MARKET TRACTION

Trading or Better Still, “Not Trading”, in the Summer of Nothing

This Week's Trade Ideas:

(View Webinar*)

Bullish Ideas:

(View Webinar) AXP > American Express > $101.71 Last. Buy the Aug. 17^{th} 100 Calls for $3.25 or less with a close or anticipated close above $102.09 in an up market with expectations for continued strength in the major indices and the XLF.

(View Webinar) VZ > Verizon > $51.51 Last. Buy the Aug. 17^{th} 51 Calls for $1.40 or less with a close or anticipated close above $51.94 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.

DIA Trigger > $252.66 (Likely Dependent on Earnings Reactions**), DE Trigger > $142.00.**

Bearish Ideas:

Searched far and wide but too many earnings are due soon on bearish charts. Still searching…

None at this time.

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:

Swing trading in an environment like this can be very challenging and clearly, news, that we can’t foresee and time, continues to be a main driver of stock movement! We’ve tried to make remaining nimble a focus here in the newsletter and in our **Morning Call** webinar and will continue to do so.

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Outlook:

Remarkably, last week's Outlook is this week's Outlook Again!

It's gotten caught up in resistance levels we've had in place for quite a while.

Stocks, aside from FAANG and maybe a few others, are ensnared in a web of nothingness and have been immobilized. Frankly, this _ _ _!

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 again, largely, a "nothing burger" with an extra frustration sauce!!! 😠

*"As can be seen below in **Market Overview**, the SPX is very little changed from where it was when we last published. Thus, stocks haven't moved much aside from a few notables and NASDAQ darlings."* – that's the exact syntax from last week and it still applies!!! 😠

Covering the bullish names first (with a frustrated tone), **TOL** put in little effort to even try to move higher. **DG**, about the same and both weakened as the **SPX** backed off post Trump tweet. At one point, **DLTR** moved up a *whopping* $2.00 or so from where we spotted last Tuesday. **BBY** had a brief, shining bullish candle on Thursday and then retreated with the **SPX**. Fortunately, **LITE** didn't trigger and then fell victim to tariff selling and in a big way. **ALB**, followed a technical path similar to **LITE** after not trying to trigger.

As for the bears, they continued to slumber. **TD, INTC,** and **MTW**, all held support and even managed to try to move up and were aided by the **SPX** not dropping below nearby support.

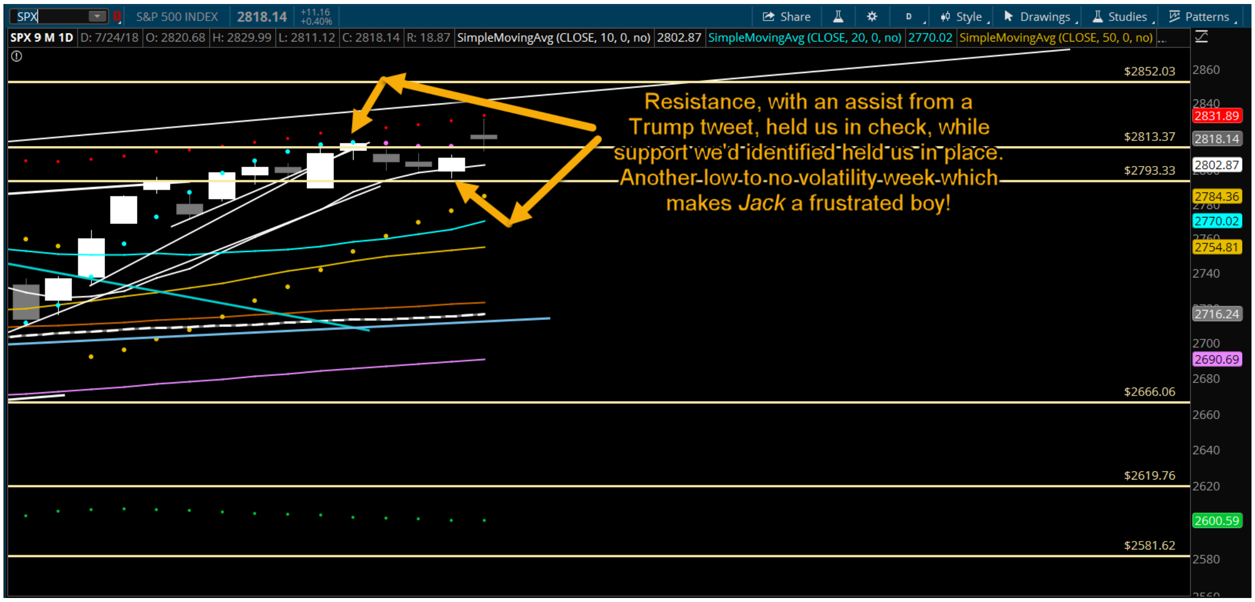
To summarize, 😠😠😠😠😠😠😠😠😠😠😠😠😠😠😠😠😠!

