

## As Goes January

The toughest part of being a market analyst is being right. It only takes a few well-publicized correct calls, some of which may have been arrived at in a less-than elegant manner, to get labeled a "guru." Then the pressure to keep on being right intensifies, and inevitably you will make a spectacularly bad call. Most readers can name two or three such fallen angels rather quickly.

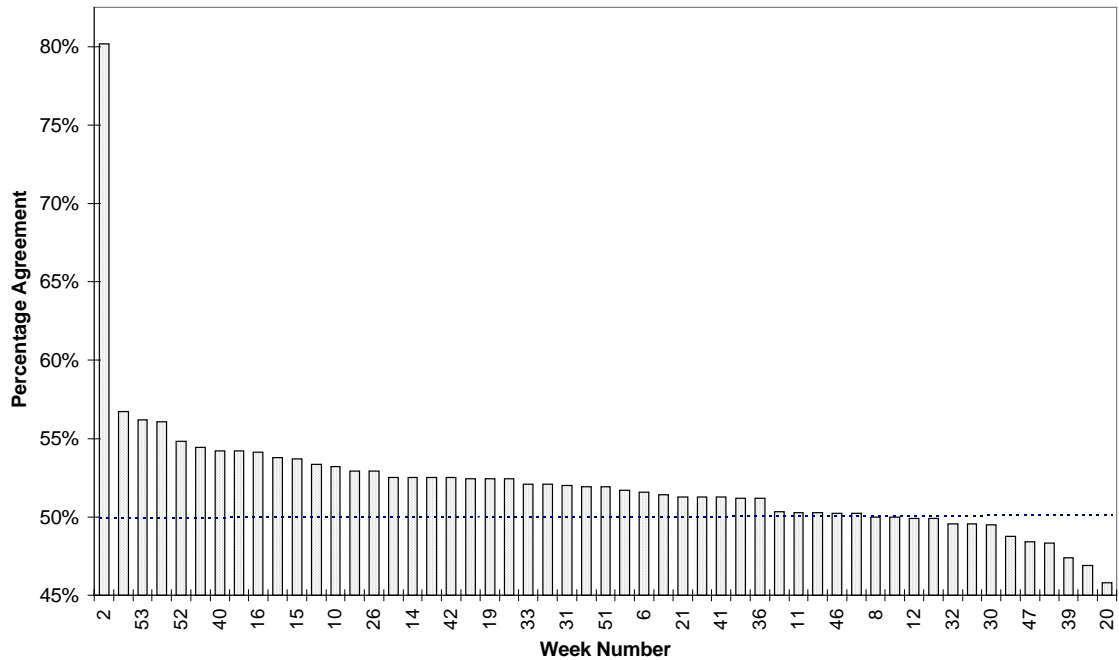
Your loyal correspondent's phone rang on January 8, 1998, the end of the fifth trading day of 1998. The stock market was in negative territory for the year at the time, with Indonesia being the culprit-du-jour, and the question was asked: Does this mean that 1998 will be a down year? Statistics from the redoubtable Yale Hirsch, author of the *Stock Trader's Almanac*, had shown that the first five days of the year predicted the year's outcome with a 72% accuracy rate.

A fascinating little factoid, to be sure, but it begged the question as to whether other weeks had an even higher or lower correlation with the ultimate outcome of the year's festivities. After engaging the reporter in the usual banter in which the most accurate prediction of 1998 was made, "This is going to be a choppy year, the kind that can make both bulls and bears unhappy," a promise was made to the reporter that the question of what week had the highest correlation with the year's ultimate outcome would be answered once and for all.

The test would be simple. Weekly data for the S&P 500 cash index over the 1929-1997 period would be ranked, by week number, to how often that week number's change matched the change for the year. The weekly change was defined as Friday-to-Friday, and the week number was defined as the number of that week's Sunday; this created 53 weeks. The data for 1947, which finished exactly unchanged, was eliminated.

One should expect the correlation between weekly change and the ultimate annual change to be random. This assumption is correct for every week but one: the week following the second Sunday of the year, which had an 80.2% correlation with the annual change, well in line with Hirsch's data for the first five days. Nothing else was even close, not even the first week, whose correlation was only 56.1%.

