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MARKET FACTS

A Historical Look At The Markets
February 9, 1999

Seasonality in the Financial Markets

In general we do not talk much about seasonality in the financial markets. While we are open to the concept of seasonality, it so often is applied incorrectly that it gets a bad name. Bulls only highlight bullish periods and conveniently go quiet during bearish periods. Bears do the opposite.

The key issue with seasonality is that it is a zero sum game. For every good period there is an opposite bad period. In the end, you are right back to where you started. So, if you use seasonality, you must apply it evenly throughout the entire period. Despite its incorrect applications, it is still a subject worth exploring. What follows are some of the more interesting seasonal patterns in the markets.

Long-Bond

Chart 1 shows the long-bond's total returns by month from 1981 (the start of the great bull market) to 1998. Note the clear pattern that emerges. January through April is a poor period for the bond market with each month worse than the previous. September through December are good months. How would one play the seasonality in the Long-Bond? Sell New Years, go neutral on Easter and buy Labor day.

We should also note that February is a particularly interesting month. Ten of the last 20 years, February was one of the three worst months of the year – including last year which ranked 11 out of 12 months.

The Relative Total Return of the 20-Year Corporate Bond to the Long-Bond

Chart 2 shows the **relative** total return by month of the 20-year corporate bond to the long-bond. The period covered is 1981 to 1998. Note that this pattern is the opposite of the long-bond. That is, corporate bonds do relatively well in the early part of the year and poorly near the end of the year. How would one play this seasonality? Over-weight corporates on New Years, move to a neutral weighting on Easter and under-weight corporates on Labor day.

The S&P 500

Chart 3 shows the S&P 500's total returns by month from 1981 to 1998. In this case the pattern is more ambiguous than the long-bond. In general, the S&P 500 does better around the turn of the year, from November to January and worse in the summer months. How should one play this seasonality? Buy Halloween, go neutral on Ground Hog's day and sell Memorial Day.

The Relative Total Return of Large Capitalization Stocks to Small Capitalization Stocks

Chart 4 shows the **relative total return** by month of large capitalization stocks to small capitalization stocks. The period covered is 1981 to 1998. Note that large capitalization stocks badly under-perform small capitalization stocks in January (the "January effect"). But, in the second half of the year large capitalization stocks do well relative to small capitalization stocks. How should one play this seasonality? Under-weight large capitalization stocks on New Year's, move to a neutral weighting on Easter and, over-weight large capitalization stocks on Memorial Day.

Conclusion - Tying It All Together

Is there a theme in this seasonality? We believe so. Riskier assets do better early in the year and "safer" assets do better later in the year. For instance, the 20-year corporate bond does better than the long-bond in Q1 and the reverse is true in Q4. Likewise, large capitalization stocks do worse than small capitalization stocks in Q1 and large capitalization stocks do better in Q4.

Why is this? Our (imperfect) theory revolves around risk. Since professional investing is dominated by year-end performance bonuses, investors and managers are more willing to take risk earlier in the year. This way they can get a jump on beating their benchmark early. Later in the year, when a portfolio's returns are pretty well set, less risky assets are preferred.

