MARKET TRACTION

Mid $260.00s SPYs Target Reached – Now what? Just Keep Watching

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This Week's Trade Ideas:

Bullish Ideas: (View Webinar)

None at this time. Along with the SPYs, most stocks have only just weakened today.

Bullish Mentions: **(View Webinar)**

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

None at this time. Along with the SPYs, most stocks have only just weakened today.

Bearish Ideas: (View Webinar)

JWN > Nordstrom Inc. > $47.07 Last. Buy the Feb 15th 47.5 Puts for $2.10 or less with a close or anticipated close below $46.85 in a down market with expectations for continued weakness in the stock.

Bearish Mentions: **(View Webinar)**
Based upon closing prices and all assume a down market with expectations for continued weakness in the major indices.

PFE, EIX, SNY.

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.

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Outlook:

Last week's Outlook is pertinent again as it has been week after week for months:

In the week that's passed, we saw a little more rallying initially, then a minor pullback that may have refreshed spirits, and ***that makes our mid-$260.00's SPYs challenge more likely save for major news impacts we can't foresee****. Effectively, the minor pullback or pause we often reference seems to have occurred. New recent highs are being made and at the moment* ***we have to roll with our short-term bullish take on matters****. If Brexit or some other news bomb doesn't interfere,* <u>***we're still thinking that we move up another 2% roughly and we'll see what happens if we get there***</u>*.*

The SPYs made it almost exactly to the $267.00 level before retreating today seemingly on the China slow-growth and housing slow-growth news. We were overbought and now, as we noted last week, we'll see what happens. We'll see if the 50 SMA holds and if not, then we'll see if the $260.00 support level will do the trick.

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 yet another exclusively bullish week. We've wanted to have a bear here or there but just haven't been able to justify it as the market has remained very bullish despite now being overbought.

MSFT was our official bull and it did make roughly a $3.00 push higher last week, which was muted but still pretty solid.

NKE, SQ, and **PYPL** were bullish mentions and only **PYPL** failed to rally, so that's not too bad either.

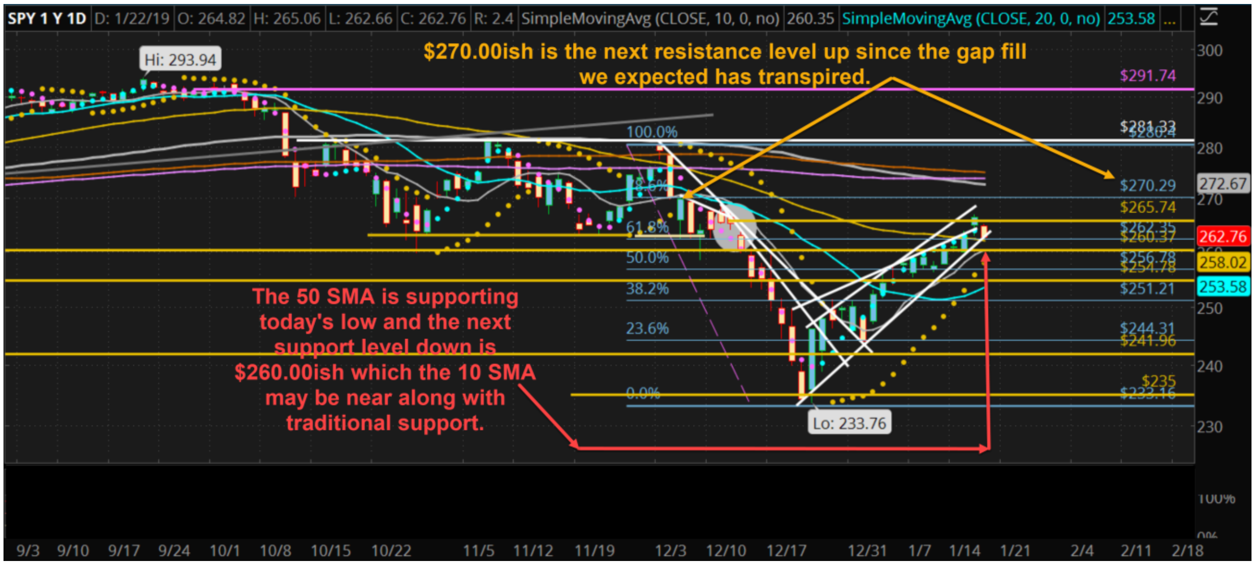
The prior week's names, **EQT, YUM, OKTA, TWLO, TEAM,** all of which were bullish, largely continued to try to hang in there as well. **EQT, YUM and TEAM** aren't up as much we hoped given the market's nice move. However, **TWLO** and **OKTA** did continue to power up with OKTA really jamming up.

