Welcome to the ***Leveraged Investing Club Limited Downside Letter*** for October 5, 2014.

In this week's ***Limited Downside Letter***, we incorporate some macro economic analysis and look at a couple of individual stocks that I expect to hold up pretty well in the months ahead.

U.S. Economy, Rising U.S. Dollar, and Future Interest Rate Hikes

First caveat – I'm not an economist by any stretch of the imagination, and the "analysis" which follows should be considered fairly cursory.

But there is a certain structure and logic behind it which, I believe, to be sound.

So here goes . . .

In recent weeks, in the ***Limited Downside Letter***, I've featured a number of energy-related trading ideas, some of which have subsequently been under pressure as U.S. Dollar denominated energy prices have been falling.

The primary culprit for those falling energy prices? A strengthening U.S. Dollar.

So why is the value of U.S. Dollar up 8% in the last 3+ months?

There are a number of factors – deteriorating economic conditions (and fresh Quantitative Easing) in Europe, a seriously devalued Yen, concerns about China, and, yes, an improving U.S. economy (as our own Quantitative Easing winds down and the prospects of actual interest rate hikes begin to loom).

While U.S. energy companies have been hit the hardest in recent weeks, earnings growth estimates of S&P 500 companies have also been getting ratcheted back (46% of S&P 500 revenues come from outside the U.S.)

There is currently a debate about whether the U.S. Dollar's "breakout" signals the beginning of an even greater strengthening, or whether the dollar is in the process of topping.

Regardless, the two stocks I've selected this week should benefit in a rising interest rate environment, or rather an expanding yield curve environment, while at the same time not be exposed to international currency headwinds.

[Here's a quick Investopedia primer on yield curves]

[And here's some additional data out of Federal Reserve Bank of Cleveland showing the recent steepening of the yield curve]

And I also recently came across this fascinating table:

Chart 3

Performance 9 Months Before First Hike After a Pause

Sector	Average Change (%)	% of Time Positive
Financials	18.0	100.0
Technology	16.4	100.0
Energy	16.3	100.0
Industrials	16.0	100.0
Transports	15.0	100.0
Materials	14.9	100.0
S&P 500	12.8	100.0
Consumer Staples	12.0	100.0
Cons Discret.	11.1	100.0
Health Care	11.1	66.7
Telecom Svcs	6.8	100.0
Utilities	1.4	66.7

Source: Bespoke

The consensus – such as it is – seems to be for the Fed to begin hiking rates sometime in mid-2015, so this table could end up being pretty prescient and relevant.

You'll note that financials are at the top of the list.

With an improving U.S. economy, more favorable interest rate environment (from the perspective of the banks), and a cost-savings trend of closing local branches, this could be a very good time to put high quality U.S. banks on your radar screen.

WFC and USB

My two favorite big U.S. banks are Wells Fargo (WFC) and U.S. Bancorp (USB).

USB is somewhere between big regional bank and small national bank, but it's an extremely well run and conservative institution. And WFC is also well run (and one of Warren Buffett's favorite businesses) and has significant operational advantages due to its massive scale.

Both banks are domestic institutions rather than international institutions, and with the U.S. seeming to be one of the brighter spots in the global economy at present, that should serve them well.