Chart 1

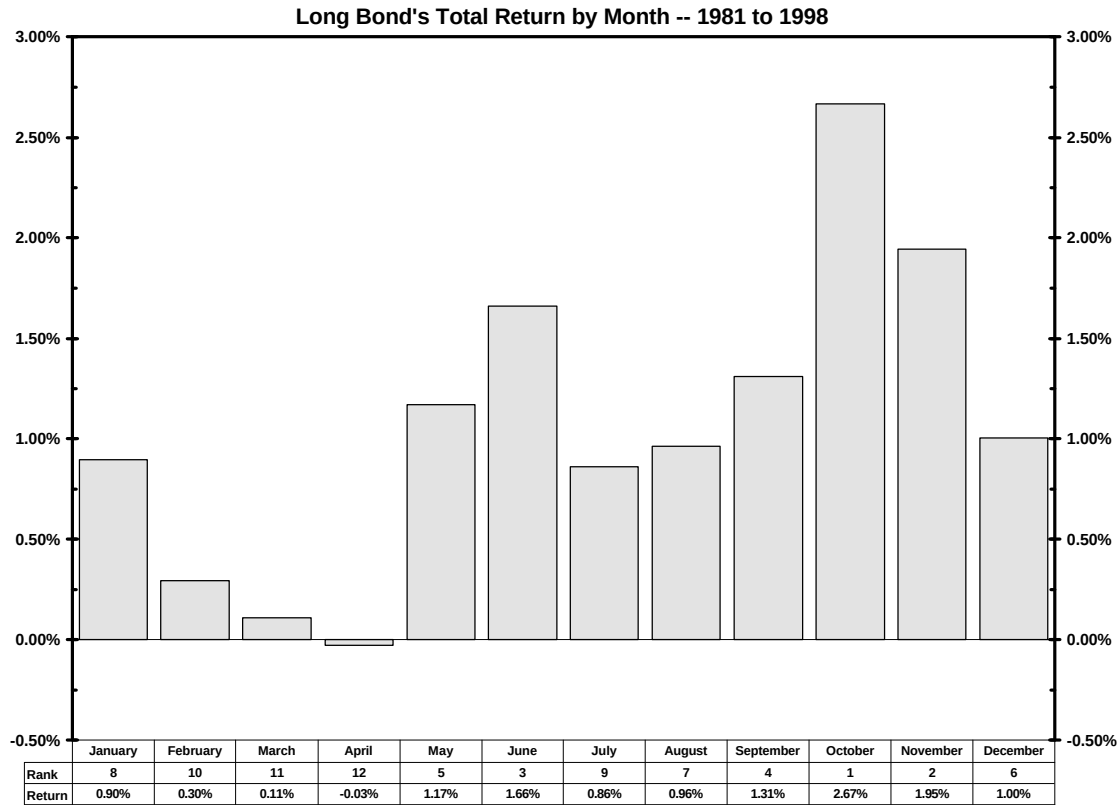


Chart 2

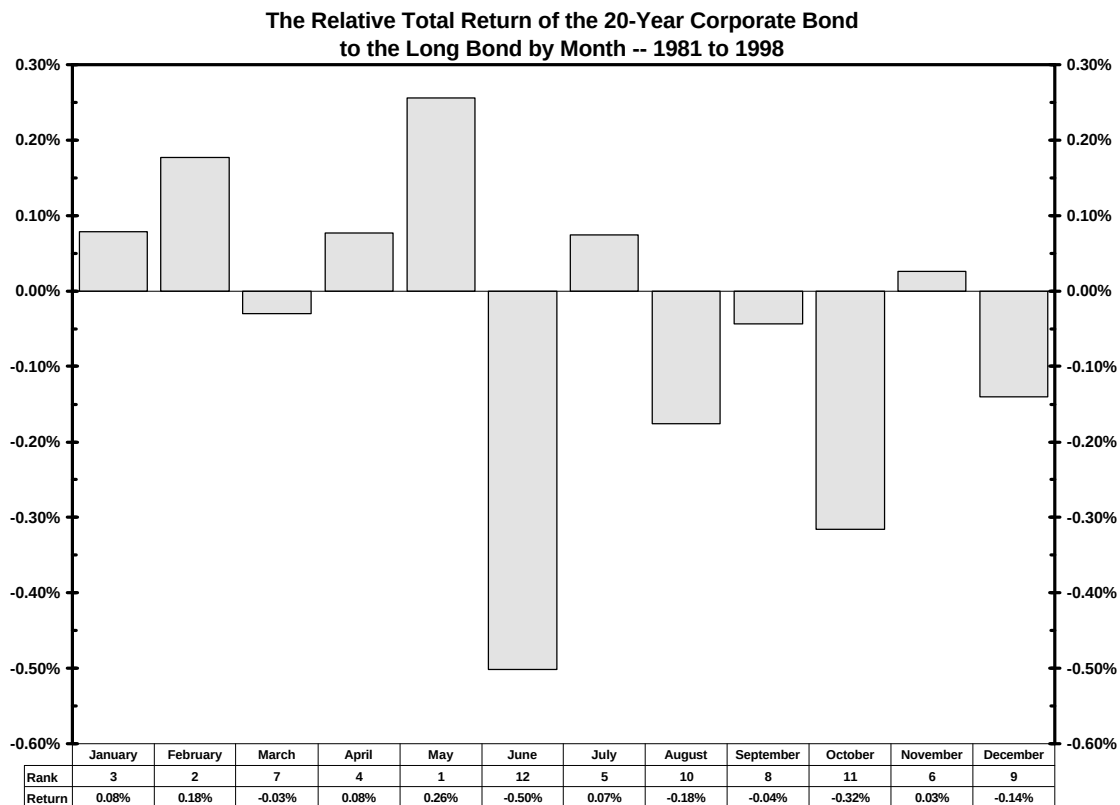


