MARKET COMMENTARY

$SPX remains in a trading range, frustrating both bulls and bears. The outlook is muddled until the trading range (2322–2400) is broken.

Stocks (as measured by the $SPX Index) have had plenty of chances to collapse or to rally to new highs. Instead they have done neither, frustrating both bulls and bears. The action last night is a case in point. S&P futures dropped 17 points in a matter of minutes, after it became known that the U.S. had attacked Syrian military air bases with missiles. But less than 12 hours later, without any particular follow-through news on the subject, S&P futures had regained all of the losses.

In looking at the $SPX chart, two things stand out to me: 1) there is still a downtrend in place, from the all-time highs on March 1st, and 2) the support level at 2322 remains untested and thus is important. One could also make a case that the support at 2300 – the level from which the strong February rally that carried $SPX from 2300 to 2400 in a matter of days – is very important as well. If that were to give way, it would negate the entire action that has taken place over the past couple of months. On the upside, even if the downtrend line were broken through on a closing basis (it was penetrated intraday this past week, but $SPX closed back below the trend line), $SPX would have to break through to new all-time highs in order to change the status of the $SPX chart back to “bullish.”

The “modified Bollinger Band” (mBB) sell signal from early March remains in place. Its target is the lower, –4σ Band, which is currently at about 2320 and moving sideways. It is interesting to note that if the target is fulfilled (at least with the –4σ Band where it currently is), the 2322 support level would be broken. Hence there might be some further downside follow-through in that case, and rather than close out shorts taken on the mBB sell signal, we would rather institute a trailing stop for bearish positions.

<table>
<thead>
<tr>
<th>Date</th>
<th>Adv</th>
<th>Decl</th>
<th>Net</th>
</tr>
</thead>
<tbody>
<tr>
<td>20170316</td>
<td>1943</td>
<td>1519</td>
<td>424</td>
</tr>
<tr>
<td>20170317</td>
<td>2025</td>
<td>1465</td>
<td>560</td>
</tr>
<tr>
<td>20170320</td>
<td>1190</td>
<td>2316</td>
<td>-1126</td>
</tr>
<tr>
<td>20170321</td>
<td>476</td>
<td>3486</td>
<td>-3010</td>
</tr>
<tr>
<td>20170322</td>
<td>1687</td>
<td>1692</td>
<td>-5</td>
</tr>
<tr>
<td>20170323</td>
<td>2185</td>
<td>1176</td>
<td>1009</td>
</tr>
<tr>
<td>20170324</td>
<td>1696</td>
<td>1529</td>
<td>167</td>
</tr>
<tr>
<td>20170327</td>
<td>1783</td>
<td>1618</td>
<td>165</td>
</tr>
<tr>
<td>20170328</td>
<td>2651</td>
<td>919</td>
<td>1732</td>
</tr>
<tr>
<td>20170329</td>
<td>1591</td>
<td>1521</td>
<td>344</td>
</tr>
<tr>
<td>20170330</td>
<td>2135</td>
<td>1345</td>
<td>790</td>
</tr>
<tr>
<td>20170331</td>
<td>1865</td>
<td>1521</td>
<td>344</td>
</tr>
<tr>
<td>20170403</td>
<td>949</td>
<td>2673</td>
<td>-1724</td>
</tr>
<tr>
<td>20170404</td>
<td>1561</td>
<td>1755</td>
<td>-194</td>
</tr>
<tr>
<td>20170405</td>
<td>885</td>
<td>2712</td>
<td>-1827</td>
</tr>
<tr>
<td>20170406</td>
<td>2727</td>
<td>820</td>
<td>1907</td>
</tr>
</tbody>
</table>

90% Days are shown in red rows
Yellow fill: Cum breadth all-time high
Equity-only put-call ratios remains mixed in their signals. The standard ratio (Figure 2), rolled over to a buy signal last week and is trending lower at this time. However, the weighted ratio (Figure 3) is just moving sideways and is not trending downward. Hence, the computer analysis programs continue to grade the weighted ratio as “sell.” From a longer-term perspective, both ratios have remained at low levels all of this year so far. Hence, they are generally in an overbought state, but for them to give convincing sell signals, we are going to need to see these ratios move to 2017 highs and trend higher from there.

