.

While the St. Leger Stakes has little to do with stock market seasonality, it does coincide with the end of the worst

months of the year for stocks. Market seasonality is a reflection of cultural behavior. In the old days, farming was the big driver, making August the best market month—now August is one of the worst.

This matches the summer vacation behavior, where traders and investors prefer the golf course or beach to the trading floor or computer screen. Institutions' efforts to beef up their numbers help drive the market higher in the fourth quarter, as does holiday shopping and an influx of year-end bonus money. Then there's the New Year, which tends to bring a positive new-leaf mentality to forecasts and predictions as well as the anticipation of strong fourth- and first-quarter earnings.

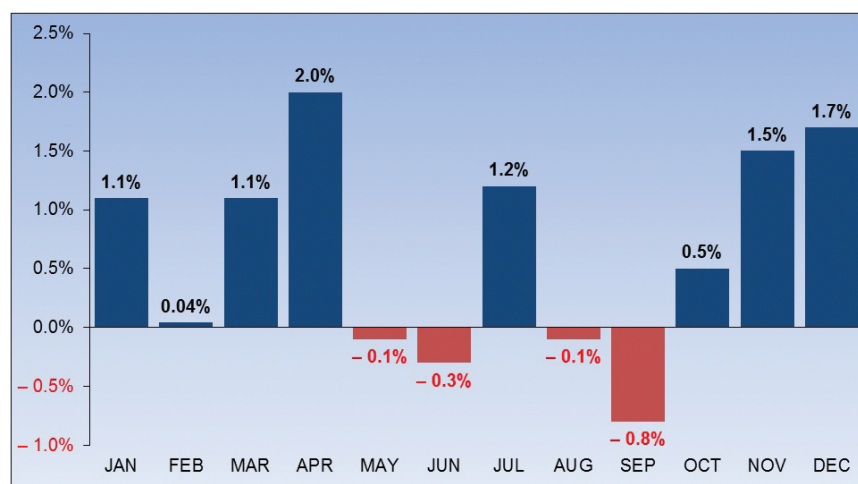
After that, trading volume tends to decline throughout the summer. In September, there's back-to-school, back-to-work and end-of-third-quarter portfolio window dressing that has caused stocks to sell off, making it the worst month of the year on average. Though we may be experiencing some shifts in seasonality, the record still shows the clear existence of seasonal trends in the stock market.

Performance of Best Six Months

Investing in the Dow Jones industrial average (DJIA) between November 1 and April 30 each year and then switching into fixed income for the other six months has produced reliable returns with reduced risk since 1950. Exogenous factors and cultural shifts must be considered, however. Farming made August the best month from 1900–1951. In fact, before 1950 the better strategy appeared to be “buy in May,” the polar opposite of present day. Compare this to modern day where August has been the second-worst month of the year for the Dow and the S&P 500 index since 1987.

Figure 2 illustrates that November, December, January, March and April are the top months since 1950. Add in February, and you have an impressive trading strategy. These six consecutive months gained 14,654.27 Dow points in 62 years, up in 48 years and down in 14, while the remaining May through

Figure 2. DJIA Monthly Annual Percentage Gain (1950–2012)



Source: *Stock Trader's Almanac*.

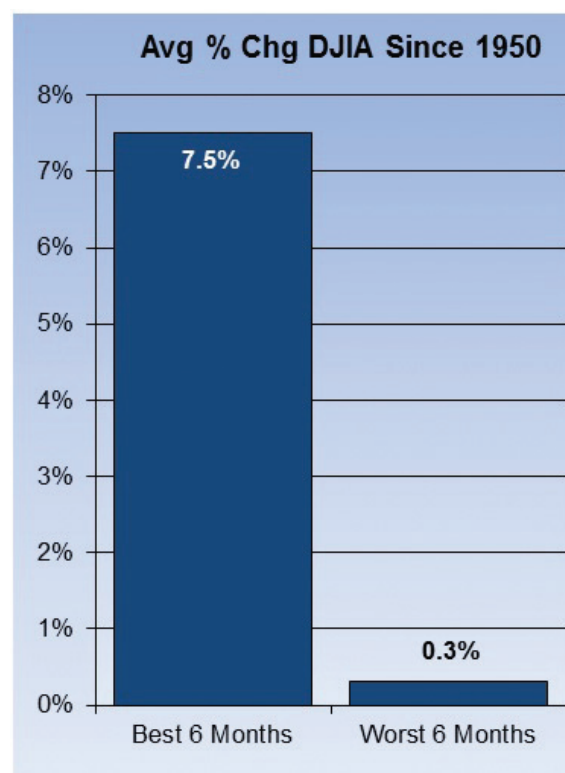
October months lost 1,654.97 points, up 37 times and down 25. Figure 3 shows the average change in the Dow Jones industrial average for both the best and worst six-month periods.

