

MARKET TRACTION

IN THIS ISSUE:

Summer Lovin' in Tech Land at Movie Theaters Everywhere!

This Week's Trade Ideas:

(View Webinar*)

Bullish Ideas:

(View Webinar) USB > US Bancorp > \$53.30 Last. Buy the Sept. 7th 52.5 Calls for \$1.50 or less with a close or anticipated close above \$53.51 in an up market with expectations for continued strength in the major indices.

Bullish Mentions:

Based upon closing prices and all assume an up market with expectations for continued strength in the major indices.

GILD Trigger > \$79.00, GS Trigger > \$239.73, PNC Trigger > \$146.55, FSLR Trigger > \$54.60.

Bearish Ideas:

(View Webinar) MAR > Marriot International > \$124.43 Last. Buy the Aug. 24th 125 Puts for \$3.35 or less with a close or anticipated close below \$123.96 in a down market with expectations for continued weakness in the major indices. ***Post Earnings Phase! *ATM Put for breakdown.

(View Webinar) HLT > Hilton Worldwide > \$77.60 Last. Buy the Sept. 21st 77.50 Puts for \$2.35 or less with a close or anticipated close below \$76.79 in a down market with expectations for continued weakness in the major indices. *ATM Put for breakdown.

Bearish Mentions:

None at this time.

We strongly suggest viewing this week's **Morning Call** webinar for full details with respect to these idea(s), last week's and options education.

Special Note:

Remaining nimble is a focus in the newsletter and in our **Morning Call** webinar and will be so.

Outlook:

We're not sure! The rekindling of the *Tech Love Affair* is already short-term overbought and that's really the only thing that's pulling up the indices at this point.

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Technicals:

Will be discussed in-depth in the **Morning Call** webinar.

Fundamentals:

These trade idea(s) and mentions are technically-driven.

(Editor's note: These trade ideas may be updated periodically, in keeping with market conditions. It is intended solely for educational purposes.)

Recap of Last Week:

Last week was rough on us personally. No doubt about it. As for our stocks:



Once again, that fits the bill. **CL** could have been taken as a trade late Friday despite it finishing the day on a very weak note, and if so, the stock price is off about 10c from the trigger level as we write. A whole little bit of nothing!

JNJ closed at but not above our trigger last week. We updated on it for the most zealous among us in case they just couldn't wait for a close above that level. The next day it fell below the 200 SMA, the level we noted we would "very quick stop" at. It's really not far removed from the 200 SMA at this point.

M and **QQQ** were untradeable for the most part. They wouldn't let **QQQ** fall due to the technical juncture it was at last week. We noted how vulnerable it was and how that could undo things in the markets in a big way and thus the Gang made sure no harm came to those stocks and have bought them up as if they're at a great discount. **M** was weak initially, and in our webinar, we noted that much of the weakness had kicked in too soon and that the stock was likely too close to finding support at the 50 SMA. That's exactly what it did and naturally it hasn't been weak since as they've begun to keep the indices levitated for the fun of it.

We added **D** and **FSLR** in an update after our webinar last week. Trying again to find something interesting and profitable. **D** never really got close to our trigger level as our bear add. On the bull side, **FSLR** has continued to dawdle in the consolidation it's been in for quite some time. It's not far from triggering to the upside and actually tried earlier today (Tuesday). However, it was sent packing lower and hasn't triggered. The 50 SMA seems to have been its source of fear today.

All in all, it was another week of weak! Weak or no participation by the stocks we've focused on. The narrowness of the activity in the markets is really hampering us in maintaining our prime directive:

Respectable profits with low risk.

We've even broadened out a little to try to get into names that are a little riskier but to no avail. Due to this low volatility environment persisting in so many stocks, we're introducing other strategies that readers can employ to profit should they choose to do so. See **Options Academy**.

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Market Overview

Last week was a rough one for us due to health issues. Fortunately, we're bouncing back just like the indices. The seasonality we've been covering for the past month or so is playing out like clockwork so far... As is the narrowness issue that we've covered over the same period. To wit, we may as well dive in on **FAANG** as it is the leader of the narrow advance party:

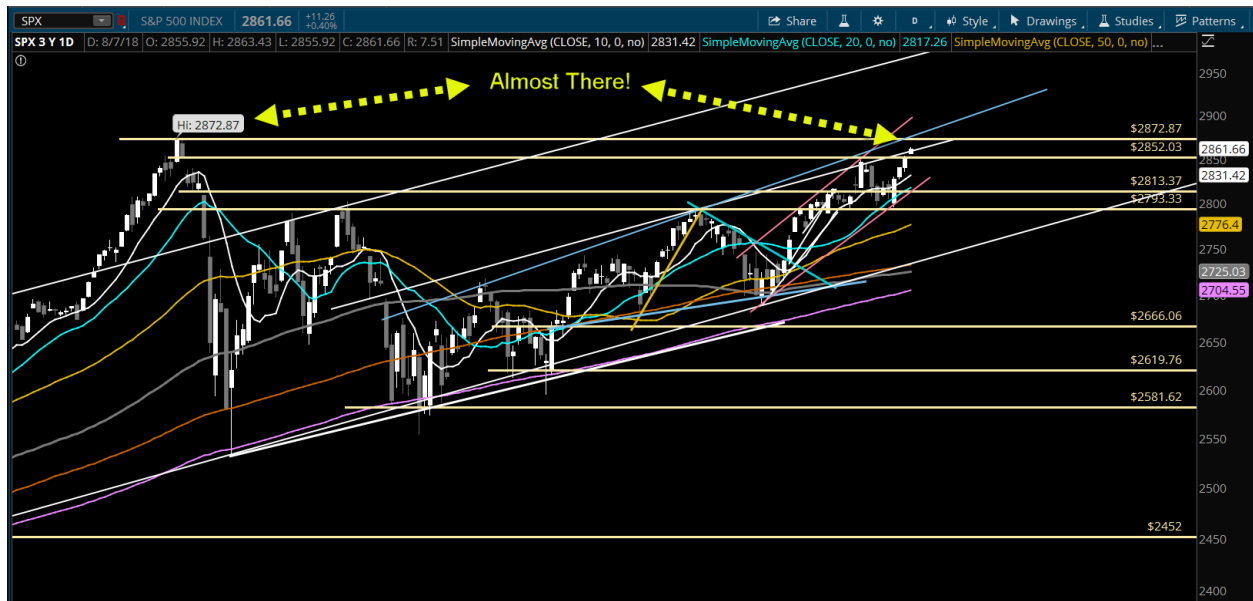


Last Tuesday we spotted that **FAANG** was at risk of falling below trend and made note of it in Wednesday's webinar. Wall St.'s crack team got to work on it in a big way at just that time and has yet to stop! They're putting in OT but manufacturing new All-Time-Highs isn't as easy as it would seem when so many stocks are failing to join the party. (See **Below the Radar**)



The euphoria has spilled over into the S&P 500 leaving it at the door of All-Time-Highs. This is something we noted that we'd surprised if they DIDN'T try to pull this off, and now, they have.

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They've even been able to use the *Summer Trade* and *Tech Euphoria* to juice the trade war-vulnerable DOW back up to new recent highs!:



Here's how we concluded things a few weeks back, pre-illness:

We must allow for more upside movement. It can't be ruled out. There's no argument to be found here to counter that many Tech stocks are price to perfection. However, until that's not the case, **there's no point in fighting against them.** The "narrowness" of it all leaves us concerned as many longtime observers are at this time. But the trend is the trend and until it is on the ropes in some way, we can't fight it! Until these indices threaten to break below support or become exhausted, we'll be more inclined to lean with northward winds and hope that other stocks begin participate. If they don't begin, that will be a problem in more ways than one and **we may just have to buy ETF calls!**

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The past month of trading, until midweek of last week, was very pedestrian. We couldn't get good *net change* from Tuesday to Tuesday. The narrowness of the rally has left many, many stocks behind, which is still background-noise-concerning. However, the truth remains. Our technical take has largely been bullish, and the indices have acted that way, largely. Save for last week's critical support juncture, they've kept things advancing nicely as we posited when JUNE was closing out. That's left us frustrated as we've noted several times. In retrospect, we'd have been better off simply buying ETF calls as **FAANG** helped drive up the major ETFs. That would have been a safer way to capitalize on our overall bullish take aside from individual issues that have largely treaded water. They remained as wallflowers when we were expecting them to begin to join the party. It's that simple. This lack of participation doesn't happen often, but it does occur prior to market peaks which are preceded by blow-off phases, much like the one we saw to end last year and start this one. We'll see if this easy breezy wafting higher mode persists through August and if so, the economy better deliver the goods or there could be hell to pay for stock prices with interest rates still set to rise.

Finally...

The second week of August is shaping up to be the second week of August. Very light calendar with most likely flashpoints coming on Thursday and Friday due to Evans interview and price index updates.

