Three Ways To Play CHEAP OIL

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3 Ways To Trade The Collapse In Oil…

The price of oil dropped more than 40% from June 2014 to December 2014, going from $105 a barrel to below $60 a barrel.

The plunging price of crude oil is basically being caused by one factor… oversupply.

That is, there's a huge glut of oil, at least in part due to all the shale oil being produced.

Moreover, OPEC has decided not to cut back on oil production. Because many shale oil operations aren't profitable below $70 a barrel, OPEC is probably trying to weed out some of its competition by allowing oil to remain cheap.

While this strategy could change, apparently OPEC believes crude oil will level out around $60 a barrel.

Meanwhile, every day I'm hearing from traders asking the best way to play this dramatic shift.

Part of the challenge in making money by trading options (or just in the financial markets in general) is the zero-sum game factor. That is, for every winning trade, there's someone on the other side losing money.

In options, it often means the most obvious trades will be too expensive for the average trader to afford.

That's because the big players will get into the low hanging fruit trades for size before we even have a chance to open our Internet browser. As such, the option prices will be driven up because of demand.

Sometimes, in order to get the most value from your options trades, you need to think a little outside the box.

Instead of doing the most obvious trade, try to think what else may occur because of a certain scenario.

So, for example, when the price of crude oil drops, an obvious trade may be to buy puts on oil companies.

But, you can bet those puts will be expensive in such a clear case.

Sometimes, you may find the out-of-the-box trades work better than the more obvious ones. Here are three alternative ideas for trading the collapse in oil prices.

Don’t Short The Producer – Buy The Gas Consumer!

Instead of going for expensive puts on oil companies, take a look at companies that will benefit from lower oil prices.

For example, trucking companies.

The theory is, trucking companies will save big money if gasoline prices are lower.

They’re sure to show bigger profits if costs are down, but business conditions are otherwise the same.

I can just about guarantee you those trucking company calls will be cheaper than oil company puts. The five largest trucking companies in the U.S. are

- UPS (UPS),
- FedEx (FDX),
- J.B. Hunt (JBH),
- YRC Worldwide (YRCW) and
- Con-Way (CNW).

They’re all worth a look.

Another sector that will benefit from lower oil prices is agriculture. Growing crops is a very energy-intensive process.

A company like Archer Daniels Midland (ADM) which not only produces agricultural commodities and products, but also transports them and processes them could see substantial cost savings and improving margins from oil prices under $70.

Play The Long Game

And finally, here is one surprising way to trade the oil collapse: go long.

Oil and gas could remain inexpensive for quite a while longer. However, that doesn’t mean it’s too early to take advantage of cheap energy companies.

Keep in mind, investors will start loading up on opportunities well before the data become conclusive.

Here's a trade similar to one I recently recommended to members of my paid Options Trading Wire service.

Trade: Buy Encana (ECA) April 12 Calls for $1.25 or better

ECA is the largest gas producer in Canada and is ramping up activities despite the falling price of oil and gas.

The company has stellar fundamentals and is in no danger of cutting its dividend. What's more, the options are cheap so we can buy all the way out to April.

Buy the April 12 calls here, and wait for oil to settle in to a range.

Another way to go long is to buy long-term calls (or LEAPS) on an oil-tracking ETF, giving you a chance at some really cheap options. And at some point, oil will return to previous levels.

Make Sure To Cover Yourself!

One other thought...

This also could be an excellent covered call opportunity.

You see, while I don't expect oil to drop below $50, I also don't see it climbing much above $65 either. It's going to take time to work through the supply glut. And, while supplies are being used up, oil should hover in the $50-$65 per barrel range.

A safe strategy could be to purchase an oil ETF and sell calls equivalent to roughly the $65 mark in crude, or a little higher. In this way, you'll protect your downside, earn income, and take part in any short-term upside (up to your short strike).

Don't forget, all commodities can be volatile. But, we may have a predictable range in crude oil for the next few months, at least.

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Sincerely,

Gordon Lewis,
Chief Options Strategist
Options Trading Research