Seasonal Portfolio Management

Use of the words “buy” and “sell” has created some confusion when used in conjunction with our Best Six Months Switching Strategy. They are often interpreted literally, but this is not necessarily the situation. Exactly what action an individual investor takes when we issue our official fall buy or spring sell recommendation depends upon that individual's goals and, most importantly, risk tolerance.

A more conservative way to execute our switching strategy, the in-or-out approach as we like to refer to it, en-

Figure 3. Average Percentage Change in DJIA Since 1950



Source: *Stock Trader's Almanac*.

tails simply switching capital between stocks and cash or bonds. During the “best months,” an investor or trader is fully invested in stocks or stock index

exchange-traded funds (ETFs) and mutual funds. During the “worst months,” capital would be taken out of stocks and could be left in cash or used to purchase a bond ETF or bond mutual fund.

Another approach involves making adjustments to a portfolio in a more calculated manner. During the “best months,” additional risk can be taken as market gains are expected, but during the “worst months,” risk needs to be reduced, but not necessarily entirely eliminated. There have been several strong “worst months” periods over the past decade, such as 2003 and 2009. Taking this approach is similar to the in-or-out approach; however, instead of exiting all stock positions, a defensive posture is taken. Weak or underperforming positions can be closed out, stop losses can be raised, new buying can be limited and a hedging plan can be implemented. Purchasing out-of-the-money index puts, adding bond market exposure, and/or taking a position in a bear market fund would mitigate portfolio losses in the event a mild summer pullback manifests into something more severe such as a full-blown bear market. This is the approach that we use in the Almanac Investor Stock and ETF Portfolios.

January Jambalaya

The January Effect

The tendency of small-cap stocks to outperform large-cap stocks in January is known as the “January effect.”

It has been reported that the January effect was first identified by economist and investment banker Sidney Wachtel. He studied the seasonal movements in the stock market and is believed to have coined the term. Wachtel detailed his research in his 1942 paper, “Certain Observations on Seasonal Movements in Stock Prices,” which was published in the *Journal of Business*. The theory and pattern was that U.S. stock prices outperformed in January and that small caps outperformed large caps in January. The January effect phenomenon was originally likely caused by year-end tax-loss selling of small-cap stocks,

driving their stock prices down. These bargain stocks are often bought back in January with the help of year-end bonus payments.

In a typical year, small-cap stocks stay on the sidelines, while large-cap stocks are on the field. Then, around late October, small stocks begin to wake up and in mid-December they take off. Anticipated year-end dividends, payouts and bonuses could be a factor. Other major moves are quite evident just before Labor Day—possibly because individual investors are back from vacations—and off the low points in late October and November. Small caps hold the lead through the beginning of May.

Wall Street's “Free Lunch”

Investors tend to get rid of their losers near year-end for tax purposes, often hammering these stocks down to bargain levels. Over the years we have shown in the *Stock Trader's Almanac* that New York Stock Exchange (NYSE) stocks selling at their lows on December 15 will usually outperform the market by February 15 in the following year. When there are a huge number of new lows, stocks down the most are selected, even though there are usually good reasons why some stocks have been battered. We call this the Free Lunch Strategy.

In response to changing market conditions, we tweaked the strategy the last 13 years, adding selections from the NASDAQ market, the American Stock Exchange (Amex) and the OTC (over-the-counter) bulletin board, and selling in mid-January some years. We have come to the conclusion that the most prudent course of action is to compile our list from the stocks making new lows on Triple-Witching Friday before Christmas, capitalizing on the Santa Claus Rally. (The Santa Claus Rally is the propensity for the S&P 500 to rally during the last five trading days of December and the first two of January by an average of 1.5% since 1950.) This also gives us the weekend to evaluate the issues in greater depth and weed out any glaringly problematic stocks.

This Free Lunch Strategy is only

an extremely short-term strategy reserved for the nimblest traders. It has performed better after market corrections and when there are more new lows to choose from. The object is to buy bargain stocks near their 52-week lows and sell any quick, generous gains, as these issues can often give up these bounce-back gains immediately.