Market breadth hit a rough patch this week (see box, page 1) and because of that, both breadth oscillators rolled over to sell signals, despite positive breadth on April 6th. We often say that breadth signals need confirmation from other, longer-term indicators. But the last few breadth signals have been pretty good on their own, so this sell signal should not be taken lightly.

New highs continue to exceed new lows throughout this pullback that has lasted a month now, so that is a generally positive signal overall. It’s not that new highs are running at a tremendous rate (on most days, they are slightly less than 100), but there are very few new lows almost every day.

The volatility complex remains bullish, but there are some signs that things might be changing. First and foremost is the fact that $VIX has not closed above 13.50. That alone keeps the $VIX chart in the bullish camp, for stocks. Furthermore, it would really have to close above 15.00 in order for us to declare that $VIX was on a full sell signal for the stock market. Having said that, you can see from Figure 4 that there have been several probes above 13.50 in the last few weeks, including a probe all the way above 15 on the day that $SPX bottomed at 2322. Hence these charts are related. What we don’t see, though, is complete match up in their relationships: $SPX has been trending slightly lower since March 1st, but $VIX has not been trending perceptibly higher over that same time period. Thus $VIX has been more bullish than the stock market itself. There is a brief article following this one, detailing what this might mean from a larger perspective. In short: sellers of $VIX are more aggressive than buyers of $SPX.

The construct of the volatility derivatives – $VIX futures and the CBOE Volatility Indices – is weakening,
but is still bullish at this point. The worrisome thing here is that the May $VIX futures are trading at lower prices than the April $VIX futures. Hence, there is a slight inversion of the term structure in the futures, but only in the front end, so far. It would be more serious if the June $VIX futures were to fall below the price of the April $VIX futures. That is not immediately imminent, but that spread is down to 50 cents (see table below). Other than that, the $VIX futures are all trading at a premium to $VIX, and the other parts of the term structures continue to slope upward. So, we’re still grading this as a modestly bullish indicator.

In summary, the market is struggling to establish an identity. On Wednesday of this week, $SPX was trading up strongly, only to see a complete negative intraday reversal wipe out the entire rally (it was blamed on comments by Speaker of the House, Paul Ryan, that indicated that tax reform might not come easily and might not come this year. That’s a surprise? It took Reagan over five years to pass tax reforms). But, as noted earlier, downside probes, such as the one after the missile attack last night, haven’t “stuck” either. As a result, despite what other indicators are saying, we continue to watch for breakouts by $SPX and $VIX as the primary guides as to how new market direction might emerge. Otherwise, the trading range market persists, frustrating most everyone except for option premium sellers.

From the box on the right, above, there are two things that should be noted: 1) the 20-day historical volatility of the $VIX futures has increased across the board; 2) the volatility flattening between April and May monthly futures is also reflected in the weekly futures (last row in the box).

Since there could still be some short-term trouble in the stock market, we are going to leave the following recommendation open (it was originally made two weeks ago).

**Position S907: Bearish SPY Position, Based on Technical Deterioration:**
1) IF $VIX Closes above 13.50, THEN Buy 3 SPY Apr (21st) puts one strike in-the-money
2) IF $VIX Closes above 15.00, THEN Buy 3 SPY Apr (21st) puts one strike in-the-money
3) IF $SPX Closes below 2300, THEN Buy 4 SPY Apr (21st) puts one strike in-the-money

*And roll all current SPY positions down to the SPY Apr (21st) 230 puts.*

NOTE that condition 3) above (and only condition 3) involves rolling all other positions down as well.
Some Further Comments on The $VIX Futures Term Structure

Last week, we wrote about the term structure of the $VIX futures, and how one should heed it if it begins to invert. In that regard, we showed a chart of the difference in premium of the two front month $VIX futures going back a couple of years. This week, we dusted off some previous research that showed a sometimes more reliable indicator of pending bearishness for stocks is to be wary of an inversion between the third month $VIX future (VX₃) and the front month $VIX future (VX₁). The accompanying chart shows this spread going all the way back to the inception of $VIX futures trading in 2004.

