CANADIAN EQUITY DERIVATIVES

Quarterly Newsletter - April 2017

MANAGER'S COMMENTARY

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TMX | Montréal Exchange

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2017 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)

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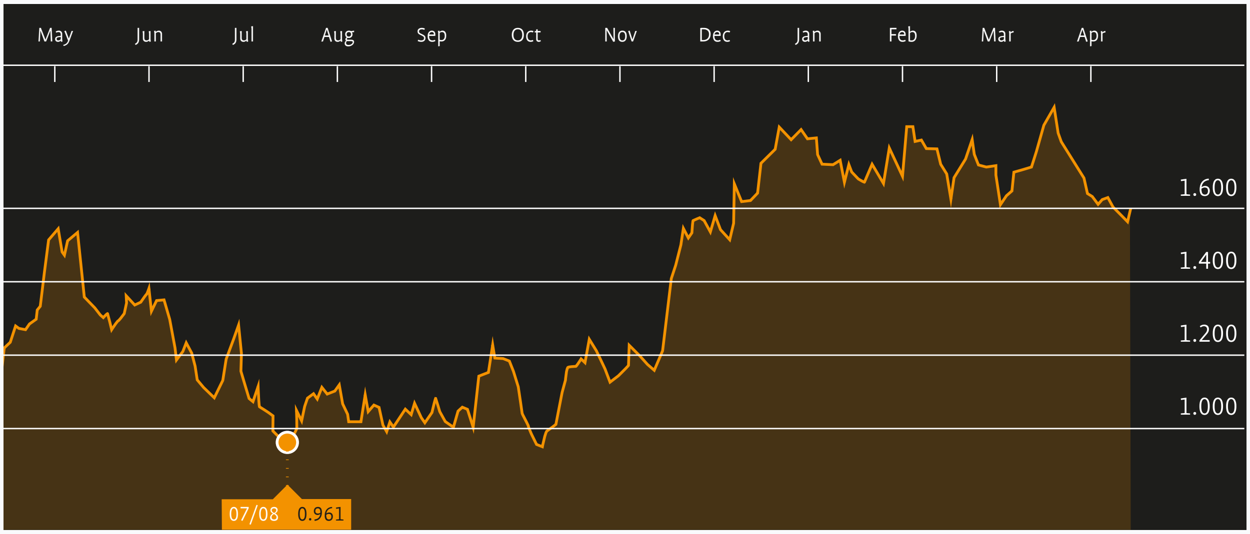
THE REFLATION TRADE IS DYING, NOW WHAT?

By Patrick Ceresna

It was in the summer of 2016, with the 10-year Government of Canada Note yielding 0.96%, that a new narrative was born, under the pretext of improving economic and inflation data, it planted the seeds of the now well established reflation trade. Prior to this, throughout the first half of 2016, the defensive sectors like telecoms, utilities, REITs and particularly bonds were some of the best performing sectors in the markets. That all rapidly changed throughout the summer of 2016 in what can now be identified as the key asset class and sector rotation moment of that year.



Source: Bloomberg Markets

The big winners were all anchored on the rotation into- long U.S. dollars, long financials, long cyclicals and long emerging markets and/or long almost any high beta stock. This entire narrative was given a big boost of liquidity with the Trump victory and the herds of retail buyers who wanted a piece of the action. This reflation story has been easy to follow and easy to sell to an audience hungry for easy gains. Just one problem has developed. It has stopped working. Since the start of the year almost all the major reflation theme sectors have been stuck in the mud.

While the Canadian banks and energy stocks have begun correcting, giving back much of their early year gains, we rather are seeing the low beta, high dividend stocks performing very well. This includes gains in Government of Canada bonds, utilities like Fortis/Hydro One, telecoms like Rogers/BCE and REITs like the Canadian Apartment REIT and RioCan.