Chart 3

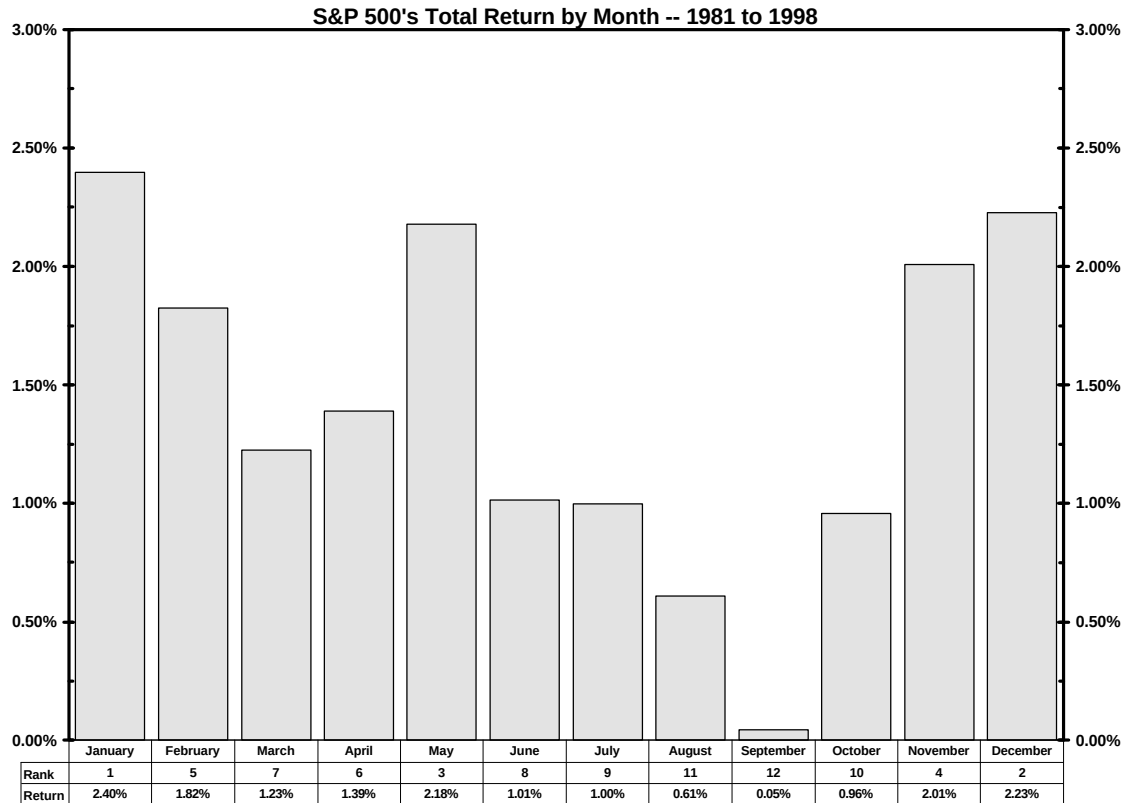


Chart 4