While the $SPX chart is not overlaid here, it can be stated with certainty that when VX₃ – VX₁ turns negative, it is time to be negative on stocks until this spread returns to a positive status. Sometimes it reverses quickly, such as during Brexit or the US elections in 2016 (far right side of chart). But at other times, it remains negative for long periods of time, such as the financial crisis of 2008 or the fall of 2011. What is quite advantageous during those times is to own VXX, because that ETN benefits from an inverted term structure. Long VXX will outperform long $VIX in such cases.

As an aside, we have seen a number of articles espousing the idea of being long XIV (the inverse volatility ETN) in recent weeks. Yes, it has been a tremendous performer, especially since last November’s election. However, by a sort of contrary analysis, one would have to think that the easy money in “long XIV” has already been made. Hence we are going to make a conditional recommendation:

**Position S911: VX₃ – VX₁ trade:**

IF June $VIX futures settle at a LOWER price than April $VIX futures on any day, THEN Buy 8 VXX April (28th) calls one strike in-the-money.

---

$VIX futures spread: month 3 - month 1

Figure 5
NEW RECOMMENDATIONS – 04/06/2017

Special Biotech Situations

<table>
<thead>
<tr>
<th>Stock</th>
<th>Expensive</th>
<th>Comment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Symbol</td>
<td>Month(s)</td>
<td>Several drug trials; Phase 2 “during 1st half 2017”</td>
</tr>
<tr>
<td>AXON</td>
<td>Jun, Sept</td>
<td></td>
</tr>
<tr>
<td>IMDZ</td>
<td>Jun</td>
<td>No news</td>
</tr>
<tr>
<td>SAGE</td>
<td>May</td>
<td>Several drug trials in progress</td>
</tr>
</tbody>
</table>

AXON continues to be quite unusual. There are now two volatility spikes – on in June and another in September expiration. These correspond to two or three different drug trials that are in process at the company.

PRTK announced that is Phase 3 trial of a bacterial pneumonia drug met primary endpoints. The stock jumped about 4 points, and implied volatility dropped severely.

Naked Put Sales

The list of potential put sales that satisfy our rather restrictive criteria regarding expected return and risk in the stock is empty. Thus there is not recommendation in this section this week.

Volatility Skewing

The Frexit Vote

European implied volatilities on the broad stock market are quite inflated in advance of the upcoming vote for Prime Minister in France. It is somewhat similar to Brexit last summer in England and has thus been nick-named “Frexit.” If one has access to trading in European indices and Volatility futures directly, he might consider a spread of long May $VIX futures and short May EU $VIX futures. But since most of our customers don’t have access to those markets directly, we would have to try another approach.

The ETF that trades with symbol FEZ is an ETF on the Eurostoxx 50 Index. That is exactly the index on which the European volatility futures are based. In theory we would want to sell straddles on FEZ to capture the high implied volatility. The highest implies are in the April 28th options – the nearest expiration date after the vote. Implieds are at or slightly about 20% for that month. That may not seem high, but when you consider that $VIX is at 12-ish, it is high in that regard. There are risks, though. FEZ could plummet if the Frexit candidate wins, as stocks did after Brexit. Alternatively, there are some who say that European stocks are cheap, and if the threat of Frexit were removed, they would rally. So one can’t merely sell the FEZ straddles and walk away.

Perhaps there is some hedge using SPY and SPY options or even $VIX, but it is not clear that U.S. markets are going to move much based on this vote. They did on the Brexit vote, but now that traders realize there was no long-lasting effects of the Brexit vote, a Frexit reaction in U.S. stocks could be subdued or even non-existent.

We still have some time before we actually make a recommendation here, so we will continue to give it some thought.

Event-Driven Straddles

The “threshold price” is expressed as a percentage of the stock price. For example, suppose that we have determined that in the past ten earnings reports, stock XYZ moved more than 4.5% on six of the ten occasions.
Thus we would be willing to pay 4.5% of the stock price for the near-term straddle, pre-earnings. That is the threshold price.

