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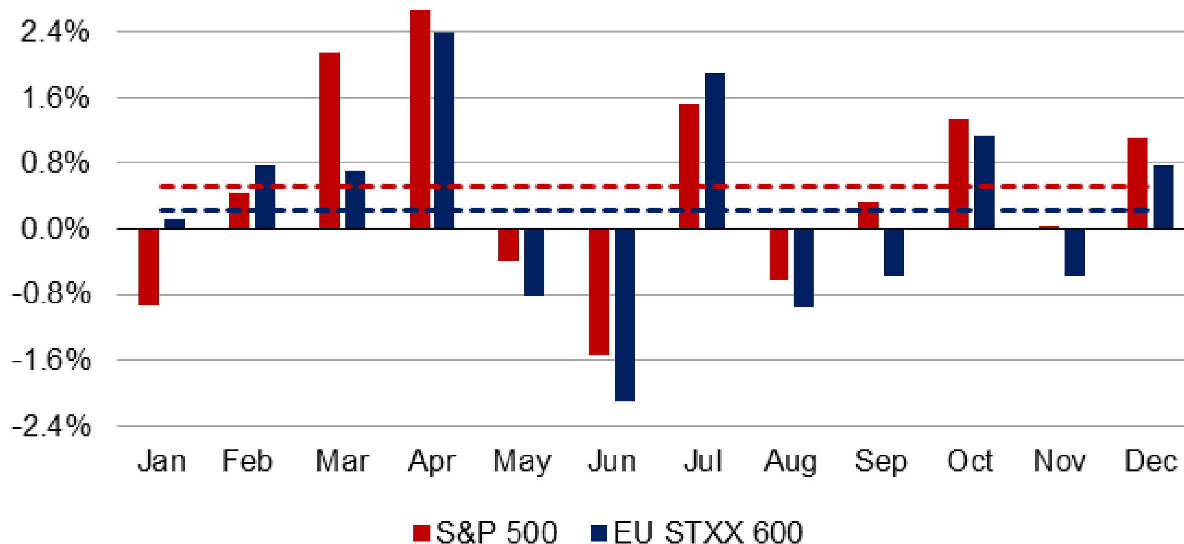
Is there a potential for a year-end rally in stocks?

Peter Szopo

From a technical point of view, the concept of a "year-end rally" is a myth. At least, this is what empirical evidence is telling us. In the past 10 years, the S&P 500, for example, posted a December performance, on average, of 1.12%, making December only the 5th-best month of the year (Fig.1). Over the entire period – from 2006 to 2015 – there was not a single year, in which December was the best performing month.

For the Stoxx Europe 600, the picture is similar. The average December performance from 2006 to 2015 was 0.77%, making December the 5th best month of the year in Europe as well. Only once during the past decade, in 2006, the December performance was higher than in any other month of the year.

Fig.1: Monthly performance (average 2006-2015)



Source: Bloomberg; Erste Asset Management

The fact that the empirical evidence does not support the notion of a “year-end rally” is no big surprise. That a year ends on the 31st of December according to the Gregorian calendar is one of the best-known facts in the world. If there was a better-than-random chance to profit from this event, financial markets would be grossly inefficient – which they are clearly not.

Near-term support for stocks

While there is clearly no pattern of regularly soaring markets towards year-end, the question what factors will drive equity markets in the near-term is fully understandable and legitimate. There are several positive developments that will likely support stocks in the next weeks:

- The ‘reflation trade’ – the bet that equity market will receive support from expansionary economic policies and a pick-up in inflation – is gaining momentum. This theme started evolving during summer but has gained traction as a result of the outcome of US election. While many details are still unknown about the next president’s economic program, the announced infrastructure program and tax cuts are estimated to add about 1% to US economic growth in 2017 and 2018. This and the intended protectionist measures will likely strengthen inflationary pressures.
- In addition to the improving economic outlook for 2017, also the current economic news flow is getting better across the developed world. Recently, the Citi Economic Surprise Indicators have moved into positive territory in the US, Europe and Japan.
- Corporate earnings could turn out to be another source of tailwinds for stocks. After a series of disappointing reporting seasons, third quarter interims both in the US and in Europe surprised on the upside and signaled that the earnings recession is coming to an end.
- Investors’ more constructive view on equities is also underpinned by sharply rising inflows into equity funds. According to Bank of America’s recent fund flow monitor (“Violent Rotation”, dated Nov 17), the week before saw the “largest equity inflows in 2 years ($28bn)” and the “biggest bond redemptions in 3½ years”.

