# December 2009 Economic Update

## The Economy

- The market's action has been fairly choppy until the latest rally which brought the major averages back above their prior highs. However, after gains in the major indexes of over 60% since the March lows, it's not surprising to see some periods of "digestion."
- Given the continuing improvement in economic data, and the apparent impending rebound in employment, the big question is: when do the massive stimulus measures currently in place end, and what happens to the economy when they do?
- G-20 countries maintain a commitment to stimulus, but emergency measures are beginning to be removed in some nations.
- Strong growth has resumed in commodity-oriented economies, particularly Australia, Norway, and Brazil. Recoveries in European economies have diverged, with UK weakness continuing while France and Germany have experienced auto manufacturing rebounds.
- There were modest gains in U.S. consumer spending, housing data, and manufacturing activity for November, and the unemployment rate dropped to 10%.
- Value stocks have outperformed their growth counterparts, and large-cap stocks continue to outperform their small-cap brethren.
- Gold prices moved to, yet another, new high early in the month, but then headed lower due to better economic news.
- Improvement in the U.S. labor market pushed Treasury prices down and yields up.

## Summary

- In general, we view a sideways-to-up path as a positive, allowing economic development and earnings improvement to catch up with the forward looking equity markets.
- There will likely still be periods of profit-taking through the end of the year, and we remain relatively optimistic due to earnings improvements, economic data showing recovery, and historical seasonality being positive in December (see attached conversation for more on seasonal periods).
- We are wrapping up 2009 in modestly high spirits, and as always, we are thankful for our clients support and trust throughout the year!

## Seasonality

From Michael Carr
Dunn Warren

We briefly noted that the stock market is in a seasonably favorable period. This means that it is a time of year when stocks show a historical tendency to go up in price. It is actually a very useful idea, and one that can be used to help in the pursuit of profits. There are months that are more favorable than others, and times within some months that show strong gains. It is important to understand why seasonality should work, otherwise we have simply tortured the data until we found something that worked in the past but may not hold up in the future.

Seasonality originates in the grain markets. Corn and soybeans, for example are planted in the spring and harvested in the fall. With soybeans, we find that they usually go up in price from October through April and down for the other six months. This makes sense when we realize that the markets are constantly evaluating supply and demand. In the winter months, supply is fixed and traders are bidding up the prices on a known quantity. As planting season approaches, they tend to be optimistic and overestimate how well farmers will fare. This explains why prices usually fall while the crop is in the ground.

That's the easy part – grains are obviously seasonal because farmers just can't physically plant or harvest them in the winter. Where the earth is in its annual rotation around the sun determines what the farmers do, and this reality has always determined their actions.

The obvious question is how this translates to the stock market. And the answer can be found by looking at how beans behave in December. They actually decline about 55% of the time in the last month of the year, despite the strong seasonal tendency to rise in the rest of the winter months.

Just like investors, farmers do a lot of tax planning at the end of the calendar year. When they harvest the beans, they often store them in grain silos. Assuming they have the financial resources, they can then sell when prices are favorable. In December, they face loan payments and tax decisions which usually force them to raise cash. To do this, they have to sell from their inventory, and as they sell the prices go down.

Seasonal factors, often tax driven, also play a role in the stock market. Stocks generally do better over about the same time that soybeans do. The best six months of the year begin in November and run through April.

The end of the year is a time for tax planning for almost everyone. Many investors sell losers to take a tax loss that can be used to offset capital gains. If this is true then we should see that speculative stocks do worse than the stocks of larger, well-established companies. That's because losing positions tend to be stocks bought on a hunch or because they have a great story behind them, basically they are long shots. When these turn out to fare worse than expected, as they all too often do, most investors sell them and buy more conservative stocks. The data supports this theory. The stodgy Dow Jones Industrial Average is up 73% of the time in December, which is its best month. The exciting NASDAQ 100, an index of technology stocks, is only up 46% of the time in December.

This pattern continues into April as investors pour money into retirement plans. Large portions of those IRAs and 401ks find their way into stocks. The result is that we have an increased demand for a fairly fixed supply of stocks. Just like with the soybeans, more demand leads to higher prices.

This pattern doesn't always work. And successful investing requires more sophisticated strategies than simply buying on the first of November and selling on May 1 every year. Using this strategy last year would have led to a loss of a little more than 10% on the S&P 500. In 2007, the loss would have been more than 11% in that index. Seasonal tendencies do offer a clue to what should happen based upon history.

In the markets, history never repeats exactly, but to paraphrase Mark Twain it does tend to rhyme. Over the five months that remain in the best six months, we may not see large gains as several bearish factors compete with the strong seasonal pattern.

The market is consolidating the large gains experienced since the March bottom. This is based on the idea of momentum and the fact that nothing can go up forever. Think about what happens if you hit a golf ball. As it leaves the tee, it is moving higher and slower. It is moving its fastest, with the greatest momentum, immediately after you hit it. Eventually the force of your swing dissipates and the ball slows down and falls back to earth.

Stocks show similar behavior. They often move fastest off the bottom and lose energy as they move higher. Stocks moved very fast last spring and into the summer. The rate of gains in the market indexes has slowed recently, and consolidation is possible in the months ahead. It's also possible that prices will fall back to earth soon (after all, valuations are getting a little rich).

In addition to seasonal tendencies, there are also cyclical tendencies in the market. Prices tend to move up and down over time. Many analysts believe that markets move in a four-year cycle, tied to the timing of the Presidential elections. On average, the stock market has its worst year in the second year of a President's term. As 2010 begins, so does the second year of Barack Obama's term. The Presidential cycle shows the market trading down into February/March and fighting back to the breakeven mark by May. A summer decline follows with an October bottom. The second year of the tem, on average, ends with a loss.

That leaves us without a clear direction over the short term, and proof that we can't rely on any single tool to manage stock portfolios.

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