WARRINGTON
ASSET MANAGEMENT

April 2013 Market Commentary

The U.S economic recovery continues at a tepid pace, as many indicators are weakening (partly due to tax increases and decreased government spending stemming from the sequester) and yet the major US stock indices are making all-time highs (minus the Nasdaq, which is still significantly below its year 2000 levels). What is going on to cause this disconnect between equity markets and economic fundamentals? In short: the Federal Reserve. Due to its massive $85 billion per month of bond purchases, asset prices of all types are increasing steadily (stocks, bonds, and house prices to name a few). According to David Rosenberg at Gluskin Sheff and Associates, since early 2009 there has been a 0.87 correlation between the Fed's balance sheet and the direction of S&P 500 index, which is more than four times greater than the historical average prior to the recent Quantitative Easing expansion. The balance sheet is ballooning due to the continual asset purchases, increasing at a 40% annualized rate so far in 2013. Hedge fund manager Doug Kass captures the extent of investors' complacency perfectly by saying: "Investors now believe that Central Bankers have repealed the laws of investment gravity."

With such certainty of where the markets are going, what could go wrong? Plenty. Even Federal Reserve board members have voiced grave concerns about the distortions in asset markets that the Fed's activities have caused. Given the Fed's history of being late to act in stemming crises, they are right to have such worries. Will the Fed be able to stop purchases or shed balance sheet assets in a timely manner should inflation become more pronounced? Highly unlikely, as the world has witnessed the past difficulties in resolving previous distortions related to the tech and housing bubbles. Perhaps avoiding bubbles in the first place should be higher on the Fed's agenda going forward?

During April, Warrington's manager positioned the portfolio to capitalize on a decline in the S&P 500 index. Through the first few weeks of the month, no such pullback occurred. However, on April 15th global commodity markets (gold, silver, crude oil) declined precipitously and the Boston Marathon terrorist attacks occurred, causing the S&P to decline 2.5% and the VIX to increase 43% in one day, the 8th highest daily increase in its history (dating back to 1986). After a few days of choppy volatility, the S&P 500 index resumed its upward bias and closed the month at new, all-time highs. Warrington was able to recoup most of the costs of its spreads but was unable to profit from the retracement to new highs, incurring a small loss for the month.