CANADIAN EQUITY DERIVATIVES

Quarterly Newsletter - January 2017

MANAGER'S COMMENTARY

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TMX | Montréal Exchange

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2017 Trading Calendar

JANUARY

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				

FEBRUARY

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				

MARCH

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	

- --- 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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WILL THE TRUMP EFFECT DERAIL THE CANADIAN ECONOMY?

By Patrick Ceresna

The Trump administration has made it very clear that protectionism is a top priority. Many Canadians are quick to suggest that the focus will predominantly be on China and Mexico, but that may be an erroneous assumption. The incumbent administration has made it clear that the retaliatory trade measures against Mexico apply to Canada as well. This "America First" agenda is great for Americans, but presents many uncertainties for Canadians. This comes at a time when the Canadian economic growth is floundering, searching for where the fuel for the next growth cycle will come from. At least for now, it is fair to say that it is too early for investors to panic on trade policies that have yet to be created and bilateral negotiations that have yet to be had.

So where are the real risks in the first quarter of 2017?

Interest rates. The bond markets peaked in the summer of 2016 and were broadly distributing in the months prior to the election, but it was the animal spirits associated with a Trump/Republican victory that ushered in a sharp drop in bonds and general rise in interest rates. Why is this important? Because it was not just a rise in interest rates in the U.S., but a broad rise in global risk premiums in almost all global bond markets. This is where the real collateral damage of the trump administration lies.

In Canada, we have modest inflation and slow growth. The Bank of Canada Governor Stephen S. Poloz has been reluctant to raise short-term interest rates in Canada as many analysts are suggesting there is no immediate catalyst to raise rates. Yet, interest rates on the 10-year Government of Canada bond, which was yielding 0.954% on September 29, 2016, has almost doubled, hitting 1.837% on December 15, 2016. That is not a central bank driven rise in rates, rather it was predominantly driven by a rise in global risk premiums. It certainly doesn't help that predominant rock star bond managers have been openly contemplating the end of a secular bull market in bonds.

Government of Canada 10-year Note

Source: www.bloomberg.com/quote/GCAN10YR:IND

This is, unequivocally, the single biggest macro issue for the first half of 2017.

The implications may be far reaching. Here is how Bank of Canada views the risk:

> "A large and persistent rise in global risk premiums and the ensuing increase in interest rates would lead to tighter financial conditions, a drop in confidence, weaker growth and rising debt-service burdens, both globally and in Canada. Since the 2007–09 global financial crisis, Canada's external assets and liabilities have both grown rapidly. On the liability side, this rise is mostly attributable to the purchase of Canadian debt securities by foreign buyers. There is a risk that these foreign portfolio investment inflows—which have put downward pressure on borrowing costs for Canadians—could reverse and thus exacerbate the increase in risk premiums. This re-pricing of risk would prove to be even costlier if fixed-income market liquidity turns out to be fragile."

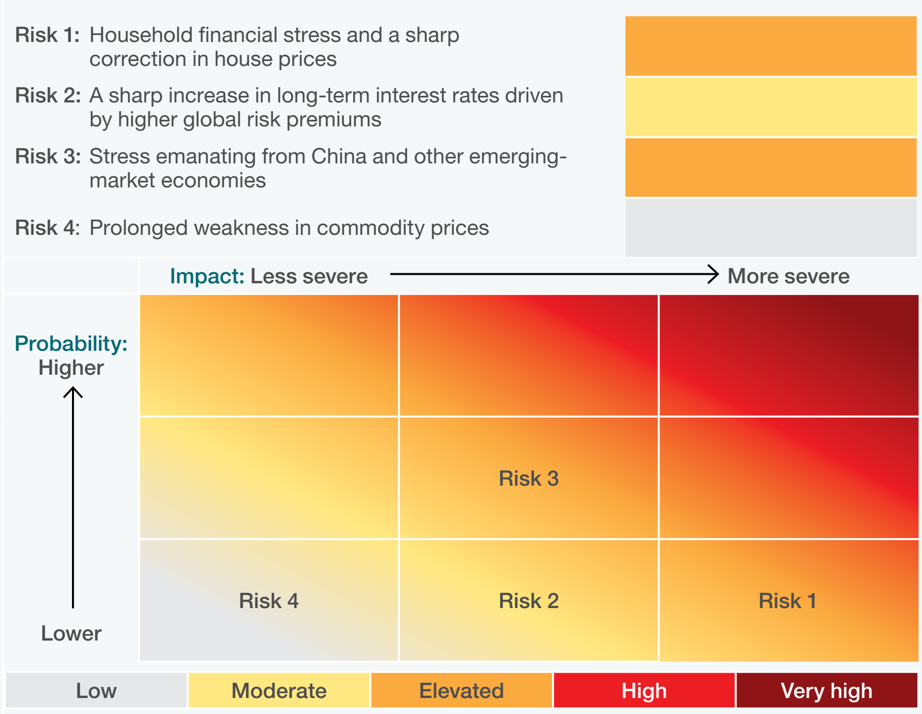
Source: www.bankofcanada.ca/2016/12/fsr-december-2016/ pg. 15