This Week's Economic Calendar

TIME (ET)	REPORT	PERIOD	ACTUAL	MEDIAN FORECAST	PREVIOUS
MONDAY, AUG. 6					
2 pm	<u>Senior loan officer survey</u>	Q2			
TUESDAY, AUG. 7					
10 am	<u>Job openings</u>	June	6.7 mln	--	6.7 mln
3 pm	Consumer credit	June		--	\$25 bln
WEDNESDAY, AUG. 8					
8:45 am	Thomas Barkin speech				
THURSDAY, AUG. 9					
8:30 am	Weekly jobless claims	8/4		217,000	218,000
8:30 am	Producer price index	July		0.2%	0.3%
10 am	Wholesale inventories	June		--	0.6%
1 pm	Charles Evans interview				
FRIDAY, AUG. 10					
8:30 am	Consumer price index	July		0.2%	0.1%
8:30 am	Core CPI	July		0.2%	0.2%
2 pm	Federal budget	July		--	-\$43 bln

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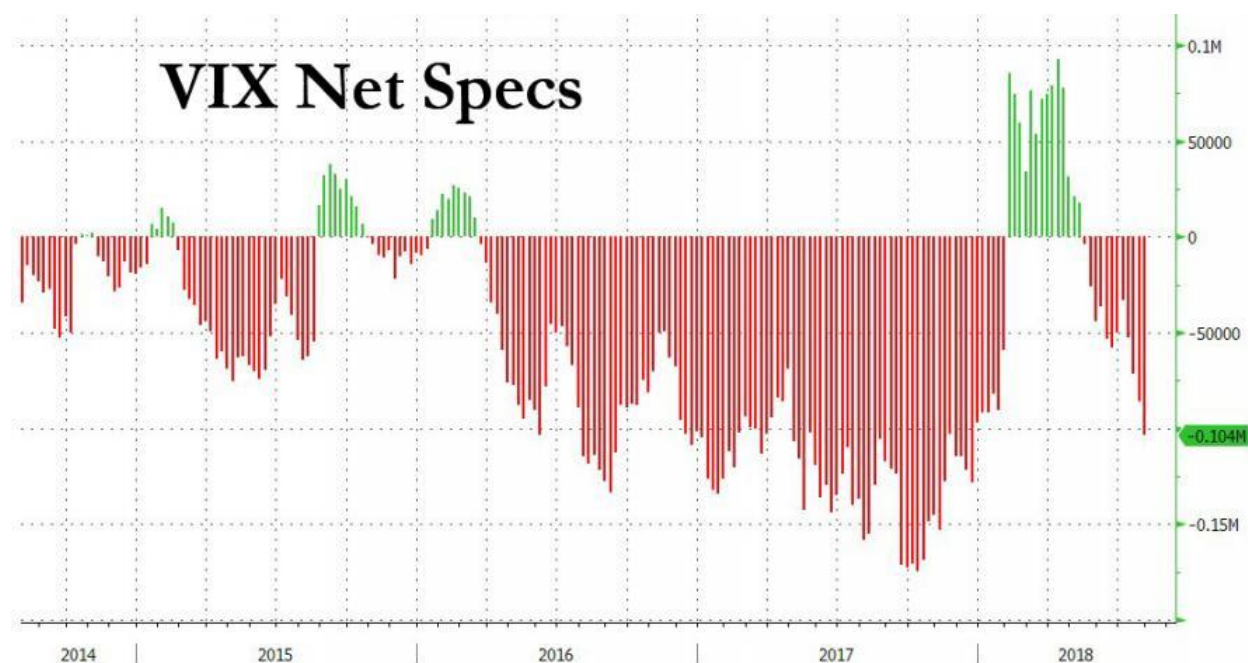
Below the Radar

We're back to *Summer Doldrums* in terms of **BTR** content. The Interweb was fairly-bare over the past week. Societal developments and friction-building over controversies-galore are taking up a lot of space. Still though, we found a few items worth noting...

Something we've discussed many times has been the "*rush for the exits*". To refresh, that's the state of affairs that has often persisted in the background of the FED-Juiced equity markets we've grown accustomed to over the past decade. Many money managers have a sense that equity prices are not sustainable at these levels but feel forced to invest to not miss out and fall behind their "always-risk on" money manager peers. Many believe that they'll be one of the first to exit when the time comes (because they're the most brilliant of the brilliant) and naturally, that would be just in front of a massive and long-overdue correction. Others feel this way, which is to say that once they know to leave, they'll not be able to do so:

