

INSIGHTS ON FRONT STREET



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SELL SOME IN MAY AND GO AWAY

MAY 2008

There is an old adage on Wall Street that says to achieve better returns investors should sell their stocks in May and go away until November. History has shown that stock market returns are significantly higher on average from November through April than they are from May through October. However, with stocks still lower this year than they were in October it may be different this time. The market is now acting better but our worries about the economy remain so we would at least sell some stocks in May until better investment opportunities present themselves.

Like any simplistic trading rule, "Sell in May and go away" has not worked in every year. Look at last year. The S&P 500 Index was up about 5% from May through October but was down about 10% from November through April. Nevertheless, its historical record is still pretty amazing.

According to the *Stock Trader's Almanac*, the Dow Jones industrial Average was up an average of .3% from May through October in the years 1956 through 2005. During that same 50 years the average return for the Dow was almost 8% from November through April. Those results look pretty convincing but before taking action there are some other related statistics that you need to consider.

For example, five out of the last six times that the Dow Jones Industrial Average was down from November to May (like this year), the average return for the next six months was a little over 6%. Also, if you look at the average returns of the Dow by month since it

was created in 1897 you find that July and August are the second and third best months of the year just behind December. However, the third quarter tends to end with a sell off as September averages a negative return, the worst month of the year.

To add even more weight to the thought that it might be different this year is that many technical analysts have recently become bullish at least for the next couple of months and some for the rest of the year.

Technical analysts study charts for the stock market and individual stock prices as well as the volume of the number of stocks traded. They are looking for familiar patterns and trends that can help them forecast the future direction and amount of the move.

These analysts have been encouraged by the stock market's orderly move up from the lows in March in the face of concerns about whether the economy is in or soon to be in a

recession. In April both the Dow Jones Industrial Average and the Dow Transportation Index (truckers, railroads, and airlines) both rose above their respective peaks in February, a clear buy signal for those investors who follow the *Dow Theory*.

Those market strategists with a bullish view also point to the *short interest* on the New York Stock Exchange. That is the number of shares of stock that have been borrowed and sold with the expectation that the prices of those stocks will go down. It recently reached a record 15.2 billion shares. If the prices of those stocks were to go up because of a market rally then those short sellers will have to repurchase those borrowed shares back in a hurry to limit their losses. That could add some significant fuel to the rally.

For those of us who focus much more of our attention on the economic and market fundamentals, we continue to look at this recent stock market rally with some skepticism. While we would like to believe that the recession (or slowdown if you prefer) is near an end and that the economy will be in a normal growth mode by yearend, we don't see that happening.

The stock market has rallied on recent economic news that seemed to contradict those of us who see the economy in a recession. However, we think that reaction was a little misplaced after a closer look and analysis of what the numbers were really saying.

The gross domestic product (the amount of goods and services produced in the U.S.) actually grew .6% in the first quarter of this year, a little better than expected. (*the bulls say "recession, what recession?"*). Consumer spending rose more than expected in March, up .4% from February. (*Looking good!*) The unemployment rate fell to 5% in April from 5.1% in March and the job losses "only" amounted to 20,000 instead of the 85,000 expected. (*The bear market is over!*). Hold

on a minute. Let's look at these numbers more carefully.

First of all, the GDP was up, that is true, but it was entirely do to companies unintentionally building excess inventories. Real final sales were down for the quarter.

John Mauldin, a renowned market strategist, also pointed out in his last newsletter that had the officials who calculate the GDP numbers used the Consumer Price Index for the inflation number instead of their own computation, the economy would have shown a decline of 1% for the first quarter. That looks more like a recession to me.

Consumer spending was up in March because of the rise in the prices of food and gasoline. Excluding inflation, spending was about flat. It was up only 1% for the whole quarter, which was the slowest growth since 2001 when the economy was last in a recession.

Lastly, we are pretty sure that the employment numbers for April will be revised downward in the months to come. Let's just say that the Bureau of Labor Statistics way overestimated the number of new small businesses created in April.

While we acknowledge that the stock market is forward looking and is betting on a better economy 6-12 months from now, we think investors are discounting a much stronger economic recovery than what will actually arrive. The decline in housing prices and its consequences has much further to go despite, in our opinion.

The technicians may be right and the stock market rally may continue a little longer. However, we are inclined to sell some of our stocks in May, buy some attractively priced corporate and municipal bonds, and wait for better buying opportunities that will come along.

