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Unpacking the January Effect

Sometimes it is said that there are no free lunches on markets. Proponents of the efficient market hypothesis (EMH) purport that prices change immediately to reflect all publicly available information. However, certain tradable anomalies have been identified throughout the years that question this assumption. One of these concerns the current calendar month... The January Effect.

The January Effect is the belief that the stock market tends to go up in January more than any other month. This phenomenon was first identified in 1942 by an investment banker who studied returns going back to 1925. Researchers confirmed this theory over the years in US stocks, other asset classes, and on other international markets. While there's no assurance that this theory will always hold up, it is surprising to see this sort of recurring pattern in markets that are considered to be generally efficient.

Several explanations have been offered up for the existence of this effect.

The first is that it is the result of efforts to maximise tax-adjusted performance. In the US, it is quite common that investors sell their losing stocks in December in that they can use those crystallised losses to offset or reduce capital gains tax liabilities. If they believe in the long-term prospects of the stock, they will likely then buy it back in January, leading to a surge in buying pressure. While some researchers have confirmed this theory, it does not wholly account for the January Effect. That's because the anomaly has also been observed in countries where the fiscal year doesn't end in December, or in those where there are no capital gains taxes.

Another possible reason is that employees receive bonuses in January for the prior year, which they decide to put to work on the stock market. However, retail investors are unlikely to be able to move the market to such a degree.

This leads to a third plausible explanation: window dressing. As the end of the year draws closer, professional asset managers might be more likely to rebalance their portfolios, discarding speculative or losing stocks that could appear unpalatable to clients in annual reporting. This puts downward pressure on prices late December, before some form of rebound plays out in January when the selling pressure eases.

Lastly, proponents of behavioral finance might argue that the effect is down to psychology. Acknowledging that we are not cold, hard utility maximisers as the EMH implies, and rather, that we are humans, often driven by our moods and emotions, it could be that the January Effect is simply the optimism that the new year brings manifesting itself on markets. It could be that investors start the year with a renewed sense of determination and opportunity, with fresh trading resolutions and objectives.

Another interesting oddity to point out is the "January Barometer". Some studies have found that January has had some predictive power for overall market returns for the year. When January is a down month, it does not augur well for stocks in the year ahead and vice versa. This held true in 2022, and thus far, we could say it might bode well for 2023.

While it is interesting to note these small market curiosities, we would like to remind you that they are not always consistent, especially in more developed markets, which are considered more efficient. This is why we come back to the advice we always provide to our clients: it is often futile to try to anticipate market developments. The best strategy is often to invest with a long-term investment horizon, avoiding costly round trips, both in terms of costs and performance.

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