May 2022 Market Commentary

Although the S&P 500 had the "flattest" monthly return since 1979, recording a gain of just 0.01%, the overall swings in the index were much more pronounced. With three different rallies of 6% or greater, and two declines of -6.9% and -10.4%, the oscillations in the broad-based index were significant. As the market is digesting changes to some of the foundational tenets that have been the drivers of its current valuations (low interest rates and inflation, benign fiscal and monetary environments), these wild swings shouldn't come as unexpected. What is harder to explain is the response from the volatility-based markets, which are essentially yawning in the face of these outsized moves.

While opportunity sets were less than ideal, the Strategic Program was able to record a gain of +0.20% in May. Gains were achieved very early in the month as the S&P faltered on the first trading day of May, but subsequent hedging costs from wild market swings offset some of those early profits. As the month progressed, and the S&P rallied from lows previously reached in March of 2021, a key volatility metric known as skew (a measure that compares the prices of options at varying strike prices), plummeted to extreme lows. These levels indicate a high degree of complacency and compressed the ratio spread pricing making the risk/reward opportunities less attractive.

The complacency reflected in these poor volatility measurements lead to the prices of individual options becoming depressed. One measurement of the attractiveness of options is a metric found by comparing the implied volatility (the market expectations for volatility in the near future) to the realized volatility (the actual volatility seen in the market). When implied volatility is less than realized volatility, options can seem to be underpriced, making selling those options less desirable. This, combined with the dramatic swings in the market, led to us spending more to hedge our positions than usual, resulting in a net monthly loss of 0.12% for the Tactical Program.

The dichotomy of market participants' complacency versus the outsized market movements is very telling to the near-term outlook for equities. If recent lows are breached, this could awaken volatility markets which are underpricing the current headwinds. The growing list of market concerns increases daily and so the core question is, do these concerns indicate we are on the precipice of a major market shift? Is the 40+ year-long bond bull market finally over? Will higher interest rates wreak havoc on many speculative companies? Will inflation and slowing growth lead to a recession? We believe that volatility markets are underappreciating near-term risks and so look for them to "catch up" to equity markets which we see uncovering many new trading opportunities.

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