WARRINGTON
ASSET MANAGEMENT

August 2020 Market Commentary

The recovery from the panic lows of March continued in August, pushing the S&P 500 Index ("S&P") to all-time high levels, a feat which seemed highly improbable only a few months ago. The steady grind higher in August can be attributed to a number of factors, but at the top of the list would be the continued outsized Federal Reserve stimulus, combined with the new pledge to let future inflation run higher than 2%. Ongoing talks of additional fiscal stimulus by both parties has also led investors to believe that politicians will find common ground and conjure additional relief. By the end of the month, the S&P had rallied 7.2%, a gain achieved with minimal volatility: The Index only had two daily losses of more than 0.25% but had thirteen days of gains over 0.25%.

The Strategic Program had a number of profitable trades which utilized call spreads to capture upside moves in the S&P, but those gains were offset by premiums paid for trades structured to profit from market declines, resulting in a net loss of 0.25%. Realized volatility in the S&P continues to be muted, while expected volatility remains elevated at levels near the higher end of historical ranges. This dichotomy allowed us to structure trades with strong profit potential, but the steady grind higher in the S&P did not lead to those positions being profitable in August.

The Tactical Program was able to take advantage of the higher implied volatility to record a gain of +0.35% in August, even after factoring in hedging costs incurred to adjust existing call positions. Somewhat notable was the fact that the S&P reached new all-time highs as overall market volatility also rose, a rare disconnect. We were able to capitalize on this anomaly to achieve additional profits for the month. We continue to hold smaller average position sizes, as the higher implied volatility drives up option premiums and, we believe, poses greater underlying risks in this unique market environment.

With most major U.S. stock indices at all-time highs, the casual observer may conclude that all is well with the economy. However, we contend that the indices are masking areas of true weakness in the U.S. economy and financial system. Valuations appear extremely stretched, as evidenced by the forward price-to-earnings ratio of 26x, the highest level since September 2000, and the cyclically adjusted price-to-earnings ratio ("CAPE") of 30.6, one of the highest ever recorded and exceeded only prior to the Dot.Com crash of 1999/2000 and historic market crash of 1929. Also, much of the consumer rebound can be directly traced to government stimulus, with personal incomes rising 12% while worker's wages are down 8%, but direct government assistance is up 146%. Such a situation is untenable and reveals the true nature of the health of the U.S. consumer. In light of this fragile situation, we remain cautious as we continue to seek out positive risk/reward opportunities for our clients.

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