Fake News, or Fake News After the Fact?

For starters, welcome to our 1st Tuesday Trade Idea. Generally speaking, I will go through a little bit on the market as a whole. From there I'll talk about the theme that is driving my trade idea. Finally, I'll walk through the trade I like and why. This will be done from a fundamental and 'technical' approach for direction, with an overall focus on volatility. Should be fun. If you have feedback, we welcome it, especially early on while I am developing this concept.

Regards,

Mark

Overall Market

We continue to preach ignore the noise here at Option Pit. Despite the cacophony of headlines, the last week or so:

1. Trump Impeachment

2. China Investment Curtails

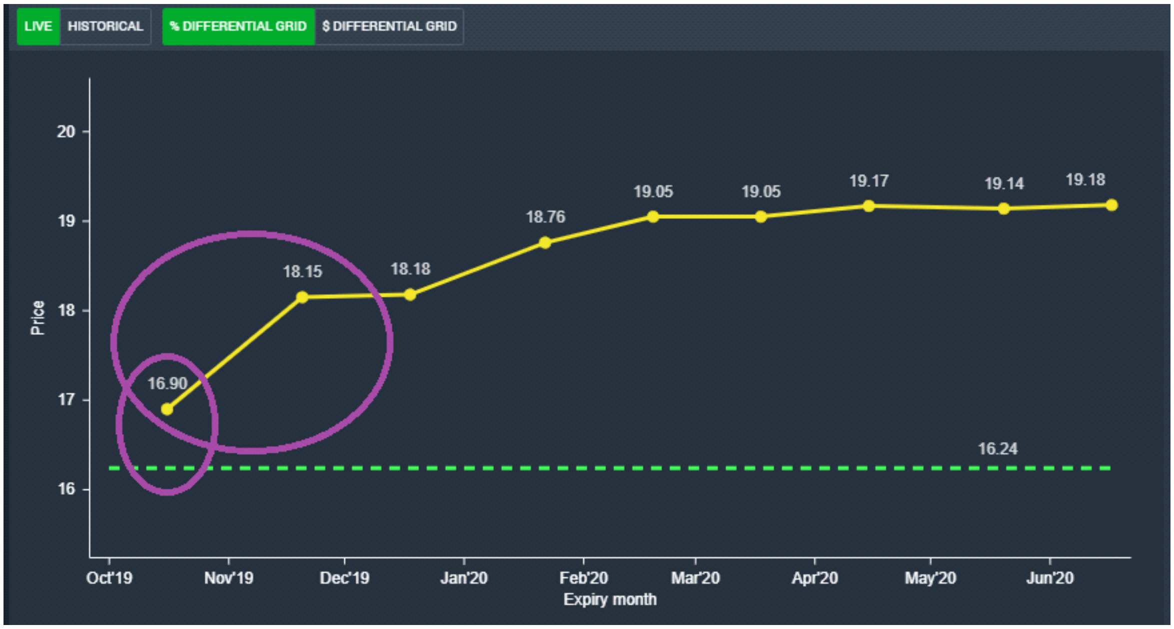
3. Economic Worries

4. Lack of economic worries driving rates higher

The net of all of this noise has been a whole lot of nothing.

The market had one strong up trade from late August through early September. This was on a heels of one strong down trend. The last down trend brought us chop (the 1st yellow circle). The most recent up trend also brought us chop. The question is, does this next round of chop bring a down trend or an uptrend?

My answer leans toward an uptrend. Here is why: there are NOT a whole lot of questions out there right now. The only major thing markets want to know is what is going on with China. We do not think impeachment matters, and seem to have been proven right by the price action of the S&P 500. More importantly we are watching the VIX Curve closely. Despite some decent sell offs in the S&P 500 over the last week of chop, WITH a slight down trend, the VIX Curve has held a decent contango almost continuously.



Monday's rally with subsequent VIX drop is interesting in that the spread between VIX and the Oct future remained somewhat tight. We have found that this type of relationship, falling VIX and closely falling VIX future has led to the market having some legs higher. The longer the VIX drops WITH the VIX futures, the longer the rally.

