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A Better Year for Stock Markets?

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LONDON – Although it has been almost a decade since I gave up a full-time job in finance, markets – and market oddities – still fascinate me, especially when they send signals that run against a widely held consensus among analysts and investors. Given all the disappointments in 2022, the outlook for the new year is quite downbeat. Major corporations are announcing layoffs, and the International Monetary Fund is forecasting that at least one in three countries will experience a recession this year.
The reasons for such pessimism are not hard to find. The big inflationary surprises of 2022 triggered a massive and rapid tightening of monetary policies in most major economies, and key central banks have continued to talk tough. Although the US Federal Reserve reduced the size of its interest-rate hikes from 75 basis points to 50 bps in December, it has made clear that more rate hikes are likely – and that a rate cut is not in the cards for 2023. Making matters worse, many other problems, like Russia's war in Ukraine, continue to simmer, threatening supply chains, markets, and economies around the world.

At some point in my career, I was introduced to an old almanac that offered an endless array of heuristics about US stock markets' past performance. One nugget that always stuck with me is the five-day rule: If the S&P 500 index makes a net gain during the first five trading days of the calendar year, equities will perform well for the year overall. When I asked my colleagues to check it for the 1950-2014 period, they found that it held true more than 80% of the time.

Well, in the first five days of 2023, the market rose by just over 1%, which means there is over an 80% chance that it will be positive on the year – at least according to the five-day rule. But before you rush to buy your favorite stocks, let me add a few obvious caveats. First, the stock market tends to rise more than it falls: down years are nowhere close to as frequent as up years. This is not particularly surprising, considering the prominent role that equity markets play in finance.

Second, the five-day rule is not airtight. There is almost a 20% chance that a rising market during the first five trading days ends up being down on the year. Ultimately, economic conditions, not some hoary heuristic, will determine the outcome. After all, why should the first five days be determinative of anything? It is understandable that many retail and institutional investors would want to signal confidence for the year, but there is no underlying economic reason why this period should be considered especially predictive.

Nevertheless, other recent developments offer some cause for hope. Commentators may soon change their tune, and that could make investors more open to embracing a different collective narrative than the one that has been influencing their behavior so far. I can see three reasons why that could happen.
First, despite the war in Ukraine, many commodity prices – including natural gas – fell significantly in the second half of 2022. That not only increases the probability that inflationary pressures will ease; it also means that companies and consumers' disposable income is not as vulnerable as was previously assumed. Equally important, several high-frequency indicators for late 2022 and early 2023 have been better than expected, notably in Europe.

Second, other inflation indicators have also been better than expected on both sides of the Atlantic, including the most recent US wage-data series. While the Fed and many other central banks insist that they will remain hawkish, I am reminded of something a famously successful US hedge fund manager once told me: The only thing you can know about the Fed is that it will change its message when the evidence changes. If the inflation picture continues to improve faster than Fed officials expect, they will change their view.

Finally, one must not forget China, which suddenly abandoned its zero-COVID policy in December. Notwithstanding the massive surge in infections and hospitalizations, the end of lockdowns sets the stage for a big cyclical bounce in the Chinese economy – even with all the other structural challenges that Chinese authorities must confront. Recall that there was a similar post-lockdown rebound in many other countries (even the United Kingdom, despite all its other problems).

Investors will seek further clues in what happens next. If markets manage to remain slightly more bullish through the end of the month, I suspect many commentators' views will also shift. Then it will be time to consider whether things are really looking up – or whether the five-day rule is best ignored.

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