CANADIAN EQUITY DERIVATIVES

Quarterly Newsletter - July 2015

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TMX Montréal Exchange

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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.

Martin Noël

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

JULY

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	

AUGUST

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					

SEPTEMBER

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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IMPACTS OF A POTENTIAL CANADIAN RECESSION

By Patrick Ceresna

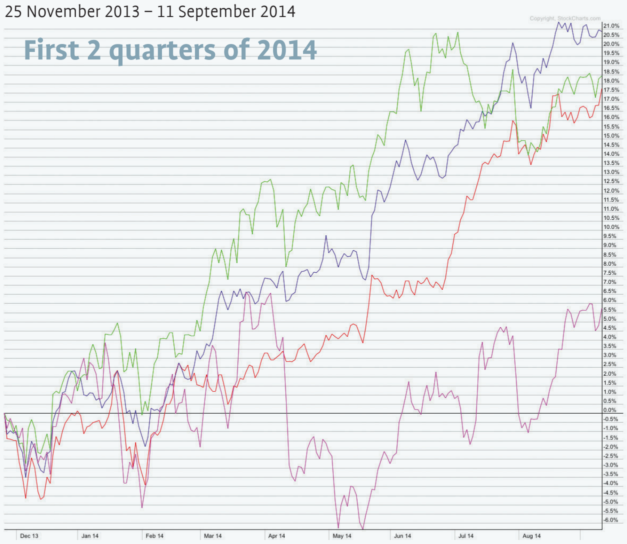
The current debate amongst economists is whether the Canadian economy is currently in a recession. The debate centers on the technical definition of a recession, which is considered to be two consecutive quarters of negative Gross Domestic Product (GDP), versus those who feel that employment numbers better reflect the state of the economy. Unless we witness a material turnaround in the GDP trend, there is a very real possibility that the next few months will signal an official recession.

Clues from the Markets

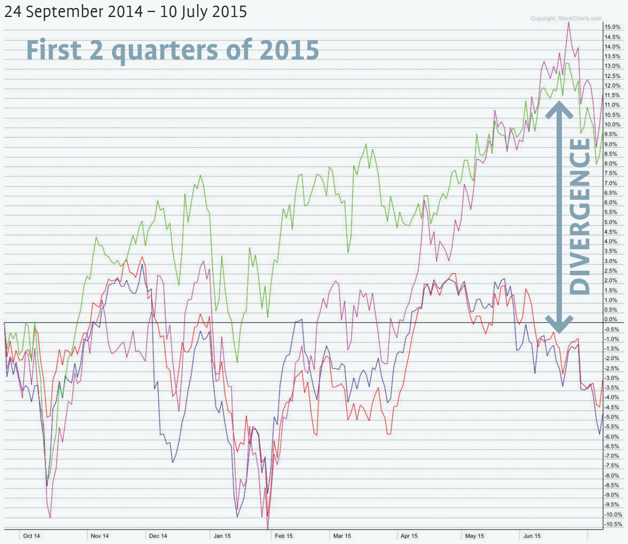
The deteriorating conditions in the Canadian economy can be identified by the technical weakness in the economically sensitive financial sector. To best illustrate, we feel the divergence between Canadian and American banks is noteworthy. At minimum, we can conclude that the markets have been discounting this risk throughout 2015 so far.

