CANADIAN EQUITY DERIVATIVES

Quarterly Newsletter - July 2017

MANAGER'S COMMENTARY

FINANCIAL STRESS AND INTEREST RATE HEADWINDS FOR CANADIAN REAL ESTATE

p.3

THE OPTIONS PLAYBOOK

Playing the Retracement on Imperial Oil (TSX: IMO)

Cash-Covered Put on BCE Inc. (TSX: BCE)

p.7

TMX Montréal Exchange

Patrick Ceresna

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.

2017 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)

For more information, please contact
Josiane Lanoue, Senior Manager, Business Development, Equity Derivatives
jlanoue@m-x.ca or 514 871-3539

FINANCIAL STRESS AND INTEREST RATE HEADWINDS FOR CANADIAN REAL ESTATE

By Patrick Ceresna

"Learn how to see. Realize that everything connects to everything else." Leonardo da Vinci

Amongst the broad Canadian population, there is no greater perceived truth than the following: "Real estate provides the highest returns, the greatest values and the least risk." This belief has led to almost a decade-long increase in real estate prices across Canada following the 2008 crisis (mainly in Vancouver and Toronto) to levels that far exceed macro fundamental justification.

Should we consider this phenomenon a real estate bubble? To paraphrase a quote that I have heard long ago, "It is easy to spot a bubble, but it is very hard to market time when the bubble will burst." That is largely due to the bizarre phenomenon that irrational and overvalued prices have the ability to become more irrational and even more mispriced. Above all, prices can remain high for extended periods. Many traders, myself included, often preemptively attempt to identify the turning points, only to experience humility in the face of the steadfast herd of bulls.

Over a long enough time horizon, the macro fundamentals will prevail and any mispricing eventually has a mean reverting moment. The only question is what catalysts could drive a mean reverting event? The most obvious catalyst would be a recession. Would a drop in real estate be the catalyst for a recession or would a normal business cycle style recession be the catalyst for a correction in real estate (cart before the horse)?

I unequivocally accept that business cycles are real and every economic expansion ends with an economic contraction, namely a recession. While we have had a short lull in Canadian GDP growth back when oil prices precipitously declined through 2015, our last material economic recession occurred during the Global Financial Crisis. While this is already one of the longest economic expansions on record, it does not guarantee it is ending. So, what can turn this business cycle? In the past, often a hawkish shift in monetary policy and the tightening of credit conditions have led to that turn.

History has shown that central banks often play an important role in turning the business cycle. As the economic data strengthens, it opens the window for central banks to begin increasing interest rates, which tightens credit conditions and provide less liquidity to drive asset prices. As the Bank of Canada made the decision to raise overnight rate target for the first time in seven year by 25 basis points, the stability of the financial system could be impacted. However, it may also represent an opportunity for investors.

Trading a Directional Bias on Real Estate

There are many risks in trying to time the turning point of real estate, which makes outright short selling of financials a speculative trade. Not only do you tie up your trading capital, it comes with a negative carry as many of these institutions have dividends in the 3-5% range. Hence, buying a put option becomes an interesting consideration for expressing the trade.

Genworth (TSX:MIC) is a publicly traded mortgage insurance company. Very similar to Canadian Mortgage and Housing Corporation (CMHC) , the company primarily insures the banks from losses on mortgage loans. However, unlike CMHC, Genworth is not in a position to be bailed out by the government if they become financially challenged.

The stock price has recently vaulted higher in association with the Berkshire bailout of Home Capital. It is now trading just a few dollars from its all-time highs. While the options are not cheap, this is a very interesting price level to be positioning for a speculation that it is the turning point.

