ARGUS®

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Dodging the June Swoon Could Be Key to Avoiding Summer Bummer

The stock market is in quiet waters, drifting higher on the wisps of a successful 1Q earnings season and solid if unspectacular economic data. With the hubbub in Washington seemingly dying down, investors are positioning for the calendar 2Q17 EPS season, which should get going in earnest in mid-July. By early August, investors will be itching to get on with their first real vacation in two years, given that summer 2016 was consumed by one of the most surprising and vituperative election seasons in memory.

On that basis, we would like to see a solid 2Q EPS season and an appropriately positive market response before the real summer doldrums set in. As investors await a second straight promising earnings season, June's fairly good market performance has gone unremarked. We think it is worth looking at, given that prior solid Junes have prefigured better-than-average full years for the stock market.

THE MOON (AND THE MARKET) IN JUNE

On average, June is not a very good market month. Since 1980, the S&P 500 has averaged a dead flat performance in June (excluding dividends). Also since 1980, the S&P 500 has averaged full-year capital appreciation (again excluding dividends) of 9.8%. Not to be daunted, the stock market uses its "good" months – which include March, April, October, November and December – to build outsized gains that overcome flat months such as June and out-and-out bad months such as September.

Both June and September fall within the summer dead zone memorialized in the "Sell in May" meme. There is, of course, lots of variation in June performance, and 2017 is turning out to be a good example of that variation. With just a few trading days left in June 2017 (as we went to press), June 2017 had recorded approximately 1.2% capital appreciation on the S&P 500.

We decided to look at full-year performance in those years in which June did better than 1% appreciation on the S&P 500. It turns out those are better than average years. We counted 14 times over the past 37 years (sine 1980) in which the S&P 500 appreciated more than 1% in June. For those years, the S&P 500 averaged capital appreciation of 17.2%, or 740 basis points better than the average for all years from 1980 to 2016.

In 10 of those 14 years, June was actually up 2% or more on the S&P 500. Average performance for those 10 full years was also 17.2%, no better than the average performance for 1%-plus June years. Only once between 1980 and 2016 did the S&P 500 rise more than 1% in June, yet the full-year return was negative. That was in the internet implosion year of 2000, in which June was up 2.4% but the index declined 10.1% for the full year.

Given that we have identified September as another troublesome month – in fact since 1980 it is the worst month on the S&P 500 – we also examined how the stock market fared in years with positive Septembers. The market does pretty well, it turns out, when September is up 1% or more, averaging a 20.3% full-year gain. And, in the seven years since 1980 in which both June and September gain at least 1%, the S&P 500 averages full-year capital appreciation of 17.2%.

Finally, the entire "Sell in May" period – which we identify as spanning June 1 to September 30 – has averaged a gain of just 0.9% on the S&P 500 since 1980. That is a pretty meagre four-month return. But for the 12 years since 1980 in which the four-month "sell in May" summer span generated at least 5% capital appreciation, the S&P 500 has averaged a full-year return of 18.8%.

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EPS SEASON COULD KEEP THE GOOD VIBRATIONS HAPPENIN'

Once July gets going, investors' focus will become a lot more granular than on overall monthly performance. Calendar 2Q17 earnings will be a trickle in the trading week beginning 7/3/17; will pick up to garden-hose strength with the big bank reports in the 7/10/17 trading week; and will turn into a firehose in the week beginning Monday 7/17/17.

For calendar 2Q17, Argus is forecasting growth of about 13% for S&P 500 earnings from continuing operations. We believe stocks will be energized by 2Q17 earnings, which should represent the first positive annual comparison for any 2Q since the second quarter of 2Q14. We note that 2Q14 was also the last time, up until 1Q17, that earnings grew in double digits year-over-year for any calendar quarter.

Standard & Poor's performs its own quarterly EPS growth calculation, including by sector. According to S&P, the sectors with the strongest annual EPS growth forecasts for 2Q17 (excluding Energy) include Information Technology, Financial Services, and Healthcare. Energy is likely to rebound sharply from a negative number in 2Q16, but will still be a relatively small contributor to absolute earnings for the quarter.

Of the three sectors, only Healthcare is considered defensive – and that characterization is arguably out of date, given sensitivity of consumer healthcare utilization to elective procedures and life-style medicines. Healthcare and Technology have led the market in 2017, with both sectors up over 17% (as measured by iShares sector ETFs). Strong EPS growth for these market-leading sectors is important, as it should prevent valuations as measured by PEG and PEGY from getting too stretched out.

CONCLUSION

The S&P 500 was up about 9% on a capital appreciation basis and up about 10.2% on a total return basis just ahead of the mid-year 2017 mark. Based on average full-year returns on the S&P 500 since 1980, the market in 2017 has almost achieved its full-year objective. The goal for the remainder of the year will be to at least sustain the year-to-date gain and hopefully build on it.

A strong EPS season might provide the market with enough tailwind to tack on a few percentage points more gain. Those could be vital chips as the year progresses, particularly if consumer and industrial economy data fail to recover from early-summer softness; easy earnings comps begin to roll off and EPS growth slows; and President Trump's agenda remains stalled by GOP infighting. In that case, we could see the bullish mood turn sour, prompting investors to take their winnings off the table.

We continue to believe the earnings environment is positive and that the global economy remains healthy enough to support solid economic growth. Washington remains a sideshow to the market, in our view. We would continue to use any periods of uncertainty and retrenchment to establish or add to positions in blue-chip industry leaders.

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