When Investing Goes Viral

When we have sell offs, where the S&P 500 tanks more than 50 points, I often get asked to go on TV and say why it happened.

The interesting thing is that there are usually two answers. The headline answer and the real answer.

This does not just happen in markets, it happens in just about every troublesome thing in our lives.

My son does not want to go to bed tonight.

He says he is hungry.

He says he is not tired.

The truth is, he is probably going through a phase where he is a little bit afraid of the dark.

There is a solution to my son's hunger and lack of tiredness. I gave him a couple of taco shells and a drink of water...

I also turned on the hallway light.

So why does the market sell off? There are two answers, the headline, in the case of the 50 point draw down on 1/27/2020, it was fear of the Coronavirus...in the headlines…

According to the news.

So why would a virus linked sell off be led by some of the best performing names in the technology sector.

Why would Amazon...who is specifically run so you never have to leave your house down nearly 2%.

Why would Microsoft be down nearly 2%

What about Facebook? A viral outbreak says sell this stock off 1.4% to the logical person?

Why is Apple down almost 3%

Why is GOOGLE down close to 2.5%

You could make an argument for AAPL being sold, but why the others?

The answer is that sometimes a headline is an excuse and not the real reason for selling.

All of the above companies have earnings this week.

The above 5 companies make up about 17 % of the S&P 500, 40% of the NASDAQ 100, and AAPL was the largest component of the DOW Jones Industrial Average until Friday.

All of these companies, with maybe the exception of AMAZON have had EXCEPTIONAL performance over the last 3 months, one might say unbelievable performance.

One could make a strong argument that the price action from the 24th and the 27th is as much related to 5 companies being overbought as it is related to anything having to do with a virus.

I am not saying that Caronavirus cannot become a truly systemic issue, it can, but the price action from those two days is as much or more related to pre earnings profit taking as it was related to the headline in the media.

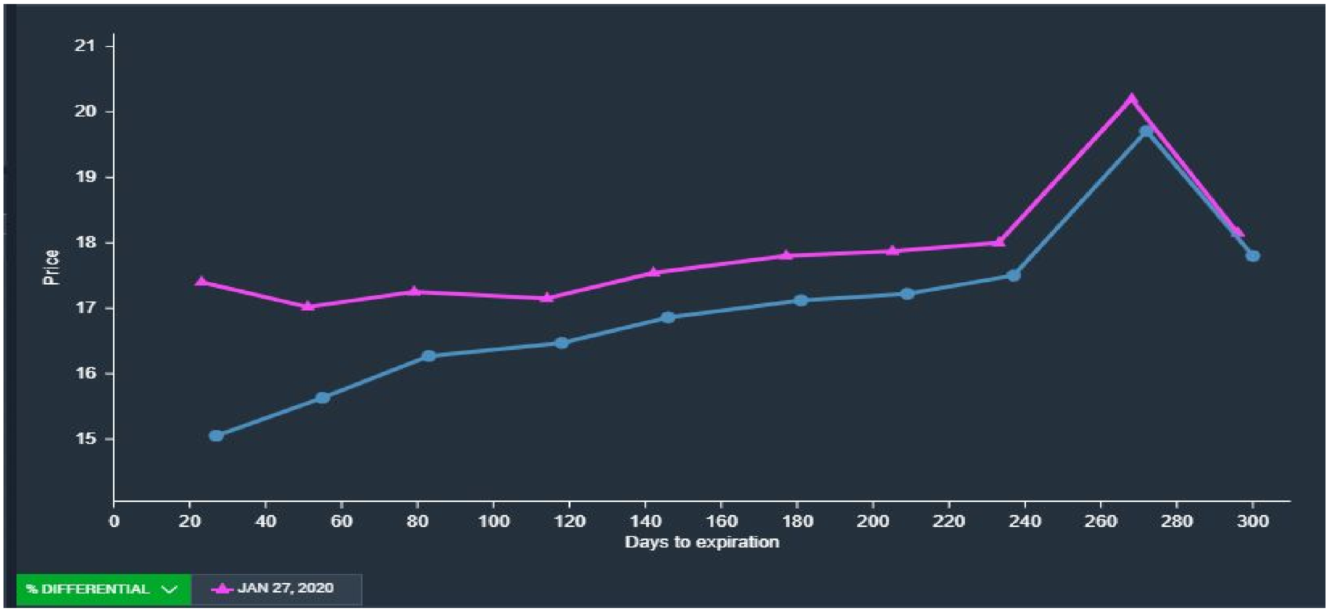
The Market

Well all hell has broken loose, markets are almost 3% off of their highs:

The dow is actually down on the year right now, showing how my above thoughts relate to the S&P 500 and the overall market.

In just a couple of days we have seen the VIX go from signalling all clear to saying ummmm….

Let's take a look at the movement in VIX between last Thursday and yesterday's close.



VIX futures are now flat to slightly backward, 3 trading days ago we were in a standard contango (I'll talk about the huge pop in Oct 2020 next week). All told the VIX is saying.. Um we are scared that there COULD be a real sell off. It is not confirmed yet, March is still cheaper than April. But with the cash above every month out to September, there is risk of a legitimate sell off here in the next few days.

VIX is going up with the market dropping. This is what we expect. I would say that yesterday's sell off saw a commensurate VIX pop, not a crazy overreaction, and not an underperformance. Basically, yesterday did not provide very much clarity. This is because I believe the sell off is as much tied to AAPL as it is the Virus.

Last week when AAPL was $320, the earnings strangle was about $16. Today the strangle is near $19. There is real risk starting to be priced into AAPL earnings. If they are bad tonight, the market is going to go down. Hedge AAPL, hedge the market.

More evidence that the market is fearful is VVIX which stands at 107. It has blown higher in 2 days after being WAY too cheap last week (thus the green light in my last piece).

I am not sure if we are going to have a protracted sell off at this point, but conditions exist for it to happen. Either way we are GOING to see movement.

Option Pit Traffic Light

SPX: Yellow

VIX: Green

SPX IV: Green

VVIX: Yellow

DISNEY

Walt Disney Co has gotten THWACKED. Not just yesterday, but over the last few weeks. Since Disney Plus announced that they launched with 10 million users, the stock has gone straight down.

The fear of Coronavirus affecting its parks is real. The parks are extremely profitable, so for this to happen should be considered a real negative. The question is though, is DIS worth less than the day before it announced earnings last November. My answer is a clear no.

The stock is well below the 200 DMA but appears to be trying to make a run back above that level. I think if it can pop above the 200 DMA which is $138.36 it's going back to $145, potentially BEFORE earnings which are on Feb 4.

Movement appears to be picking up in the name, after cratering over the last month. If DIS does not go up, it's probably not going to sit, it's probably going to $130.   However, I think the move will be up, not down.

With earnings coming up and the stock getting face punched the last few days, the IV of the options has gone WAY up, making buying a straight call pretty darn difficult. Even a call spread is a touch over the top in terms of cost.

Thus, I am going to go a little bit out of the box for today’s trade.   WIth IV high and belief that the underlying is going to rally, I can either sell a put spread or buy a call butterfly.

