THE GLOBE AND MAIL

# So much for the ‘January Effect.’ What a weak start to 2022 may mean for the rest of this year

**GEORGE ATHANASSAKOS**
SPECIAL TO THE GLOBE AND MAIL
PUBLISHED 4 HOURS AGO

What is going on this January with the stock market? With the S&P 500 index down about 10 per cent so far this month - signaling a correction - does this invalidate the so-called January Effect?

Not so fast.

The January Effect is the tendency for the first month of the year to be, on average, a strong month for stocks, particularly those of smaller companies.

The key word in the above definition is “on average.” The stock market strength in January is not a forgone conclusion. In many years, the so called “January effect” does not happen, and in some of those times the stock market experiences a pronounced negative return in January, as it seems to be happening this year.

January’s stock market performance, in my opinion, depends a lot on how the year ahead is expected to unfold. Typically, increased profit expectations from quarter to quarter and a steepening (or expected steepening) of the yield curve - the spread between the 10-year Treasuries and the 1-year T-bills (both of which are signs of healthy economic expectations) relate to positive January returns; weakening profit expectations and a flattening (or expected flattening) of the yield curve are associated with a negative January. The first condition for a weak January is already in place, while the second is quite likely to be unfolding given the expectation of aggressive tightening by the U.S. Federal Reserve and other central banks to combat inflation.

Let me explain.

The high average returns on risky securities in January are caused, in my opinion, by systematic shifts in the portfolio holdings of professional portfolio managers who rebalance their portfolios to affect performance-based remuneration. Institutional investors are net buyers of risky securities in January when they are motivated to include less-known, high-risk securities in their portfolios and are trying to outperform benchmarks.

Later on in the year, portfolio managers lock in returns by divesting from lesser-known, risky stocks and replace them with well-known and less risky stocks or risk-free securities, such as government bonds. Such behavior affects prices and security returns in a predictable way. Risky stocks and high-risk bonds are bid up early on in the year and down later on in the year, whereas low-risk stocks and risk-free bonds exhibit the opposite behavior - down early in the year and up later. On average, such behavior causes the January effect.

However, my research shows that the strength in risky securities in January largely depends on what institutional investors think of the year ahead.  A “January” seasonal is mainly observed when there are no recession or bear market expectations in January, which is most of the time. This is normally the case when quarterly profits are increasing and the yield curve is becoming steeper. In recessions or bear markets no January stock return seasonality is documented.

In fact, when quarterly profits are declining and the yield curve is becoming (or expected to become) flatter, a negative January effect is observed. This is because portfolio managers do not invest in risky securities indiscriminately, irrespective of whether the year is (or is expected to be) a bull or bear market and irrespective of whether the year is (or is expected to be) a recovery year or a recessionary year.  Portfolio managers invest in risky securities when the year ahead is expected to be a good one and withhold their investment from such securities when the year ahead is forecast to be adverse.

I examined stock returns in January when the equally weighted CFMRC (Canadian Financial Markets Research Center) index declined, as well as when this index rose in January for the 1957-2018 period. The January return for the equally weighted index in a down market (in 12 out of 62 years) was, on average, -3.63 percent. In an up market (i.e., when the equally weighted index went up, 50 out of 62 years) the average January return for the equally weighted index was, on average, +6.61 percent. The corresponding numbers for subperiods, 1957-1987 and 1988-2018, were -3.35 percent and +7.95 percent, and -3.90 percent and

+5.27 percent, respectively. In other words, January returns, when they are positive, can be very strong. Unfortunately, when they are negative, they can also be very negative. Fortunately, there are more positive Januarys than negative ones, but a positive January is no slam dunk.

January shows weakness for stocks when institutions start to think that the year will not be that good for the stock market.  And of course if they're on average right, then this does not bode well for stocks this year. Hence the saying "as January goes, so does the year."

*George Athanassakos is a professor of finance and holds the Ben Graham Chair in Value Investing at the Ivey Business School, University of Western Ontario.*

*Be smart with your money. Get the latest investing insights delivered right to your inbox three times a week, with the Globe Investor newsletter. Sign up today.*

© Copyright 2022 The Globe and Mail Inc. All rights reserved.
351 King Street East, Suite 1600, Toronto,ON Canada, M5A 0N1
Phillip Crawley, Publisher