Genworth MI Canada (TSX: MIC)

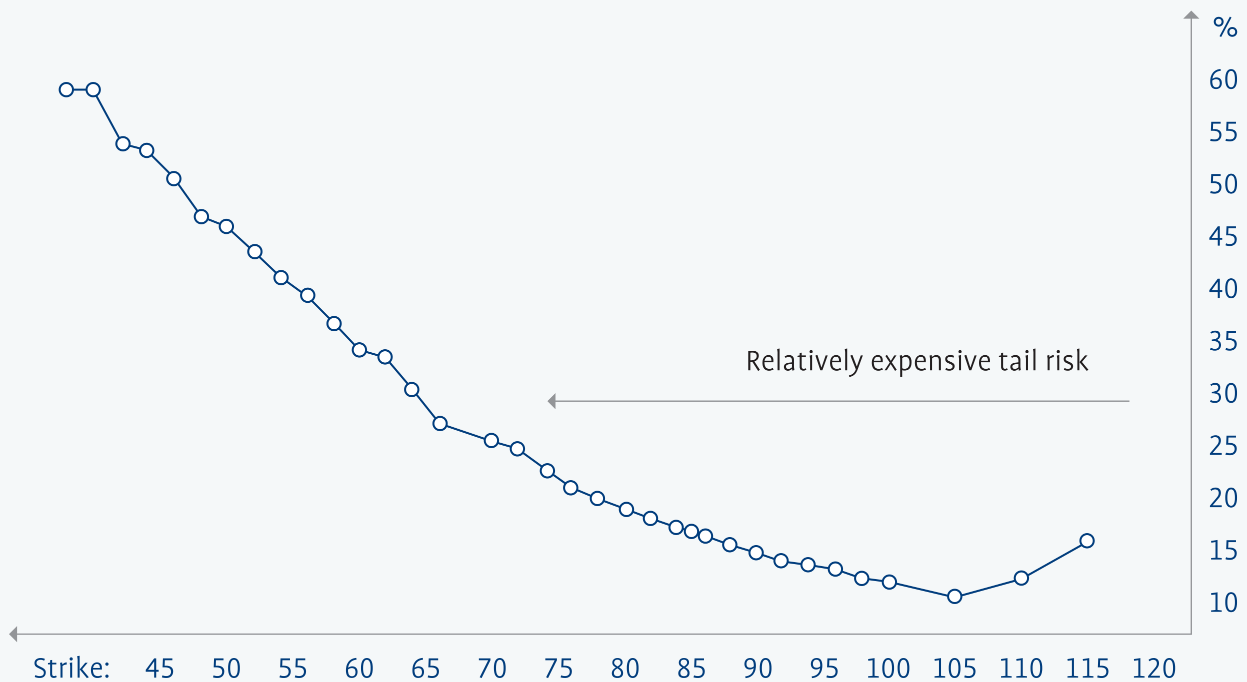
Genworth was trading at $36.23 on July 7. The January 2018 $36.00 put option can be purchased at around $3.00. To put the asymmetry into context, the risk component to the trade is limited to the cost of the option, which is $3.00. If Genworth returned to the January 2016 lows of $22.00, the intrinsic value of the put could be $14.00. If an investor has the conviction that real estate will deteriorate this year, this may be an interesting trade.

Hedging Canadian Bank Risk with Debit Spreads

To stay within the narrative of the emerging stresses in real estate likely to weigh heavily on the Canadian banking system, we explore a few methods of hedging a long bank stock position. In this particular case, we look at Royal Bank (TSX:RY). While it appears to be a simple exercise of buying a protective put, investors need to consider some idiosyncrasy to the existing option chains. The most obvious is the significant skew in the implied volatility (IV). I would speculate that one of the precipitating factors in creating the lopsided skew, particularly the low implied in the $95-$105 range, is likely attributable to the increased popularity in premium selling strategies like covered call

Royal Bank (RY) Implied volatility Skew

January 2018 options



With above average dividends being discounted in the pricing, there is almost no attractiveness to implementing strategies like collars and outright protective put buying. So what is a more prudent approach to hedging downside risk? One strategy that naturally complements lopsided skew involves put debit spreads. Structurally, investors are buying the lower IV and selling the lower strike with a higher IV. This strategy allows the spreads to be open with favorable risk/reward propositions. Let's look at the current pricing of a downside hedge using a debit spread:

Here is the breakdown:

- Royal Bank (TSX:RY) is trading at $95.26 on July 6.
- Royal Bank has a 52-week range of $79.75 - $99.90.
- The January $90.00 put option is trading $2.20-$2.70.
- The January $80.00 put option is trading $0.50-$1.05.
- The bid/ask spread is $1.20-$2.20.
- Royal Bank is scheduled to pay $0.87 quarterly dividends in July, October and January 2018.

