Stock investors are counting on the 'January effect' to revive the bull market

After the worst December for stocks since the Great Depression, investors are hoping that the market's history of outsize returns in January will help put the market on track for healthy gains for the remainder of the year.

Since 1950, the S&P 500 SPX, +1.32% has gained, on average, 1.8% in January, compared with an average rise of 0.7% in other months, according to Ed Matts, founder of Matrixtrade.com. In a Sunday research note, Matts wrote that January gains are the result of "bed-and-breakfasting, where a stock is sold at the end of the year to crystallize a tax loss, and then immediately rebought in the New Year."

This effect, however, has waned over time after it was initially discovered in 1976. But that doesn't mean that January isn't an important period for markets, as performance during the first month of the year is strongly correlated with overall annual performance in the subsequent months.

"A comparison of January's performance to the rest of the year reveals a correlation coefficient of 0.25, a meaningfully strong number," Matts wrote. "Sampling every other month gives a correlation coefficient of only 0.016, a significantly lower number," which bolsters the theory that as goes January, so goes the year.

But there are reasons to believe that this January may be different, according to Michael Arone, chief investment strategist with State Street Global Advisors. "There are so many things that have historically worked or have been strong signals in the past that broke down in 2018," like the tendency for markets to rise in the months following midterm elections or December to be a top month for equity gains, "that it will be interesting to see if the January effect adage will hold true," he said.

A 5.6% gain for the S&P 500 in January 2018 didn't foretell a positive year for stocks. The index declined 6.2% in 2018, while the Dow dropped 5.6%. Stocks ended a choppy year on a down note. The S&P 500 fell 9.2% last month, while the Dow Jones Industrial Average DJIA, +1.38% shed 8.7%, marking the worst December for both indexes since 1931. One reason to question whether January will be a month of outperformance, Arone argued, is that there is an unusual degree of uncertainty facing markets in 2019.

For the first time in many years, investors are just as likely to predict that the Federal Reserve will lower interest rates by the end of the year than they are to raise them. An unprecedented conflict over trade between the world's two largest economies may be upending investment and supply-chain plans for American corporations. And a partial shutdown is calling into question whether the U.S. government can perform basic functions like passing a budget or avoiding the breach of the debt ceiling.

At the same time, there may be added reason to think that the trajectory of markets in January will presage performance for the rest of the year, given how important the start of fourth-quarter earnings season will be for investors looking to get a grip on the underlying health of U.S. companies.

"Fortunately we have an earnings season that should help investors understand how tighter monetary policy and the trade dispute has changed their expectations for growth going forward," Arone said.

Therefore, earnings season, and especially the guidance executives provide for 2019 profits and investment, will be even more important than in years past, as investors attempt to understand the effects of a variety of unusual forces acting on the market in January and beyond.

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