Don’t count on the ‘January Effect’ to save markets in 2023

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Stock markets, on average, exhibit considerable strength in the month of January, based on academic studies, giving rise to the well-known “January Effect.”

The key word in the above definition, however, is “on average.” Stock market strength in January is not a foregone conclusion. In some years, the stock market experiences a pronounced negative return during the month. January’s stock market performance, in my opinion, depends a lot on how the year ahead is expected to unfold.

But based on whose expectations? I think it’s institutional investors, as it is the trading behaviour of these professional traders that drives the January Effect.

Every January, portfolio managers make investment decisions with the aim to increase the probability they will earn a large bonus at year end, depending on whether, and by how much, they outperform their benchmarks. To do so, they invest in securities that are riskier than their benchmark at the beginning of the year (higher risk implies, on average, higher returns). Because of this behaviour, risky securities tend to have high returns in January as portfolio managers pile in, bidding up the price.

In such cases, the second half of the year tends to be weaker in relation to January, as managers bail out of those risky securities to lock in profits – and their Christmas bonus. As they disinvest from those securities, managers tend to move to less risky or risk-free securities, pushing up those less risky securities’ prices. As a result, low risk and risk-free securities experience weakness in January and relative strength toward the second half of the year in relation to January, giving rise to the January Effect.

However, 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.

Based on my research, portfolio managers tend to invest in risky securities when the year ahead is expected to be a good one, and withhold their investment from such

securities if the year ahead is forecast to be adverse. In other words, the strength in risky securities at the beginning of the year is not a sure thing, but it largely depends on what institutional investors think of the year ahead. If institutional investors are, on average, right when they expect a recession or a bear market in the year ahead, and they divest from risky securities in such cases at the beginning of the year when portfolios are rebalanced, it is only natural to also expect risky securities to experience weakness in January.

To shed light into this conjecture, I constructed an economic indicator consisting of variables that could be a proxy for indicators that institutional investors would consider before making investments, such as the yield curve and corporate profit expectations. Could this indicator anticipate stock market performance over the following year, as well as, implicitly, professional portfolio manager behaviour?

What I found was that increased profit expectations from quarter to quarter and a steepening (or expected steepening) of the yield curve – using the spread between the 10-year Treasuries and one-year T-bills (both of which are signs of healthy economic expectations) relate to positive January returns. On the other hand, weakening profit expectations and a flattening (or expected flattening) of the yield curve are associated with a negative January – and both conditions are now already in place.

Corporate profit expectations are being revised down quarter to quarter and the yield curve has become more negatively sloped over the past three months given the aggressive tightening by the U.S. Federal Reserve (and other central banks) to combat inflation. According to data from FactSet, the estimated year over year current (end of December) 2023 earnings growth estimate for S&P 500 companies is 5.5 per cent, which is below the estimate made at the end of September, which was 8.2 per cent. In other words, analysts have lowered the 2023 earnings estimate in aggregate over the past quarter.

At the same time, the yield curve spread was minus 0.22 at the end of September (meaning 10-year bonds were yielding 22 basis points less than one-year bonds). As of the end of December it is minus 0.82, having turned more negatively sloped over the past quarter.

Both indicators do not bode well for the stock market in January. Given the saying "as January goes, so does the year," this may not augur well for the 2023, either.

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