WARRINGTON
ASSET MANAGEMENT

August 2019 Market Commentary

Volatility returned to the S&P in August. While multiple sources were responsible, the most obvious catalyst was the escalation of the trade war with China. Just one day after the Federal Reserve indicated that U.S. monetary policy would be responsive to further trade war skirmishes, President Trump provided justification for further policy easing when he tweeted to invoke additional Chinese tariffs. Later in the month the Chinese retaliated, and Trump responded with more tariffs. The net result of these actions, which also caused a huge rally in bond markets, was a dramatic increase in market volatility. The S&P rallied or declined by 1% or more on eleven separate days in August, the most in one month since February 2018, and the index had three separate days with declines over 2.5%, the most in nearly eight years.

The Strategic Program successfully avoided this volatility by focusing on the additional risk introduced by the trade war, which dictated we use a more conservative stance than in recent months. While this program generally welcomes increased volatility, the "Headline Roulette" (extreme market moves based on unpredictable headline announcements) meant that it was difficult to forecast the direction of the next market move, making risk management paramount. When we did trade, we were quick to hedge positions and accept small losses if the market turned against us, but we also were able to capture profits when they were presented. The net result of this conservative trading was a small gain of +0.01%, in a month where the S&P futures oscillated 8%, intra-month.

The rapid increase in volatility also required a conservative stance in the Tactical Program. After incurring a nominal loss on the first day of August, we reduced put positions during the month, often choosing to have zero downside exposure. Instead, we chose to collect premium on fractional-sized positions of short, deep out of the money calls positioned above recent all-time highs, which proved profitable even though the market had a few sharp rallies. Ultimately, this defensive bias avoided most of the significant market swings to end the month with a small loss of -0.17%.

While the trade war continues to dominate investors' attention, we believe the fixed income markets are sending an important message about the health of global economies. Recently, multiple yield curves have inverted, and the absolute level of treasury yields has plummeted. The US 10-year note was yielding 2.02% at the end of July and dropped as low as 1.45% in August. This could indicate an increase in the likelihood of a recession, which could force the Fed to cut rates further from already low levels. Combined with the ongoing trade posturing that continues to overhang the market (with little actual negotiation evident), we believe the VIX will remain elevated in the August range of 17-20, up from 12-13 in July. This range is more in-line with historical averages and has generally provided significant profit opportunities for our strategies, assuming no significant volatility spikes occur.

As always, we appreciate your support of Warrington Asset Management.