What is wrong with the January Effect this year?

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Investors around the world anticipate the month of January with excitement. This is because January tends to be, on average, a strong month for stocks, particularly those of smaller companies.

However, the key words are “on average.” In many years, the so-called “January effect” does not happen and in fact sometimes the stock market experiences a pronounced negative return.

January’s stock-market performance, in my opinion, depends a lot on how the year ahead is expected to unfold. Increased profit expectations from quarter to quarter and a steepening of the yield curve – when spreads widen between long-term and short-term Treasury yields – both signal healthy economic expectations and relate to positive January returns. By contrast, weakening of profit expectations and a flattening of the yield curve are associated with a negative January.

Something rather unusual, however, has been happening this month. Equity markets have been under selling pressure, even though profit expectations are rising and the yield curve is steepening.

What could explain this?

First, let me explain more about the “January effect.”

The high average returns on risky securities in January are caused, in my opinion, by systematic shifts in the portfolio holdings of professional portfolio managers who rebalance their portfolios to affect performance-based remuneration. Institutional investors are net buyers of risky securities in January when they are motivated to include less-known, high-risk securities in their portfolios and are trying to outperform benchmarks.

Later on in the year, portfolio managers lock in returns by divesting from lesser-known, risky stocks and replace them with well-known and less-risky stocks or risk-free securities, such as government bonds. Such behaviour affects prices and security returns in a predictable way. Risky stocks and high-risk bonds are bid up early on in the year and down later on in the year, whereas low-risk stocks and risk-free bonds exhibit the opposite behaviour – down early in the year and up later. On average, such behaviour causes the "January effect" – and it's equally true for both U.S. and Canadian stocks.

However, my research shows that the strength in risky securities in January largely depends on what institutional investors think of the year ahead. A positive "January" is mainly observed when there are no recession or bear market expectations in January. This is normally the case when quarterly profits are increasing and the yield curve is becoming steeper.

In recessions or bear markets, a positive January effect is largely absent. In fact, when quarterly profits are declining and the yield curve is becoming flatter – a signal of economic contraction – a negative January effect is observed. This is because portfolio managers do not invest in risky securities indiscriminately, irrespective of whether the year is expected to be a bull or bear market and irrespective of whether the year is expected to be a recovery year or a recessionary year. Portfolio managers invest in risky securities when the year ahead is expected to be a good one and withhold their investment from such securities when the year ahead is forecast to be adverse.

I examined Canadian stock returns in January from 1957 to 2012 and found that returns are often pronounced in either direction. The January return for an equally weighted basket of Canadian stocks in a down market was, on average, -4.2 per cent. In an up market, the average January return for the equally weighted index was 7.15 per cent.

Now, to the present. Two key market-driven expectations do not square with the negative January effect we have been experiencing thus far.

First, quarterly S&P 500 earnings per share are forecast to rise by about 2 per cent in the first quarter from the previous quarter, then by 6.1 per cent in the second,

followed by a gain of 6.5 per cent in the third and 3.6 per cent in the final quarter of 2025.

Annually, S&P 500 earnings per share are forecast to increase by 13 per cent in 2025 after rising by 10 per cent in 2024. There is no profit recession in anyone's book.

Second, the spread between the 10-year Treasury bond yield and the one-year Treasury bill (the part of the yield curve I look most closely at) has turned positive. In June of last year, the 10-year yield was 54 basis points below that of the one-year – it was inverted, which is often a sign of a looming recession. However, as of this month, the 10-year Treasury is 48 basis points above the one-year.

One explanation could be that markets and sell-side analysts are ahead of themselves when it comes to expectations of higher inflation and productivity gains propelled by AI developments. Maybe the smart money – institutional investors – are anticipating the 10-year Treasury yield will once again drop below the one-year yield, and profit expectations will soon start to moderate or turn negative as the year drags on.

If we continue to see a pullback in markets this month, expect some negative surprises for interest rates and profits in the year ahead.

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