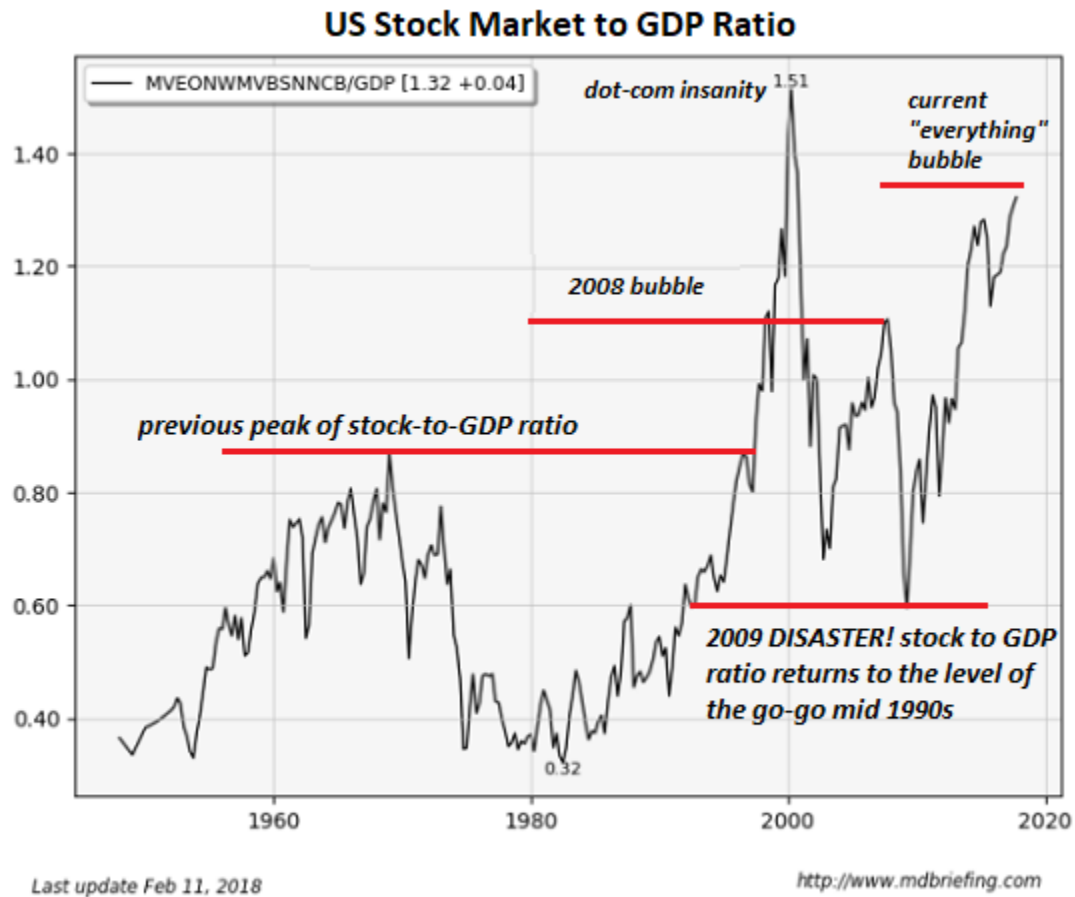
<https://www.zerohedge.com/news/2018-08-07/its-not-trade-war-or-market-drop-keeping-credit-investors-night>

The piece is worth the read because various market liquidity measures continue to deteriorate and thus many are worried that the remaining liquidity will disappear in a flash when the real selloff begins. That would leave many trapped and facing an awful amount, maybe a historically unprecedented amount of stress in trying to liquidate long-side risk, not mention that it would likely produce a jaw-dropping surge in the VIX as long-side players scramble for any protection they can lay their hands on. And to that we can add that there may be even more fuel for that fire in the form of far too many short-volatility players that have been burying the VIX in sell wave after sell wave and for months! See the recent trend!:



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Now, before we continue, let's establish the scene:



notes by charles hugh smith www.oftwominds.com August 2018

We're now making new highs seemingly on our way to the All-Time-High when the stock market's pricing is viewed in GDP terms. Obviously, the level we're at is concerning but this also demonstrates how unhinged from reality the market has been by and large over the last 25 years of largely FED-induced bubble formation. That takes care of *where we are* and *why they're worried!*

Now let's get into the NOW on other measures.

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Fear & Greed Index

What emotion is driving the market now?



Previous Close	72
Greed	
1 Week Ago	66
Greed	
1 Month Ago	40
Fear	
1 Year Ago	61
Greed	

Last updated Aug 7 at 2:02pm

As we've noted, the F&G has generally been working its way deeper into Greed territory. And now for few dogs pulling the sled:

Stock Price Strength

Extreme Greed

The number of stocks hitting 52-week highs exceeds the number hitting lows and is at the upper end of its range, indicating extreme greed.

