AEGON Asset Management

Monthly outlook – April

What's in store for the equity market?

Sell in May and go away, stay away till St. Leger Day?

It's that time of year again, just before May, when we speculate about the future of the equity market. Many investors have the well-known English saying running through their minds: "Sell in May and go away, stay away till St. Leger Day". The phenomenon also crops up in specialist literature under the name of the "Halloween effect", and the basic idea is that it is sensible to offload shares at the beginning of May. Instead of them, according to the saying, preference should be given to bonds and deposits; you should go on vacation and put the equity market out of your mind, and then buy the shares back later. In the period lasting from the beginning of November to the end of April, share prices tend to display significantly higher growth than in other months. The St. Leger's day that features in the original saying refers to the St. Leger Stakes, a famous horse race that has been run in Britain since 1776. The race is held on the second Saturday of September every year. While St. Leger's day is not known to many people apart from the British and horse-racing fans, the Halloween festival held on the last day of October receives a great deal more publicity, not to mention the fact that it really is better to time your return to the market for the end of October.

There is more and more talk about this seasonality, and the idea is taking on a greater currency as time progresses, as it potentially turns into a self-fulfilling prophecy. The growing recognition of the phenomenon is well-illustrated by the fact that a Google search of the internet yields 141 million hits for the phrase "Sell in May and go away".

Nevertheless, in scientific circles the theory is the subject of a heated professional debate. *Sven Bouman*, former head of the equity division at AEGON Asset Management in The Hague – currently the founder and CEO of Saemor Capital – and *Ben Jacobsen*, professor of finance at New Zealand's Massey University, confirmed the existence of the phenomenon in a research paper published in the American Economic Review in 2002. They studied the monthly yields of the equity markets of 37 countries between January 1970 and August 1998. In 36 countries the Halloween effect was demonstrable, while among the European share markets it was at its most pronounced in the United Kingdom. The authors reached the conclusion that in the May-to-October period monthly yields were lower than they were between November and April, and also noted that in what they referred to as the worse period, yields could be lower than the short-term interest rate.

According to the Efficient Market Hypothesis, this is impossible. The yields on equity should not, in a foreseeable manner, be lower than the short-term interest rate, or rather, the risk-free yield available in the market. At the same time, it is not clear precisely what causes this effect.

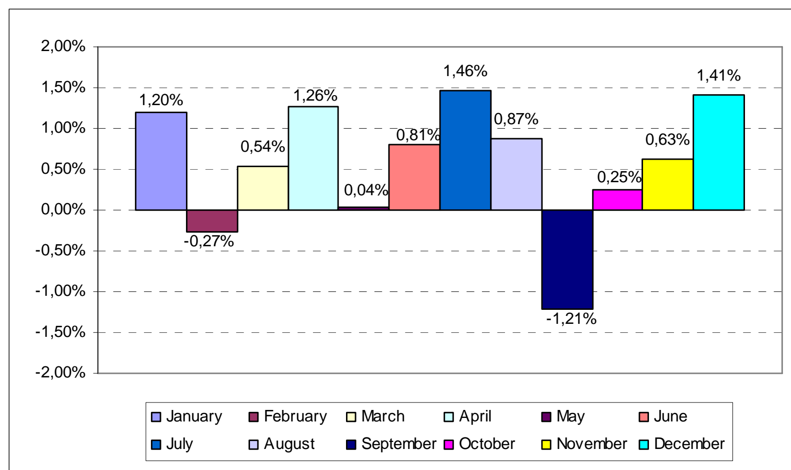
Edwin D. Maberly, a mathematician and professor of economics at Monash University, Australia, and *Raylene M. Pierce*, a lecturer at Lincoln University, New Zealand, dusted off the above-mentioned study in 2004. In their article subsequently published in Econ Journal Watch, they expressed the view that the Halloween effect results from two prominent events in the United States of America. In their opinion, if these events are eliminated, then the Halloween effect becomes insignificant; in other words its impact is negligible. One of the events they cite is the stock-market crash of October 1987, during which the US equity market, and numerous others around the world, plummeted dramatically. On 19 October 1987 the Dow Jones Industrial Average Index nosedived, dropping 23%. Although this correction had no substantive effect on the long-term upward trend, it took the market almost two years to claw its way back to the pre-crash level. The other event identified by them was the bankruptcy of the Long-Term Capital Management hedge fund in August 1998, which is also the subject of an excellent book by Roger Lowenstein. Entitled "When Genius Failed: The Rise and Fall of Long-Term Capital Management", it describes how a group of stock-market gurus and Nobel prize-winning economists thought that they were capable of beating the market. They thought – just like the alchemists – that in possession of the right knowledge they would be able to generate unlimited wealth. Initially, people were envious of them and all other investors who shared in their spectacular success. Eventually, however, the net result of their dealings was a thousand-billion dollar gaping hole in the global financial system.