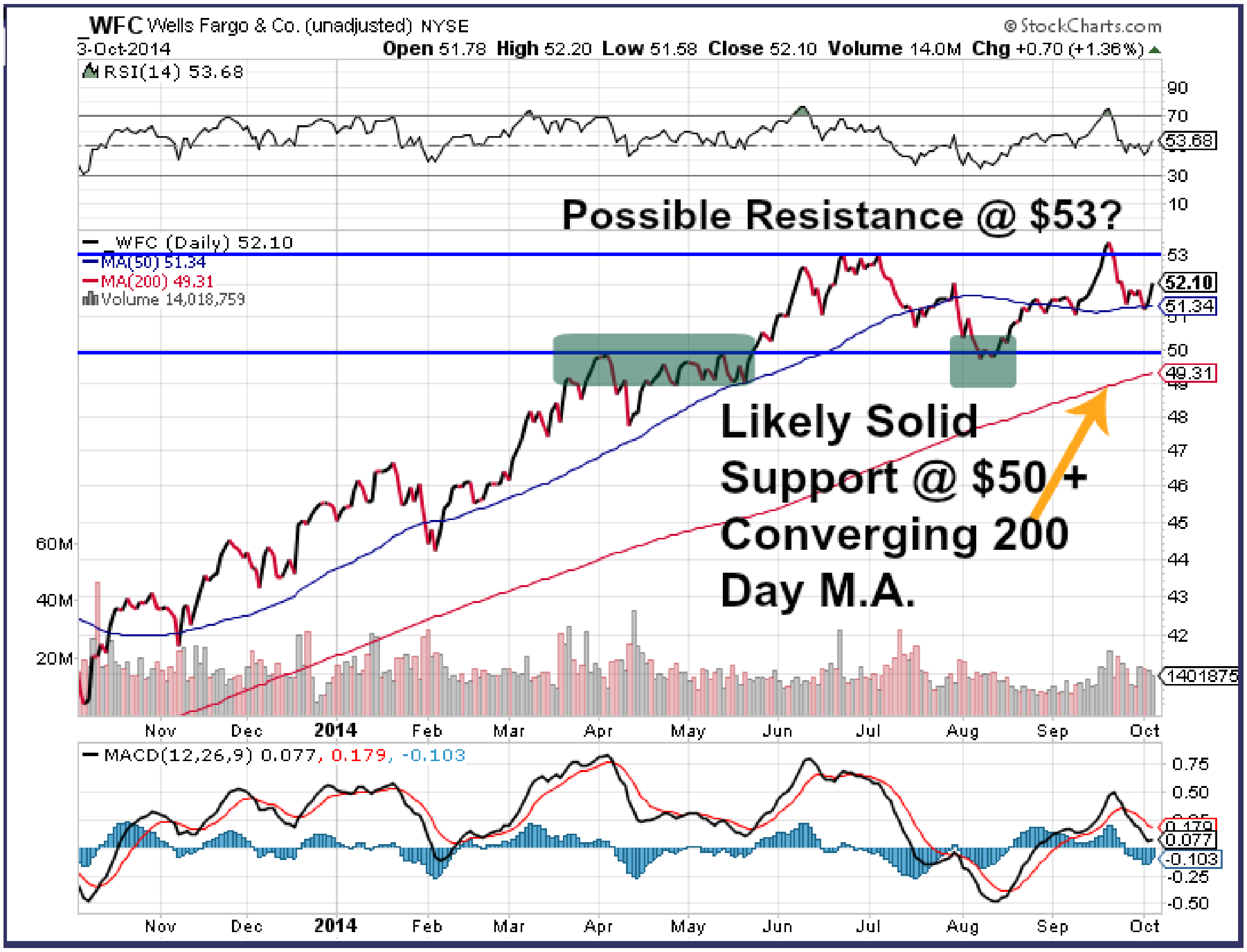
Although I've successfully written puts on JP Morgan (JPM) in the past, neither USB or WFC has the derivatives risk that JPM does.

And I consider both banks to be superior on a risk management and overall operational basis than either Citi (C) or Bank of America (BAC).

