



Hayam Dukan Anagatam

“Avert the danger which has not yet come.”

- ancient Sanskrit aphorism





Stock Market: staircase to riches or trapdoor to losses ?

- The gap between the ‘Nominal’ and the ‘Real’ or inflation adjusted stock market is the **widest in history**. The “Real” S&P 500 is still **25% below** its Dot-Com peak.
- In the past such large gaps have been bubbles.
- **Fed stimulus has created a stock market bubble.**
- Everyone agrees: “You can’t lose in this stock market.” The last time I heard “you can’t lose” it was real estate, at the height of the housing bubble.
- Bullish euphoria this time of the year has always been a **seasonal warning signal**, not a buy signal
- There is that ancient proverb: **‘Sell by May then Go Away.’** The other half of the proverb is ‘Buy Back on Saint Crispin’s Day.’ That would be 25th October.
- This advice has shined the brightest in those years with the most extreme bullish sentiment going into May.

And that brings us to the other half of this bulletin.

See at right.

“Dow 16,000!” was the April 22, 2013 cover story in Barron’s.

Quoting from that article:

“In our latest survey, **74%** of money managers identify themselves as **bullish or very bullish** about the prospects for U.S. stocks - **an all time high** for Big Money, going back more than 20 years.

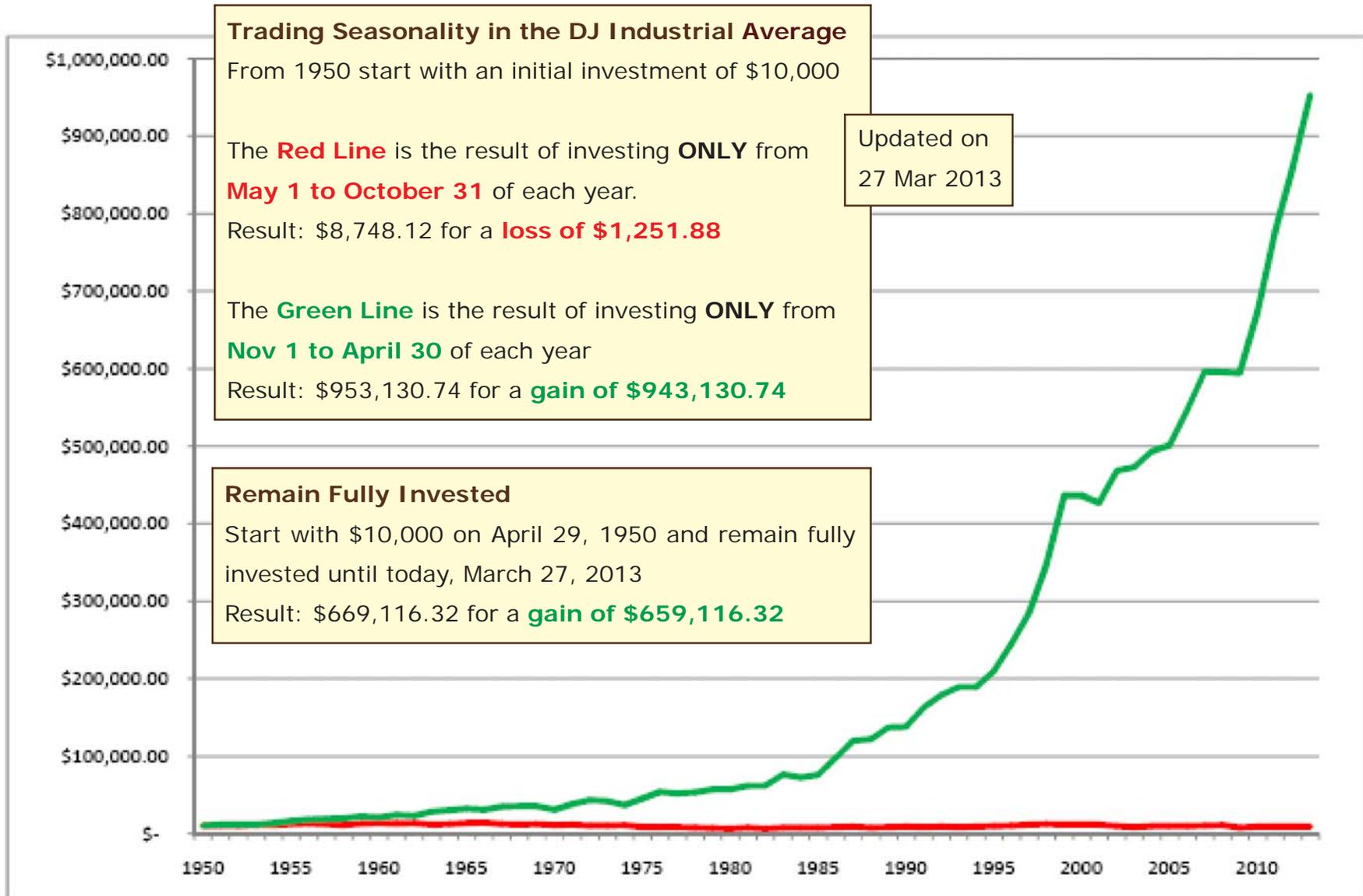
“A quick trip through history reveals that only 45% of managers were bullish in the spring of 1999, and 54% in the fall of that year, even as the dot-com boom was inflating.