The tension on broader interest rates are likely to continue to pressure Canadian mortgage rates higher at a time when house prices are historically high and affordability in question. Will the rising level of Canadian household indebtedness and the rising mortgage rates usher in the much talked about housing slowdown?

There is a second risk to a Trump administration that must be accounted for – **China**.

The Bank of Canada has been for years publishing their list of risks to the stability of the Canadian financial system and persistently they have highlighted the risk of stress emanating from China and other emerging-market economies.

Table 3: Key risks to the stability of the Canadian financial system



Source: www.bankofcanada.ca/2016/12/fsr-december-2016/ pg. 14

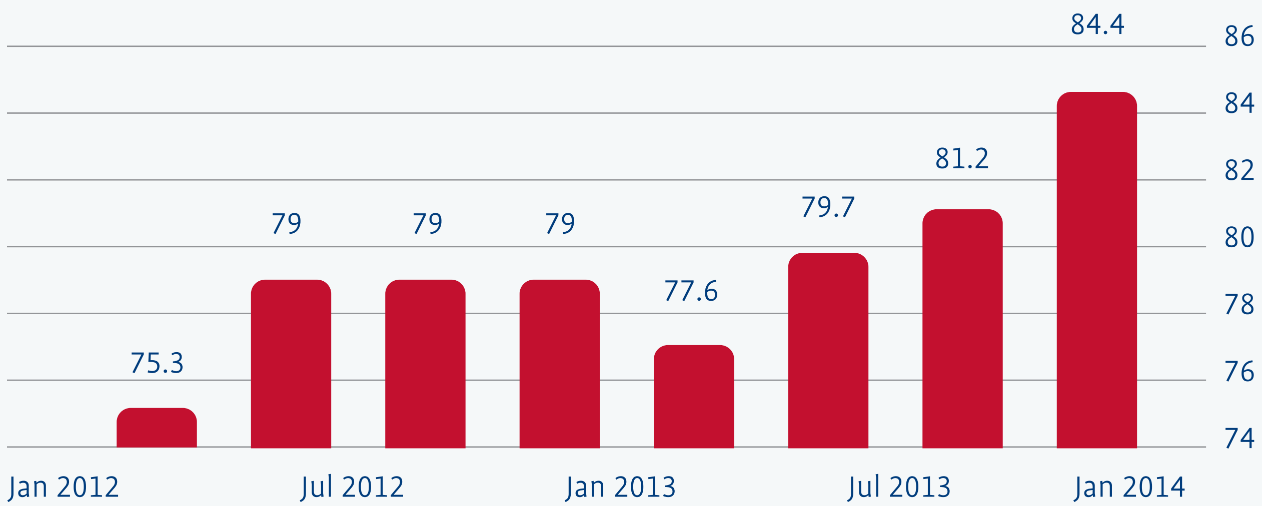
Does the Trump administration make this an immediate and present danger?

China continues to have material imbalances in its currency flows as they are trying to contain a 1 trillion-dollar+ capital outflow over the last 18 months. They have been very aggressive with capital controls and have been trying to turn the tide without having to raise interest rates domestically. This has been forcing the Chinese to sell their U.S. Treasury holdings and adding further pressure to interest rates in the U.S. and abroad.

China's credit and currency issues are incredibly complex. Many analysts continue to forecast that the Peoples Bank of China will be able to successfully orchestrate a soft landing and recovery, but will a pending trade war with America be the imbalance to usher in a more ominous economic cycle?