**Concurrence Of Weekly Change With Annual Change  
S&P 500 Cash Index, 1929-1997**



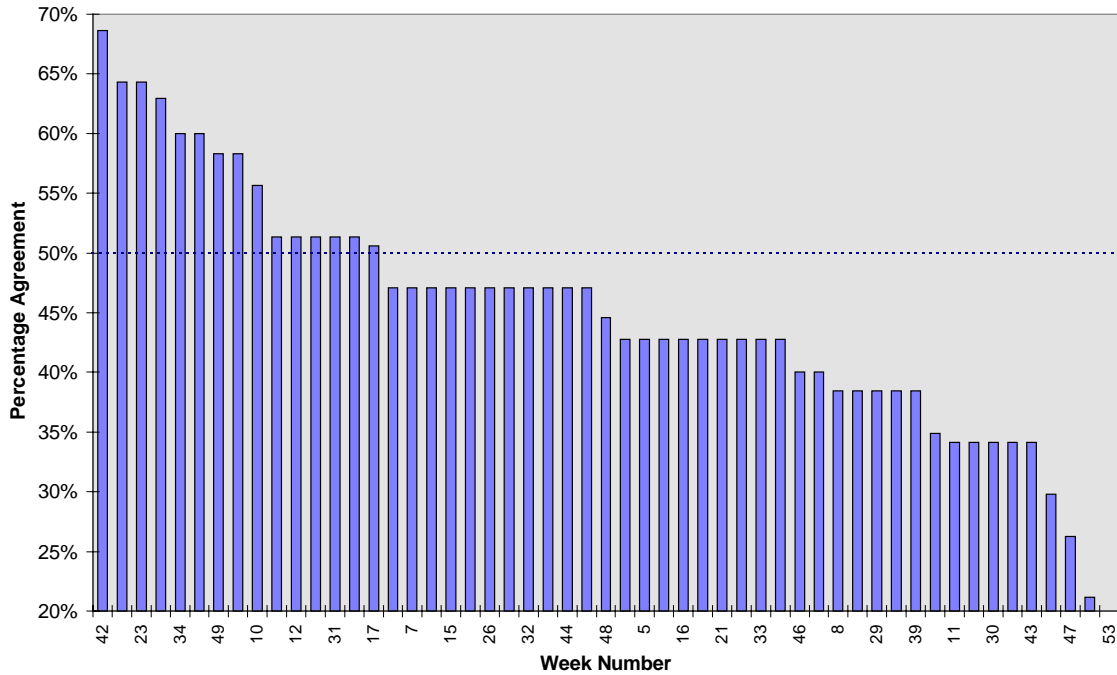
Can this mysterious phenomenon be explained by someone not named “Geraldo?” The long-term trend of the stock market is higher, and can be categorized as a Brownian motion process with a positive drift. The early part of the year is characterized by strong new investment from bonus payments, bond coupon payments, New Year’s resolutions, and tax-related investment decisions. This massive fund inflow tends to move prices higher, matching the long-term trend of the market.

Still, there is something unsatisfying in this relationship. Since it depends upon just one week, and since that week is so early in the year, it forecloses opportunities for further discussion for the rest of the year. What would CNBC do for the remainder of the year, digitally splice Maria Bartiromo into reruns of Gilligan’s Island?

Fortunately, we have a better indicator for how the year will end, the oats/notes spread (see “A Modest Proposal, *Futures*, January 1997, or “Hedgers Don’t Wear Chains,” *Futures*, January 1998). The oats/notes spread is calculated by subtracting the spot month of the Ten-year notes contract from the spot month of the oats contract. No more, no less.