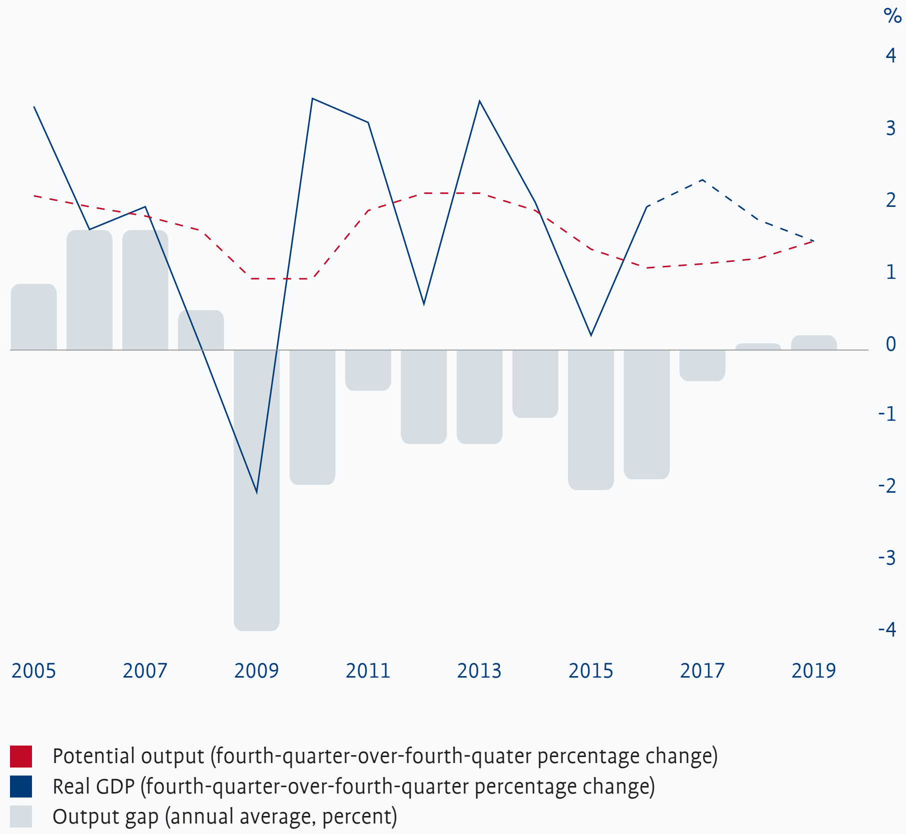
Drivers for 2017

Can Canada sustain its current growth?

There is little disputing the importance of U.S. growth as a key precipitating factor in influencing Canadian economic trends. With the recent increase in growth numbers in Canada, even the Bank of Canada is skeptical that this is sustainable. A large part of the ramp up in growth numbers was attributable to the bump up in investment in the oil and gas sector, while almost all non-commodity business investment and exports remain weak. This is the environment with arguably some of the best American macro data we have seen in years. So, the question must be asked, how badly will the contagion be north of the border if the Trump reflation trade runs out of steam?