We strongly believe in falling the VIX contango percent and daily decay. Interestingly, when the contango spread and daily decay numbers have gotten high, that has been the best time to play a market turn lower. Essentially, when the numbers scream to short VXX, that is actually the time to think about going long. When the numbers say VXX is not a great 'sell and hold' have been the times when VXX has had the greatest moves lower (see Monday).

The major concern we see from a vol perspective, that continues to give us trepidation, is VVIX. The index has been stubbornly high. High VVIX equals higher likelihood of the VIX going higher (we will get more into this on another letter).

Trade Trends:

The China trade continues to be an interesting trade. We are HUGE believers in short term opportunity trades. The recent news surrounding China and the US (that the US might restrict investment or delist Chinese securities) is so ludicrous that it is likely completely false or at a minimum just an idea that was 'tossed around' a bit, likely not taken seriously. This is especially true given the market reaction on Friday September 27th.

What is interesting is that despite Peter Navarro, the absolute hawk on Trump's China team, essentially denying the report, many Chinese stocks have not recovered the way one might expect. Take a look at Alibaba:

On Friday the 27th, the stock absolutely tanked, presenting its biggest down candle since the early July tariff shocker. The move BABA took lower FAR exceeded any move we saw in the S&P 500 or other US indexes. BABA even made some of AAPL's moves seem small, and AAPL has been extremely China-sensitive.

On the China news, BABA, in one day, fell below the 50- and 200-day moving average. Monday it managed to get back to the 200, but could not hold it. It seems that there is going to be a stronger denial from the Trump administration than what Mr. Navarro reported Monday. If markets do receive a stronger denial than Monday's, BABA is likely to get a HUGE pop higher. Without this denial, the underlying could 'flop around' for a bit, but we still see the underlying moving higher, similar to the price action from early July, just on a smaller scale.

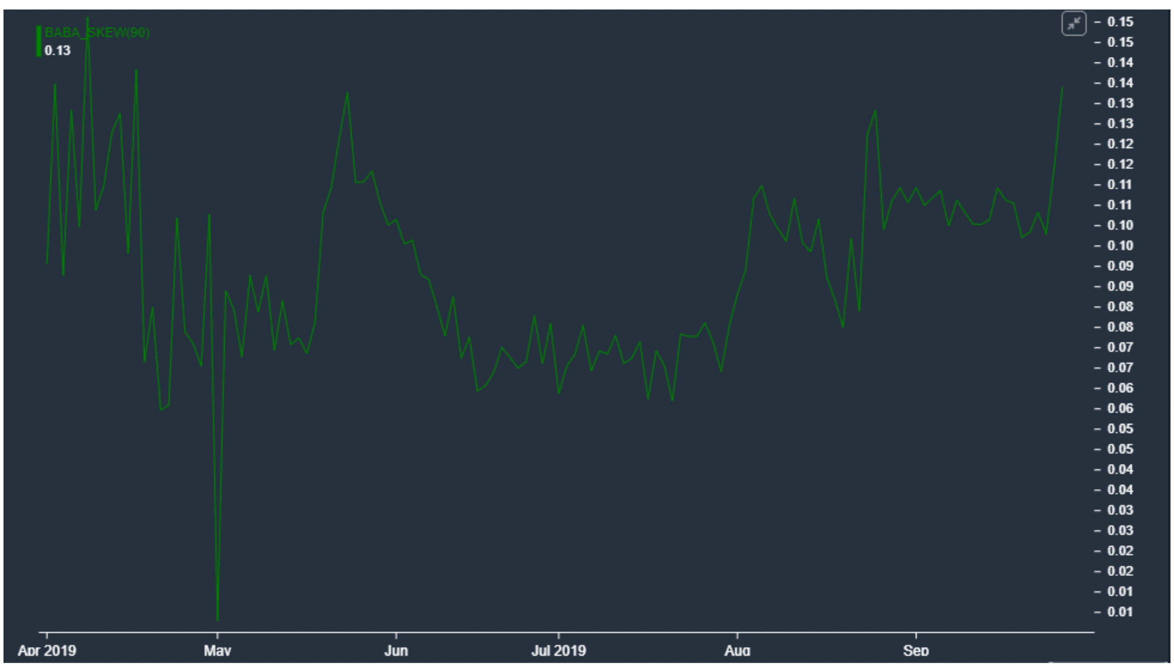
Thus, our theme for the week, is long Alibaba.