Years later, in 2008, *Brian M. Lucey*, a professor at Dublin's Trinity College, and *Shelly Zhao*, a professor at Ohio's Kent State University, revisited Bouman and Jacobsen's work. They examined the US equity market over a broader period, from 1926 to 2002. By conducting what is known as a sub-period analysis, they reached the conclusion that the Halloween effect is not consistently significant.

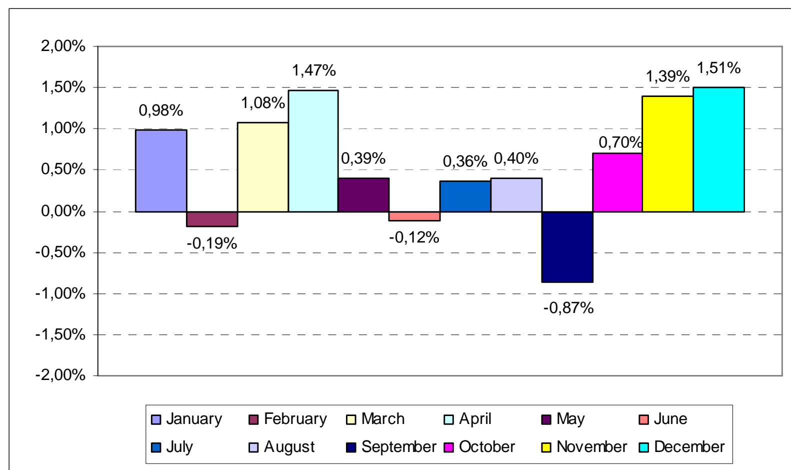
In January 2010, in the pages of Econ Journal Watch, *H. Douglas Witte*, professor of finance at the US Missouri University, once again scrutinised the Bouman and Jacobsen study. Applying robust regression techniques, in contrast to Lucey and Zhao's findings, he reached very similar conclusions to Bouman and Jacobsen; in other words the Halloween effect, in his opinion, is a significant factor in the equity market.

The media also frequently cites the above-quoted market adage in the run-up to May. In numerous cases the coverage confirms, and on a good few occasions refutes, the existence of the effect. So let's cast an analytic glance over some timelines of varying length, derived from the monthly closing prices of the S&P500 index.

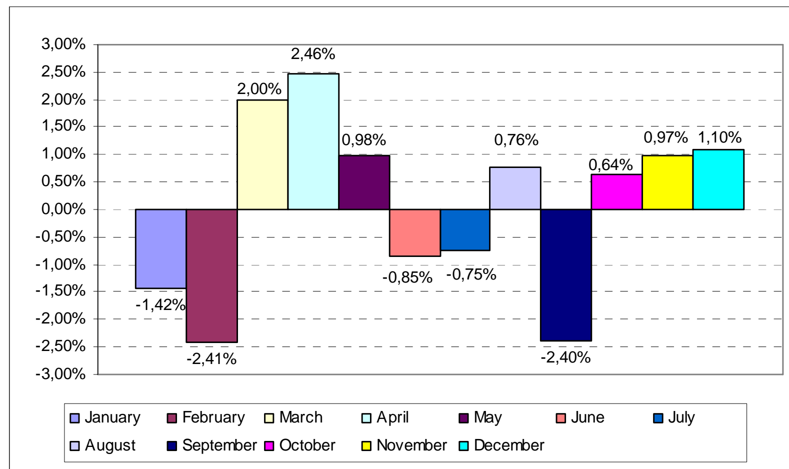
1. Average monthly yields of the S&P500 index from December 1927 to the present day:



2. Average monthly yields of the S&P500 index over the past 50 years:



3. Average monthly yields of the S&P500 index over the past 10 years:



Source: Bloomberg, AEGON Global Asset Management / AAM CEE

In the first timeline, which is also the longest, the yield for the good period (November to April) was 4.76%, while the yield for the bad period (May to October) was 2.22%. In both cases the yield for the overall period is equal to the average yields for the months that make up the period. In the analysed period, the best May yield was 23.12% in 1933, while the worst May yield was -23.95% in 1940.

