CANADIAN EQUITY DERIVATIVES

Quarterly Newsletter - April 2015

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Patrick Ceresna is the Chief Derivative Market Strategist for Learn To Trade Global (LTTG) and optionsource.net and has been a content provider and speaker for the Montreal Exchange for over 5 years. Patrick is a Chartered Market Technician (CMT), Derivative Market Specialist (DMS) and Canadian Investment Manager (CIM) by designation. Prior to becoming a partner at LTTG, Patrick spent ten years working at key financial firms in numerous trading roles including the trading of a large fund dedicated exclusively to options writing. Patrick specializes in analyzing the intermarket relationships of the broader derivatives market and the impact those trends have on trading and investment decision making.

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Martin Noël holds an MBA in Financial Services from the Université du Québec à Montréal since 2003. The same year, he received his Fellow of the Institute of Canadian Bankers and was awarded the Silver Medal for his superior level of performance in the completion of the Professional Banking Program.

Martin began his career in the derivatives industry in 1983 as an options market maker for various brokerage firms on the floor of the Montréal Exchange. He later became an Options Specialist and ultimately an independent trader. In 1996, he joined the Montréal Exchange as Options Market Supervisor where he had the opportunity to contribute to the development of the Canadian options market. Since May 2009, he is President of Monetis Financial Corporation, which specializes in professional trading and financial communication.

2015 Trading Calendar

APRIL

S	M	T	W	T	F	S
			1	2	3	4
5	6	7	8	9	10	11
12	13	14	15	16	17	18
19	20	21	22	23	24	25
26	27	28	29	30		

MAY

S	M	T	W	T	F	S
					1	2
3	4	5	6	7	8	9
10	11	12	13	14	15	16
17	18	19	20	21	22	23
24	25	26	27	28	29	30
31						

JUNE

S	M	T	W	T	F	S
	1	2	3	4	5	6
7	8	9	10	11	12	13
14	15	16	17	18	19	20
21	22	23	24	25	26	27
28	29	30				

- --- Listing
- ····· Last trading day
- — Expiration
- ● Equity & ETFs options
- ■ Weekly options
- ● S&P/TSX 60 Index Options (SXO)
- ● Options on the US Dollar (USX)

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CHOPPY WATERS FOR CANADIAN ECONOMY

By Patrick Ceresna

As a Canadian investor, there is no shortage of things to worry about in the economy. There has been a fundamental macro shift in the global market landscape driven by dropping oil prices and a surging U.S. dollar on the back of diverging central bank policies in Japan, Europe and the U.S. So what is in store for Canada? Will we see the Canadian dollar stabilize or oil rebound?

A The U.S. Dollar

It was not long after Mario Draghi hinted that the European Central Bank was to embark on its own quantitative easing program that the Euro began a rapid devaluation and the U.S. dollar began a sustained rise. With the state of the global economy deteriorating, the U.S. dollar began rising considerably against almost all currencies. This weighed heavily on commodity prices. It was almost impossible for Canada to avoid being impacted by this macro tsunami. The question now is where will the Canadian dollar stabilize? If the Canadian economy continues to show signs of deterioration, is there room for a decline down to $0.70.? What is clear is that the bank of Canada does not appear to be in a rush to defend our currency. If this trend continues, the U.S. dollar will remain strong and commodity prices sluggish as a result.

Oil

There is no debate that weak oil prices are weighing heavy on the broader economy and far more directly on Alberta. The expectation for sustained lower oil prices has been the primary driver for the Bank of Canada lowering its growth rate expectations to 1.5% in the 2015 year. A sustained lower price in global oil may particularly impact the Canadian producers because the heavy bitumen oil sells at a substantial discount to the Texas Light Sweet crude that many North American fracking wells are now extracting. Can the oil sands producers make it economical to keep producing or will we see a massive multi-billion dollar write down cycle similar to what the gold miners went through in 2013?