An investor who overlays the put debit spread over a long stock position has hedged the downside risk of Royal Bank below $90.00 down to its 52-week lows at $80.00. Assuming a fill price on the spread under $2.00, the investor still has a positive cash flow carry net of the dividend stream. For investors looking to hold their bank stocks in the long-term but wish to hedge out intermediate risks, this approach is worth considering.

It is not rocket science to know Canadian real estate is in a bubble, but timing its eventual burst and mean reversion is still, over the short term, pure speculation. Options offer a valuable tool to control and define the risk component of the trade and to hedge the risk associated with financial institutions most vulnerable to a potential downturn in housing.

Playing the Retracement on Imperial Oil (TSX: IMO)

The entire energy sector has been in contraction since the start of the year mainly due to the persistent deterioration of oil prices. While it is very premature to speculate that the major macro turning point in oil is afoot, many energy companies are approaching notable support lines with some increasingly oversold indicators. Selling of this magnitude is often accompanied by some distinctly bearish news. In the case of Imperial Oil, it has been associated with a number of downgrades concerning their Kearl and Cold Lake projects. While I would not dispute the disappointing news, high-quality stocks are typically quick to bounce as soon as the weak hands are shaken out and the value investors buy the dip. In this case, Imperial Oil is approaching decade lows in the mid to low 30's. Investors attempting to catch the proverbial falling knife can do so with a risk-defined trade.

Breaking down the strategy

- IMO was trading at $36.17 on July 7.
- IMO has a 52-week range of $35.85-$48.72.
- The August 18, 2017 $36.00 put is asking $1.01.

One could consider buying the shares at $36.17 and buying a short-term (40-day) protective put at the $36.00 strike price, which offers a very simple binary outcome:

- **The stock bounces back toward $40.00.**
  Under this scenario, the protective put would expire worthless
  and the investor remains long the stock position.
- **The stock continues to decline.**
  Under this scenario, if Imperial Oil falls below $36.00, the investor would exercise their right to sell the stock at the $36.00 strike price. The maximum potential loss is limited $1.18, $0.17 on the stock and the $1.01 cost of the option.

Imperial Oil (TSX: IMO)

Cash-Covered Put on BCE Inc. (TSX: BCE)

After a strong start to the year, BCE Inc. has been consolidating at a lower level with much of the broader Canadian market. With its large and relatively stable dividend, investors sometimes use short-term dips in the stock as an opportunity to accumulate a new position at more favourable prices. BCE's support lies around $57.00 where it consolidated for close to five months. With the stock trading at $58.49 on July 6, we are a stone's throw away from key support lines. If investors view these price levels as an attractive accumulation level, they can use short-term put options as a way to potentially acquire additional stocks while generating an income in the meanwhile.

Breaking down the strategy:

- BCE Inc. (TSX:BCE) is trading at $58.49 on July 6.
- BCE has a 52-week range of $56.80 - $63.41.
- The August 18, 2017 $58.00 put option is bidding $0.65.
- Every put sold represents an obligation to buy 100 shares or $5,800.00 ($58.00 x 100) by the expiration date.

BCE Inc.

The $0.65 premium represents a 1.11% income in just 43 days, which is earned for undertaking the obligation to buy the stock at $58.

- **If the stock declines below $58.00**
  The investor's adjusted cost base (break-even) becomes $57.35 ($58.00 - $0.65), which is relatively close to its 52-week low of $56.80.
- **If the stock remains range-bound or bullish**
  The investor generates a respectable income return on a blue-chip stock without buying additional shares.

TMX | Montréal Exchange

STRATEGIZE WITH OptionsPlay

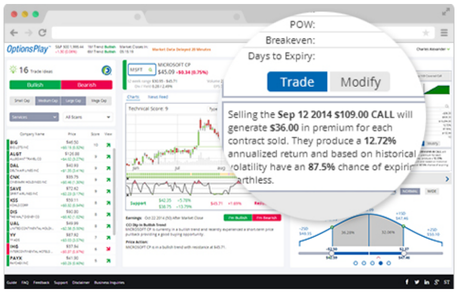
Are you and your clients seeking actionable ideas for trading and income strategies?

