January 2020 Market Commentary

The massive liquidity injections restarted by the Federal Reserve last September continue to suppress a major disruption in the repo markets. While originally advertised as being "temporary", late in January the Fed vowed to continue providing liquidity "at least" through April, with many pundits predicting another possible repo dislocation by the end of March. This seemingly unlimited promise of liquidity and the aggressive Fed response to what is perceived to be a minor financial "plumbing" issue has been interpreted by market participants as extremely bullish news, and the S&P climbed 3.3% over the first few weeks of the month, overcoming fears of escalating tensions with Iran. However, late in the month the breaking news of the spread of a new deadly strain of Coronavirus throughout China and 25 other countries spooked world markets, causing the S&P to give up its gains and end the month with a small loss.

The end of month volatility triggered our risk management in the Strategic Program, impacting performance as hedging costs subtracted from nominal gains earned earlier in the month, resulting in a net return of +0.04%. In situations where there are new unknowns entering the marketplace very rapidly, we will always err on the side of caution, and seek first to protect capital. Once we are able to assess additional information and develop a degree of clarity, we will then look for profitable trading opportunities. The late month sharp S&P reversal and subsequent VIX curve inversions provided no such clarity. After hedging our ratio put spreads prior to the end of the month, we did not reenter significant positions for the balance of January.

The Tactical Program was also impacted by the late-month volatility expansion and quick downside move made by the S&P. As mentioned, our risk management discipline dictates closing or hedging positions when our risk triggers are crossed, which has repeatedly proven successful in avoiding losses due to outsized market moves. Despite achieving profits through the market's rally in early January, hedging costs weighed on performance, resulting in a net loss of -0.11%.

Uncertainty surrounding the true damage of the spread of the Coronavirus (in China and beyond) was one reason we hedged our portfolios, but it is important to note another key contributing factor was the inversion of the VIX futures curve. As the shape of the VIX curve was already flat, we knew that it would not take much a of market reversal to invert the curve, a signal we have used many times in the past to successfully avoid large declines in the S&P and the coincident volatility spikes This confluence of factors triggered our risk management and may keep us effectively on the sidelines for extended periods, but we will continue to evaluate new trade opportunities and seek out opportunity in a prudent manner.

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