“Similarly, bullish sentiment was in the mid-40% range in the mid-2000s, as the housing market was on the boil and stocks were hitting fresh peaks.

From the same Barron’s article **94%** of Money Managers are bullish five years out. Another new record.

Bubbles are always invisible until they burst.

So only 6% are even open to the notion of an unsustainable bullish sentiment extreme. Bullish sentiment extremes both make and reveal speculative bubbles. Those who are long going into a bubble always have a list of very good reasons why it will be different this time around. It never is.





Seasonal Cycles in Market Prices: Fundamental or Biological?

We do not question the fact of seasonal price swings in energy. We have extensively detailed the case for seasonal price trends in Brent, WTI, Gasoline, Oil, Diesel, Natural Gas, and the major energy spreads. We automatically attribute these seasonal price swings to seasonal demand swings. That automatic attribution is the extent of our investigation. It is so obvious that no more thought is required. Or so we assume.

For examples, Gasoline prices rally from winter to spring in expectation of higher summer demand. And Natural Gas prices rally from summer to fall in expectation of winter heating demand. The existence of these seasonal price trends is unthinkingly chalked up to seasonal shifts in the underlying market fundamentals. However if one looks at this situation more closely the connection between the seasonal price trends and the shifts in seasonal demand are not as direct as one might expect. In fact as soon as one attempts to link the percent changes in seasonal price swings with the percent changes in actual seasonal demand the whole edifice of assumptions comes tumbling down. The percent changes in price far outstrip the percent changes in demand. The two are not even remotely close.

For example, Gasoline prices rally from winter to spring. We assume that this is because summer demand for gasoline is much higher than winter demand. The thirty year average winter to spring rally in Gasoline prices is a 57% increase in spot futures value. Yet the actual swing in US Gasoline demand from the winter low to the summer peak (EIA) is only a 4% to 8% gain. And the cost difference between summer and winter grade gasoline is only a few pennies per gallon. There is a similar disconnect between the actual demand swing and the average price swing in every seasonal trend in the energy markets.

We know the markets are very emotional. We know speculators load up on the long side at seasonal peaks and then bail out at seasonal lows. We know that the race to exit these losing positions keeps the momentum of the seasonal cycles intact. However, even knowing all this a 57% increase in Gasoline prices for a 6% increase in demand is way out of wack. There is clearly something else going on here. What might we be missing? It is our suggestion that there is a big "Seasonal Affective Disorder" component to the seasonal price swings in the various markets - energy, currencies, and the stock market.



Seasonal Cycles in Market Prices: Fundamental or Biological?

When confronted with the fact that market fundamentals cannot account for the seasonal price swings in energy the typical response of market experts is to blame the speculators. However that must mean that the markets are completely useless as accurate gauges of the underlying realities they are supposed to record and monitor. Before we throw the markets on the trash heap perhaps we should first enquire if we might be missing something. What might have escaped our attention? Our search for a missing element begins with a closer look at the seasonal cycle.

Every single seasonal price trend in the energy complex shares a common feature. That commonality is a price trend from spring into winter, and then another trend from winter into spring. If we limit our analysis of seasonality to the energy complex then we have no reason to doubt that these seasonal cycles are the product of underlying fundamental swings, magnified by the emotional content of the market. Seasonal demand swings times emotional equals seasonal price swings. Easy. Simple. Done here.

However let us now look to the table on page 3. From 1950, an investment of \$10,000 in the DJIA invested exclusively from spring to winter would have lost money. From 1950 the same \$10,000 invested exclusively from winter to spring is now worth over \$950,000 dollars. How can we explain this in terms of underlying market fundamentals? How can stock market prices be seasonal?

There is absolutely no fundamental reason whatsoever for the dramatic difference between the \$8,748.12 result of spring to winter investing and the \$953,130.74 result of winter to spring investing. The composition of the DJIA is not composed of companies with a seasonal swing in profits, dividends, or capital gains. In fact virtually the same financial results obtain from the exact same seasonal investment programs in the S&P 500 Index. The profitability of the five hundred largest USA corporations are not seasonal in nature.

The academic community finally started paying attention to this phenomena with the 2002 ground breaking study by Sven Bouman and Ben Jacobsen. Their report "The Halloween Indicator, Sell in May and Go Away: Another Puzzle" is definitely recommended reading. They found evidence of a 'Sell in May' effect as far back as 1694. So forget trying to explain this effect in terms of IRS tax deadlines and 401.K activity.

