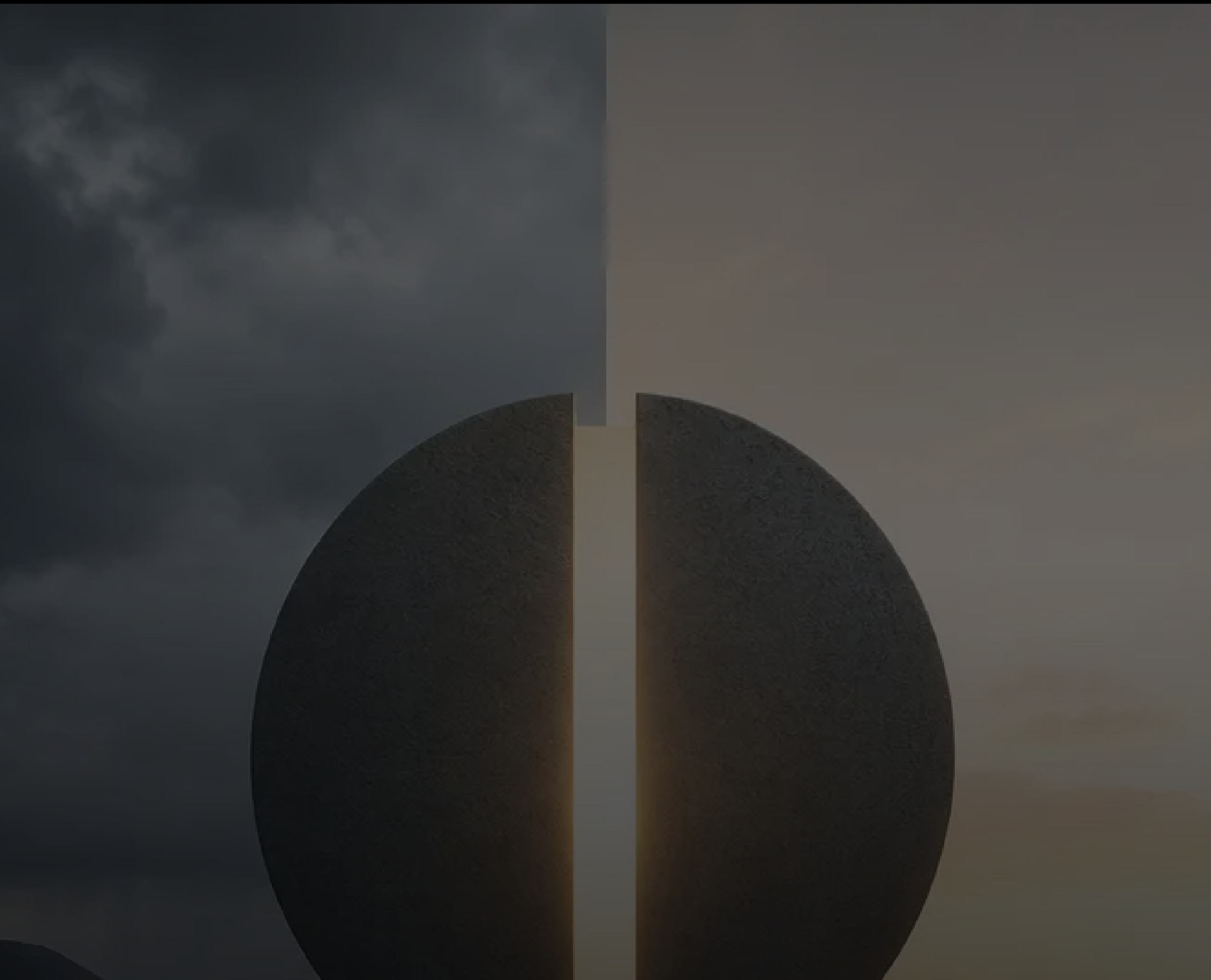

MARKET VIEWS · INVESTMENT INSIGHTS

Cheap Hedge Into *FOMC*

How does one protect the downside and yet retain the upside?

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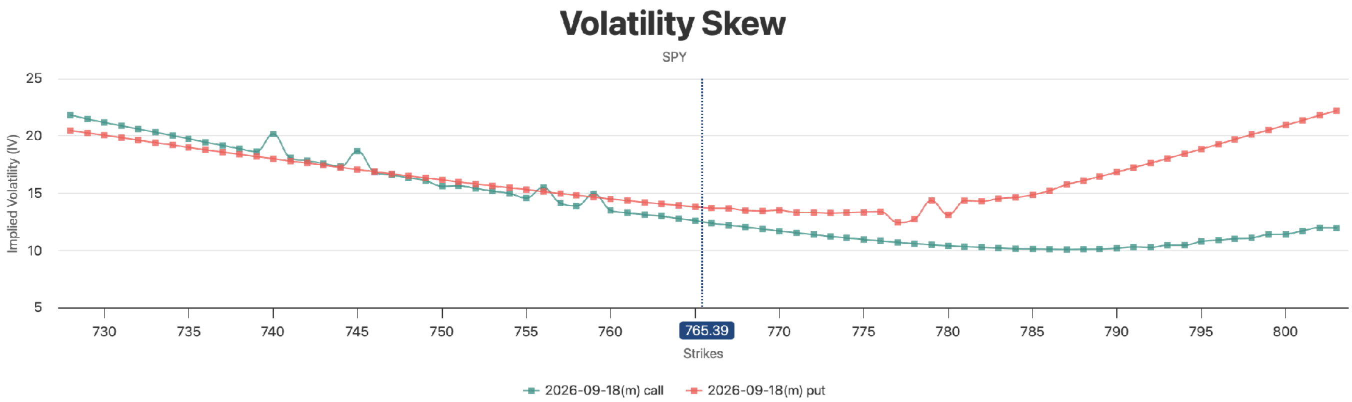
WORRIED ABOUT 16TH SEP? HERE IS A HEDGE

