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January effect may set markets' tone for New Year

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CHARLOTTE, N.C. (AP) - The stock market faces a big test as 2010 trading gets under way: whether its performance will be lifted by the phenomenon known as the January effect, or squelched by uncertainty about the economy.

The January effect is the buying blip that often occurs with the start of a new tax year. Investors who sold stock before the end of the old year to claim a tax loss reinvest that money when trading begins again.

Market historians and many investors are fascinated by the January effect because it often sets the tone for the rest of the year. In 2009, stocks were up at the start of January; although they were at 12-year lows two months later, they ended the year having had their best performance since 2003.

"If the first five trading days of January are up, the end of January will usually be up and the correlated end of the year is usually up," says Ray Harrison, Principal of Harrison Financial Group in Citrus Heights, Calif. "I say, usually, but I believe we're headed that way."

The economy, however, could trip up a January effect. The coming week brings some critical economic reports including the Labor Department's employment report for December.

The government's news last month that employers cut just 11,000 jobs in November, far fewer than the market anticipated, has lifted expectations for the report due out Friday. Economists surveyed by Thomson Reuters are forecasting on average that 23,000 jobs were lost. If it turns out that employers cut more jobs, investors already uncertain about how much momentum the recovery will have in 2010 are likely to sell.

But a surprisingly strong report could have an equally chilling effect on stocks. The concern in the market is that a healthier economy will lead the Federal Reserve to pull back its stimulus measures, and investors aren't sure of the economy's ability to flourish on its own.

The January effect could also be threatened by fourth-quarter earnings. Investors have already been pricing in strong earnings reports, especially since the results are being compared against companies' terrible results from the final three months of 2008. But if the reports aren't strong

enough, if companies are still showing weak revenue growth or if their outlooks for the future fall short of expectations, January could be a troubling month in the market.

"Earnings are critical. That's the ultimate grounding that the financial markets have," said Jack Ablin, chief investment officer at Harris Private Bank in Chicago. "If something is off, the market may have a small pullback."

Still, if the January effect holds, there will be plenty of gains to be had, especially if small cap stocks, as expected, outperform big and midcap stocks. Typically, mutual fund managers and other institutional investors, who sell off the shares of riskier small companies to make their end-of-year balance sheets look better, then buy them back early in the new year.

"It's competitive among money market managers," Harrison said. "They want to outpace their peers, and they will invest early and more in the market."

Since 1950, there have been only five times when the January effect turned out to be a poor indicator of the rest of the year, according to the "Stock Trader's Almanac," a book that tracks market trends.

For some, however, "January may be a letdown," Ablin said. He said it's difficult for investors to profit from the January effect because the market now expects it to happen and therefore prices it in before the end of the old year.

Ken Grant, partner at Waterstone Private Wealth Management in Tulsa, Okla., says ultimately, the markets do not follow calendar or tax deadlines.

"You can try, but all these economic cycles move at their own pace," he said.

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