BABA Structure

Let's briefly look at the structure of Alibaba Options. To start, the 30 day IV of BABA options are elevated relative to the last few months, but actually toward the low end of the rate on the year, about the 30th percentile.

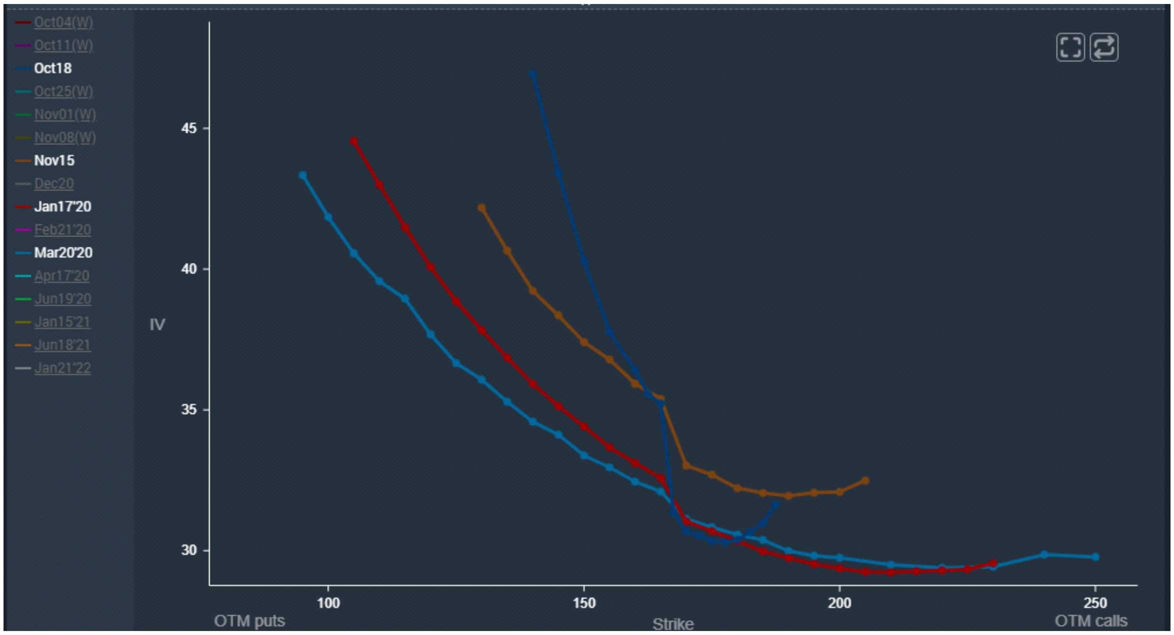
The 90 day IV did not get the same pop last Friday, and thus remains in a lower percentile than IV30. We see IV as something that should be faded, but not with 'two hands'. Thus, we like leaning short vega (exposure to volatility); we don't love being massively short vega (something like a short strangle is NOT on our radar).

The next thing to look at is the Skew of the options. In a word... puts are expensive:



Skew (the cost of out of the money puts relative to out of the money calls) is near a 6-month high and actually HIGHER than skew got in July. Thus, IV is elevated relative to recent months, and puts are even more elevated. This leads us to the conclusion that puts are driving the higher IVs across the board, and calls are likely NOT expensive, at least those relatively close to the money.

Looking at a chart of skew across several months the view is a little more obvious:



Notice how steep the downside is in October, and November. Skew appears to be expensive in longer dated months as well. January in particular seems to look like an interesting place to set up a Risk Reversal (short Out of the Money put, long OTM call). While we will not trade a Risk Reversal this week it is worth pointing out as a stock replacement.

Another view, we can see from this chart, is the term structure. Clearly, earnings are between October and November expiration. January appears to be relatively cheap when compared to November and March. The numbers themselves tell me the picture does not lie:

Oct04(W)	Oct11(W)	Oct18	Oct25(W)	Nov01(W)	Nov08(W)	Nov15	Dec20	Jan17'20	Feb21'20	Mar20'20	Apr17'20
37.46	33.98	33.49	32.05	34.46	34.90	34.52	32.40	31.96	32.16	31.71	31.39
0.20	-1.90	-1.20	-1.00	-1.00	-1.80	-1.10	-0.90	-0.70	-0.60	-0.80	-0.50

Looking at the numbers above, earnings are likely the week of November 8th.