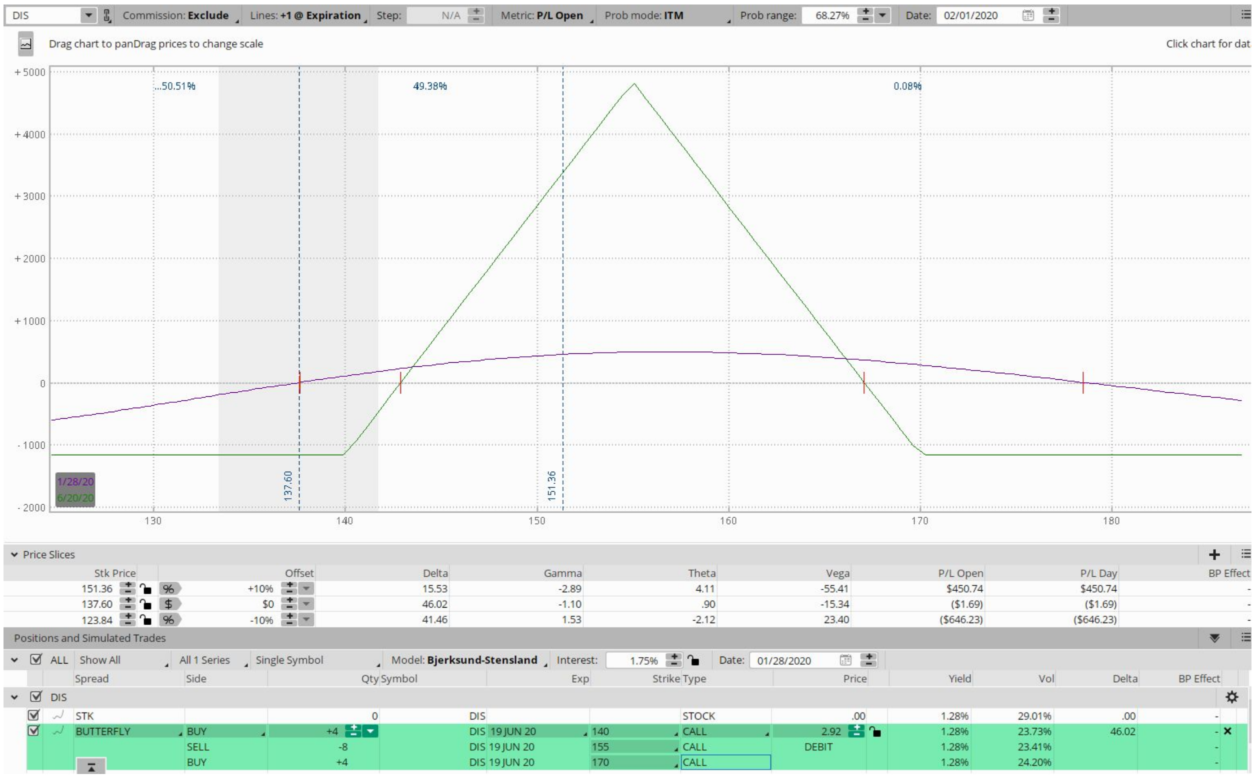
Because I think the stock is going to $145-$150 not just back to $140, I actually like a butterfly better.
If you are not familiar with a butterfly, the simple version of the trade is a call debit spread, I will lay out both, in a moment.

Let's quickly look at the term structure: two things I want, wiggle room and time, while still getting edge in being short volatility. By going out to June or July, I get to look at 2 earnings cycles and I can sell premium that is still relatively expensive.

Expiry	Jan31(W)	Feb07(W)	Feb14(W)	Feb21	Feb28(W)	Mar06(W)	Mar20	Apr17	Jun19	Jul17	Sep18	Jan15'21
Sigma	26.82	39.44	32.73	29.05	27.40	26.59	25.02	23.13	22.92	22.76	22.75	22.57
Sigma Chg	-2.83	1.45	0.52	0.03	0.07	0.05	0.05	-0.07	-0.10	-0.09	-0.11	-0.49
Vol												

I would be a buyer of the JUNE 140-155-170 call butterfly paying $2.90 or better. The pay out is about 5 to 1, but I am really only looking to sell the spread at about 4 dollars. I will make that much when the stock gets back to $145 or so. If I am not a butterfly trader, I would execute the June 140-150 call spread INSTEAD of the June 140-155-170 call fly. This is to keep costs down. If I do NOT have the ability to spread in my account and intent on trading DIS, I would be a buyer of the June 140 calls, but at 7 dollars this is a stretch and would need to get sold in a day or two and should NOT be considered a long term hold.

Trade: Buy to open 4 DIS June 140 call for $7.15, sell to open 8 DIS June 155 calls at $2.60, and buy to open 4 DIS June 170 call for $.90



My target on this trade is $4.00 or better. If DIS falls I will have adjustments buying the 155 calls back.

Your Only Option,
Mark Sebastian