Overall, the past few weeks have been hard ones to find bear names or to be a bear at all. Fortunately, our bullish leans have put us in-step with the predominate trend.

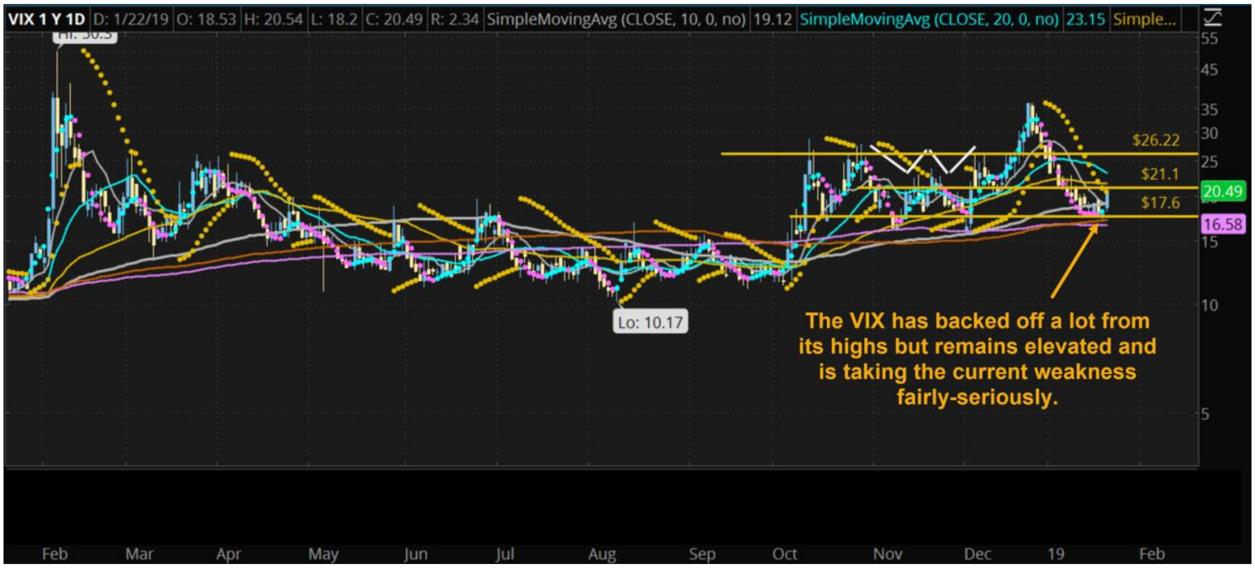
Market Overview

We continue to trade as a “package deal” with correlations remaining very high and thus there’s little difference between the SPYs and the other index ETFs.

We’ve seen yet another “V” recovery that closed the gap we’ve been watching for quite a while. Our mid $260.00s target has been achieved and now, since we’re short-term overbought and possibly still within a rising wedge, we need to see if the 50 SMA will hold on this drop. If not, then we must turn to the $260.00ish support. If new highs are made, $270.00ish is the next target level.



With the run we’ve had, and the target level reached, we have to move into a more neutral stance. The bears are due back in town and so we need to keep a very close eye on matters if $260.00 looks like it can give way. Our short-term neutral take seems to be backed by the VIX action:



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Options hedgers are unsure of what's likely to happen and so though elevated, the cost of portfolio insurance is on its way back up again.

Remaining nimble may become even more important this and next week than it has been over the past month of trading.

The calendar for the week is light, very light compared to last week's and what's to come next week. Existing home sales have already set an ugly tone for the week in the USA and that comes after China's growth came in very light over the long holiday weekend. Leading Economic Indicators on Thursday could be one to watch.