Chart 1: Performance of Canadian and American Banks

25 November 2013 – 11 September 2014



24 September 2014 – 10 July 2015



Royal Bank of Canada   Toronto Dominion   Wells Fargo   JP Morgan Chase

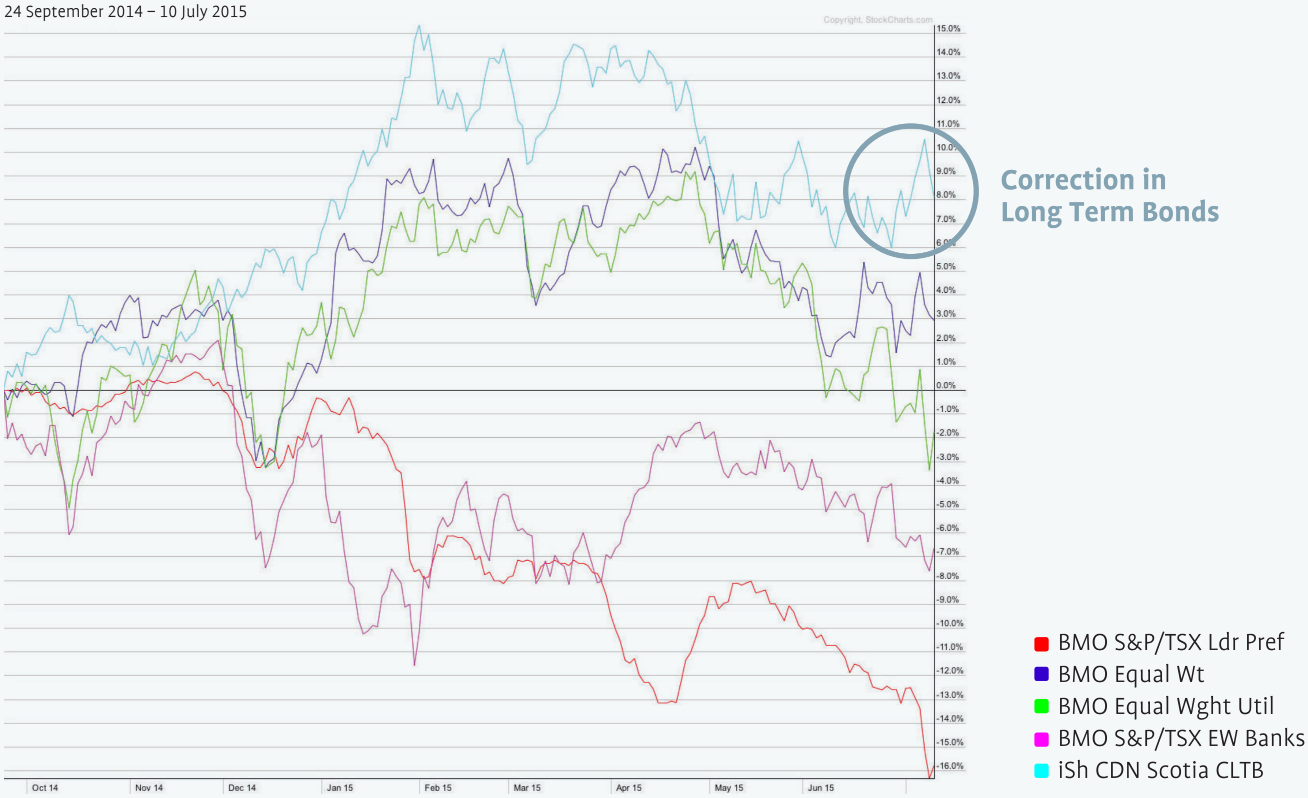
The strong correlation of Canadian and American Banks through much of 2014 is now distinctly broken. The market is clearly pricing in economic and currency risk.

Trend of the Bond Proxies

We have also seen a considerable deterioration in defensive high-yield assets. Clearly the material reversal in European and American yields from the early year lows has forced longer term interest rates higher, driving a correction in all the longer term Government of Canada bonds. What is particularly noteworthy is that many advisors have been reducing bond market exposure and replacing them with bond proxies like preferred stocks, utilities and Real Estate Investment Trusts (REITs). To date this strategy has not paid off as the credit spreads have been widening considerably.

Chart 2: Performance of Bond Proxies

24 September 2014 – 10 July 2015



In spite of the negativity, the Long Term Bond Index has been the best performing asset throughout the year.

Another important consideration is the material underperformance of the preferred share index, which is down over 16% year to date.

We consider these observations to be a clear indication that the big investors are voting with their money on the state of the Canadian economy. There would be very little need for these defensive higher yield assets to correct so dramatically unless there were inherent risks to the assets themselves. We ask the question - is this a buying opportunity or the "canary in the coal mine" warning us that there is more danger ahead?

Bank of Canada's Concerns

To us, the risk of a recession is not just about the slowing of the global growth story and/or the collapse of oil prices, but rather a story of the contagion effect that could spill over to end a relatively overvalued market.