January Barometer

January's predictive prowess has been a powerful tool for traders and investors for decades. Back in 1972, my father, Yale Hirsch, the creator and founder of the *Stock Trader's Almanac*, devised the January Barometer. Ever since the passage of the 20th “Lame Duck” Amendment to the Constitution in 1933, it has basically been that as the S&P 500 goes in January, so goes the market for the year.

The January Barometer has registered only seven major errors since 1950, for an 88.9% accuracy ratio. Of the seven major errors, Vietnam affected 1966 and 1968. 1982 saw the start of a major bull market in August. Two January rate cuts and 9/11 affected 2001. The market in January 2003 was held down by the anticipation of military action in Iraq. The second-worst bear market since 1900 ended in March of 2009, and Federal Reserve intervention influenced 2010.

As the opening of the New Year, January is host to many important events, indicators and recurring market patterns. U.S. presidents are inaugurated and present State of the Union addresses. New Congresses convene. Financial analysts release annual forecasts. Residents of earth return to work and school en masse after holiday celebrations. On January's second trading day, the results of the official Santa Claus Rally are known, and on the fifth trading day, the First Five Days early warning system sounds off (when the first five trading days of the year are up, the full year has ended up 85% of the time over the last 40 years). However, it is the whole-month gain or loss of the S&P 500 that triggers our January Barometer. Beyond the obvious reasons, a positive January is much

better than a negative one, since every down January in the S&P 500 since 1938, without exception, has preceded a new or extended bear market, a 10% correction, or a flat year.

Detractors of the January Barometer refuse to accept the fact that the indicator exists for only one reason: the 20th “Lame Duck” Amendment to the Constitution. Prior to 1934, newly elected senators and representatives did not take office until December of the following year, 13 months later (except when new presidents were inaugurated). Since 1934, Congress convenes in the first week of January and includes those members newly elected the previous November. Inauguration Day was also moved up from March 4 to January 20. In addition, during January, the president gives the State of the Union message, presents the annual budget and sets national goals and priorities.

These events affect our economy, Wall Street and much of the world. Add to that January’s increased cash inflows, portfolio adjustments and market strategizing and it becomes apparent how prophetic January can be. Switch these events to any other month and chances are the January Barometer would become a memory.

Over the years, there has been much debate regarding the efficacy of our January Barometer. Disbelievers in the January Barometer point to the fact that we include January’s S&P 500 change in the full-year results and that this detracts from the January Barometer’s predictive power for the rest of the year. In light of this debate, we calculated the January Barometer results with both the full-year results and the returns for the following 11 months (February through December). You can see these results, along with the S&P 500’s return for the Santa Claus Rally and the First Five Days in Table 1.

The Indicator Trifecta

The lack of a Santa Claus Rally has often been a preliminary indicator of tough times to come. This was the case recently in 2000 and 2008. A

Table 1. Three Positive Early Indicators for S&P 500 Full-Year Performance

Highlighted rows are post-election years.

Year	S&P 500 Index Gain (%)					Full Year
	Santa Claus Rally	First Five Days	January Barometer	February	Last 11 Months	
1950	1.3	2.0	1.7	1.0	19.7	21.8
1951	3.1	2.3	6.1	0.6	9.7	16.5
1952	1.4	0.6	1.6	(3.6)	10.1	11.8
1954	1.7	0.5	5.1	0.3	38.0	45.0
1958	3.5	2.5	4.3	(2.1)	32.4	38.1
1959	3.6	0.3	0.4	(0.02)	8.1	8.5
1961	1.7	1.2	6.3	2.7	15.8	23.1
1963	1.7	2.6	4.9	(2.9)	13.3	18.9
1964	2.3	1.3	2.7	1.0	10.0	13.0
1965	0.6	0.7	3.3	(0.1)	5.6	9.1
1966	0.1	0.8	0.5	(1.8)	(13.5)	(13.1)
1971	1.9	0.04	4.0	0.9	6.5	10.8
1972	1.3	1.4	1.8	2.5	13.6	15.6
1975	7.2	2.2	12.3	6.0	17.2	31.5
1976	4.3	4.9	11.8	(1.1)	6.5	19.1
1979	3.3	2.8	4.0	(3.7)	8.0	12.3
1983	1.2	3.2	3.3	1.9	13.5	17.3
1987	2.4	6.2	13.2	3.7	(9.9)	2.0
1989	0.9	1.2	7.1	(2.9)	18.8	27.3
1995	0.2	0.3	2.4	3.6	30.9	34.1
1996	1.8	0.4	3.3	0.7	16.5	20.3
1997	0.1	1.0	6.1	0.6	23.4	31.0
1999	1.3	3.7	4.1	(3.2)	14.8	19.5
2004	2.4	1.8	1.7	1.2	7.1	9.0
2006	0.4	3.4	2.5	0.05	10.8	13.6
2011	1.1	1.1	2.3	3.2	(2.2)	(0.003)
2012	1.9	1.8	4.2	4.1	8.7	13.4
2013	2.0	2.2	5.0	—	—	—
Average				0.5	12.3	17.4

Source: Stock Trader’s Almanac.