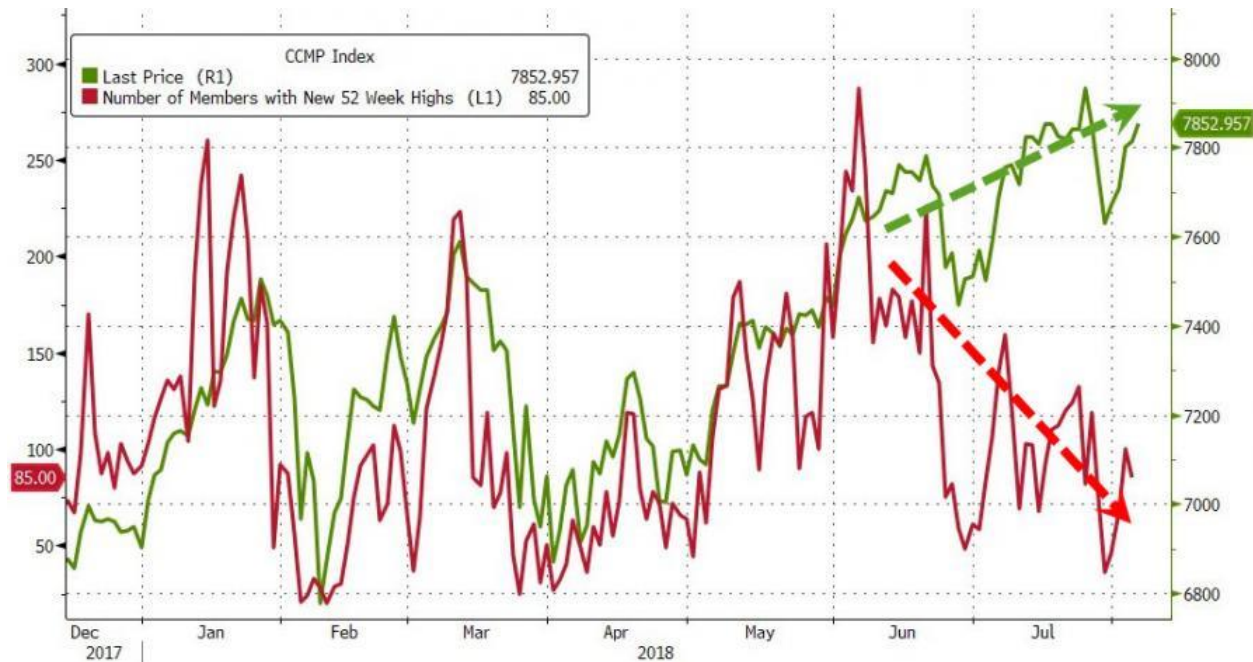
Fewer Stocks WORKING!

Net new 52-week highs and lows on the NYSE



And yet another look at the lack of market breadth improvement or as we've noted of late, the narrowness of the advance:

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Despite that or actually because of it (the near-incessant rise in a few heavily-weighted names), indices jam higher and thus Greed continues to break out!:



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And, it is doing so in a “*what, me worry?*” way that we’ve all grown accustomed to seeing. They’re piling into cyclically sensitive names and foregoing defensive ones...still:

