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Why we are not 'Selling in May'

'Sell in May and go away' is an old market adage that has considerable basis in fact. Over the past 63 years, the average six-month price gain for the S&P 500 from May 1^{st} through October 31^{st} was 0.7%, compared to 6.6% from November through April (based on data from Ned Davis Research). The catch is that one-third of the time, May-October returns beat November-April returns. We expect the 39% annualized returns from last November to far exceed the returns over the next six months (see Weekly Chart), but our judgment is that the short-term downside risks to stocks do not justify the challenge of trying to time a tactical move to cash or short-term bonds. Our reasons are as follows:

Fundamentally, the Federal Reserve, the European Central Bank and now the Bank of Japan are committed to *open-ended* monetary stimulus, whereas all three of the Fed's previous quantitative easing programs had ending points. Unlike 2010, '11 and '12, the US housing market is booming, consumer wealth is at an all-time high, and unemployment is falling. Additionally, more S&P 500 companies have beaten first-quarter earnings estimates than in the past seven quarters based on our gauge of earnings surprises, which compares actual earnings with the consensus estimate six months prior to the report date.

Technically, stocks continue to act well – the S&P 500 successfully broke out above two previous major bull market peaks and its primary trend (we use the 200-day moving average) is steepening. Finally, US stock ownership is at record lows (according to a Gallop poll) – only 52% of adults are invested in individual stocks, stock market mutual funds, or in a self-directed retirement plan. We believe low levels of stock ownership represents potential buying support over the next few years as investors recognize the low return potential of fixed income assets.

China's new leadership takes a 'slow boat' to a more balanced economy. We believe China's new leadership is more cautious and more focused on gradual long-term structural reform than their predecessors. In a world starved of growth, we would like to see reforms proceed more clearly and assertively, and China's significant savings pool spent on productive infrastructure investment, but this is not the tone we detect. Following the 2008-2009 global financial crisis, China countered the global recession with massive infrastructure spending and property development. In hindsight, most of this investment proved wasteful, and its consequences – property bubbles and bad debts – now challenge the new leadership. It did, however, tremendously boost short-term domestic demand for both China and the companies that supply her raw materials. To illustrate the magnitude and impact, the S&P Metals and Mining index, which lost 75% of its value in the last half of 2008, regained most of those losses by the summer of 2011.

China's leaders have long recognized the need for rebalancing the economy towards consumption, but the trade-off in terms of lower growth, more open markets, and an appreciating currency have caused much internal debate. Based on their actions and statements, the current leadership seems to believe the investment-led development path that had heretofore powered China's decade of double-digit growth is increasingly counterproductive and they have been emphasizing 7.5% growth as the new norm. On May 6th Premier Li Keqiang announced his reform objectives for 2013. Relative to previous years, we see more emphasis on industry deregulation (less red tape), greater transparency in government to reduce corruption, increased risk control of local government debt, continuing gradual currency and interest rate liberalization, and improvement in the social safety net (healthcare reform and planned urbanization). All of these, ***if implemented***, are to be lauded. Furthermore we think the widening of the yuan's trading bands against the US dollar, which has allowed China's currency to appreciate 2% since February, shows that on one front the leadership is willing to follow its words with actions. Liberalization of internal migration will be another test of the new leaderships' sincerity. Currently, migrant workers have to register in the cities in which they live and are denied access to basic social services; this is called the Hukou system. As a result, migrant worker savings tend to be higher than they normally would be otherwise. Goldman Sachs estimates that "effective Hukou reform could boost urban household consumption by 3-5 percentage points of GDP."

We expect China's economy, which is now about 11% of global GDP, to grow at a mid- to high-single-digit pace, driven increasingly by domestic consumption. This is good news for global economic growth; and especially for consumer-oriented multinational firms with sales in China, but not good for the commodity-sensitive companies that benefited from excessive infrastructure spending. We continue to position our portfolios to reflect this change.

THE WEEKLY CHART: A HEALTHY TECHNICAL PICTURE BUT AN UNSUSTAINABLE TREND

Source: RiverFront Investment Group; Standard & Poor's; Past performance is no guarantee of future results.

As we wrote two weeks ago, we expect stocks to have a period of consolidation or a modest pullback even as we think they will end the year higher. The 39% annualized pace of the S&P 500's rally from its November lows (blue trendline in the chart) is unsustainable in our view – at that rate the S&P 500 would end the year at about 2000, and we do not think stocks could return 40% in a year in which economic growth is so painfully slow. With the S&P 500 up more than 3% over the past two weeks, our expected support levels in the event of a pullback have risen. Our initial level of support is now 1565, the 23.6% retracement of the rally from November's lows, the four-week consolidation zone that began in mid-March, and the previous 2007 record high. Below that, we see strong support at 1525 (the 38.2% retracement and the 2000 bull market peak).