For straddle sales, the “threshold price” works in a similar manner. Suppose that, for another stock ZZZ we have noted that the stock never moved more than 6.2% after earnings, in the last ten earnings reports. Hence if we could sell straddles for 6.2% of the stock price or more, we would.

Once again, there are many stocks that reporting earning that have a horizontal skew. In fact, for next week, there is only FAST. But it doesn’t qualify by the parameters that we use for earnings-driven straddle buys.

**Extremes In Sentiment In Futures Trading**

We have often mentioned the worth of following the Daily Sentiment Index (DSI) readings on the various futures markets, as determined by Jake Bernstein’s trader surveys in those markets: [www.trade-futures.com](http://www.trade-futures.com).

There are oversold conditions in **Wheat** (11% bulls), **Soybeans** (13%), **Soybean Meal** (15%), **Coffee** (10%), and **Sugar** (15%).

There are overbought conditions in **Silver** (80%) and **Lumber** (90%).

There is a new buy signal in **$VIX futures** (20%, up from 10% a little over a week ago). However, we already have a $VIX breakout covered (see page 3), which is a preferable way to play this in my opinion.

There are no new sell signals.

**Volatility Trading**

The current state of $VIX futures and options is not conducive to new positions for any of our strategies at this time. We prefer not to force it, so there is no new recommendation this week in this section.

**Put-Call Ratios:**

We had a conditional recommendation last week that was not elected. The recommendation remains in place for this week (note the change of Position Number).

**Position PC1446: Conditional Put Buy in 3M Corp. (MMM)**

IF MMM closes below 189,

THEN Buy 5 MMM Apr (21st) 190 puts.

MMM: 191.88

There are new buy signals in **GD, LB, TBT, XLE_w, and Swiss Franc futures_w**.

There are oversold conditions in **GG, URBN, and the following currency futures: Australian Dollar_w, British Pound_w, and Euro FX_w**.

There are no new sell signals.

There are overbought conditions in **AZN, ANTM, CIT, HES, ORCL_w, RIG, XRT, and the following futures: Feeder Cattle_w, Lean Hogs, and Nat Gas_w**.

**Position PC1448: Conditional Call Buy in L-Brands (LB)**

IF LB closes above 48-1/2,
THEN Buy 4 LB May 47.5 calls
LB: 47.15
FOLLOW-UPS TO PREVIOUS RECOMMENDATIONS

HYPOTHETICAL PERFORMANCE RESULTS HAVE MANY INHERENT LIMITATIONS, SOME OF WHICH ARE DESCRIBED BELOW. NO REPRESENTATION IS BEING MADE THAT ANY ACCOUNT WILL OR IS LIKELY TO ACHIEVE PROFITS OR LOSSES SIMILAR TO THOSE SHOWN. IN FACT, THERE ARE FREQUENTLY SHARP DIFFERENCES BETWEEN HYPOTHETICAL PERFORMANCE RESULTS AND THE ACTUAL RESULTS SUBSEQUENTLY ACHIEVED BY ANY PARTICULAR TRADING PROGRAM.

ONE OF THE LIMITATIONS OF HYPOTHETICAL PERFORMANCE RESULTS IS THAT THEY ARE GENERALLY PREPARED WITH THE BENEFIT OF HINDSIGHT. IN ADDITION, HYPOTHETICAL TRADING DOES NOT INVOLVE FINANCIAL RISK, AND NO HYPOTHETICAL TRADING RECORD CAN COMPLETELY ACCOUNT FOR THE IMPACT OF FINANCIAL RISK IN ACTUAL TRADING. FOR EXAMPLE, THE ABILITY TO WITHSTAND LOSSES OR TO ADHERE TO A PARTICULAR TRADING PROGRAM IN SPITE OF TRADING LOSSES IS MATERIAL POINTS WHICH CAN ALSO ADVERSELY AFFECT ACTUAL TRADING RESULTS. THERE ARE NUMEROUS OTHER FACTORS RELATED TO THE MARKETS IN GENERAL OR TO THE IMPLEMENTATION OF ANY SPECIFIC TRADING PROGRAM WHICH CANNOT BE FULLY ACCOUNTED FOR IN THE PREPARATION OF HYPOTHETICAL PERFORMANCE RESULTS AND ALL OF WHICH CAN ADVERSELY AFFECT ACTUAL TRADING RESULTS.