We remain in a "nothing's going on" state and we've had enough of it and it's not conducive for swing trading. All we can do is get prepared and thus we will.

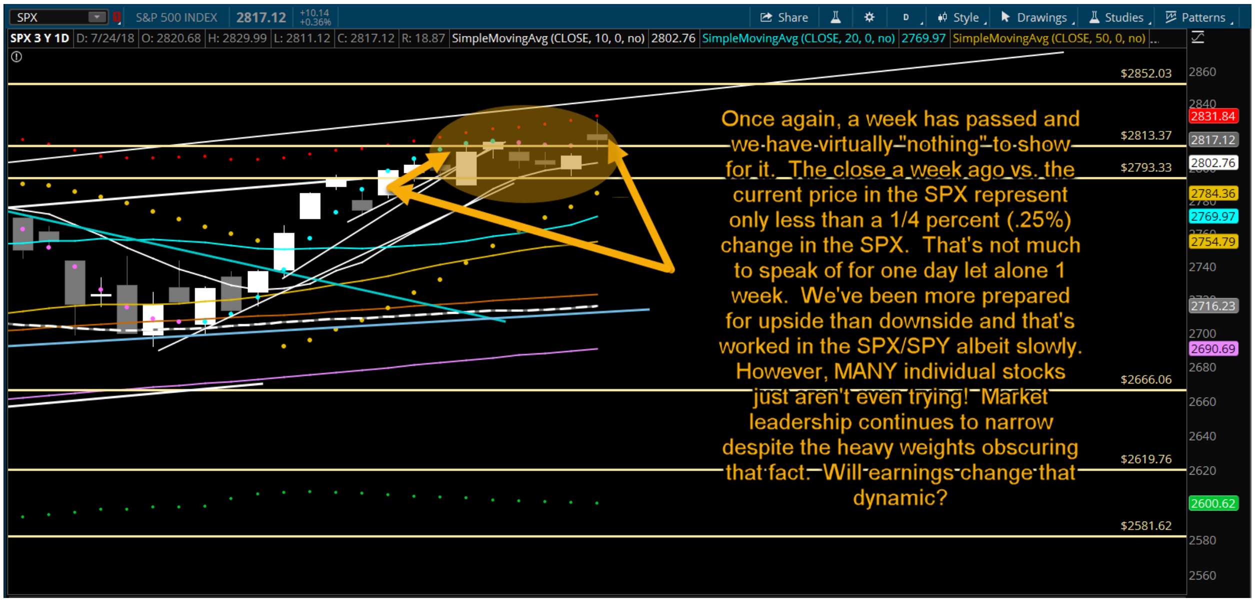
Market Overview

Last week can be summed up this way: Things began working a little to the upside, Trump tweeted about the FED, that ended the party after a failure to push through our resistance level, and then stocks slid slightly to our support level. “Hooray” – Bronx Cheer style.

That was really it and it wasn’t good. July has been good for the indices, but it’s been shabby for many stocks as the “big boys” keep powering up and in doing so mask the ho-hum performance of so many other stocks. In short, July has been frustrating. We came into the month with a take on the indexes that was bullish and a basic rationale for that and have had more bulls than bears at the ready, but success hasn’t been there to have for many names and that’s *damn* frustrating, plain and simple.



How bored-to-tears has it been? VERY!:



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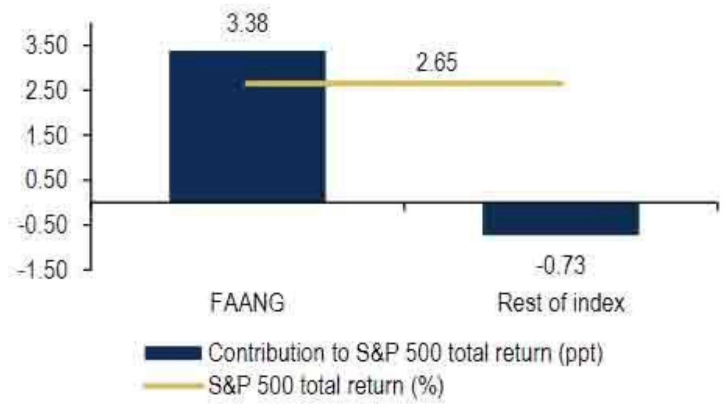
As we write, today's candle's not that encouraging either and with so many earnings reports slated, anything can happen in that news trumps charts and so do tweets while we're at it. There really can't be anymore earnings news in one week than is going to be shoehorned into this one!

We're reprinting last week's graphics from **Market Overview** because they're that important.

