WARRINGTON
ASSET MANAGEMENT

January 2023 Market Commentary

Hopes for a dovish Federal Reserve fueled a stock market rally in January. As many Fed governors publicly announced thoughts that rate hikes could end soon, markets took these forecasts that the long-awaited "pivot" could come as early as the February meeting. Interest rates declined to their lowest levels since September 2022, the S&P climbed 6.3%, and the Goldman Sachs Most Shorted Index (a measure of the performance of the stocks with the highest short interest percentage) rose 24.2%, a testament to the increasing risk appetite in markets.

The Strategic Program recorded a slight loss of 0.28% for the month, as the steady grind higher was only briefly interrupted mid-month by a short-lived market decline. We were able to capture gains on some ratio put spreads during that pullback, but the rally quickly resumed, launching the S&P back near the psychologically-important level of 4100, an area that has been resistance to further gains in the recent months.

The Tactical Program gained +0.09% in January, as the CBOE Volatility Index ("VIX") dropped and became more closely aligned with actual market volatility. Comparing the CBOE Realized Volatility Index ("RVOL") to the VIX shows how both indexes reached lows not visited since April 2022. When there is a large disconnect between these, and RVOL exceeds the VIX, selling options is a less-attractive proposition. Because this relationship reverted to historical norms, more attractive opportunities arose and we were able to capitalize on them and produce profits in the program.

In the options space, one subject has been heavily discussed lately is the notion that the VIX is "broken". Having declined materially to lowest point since the start of 2022, many feel that the potential risks in markets should cause this "Fear Gauge" to be higher, but the VIX is simply a measure of volatility in options with expirations ranging between 23-37 days in the future. However, many options have expirations much shorter than that timeframe, and therefore are completely ignored by the VIX calculation. Specifically, options that expire on the same day that they are traded (known as "0 DTE" options, or zero days until expiration) have exploded in popularity. Since they do not impact the VIX directly, the increased trading is not reflected in that index. Additionally, we would argue that the increased volume of trading in these options has opened a new source of market-disrupting potential. The leverage that traders can employ with these positions can be significantly greater than those with longer expirations, and this exposure is underappreciated by the market. Should a material late-day rally or decline occur, the losses from these options could be substantial for the aggressive speculators who employ them. We will continue to monitor this space and factor in the potential for negative ramifications from this previously quiet of corner when searching for new trading opportunities.

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