The following figures represent hypothetical performance; these positions were not actually traded in an account. Position profit includes a commission of $15 round turn in futures, $15 per side in futures options, $2.00 per option for stock and index options, and 2 cents per share for stock.

NOTE: on this page, all stops are mental closing stops unless otherwise noted.

POSITIONS CLOSED SINCE LAST ISSUE

<table>
<thead>
<tr>
<th>Category</th>
<th>Position</th>
<th>Profit/Loss</th>
</tr>
</thead>
<tbody>
<tr>
<td>Spec:</td>
<td>PC1434: INT puts</td>
<td>–980</td>
</tr>
<tr>
<td></td>
<td>PC1442: USO puts</td>
<td>+1950</td>
</tr>
<tr>
<td></td>
<td>S908: SVXO/SVIXMO sell signal</td>
<td>+360</td>
</tr>
<tr>
<td></td>
<td>S909: GNMX biotech event-driven straddle buy</td>
<td>+20</td>
</tr>
</tbody>
</table>

Position F486: The April (13th) ES futures put ratio spread: This is expiring in five trading days (next Thursday, because the market is closed on Good Friday). If the stock market dips from current levels, this spread could widen in our favor. Exit a third of the spreads at a credit of 5.00, if possible. Then exit another third at 10.00 credit, if possible. We will put out an interim hotline next Thursday if further adjustments are necessary.

Position I634: the April (13th) SPY put ratio spread: we want to follow a course similar to that described in the instructions for Position F486, just above. Exit a third of the spreads at a credit of 0.50 if possible. Exit another third at a credit of 1.00, if possible. If necessary, we will address any further actions in an interim hotline next Thursday.

Position PC1426: the expiring AAPL Apr (7th) 141 calls. Roll to the April (28th) 143 calls. Raise the trailing stop to 140.80.

Position PC1427: the FB Apr (21st) 142 calls: raise the stop to 139.80.

Position PC1434: the INTC Apr (13th) 35.5 puts: were stopped out on April 3rd.

Position PC1443: the May OJ 175 calls: expire on April 21st. The put-call ratio has rolled over to a sell signal, but these calls have no bid. Sell them if you can.

All other put-call positions remain as is, for their original signals are still in place (IBM, FXE, NEM and OA).

Position S715: the “modified Bollinger Band” sell signal: the expiring Apr (7th) 238 puts. Roll to the April (28th) 236 puts. We continue to hold these in line with the mBB sell signal. Hold without a stop unless the following condition occurs: IF SPY closes below 231.50, THEN set a trailing stop at 233. That is, if SPY closes below 231.50, it could lead to a larger downside break, but if it instead rallies back above 233, then we’ll exit these puts.

Position S761: the VXX Apr (21st) 16 puts. The term structure in the first two months of the $VIX futures has inverted (April $VIX futures are trading at a higher price than May $VIX futures). As a result, we want to exit this position now.

Position S907: the SPY Apr (21st) 235 puts. The trailing stop remains at 237; that is, sell these puts if SPY closes above 237.

Position S910: the AXON May (19th) 15 straddle. The stops remains the same: sell this straddle if it’s bid at 1.75 or less.

Position W1: The SPY weekly calendar spread. We are long Apr 21st options and short Apr 7th options. The calls have strikes of 240 and 239, and the puts 235. If it is necessary to roll the entire position, buy May 19th options and sell Apr 13th options, using integer strikes closest to +/-2.5 points from the SPY closing price on Friday. Otherwise, roll the Apr 7th options to Apr 13th options as follows:

- SPY > 242: re-center as noted above
- SPY 241-242: sell 241 calls and 236 puts
- SPY 237-241: sell 240 calls and 236 puts
- SPY 234-237: sell 239 calls and 235 puts
- SPY 233-234: sell 239 calls and 234 puts
- SPY < 233: re-center as noted above.

April 7, 2017

There is risk of loss in all trading