Chart 5: Excluding FAANG stocks, index returns would have been negative

FAANG stocks' contribution to the S&P 500 1H18 total return

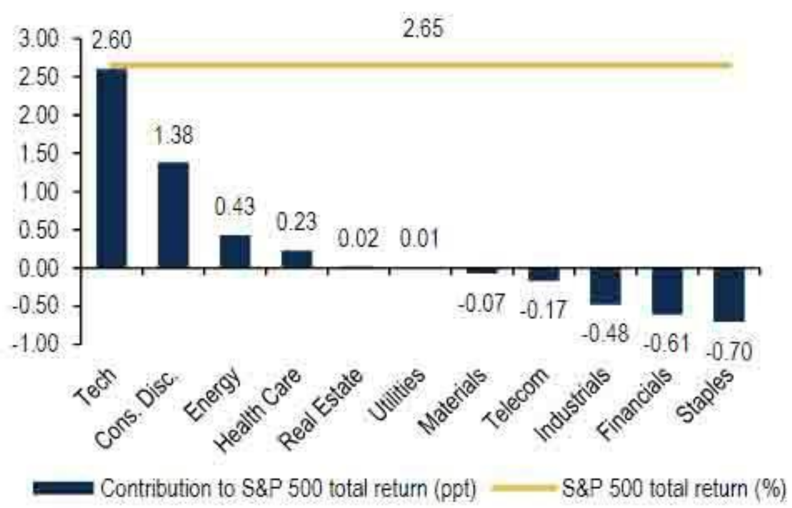


Note: FAANG = FB, AAPL, AMZN, NFLX, GOOG/GOOGL

Source: S&P, BofA Merrill Lynch US Equity & US Quant Strategy

Chart 4: Tech contributed 98% of the S&P 500 total return in the 1H

Contribution of sectors to the S&P 500's 1H18 total return



Source: S&P, BofA Merrill Lynch US Equity & US Quant Strategy

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It's very clear that were it not for TECH and especially FAANG, this market would be in much different technical straits. We've seen this kind of a mania before, but this time big money is being made by these companies (all accounting gimmicks aside). That's a very different story than Tech Bubble 1.0. Which, despite this:

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 obervers 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!

Finally…

We're told that (175 of 500 S&P) 35% of large companies are set to report their earnings this week so we have to believe that will result in determining the week's fate or at least will to a large extent. The calendar of economic releases is a little lighter than last week but there's more than enough there to move stocks if they'd like to do so. The ECB may have something to say on Thursday which could be market moving and certainly the initial Q2 GDP on Friday could be the stuff that bullish dreams are made of to put an upside exclamation point onto the finish of this week's trading. Then again, it could dash hopes if it is anything shy of spectacular. We shall see…

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This Week's Economic Calendar

TIME (ET)	REPORT	PERIOD	ACTUAL	MEDIAN FORECAST	PREVIOUS
MONDAY, JULY 23					
8:30 am	Chicago Fed national activity index	June	0.43	--	-0.45
10 am	Existing home sales	June	5.38 mln	5.38 mln	5.41 mln
TUESDAY, JULY 24					
9:45 am	Markit manufacturing PMI flash	July	55.5	--	55.4
9:45 am	Markit services PMI flash	July	56.2	--	56.5
WEDNESDAY, JULY 25					
10 am	New home sales	June		660,000	689,000
THURSDAY, JULY 26					
8:30 am	Weekly jobless claims	7/21		219,000	207,000
8:30 am	Durable goods orders	June		3.7%	-0.4%
8:30 am	Core capital equipment orders	June		--	0.3%
8:30 am	Advance trade in goods	June		-$67.3 bln	-$64.8bln
10 am	Housing vacancies	Q2			
FRIDAY, JULY 27					
8:30 am	Gross domestic product	Q2		4.3%	2.0%
10 am	Consumer sentiment	July		97.3	97.1

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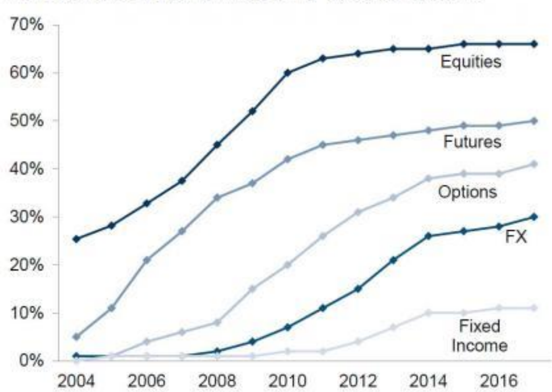
Below the Radar