The June 2015 Financial System Review lists the four key risks as:

- Household financial stress and a sharp correction in house prices
- A sharp increase in long-term interest rates
- Stress emanating from China and other emerging market economies
- Financial stress from the euro area

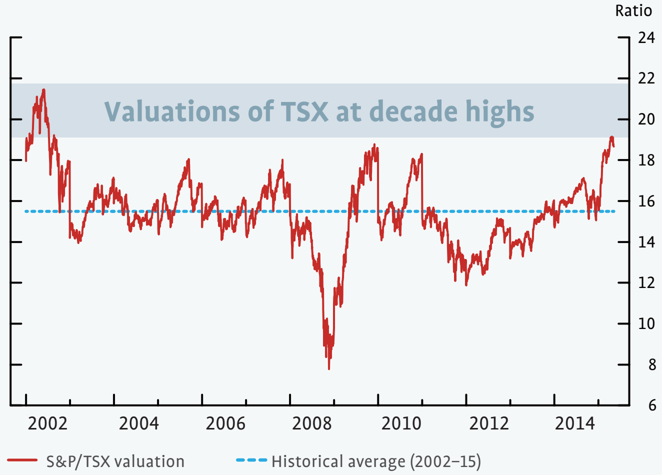
As far as I am concerned, the first two are the most concerning. After the material decline in energy and basic materials, the economy is becoming overly reliant on the Canadian consumer remaining strong and confident. This has been the single pillar bearing the weight of the Canadian economy. This confidence is to one degree or another being fuelled by the perceived paper profits in home equity. This continues to drive real estate speculation, home renovations and the economic multiplier effect associated with a healthy real estate market.

While the Alberta market has slowed, we have to conclude that this party is not yet over. To me, the real risk is that, if given enough time, every market has a reversion to the mean move. Even if the more favourable outcome of a soft landing was to occur, what part of the Canadian economy will be able to pick up the economic slack?

Market Valuations

It certainly cannot help the situation that recession fears are emerging at a time when the Canadian S&P/TSX valuations are at decade highs, exceeding the 2007 peaks. While this is never a bearish indicator in itself, it does stress the limited upside of stock market equities without true emergence of new organic earnings growth. Even a reversion to the historical average could result in a double digit decline.

Chart 3: Detecting stretched valuations in equity markets
Forward price-to-earnings ratio, daily data



Have to go back to 2002 to find valuations as high as today.
Source : BoC FSR June 2015 pg. 42 / Bloomberg

Using Options to Manage Risk

In spite of the risks, many advisors need exposure to the Canadian market and cannot simply liquidate the Canadian holdings without dealing with the capital gain/loss implications, transaction costs, increased regulation and reporting of foreign holdings, loss of potentially lucrative income streams and lack of viable alternative investments. So what alternatives are there for professionals?

Options are a very useful tool in this kind of market environment. Often mistakenly stereo-typed as high risk, many advisors overlook the important value add strategies that can be used to reduce the risk in portfolios and/or enhance an investor's income in periods of limited upside potential.

As an illustration, if advisors were to feel the upside potential of the Canadian banks was marginal, they could elect to enhance the income received through owning the stock beyond the dividend by selling a covered call out for the remainder of the year.

Let's take a look at Royal Bank as an example.

- Hypothetical high net worth client owns 1000 shares of Royal Bank originally purchased years ago at an average cost base of $60.00 CAD. The shares are trading at $76.00 at the time of writing.
- The investor is collecting a healthy 4.10% dividend stream.
- Advisor feels the upside will likely be limited to the April highs in the $80.00-$81.00 range.
- The six-month January 2016 $80.00 strike covered call is bidding $1.76, or a 2.32% cash flow.
- With the sale of the covered call, the advisor has capped the upside potential of the stock, but has now increased the income stream for the client.
- Because the covered call premium is immediately received, if the stock declines further, the premium can be used to reduce the average cost base of the underlying shares.

The process of selling covered calls can be an administrative burden on advisors focused on relationship building, which makes a number of covered call writing exchange traded funds an interesting alternative. These Exchange-Traded Funds (ETFs) are likely to create alpha in periods where broader Canadian equity products have an increased risk of underperforming.

Beyond using covered calls for income, there are a number of more sophisticated approaches to managing risk, such as hedging with index options and utilizing collars to limit downside risk. Advisors that take the time to develop appropriate option strategies to use in their businesses are often helping themselves as much as they are helping their clients.

