WARRINGTON
ASSET MANAGEMENT

December 2018 Market Commentary

The statistics describing the intensity of the stock market rout in December almost seem to be hyperbole. From the start of the month, the S&P had seventeen consecutive intraday declines of 30 points or more (even on days where the index closed higher), for the first time in history. Later in the month, the S&P closed down over 1.5% on four consecutive days, for only the third time since the Great Depression. Conversely, the 116-point gain in the S&P 500 on December 26th, was the largest point gain in history, and the largest percentage gain since March 2009. These eye-popping, once-in-a-generation statistics bear witness to the extreme volatility in the stock market this month. The VIX spiked dramatically, and the market declines caused many market participants to seek soothing words and indications of future easing from the Federal Reserve. However, those hopes were dashed at the December 19th policy announcement and press conference. Disappointed markets then continued their torrid declines, falling to an intramonth selloff of almost -18%. The S&P recovered from those lows but ended December down 9%, and closed 2018 with a loss of -4.4%.

The Strategic program was positioned for a mean reversion early in the month, after the S&P gapped higher on the first day of December. Rather than just mean revert, the S&P declined sharply in two trading days (interrupted by the market closing for President George H.W. Bush's funeral). Over those two days where the market dropped from our top Red Band to our bottom Red Band (the quickest such drop since November 2009), we quickly hedged the downside risk exposure in the portfolio and incurred an approximate loss of 4%. Over the balance of the month, we were able to find opportunities to partially offset this decline, ending December with a loss of approximately 3%. In a year where most asset classes generated a negative yearly return, the Strategic program ended 2018 up approximately +4%.

The Tactical program began December holding a small position of short puts as the volatility in the S&P started to increase. As the market decline accelerated, our risk management mandate led us to close those positions and incur a small loss. During the remainder of December, the increased volatility helped us to realize gains on short call positions significantly above the market. Additionally, we were able to selectively achieve gains on very short-term (one to two days prior to expiration) puts. The sharp increase in volatility led to a preferable risk/reward on those positions as compared to the longer-dated positions (approximately one week) we generally use in the Tactical program. Those gains helped offset early losses and resulted in a monthly decline of 0.06%, and an annual gain of approximately +5.3%.

After such a strong decline in what has historically been very positive month for the stock market, investors are right to question the generally rosy outlook for the near future. While unemployment and inflation are still low, these are often lagging indicators, turning worse well after the economy has begun to decelerate. As we have mentioned many times in our monthly letters, the liquidity provided by global central banks continues to decline, and there are strong indications that this liquidity was at least partially responsible for the bull market of the last decade. If the rally was fueled by such monetary policy, would the unwind of that same policy lead to market declines? We will continue to look for profit opportunities regardless of market direction, focused on risk and the continued market volatility.

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