Report on Business: Globe Investor Markets

Bad news – the recession is already here

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I am afraid I do not have good news. We are already in a recession. When pundits sit down a year from now to document the economic cycle, they will probably confirm this. For months now, the signs have been out there. Financial conditions are tightening up, banks are becoming more stringent in giving loans to individuals and businesses, capital spending and global growth are starting to show signs of weakness. And all of this is happening at the same time that inflationary expectations are building.

There are two well known seasonal effects in the financial markets that, in my opinion, are showing a recession. They relate to the expressions "sell in May and go away" and "as January goes, so goes the year".

"Sell in May and go away" argues that stock markets do better in the November to April period than in the May to October period, whereas the "as January goes, so goes the year" argument is that if markets show a negative return in January, or even in the first few days in January, this bodes ill for the whole year.

Both maxims are driven by the behaviour of institutional investors and the way they trade throughout the year with the objective to maximize their own benefits when compensation time comes in December.

Portfolio managers invest throughout the year to outperform benchmark portfolios and secure their Christmas bonus. To do so, they put their money in risky securities at the beginning of the year and move away from risky securities toward year end. As a result, for risky securities, returns in January (or the first few months of the year) tend to be quite high. In such cases, the second half of the year tends to be weak in relation to January, as managers bail out of those securities in order to lock in profits. As they disinvest from those securities, managers tend to move to less risky or risk-free securities pushing up those less risky securities' prices. Those large, low risk companies' securities and risk-free securities experience weakness in the early part of the year and strength towards the second half of the year in relation to January.

My research documents that the strength in stock returns in January is actually spread over a few months around January as it is not unexpected that some arbitraging takes place by those investors not bound by the conflicts portfolio managers face.

Moreover, the games institutional managers play do not take place all at once in January but spread around the month of January and portfolio rebalancing is also spreading around it in the first and last few months of the year. Seasonal strength is then documented in more than just January, namely from November until April for risky securities and the reverse from May to October. This gives rise to the "sell in May and go away" expression.

My research shows that stocks have experienced a positive return in the November-April period in 38 out of the 47 years of my sample (1957-2003) and a negative return in only nine years. Out of the nine negative return years, seven years – 1960, 1970, 1973, 1974, 1982, 1990 and 2000 – were recession years. That is, the November to April period has been dominated by positive stock returns, except during recessions when returns turn negative. By way of comparison, stock returns in the May to October period were negative in 18 out of the 47 years and only one of these years was a recession year.

My research also shows that the strength in risky securities in January is not a sure thing; it largely depends on what institutional investors think of the year ahead. 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.

They only 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 expected to be adverse. 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 and in the months of the year that follow and, as a result, for the year as a whole.

The bottom line is this: a “January” or “semi-annual” seasonal effect is only observed when there is no recession or bear market in “January” or the “November-April” period. In recessions or bear markets, no January or semi-annual stock return seasonality is documented.

Does this ring a bell? January and the November-April period this time are turning out to be a bust and the signal they give is that so is the economy. For example, the S&P 500 is down 5.3 per cent year to date and 10.3 per cent since the end of October. The corresponding numbers for the S&P/TSX composite are a loss of 2.1 per cent year to date and down 7.4 per cent since the end of October.

I do not need to wait for the economic numbers to confirm this. Financial markets have already cast their vote. As things stand out so far, there is strong evidence to support the argument that the economy is currently in a recession.