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Subject: The Fed is Short Strangles - Buy SPX Knock-Out Puts + hedge tech and oil
Date: Tue, 20 Jun 2017 14:35:16 +0000
Attachments: GEVI_6.20.2017.pdf
Inline-Images: image004jpg01D2E9A3AAB2EEC0.jpg; image005png01D2E9A3AAB2EEC0.png; image006jpg01D2E9A3AAB2EEC0.jpg; image007png01D2E9A3AAB2EEC0.png

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Let's call a spade a spade. Any attempt (by me, or anyone) to make a case for buying protection in this market constantly seems to be thwarted by a 1% SPX rally immediately following... **That said, it's always when everyone's thrown in the towel on a trade that it starts to work.**

What about the Fed?
Some think the Fed's hawkishness last week was tantamount to them disengaging from their traditional "Fed Put" role. **Not so, we think.**

- We think the Fed is very much concerned with normalizing financial conditions ***both in a bubble, and in a crash scenario***.
- The only difference now is that they seem to have acknowledged that we are closer to the former (bubble) than the latter (crash).
- **So they are now effectively short a call AND short a put on the mkt – i.e. they will act to protect risk assets from a dangerous move lower OR higher.**
- **TAKEAWAY –** Look at range trade ideas, teeny upside ideas, and carry-effective hedges here.

Trade Ideas:

1) **Nasdaq/tech hedge: QQQ buy the July 139/129 put spread for $1.45 (ref 140.46).** Tech positioning is still overweight, so hedge longs with point spreads to monetize steep skew in the QQQs (1m 90/100 skew is in the 78th %-ile over the last 2 years)
2) **Nasdaq cheap upside/long replacement: QQQ buy the Jul 145 calls outright for 39c on a 16d.**
3) **Oil hedge – Buy USO Sep 8.5/7.5 put spread for 25c.** WTI has been in a downtrend, breaking through key $44.09 support. With recent increases in US production, we see further room to run lower in the short term. We also like owning USO vol with 3m ATM implied in the 16th %-ile over the last year.

Buy In-the-Money SPX Knock Out Puts

→ Buy the SPX Sep 2475 put with a 2300 knock-out (continuous observation) for 70bps (spot ref 2451).
→ This offers a 60% discount to the vanilla 2475/2300 put spread, which is itself historically cheap.

Or buy the SPX Sept 2400 put with a 2250 knock-out (cont obs) for 28bp (68% discount to vanilla)

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Rationale/Payout:
If SPX stays above the 2300 barrier at all points in time before expiry, the structure is equivalent to a 2475 put option. If the barrier is instead breached, the maximum loss will be equal to the (low) upfront premium. The 2300 barrier is about 6% out-of-the-money, hence allows for the elusive 5% correction not seen since Brexit (on a closing basis). However, investors can mitigate the risk of breaching the barrier by either moving it farther down (e.g., a 2245 barrier would indicatively raise the cost from 0.7% to 1%), or by only observing it on a close-to-close basis (in turn sacrificing part of the discount).

The trade prices attractively today due to exceptionally steep SPX put skew, which is near its highs established since 2004. With steep SPX put skew, the market is implicitly pricing in a high probability that the option will knock-out during its life, i.e., that relatively large drawdowns are more likely. As detailed above, however, we see many reasons why the most likely near-term scenario for US equities is to remain range-bound. The structure is short 11% delta at inception and has the same vega sensitivity as the equivalent put spread (short 6bps).
GEVI Link Here

[redacted]. ***CTAs are crushing it:***

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