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Very Good Years Tend to Get Better

Cullen O. Roche
Founder
Orcam Financial Group, LLC
cullenroche@orcamgroup.com

The S&P 500 is now up 24% year to date. This might sound crazy, but since 1928 that's actually occurred 24 times. That's roughly 28% of the time. That's a big number when one considers that the nominal return on the S&P 500 is about 9.5% per year. But what's crazy about 2013 is not that the market is up substantially, but that it's been a near straight shot to this point.

Since 1928 the S&P 500 has had a monthly standard deviation of 16. But this year, the monthly standard deviation is just 10. That means we're operating at almost three times the average return with almost 40% less volatility than usual. In other words, it's been almost impossible to feel stupid this year if you've been overweight stocks.

What's even crazier about this year is that US Treasury bonds have had a standard deviation of 12.8 while on their way to a –9% return. They've been more volatile than stocks and underperformed by 33%. That's compared to a historical standard deviation of 7.7 and an average nominal return of 5.4% since 1928.

We've entered a bizarre world where things have been truly flipped upside down. But the contrarian in me can't ignore the historical data. When we look at the last two months of the year the data doesn't lie. According to Scott Krisiloff of Avondale Capital good years tend to turn into spectacul years. He notes:

"Below is a list of all the times that the S&P 500 has been risen by more than 10% in the first 10 months of the year….

Long story short—
Don't Fight the Trend.

On average the index has risen by another 4.5% over the final two months. Of the 24 times that this has happened, the index has only fallen in three years, and in those years it has never fallen by more than 70 bps. On the other hand there have also been some monster finishes within the data. In 1985 and 1998 the index was up by more than 11% in the final two months.

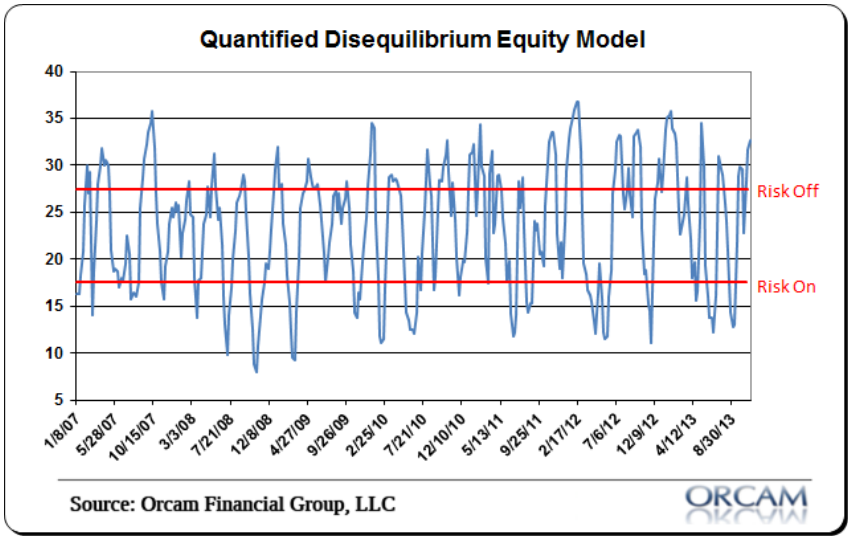
Even more amazing, if the year ended right now, 2013 would be only the 11th best year in S&P 500 history. However it's already in 5th place for best first 10 months. Considering how well the index did in other years with this pace, we can't rule out the possibility of a 30% increase in 2013!"

Year	First 10 Months	Last Two Months	November	December	Full Year
1975	29.9%	1.3%	2.5%	-1.2%	31.5%
1958	28.4%	7.6%	2.2%	5.2%	38.1%
1995	26.6%	5.9%	4.1%	1.7%	34.1%
1997	23.5%	6.1%	4.5%	1.6%	31.0%
2013	23.2%				
1989	22.6%	3.8%	1.7%	2.1%	27.3%
2003	19.4%	5.8%	0.7%	5.1%	26.4%
1991	18.8%	6.3%	-4.4%	11.2%	26.3%
1980	18.1%	6.5%	10.2%	-3.4%	25.8%
1961	18.1%	4.3%	3.9%	0.3%	23.1%
1963	17.3%	1.4%	-1.1%	2.4%	18.9%
1967	16.9%	2.7%	0.1%	2.6%	20.1%
1983	16.3%	0.8%	1.7%	-0.9%	17.3%
1986	15.5%	-0.7%	2.1%	-2.8%	14.6%
2009	14.7%	7.6%	5.7%	1.8%	23.5%
1996	14.5%	5.0%	7.3%	-2.2%	20.3%
1976	14.1%	4.4%	-0.8%	5.2%	19.1%
1985	13.5%	11.3%	6.5%	4.5%	26.3%
1998	13.2%	11.9%	5.9%	5.6%	26.7%
1964	13.1%	-0.1%	-0.5%	0.4%	13.0%
1988	12.9%	-0.4%	-1.9%	1.5%	12.4%
2012	12.3%	1.0%	0.3%	0.7%	13.4%
1999	10.9%	7.8%	1.9%	5.8%	19.5%
2006	10.4%	2.9%	1.6%	1.3%	13.6%
Average		4.5%	2.4%	2.1%	

That's an amazing statistic. And while the past doesn't repeat it certainly does tend to rhyme. Animal spirits appear to have gripped the markets by the throat at present and the idea that QE will continue along with continued modest economic expansion has market participants excited. In addition, this is the time of year when we tend to see money managers eagerly buying all the dips trying to play catch-up with their various benchmarks. The biggest risk to money managers at this time of year is not absolute performance, but the relative risk of underperforming their benchmark.

It might be tempting to get short or bearish into the year-end, but this is a notoriously tough time to be bearish on the market. My tactical indicators are still pointing to caution so I would remain somewhat cautious here on the long side, but I would definitely be hesitant about getting too negative on the market. The history of the market doesn't bode well for the bears in the last two months so this irrational feeling market has the potential to continue for the remainder of the year.

It’s my guess that 2014 will be filled with more worries about the sustainability of economic growth as well as worries over the end of QE. But we’ll cross that bridge as the new year comes around.



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