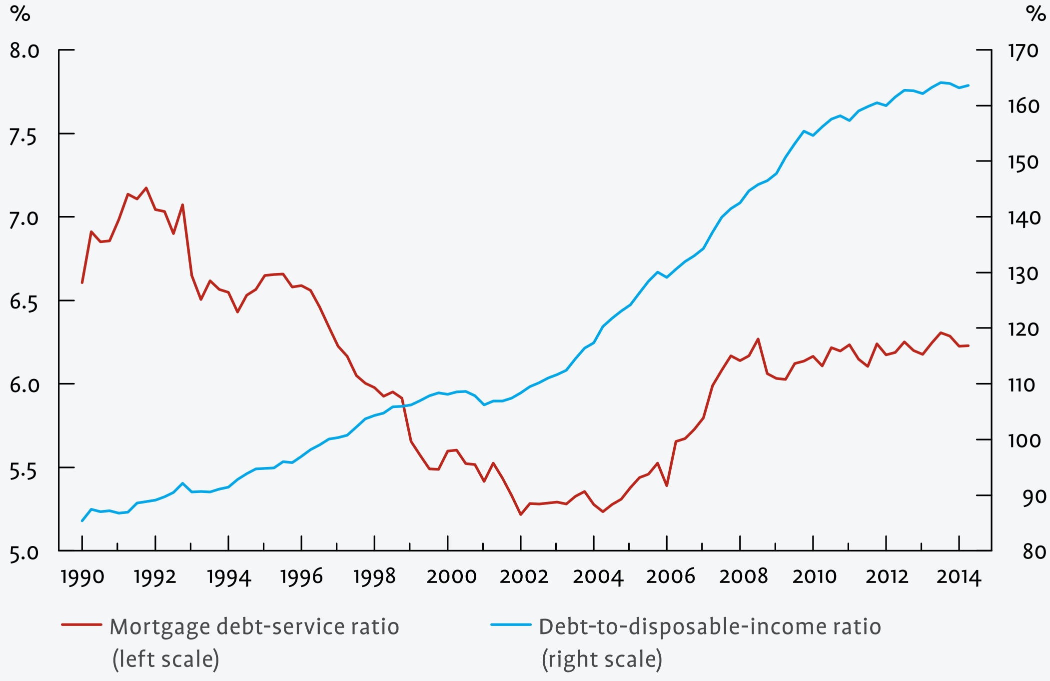
The Economy

The real risks may not be the price of oil itself, but a negative economic feedback loop that could force a broader economic slowdown throughout the entire economy. If the impact of oil was to be looked at in isolation, Canada would likely be able to weather the storm, but when combined with a number of concerning economic considerations, one can see the vulnerability to a contagion effect.

The first consideration is real estate. There have been many skeptics that have been sounding the alarm bells of Canada's expensive and overheated real estate market, but none were as alarming as when the IMF raises the red flag. The International Monetary Fund (IMF) concluded that that the real estate in the biggest Canadian cities was the second least affordable market in the world next to Hong Kong. This is particularly concerning as much of the job growth in Canada was attributed to the energy and housing markets.

House prices could in theory be sustained and a soft landing could plausibly occur, but it would rely heavily on stability in Canadian household income and confidence. What makes the situation concerning is the lack of wage inflation and the growing levels of household debt. While the Bank of Canada has suggested that the numbers have stabilized, one still must recognize that the average Canadian household carries 163% of debt to disposable income, one of the highest debt levels in the world. When the Bank of Canada looks to stimulate an economic turn, will the consumer have the confidence and the financial capacity to borrow and spend like they have in the past?

Debt-to-Disposable Income and mortgage Debt-Service Ratio



Note: The mortgage debt-service ratio is mortgage interest plus an estimate of the required principal repayment relative to income.