While trading the past month or so has been very muted, **BTR**-type material is finally appearing with more regularity. Last week things picked up and this week was solid again. We had a few discussions this weekend with traders that are very concerned about this market's underpinnings and age. They've been thinking that the Fall may not be so kind to stock market. Many know that October has produced many dramatic moments over the years so naturally they're thinking that could be the time when things begin to unravel. Their fears centered on other things beyond age such as trade issues, *geopol* issues, rising rates, inflation surging etc. They've been concerned about how engineered this bull market has been with the FED and corporate America having a heavy hand in lifting stock prices and supporting them whenever they've been on the brink of a major correction. What they didn't mention is something that's been OFF the radar for a while: The very nature of the modern market. Given all this, this story couldn't have appeared at a better time to remind us again that "algo" and "hft" trading and passive investing could be setting us up for very serious issues should the market begin to deteriorate. This article is a little technical but worth the full read: https://www.zerohedge.com/news/2018-07-22/morgan-stanley-its-not-your-imagination-large-moves-are-becoming-more-common-market

Algorithmic trading has grown across asset classes…

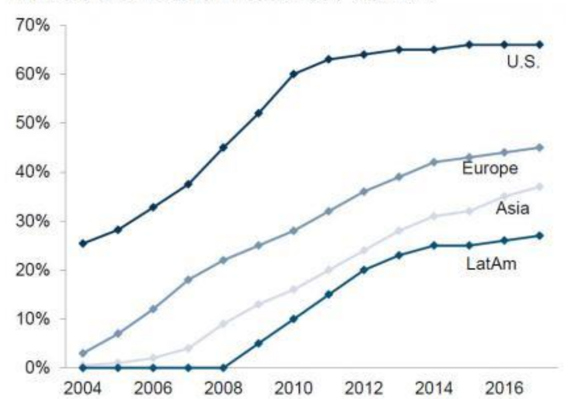
Market share of algorithmic trading by asset class, %



Source: Aite Group, Goldman Sachs Global Investment Research.

…and regions (though the US still leads the way)

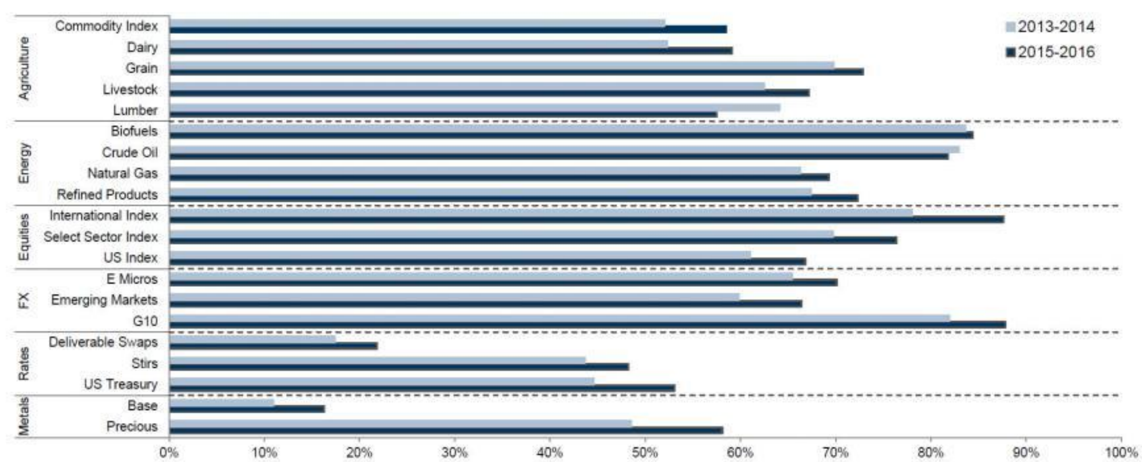
Market share of algorithmic trading by region, %



Source: Aite Group, Goldman Sachs Global Investment Research.

Algorithmic trading has become more popular across products within futures markets

Market share of algorithmic trading in futures markets, %



Source: CFTC, Goldman Sachs Global Investment Research.

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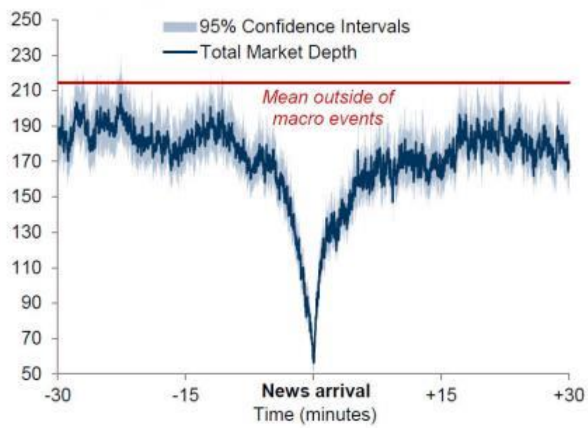
Market depth drops around fundamental news events...