This Week's Economic Calendar

TIME (ET)	REPORT	PERIOD	ACTUAL	MEDIAN FORECAST	PREVIOUS
THE GOVERNMENT SHUTDOWN COULD DELAY THE RELEASE OF SOME DATA THIS WEEK.					
MONDAY, JAN. 21					
	None scheduled Martin Luther King Jr. Day				
TUESDAY, JAN. 22					
10 am	Existing home sales	Dec.	4.99mln	5.10mln	5.33 mln
WEDNESDAY, JAN. 23					
	None scheduled				
THURSDAY, JAN. 24					
8:30 am	Weekly jobless claims	1/19		218,000	213,000
9:45 am	Markit manufacturing PMI	Jan.		-	53.8
9:45 am	Markit services PMI	Jan.		-	54.4
10 am	Leading economic indicators	Dec.		-	0.2%
FRIDAY, JAN. 25					
8:30 am	Durable goods orders*	Dec.		2.0%	0.8%
8:30 am	Core capital equipment orders*	Dec.		-	-0.6%
10 am	New home sales*	Dec.		575,000	N/A
***COULD BE DELAYED BY GOVERNMENT SHUTDOWN**					

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Below the Radar

We present this week's **BTR** with a reminder. Financial television has been doing what they do best for the past month. Naturally, as you assumed, they've explained all concerns away and believe that 2019 will be another banner year for the stock market! Just like they told us 2018 would be! Anyway, despite being bullish in the short-term for several weeks, we always try to respect the downside risk during periods like this and when the charts have vulnerability within them in the form of patterns. Keep that in mind while reading and handling trades if you're active right now!

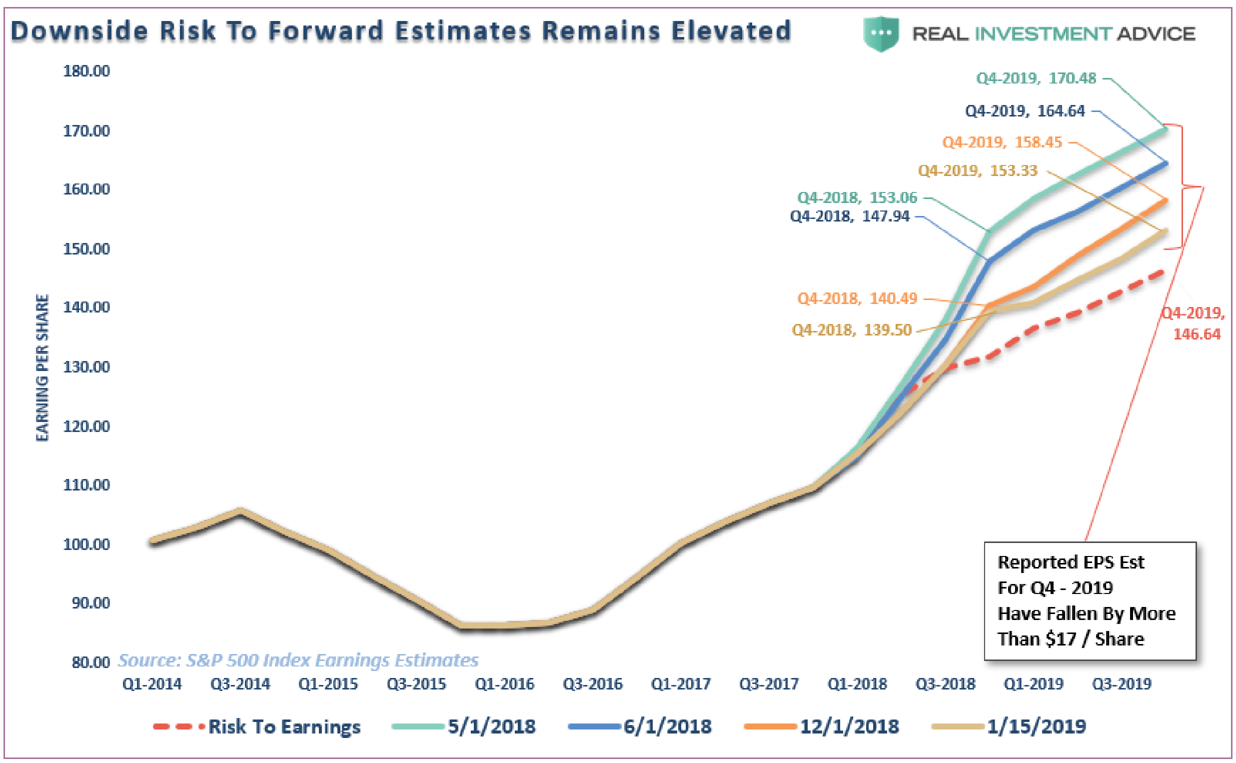
We'll get started with material from Lance Roberts that argues, among other important things, that 2019 earnings estimates remain too high. We liked the entire piece but culled our favorite portions:

" So far in fourth quarter reporting season, with 11 percent of the results reported for the S&P 500, three-quarters of companies have actually surprised Wall Street's forecasters. ***Earnings are shaping up to be better than people expected."*** *– CNBC*

Roberts ran with that and who can blame him? CNBC never learns, they never stop serving as cheerleaders.

"With earnings season underway, there is support in the short-term for asset prices but remember that earnings are only beating sharply downgraded estimates. ***(This is the equivalent of companies scoring a 71 after the level for an "A" was reduced from 90 to 70)"*** **– Lance Roberts**

Now note, with aid of the graphic, how high the Street has earnings expectations set to STILL despite the signs of weakness that have been popping up in more places:



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*In other words, equities have gotten **MORE expensive** over the last 6-months rather than less. However, given that **bottom line earnings per share is grossly manipulated through share repurchases, accounting gimmicks, and outright "fudging,"** more on this in a moment, top-line revenue gives us a much more accurate picture of the excessive prices being paid for stock ownership. **Currently, investors are paying 2x sales which exceeds the peak paid in 2000.***

Yep, we're really, really, really up there!:

This one below we particularly appreciated. Roberts pegs 86% of the revenue growth that we've supposedly witnessed since 2009 as being the result of accounting gimmicks!

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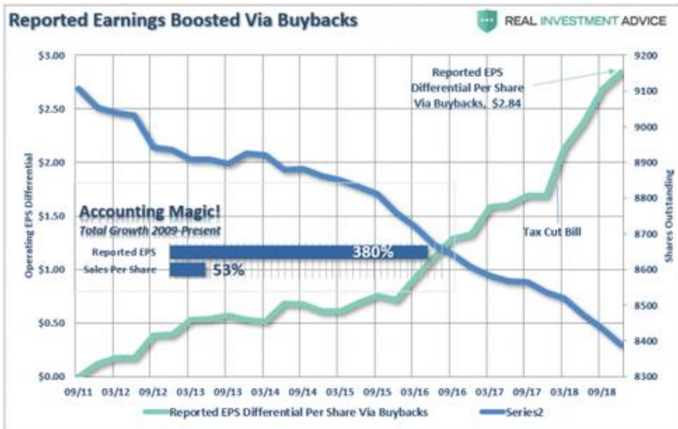
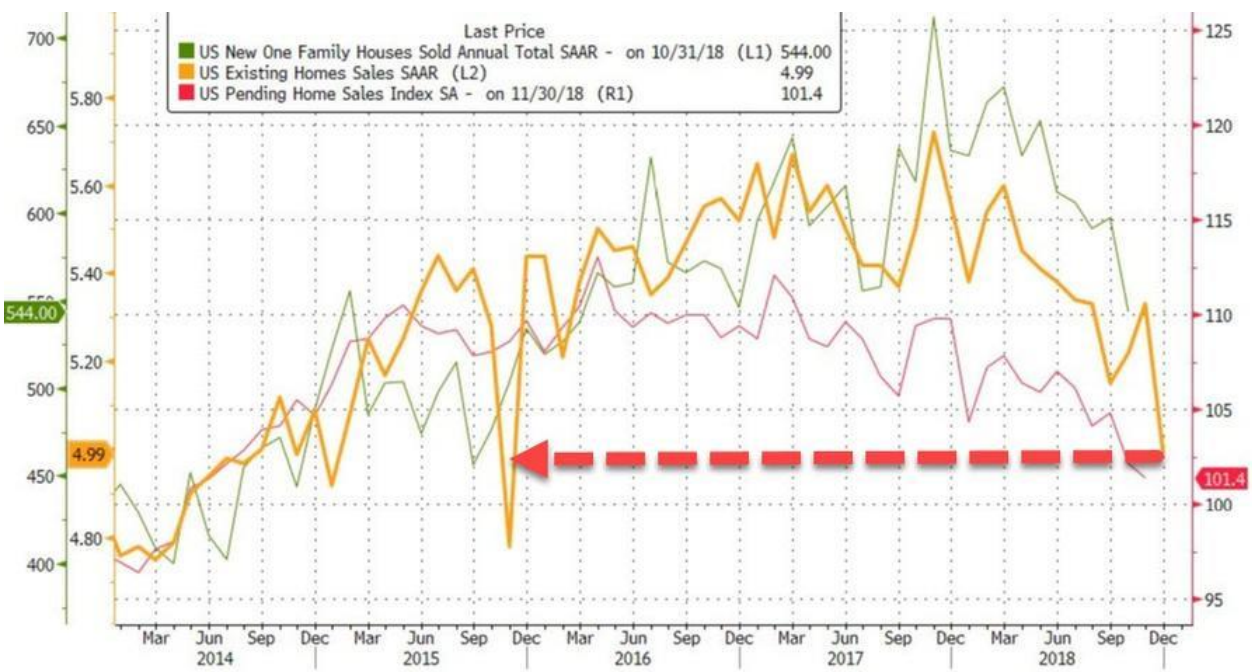