Real GDP growth is projected to slow toward potential output growth

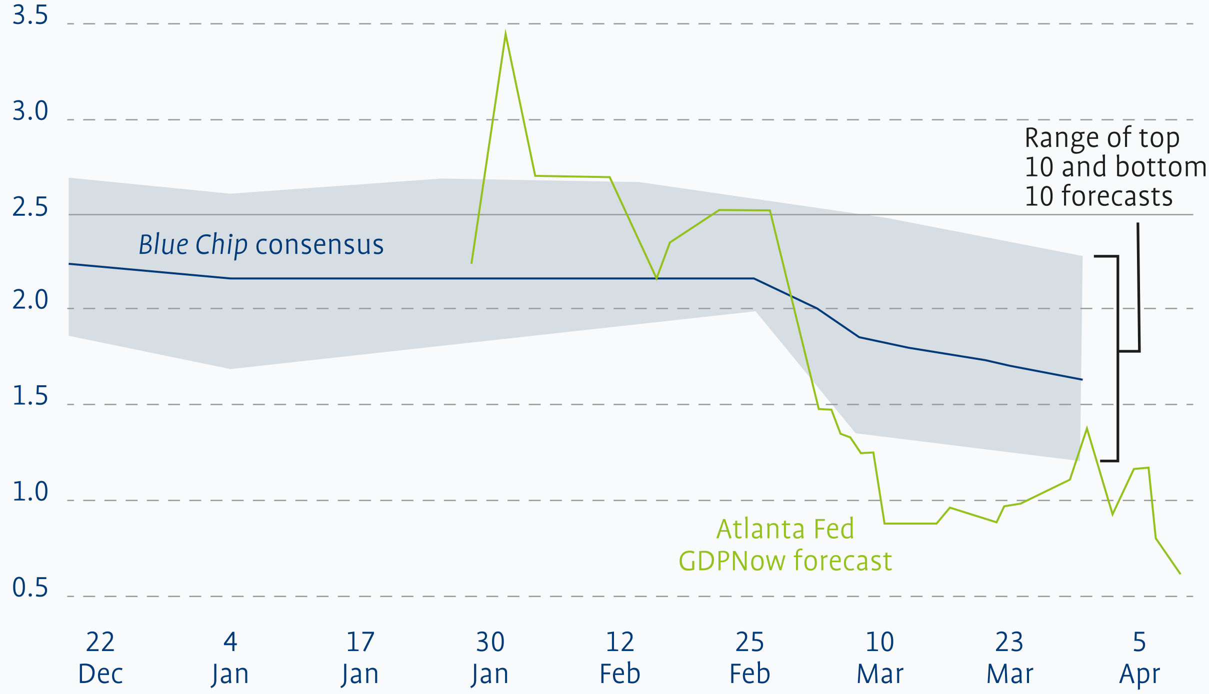
Annual data



As the first quarter of the year passes, much of the bullish U.S. economic data, like the ISM, has now reached such high levels that there is little room for further gains. This would suggest that the boost the markets have been getting from improving data will now have to digest a period of normalization and retracement. This has driven many growth forecasts lower, like the Federal Reserve Bank of Atlanta's Center for Quantitative Economic Research's GDPNow forecast for the growth rate of real domestic product (GDP). Their current forecast is now at the lowest level of the year at a very subdued 0.60%, a far cry from any alarming reflation fear level.

Evolution of Atlanta Fed GDPNow real GDP forecast for 2017: Q1

Quarterly percent change (SAAR)



Source: *Blue Chip Economic Indicators and Blue Chip Financial Forecasts*
Note: The top (bottom) 10 forecast is an average of the highest (lowest) 10 forecasts in the *Blue Chip survey*.

Where are we in the business cycle?

Recessions Happen.

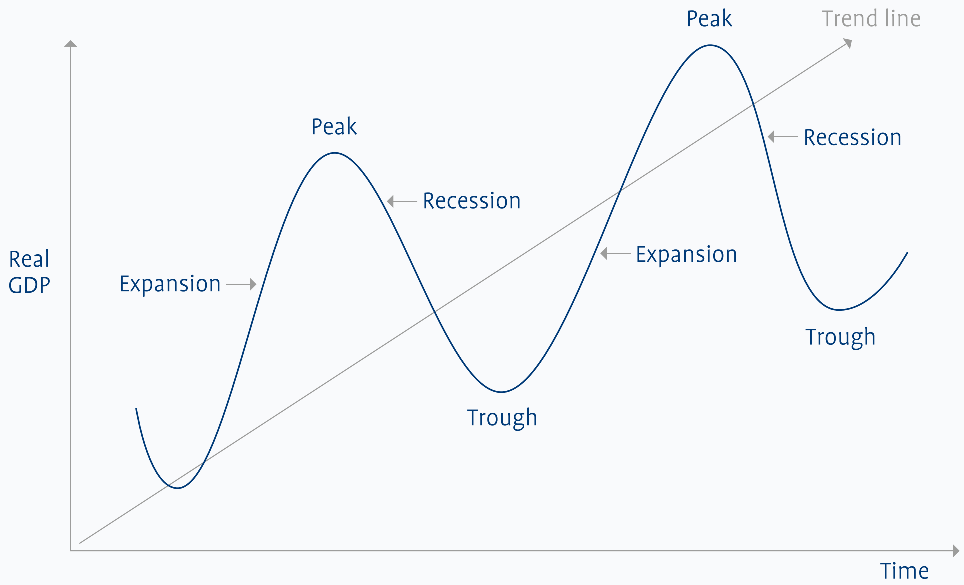
The inherent observation must be the uncanny correlation of the timing of Canadian recessions with those south of the border. During the 2008 financial crisis, there is an often-quoted adage of "when the U.S. sneezes, the world catches a cold. This cannot be truer for the Canadian economy which is so economically intertwined that the animal spirits alone would have an economic drag. So it is important to take into consideration where the U.S. is in its current business cycle.