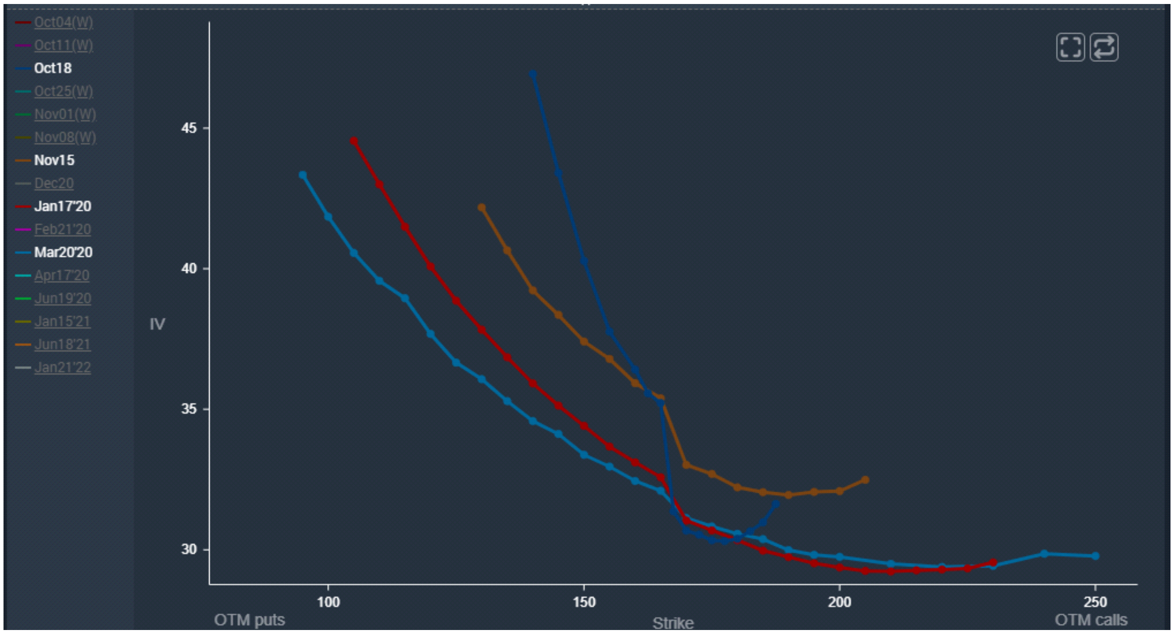
The Trade:

Based on the price action of BABA, we want to be bullish. Based on IV, we COULD sell puts; we see a put debit spread or cash secured put as a simple way to take advantage of the crazy IV and skew in BABA.

We are going to propose a slightly more advanced trade: a spread swap. This is similar to a risk reversal but has more limited risk. The trade sells a put spread, and buys a call spread.

1. pick the month we want to trade in
2. sell the expensive vol
3. buy the cheap IV
4. carry little to no vega

Looking at the skew chart again, hone in on October:



