WARRINGTON
ASSET MANAGEMENT

December 2013 Market Commentary

For most of 2013, analysis of the Federal Reserve's actions has focused on an eventual decrease in the monthly $85 billion of asset purchases. At the Fed meeting in December, this "Taper" was finally announced. While this in isolation could be viewed as a negative development in the eyes of the liquidity-addicted stock markets, the Fed also reiterated its intent to keep interest rates at essentially zero for an even longer period of time. This give-and-take by the Fed is seen by the Manager as an obvious attempt to avoid the extremely negative stock market reaction when the idea of a "Taper" was floated in June, which threatened the "Wealth Effect" that they have worked so hard to create over the last few years. For the moment it appears to have worked, as the commitment to keep rates low caused markets to accept the initial "Taper", rallying to new all-time highs following the announcement.

The manager entered the month holding ratio put spreads designed to capitalize on a decline in the S&P 500 futures. Prior to the Fed announcement, the market did indeed trade somewhat lower, declining 1.8% from the end of November. Given the difficulty in anticipating the outcome of the Fed announcement (the general consensus was split with some expecting a small taper and others expecting no decrease in asset purchases), the manager closed half of the overall position to lock in profits. This proved to be a good tactical decision at the time and a prescient decision given hindsight. Even though the balance of the regular-expiry position as well as the end of month spreads expired out of the money (due to the markets climbing rapidly after the Fed announcement), the manager was still successful in posting a modest gain for the month.

The proposed schedule of Fed asset purchases implies gradual decreases until the program is terminated by the end of 2014. The manager anticipates that asset markets will untether from the strong correlations which have resulted from the overwhelming liquidity injections of the Fed and will revert to more normalized patterns, rising and falling based on market forces, not artificial outside influences. As the asset purchases approach zero, markets will price in the eventual elimination of these flows and some of the imbalances that have developed over the past few years can begin to be unwound. Warrington's manager is preparing for an increase in volatility in stock markets and will continue to position the portfolio to try to capitalize on such an environment.