This page 3 table tells us with crystal clarity that there is a very big yet completely unseen seasonal dynamic at work in the stock market. This unseen factor is largely camouflaged in the energy markets because there, everyone thinks in terms of seasonal energy fundamentals. However there is no such camouflage to hide behind in the equity markets. The reality is exposed. We have overlooked something very large.



Seasonal Affective Disorder and Financial Trends

A seasonal basis to mood swings was first proposed as a medical condition by Norman Rosenthal, MD, in a 1984 paper. Subsequent research has confirmed his initial findings. But of course Rosenthal was not the first to notice a connection between the change of seasons and swings in the collective mood. The phenomena of 'winter depression' was described as early as the 6th century in Scandinavia. The medical description is "Seasonal Affective Disorder" (SAD) and it is a much more widespread problem than mere winter blues.

Many people experience serious mood changes when the seasons change. Symptoms include needing more sleep, having less energy, increased depression, heightened anxiety, difficulty concentrating, and increased pessimism. A milder form of SAD known as 'Subsyndromal Seasonal Affective Disorder' is experienced by an estimated 14% of the US population. About 6% of the US population is estimated to suffer from the full blown SAD. As this phenomena has been linked to less daylight hours its prevalence is estimated to range from 1.5% of the population in Florida to 25% of the population of Alaska.

Both SAD and Subsyndromal SAD are induced by the onset of winter, and to a lesser extent, summer. If the medical experts are correct and 14% or more of the population grows more depressed and pessimistic at the approach of winter and summer then there will be effects in the financial markets.

Two important observations are implicit in the description of both SAD and Subsyndromal SAD. First, this is a very widespread phenomena that affects some more than others. While some end up in the hospital, most that are affected but are able to continue their daily lives. Second, as winter gives way to spring the population grows less depressed and less pessimistic. So this is a latitude related phenomena.

Now where are the major stock exchanges and commodity markets? With one exception they are all at northerly latitudes. There is of course New York and London, but also Chicago, and Frankfurt, and Moscow, and Beijing. The one exception is Mumbai.

With this information let us return to the page 3 plot. We propose that the difference between \$8,700 and \$950,000 is result of seasonal influences on the collective mood.

As the days start to get longer from the depths of winter, the collective mood becomes less depressed and more upbeat. The collective mood of optimism peaks in the spring. The more upbeat and optimistic the seasonal mood, the higher the valuation of the stock market. The more depressed and pessimistic the seasonal mood from spring into winter, the lower the valuation of the stock market. The page 3 plot reveals seasonal migrations in the stock market. Herding behavior is migrating under the influence of seasonally produced mood swings.



SAD and Financial Trends: Implications

One big casualty of the page 3 plot is the already largely discredited 'Efficient Market Hypothesis' and its insistence that there is always a rational basis for stock market valuations. What the page 3 history indicates is that the relative value of the stock market is a function of the collective mood, and the collective mood is a function of the change of seasons. The difference between the \$8,700 result and the \$950,000 result is not dividends, earnings, business trends, or economic cycles. The difference is seasonal. The difference is between a season where depression and pessimism are on the rise, and a season where optimism is on the rise. It is a simple function of trends in daylight hours.

Now this is very valuable information for any investor. It clearly signals the most prudent course of investing. It strongly suggests that the 'buy and hold' strategy should only be employed in the period from winter to spring. And this information strongly suggests that for the period from spring to winter one should be on the sidelines in cash or cash equivalents.

The knowledge of this seasonal dynamic in the stock market is advice that no one will ever get from any stock broker or media based financial advisor. Stock brokers strongly prefer a regular monthly stream of brokerage income all year long. And to keep up their ratings the various cable TV business channels need something to recommend buying every month, every week, every day, and every hour.

Of course the stock market has not suffered a sharp spring to winter drop in every year of its existence. And the stock market has not enjoyed a sharp winter to spring rally every year. However the stock market history on page 3 clearly reveals a powerful influence that compounds over time into an effect that is way too overwhelming to be able to dismiss. This is the seasonal equivalent of the miracle of compound interest.

How might we inoculate ourselves from this seasonal malady? How can we protect our net worth from getting maximum bullish and 'all in' on the long side in May, then getting maximum bearish and all out in October? We need to check sentiment and momentum levels every May and every October. If going into May sentiment is overly bullish, there is bearish momentum divergence, and up trend lines are breaking... well then we should sell out and go away until late October. If going into late October stock market sentiment is overly bearish, there is bullish momentum divergence, and resistance lines are breaking, then we should get long and remain long into April.

However the strength of our 'field independence' is much more important than knowledge of these tactics. If we fail to recognize May stock market euphoria and October stock market blues as the seasonal effects that they are, then every year we risk buying into an over-valued stock market in the spring and selling out from an under-valued stock market in the winter.