Based on data from the National Bureau of Economic Research, post WWII, the average American economic expansion has been 69.5 months. We are now going on 95 months in the current expansion making this the 3rd longest business cycle on record. Do you dare utter the words- "It is different this time because......"? Recessions not only happen, but more importantly, they are often induced by Federal Reserve tightening. Janet Yellen and the FOMC committee owe Donald Trump nothing. The recent surge in confidence and data gives the FOMC the window by which they can tighten without spurring on a negative reaction from the street which arguably was the primary obstacle for having not moved earlier.

While there is nothing stopping the current expansion from perpetuating, one cannot deny the simple acceptance that this is the late stages of the business cycle. Now if you are hanging on the belief that main street analysts will warn you in advance of a turn in the business cycle, think again. In an Economic Letter from the Federal Reserve Bank of San Francisco titled: Persistent Over-optimism about Economic Growth, the authors state:

> *“Economic forecasting can be a humbling endeavor. In a cross-country study of private-sector forecasts from 1989 to 1998, Loungani (2001) finds that “the record of failure to predict recessions is virtually unblemished.”* http://www.frbsf.org/economic-research/publications/economic-letter/2015/february/economic-growth-projections-optimism-federal-reserve/

A famous Mark Twain saying of “History doesn’t repeat itself but it often rhymes”. If that is to be true, most main street analysts will once again miss the warning signs to the next economic contraction in the U.S. and in Canada. If the data does start to slow and turn, the reflation trade will have to contend with new dis-inflationary forces that will derail the entire narrative.



What if nominal growth and inflation are more benign than expected?

Facts:

- Global liquidity is shrinking as almost all central banks in the world are either tightening or beginning the process of unwinding extended periods of QE
- The Bank of Canada is walking a tightrope with monetary policy in the midst of a real estate bubble in some of its biggest cities
- The growth rate of the money supply is slowing both in the US and Canada
- The velocity of money and loan creation continues to slow

What fiscal or demographic forces can offset such monetary policy conditions? While these conditions alone do not guarantee a recession, it is important to simply accept~~,~~ the accommodative central banks of the last decade are gone and now the economy is going to be left to see if it can swim in the choppy waters without its central bank water wings.

Recession or not, do you really want to bet that this is the backdrop behind rapidly rising growth and inflation?

How to Trade It?

I will stand by my 2017 forecasts that being positioned in longer duration government bonds, low beta, non-financial high dividend paying stocks like telecoms and utilities will fare much better than the main street analysts suggest. Though short-term rates will likely go higher in the U.S., Stephen Poloz has not budged keeping short term rates unchanged. The risk remains that this continues to be a yield curve flattener trade.

What to consider regarding investors holding the reflation trade stocks like - cyclical high beta and financial names?

In short summary ... Buy protective puts to lock in your gains.

It has been a great run. Just reflect back to all the past market cycles you have invested through, when you have seen material paper profits made and subsequently be given back without taking action. Investors who profited from the meaningful strength in the financial, cyclical and high beta names are in a position that, on balance of probabilities, is skewed against explosive further gains with increasing risks. Is it not worth a few dollars profit to hedge those gains?

Long Call on BCE Inc (BCE)

Within the reflation trade narrative of the last 9 months, BCE Inc. has been a serial underperformer. With its large and stable dividend, BCE fell victim to the route in the bond markets as almost all bond proxy stocks suffered in the global repricing of interest rates. The underperformance has seen the stock behaving like a serious laggard spending 5 months range bound pivoting off the $57.50 level. Over the last few weeks, we have seen material strength in all the low beta defensive names and ushering in a technically bullish breakout on the BCE shares. If this breakout sticks, we could see a material strengthening of the stock back to its $63.40 52 week high.

Here is the breakdown:

- BCE Inc. (TSX:BCE) is trading at $60.40 (April 9th, 2017)
- BCE has a 52wk range of $57.12 - $63.40
- The August 18th, 2017 $60.00 call is asking $1.35

The call option gives the trader a risk managed way to participate beyond just buying the stock. If the stock was to return back to its 52-week high at $63.40, the option will have more then doubled in value.

- If BCE fails to follow through and rather declines back to its lows, the traders risk is limited to the $1.35 cost of the option.
- If the stock was to rise, the investor can choose to take profits on the call or could consider exercising their right to buy the shares a $60.00.

