Sam Stovall | Chief Investment Strategist CFRA | Author of *The Seven Rules of Wall Street*

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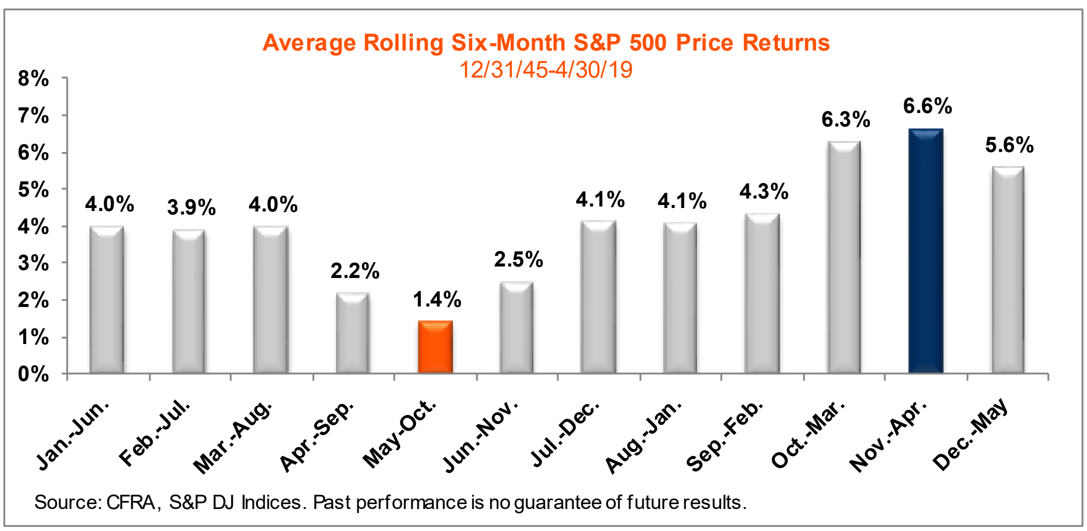
Seasonal Rotation

It's better to rotate than retreat, even after strong starts to the year

When April came to a close, the S&P 500 posted strong returns for the month and year-to-date periods, capping what *The Stock Trader's Almanac* calls "the best six months of the year". Indeed, through April 30, the S&P 500 gained 3.9% for the month and saw positive returns for eight of its 11 sectors. Year to date, the 500 was higher by 17.5%, which was the third best YTD performance since WWII. In addition, all 11 of its sectors were higher on the year.

Yet the strong start to the year has many investors debating if they should listen to the rule and rotate, rather than retreat, in the fast-approaching "Sell in May" period. History reminds us that "the Rules rule" and that investors may still be well served by rotating defensively after such a jack-rabbit beginning. Indeed, a 50% exposure to the S&P Equal Weight 500 consumer staples and health care sectors in the May through October period following the top 10 four-month beginnings since 1990 saw the defensive sectors outpace the broader index by a 2:1 margin and beat the benchmark 70% of the time.



Sell in May and Go Away

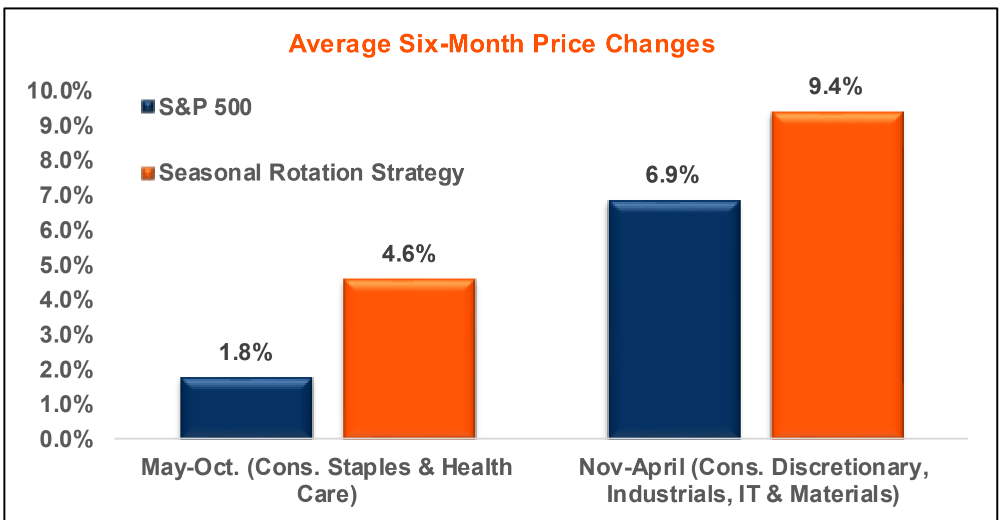
Most investors are familiar with the old Wall Street axiom "Sell in May and go away." Tradition holds that the stock market registered the weakest six-month return from May through October (M-O), when the S&P 500 posted an average gain of only 1.4% since 1946, and the strongest from November through April (N-A), when it was up an average 6.6%. What's more, the S&P 500 recorded a positive six-month return 77% of the time N-A, but only 64% of the time M-O. Finally, the market's return in N-A outpaced the return in the subsequent M-O period in seven out of every 10 years. This pattern of seasonal strength and weakness is not just a U.S. large-cap phenomenon. The S&P Equal Weight 500, S&P SmallCap 600 and S&P Global 1200 also saw their weakest six-month returns in the M-O periods and their highest six-month gains N-A.