What is most bizarre is that Canadian Consumer Confidence has been on the rise as we are approaching 6 year highs. This is counter intuitive to the rising levels of household debt and mortgage rates, but could be rationalized by animal spirits as many Canadians have been captivated by the political drama south of the border. How long will this confidence continue?

Canadian Consumer Confidence



Source: www.tradingeconomics.com | Decima Research Inc.

I ask the question, will 2017 start with a Trump euphoria hangover? Canadians will have no tax cuts and no new fiscal stimulus as the Liberals have already been implementing their political promises over the past year. What if the numbers continue to be lackluster? What if Trump was to insist to renegotiate Canada's trade agreements? One way or another, it is easy to be able to conclude that 2017 will be volatile and that the Canadian markets can easily regress back to their long-term mean levels.

Considering Using Options?

For those professionals that are not utilizing options as an active part of their portfolios, one may consider that today's market environment is strategically ideal. Option strategies can help create compelling ways for managers to keep participating to the long side of an overbought market with a defined risk. In addition, options can further be used to enhance your income returns and be used to hedge the downside risks of stocks and ETFs.

Learn more by accessing all the free guides and strategies at www.m-x.ca/educ_guides_strat_en.php

Covered Call on Franco-Nevada (FNV)

Franco-Nevada Corporation remains one of the premier gold-focused royalty and streaming companies. Even during the most challenging phases of the three year gold bear market, the company has been able to persevere, always remaining profitable beyond a few quarters. Over the last six months, Franco-Nevada's share prices have been consolidating in correlation with gold mining companies. We view this as an opportunity to buy the stock and generate income with a covered call.

Here is the breakdown:

- Franco-Nevada (TSX:FNV) is trading at $83.70 (January 16th, 2017)
- FNV had a 52 week range of $58.67 - $105.69
- The July 21st, 2017 $88.00 call is bidding $6.00

One can generate a 7.17% premium income for selling the 6-month covered call while leaving $4.30 upside on the stock.

- If the stock declines, investors average cost base (break-even) would be $77.70 ($83.70-$6.00)
- If the stock remains range bound, investors can generate a healthy income while owning a solid gold royalty company
- Alternatively, if the stock was to rise above $88.00 and investors were assigned on the covered call, they would have made a $10.30 (12.31%) return in a half year.

Cash Covered Put on Rogers Communications (RCI.B)

Rogers Communications remains one of Canada's telecom juggernauts. Recently, the entire telecom space has pulled back. Driven by the anticipation of higher interest rates, there has been a general rotation out of low-beta defensive names and into the high-beta cyclical sectors. If the economic data in the upcoming months proves to be benign, there is an opportunity to accumulate these beaten down defensive names at potentially favorable levels. One way to accumulate stocks is to sell put options at levels you are willing to own the shares. Let's look at an example using Rogers.

Here is the breakdown:

- Rogers Communication (TSX:RCI.B) is trading a $51.12 (January 16th, 2017)
- RCI.B had a 52 week range of $46.15 - $58.99
- The July 21st, 2017 $50.00 put is bidding $2.20
- Every put sold represents an obligation to potentially have to buy 100 shares or $5,000.00 ($50.00 x 100) by the expiration

The $2.20 premium represents a 4.40% income in just 6 months for undertaking the obligation.

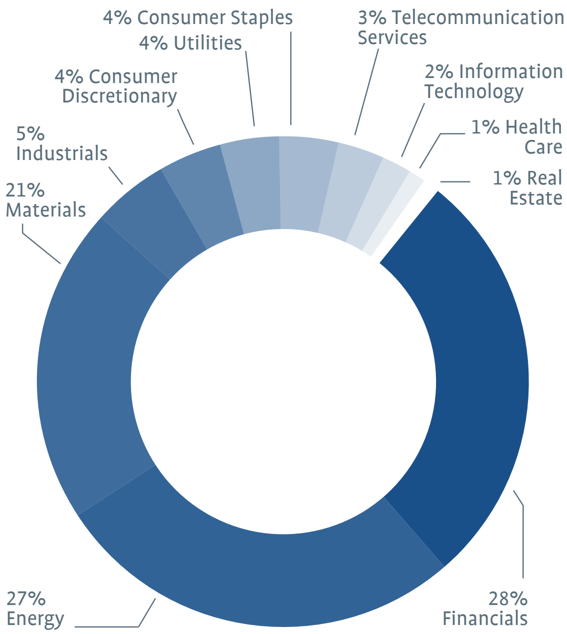
- If the stock declines below $50.00, investors will be assigned to the shares with an adjusted cost base (break-even) of $47.80 ($50.00-$2.20) or $3.32 lower then where it is currently trading and relatively close to its 52 week low.
- If the stock remains range bound or bullish, investors generated a respectable income return.

