WARRINGTON
ASSET MANAGEMENT

May 2020 Market Commentary

Given the severity of the sell-off earlier this year, it is not surprising that investors' emotions are still on edge, even though stock indices have made substantial recoveries from the extreme levels in March. A sign of this nervousness is evident in the still-elevated CBOE Market Volatility Index ("VIX") and VIX futures, as the expectation of continued volatility has prevented the VIX from declining, as might be expected given the rally. Despite the S&P 500 Index ("S&P") closing up 4.8% for the month, the daily gyrations during May contained two declines of -6.5% and -6.3%, as well as rallies of 6.4% and 11.1%, no doubt contributing to the elevated level of the VIX.

The Strategic Program was able to capitalize on the volatility and captured profits on both call and put positions during the month. Even though our main positions in the portfolio were structured to profit from a secondary (and potentially dramatic) decline in the S&P, we still were able to utilize ratio call spreads to scalp profits from the intermittent rallies, which contributed half of the profits for the month. The program ended with a net gain of approximately +0.51%.

The Tactical Program was also able to take advantage of opportunities presented by the multiple rallies and declines in May, as well as a volatility pricing feature that can often provide additional benefits. When implied volatility is greater than realized volatility, traders are expecting higher future volatility and are therefore willing to pay higher prices for deep out-of-the money options. When actual volatility turns out to be less than anticipated, options will lose this added premium value, providing profits to the sellers. While our risk management discipline continued to lead us to trade reduced position sizes, we were still able to exploit these discrepancies to achieve profits on both call and put positions for the month, netting a gain of +0.46%.

Although stock market rallies are signaling that the worst of the financial decline may be over, we continue to reserve judgement on the economic damage of the pandemic. Despite many businesses across the country reopening, the level and pace of returning demand going forward is opaque. At the end of May (with one month left in the second quarter), the Atlanta Federal Reserve forecasts an annualized GDP decline of -51%. This is an astounding figure that, when coupled with the depression-level unemployment numbers, portends a harsh economic reality that may not be fully discounted by a stock market that appears to predict an unrealistic return to pre-pandemic economic conditions.

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