October 2017 Market Commentary

Abnormally low stock market volatility continued in October, and the lack of market declines has become extreme. Since 1928, there is an average of nine days each year where the S&P closes down 2% or more, and so far in 2017 there have been none (with the most recent dating to September 2016). The lack of volatility is not just to the downside: according to research from Merrill Lynch, on average the S&P gains or loses 1% or more in a day about 50 times per year. So far, 10 such days have been recorded in 2017, the lowest total since the 1960s. Low volatility can be looked at as a powder keg: its presence alone does not cause problems, but any conflagration could be intensified.

The Strategic program was able to record a small trading gain of 0.2% as the S&P declined over three days in late October. This nominal pullback allowed us to salvage some value from long puts held in the portfolio. Low volatility has led to our use of ratio put spreads with shorter lifespans (usually a 1-2 week holding period prior to expiration, rather than 3-4 weeks that would be preferred in a normal volatility environment). Using spreads with less time exposure can help to offset risk from volatility expansions, while still allowing significant profit potential.

The Tactical program continues to generate consistent gains in this low volatility market with all short option positions profitable in October. The Tactical program recorded a gain of approximately 0.9% for the month. We continue to maintain our focus on risk management, knowing that a volatility shock and resulting market dislocation could occur at any time.

While markets continue to ignore potential negative shocks, we understand fully that the next pullback or bear market can start from a seemingly insignificant event. Should the proposed tax reform fail or if geopolitical events escalate too far, markets, which have priced in significant good news and future earnings growth, could quickly recalibrate to a new level of reduced expectations. That unwind, coupled with the massive short volatility exposure, could have severe negative consequences. Until such time, we will continue to monitor markets looking for profit opportunities and to detect early clues that such an event could be forthcoming.

As always, we thank you for your continued support of Warrington Asset Management.