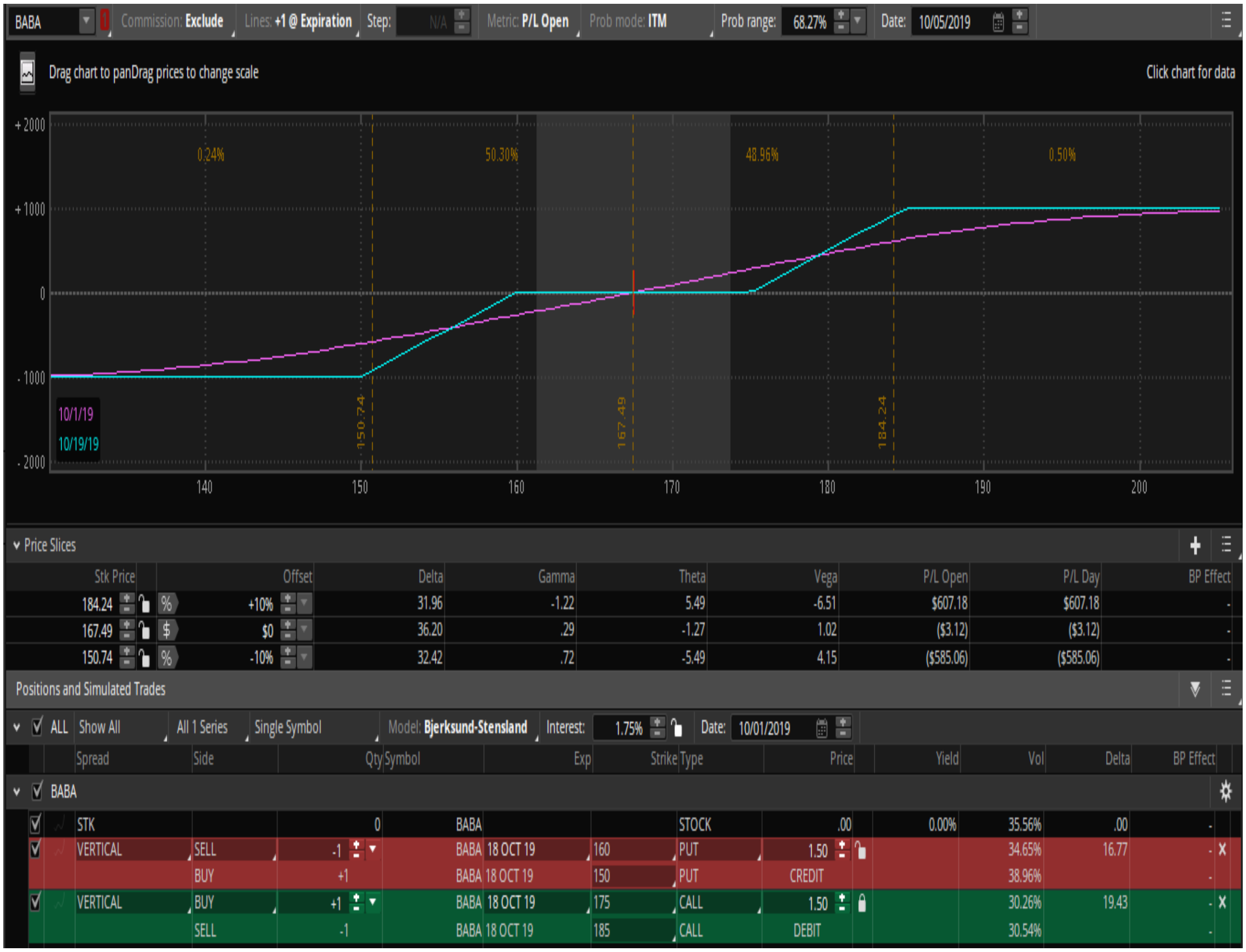
Notice that the low point for IV is just out of the money calls. Once the underlying gets much above 180, IV starts to rally. Also, notice how pricy downside is. This is a perfect set up for a trade taking advantage of BABA's level.

Looking at the chart of BABA:

I think 185 is about the high it is going to get near term. I can sell the 160-150 put spread, which is around the lows from July, and buy the 175-185 call spread, which only stops losing money at my high point, and out lay NOTHING. This gives me 7.5 points of downside protection for some continued turbulence, but plenty of upside (also 7.5 away) if BABA makes a quick move higher (which I think it could).

Trade: sell BABA October 160-150 put spread collect $1.60, buy October 175-185 call spread pay $1.30.

Here is the risk chart:



RISK MANGEMENT

On a scale of 1 to 10 in risk this trade is an 8, thus it is highly risky. If one wants to address this trade in a less risk fashion, one could simply buy the call spread.

The most this trade could lose in a worst case is $1000.00. For risk control, we are setting a downside max loss of $150.00, or 15%.

Our upside target is $200.00, or 20%.

We will close the put spread when it becomes worth less than $.50 regardless of profit.

Send your questions and comments to licia@optionpit.com or use our chat window on the Option Pit website.

Mark Sebastian