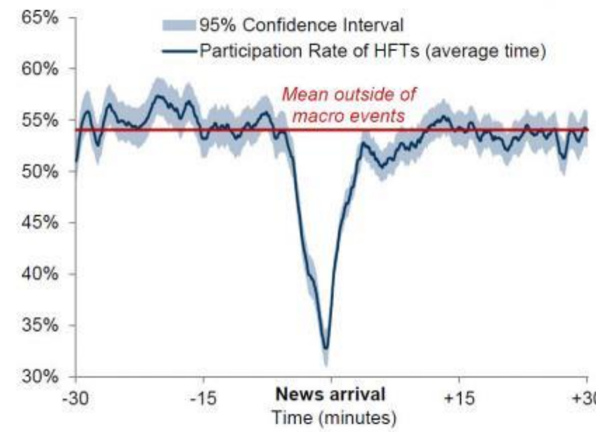
Number of contracts around news events



Source: Eurex, Hautsch, Nikolaus and Noé, Michael and Zhang, S. Sarah (2017).

...as HFTs withdraw liquidity

HFT share of market volume, %, around news events



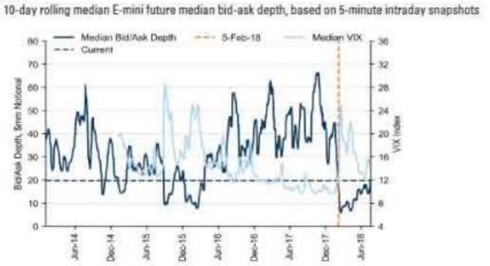
Source: Eurex, Hautsch, Nikolaus and Noé, Michael and Zhang, S. Sarah (2017).

If it looks to you like the markets are largely in the hands of machines and that those machines are "turned off" when critical news is pending, you're onto it! Naturally, we must ask, what if the machines are turned off for much longer stretches of time given how dependent modern markets are on them to provide "liquidity"? EXACTLY! There's a serious chance that there won't be very much liquidity should cascade-style selling develop post-event/news item.

There's even more to be concerned about here in the Summer of 2018 with respect to the market's functionality. ZH recapped Goldman Sachs commentary and research focusing on worsening market liquidity. This is a fairly-heavy piece to read but it does offer more evidence that the market is much more fragile below the surface than most realize. Obviously, that doesn't bode well if something triggers serious selling and much more you-know-what hits the figurative fan:

Exhibit 6: Bid/ask depth fell sharply in early 2018 and remains near its low points from 2015-6

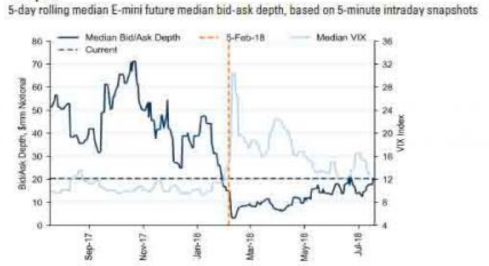
10-day rolling median E-mini future median bid-ask depth, based on 5-minute intraday snapshots



Source: Goldman Sachs Global Investment Research, Reuters

Exhibit 7: Zooming in on the last year, futures' quoted depth fell sharply prior to February's VIX spike

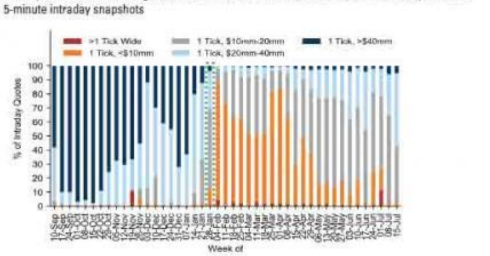
5-day rolling median E-mini future median bid-ask depth, based on 5-minute intraday snapshots



Source: Goldman Sachs Global Investment Research, Reuters

Exhibit 8: SPX futures' top-of-book depth had declined sharply prior to February's sell-off

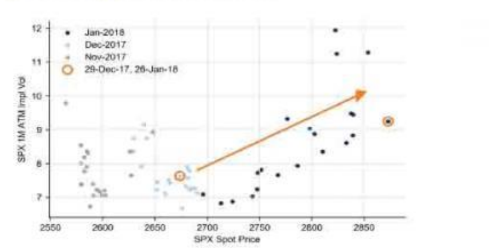
Weekly distribution of average bid/ask width (# of 0.25 ticks) and size ($mm notional), based on 5-minute intraday snapshots



Source: Goldman Sachs Global Investment Research, Reuters

Exhibit 9: SPX implied vol rose in January despite rising spot index

SPX spot price and 1-month at-the-money implied vol



Source: Goldman Sachs Global Investment Research, Goldman Sachs Group Inc.