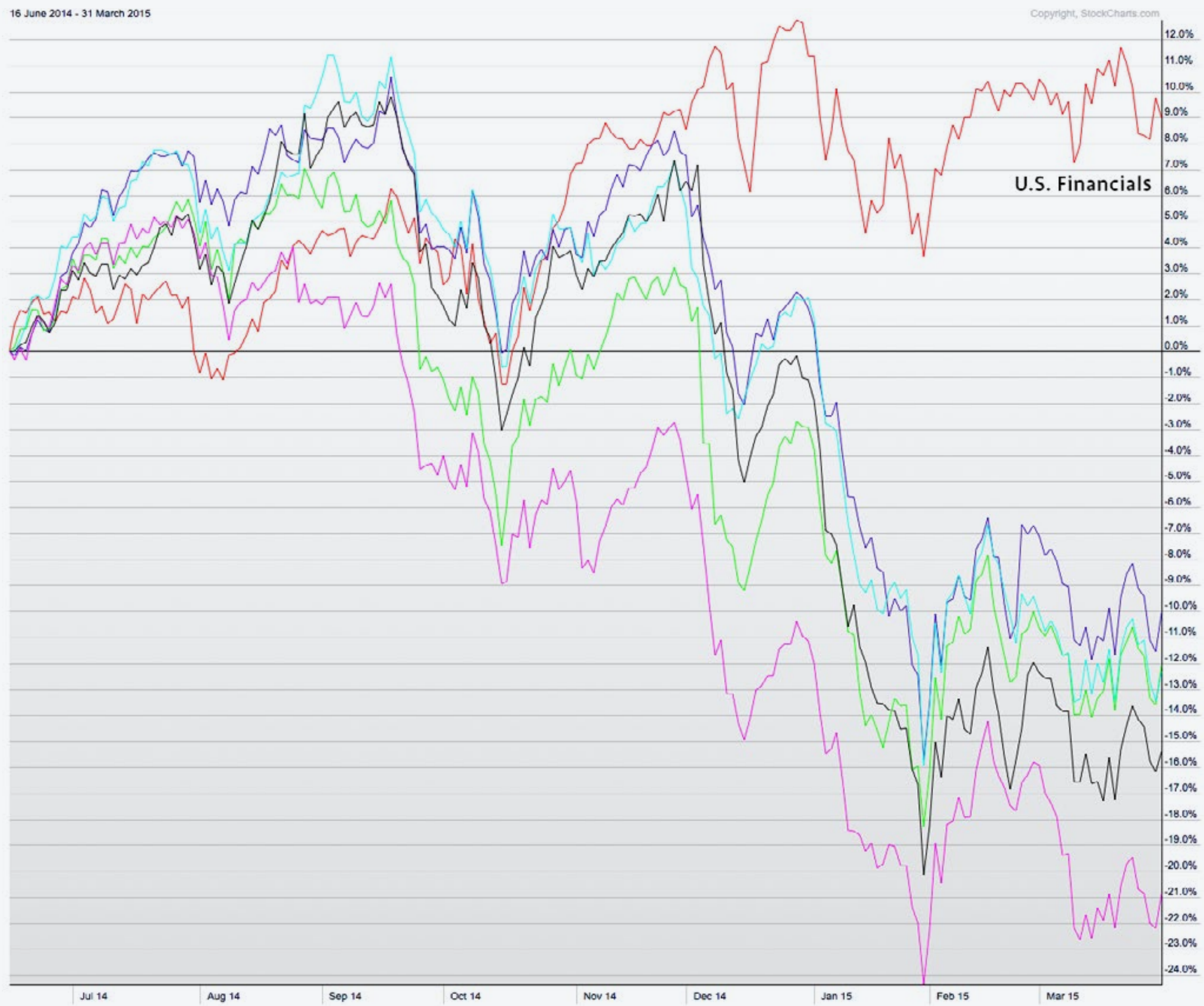
Sources: Statistics Canada and Bank of Canada calculations

Last observation: 2014Q2

Canadian Banks

International investors have become increasingly aggressive in predicting the downturn of the Canadian economy and particularly the Canadian Banks, which are the most leveraged to the financial and real estate boom. No better illustration of that is comparing the performance of the 5 biggest Canadian banks to the U.S. Financial ETF.

