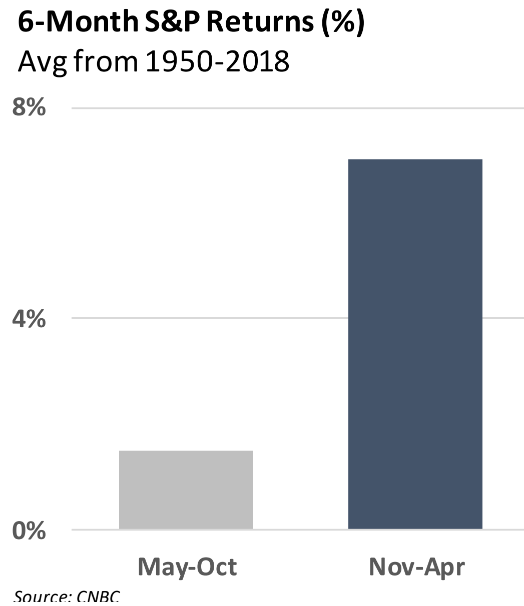
Graybill, Bartz & Associates, Ltd.

COMMENTARY

May 2019

"Sell in May and Go Away." It is one of the oldest adages on Wall Street, but what does it mean and what are the implications for investors? The phrase is thought to originate from a longer, old English saying, "Sell in May and go away, and come on back on St. Legers Day", referring to the custom of merchants and bankers leaving the City of London near the beginning of the summer for their vacation homes, and returning in time for the St. Leger's Day Stakes horserace in September. At this point, you are probably asking yourself: "what on Earth does this have to do with the stock market?" The saying reflects a historical trend showing that investing in stocks in the months between November 1 and April 30, and then moving into Treasuries for the next 6 months has generated remarkable returns. As you can see on the accompanying chart, the average 6-month return on the S&P 500 from 1950-2018 during the months between November and April has been about 7%, while the average 6-month return in the months between May and October has been 1.5%. No doubt, a powerful trend of outperformance. One leading explanation for the phenomenon, similar to that of Victorian England, is that the U.S business and investment communities prefer the beach to the office during the summer months, leading to lower levels of trading volumes. Given that markets tend to go up over time, less volume tends to mean less price appreciation over the long haul. Or so the theory goes.



Whatever the true explanation for the observed historical seasonal outperformance, and given the performance of the market during the first four months of the year, adopting the strategy seems more tempting than ever. The S&P 500 has now rallied 18% to start the year through the end of April, the best start to the year since 1987. The continued rally has been driven by strong news on both the corporate earnings and economic data fronts. The full numbers are not in yet for the first quarter earnings season, as about 70% of companies have reported, but investment bank Credit Suisse now expects to see cumulative earnings growth of about 2.5-3%. While not the strongest earnings growth seen in recent years, it has come as a huge sigh of relief, as the consensus expectation was for a decline of 3%. On the economic front, the initial report for Q1 GDP growth came in last week at 3.2%, a robust figure that topped consensus estimates of 2.5% growth. While subject to future revisions, this marked the best growth to start a year in four years. Not all was rosy in the report however, as the upside beat was driven by net trade and inventories, two categories that tend to be volatile quarter to quarter, and thus less of a confirmation of a sustainable uptrend. Bears interpreted the data to mean that the beat was transitory in nature, and focused on the personal spending data, which only grew 1.2%, suggesting that average consumer spending on everyday goods and services did not drive the growth.

While GDP and earnings data look healthy, recent inflation data has come in lower than expectations, keeping the Federal Reserve on pause. The markets have even begun to forecast that the next Fed interest rate move will be a cut and not a hike, a situation no one was predicting as recently as last autumn. This may turn out to be shortsighted, as at this point last year the general consensus was that inflation was getting too hot; now it is getting too cool. In reality, inflation has hovered above and below the key 2% mark at various times for the last decade without a decisive move in either direction. With the unemployment rate well below 4% and wage growth still above 3%, the inflation picture may change again in 2019, and take stock market sentiment with it.

Circling back to "Sell in May and Go Away", given the historical prevalence of the phenomenon and strong market returns to start the year, should we put the classic adage into action? Further digging into the numbers suggests that the strategy is not be as fruitful as it was at first glance. A study by CXO Advisory group found that over 140 years of data, the period from November-to-April did outperform the period from May-to-October, but that holding on to stocks during the entire year outperformed either buy-and-sell strategy. This outperformance is driven by factors not reflected in the numbers shown on the prior page: dividends and transaction costs. Every year that you sell your stocks in May, you are foregoing dividend payments you would have otherwise received and reinvested, you are paying commissions to sell your shares, and you are creating taxable gains that need to be paid to Uncle Sam. With all of these costs considered, the strategy no longer looks as appealing. It is a great reminder that market timing is a very difficult game to play, and that the superior strategy is to own a diversified portfolio of asset classes and to occasionally rebalance based on market and individual security fundamentals. At the end of the day, we will not be selling in May and going away, but we may be taking a more conservative stance after a long, uninterrupted rebound heading into the slower summer months.