He sees reality intruding on Wall St.'s "don't worry, all is well" spin and rather soon:

The *"sugar high"* of economic growth seen in the first two quarters of 2018 was from a massive surge in deficit spending and the rush by companies to stockpile goods ahead of tariffs. While those activities create the *"illusion"*of growth by pulling forward *"future"* consumption, it isn't sustainable and profit margins will follow suit very quickly.

We found the graphic below and had to include it given our take that Powell and his merry friends at the FED have taken rates up too quickly. Housing affordability has really taken a hit due to higher rates and with this week's report, it's now official that FED has knocked us back to 2015!



The US housing market is a pretty big deal and now we can officially add it to the mess we covered last week in **BTR** with respect to European and Chinese industrial production.

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Where do we go from here? How should we interpret the current state? We checked in on DAVOS and we've got the thinking of the luminary's luminary in the form of Ray Dalio to both guide us and wrap up with for the week:

"What scares me the most longer-term is that we have limitations to monetary policy, which is our most valuable tool, at the same as we have greater political and social antagonism," Dalio said during a panel discussion at the World Economic Forum (WEF) in Davos on Tuesday. **"So, the next downturn in the economy worries me the most,"** he explained.

"There are a lot of parallels with the late 1930s. In 1929-1932 we had a debt crisis, and interest rates hit zero. Then there was a lot of printing of money and purchases of financial assets which drives financial assets higher."

"It creates also a polarity, a populism and an antagonism. We also had at that time the phenomenon of a rising power, like China, dealing with conflict with an existing power. **These types of political issues are now very connected to economic issues in policy.**"

"When we cut corporate taxes and made interest rates low enough that it was attractive enough to buy financial assets, particularly by companies having mergers and acquisitions, that caused a lot of growth in corporate debt. And that growth in corporate debt was used to finance the purchases. That is going to be less."

Super-cheap money is over for now and we're left with more corporate debt than ever. The FED may be a little more likely to pause than they were a month ago, but they still seem very far removed from lowering rates and "FED PUT" is supposedly a thing of the past. It should remain very interesting for a while with economic slowing popping up in a greater number of places and to a greater degree than was expected in such as short period of time. Late last summer, we remarked that the economic numbers we're so good that it was worrisome because they rarely get better than what we saw then. We, and others the saw it that way at the time may have been onto something…

Remain nimble my friends!

Bank and Roll!

Options Academy

Last week we decided it was long overdue to dive into dividends and this week we're picking up where we left off, which was:

…The second type of options dividend risk that traders, stock and option alike, need to be aware of relates to the risk of dividend payouts when short shares or upon assignment when short options contracts.

When dividends are paid, companies pay the designated amount per share to each shareholder. However, short stock positions present a somewhat unique problem as it relates to dividend payments.

To short shares of a stock, an investor borrows the stock from a current owner of shares and then sells the stock (short – since they do not actually own it and will need to buy it back later) in the open market to another investor (another stock owner). However, the original owner of stock that lent his shares to the short seller retains his benefits of ownership despite loaning the shares to be shorted.

