WARRINGTON
ASSET MANAGEMENT

May 2018 Market Commentary

A nominal selloff at the beginning of May sent the S&P 500 index back to its 200-day moving average, an important technical support level watched by many market participants. While the market did trade below that critical level intraday it closed the day well above it, leading to a sustained rally over the course of the next two weeks. Over that period, the S&P gained 5.8% and stayed within a 1.5% trading range until fears concerning Italy's fragile position in the EU resurfaced and sparked the worst daily decline in the S&P in over a month. Concurrently, the VIX rallied 42% at its highest point that same day. The possibility of a new European debt crisis could prove to be a source of volatility for markets going forward.

The Strategic program was able to protect capital during the strong rally early in the month and profit nominally on the moderate volatility during the final week of May, resulting in a flat return for the month. May began with limited short call exposure structured to minimize losses from an acceleration in the market's uptrend. Given that there was no material decline in the market until the last week of May, most of the ratio put spreads expired out of the money. However, the decline during the final few days of the month provided a small window of opportunity to realize profits, which offset prior costs of the put spreads.

The Tactical program hedged downside positions in early May as the S&P broke its 200-day moving average. A further downside acceleration did not materialize and, as the market rallied, we initiated new short put positions to capitalize on the rising market. The strong rally then required a small degree of hedging call exposure to reduced position sizes at higher strike prices. The sideways action for the last two weeks of the month allowed the program to realize gains on both call and put positions, leading to a monthly net gain of approximately 0.38%.

Early in the month, Goldman Sachs published a research piece in which they argued that the VIX is far lower than some indicators might suggest. When they published this the VIX was at 13, but they estimated that it should be closer to 15-18, given the actual market volatility and the level of many reported economic indicators. Despite this analysis, the low VIX trend continued through May with only a brief rally later in the month that almost immediately retraced to prior low levels. This ongoing complacency by market participants and increased unreliability of volatility measurement products further supports Warrington's view that, while an extended low VIX alone is not cause for market panic, things may not be as stable as many investors believe. For this reason, we continue to focus on our increased risk management discipline while also seeking the potential for outsized profit opportunities.

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