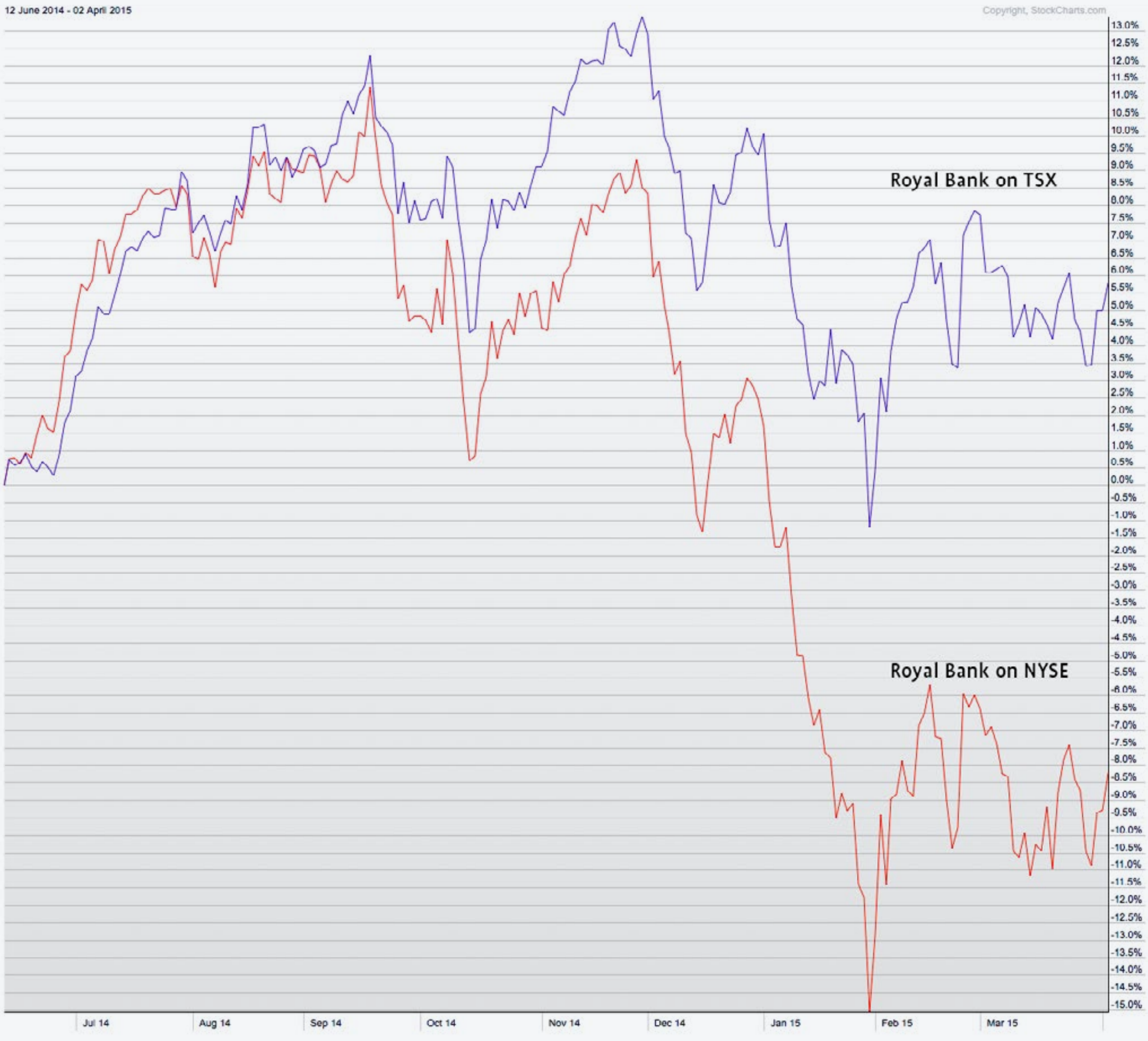
U.S. Financials vs. Canadien Bank



- Bank of Montreal
- Canadian Imperial
- Financials
- Royal Bank of Canada
- The Bank of Nova Scotia
- Toronto Dominion

To date, international speculators shorting the Canadian Bank stocks are making good money, but the returns can be largely attributed to the drop in the Canadian dollar. To illustrate in the chart below, Royal Bank is up close to 6% on the year in Canada, but down over 8% in New York. Those speculators are not just betting on the currency move, but now are waiting for the other shoe to drop with a real downturn in the economy.

Royal Bank - NYSE vs. TSX



- Royal Bank of Canada on NYSE
- Royal Bank of Canada on TSX

Will they be right?

There are no certainties and the market often makes many speculators look like fools. Equally, there are some big macro considerations that make Canadian banks vulnerable if the economy was to fall into a negative feedback cycle. This is why it is always a good idea to consider hedging many of the risks.

It is common for the average Canadian investor to be holding a sizable allocation to the high dividend paying banks. Any investor considering the idea to just sell the shares would need to consider capital gains, transaction costs and the loss of a dividend income stream. More importantly, if the shares were sold and the sector was to recover, the investor would not participate. This is where options can be a consideration.

Hedging Canadian Financials with a Put Option

In this example, an investment advisor has a high net worth client with a $1,000,000 portfolio of which $60,000 is invested in 4 Canadian financial stocks (Royal Bank, Bank of Nova Scotia, National Bank and Manulife). The client is relying on the dividend income and has considerable capital gains if the shares were sold. The client understands that these stocks are going to fluctuate, but the investment advisor wants to remove the risk of a violent and unexpected decline.