Bear Spread on XIU

At the time of writing, iShares S&P/TSX 60 Index ETF units (XIU) were trading at $21.18. According to the Stochastic Oscillator, the security's drop is accelerating. This could push the price towards the major support level which hovers around $20. An investor wishing to make the most of this potential decline in the next few months could set up a bear spread with put options. The purchase of XIU 150918 P 21 put options at $0.58 per unit, and the sale of XIU 150918 P 20 put options at $0.28 per unit amounts to a debit of $30 per contract. This is also the maximum loss under this strategy. The maximum profit of $70 per contract is obtained if the price of the security is less than $20 by the September expiration month. The position will generate profit if the price of the security drops below the breakeven point of $20.70. The choice of a 22/21 bear spread with put options (purchase of 22 at $1.10 and sale of 21 at $0.58) is only one possibility among many. The $52 debit per contract is also the maximum loss on this spread. The maximum profit of $48 per contract in this case is obtained if the security falls below the strike price of $21 by expiration, and the position remains profitable so long as the security remains under the breakeven point of $21.48.

Sale of Covered Call on XIT

The price iShares S&P/TSX Capped Information Technology Index ETF units (XIT), trading at $11.70 at the time of writing, has just slipped below the $12 weekly moving average of 34 trading sessions. This is a first since the summer of 2011 when XIT was about to lose nearly 40% over a 12-month period. This doesn't mean that we're going to witness a similar debacle but it should nevertheless urge us to exercise caution in the next few months. An investor holding XIT units could sell a call option contract for each block of 100 units held in order to take advantage of the erosion of the time value after the relative stability the security could experience, obtain light protection in the event of a decline and, finally, show a profit in the event of a rise. 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 the XIT 150918 C $11 call options at $0.80 per unit would generate a maximum profit of $52 per contract, for a return of 0.9% over the 70-day period until the September expiration month (4.8% annualized). The breakeven point of $10.90 provides protection against a decline of 6.8%. The sale of the XIT 150918 C $12 call options at $0.22 per unit provides protection against a decline of 1.9% with a breakeven point of $11.48 and a potential maximum profit of 4.5% over the 70-day period until expiration (23.6% annualized).

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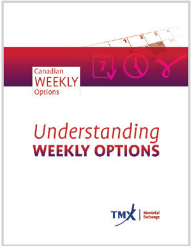
Canadian WEEKLY Options

Trade weekly options to benefit from their:

- **Flexibility** - with more choices of expiration dates
- **Cost-effiency** - due to less time to expiry
- **High gamma** - from small price movements in the underlying

BMO Bank of Montreal
BNS Bank of Nova Scotia (The)
ABX Barrick Gold Corporation
BTE Baytex Energy Corp.
BCE BCE Inc.
BB BlackBerry Limited
CM Canadian Imperial Bank of Commerce
CNR Canadian National Railway Company
CNQ Canadian Natural Resources Limited
COS Canadian Oil Sands Limited
CVE Cenovus Energy Inc.
CPG Crescent Point Energy Corp.
DGC Detour Gold Corp.
ECA Encana Corporation
G Goldcorp Inc.
XIU iShares S&P/TSX 60 Index ETF
MFC Manulife Financial Corporation
NA National Bank of Canada
POT Potash Corporation of Saskatchewan Inc.
RY Royal Bank of Canada
SLW Silver Wheaton Corp.
SU Suncor Energy Inc.
TCK Teck Resources Limited., Cl. B
TD Toronto-Dominion Bank (The)
YRI Yamana Gold Inc.