The Technicals

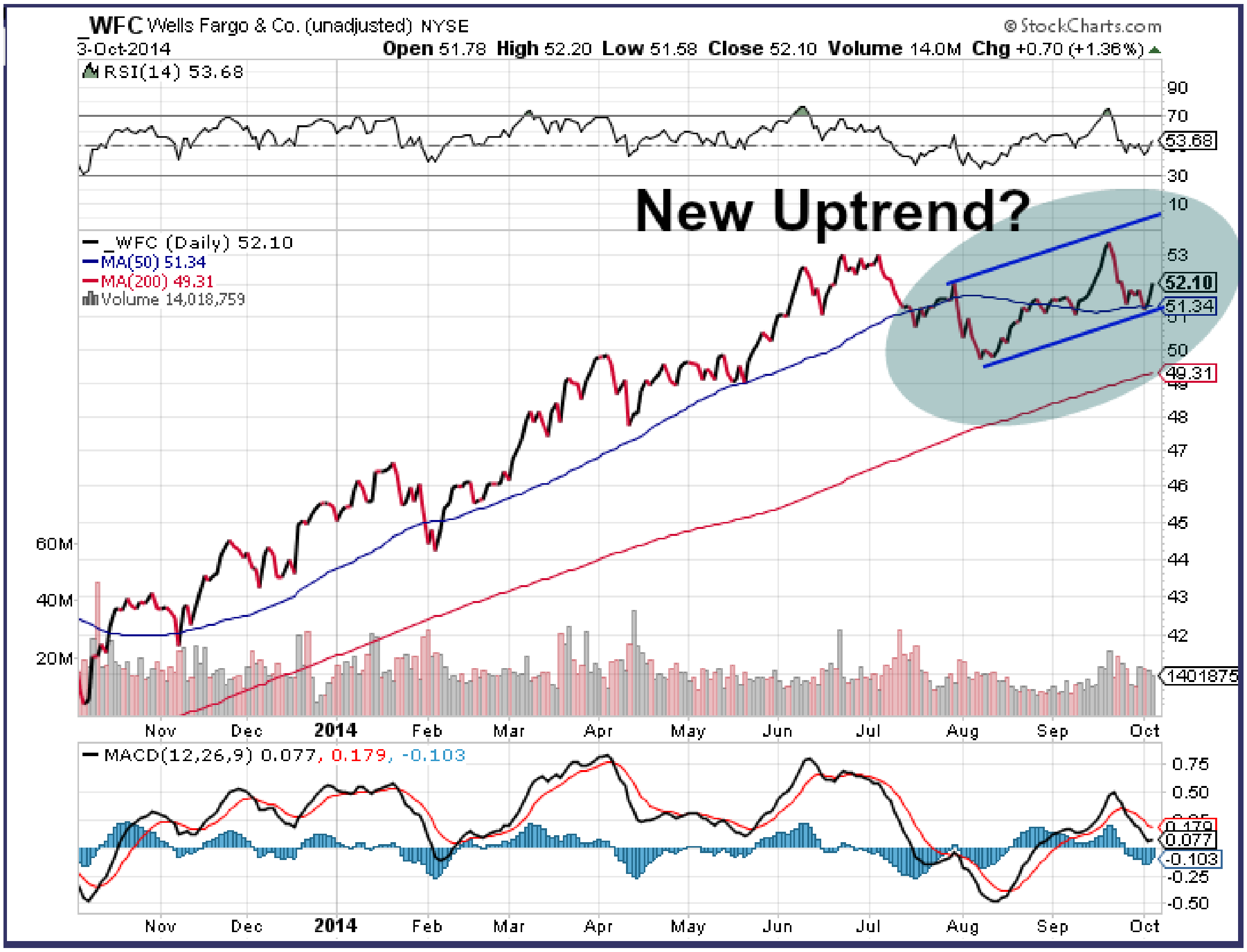
The charts for both stocks look pretty intriguing.

We'll start with WFC first:



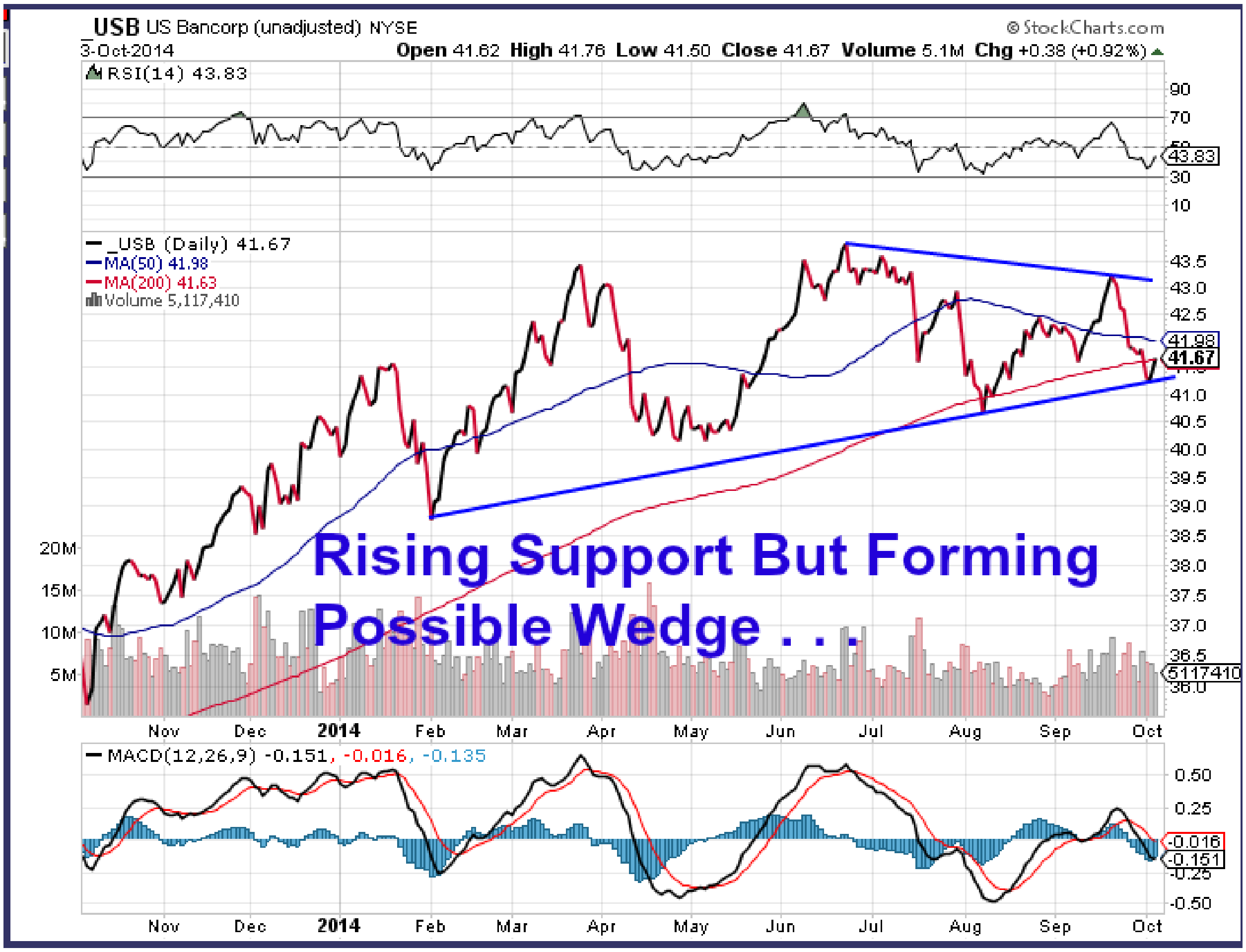
As you can see, the stock bounced off its 50 day moving average strongly last Friday, and there appears to be solid support at the $50 level.

