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Predictive value of the first day and first five days of the year

I would be surprised if you have not yet heard that stocks went up strongly yesterday, the first trading day of the new year. More than a few of the typical market "seers" have identified this as a good omen for stocks this year, usually pointing out that stocks have fallen quite a bit (no surprise) and are now reasonably valued. Others point out that economic problems point to 2009 not being a particularly good one for stocks, and they can cite the presidential cycle for support. Following my usual practices, I will take a look at what the historical data say.

I have discussed the so-called January Barometer several times. (The most complete discussion, from four years ago, is on my web site: www.pankin.com/persp044.pdf) In short, it says that if stocks are up in January, the rest of the year and the next 12 months are likely to be a good time to own stocks. Down Januaries are followed by mixed results although last year would give a different impression. The S&P 500 fell by over 8% last January and was off more than 38% for the year.

Could the first day of the year have any predictive power for the rest of the year? *The Wall Street Journal* today shows a list of the ten best first day moves of the Dow Jones Industrial Average and how that index did for the year. Yesterday's almost 3% rise was the sixth best. Four of the top five were followed by up years. However, due to a drop of over 50% in 1932 when the first day was up 3.2%, the average of those five is barely positive. The other four years in the list saw two up years and two down years with an average gain of almost 8% driven mainly by 1975's rise of over 38%. That doesn't tell us a whole lot.

I could easily get daily data for the S&P 500 starting in 1950, so I looked at 1951-2008, a 58 year period. That index was down 31 of the first days, 47% of the time, and the average change the first day was effectively zero. For the purposes of the analysis, I divided the years into three approximately the same sized groups. They were defined by the first day being up more than 0.5%, down at least that much, and in between the two. In the 58 years the S&P

gained an average of a little more than 8%, so that is the basis of comparison. When the index gained more than half a percent on the first day, the average for the rest of the year was a gain of almost 12%. Interestingly, when the S&P dropped by at least half a percent, the rest of the year saw the index gain almost 9%, slightly more than average. The in between years saw an average gain of less than 5%, far below average. So a nice gain the first day like yesterday's 3.2% is a good sign for the rest of the year although statistical tests show that the relationship between the first day and the rest of the year may well be due to chance alone.

Another popular "barometer" for stocks is how the market does in the first five days of the year. We will have to wait until Thursday to know how that period turns out this year, but we might as well see how well that has predicted 1951-2008. On average, the first five days of the year do better than the first day. The average change is about 0.2% and 35, 60%, of the years see the first five days positive. The dividing points for the approximate thirds are plus and minus one percent. The top group sees an average gain a little over 12% as compared to the not quite 8% average for the rest of the year. The middle group is a little below average, and the low group gains at only about half the overall average. The first five days, not surprisingly, are a better predictor of the rest of the year although still lacking in statistical significance.

To be symmetric, let's look at the last five days of the prior year and see how well or not they predict the coming year. Gains in this period are sometimes called a "Santa Claus rally" although I have seen that term applied to different periods in December. It is historically a good period for stocks, perhaps because tax selling is mostly done. The average gain for the last five market days of the year is almost one percent, and 45, 77%, show gains in the index. The dividing points I use are up one and a third percent and one-third of a percent. However, the following year is negatively correlated—not statistically significant—with the changes of the index in the following year. The top group sees gains of a little over 5% as compared to the over 8% average year. The best group is the in between group, and the low group is slightly above the overall average. Any purported maxims about Santa coming to call (or not) on Wall Street should be ignored.

A natural question is how am I going to use this information about the first day and the first five market days? I don't put a whole lot of stock (pun intended) in calendar based trading methods. That does not mean they do not work. They do not fit my investment personality. I prefer methods that evaluate current market conditions and indicate the better times to own broad market indices, bonds, and alternative investments such as gold stock or real estate stock funds. The model I use for stocks for Tactical Asset Allocation (TAA) is a long way from giving a buy signal. Other models that I feel are worth paying attention to are also not at all close to turning positive. That means my TAA accounts are not likely to buy stock market index funds in the near future.

On the other hand, from a technical analysis viewpoint, it looks like the market may be starting a meaningful move up. The S&P 500 moving above the 1,000 level where moves up reversed in October and early November would be a meaningful indication that the market had seen it lows. (The S&P has moved more than 20% above its low in late November, which should put us in an "official" bull market. I haven't seen or heard that pointed out, which reinforces that such designations are what I call Wall Street gibberish.) Various technical indicators are showing more strength than they did during the prior moves up that later reversed. Moreover, the hypothetical (because I have kept the accounts in cash for several months) performance of my sector fund trading systems is much improved and consistent their longer term behavior. I have started to take limited sector fund positions in accounts that trade the Fidelity Selects or the Rydex sector funds. If the current move up is not sustained and stocks start to fall to near or below their recent lows, I will not hesitate to move those accounts back to the sidelines as the risks of continued trading will be too high relative to the potential rewards.

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