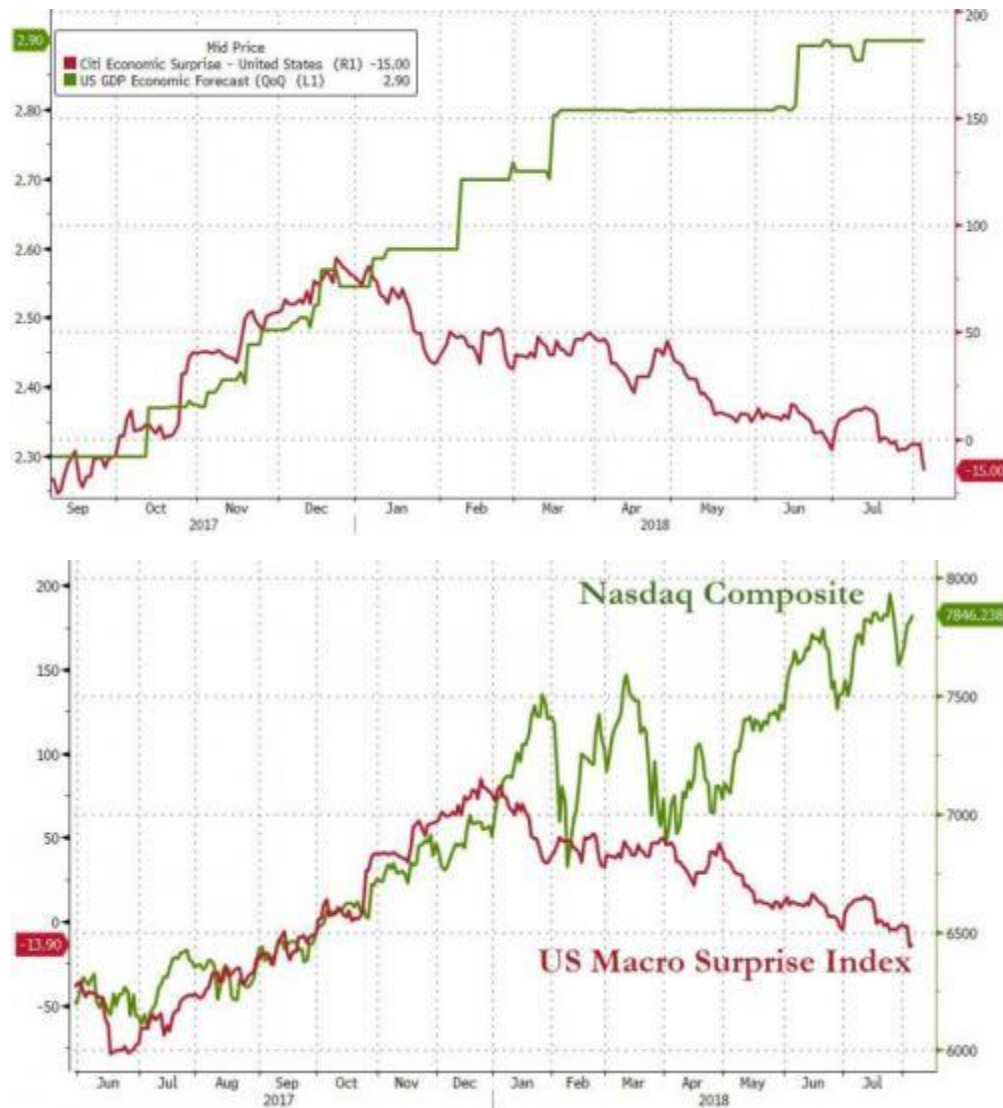


Remember, despite our concerns last week when the indices and FAANG were at critical levels, levels we noted must be held if things were to remain intact, we also sensed that July and August might be very much like the average July and August:

Month	Average DJIA gain since 1896
January	+0.9%
February	-0.3%
March	+0.8%
April	+1.2%
May	0%
June	+0.2%
July	+1.4%
August	+1.3%
September	-1.2%
October	+0.2%
November	+0.9%
December	+1.4%

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Much like last week's technical discussion that noted that they had to elevate the indices from the precarious perches they were set on, the same will likely be true after they *August* August! The performance better pick up to justify where they've brought us!:



Bank and Roll my friends!

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Options Academy

Following up on where we left a few weeks ago, we'll go a little bit deeper into selecting good options strikes but also strategies! That's right, we're branching out! We're going to rework our plans, and instead of moving directly into why it works well to consider ITM options between 65 to 85 delta, depending on your goals and time horizon, we're going to weave in a discussion on using OTM spreads to help us profit. Why? Because this Summer has been FAR more boring and absent of sustained movement than we expected. With the mélange of background news, we've been observing for months, we believed that the *FED meetings* and the *Earnings Season* were likely to deliver some sustained movement for most stocks. That hasn't been the case as the SPX has remained bottled up for quite a bit of the past month or so. The most recent several days have delivered some movement but prior to the closing of last week, we hadn't made much progress for weeks. That's left us frustrated despite knowing that it is part of the grand scheme of things and that we can't have good trending action ALL the time... and we can add to that that we were bullish on the SPX for over a month with respect to our outlook, but haven't gotten follow-through from many of our bullish stocks selections.

Thus, we've decided to outline 3 ways to approach directional trading while utilizing options. Now there are many, many ways in which that can be done to be clear. Our preferred way, a simple long call or long put strategy, obviously depending upon our directional bias, will only be profitable if movement develops to at least some extent and in agreement with our forecasts. We've written quite a bit about that and our options selection process and we will return to the simple long call/long put approach in the next week or two but, to illuminate on where we're going, we've decided to introduce the "*short vertical spread*" approach. It has its pros and cons and we're going to cover them now from the bull side. The bear side is virtually the same but naturally the opposite in terms of direction.