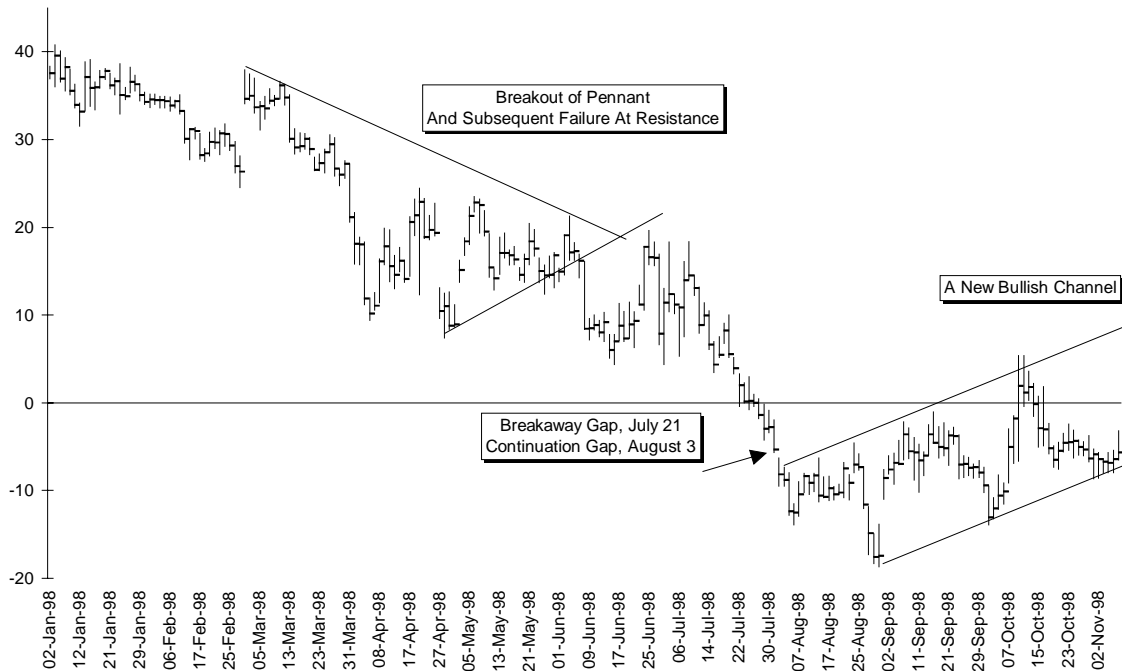
While nothing in the much shorter history of the oats/notes spread, which begins in 1983, can reproduce the gaudy 80.2% correlation of the S&P 500’s second week, it does have a total of six weeks with 60% or greater correlation and a whopping 17 weeks with 40% or less correlation; this last statistic is important since a reliable negative indicator is just as valuable as a reliable positive indicator. The verdict is clear: While only one week for the S&P 500’s own history is reliable as a predictor of the year’s ultimate change, twenty-three weeks of oats/notes could win you a few barroom bets.

**Concurrence Of Weekly Change In Oats/Notes With  
Annual Change In S&P 500, 1983-1997**



But wait, there's more! The 1997 performance of the oats/notes spread in calling the one-day ultra-crash of October 27, 1997 is not an isolated instance. The performance this year is astounding enough in its forecasting ability for the S&P 500 to be accorded, by self-proclamation, this column's first annual Abby Award. How so? Even as the S&P 500 was soaring to new heights during the first two months of 1998, the oats/notes spread was dormant. Then, it entered a prolonged pennant-shaped consolidation formation from early March through mid-June, a period which led the S&P 500's April-June consolidation by at least one month. The spread broke out of its consolidation to the downside by early July, which the stock market was still moving higher, failed at the pennant's lower trendline, and then went south. The spread gapped lower on July 21, the day after the S&P hit its high, and then had a continuation gap downward on August 3. These moves called the crash of late August early by one month. The low for the year was hit on August 28, one day ahead of the first bottom of the 1998 bear market.

## Oats/Notes: Miracle Or Marvel?



Is the oats/notes spread merely a bear market indicator, a quantitative Cassandra? No, it forecasts upturns as well. On both September 11<sup>th</sup> and October 1<sup>st</sup>, it held a rising trend line from the August 28<sup>th</sup> low. This new bull market channel has held quite nicely through the strong rally in the S&P 500 through the first week of November 1998.

Stock market investing has become a national obsession, perhaps dangerously so: Historically, periods of such passion coincide with market peaks. Those of us old enough to remember the 1970s recall similar passions for real estate, tangible commodities, and hairdos and fashions that, in all fairness, only can be described as hideous. One characteristic of any boom is that it spawns too many pundits and prognosticators whose methods are based upon little more than some lucky guesses, unwillingness to alter opinions in the face of evidence, and models based upon spurious correlation.

The oats/notes spread, unlike most technical indicators, has some solid fundamentals behind it. The lower grain prices seen throughout 1998 were symptomatic of the global deflationary pressures that drove the CRB index down to twenty-year lows by late August. The lower interest rates produced by this move and a spectacular flight-to-quality pushed bond prices up to 1960s-type levels. Together, these two forces influence the discounted rate of profit growth, the only true fundamental behind equity prices. Until a better indicator arrives, the second annual Abby award will remain with oats/notes.