Fed Fund Futures rate hike probability has widened post Warsh's Jackson Hole commentary. **While the probability stands at c60%, and we lean closer to a "hold", a number of leading institutions are calling a rate hike. The reality is a coin-flip in our view.**

Combine this with an index that has done largely nothing for three months and in a tight narrow range, especially in August. Arguably a market that appears complacent, as also reflected in a very normal VIX reading in the 15-16 area. ***We outlined a must defend level of 7400 for S&P (740 on SPY) and a blue skies above 7800 (780 on SPY) in our recent note - FOMC is likely to be a binary event that will wake this market out of its somnolence.***

> **How does one protect the downside and yet retain the upside?**

THE SMIRK TO THE RESCUE



Option positioning, 18 September expiry · Source: Lighthouse Canton

The chart above shows option positioning for 18th Sep expiry (2 days after FOMC) and is telling - Upside calls are cheap and the IV at the 740 level is still not excessive.

THE TRADE

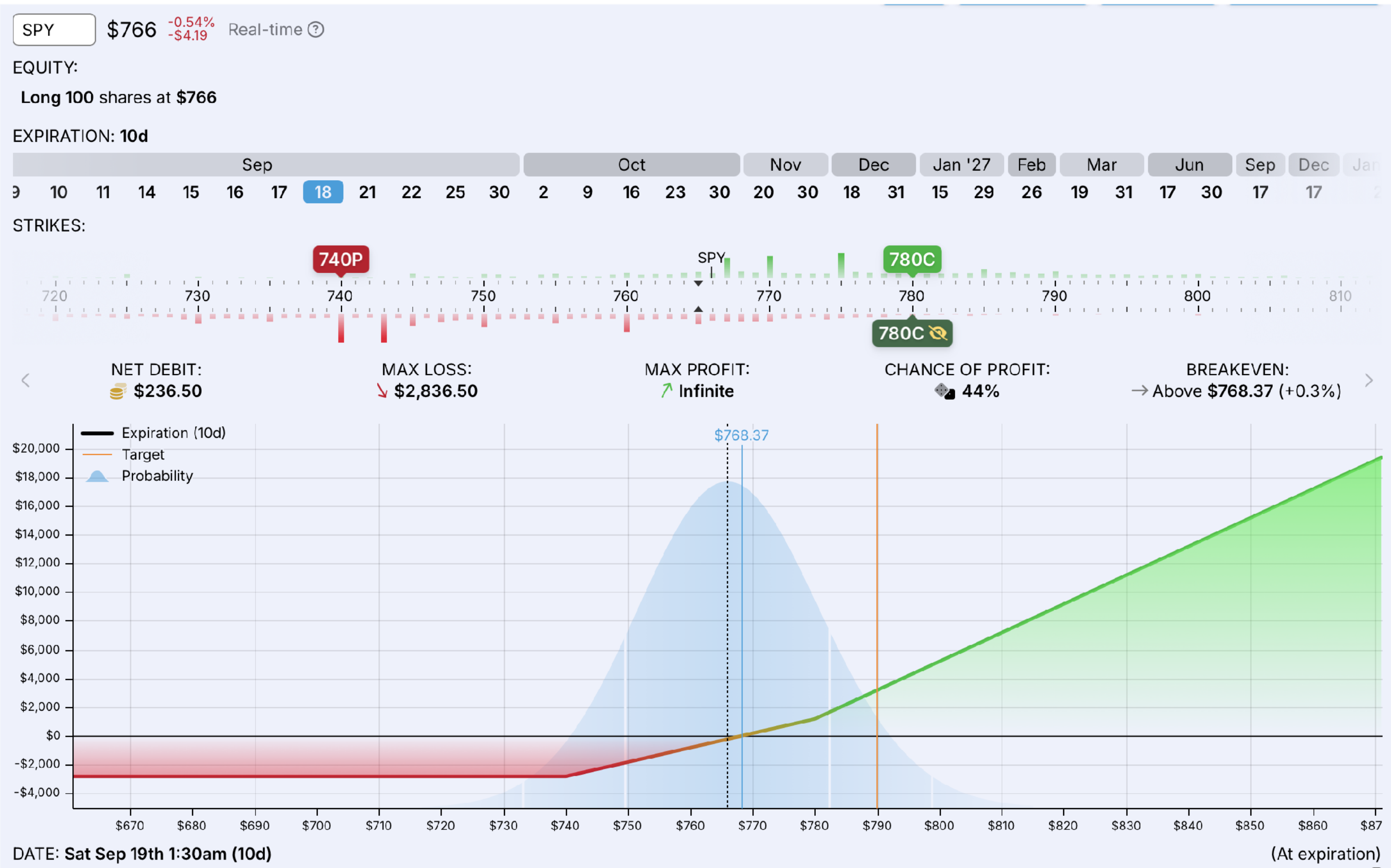
Long strangle 740–780 payoff structure · Source: Lighthouse Canton

Why This Trade Works - If the FED hikes, we expect the market to sell off rapidly, increasing the value of the Long Put, aided by the expansion in implied volatility (this is a positive Vega trade). A FED on hold is likely to calm markets and likely to create conditions for a breakout.

The "dead zone" - risks - The risk an investor carries in this trade is capped at the premium paid - should the market continue to grind in its range, then the structure loses value rapidly.

WHAT THE TRADE LOOKS LIKE IF YOU HOLD SPY

The following chart adds a long SPY position as a proxy for a broadly held diversified equity portfolio. The structure provides an effective low cost protection while retaining upside.



Long strangle overlaid on long SPY position · Source: Lighthouse Canton

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