First, a visual!:



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We'll use MSFT as our example stock and let's assume that we believe it is about to move up bullishly and it triggers but let's also go further. Let's assume that we expect MSFT to remain on the "road" it's on. If we believe that MSFT is to stay on that road, then we must believe that MSFT will NOT make the hard-right turn and veer off into the RED X. Can we make money if MSFT's stock price AVOIDS that area? Why YES, yes we can! Just another awesome thing about options, we can profit if stock prices AVOID chart areas too. So...instead of reaching for our trusty ITM calls, we're going to SELL an OTM Put Spread. In other words, if we believe that MSFT is moving higher, we believe that OTM puts will effectively decline in value and potentially become worthless. That would be EXACTLY what we want as sellers of an OTM put spread. We want to sell one option to profit from as it loses its value but buy another at a lower price to protect ourselves against unlimited loss potential. Thus, we sell one from which to make money and buy one against it to insure ourselves. Our hope is that both values decline to ZERO at expiration and we keep the PREMIUM we sold the spread for initially. It's a strange thing to buy something and hope it will be worthless but that's exactly what we want to see. We "sell now" hoping to "buy back later" for a lower price or even better to not have to buy back later because the spread is worthless. We simply keep the premium we sold the spread for at inception.



(Keep the above graphic in mind as you read below 😊)

So, let's get into the nitty-gritty. We've identified the \$105 level as the first nearby support level. Thus, we can sell that put strike because we want to bring in the most premium we can while selling at a perceived-to-be-safe technical level. MSFT shouldn't be able to easily plummet through \$105 due to the support that appears to be there.

Additionally, we then want to buy our insurance/protection in a put strike no lower than the next support level down to limit losses. That would be \$102. We'll now add in some real-world prices if we sell about 1 month out in time as a general starting point with MSFT near \$108.80:

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The Short Put Spread:

Sold 1 Sept. 7th 105.00 Put for \$0.80 to collect premium/make money.

Bought 1 Sept. 7th 102.00 Put for \$0.40 to insure ourselves against practically unlimited losses.

Net: We bring in \$0.40 in premium (Extrinsic Value).

Expectations: MSFT moves up and the spread's value declines as the OTM puts become further OTM and thus Worth-LESS on their way to becoming entirely worthless! That's our hope.

CONS First:

We can only make \$0.40 or \$40.00 in the real world! That's not a windfall!

We can't easily morph this into an unlimited upside bullish position either.

Additionally, we need to wait for the decay process to work in our favor which is not a very direct way to profits!

We can lose far more than we can make if this blows up in our faces! The Max Value of Spread is \$3.00. The difference between the strike prices ($\$105.00 - \$102.00 = \$3.00$). If we had to close this down for MAX LOSS, we'd have to pay \$3.00 to get it back after selling it for \$0.40. We'd take a \$2.60 loss!

We only make a little due to having the probabilities in our favor (see below).

Now PROS:

We're not asking the stock price to do much. All we want is for it to AVOID an area. That means that many other outcomes allow us to win! Goes up a lot, fine, we win! Goes up nicely, fine, we win! Sits still, fine. And so on.

With the stock near \$108.60, we can even have the stock drop 2% in price and still be safe and win fully!

We're starting out where the stock needs to be, above \$105.00. That gives us cushion to begin to adjust if need be and the stock unexpectedly sells off.

The delta of our short put, the \$105 strike, is only .23. The options pricing model believes that it only has a 23% chance of the option finishing ITM. Naturally, we can infer and flip that to see that it believes there's a 77% chance that the option expires worthless! That suggests that we have a high probability of winning and roughly should see our short put expire worthless, from 3 out of 4 to 4 out of 5 times over the course of time.

We don't have much work to do if MSFT stays above \$105, our short strike price. As long as it does, we count on the *Sun to Rise in the East* and as long as that happens with MSFT remaining above \$105, we're good!

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Summary: We delved into this short vertical because we want readers to have another approach at the ready. The very nice thing about spreads of this type is that they'll profit if the recent stale environment persists while our long call/long put approach definitely needs movement to sustain for nice profits. If folks prefer one approach to another, now they'll have the basic mechanics to initiate trades in other ways to capture profits in the future.

Naturally, there are many variations on short vertical spreads, but the approach outlined above is rooted strongly within the chart's price structure and is sound with respect to options theory and application.

As a reminder, don't forget about the Decay Curve! We can't cover all possibilities but let's note that selling say the final 2 weeks of option's life is more lucrative than selling monthly when done so over time.

Next week we'll likely cover the straightforward long call/long put approach we prefer and from there we plan to wrap up with a "hybrid" concept that may help folks to add another arrow to their trading quivers.

If you have questions, please ask away in our next **Morning Call** webinar. ☺

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Here's a **reprint** from a few weeks back for perspective on this week's entry.

Last week's **OA** centering on avoiding the **"3 Biggest Mistakes"** most new-to-options players make inspired us to follow up with a refresher on something very basic, but very powerful, that many of us take for granted. That being, the **Stock Replacement** strategy. We'll get into more details soon but let's not skip over the "nutshell" that makes this simple but fantastic:

We can have virtually all the upside potential a stock can offer but with far less downside risk and far less capital at risk. (Yes, we can flip it around if we'd prefer to a bear.)