Looming event risks

While improving fundamentals suggest that the overall market backdrop has turned more equity friendly, there are reasons to remain cautious, particularly in face of significant event risks both in Europe and in the US:

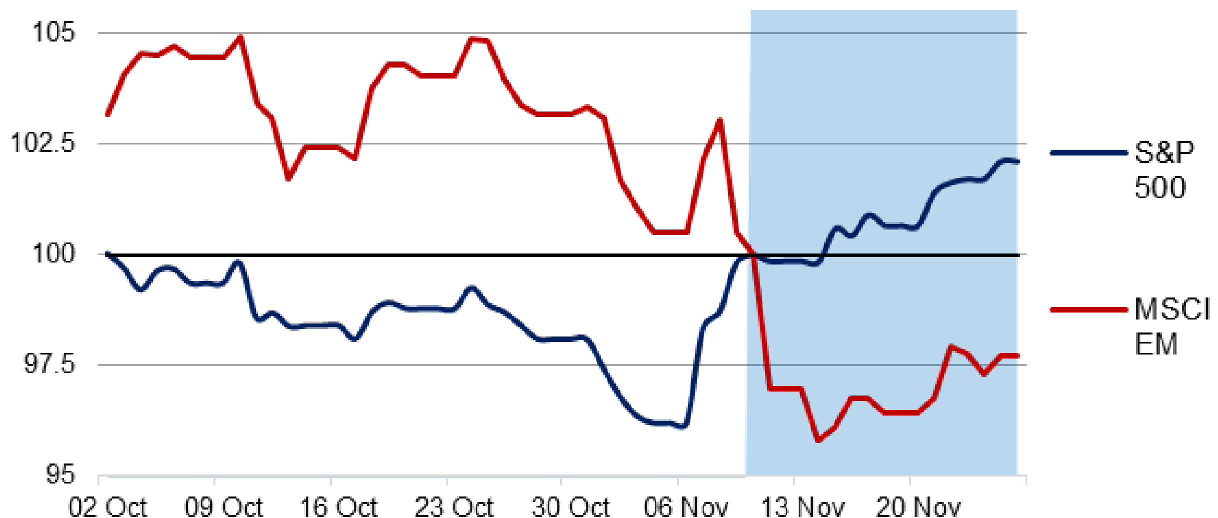
- In Europe, the Italian referendum on December 4 could have a market moving impact. It will likely both increase political uncertainty in Italy, and more importantly, fuel speculation of another Euro crisis in 2017. That said, the Brexit-example demonstrated that markets do not seem to be overly concerned about the longer-term implications of political events on the future of the “European project”. Italy will continue to struggle on, and the possible fallout on the future of the common currency will not be immediately noticeable.
- On December 14, the Federal Reserve Bank will most likely lift the interest rate by another 25 basis points. This has more or less been flagged by the Chairwoman Yellen and this is also what markets expect. The implied probability of a rate hike by the future market has climbed to 100%. Therefore, markets will not be surprised by the hike itself, particularly, when it comes together with strong activity data in the next 2-3 weeks. However, the Fed’s guidance for next year may still

surprise investors (too dovish or too hawkish, who knows), pushing up volatility.

- Finally, while the broad direction of Donald Trump's economic agenda is known, there are still many black holes regarding its details and timing and on personnel. US politics will have the potential to surprise investors for some time.

Source: Bloomberg, Erste Asset Management

Markets have already strongly responded to the new post-election pre-Trump environment. The main US equity indices have reached all-time highs, the US dollar is trading at 15 year highs and US treasury yields jumped almost 60 basis points relative to pre-election levels (Fig.2). The fact that implied equity volatility quickly has returned to pre-election levels – falling below 13 in the US and touching 20 in Europe – suggests that investors try to believe in the reflation scenario and are not overly concerned about the event-risks listed above.



Source: Bloomberg, Erste Asset Management

Regional differences

In light of recent trends and foreseeable event risks, the near-term outlook differs for various regions:

- While US stocks have benefited the most from the post-election rally (Fig.3), the positive momentum could continue until the end of the year. The recent rise in bond yields and the anticipated easing of financial regulation support US financials (approximately 15% of the market's total capitalization) the most. Moreover, US-companies will be the main beneficiaries from the anticipated increase of infrastructure spending and possibly also from tax-reform, although it will take months before the specifics of the new government's fiscal expansion will be known. Overall, risks for the US until year-end are

skewed to the upside.

- In Europe, key drivers will be the outcomes of a number of events in December. In addition to the Italian referendum mentioned above, the ECB meeting on December 8 will signal how committed the Central Bank still is to its “whatever it takes” position. And the presidential election in Austria, while not overly important in itself, may be seen as an indicator, how right-wing populism will perform in next year’s elections in the Netherlands, France and Germany. Overall, risks in Europe seem skewed to the downside.
- Emerging Markets (EM) have suffered after the election (Fig.3) and will likely stay under pressure longer term reflecting dollar strength and higher US bond yields as well as the threat of a more protectionist trade regime. That said, if Fed-chair Janet Yellen manages to combine a moderate rate hike with a dovish guidance for 2017, there is a chance of EM equities and currencies bouncing back after their post-Trump correction.

However, as interesting as it may be to speculate about the likelihood of a year-end rally or about the reasons, why we not get one, the more important issue is to comprehend how the world has changed during the past, say, 12 months. This will be the real challenge in 2017 and probably beyond.

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