Top 10 Most Active Option Classes (Q4 2016)

RANK	SYMBOL	VOLUME	INSTITUTIONAL	RETAIL	INSTITUTIONAL %	RETAIL %
1	XIU	2,669,746	2,487,777	181,969	93%	7%
2	RY	255,335	98,037	157,298	38%	62%
3	ZSP	242,125	240,295	1,830	99%	1%
4	MFC	231,756	147,236	84,520	64%	36%
5	XGD	205,824	149,636	56,188	73%	27%
6	TD	203,656	73,327	130,329	36%	64%
7	ECA	203,635	114,433	89,202	56%	44%
8	BMO	193,500	94,182	99,318	49%	51%
9	BNS	186,773	87,227	99,546	47%	53%
10	CM	177,247	80,688	96,559	46%	54%

Options Trading Volume by Sector

Q4 2016



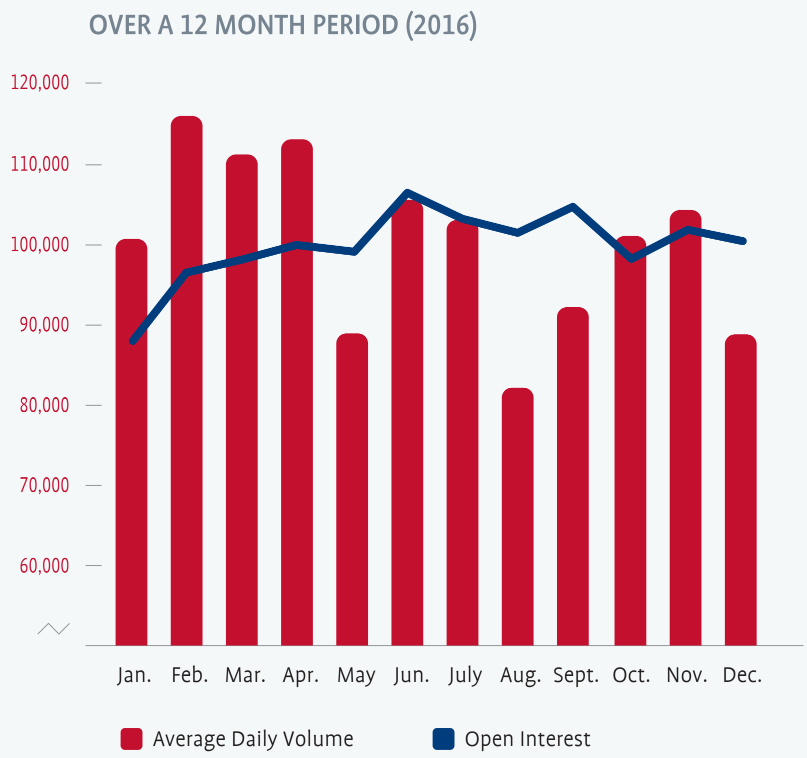
Source: Bloomberg

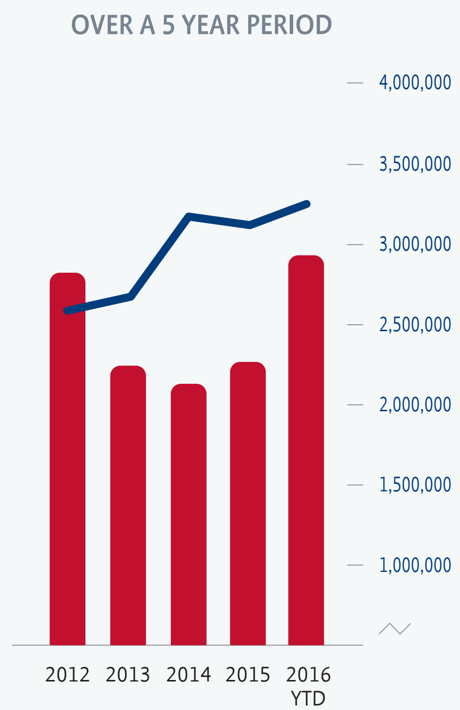
Note: Options volume from delisted or acquired companies are excluded.

