Philequity Corner (November 19, 2007)
By Joseph Liao Ong

Will Santa come to town this Christmas?

After the stock market's vicious drops in the past weeks, people are wondering if there will be a Santa Claus rally?

The major stock indices (DJIA and S&P 500) are down more than 7 percent from their all-time highs as it appears we have yet to see the worst of the sub prime mortgage meltdown. In fact, Wall Street's largest banks and brokers are expected to write down as much as $70 billion this year on sub prime-related losses. On Friday, investors' doubts were further reinforced as Fannie Mae (the biggest home lender in the U.S.) went under fire over a new accounting methodology. This new method reportedly understates the company's potential losses from the growing mortgage crisis.

Perhaps, Santa came to town early. Ben Bernanke's decision to lower the Fed funds rate and the discount rate by 50 basis points two months ago was like a gift. It felt like Christmas in September as the stock market rallied strongly after falling sharply in August.

Rising volatility

Investors have never been more edgy during the past three years than now. In fact, volatility in the stock market as measured by the Volatility Index (VIX) has risen to its highest level since February 2003 as shown below. Also known as the "investors fear gauge," the VIX (main window) measures market expectations of near term stock volatility conveyed by S&P 500 index (middle pane).

VIX, S&P 500 & PSEi (2005 to present)

Source: www.stockcharts.com

Note the strong correlation of our own PSE index (bottom pane) with the S&P 500 index and the VIX. Every time there is a sharp rise in the VIX and the S&P 500 pulls back, there is also a pull-back in the PSE index. Similar to the DJIA and the S&P500, the PSE index is down more than 7 percent from its record high set in October.

Santa Claus Rally & the January Effect

Nevertheless, we are not discounting the so-called *Santa Claus Rally* and the *January effect* which often show that the months of December and January are seasonally strong months for stocks. We've written about these two years ago (see the Dec. 26, 2005 issue of The *Philippine Star*). Below, we show the updated table which we presented back then.

PSEi performance during December & January (1987 – 2006)

Year	Dec %Chg MoM	Jan (Year + 1) %Chg MoM	Dec-Jan Average
1987	17.5%	0.3%	8.9%
1988	15.2%	-0.4%	7.4%
1989	-16.2%	-5.0%	-10.6%
1990	5.0%	16.1%	10.6%
1991	5.9%	9.0%	7.5%
1992	-0.6%	6.7%	3.1%
1993	37.0%	-10.1%	13.5%
1994	3.5%	-13.1%	-4.8%
1995	6.2%	11.2%	8.7%
1996	2.6%	7.9%	5.3%
1997	5.5%	4.2%	4.9%
1998	-0.3%	-0.7%	-0.5%
1999	8.3%	-7.2%	0.6%
2000	6.4%	12.9%	9.7%
2001	3.5%	16.6%	10.1%
2002	-2.8%	3.8%	0.5%
2003	9.8%	4.6%	7.2%
2004	-0.4%	10.8%	5.2%
2005	-0.2%	2.3%	1.1%
2006	7.0%	8.6%	7.8%
Average	5.6%	3.9%	4.8%
No. of times w/ positive chg	14 out of 20	14 out of 20	17 out of 20
% of times w/ positive chg	70%	70%	85%

Source: Wealth Securities Research

As you can see, the month of December is normally favorable to stocks having gained an average of 5.6 percent for that month during the last 20 years. Looking back, 14 out of the last 20 Decembers (or 70 percent of the time) ended up positive for the month.

The following month of January likewise tends to be good for stocks, returning an average of 3.9 percent during the last 20 years. Also, 14 out of the last 20 Januarys (or 70 percent of the time) registered month-on-month gains.

Taking into account the combined December to January period, you will notice that 17 times during the last 20 years (or 85% of the time) the average return for those two months is positive.

Confusion in the markets

With the expectations of a year-end rally but in the face of rising volatility, investors are now confused on what to do. Again, we recommend that you go back to the basics of investing:

1) **Determine your investment horizon**. If you are investing only for the short-term, it may be advisable that you just stay on the sidelines, or else risk being whipsawed by the markets. However, if you have a long-term horizon (like us in Philequity), it is ok to ride out the volatility. In the long-term, stocks outperform bonds & cash.
2) **Review your risk profile**. If you are in cash, you would probably choose to invest in stocks at this point. However, if you are overextended, you would probably want to scale back to a level that you are comfortable with.
3) **Practice diversification and asset allocation**. These are investment strategies which we've already discussed in preceding articles.
4) **Do intensive research on the companies that you will be investing in**. Consider the earnings and growth prospects, credibility and integrity of the management, extent and possibility of dividends. Good companies (as long as it is properly managed) will grow on its own as the economy grows. As Warren Buffet said, "Buy the business and not the stock."

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