But while the above chart seems to indicate that the stock is closer to the top of its apparent recent trading range, looking at the chart from a slightly different perspective tells a different story:



From this view, it looks like WFC could be in a new uptrend (and much nearer support than resistance), and if we are truly within 9 months of an actual Federal Reserve rate hike, this could be a sustainable uptrend for some time to come.

Re: USB, it, too, has seen a rising support level in its shares, but its chart also contains an additional dynamic:



The rising support line is encouraging, but you can also see a declining resistance level as well.

(The jury on that may still be out, however – note that the mid-September highs in the stock were higher than the previous "lower highs" back in mid-July and mid-August.)

Regardless, the idea is that a stock that makes a series of both higher lows and lower highs will eventually form a wedge when the lows and the highs begin to converge – at which point the stock often breaks out decisively one way or the other.

That's something that could be happening here.

Normally, I would be a little cautious selling puts into a possible wedge, but I believe that macro factors favor the upside on the stock more than the downside.

Other Factors

As always, you should take into considerations the earnings calendar and the dividend cycle.

- USB went ex-dividend just recently – on September 26th.

- WFC traded ex-dividend back on August 6th – meaning that you should assume put option pricing will be impacted on expiration cycles beginning with the first weekly expiry in November.

- Both stocks are scheduled to release quarterly earnings in the near future – WFC on October 14th and USB roughly a week later on October 22nd.

Ways to Trade

There are numerous potential ways to sell or write puts on either stock.

With earnings upcoming, at or near the money short puts should easily hit the 15-25% annualized ROI numbers (my personal target for my own trades) over the next several weekly expiration cycles going into November.

Of the two, it looks like WFC has the higher payout.

Additionally, if you believe longer term that both stocks are in sustainable uptrends based on macro (and historical) factors, then selling puts somewhat in the money (i.e. at strike prices above the current share price) at slightly longer expiration dates (say 45-90 days) could produce some outsized returns.

Of course, doing so, would also limit your potential downside protection.

The more total premium you collect, the more overall downside protection you have – but the higher the strike price you select, the more that protection is mitigated.

And you also need to be factor in how much of the premium you collect upfront is comprised of time value and how much of it is comprised of intrinsic value (the amount by which the strike price on your short put is above the current share price).

The less time value included in the puts you sell, the more you rely on the underlying stock rising in value to achieve your returns.

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Reminder - I'm not a licensed financial advisor and I'm not officially advising or recommending any specific trade - I'm simply sharing with you with as much transparency, honesty, and detail as I can what goes into my own trade selection and thought process. Only you can decide whether any specific trade I discuss is right for you.