OptionsPlay, an educational tool, provides ideas on individual stocks and indices, whether you are bullish, bearish, or neutral.

Trade Strategy Visualization

Analytics For Everyone

Covered Call Ideas



Check out OptionsPlay today and feel free to pass this offer on, as a value-added service, to your clients.

To find out more and sign up today, visit:

→ m-x.ca/optionsplay

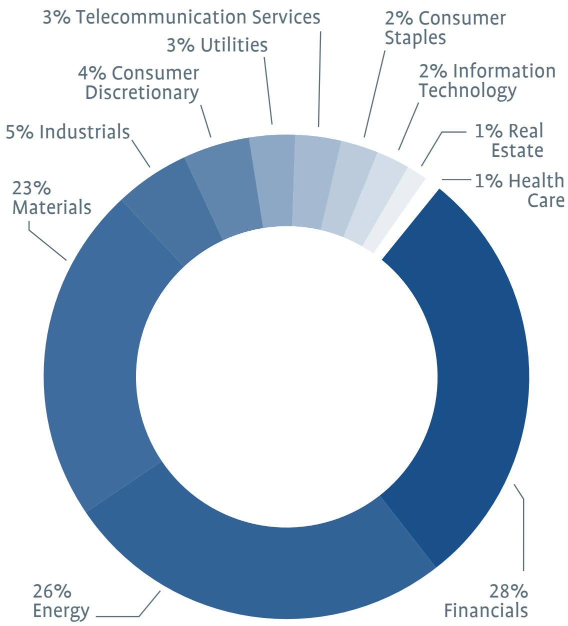
A COMPLIMENTARY OFFER FOR YOU AND YOUR CLIENTS FROM THE MONTRÉAL EXCHANGE

Top 10 Most Active Option Classes (Q2 2017)

RANK	SYMBOL	VOLUME	INSTITUTIONAL	RETAIL	INSTITUTIONAL %	RETAIL %
1	XIU	1,605,730	1,376,510	229,220	86%	14%
2	XEG	384,169	362,787	21,382	94%	6%
3	RY	213,814	74,209	139,605	35%	65%
4	CVE	206,555	117,170	89,385	57%	43%
5	TD	200,869	60,087	140,782	30%	70%
6	CM	155,615	52,677	102,938	34%	66%
7	XGD	143,762	104,210	39,552	72%	28%
8	ZEB	141,396	139,800	1,596	99%	1%
9	TECK.B	135,821	44,106	91,715	32%	68%
10	BNS	135,534	36,983	98,551	27%	73%