Most Crossed Option Classes

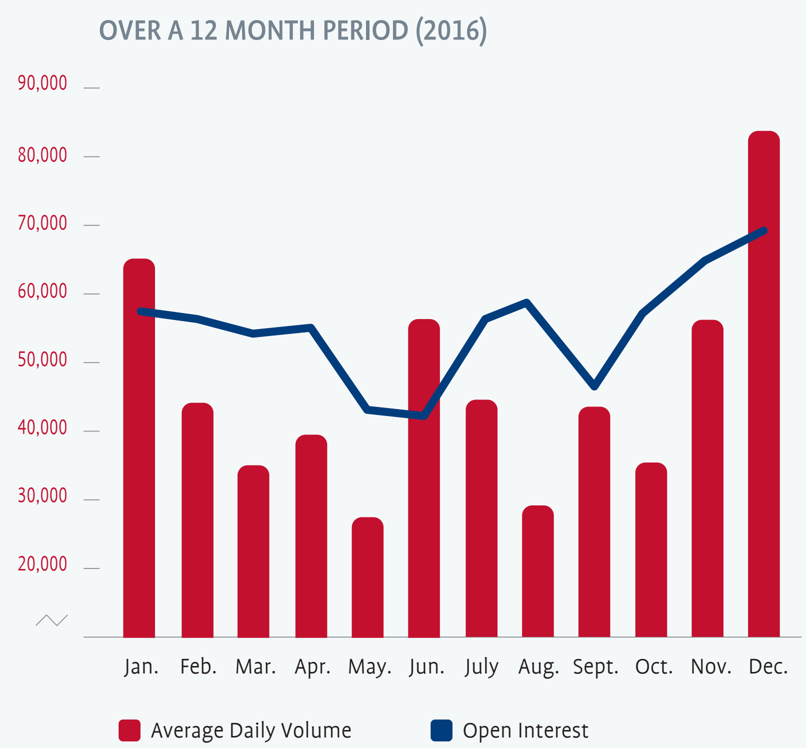
RANK	SYMBOL	CROSS VOLUME
1	XIU	2,487,777
2	ZSP	240,295
3	ZEB	166,930
4	XGD	149,636
5	MFC	147,236
6	ECA	114,433
7	RY	98,037
8	BMO	94,182
9	ZCN	90,815
10	BNS	87,227
11	XEG	84,970
12	CM	80,688
13	L	78,694
14	ENB	75,500
15	TD	73,327
16	TX60	71,265
17	NA	68,299
18	BCE	67,703
19	XFN	61,729
20	SU	60,076

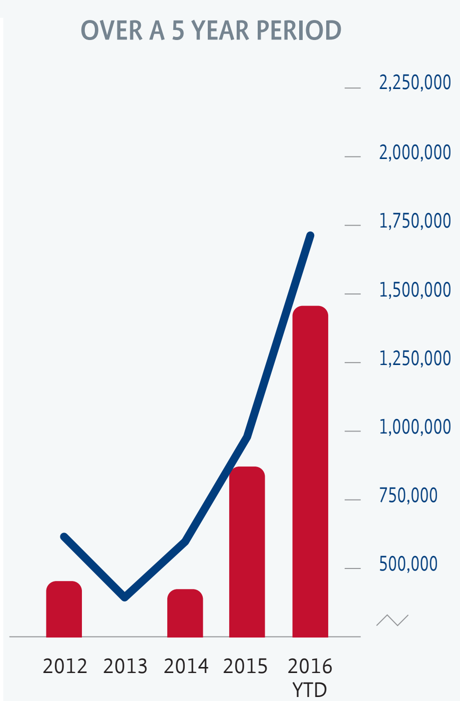
Equity Average Daily Volume and Open Interest





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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