DIPSEA

CAPITAL, LLC

September 2020 Commentary

As a cycling enthusiast, I enjoyed watching the 107th edition of the Tour de France this year and its dramatic finish. It also gave me occasion to once again observe how the pursuit of consistency is paramount to results. After 2165 miles of pedaling for a combined 87 hours and 20 minutes, Tadej Pogacar's winning time was a mere 59 seconds ahead of second place. I believe a strong parallel can be drawn with performing in the markets, as achieving consistency in all environments can also be a great differentiator for investing results.

Dipsea Capital posted its 26th consecutive positive month in September. The Dipsea Capital Fund returned 0.83% to partners for the month, 7.96% year-to-date, and 10.40% for the last twelve months.

As we noted in last month's letter, market sentiment was excessively bullish coming into September, creating, in our view, ripe conditions for a reversal. U.S. equity markets reversed sharply in September, with the S&P 500 and Nasdaq falling -9% and -12% peak-to-trough, respectively, before recovering and ending the month -3.80% (S&P 500) and -5.16% (Nasdaq). Other major asset classes did not protect investors as, for example, corporate bonds lost -1.2% and gold was down -2%.

Early in the month we noted a significant shift to net short gamma balances for large options dealers and increased stock selling in dark pools – indicating likely selling activity to come from dealer desks. As this observation aligned with our models' signals, we positioned for this and subsequently profited on downside directional trades. Later in the month, our signals indicated a shift in volatility regime, and as implied volatility began to decline, we increased exposure to volatility oriented positions, which were also profitable.

The VIX volatility index returned in September to its typical negative correlation with market direction. It initially spiked to 36 with the market's strong selloff and then mimicked August's action by dropping to its low at mid-month and bouncing back to 26 by month end. Dipsea's net market exposure for the month averaged -0.9%. Index trading accounted for 77% of September's return, with the remaining 23% coming from single-names.

Market Landscape

During the third quarter the equity market accelerated its rally, though this rally was narrowly concentrated in half a dozen large cap tech companies. Earnings were abysmal with the S&P 500 posting a 22.2% year-over-year decline. The rally became excessively frothy in August, with buyers bidding up Call options too to such an extent that option chains exhibited an atypically high degree of upside skew.

We remain in an environment of unprecedented uncertainty. It is impossible to predict the extent of further impact from Covid-19 on lives, the magnitude and continued duration of its economic effects, and what effect policy responses will have. Diametrically opposite outcomes of economic stagnation and deflation or growth and significant inflation seem equally likely.

Tailwinds supporting higher stock prices include:

1. The Fed and other major central banks remain committed to an unprecedented level of monetary expansion with the goal of stimulating their economies.
2. Despite the gridlock in the U.S. Congress, further fiscal stimulus may be passed.
3. The U.S. unemployment rate fell from 11% to 7.9% during the quarter.
4. The Consumer Confidence Index rose by 18% in September.
5. Tremendous investor cash reserves remain on the sidelines.
6. Historically, a period of positive seasonality for stocks begins in late October.

Headwinds to higher stock prices include:

1. Heightened political risks such as a contested national election, continued gridlock, and the potential for higher taxes and regulation with a change of administration are real.
2. The U.S. stock market's cyclically adjusted P/E ratio (CAPE ratio) remains elevated at 31x, 21% above its 20 year mean of 25.6.
3. We remain in a recession and GDP growth forecasts for the fourth quarter by major investment banks have been halved to 2.5 – 3.5% (annualized).
4. The ROBO ("retail-only, buy-only") put/call ratio indicates continued aggressive call buying by this segment, a contrarian indicator.
5. Increased economic lockdown from a "second wave" of Covid-19 infections.

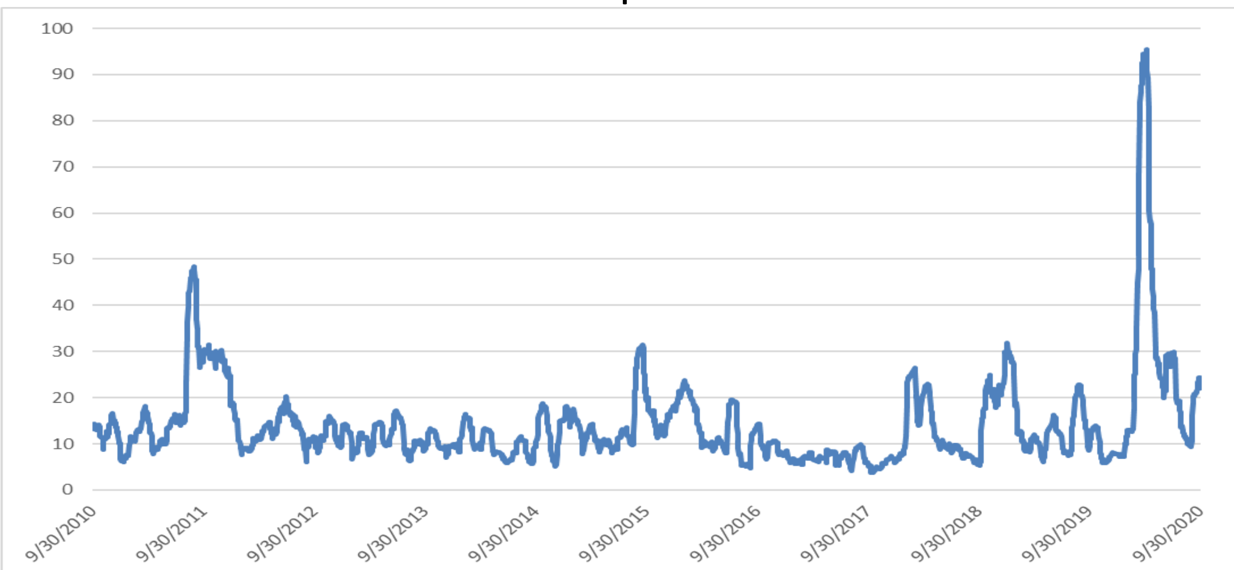
We expect a sideways market for the next several weeks, as investors are seemingly between a rock and a hard place.

Portfolio Thoughts

Market volatility this year has been by far at its highest level in over a decade and we believe the environment of unprecedented uncertainty will continue to fuel elevated volatility spikes. The

VIX futures curve remains steep with a peak in late October – early November at 32 and indicating elevated market volatility continuing through mid-2021. This creates a favorable environment for Dipsea's strategy given our dual focus on both volatility (vega) and directionality (delta) to profit on market moves.

S&P 500 1-Month Realized Volatility
Oct 2010 – September 2020



Source: S&P Dow Jones Indices

As we begin the fourth quarter, we are pleased to be executing on our goal of generating consistent returns for investors. This has not been the result of fortuitous long volatility bets, but rather of sticking to our investment process which is based on identifying market regimes and executing defined appropriate trade set-ups accordingly. Our short-term focus and flexible positioning aid in achieving our consistency goal.

As we begin the final stretch of 2020, we wish our investors a productive fourth quarter and extend a special welcome to Dipsea's new investors as of October 1st; we appreciate your support and look forward to a long and prosperous relationship.

Sincerely,

Christopher Antonio

Chief Investment Officer and Founder