Promotional Video



Informational Brochure

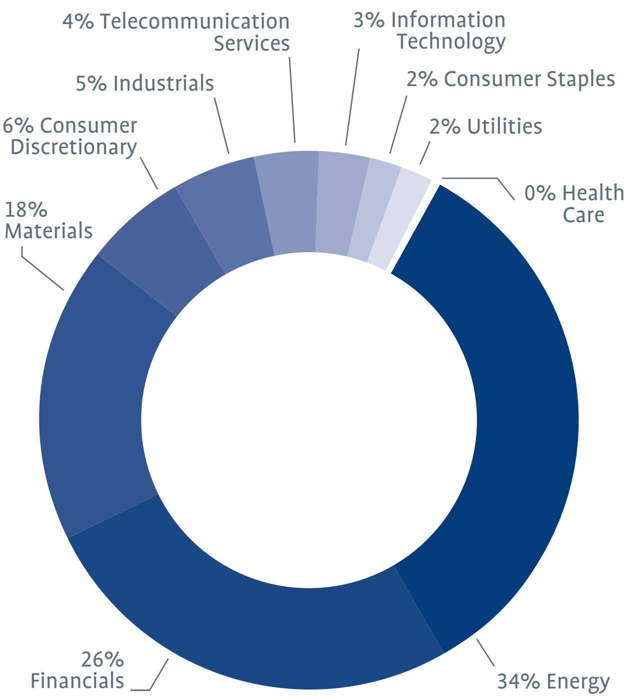

Contract Specifications

Top 10 Most Active Option Classes (Q2 2015)

RANK	SYMBOL	VOLUME	INSTITUTIONAL	RETAIL	INSTITUTIONAL %	RETAIL %
1	XIU	1,317,205	1,164,491	152,714	88%	12%
2	MFC	189,865	128,470	61,395	68%	32%
3	XEG	173,394	145,969	27,425	84%	16%
4	RY	173,330	63,403	109,927	37%	63%
5	SU	158,584	74,339	84,245	47%	53%
6	BNS	142,067	67,268	74,799	47%	53%
7	TD	135,555	52,846	82,709	39%	61%
8	XGD	134,978	115,872	19,106	86%	14%
9	COS	129,341	52,668	76,673	41%	59%
10	TCK.B	124,492	61,856	62,636	50%	50%