This means that the original shareholder is still owed any dividends paid by the company. Looking at the mechanics of this process, the second investor on the open market that bought the shares from the short seller will receive the dividend from the company as well. However, the original investor must still be made whole on any dividend payment(s), which means the short seller now **owes** the original investor the dividend(s) out of his/her own pocket.

For short sellers of stock, hopefully, they have calculated the cost of paying the dividend into their overall profitability expectations when placing the original short bet otherwise…ouch!

Now let's consider possible effects on options traders…

There is one position a trader can hold in the options market that forces one to get short stock - getting assigned on short calls. That means for sellers of calls, dividend risk is particularly elevated, because they may be forced into a position where they are obligated to pay a dividend.

For short calls, the main category potentially affected by dividends are in-the-money (ITM) options. This is because getting assigned on short calls that are out-of-the-money (OTM) is typically very unlikely.

Regarding ITM calls, how might the owner of the call(s) decide if he/she wants to exercise their option(s) prior to the ex-dividend date?

Like anything in the trading world, this is a question of value. What's of greater value to the call owner, the "option-ability" that comes with owning a long ITM call, or the dividend?

Traditionally, option traders decide this question by calculating the extrinsic value (time value) of the ITM call - they then compare that number to the expected dividend amount.

Extrinsic value, as a reminder, is everything that is not intrinsic value. The intrinsic value of an ITM option is the difference between the strike price and the market price of the underlying. So, if stock XYZ is trading $92.15 that means the intrinsic value of the $90 calls is $2.15 ($92.15 - $90 = $2.15).

Now, imagine that the $90 calls are trading for $2.20 in the open market, which is $0.05 above the price of the intrinsic value. That means that the extrinsic value of the $90 call is $0.05 ($2.20 - $2.15 = $0.05).

The trader, therefore, knows the option they own has been given a time value of at least a nickel by the market. The next step is to check whether the potential value of receiving the dividend is higher than the extrinsic value of their option.

If stock XYZ is set to pay a dividend of greater than $0.05, the call owner would likely decide to exercise their contract(s) and receive the dividend, because that value is greater than the time value of the option they own. Therefore, if they were to exercise their call, they'd forfeit that time value in the call but gain the dividend payout. If that nets out to being positive, most traders will strongly consider exercising the call to go long stock to collect the dividend and thus will no longer hold the call option since they exercised it.

On the other hand, if the dividend payment is expected to be less than $0.05, the trader might prefer to hold his/her long option(s) as they do not gain on a net basis by exercising the call. In fact, if they want to extract that extrinsic value, it would be better for them to sell out their long call(s) in the marketplace.

Traders that are short ITM calls can, therefore, check prior to the ex-dividend date whether or not the extrinsic value of the options they are short is less than the value of the dividend. If that is the case, there's a good chance the trader will be assigned on those contracts and may want to close the position prior to the ex-dividend date.

To sum up, dividends are one of the important inputs that go into the computation of an option's value. As a result, it's important to monitor the amount and timing of dividends in underlying stocks in which you trade and invest.

Depending on your risk profile and unique approach, it may be prudent to avoid trading underlying securities with patterns of inconsistent dividend payout histories as they clearly introduce more uncertainty into calculations.

If you have questions, please ask away in our next **Morning Cal**l webinar. 😜

A reprint of Part 1 on Dividends from last week's OA is just below:

In **OA** over the course of time, we haven't discussed stock dividend payments very often in relation to options trading. With that in mind, we thought it may be a good time to do so as we've seen more and more analysts suggest that 2019 and 2020 may not be banner years for the stock market even as they don't see a bear market on the horizon (they never do 😉). With that in mind, we realize that many may be tempted to head into dividend-paying stocks to eke out some level of respectable returns in the near-term whether it be in shares of stock or options. So, let's get into it shall we?

Options traders seek to profit from the changes in the price of the underlying stock which by extension causes an appreciation in value of the options contracts, assuming we're on the right side of the movement! Stock investors seek to profit from a rise in the stock price as well, but many hold on to dividend-paying stocks because of the quarterly income that that those stocks reliably provide which increase investors' returns on a consistent basis, at least that's how they see it.

So, how is options trading impacted on stocks that pay out dividends?

