Monthly Commentary

December 15, 2012

"Good investors gather information, put that information into current and historical context, then make sound decisions."

It took about four weeks to execute and rebound from the 2012 post-election correction. In reality, the election factor is probably given too much credit as equity markets were already in a natural correction from the October highs prior to November 6th. The Novembers of 1992, 1996, and 2004 saw equity markets in rising trends that were unaffected by the elections. In 2000, equity markets were already in a declining trend that was uninterrupted by the election. In 2008 and 2012 we have had two consecutive presidential elections that were followed by market corrections. Of course, some will be quick to pin the blame on the person or the party. But, as we referenced in recent Monthly Commentaries, prevailing equity market trends are dominant over who wins the right to sit in the oval office. They are like the ocean tides that rise and fall, not influenced by who is splashing at the beach.

This most recent correction was sharp but brief. The S&P 500 declined by 5.95% in the two weeks after the election having already declined 2.86% from the October highs. After recovering from the post-election decline, it paused and contracted slightly and remains 3.88% below those October high water marks, which are also the highs of the year. The DJIA, always the darling of the media, fell a more dramatic 9.05% post-election before rebounding, and it closed on Friday 3.84% under the highs for the year. Mid Cap and Small Cap indexes have had similar experiences the past couple of months. The surprise of the fourth quarter has been the resurgence of international equities, particularly the European markets. While they, too were already involved in a correction over our election period, their rebound the past three weeks has been much more robust. Last week the MSCI EAFE Index broke through resistance and are at their highs for the year.

Domestic equity markets have three distinct rally modes in place, starting with the traditional Santa Claus Rally. Originally, this referenced a tendency for equity prices to rise between Christmas and New Years, which was already a short trading week with relatively light trading volume. There are several explanations for this, ranging from an enhanced impact of systematic investment programs due because of the light volume, to end-of-year pension funding, to a general Holiday optimism. Over the years, the Santa Claus Rally began to stretch earlier into to December, sometimes into late November, as we have seen this year. This extension has been explained as investors wanting to get invested ahead of the January Effect, another short term positive. For those non-believers this is also called the December Effect, but it certainly is more fun to give Santa Claus the credit.

A second rally mode lies in the November-December-January Seasonal Rally. This is historically the most profitable three contiguous month period of the year for domestic equities. There are a number of seasonal trading strategies for equities, but almost all recognize the historic benefits and the future potential of this period. Once again, there are several explanations, from a culmination of annual tax selling to institutional implementation of forward-looking long-term investment strategies for the coming year.

A third equity market rally factor is that domestic equities continue to be in a long-term Bull Market that started back in March of 2009. This is the broadest mode, and must be interpreted within the context that short term market corrections of 5%, 10%, even 15% can occur within the confines of a long-term Bull Market. Thus far in 2012 we have seen two periods of respectable market advances interspersed with two moderate (10%) corrections. The long-term, primary trends remain positive and intact.

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For the past twelve months we have been developing a new set of indicators to help us identify primary changes in market trends. We believe that it is critical to recognize the signals that are present when major shifts in trends are taking place. The timely identification of these reversals in market trends can be a valuable tool for managing account drawdown, as well as for taking better advantage of favorable market conditions. We have tested these new indicators for the very volatile period of 2007-2011, as well as during 2012, and our confidence in the conclusions, as well as the potential benefits of buying and selling as these signals are being generated, is very high. We received positive signals in November on most all of the 64 equity indexes that we monitor. The 36 bond indexes we follow have been positive all year.

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Sources: Bloomberg, iShares.com, Marketwatch.com, Stock Trader's Almanac 2012, StockCharts.com.