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FQ INSIGHT:

January 2015: A Big Month for Momentum

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January 2015 was a blockbuster month for price momentum.[1] This was something of a surprise because momentum tends not to perform well in January as many investors are more interested in hunting for bargains at the beginning of the year. This year, however, the dramatic fall in the price of oil, combined with European quantitative easing, created powerful macro forces that overwhelmed normal seasonal behavior. In this note, we highlight features of the momentum rally, examine potential causes, and discuss portfolio positioning and our outlook for momentum.

Top style performance in January across sectors, countries, and regions

The return to price momentum was strongly positive in January across a great many sectors and countries. The magnitude of the monthly return was unusually high in the top 90% to 95% of observations for the US. It was also exceptionally pervasive, with momentum among the top performing factors within many sectors and across most countries and regions. Momentum did well in both large capitalization stocks and small caps, within value and growth universes, and in developed as well as emerging markets.

Major contributors were weak returns in energy, materials, and banks/ insurance, and strong performance from REITS

Important contributions to the outsized momentum return reflected macro themes. Energy stocks continued their downward spiral, and the weakest performers within the sector from the past year slid much further in January than the better Energy stocks (which were still down in absolute terms). Stocks in the Materials and Processing sector mirrored the behavior of Energy stocks – momentum did well, mostly by shorting the worst stocks in what was, broadly, a weak sector. In the US, momentum generated its strongest within-sector performance in Financials. The momentum factor was long REITs, which did well as investors chased stocks with high dividend yields, and was short Banks and Insurers, which suffered.

Ability to short added significant value in January

Much of the action in momentum was on the short side. Weak energy prices reduced earnings expectations for energy producers and those companies that service them. The vast majority of energy companies were losers; the question was, to what degree? For Materials and Processing, four of the five momentum-sorted stock quintiles had negative returns. Not all investors are able or willing to short, and momentum also worked for long-only investors, but the gains were smaller.

Macro themes are key drivers

It is clear that the drivers for much of January's momentum return were macro themes. In particular, declining energy prices

Past performance is no guarantee of future results. Potential for profit is accompanied by possibility of loss.

and deflationary concerns were responsible for most of the momentum return in the Energy and Materials and Processing sectors. Quantitative easing and deflationary concerns also drove some of momentum's strong return in Financials. The strong US dollar also probably contributed to momentum. Going forward, these themes are likely to persist, but perhaps to a lesser extent.

Portfolio positioning and outlook

Momentum is one of the core factors in our investment process. Portfolios usually have some exposure to it, and the extent of exposure varies dynamically, driven by our outlook. Since the third quarter of 2014, portfolios have had more exposure to momentum than usual. This has been driven by benign and stable conditions in the US market and economy as such conditions are generally supportive for price momentum.

Economic conditions are still benign, at least in the US, but the potential for market turmoil has increased. Moreover, the riskiness of the momentum factor itself has increased substantially. For these reasons, we have reduced momentum exposure in portfolios from an elevated level down to an average level.

We are monitoring the behavior of price momentum closely. After such extreme macro moves and stock returns, a moderate reversal is plausible; indeed, there has been an upward bounce in the oil price. Up to now, the increase in macro volatility has raised the volatility of the stocks directly affected, such as Energy stocks. Broad market volatility has increased only moderately. If that should change, however, and index volatility increases substantially, that would warrant a fresh look at momentum, and possibly further reductions in momentum exposure in portfolios.

Endnotes

[1]We are referring to the 'long-term' price momentum factor, using total return for the first 11 of the last 12 months. We sort all the stocks in the universe by this return, go long the equal-weighted top quintile and short the bottom quintile.

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