That's just our beginning but the simple power of options as an investment/trading vehicle is unmatched and nothing else we're aware of even comes close! However, by refining our selection process when using them, and focusing on genuine "stock replacement" calls, we further enhance our approach in many ways, some of which we'll lay the groundwork to cover now!

First though, a requisite detour through options basics and options pricing fundamentals is in order.

"ITM" – in-the-money options are comprised of two building blocks:

1. Intrinsic Value
2. Extrinsic Value

We can write many words, or we can do this exercise to better understand these building blocks:

Current Stock Price = \$91.00

ITM \$85.00 Strike Price Call Option Price = \$7.00

Current Stock Price – Strike Price = INTRINSIC VALUE

\$91.00 – \$85.00 Strike Price = \$6.00 Intrinsic Value

ITM \$85.00 Price Call Option Price = \$7.00 - \$6.00 Intrinsic Value = \$1.00 EXTRINSIC VALUE

All non-option-based investors are putting up \$9100.00 to own 100 shares of this example stock.

WE, as options players (and since options are quoted on a per share basis just as stock shares) are required to put up \$700.00 to CONTROL (not own) 100 shares of the example stock.

Why 100 shares?

That's a standardized options contract deliverable number of shares except for in special situations.

Why \$700.00 in cost?

That's the options price of \$7.00 (as quoted) x the 100 shares in the standardized contract = \$700.00.

Hopefully, now we can see that \$600.00 of our option cost, the intrinsic portion, is merely us paying for a "stub" of the stock price that we seek to control shares of for a certain time. Put another way, we're putting up a small portion of the share price because that's already built into the option's value as it is IN THE MONEY! That \$6.00 of the option's cost, as quoted, is "equity" that's already a part of the option's

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value. What remains beyond that, the \$1.00 (as quoted in the markets) or \$100.00 (in the real world) is, by definition, extrinsic value which is also known as **time value**, which is very important to understand...

The time value portion that we purchase is charged to us for many reasons in theory, but we can think of it as paying to participate in the potential the stock price offers over a certain period of time COMBINED with **something incredible: Leverage**. Our willingness to pony up that extra \$1.00 per share, SAVES us from having to put up all the extra money that's necessary to own the shares the way most Toms, Richards, and Harrys are still doing. It also does something else AMAZING for us by virtue of the fact that it prevents us from losing any more than what we've paid. If the stock price plummets below \$85.00, we as buyers/owners of the call option, are under NO OBLIGATION to take delivery of the shares. It is our right to take delivery of 100 shares if we'd like to, but we'd have no interest in buying shares at \$85.00 as the contract stipulates, if we could buy them say at \$75.00 because the share price has dropped by that considerable amount. Thus, it PROTECTS us below \$85.00 if we experience a good deal of adverse movement and limits our loss to \$700.00 whereas the stock player would experience a \$1600.00 so-called *paper loss* at the time as the stock price fell \$16.00 from \$91.00 to \$75.00.

Now, to be sure, we'd certainly experience some financial pain if the stock price dropped below our \$85.00 strike price in this example, but while the pain may linger, it would NOT INTENSIFY the way it would for the stock investor as \$85.00 gave way to \$80.00. then \$75.00. and so on, as is typical when cascade selling manifests itself. The shares-based trader has practically unlimited losses compared to the *smart* options investor. However, there is a negative aspect to this that we must cover...

TIME VALUE, which is that extra portion we're paying for, will fully dissipate as time passes and the option contract runs OUT OF TIME. That extra portion of extrinsic value that we purchase, can be thought of as rent we pay. day by day. to use that call option as our preferred vehicle. If we *ride it* all the way until it expires, we'd naturally pay the full amount of time value to have rented it. BUT, let's keep in mind that we're not required to hold the option contract all the way until it expires. We can EXIT the contract any time we'd like prior to the contract expiring and being permanently retired. Thus, we can rent day by day if we'd like and once we're no longer in need of the contract's services, we move on from it. That doesn't sound very threatening and it shouldn't as there's great flexibility in options. Much more so that most imagine. Folks tend to hear terms like "contract" and "expiration date" and begin to assume that their "married" to the situation once they enter it. That's simply not the case at all. We can exit options contract right after we've entered them, assuming the markets are still open.

Unfortunately, there's more to it than that and we'll need to use more time and more space than we originally planned next week in **OA** to thoroughly describe why it's not as easy as *picking an option, any old option*, to be consistently successful in investing. There's a smart place to position ourselves and we'll not only find it but fully explain why it is where it is and why that's the case.

If you have questions, please ask away in our next **Morning Call** webinar. ☺