Options Trading Volume by Sector

Q2 2015



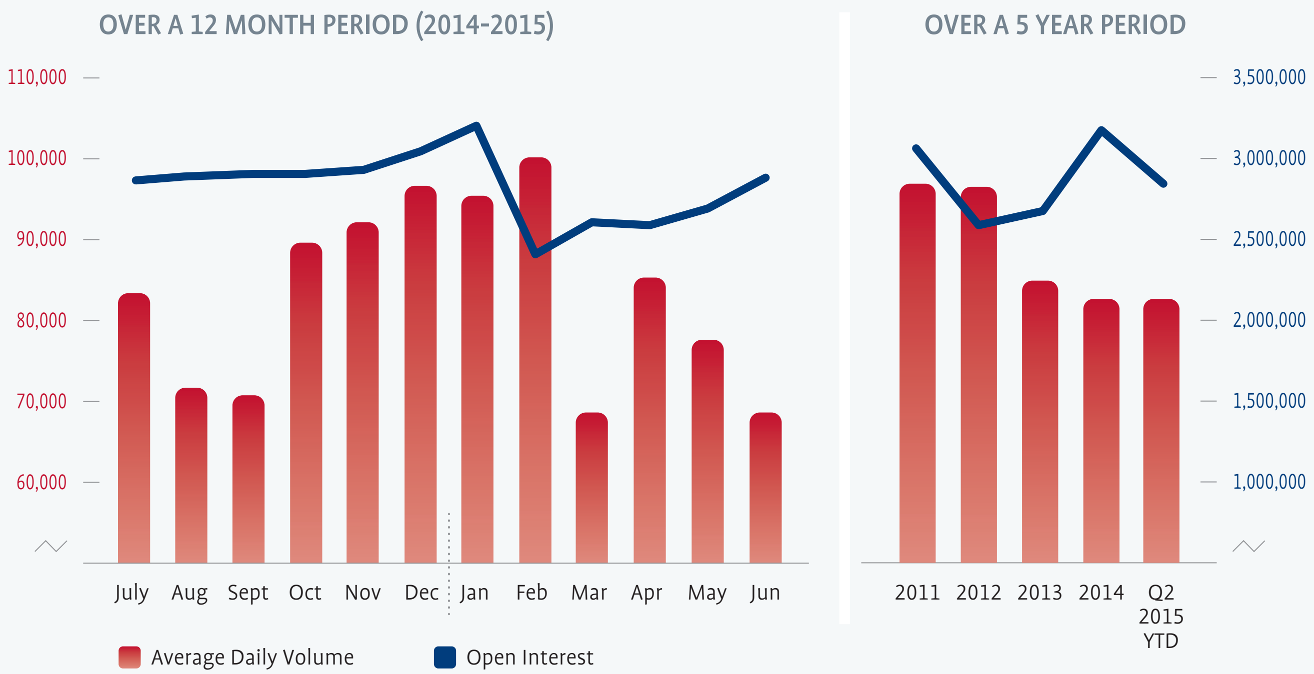
Source: Bloomberg

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

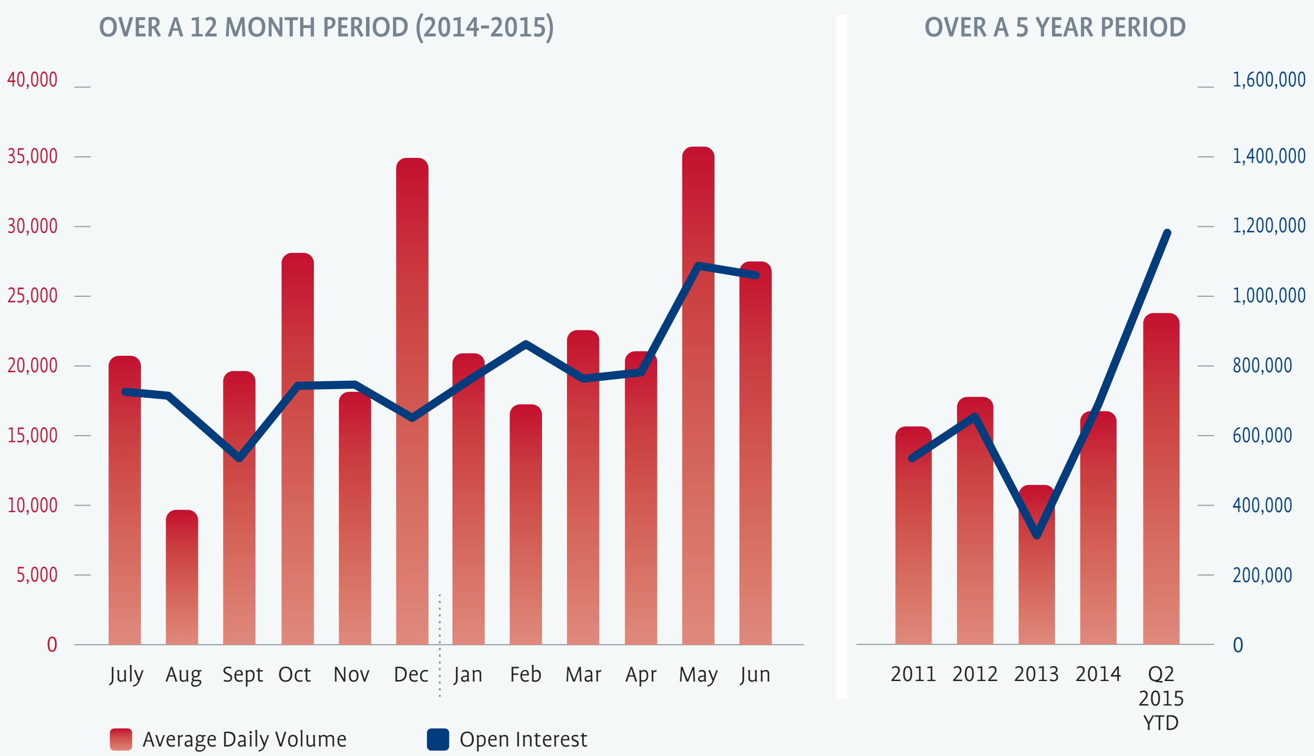
Most Crossed Option Classes

RANK	SYMBOL	CROSS VOLUME
1	XIU	1,164,491
2	XEG	145,969
3	MFC	128,470
4	XGD	115,872
5	SU	74,339
6	BNS	67,268
7	CNQ	67,161
8	EFN	66,455
9	RY	63,403
10	TCK.B	61,856
11	ZEB	60,000
12	NA	58,415
13	VSN	58,291
14	ENB	55,229
15	BCE	55,023
16	TD	52,846
17	COS	52,668
18	DGC	49,219
19	FM	44,137
20	BMO	43,070

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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