The takeaway from Goldman:

Which brings us to Goldman's summary take on why liquidity has become a dominant consideration for investors in today's market: simply said ***volatility and liquidity are interconnected, both logically and empirically,*** *to wit:*

- ***Low liquidity means high vulnerability to shocks.*** *To the extent diminished top-of-book depth is indicative of potential weak liquidity in a sell-off scenario, we may continue to be vulnerable to severe market shocks. Heightened potential for liquidity to weaken in a sell-off ultimately contributes to volatility of volatility:* ***when volatility rises sharply, weakening liquidity can make incremental trades move markets more, pushing up volatility further.***

So, what does the collapse of liquidity in a low vol regime mean for the market? Goldman's conclusion is disturbing:

Weakened availability of liquidity when conditions are favorable could point toward especially low liquidity when it's needed most – i.e. in the next severe market sell-off*. The potential for markets* ***to be vulnerable in a sell-off makes it even more prudent to take advantage of moments when volatility is back near historic lows****. We believe that this trend further helps the case for hedging, which is furthered by slowing global growth and an ever-higher spot index level. Although our economists see low likelihood of a recession in the near future, it's worth noting that the last few volatility spikes have happened in the middle of an economic expansion.*

When we couple the vicious cycle above with the all-too-common money manager mindset of "Yes I'm concerned, but I'll be the first out the fire exit", it becomes clear as to how ugly it could get in a hurry. Fortunately, hedging is cheap:

And here Goldman finds something surprising: despite depressed liquidity conditions, in the aftermath of February's volatility, ***hedges remain historically inexpensive:***

- **Put options are cheaper** than they were throughout most of the last few years, across equity indices.
- Hedge pricing is comparable to the low-volatility 2017 for many underlyings and strikes.
- **Implied/realized volatility spreads are low or negative for most equity underlyings.**

If you'd like a quick and very readable refresher on the "smoke and mirrors" maneuvering that the central banks have performed, check out this one: https://wolfstreet.com/2018/07/18/risk-pricing-central-bank-bond-buying/

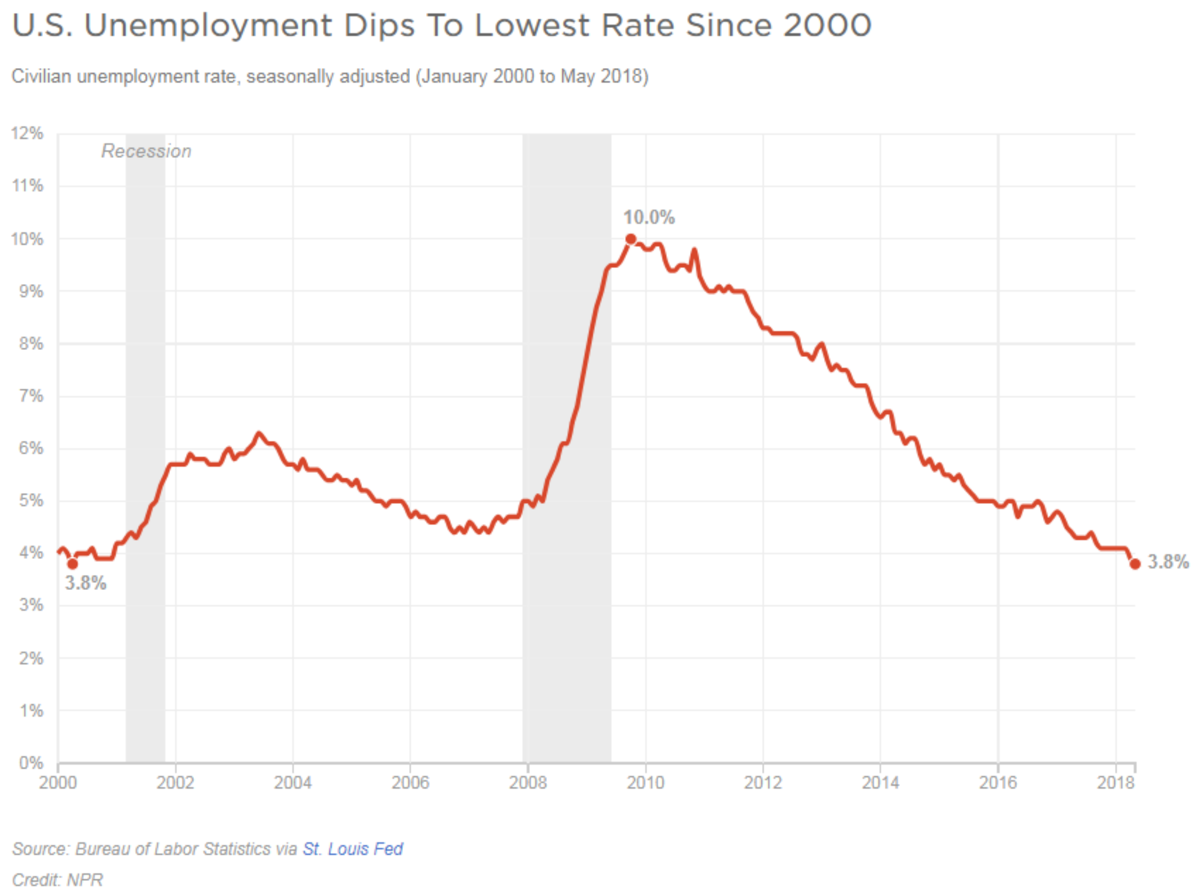
This is how it begins, and we'll leave for you to judge if the article is worth your time:

When central banks distort the markets, risk disappears from view.

"You could have a bunch of walking-zombie companies and you don't even know it," *explained Mary Callahan Erdoes,* ***CEO of JPMorgan Asset Management****, on Wednesday at the Delivering Alpha Conference in New York. "****That's a super dangerous place to be,"*** *she said.*

There's more concerning information to come but we're going to turn to something else we've been discussing for quite a while because it COULD help to move stocks higher and maybe deliver the best we'll see of things this late in the cycle, at least, that's how some concerned investors are thinking about it.

They point to items like this:

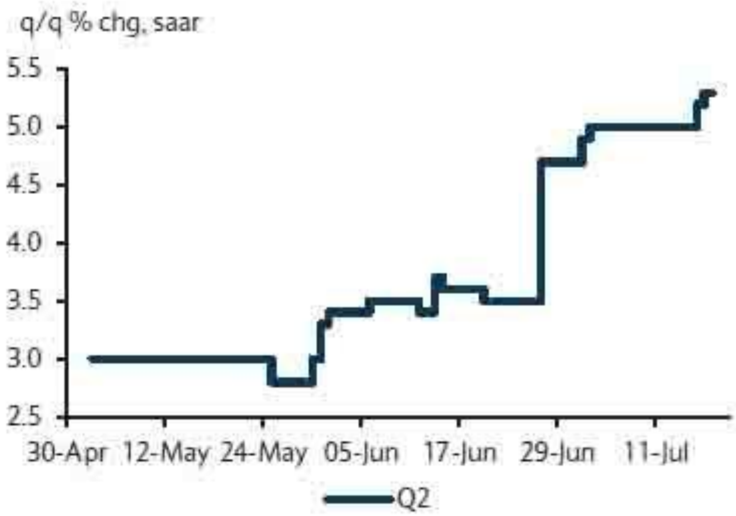


And ask: ***"How much better can it get?"***

We can clearly see their general point but it could be a while before conditions worsen and that may be all that bulls need for another jaw-dropping jam-job to the upside. Thus, and on the flip side, we have "warn" here about really good stuff too that may be buried in too much fear, hence: https://www.zerohedge.com/news/2018-07-23/53-gdp-print-deck

GDP for Q2 will certainly be one of the "biggies" this week. It's a short read and again, worth it, because it sounds a very positive short-term note but concludes with a far more concerning note. Regardless, if you just want the *key pics*, here they are:

FIGURE 3
Q2 GDP tracking at 5.3%



Source: BEA, Barclays Research

Here's just a wee nip of the rather downbeat wrap-up with more details on why trade wars provide a brief boost to GDP followed by a steep decline:

The 'stockpiling' in exports could be responsible for 1.5 percentage points of our 4.7% 2Q GDP estimate. 'Stockpiling' also appears to be at work for US companies, albeit to a more limited extent. The inventory build in 2Q is tracking at +US$38 billion, versus a +US$10 billion rate in the prior two quarters. And what's more interesting is the areas where those inventories are building, which have material overlaps with trade: electrical goods, machinery equipment, motor vehicles and parts.

In total, Morgan Stanley sees net trade and inventories making up 2.2% of its 4.7% US GDP estimate, ***the highest combined contribution since 4Q11. Their concern is that since they are one-off***