Well…, it can be a little confusing and can lead to larger than expected losses if the requisite level of care isn't taken. Let's first address the effect of dividends on option pricing and then we'll move on to how you can learn to profit or avoid losing money unwittingly. Let's have a look behind the **Dividend Curtain**…

Let's define what a cash dividend typically is thought to be and not over complicate it. From Wikipedia:

A dividend is a payment made by a corporation to its shareholders, usually as a distribution of profits. When a corporation earns a profit or surplus, the corporation is able to re-invest the profit in the business and pay a proportion of the profit as a dividend to shareholders.

Cash dividends are the type we'll focus on for our purposes but to be thorough, other types of dividends do exist. The other fairly-common type of dividend payment is a stock dividend.

A stock dividend is simply a dividend payment in which shareholders receive additional shares of the stock in lieu of a cash dividend. Now, we can get moving again…

But first (😉), let's cover the 4 distinct dividend dates you may or may not have heard of:

Declaration Date
Record Date
Ex-Dividend Date
Payable Date

The declaration date arises when the dividend is declared and announced by the company's board of directors and after they've done so, they must legally pay the dividend. When the board declares the dividend, they naturally announce the amount and the other dates that follow.

The record date informs investors as to when they must be shareholders of record and thus accounted for as such by the company to receive the dividend payment.

A very important date for us to track as traders and investors is the Ex-Dividend date. The "Ex" date is typically one business day prior to the record date. If the stock is purchase prior to the *Ex-date*, the shareholder WILL receive the dividend payment from the company but if purchased after or even on that date, they'll not receive the dividend because they weren't "on the books" of the company in time.

The payout date is what you'd expect it to be. It's the date the company officially pays out the dividend to investors that were on the books as such by the record date.

Now we can tackle dividends and risks associated with them head on, at least as they relate to options. Quarterly cash dividends paid out by stocks can have a large impact on option prices. First off, we must note that when a dividend is paid out, the underlying stock price is expected to drop by the dividend amount on the ex-dividend date. This does occur in many cases but not all as supply and demand on the morning of the ex-dividend date ultimately has the final say as to where the stock price opens that morning.

Fortunately, popular options pricing models such as the Black Scholes and Put-Call Parity model have extended versions that account for the possibility of dividend payouts. What we learn from these models is that an upcoming dividend payment will reduce the time value (also known as extrinsic value) of a call option and boost the time value of a put option. This can also be argued from an arbitrage standpoint, where the underlying stock will fall by the amount of the dividend (at least in theory) on the ex-dividend date. Thus, had the options not been pricing in this inevitability, selling a call or buying a put prior to the ex-dividend date would yield a riskless profit.

Hint: Think it through a little and you'll see the logic applied here but don't worry, we've got a brief walk-through to follow.

At a high level, there are two important items to factor when discussing options dividend risk. The first relates to the aforementioned stock price adjustment made in the market when a company pays a dividend. To expand on that for further illumination, a stock's price is adjusted down on the morning of the ex-dividend date by the amount of the dividend. So, if stock XYZ is trading $90 per share and pays a $1 dividend with an ex-dividend date of September 1st, that means that all else being equal (no major news that dramatically sways the supply and demand for shares on the opening), stock of XYZ will open trading at $89/share on the open of trade on September 1st.

Obviously, options prices are based on where a stock price is currently trading and where it might trade in the future. So, it only makes sense that the price of the calls and puts in XYZ must account for this upcoming adjustment to the price of stock as a result of the dividend payment becoming official.

To go further, let's imagine that XYZ board decides to raise or lower their dividend payout. That will affect the expectations built into the pricing of XYZ's options. Those prices will need to be recalculated to account for the amount that the dividend has been adjusted by but not only for this quarter, it will need to flow through all future quarters as well. Typically, companies declare a quarterly dividend that remains consistent for each quarter so when they adjust the dividend amount, they effectively alter the entire dividend stream beyond that quarter as a result.

In general, if a dividend payout is adjusted higher than was expected, put values will rise and call values will decline. The reverse will be true if a declared dividend payout is lower than expected. This means that a high degree of vigilance is required when trading options in underlying securities that have a somewhat irregular (or unpredictable) dividend histories.

The second type of options dividend risk that traders need to be aware of relates to the risk of assignment when short options contracts. We'll pick up on this risk in next week's installment of **OA**.

If you have questions, please ask away in our next **Morning Cal**l webinar. 😋