WARRINGTON
ASSET MANAGEMENT

October 2013 Market Commentary

In the first week of October, the fear that the US government might actually default on its debt obligations (albeit a technical default) looked like a very real possibility. The S&P 500 index traded down in the first few days, declining 2% for the month and down 5.2% from the highs in September. Even before a resolution preventing default was announced, stock markets began to rally and continued to advance after a deal was consummated. Often, when major news stories develop over time and finally culminate in a resolution, that resolution is frequently already discounted by the market. As such, and in anticipation of a "sell the news" reaction, Warrington's manager positioned the portfolio to potentially profit on a decline in stock markets. However, the S&P climbed relentlessly, gaining an incredible 7.9% from the lows earlier in October, with no real retracement until the end of the month. Subsequently, Warrington lost the debit cost of the ratio put spreads held in the portfolio as they expired out-of-the-money.

This year the Fed and their stimulus programs have had an overwhelming influence on markets, and by not "tapering" this stimulus in September (as was often hinted at in Fed speeches), Fed governors have left market participants anticipating when the proverbial "punch bowl" of stimulus will be reduced or eliminated. The market has become dysfunctional in the sense that true price discovery mechanisms have become distorted by the $85 billion per month in asset purchases, combined with essentially 0% short term interest rates. This distortion has caused equity markets to climb significantly this year, not from increased corporate earnings but due solely to expansion of the Price to Earnings (P/E) multiple. Essentially this is inflation of what market participants will pay for each dollar of earnings, and it is now at a level well above historical norms. The P/E multiple is not as stretched as it was during the Internet Mania of the late 1990s, but the market is undoubtedly much more expensive than just a few years ago, even with one of the weakest economic recoveries on record. The Fed cannot continue to prop up the stock market forever, and so the questions remain: when do they begin the process of reducing their incursions into markets, and how painful will the transition be when they chose or are forced to finally step aside?