In the second, 50-year, timeline the yield for the good period (November to April) was 6.24%, while the yield for the bad period (May to October) was 0.87%. In the analysed period the best May yield was 9.20% in 1990, while the worst May yield was -8.60%, in 1962.

In the third, 10-year, timeline the yield for the good period (November to April) was 2.70%, while the yield for the bad period (May to October) was -1.62%. In the analysed period the best May yield was 5.31% in 2009, while the worst May yield was -3.09%, in 2006.

While the above analysis, performed using a very simple method, does appear to substantiate the Halloween effect, the massive differences between the best and worst May performances also shed light on the fact that in some years the seasonal effect is present in a far more limited extent. In certain cases large gains are in the offing, but in others major losses could be sustained, so to blindly follow the “Sell in May and go away” saying is by no means a sound strategy. At the same time, it can serve as a useful input alongside other considerations, with all of these factors serving as a basis for making investment decisions.

So what are these considerations? AEGON Global Asset Management / AAM CEE essentially monitors four aspects from one month to the next, and then scores them on a five-point scale of -2 to +2, where -2 represents a very negative opinion regarding the market, and +2 a highly positive one. A score of zero reflects a neutral stance. The first aspect is the macroeconomic situation, the second is market sentiment, fund flows and positioning, the third is the technical picture, while the fourth is stock market valuation levels.

On the macro side, the PMI score for the main markets monitored by AEGON Global Asset Management / AAM CEE (USA, the Eurozone, Japan, China, India, Russia, Turkey, Poland, Czech Republic, Slovakia, Romania, Hungary), is generally over 50; in other words these economies are growing. The latest April IFO figures, which reflect business confidence in Germany, were very robust which leads to the conclusion that the rally could continue. The index has risen to 101.6 points from the March figure of 98.1 points. Both the sub-index showing expectations and the index reflecting confidence in the currency situation show an increase. The former rose from 101.9 to 104 points, while the latter grew from 94.4 to 99.3 points. The Citigroup Economic Surprise Indexes (CESIAPAC Index: 25.4 – Asia, CESILTAM Index: -0.6 – Latin America, CESICMEA Index: 51.50 – CEEMEA, CESIG10 Index: 26.0 – G10 countries) were positive in almost every case, which is also highly encouraging, since the actual figures were even more favourable than had been expected. According to the latest

Global Earnings Revision Ratio data, the number of credit rating upgrades exceeded the number of downgrades; profitability outlooks are improving.

The mood in the market still remains optimistic. The current 18.44 level of the VIX cannot be regarded as excessively low, although in the case of equities the Put/Call volume ratio is deep into the extremely bullish range, which could be a sign of overheating. At the same time, this ratio has usually only counted as a good contra-indicator in times of extreme bear markets. The Bank of America Merrill Lynch monthly survey of portfolio managers in April shows that the share of cash assets within portfolios is at a record low of only 3.5%. It's worth taking notice of this level, because a fall in cash balances to below 3.5% could be a strong sell signal.

The technical picture is very encouraging; the MSCI World Index is in an upward-moving trend. The Relative Strength Index – which reflects how overbought or oversold a market it – fell in the recent period and is now well below 70 points (above 70 points the market is overbought, under 30 points oversold), currently standing at 55.14 points, which means that the market is not overbought.

The global stock market valuation levels deteriorated, since the 4-6% price increase was only accompanied by miniscule EPS growth. The increased P/E ratios were also only slightly higher than the historic P/E levels.

After months of histrionics, on 23 April 2010 the Greek Prime Minister Geórgios Papandréou officially requested the granting of the international credit package that had been slated for use by his country. Although the media reports breaking the news of this announcement met with positive market reactions worldwide, the rejoicing later became more subdued as it emerged that many uncertainties still surround the activation and provision of the credit package.

To summarise the above: We believe in a "V-shaped" recovery from the crisis, and it's advisable to overweight equities slightly. But bear in mind that energy prices are on the rise, which will put upward pressure on inflation in the future. The government debt of most developed countries has risen alarmingly, and continues to display an upward tendency. Monetary tightening has begun in some countries, but there are still few examples of substantive interest rate raises; rather, in the first round, the focus is mainly on the withdrawal of extraordinary central-bank measures implemented in the heat of the crisis. Meanwhile, the shutdown of aviation traffic caused by the Icelandic volcanic eruption over the past few days serves as a good example of how an unforeseen factor may always arise in the system, with a potentially harsh impact on economies only just recovering from the crisis.

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