BCE Inc. (BCE)

Cash Covered Put on Goldcorp (G)

While being one of the largest and most established goldmining companies in the world, Goldcorp has struggled with consistency and short term management decisions had the stock serially underperform its piers during the 2016 gold bull breakout. While other senior gold producers like Barrick Gold are well over 100% off their 2016 lows, Goldcorp is still bouncing around within not far from its decade lows. While there is little doubt that this has any appeal to the momentum trader, it does offer an interesting proposition to the investor willing to accumulate the stock near its major lows.

Here is the breakdown:

- Goldcorp (TSX:G) is trading a $19.77 (April 9th, 2017)
- G has a 52wk range of $15.95 - $26.56
- The October 20th, 2017 $18.00 put is bidding $0.80
- Every put sold represents an obligation to potentially have to buy 100 shares or $1,800.00 ($18.00x100) by the expiration.

The $0.80 premium represents a 4.44% income in just 6 months for undertaking the obligation.

- If the stock declines below $18.00, you will be assigned to the shares with an adjusted cost base (break-even) of $17.20 ($18.00-$0.80) or $2.57 lower then where it is currently trading and relatively close to its 52-week low.
- If the stock remains range bound or bullish, the investor generated a respectable income return.

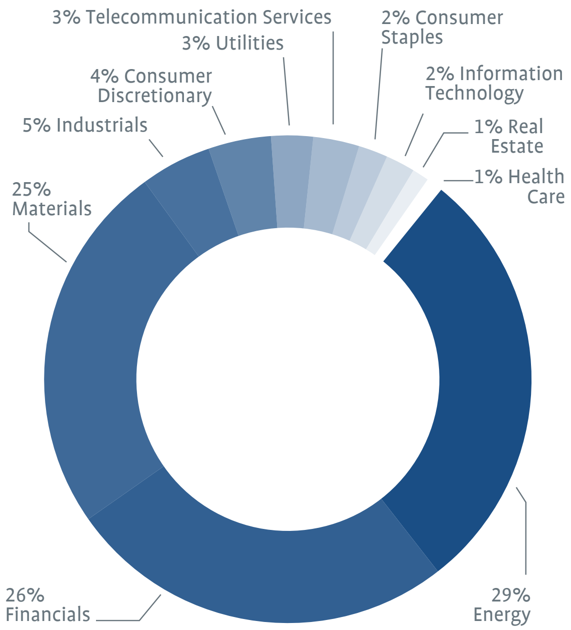
Goldcorp (G)

Top 10 Most Active Option Classes (Q1 2017)

RANK	SYMBOL	VOLUME	INSTITUTIONAL	RETAIL	INSTITUTIONAL %	RETAIL %
1	XIU	260,219	115,342	144,877	44%	56%
2	ATH	231,509	198,641	32,868	86%	14%
3	TD	173,305	70,592	102,713	41%	59%
4	ABX	164,463	77,119	87,344	47%	53%
5	BNS	163,429	70,824	92,605	43%	57%
6	G	162,616	74,777	87,839	46%	54%
7	SXO	153,230	78,726	74,504	51%	49%
8	RY	151,604	66,061	85,543	44%	56%
9	BMO	146,023	70,601	75,422	48%	52%
10	DGC	139,187	66,099	73,088	47%	53%

Options Trading Volume by Sector

Q1 2017



Source: Bloomberg

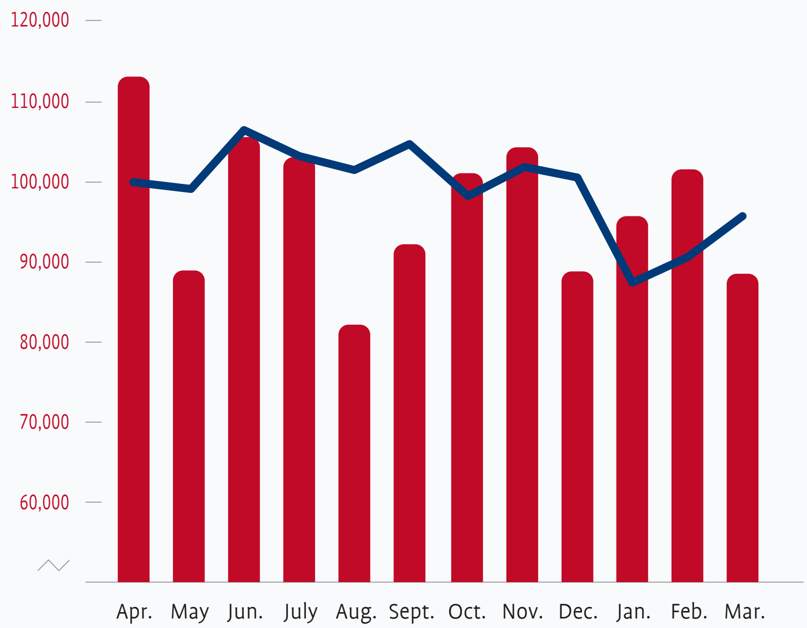
Note: Options volume from delisted or acquired companies are excluded.

