Brounes & Associates

4607 BRAEBURN DR. ▪ BELLAIRE, TEXAS 77401 ▪ 713.962.9986 ▪ ron@ronbrounes.com

Jumpstarting into 2008

Predicting the Market for the New Year (or, at least, the next 11 months)

As 2007 came to a close, investors were left scratching the heads about what the new year might bring. While many of the major equity indexes posted gains for 2007, the overall market performances was more sector- and capitalization-driven so portfolio allocation had been key to success/failure. Energy stocks benefited from the significant rise in oil prices during the year. Financials plummeted as the credit crisis expanded with each passing day. Techs enjoyed strong demand as businesses upgraded and consumers sought out the "latest and greatest" in devices. Housing continued to struggled as the subprime debacle delayed the much anticipated rebound. While the early retail numbers from the holiday shopping season were less than impressive, outstanding gift cards can still make a difference as they are redeemed over the next few months. Large-caps typically outperform their small-cap counterparts during periods of uncertainty and unease; the Russell 2000 lagged the larger stock indexes in 2007.

Looking ahead, many investors will take their market clues from the actions of the Fed as they try to predict how the economy and interest rate policy will impact their portfolios. While Bernanke and friends lowered the funds rate at three consecutive meetings in 2007, some were disappointed that the cut was not larger at the December policy session. Almost on cue, Dr. B. moved to regain their trust by announcing a joint liquidity enhancement effort in conjunction with the Central Banks of England, Canada, and Switzerland. That news came days after W. revealed a controversial plan to freeze rates on certain adjustable subprime mortgage loans in a move to "bail out" many borrowers and financial institution originators.

In early January, the initial manufacturing (ISM index) revealed sector contraction for the first time in 11 months and the dreaded "R" word (recession) began to creep back into daily water cooler conversations. Likewise, the weaker than expected unemployment release brought additional concerns that the housing and subprime challenges were moving into other areas of the economy. Layoffs at large home builders and major financial institutions were beginning to add up and other industry sectors were following suit. Undoubtedly the Fed's role was becoming more important and every time Bernanke so much as sneezed, the markets reacted.

While analyses of monetary policy and company fundamentals often serve as the primary forecasters of future market activity, some investors choose to look at a few other predictors and they may not have to wait long for the answers. Yes, as December yielded to the new year, the "time tested" *January Effect* and *January Barometer* began to enter into the discussions (and trading patterns) of certain investors, traders, and market watchers alike.

TGIJ: Thank Goodness it's January

The *January Effect* basically states that stocks often rise during the first five trading days of the new year. After all, many investors engage in tax loss harvesting strategies and general portfolio window dressing at the end of the calendar year. Others may need to raise excess cash to cover expenditures made during the holiday season. Since this activity has little to nothing to do with company fundamentals, "savvy" investors often swoop in to find mispricings in the market and take advantage during the first few days of the year. Some prognosticators even claim that the first five trading days serve as a precursor for activity for the rest of the year. In fact, since 1970, when the S&P 500 increases during those early days, the index has enjoyed a gain for the full year in 31 out of 37 years or 84% of the time.

The theory began getting more publicity and gaining traction with the advent of 24-hour business news networks, financial blogs, and pundits and talking heads sharing more market insight than most investors can possibly digest. In recent years, the *January Effect* has given way to the *Santa Claus Rally*, as bargain hunters often emerge during the last few trading days of the year, intent on getting a jump on those early market timers.

Unfortunately, the markets experienced no *Santa Claus* really in 2007 as geopolitical turmoil in Pakistan and skyrocketing oil prices prompted renewed fears of inflation and a flight-to-quality into bonds from stocks. Likewise, the weak manufacturing and labor releases early in 2008 sent equities tumbling further during the first trading week of the year as investors returned from the holidays only to find uncertainty and fear heading into the new year. The major indexes plunged during the first five trading days with the Dow and S&P 500 indexes both falling over 5% and the tech-heavy Nasdaq dropping eight percent.

The *January Barometer* takes this early year trading theory one step (or about three weeks) further and states that "*As January goes, so goes the year*." Noted market historian Yale Hirsch came up with the expression and his *Stock Market Trader's Almanac* has revealed its value over an extended timeframe. Prior to this year, since 1950 the S&P 500 has risen over 90% of the time that the index experienced January gains. For those "cautious" investors who desire a even larger sampling, since 1926, that percentage (positive January foreshadowing a positive year) falls to about 80%, though still a pretty telling predictor of future market activity. Of course, no indicator is ever perfect and most investors will tell you that one month in the market does not make a full year (sorry Yale). In January 2008, the S&P 500 index lost 6.12 percent.

Every Vote Counts

Looking beyond January, 2008 also brings a presidential election, an event that often has some interesting repercussions for the markets. While some politically-minded investors may spend hours debating Republican vs. Democrat candidates to determine who would be favored by Wall Street, in realty, the party of the eventual victor does not make much difference to the markets in election years. During the past 25 presidential campaigns, the Dow Jones has increased 17 times or 68% of the time in the election year. (Note: positive performances during pre-election years result in even a higher percentage and 2007 fell in line with another favorable return on the Dow.)

The justification for such performance goes as follows. During the years of presidential campaigns, the party in power does everything in its power to provide some economic stimuli in order to promote continuity with the Administration, whether an incumbent president or new candidate is running for office. The recent Bush subprime mortgage plan is an example for one such proposal offered to stem the tide of recent negativity and economic concern.

Conversely, the opposition party jumps on virtually every mishap that has occurred during the past three years and offers ways that they would be able to manage the economy in a more productive manner. "*The economy, stupid*" was a catchphrase popularized during Bill Clinton's first campaign against George Bush Sr. who was overseeing a recessionary period in 1992. Clinton emerged victorious and proved to be a very strong president from the stock market's perspective. If political history is on Wall Street's side, 2008 should prove to be another good year for the markets. But if all else fails, the Super Bowl winner and hemlines also make for excellent predictors. (Then again, investors can always focus on those "boring" corporate fundamentals and Fed policy).

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