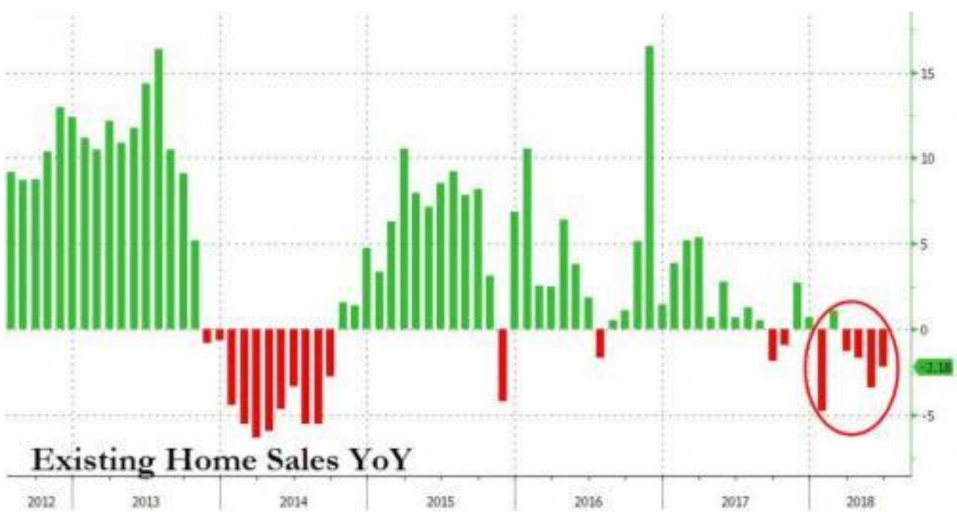
adjustments, both contributions are unsustainable and represent a pull-forward of demand that will need to be given back.

As an example, the bank notes that US GDP was +4.6% in 4Q11, then averaged +1.6% for the next five quarters.

And while Trump will be delighted to take credit for the one-time surge in the US economy, even his economic advisors will realize that Q2 growth is merely pulling demand from the future (a popular theme in this economic cycle).

Part of the concerns we heard this weekend had to do with rising rates and their effects, as noted above. Well, that's almost always a legitimate concern to us and new data may be bearing out in a way that suggests prudence is in order:

Clearly new homes are hanging in there, for now, but rates rising may have capped the good times for existing sales and the graphic below provides even more comparable perspective:



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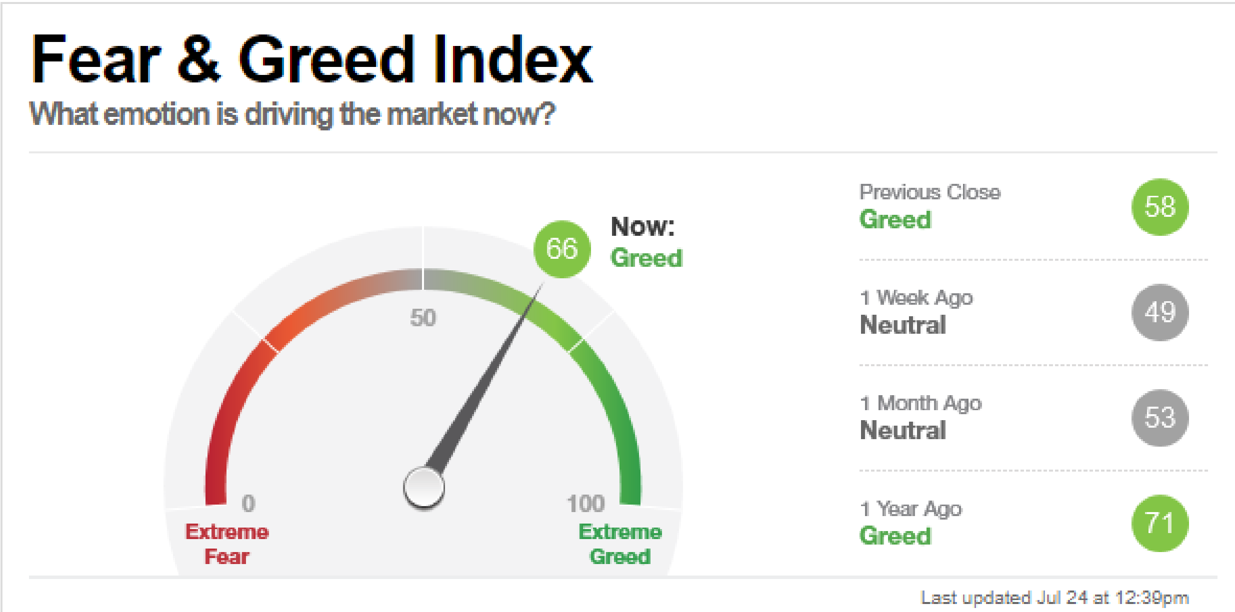
We've been discussing how even though the market is becoming more and more narrow, the indices have been steadily improving for months and the technical picture has looked better and better. That didn't help us much in past few weeks as stocks have stalled. But, now, we're finally getting things to move up more in the SPX and it didn't take much to get into the greed zone and just as *Fall Trading* is around the bend:



If it is, it's right in line with history…:

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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%

…and conditions could even more *greedy* just in front of the time many are already worrying about which is just in front of the mid-term elections. The market's liked Trump so far and we have to wonder what could happen if his party loses enough seats to bring GRIDLOCK back in a big way.

Bank and Roll!

Options Academy

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 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…

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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 **<u>something incredible</u>**: **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 **Advantage Point Morning Cal**l webinar.