Most Crossed Option Classes

RANK	SYMBOL	CROSS VOLUME
1	XIU	2,280,539
2	MFC	159,906
3	XEG	122,798
4	ZEB	116,407
5	XGD	99,026
6	DGC	87,190
7	TD	87,091
8	ZSP	85,000
9	CNQ	84,223
10	TOU	79,071
11	RY	76,741
12	ZCN	74,400
13	CM	66,930
14	VSN	62,282
15	CVE	60,839
16	CPG	60,832
17	AGI	55,928
18	NGD	53,723
19	SLF	50,710
20	OR	46,946

Equity Average Daily Volume and Open Interest

OVER A 12 MONTH PERIOD (2016-2017)

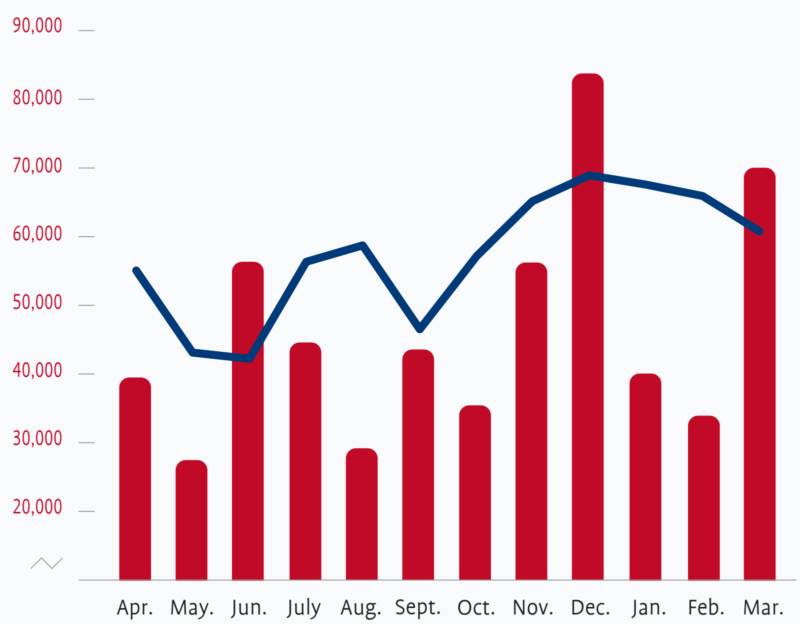


OVER A 5 YEAR PERIOD

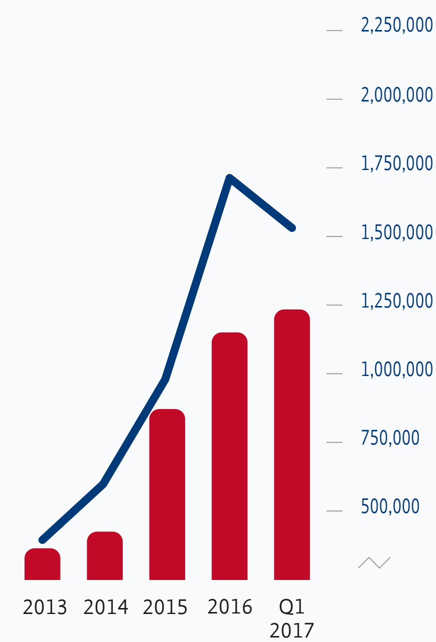
Average Daily Volume   Open Interest

ETF Average Daily Volume and Open Interest

OVER A 12 MONTH PERIOD (2016-2017)



OVER A 5 YEAR PERIOD



Average Daily Volume   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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