WARRINGTON
ASSET MANAGEMENT

December 2022 Market Commentary

Market participants continued to seek reassurances from the Federal Reserve ("Fed") in December that they intend to pivot to cutting rates soon, but at its recent meetings, the Fed has reiterated its desire for lower asset prices and tighter credit conditions. As investors have historically experienced but seem all too eager to forget, the aphorism "Don't Fight the Fed", works in both directions. The S&P 500 Index ("S&P") began the month with an initial rally but quickly reversed those early gains and continued to drop 9% in the aftermath of the Fed's announced positioning. This wrapped up an abysmal year for the S&P, with the index declining 18.2%, the worst year for the U.S. equity market since the global financial crisis in 2008.

This quick rally and decline action seen in the S&P in December (and many times throughout this year) has allowed for the deep out of the money put spreads we use in the Strategic Program to quickly gain in value. These positions, which we generally initiate at a very low cost, can rapidly increase in price when the index has a sharp decline. Even though the CBOE Volatility Index ("VIX") is reflecting levels lower than we believe are currently justified, we have been able to purchase these spreads to allow for a wide range of market oscillations and profit opportunities. The Strategic Program took advantage of this environment and gained +0.64% for the month.

Optimism from market participants looking for soothing words from the Fed led to some pricing imbalances in significantly out of the money calls. Buyers of these options that combine low premium with very high strikes are often using them as either insurance or margin-reducing trades. As we felt that the Fed would not deliver the "pivot" that many were anticipating, we viewed those options to be very overpriced. We were able to sell those positions and realized profits, leading to a gain of +0.13% for the Tactical Program in December.

While the losses in stocks this year have garnered most of the headlines, we continue to see fault lines in the fixed-income markets that are flashing warning signs. While short term interest rates did not climb much in December, the long end of the interest rate curve did, widening the spread between the 2-year and 10-year treasuries to extremes not seen since 1980. Historically, when this spread turns negative, that can be an indication that a recession is likely in the near future. It has now been negative since July 2022, with the spread continuing to grow. We contend that this has not been fully priced into markets and the prospect of a recession remains underappreciated.

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