- Advisor is recommending buying puts on the iShares CDN S&P/TSX Financials Index ETF (XFN) rather than buying puts on each individual stock.
- XFN is trading at $30.70
- The September $28.00 puts (about 10% below the current price) are trading for $0.55.
- It would take 20 puts (2,000 shares) to hedge about $60,000 of financial exposure.
- 20 puts at $0.55 would cost approximately $1,100 to buy.

So what has the advisor done? He has created a scenario where the client can continue to own the existing portfolio uninterrupted while having protection for the next 6 months. If the economy remains stable and the financials recover, the investor will participate. Alternatively, if the economy deteriorates and the Canadian bank stocks continue to decline, the put protection ensures that the downside risk is limited. The part that I appreciate the most is that the put protection can be as important psychologically to the client focusing on the long term as it is for financial protection from a monetary loss.

Bull Spread on Royal Bank of Canada (RY)

The shares of Royal Bank (RY) were trading at $76.80 when the market closed on April 2, 2015. Since its low of $71.74 on January 31, 2015, RY has fluctuated in a price range of $74 to $79. We can see the Relative Strength Index (RSI) showing signs of positive divergence on a daily basis, which could be an indication that buyers are beginning to accumulate shares of RY on weakness. In such a context, an investor who is unafraid of buying shares of RY in case of a decline, could sell RY 150515 P $76 put options at $1.56 and thus make $156 per contract. To limit losses in the event of a significant decline, an investor could buy an RY 150515 P $70 put option at $0.35, and thus transform the position into a bull spread using put options. On the May 15, 2015 expiration date, the maximum profit of $1.21 – the net premium received – will be generated if RY remains above the strike price of $76. If it falls under this strike price, an investor could then be required to buy 100 shares of RY at $76 per share for each contract executed. The breakeven point of $74.79 is obtained by adding the $4.79 loss to the lower strike price of $70. It is under this level that the position will begin to generate losses in case of decline. Finally, an investor could incur a limited loss of $4.79 per share ($76 - $70 - $1.21) if the share falls under the strike price of $70).

Sale of Covered Call Options on TransCanada Corporation (TRP)

The shares of TransCanada Corporation (TRP) have been trading within a price range of $50 to $59 since the fall of 2014. At its current price of $54.44 – at close of market on April 2, – TRP is exactly mid-range. An excellent strategy for taking advantage of the relative stability of a share price, such as that of TRP, is the sale of covered call options. Investors with TRP stock in their portfolio could make the most of this relative stability, if it continues, and get slight protection in case of a decline, while being able to profit from a possible upswing by selling covered call options on TRP shares. This strategy involves selling one call option for every block of 100 shares held. The strike price level for call options sold is a compromise between the desired capital gain, time value and degree of protection. In the current case, the sale of TRP 150515 C$ 54 call options at $1.55 per share would generate a maximum profit of $155 per contract, for a return of 2.1% over a period of 43 days until the expiration date (17.8% annualized). The breakeven point of $52.89 provides protection against a decline of 2.9%. The sale of TRP 150515 C$ 56 call options at $0.65 per share provides protection against a decline of 1.2% with a breakeven point of $53.79 and a potential maximum profit of 4.1% over a period of 43 days until the expiration date (34.9% annualized).

Options Education Day

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VANCOUVER, MAY 30, 2015

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OIC The Options Industry Council

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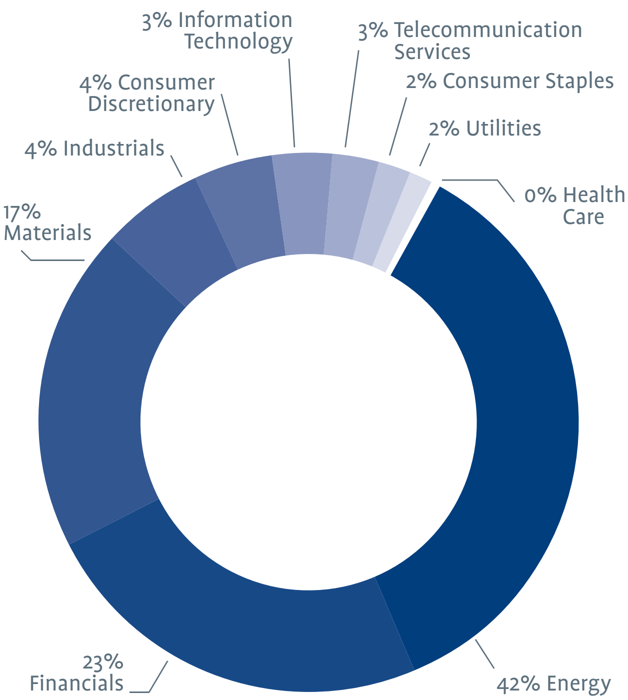
Top 10 Most Active Option Classes (Q1 2015)