Should You Really Go Away?

Even though the average advance of 1.4% for the S&P 500 from M-O is the weakest of all 12 rolling six-month periods, it delivered an annualized return of nearly 3%. This is still better than what an investor would have received from a money market fund. Also, the market rose in nearly two out of every three years. Retreating from the "500" in that six-month period would have caused investors to miss out on unexpected summertime surges of 14.1% in 1997, 14.6% in 2003 and 18.7% in 2009. Therefore, wouldn't it be better to identify a more attractive alternative approach to retreating from stocks altogether during this seasonally slow period?

Rotate, Don't Retreat!

Some sectors have their day in the summertime sun, while others skate along smoothly in winter. Since 1990, while the overall market was eking out an anemic advance of only 1.8% from M-O, the S&P 500 consumer staples and health care sectors recorded price gains of 4.4% and 4.9%, respectively. In addition, these two sectors posted 62% frequencies of beating the S&P 500 during this traditionally low-rising period for the overall market. Conversely, as the S&P 500 recorded its strongest six-month return in the N-A period, the cyclical sectors also beat the defensive ones. Indeed, since 1990, above-average price gains came from the consumer discretionary, industrials, materials and technology sectors. What's more, these sectors consistently racked up benchmark-beating returns across the large-cap, equal weight, small-cap and global index spectrum.



Source: CFRA, S&P Global. Past performance is no guarantee of future results. Data: 4/30/1990-4/30/2019.

Making Sense of Seasonality

The main reasons for seasonal weakness during the May-October period likely include: Reduced capital inflows, vacations, earnings reality, and Mutual Funds' fiscal year-end window dressing.

Capital – The above-average strength in the N-O stretch may be aided by large cash infusions into the market, particularly during the beginning of each calendar year. Pension plans typically make large contributions early in the year. Also, bonuses are typically paid by March. As a result, 401K contribution limits are typically fulfilled early in the year, with the remaining money likely invested in the market soon thereafter. In addition, should someone be due a tax refund, they will probably file their return early. This will allow them to invest their proceeds before the end of April. Finally, IRAs for the prior tax year need to be funded by April 15th of each year.

Vacations – The S&P 500 posted its weakest average three-month results in the third quarter, as investors may be focusing more on their tans than their portfolios. Since 1945, the S&P 500 rose only 0.5% in Q3 of each year versus 2.3% for Q1, 1.9% for Q2, and 3.8% for Q4.

Earnings – End-of year earnings revisions may also be a reason the market performs poorly in the third quarter. An investor may be forgiving of soft Q1 and Q2 EPS on their way toward solid full-year estimates. Should Q3 look like it's going to miss expectations as well, however, investors usually don't wait around. Like a veteran retailer, they'll "mark 'em down, and move 'em out." As a result, this could be a reason September has been the worst performing month of the year. What's more, five of the last 10 bear markets since WWII ended in October, as well as the near-bear of 2011. Therefore, stocks traditionally entered November at a fairly low level compared with other months. Also, November is around the time of year that analysts begin looking toward the end of the coming year, rather than the conclusion of the current one.

Mutual Fund Window Dressing – Finally, mutual funds publish quarterly holdings. As a result, they typically engage in end-of-quarter window dressing, meaning that they sell their underperforming holdings so as to not be shown holding these "dogs." And since many funds have fiscal years ending in October, they engage in an even more thorough portfolio pruning in this final quarter of their calendar, possibly adding to this overall seasonal pressure.

Conclusion

So there you have it. Sometimes it has paid to lock in gains ahead of the traditionally challenging May-through-October periods. And the same goes following strong starts to the year. Indeed, after the top 10 YTD returns through the end of April since 1990, the S&P Equal Weight 500 recorded sub-2% gains five times, falling more than 8% in 1998 and deeper than 9% in 2011. Yet cashing out might not be the best option either, as the EW 500 recorded an average total return that likely exceeded what one could have earned by sitting on the sidelines. However, an equal exposure to the defensive consumer staples and health care sectors outpaced the broader benchmark in seven of those 10 years and posted an average six-month total return that beat the market by a more than two-to-one margin. Therefore, like most "Sell in May" periods, it again may pay to hop onto the "rotate, don't retreat" bandwagon, even after jack-rabbit jumps.

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ADDRESS	PHONE	WEBSITE
1 New York Plaza, 34th Floor New York, NY 10004 USA	P: +1-800-220-0502	cservices@cfraresearch.com www.cfraresearch.com

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