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GETTING TECHNICAL

What Ever Happened to the Winter Rally?

By MICHAEL KAHN | MORE ARTICLES BY AUTHOR

The economic crisis has trumped traditional strength in the cold months for the second year running.

ONE TOOL IN THE TOOLBOX of the chart reader is cycle analysis and one of the more familiar is the seasonal cycle. The old saw "sell in May and go away" is a direct reference to the typically weak summer months.

Right now, we are supposedly in the sweet spot of the cycle where the bulk of stock-market gains have been made over time. But unless something dramatic happens in the next few weeks, we are facing the second year in a row where the seasonal cycle has failed.

To get a flavor for how this cycle has misbehaved in recent years, we need only go back to 2007.

The Standard & Poor's 500 closed on April 30, 2007, at 1482. By Oct. 30, the S&P stood at 1531 for a net gain of 3.3%. While positive, it was not exactly a barn burner. But that is what we'd normally expect in the summertime.

On closer examination, we will see that the first news of the subprime crisis in August sent the index down to an intraday low of 1371 -- a temporary loss of 7.5% from the April close.

That sort of volatility and lack of primary trend is the type of behavior we should expect in the summertime. Sometimes these months are dead quiet, and sometimes they are a roller coaster. But the net result -- again, averaged over the decades -- is very little return for investors.

When October ended, the market had peaked. According to the seasonal cycle, that was exactly the opposite of what *should* have occurred. And all investors know what happened after that. Selling in May was an awesome strategy last year.

When the market made a tradable bottom in November, it looked as if the stronger winter months had returned. There was no illusion that a bull market was back, but the chance to make some money in stocks, at least in the short term, seemed real.

The party lasted six weeks until the worst January on record squashed thoughts of wintertime strength. The financial crisis overwhelmed seasonal factors.

I asked several colleagues what they thought about the seasonal cycle including the possibility that the cycle had inverted, or flipped over temporarily. While not common, it does occur when previously benign forces suddenly become very prominent.

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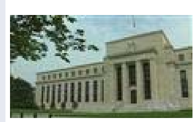
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Phil Erlanger, president of Phil Erlanger Research, disagreed. "The very definition of seasonality," he said, "is a cycle that measures fundamental factors that influence the price action of stocks at fixed intervals of time. If current price action deviates from its seasonal cycle, it is more likely that exogenous factors are overwhelming the standard seasonal factors."

Many hope that a bad winter will be followed by a better summer to somehow make up for it. Perhaps the thinking is some reversion to the mean in terms of long-term performance. But Erlanger debunked that idea, saying, "If a market behaves poorly during a strong seasonal period, the next weak seasonal period could have 'extra' weakness."

That is not good news.

To be sure, seasonal cycles are just tendencies for certain market behaviors and clearly there are no guarantees. And making seasonal analysis even less reliable is the nature of the current crisis.

Carl Swenlin of DecisionPoint.com argues that traditional technical indicators are really not worth much when the market is in such a state.

Could that be the silver lining? Expectations of continued weakness into the summer might be wrong? I'd say that is wishful thinking.

It is the use of technical indicators and traditional chart patterns that is under fire during such times. Price breakouts from chart patterns fail. Leadership in the market changes weekly. Traditional relationships, such as that between stocks and bonds, disappear.

While I remain optimistic than most that the market is in a trading range rather than at the precipice of a new leg lower, the latest failure of technical tools does curb my enthusiasm. Rather than see tradable rallies and declines within that trading range, it may be more realistic to expect the market to stay right where it is, give or take a few percent, as volatility fades and investors just give up.

And just when nobody is looking, stocks will start to recover.

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Michael Kahn, author of three books on technical analysis, former Chief Technical Analyst for BridgeNews and former director for the Market Technicians Association, also blogs at www.quicktakespro.com/blog.

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