RANK	SYMBOL	Q4 2014 VOLUME	INSTITUTIONAL	RETAIL	INSTITUTIONAL %	RETAIL %
1	XIU	723,972	561,905	162,067	78%	22%
2	COS	292,245	132,288	159,957	45%	55%
3	RY	214,842	83,189	131,653	39%	61%
4	TD	208,484	92,317	116,167	44%	56%
5	XEG	188,912	143,482	45,430	76%	24%
6	BNS	165,332	66,328	99,004	40%	60%
7	CPG	148,305	65,636	82,669	44%	56%
8	SU	144,168	44,250	99,918	31%	69%
9	BBD.B	137,684	24,382	113,302	18%	82%
10	BCE	115,644	61,720	53,924	53%	47%

Options Trading Volume by Sector

Q1 2015



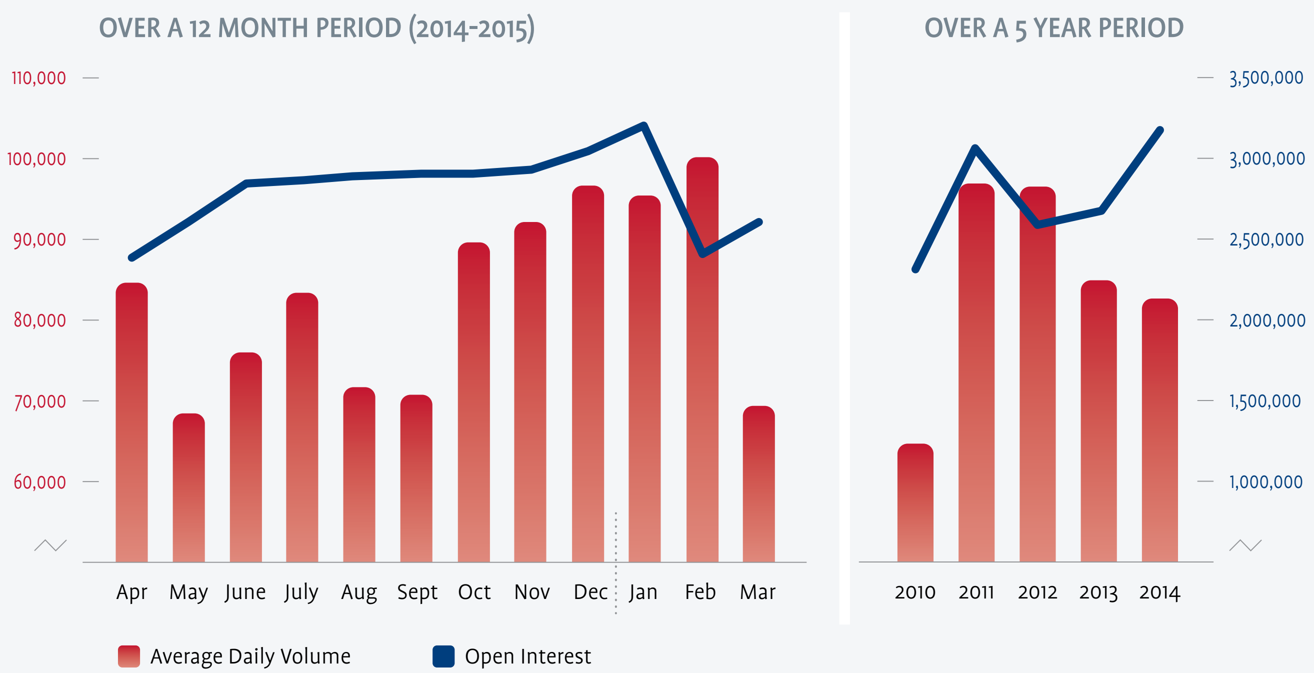
Source: Bloomberg

Note: Options volume from delisted or acquired companies are excluded.