4.0% decline in 2000 foreshadowed the bursting of the tech bubble and a 2.5% loss in 2008 preceded the second-worst bear market in history. There have been several instances in which a Santa Claus Rally preceded bad years or markets, so some caution is in order. This was the case in 2011, although the market did manage to recoup most of its losses to finish the year flat.

The last 40 up First Five Days were followed by full-year gains 34 times, an 85.0% accuracy ratio and a 13.6% average gain for all 40 years. In post-presidential election years, this indicator

has a solid record. Just six of the last 15 post-election-year’s First Five Days showed gains. Only 1973 was a loser, coinciding with the start of a major bear market caused by Vietnam, Watergate and the Arab Oil Embargo. The other five post-election years gained 22.8% on average (1961, 1965, 1989, 1997 and 2009).

It’s incredible just how bullish it has been when all three indicators are positive. Since 1950, all three indicators have been positive 27 times and full-year gains followed 25 times. Losses occurred in

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and the type of accounts held. The proportion of savings held in a Roth IRA can be a significant factor in making the determination, since they are not subject to the RMD rules.

The presence of an annuity adds another layer of complexity. Non-qualified annuities are exempt from the RMD rules, but an annuity held within an IRA is not. (Specific rules apply to annuities, and questions about them should be directed to a tax professional.) Plus, to the extent an annuity provides enough income, less than 4% may need to be withdrawn from other retirement accounts to meet living expenses. Pensions and Social Security benefits may also allow a retiree to lower his actual withdrawal rate below 4%. Conversely, some retirees may have no choice but to withdraw more than 4% to meet living expenses, even though that increases the risk of running out of money late in life.

Since so many factors can influence how much should be withdrawn from retirement savings, the decision as to whether to switch to basing the withdrawal amount on the RMD is one that needs to be revisited every year. Due to the complexity of RMD rules, there is not an easy way to determine the optimal withdrawal rate. One rule of thumb is that the more money that is held in accounts not subject to RMDs (such as Roth IRAs), the later in life a retiree will be forced to base their withdrawal amount on RMDs.

The IRS publishes a helpful list of answers to frequently asked questions about RMDs (www.irs.gov/Retirement-Plans/Retirement-Plans-FAQs-regarding-Required-Minimum-Distributions). On this webpage, you will find links to the distribution tables and worksheets for calculating your RMD.

—Charles Rotblut, CFA, Editor, AAI Journal

Feature: Stock Strategies

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1966 (Vietnam) and just barely in 2011 (U.S. debt ceiling and European debt). Excluding January's performance, the last 11 months of these years were up 24 times. The market's crash in 1987 is

the additional blemish on the record. Eleven-month average gains are impressive at 12.3%.

In 2013, the S&P posted its 17th best January gain of all time, complet-

ing the indicator trifecta. The January Barometer, Santa Claus Rally and First Five Days indicators were all positive this year—increasing the odds, but not guaranteeing, positive returns for 2013. ▲

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Trading Strategies

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whether the periods of 2003–2004 and November 2007–February 2009 were mere blemishes on the survey's record as a contrarian indicator or a sign that both optimism and pessimism can remain at high levels for an extended period of time. I tend to think the latter will be the case, given long-term market history.

The failure of sentiment to work perfectly highlights two important points. Though correlations between sentiment levels and market direction

have appeared in the past, the AAI Sentiment Survey does not predict future market direction. Overly optimistic and pessimistic investor attitudes are characteristics of market tops and bottoms, but they do not cause stock prices to change direction. Rather, it is changes in expectations of future earnings and economic and valuation trends that move stock prices. The timing of such changes has proven to be difficult to predict with accuracy.

This leads to my second concluding point: Never rely on a single indicator when forecasting market direction. Rather, consider a variety of factors—including prevailing valuations, economic data, Federal Reserve policy, government policies and other prevailing macro trends—and allow for a large margin of error in your forecast. As the saying attributed to John Maynard Keynes goes, the market can stay irrational longer than you can stay solvent. ▲

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