Options Trading Volume by Sector

Q2 2017



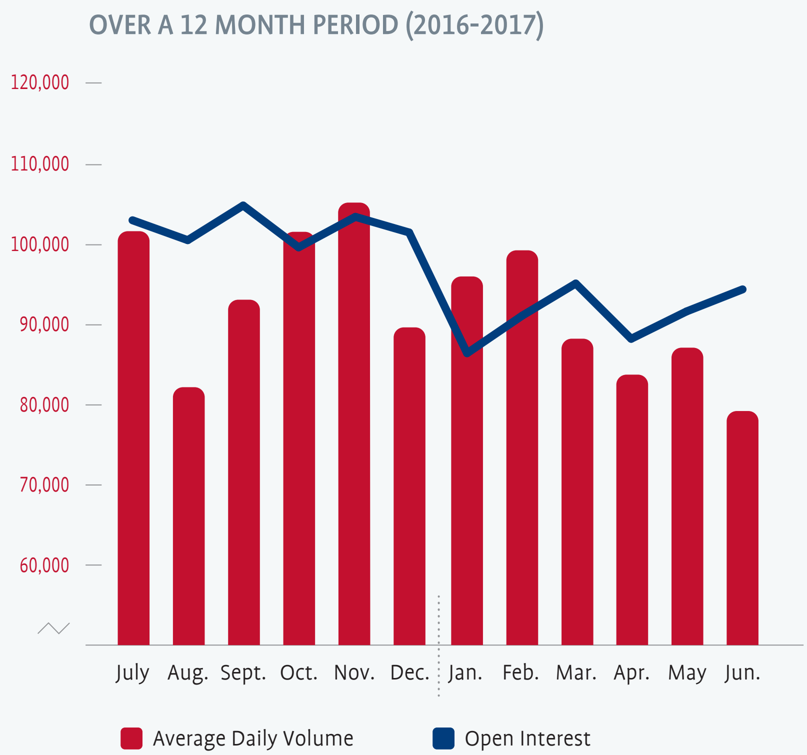
Source: Bloomberg

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

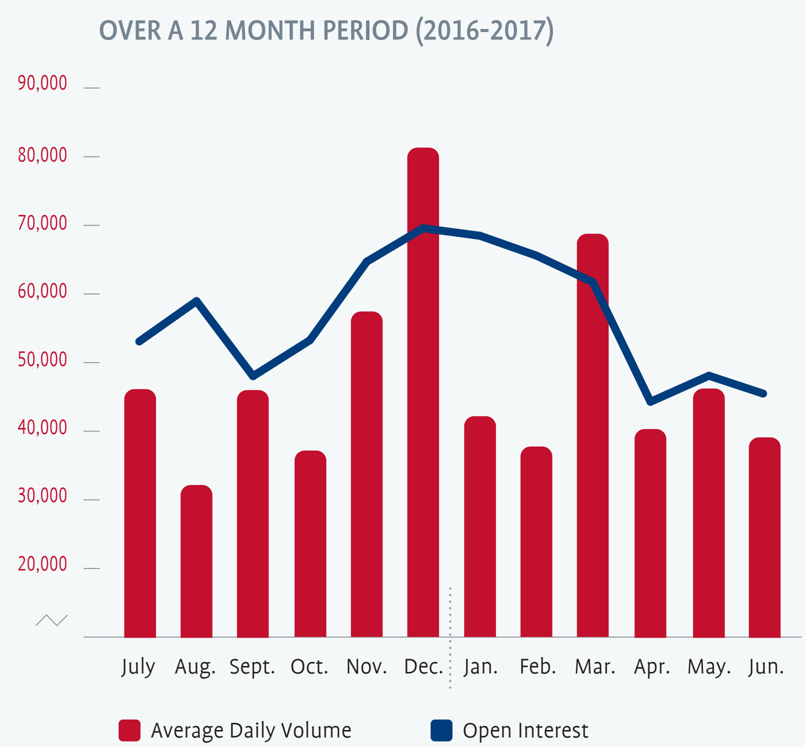
Most Crossed Option Classes

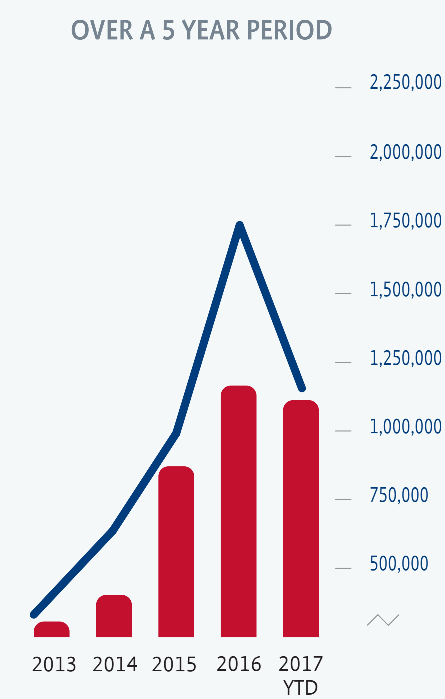
RANK	SYMBOL	CROSS VOLUME
1	XIU	1,376,510
2	XEG	362,787
3	ZEB	139,800
4	CVE	117,170
5	XGD	104,210
6	ZSP	80,000
7	RY	74,209
8	VSN	72,169
9	CNQ	66,195
10	TX60	66,190
11	TD	60,087
12	DGC	57,085
13	AKG	56,811
14	SLF	54,781
15	CM	52,677
16	TA	49,492
17	MFC	48,536
18	FM	44,220
19	TECK.B	44,106
20	NA	42,667

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

m-x.tv

OptionMatters.ca

m-x.ca/twitter

m-x.ca/facebook

m-x.ca/linkedin

m-x.ca/rss