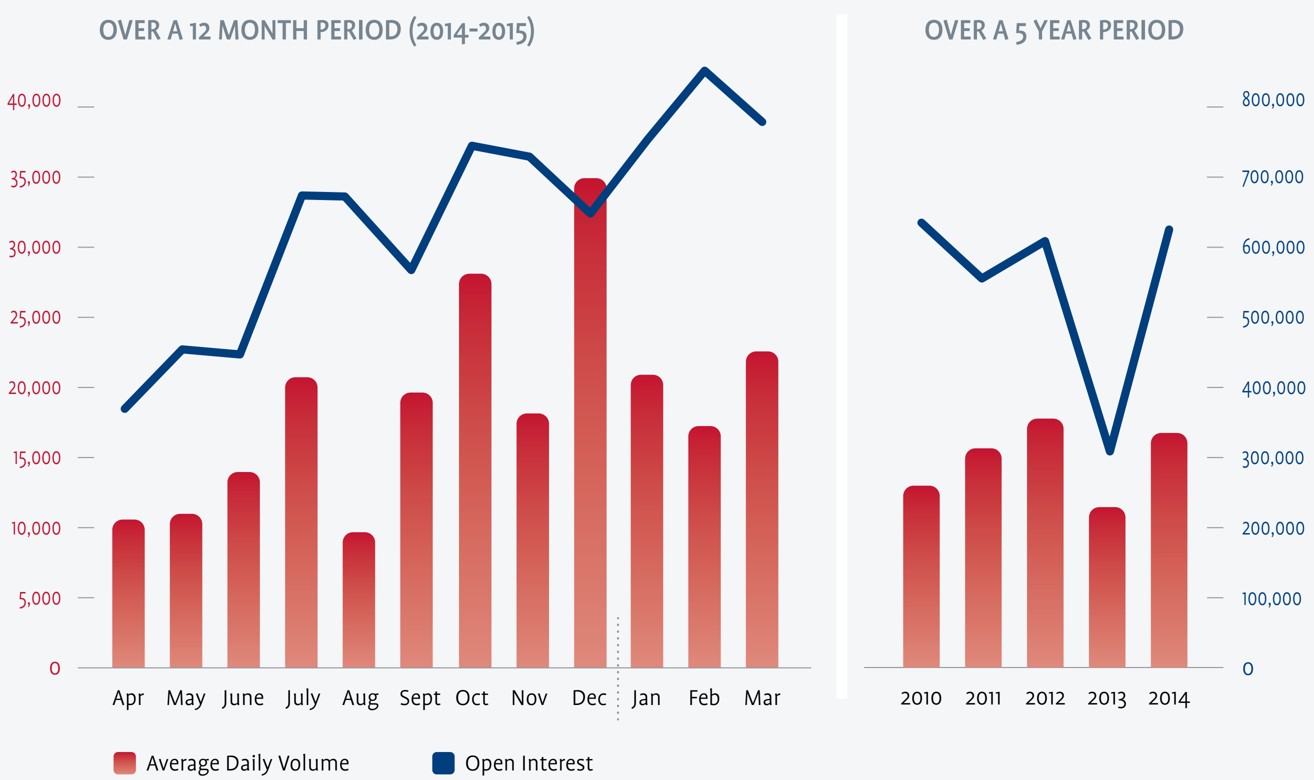
Most Crossed Option Classes

RANK	SYMBOL	CROSS VOLUME
1	XIU	561,905
2	XEG	143,482
3	COS	132,288
4	ZEB	93,280
5	TD	92,317
6	RY	83,189
7	MEG	78,251
8	XFN	69,075
9	TX60	68,170
10	BNS	66,328
11	CPG	65,636
12	ENB	63,915
13	BCE	61,720
14	DGC	61,468
15	ELD	53,513
16	MFC	47,795
17	NA	44,290
18	SU	44,250
19	ECA	36,803
20	SLF	36,189

Equity Average Daily Volume and Open Interest



ETF Average Daily Volume and Open Interest



Trading Tools

COVERED CALL Calculator

OPTIONS Calculator

TMX Trading SIMULATOR

Useful Links

GUIDES

» Equity derivatives

» Index derivatives

» Currency derivatives

» Equity options tax regime

MX INDICES

» S&P/TSX 60 VIX Index (VIXC)

» MX Covered Straddle Writers' Index (MPCX)

» MX Covered Call Writers' Index (MCWX)

OTHERS

» Options List

» Put/Call Ratios

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