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Quarterly Newsletter - October 2014

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Richard Croft

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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.

2014 Trading Calendar

OCTOBER

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	

NOVEMBER

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						

DECEMBER

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			

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

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NOISE ABATEMENT

By Richard Croft

Too much of what makes news is really just "noise." The Ebola outbreak, political risks in the Ukraine, terrorist threats in the Middle East or the latest round of liquidity infusions in the Eurozone all bear watching because its news. However, none of this "news noise" is likely to have long term negative implications for global equities.

In the end, earnings drive equity valuations and whether the multiple assigned to the price action expands or contracts depends on how much earnings are expected to grow or slow over time. Advisors would be well served to look past the noise in an effort to gain insight into earnings momentum.

To that end, let's start with what we know. Canada and the U.S. are in a slow growth recovery. Too slow if you listen to commentators who believe growth should be more robust given three rounds of quantitative easing and near zero interest rates.

That said, slow growth by itself will not stall equity markets. In a slow growth environment, the numbers are grounded and some would argue, predictable. Augment a slow growth scenario with low interest rates and companies are able to better manage capital expenditure programs. And for investors, if growth stalls, there is comfort in the knowledge that central banks stand ready to step in with their version of an economic put option.

There are those who suggest that equity markets have come too far too fast since the first quarter of 2009 trough. Five years without a 10% correction is worrisome and warranted if you believe that much of this earnings momentum is the result of share buybacks and productivity improvements, neither of which are sustainable longer term.

Still, price to earnings multiples are not excessive by historical standards. Dividend yields relative to interest rates are above historical norms and companies flush with cash are able to maintain those payout ratios. Interest rates will remain low through 2015 and I suspect any increase in rates will be marginable at best. The rising tide of baby boomers seeking income will ensure that.

Look at the performance of Canadian equities on a longer term basis and the too far too fast argument seems less convincing. Canadian stocks, as measured by the S&P TSX 60 index (not accounting for dividends), have risen 73% since 2000 which compounds out at 3.78% annually. That meagre performance can hardly be seen as speculative.

Sentiment is also providing support for a bull case. Retail investors are cautious about equity valuations, volatility remains low, gold has done nothing and oil prices are in decline. No evidence of speculative excesses and no evidence of inflation and this at a time when the US Federal Reserve is getting out of the quantitative easing game.

In my opinion, equities are still in the early stages of a longer term bull market. No doubt earnings growth will slow, which is to say the link between economic activity and profits will begin to materialize. In the longer term, that is not a bad thing.

Economic Underpinnings

In terms of economic activity, I suspect we will see a pickup in the employment numbers as productivity normalizes. That should go a long way to repairing the weak credit scores which have prevented consumers from borrowing at reasonable rates. Stability in the real estate markets should add oomph to the North American economies much as the boom in real estate prices have enhanced economic activity in cities like Toronto and New York.

There are risks in the Eurozone as growth remains tenuous but that has more to do with the fact that the European Central Bank (ECB) was slow on the uptake having to deal with the folly of a single currency across a spectrum of economic models.

My read is that the Eurozone is eighteen months behind the U.S. and will emerge from its recovery about the time the U.S. economy is getting on its legs. If the Eurozone does gel, it will eventually support another leg up in global economic activity starting in the second or third quarter of 2016.

Sector Exposure

Digging below the macro sphere, advisors will have to closely monitor their sector exposure. To that end, you might consider overweighting the banks. There are four legs underpinning this thesis; 1) even a slight rise in interest rates will lead to a generous markup in margins, 2) we are likely to witness a substantial pickup in new loans because of credit quality, 3) banks are flush with excess reserves so they have the requisite capital to fund new loans and 4) there is limited downside risk in the price of financials based on dividend yields and a too big to fail put option.

On the other end of the spectrum, I am less sanguine about energy companies as I suspect oil prices will remain weak and could trend even lower based on supply and demand metrics. With more emphasis being placed on the stability of one's supplier, unrest in the Middle East will weaken, not strengthen, the resolve of The Petroleum Exporting Countries (OPEC). The same logic applies to Russia which is why, despite the political rhetoric, it will not likely cut its' supply line to the Ukraine or Europe.

Similar conditions exist in the base metal complex. Prices will probably remain stable with little potential to expand dramatically. Again, I would cite supply and demand metrics, which on a macro scale, implies little inflation risk.

Gold will continue to lose its luster as fewer investors seek out crisis insurance. In time, investors will see the political risk surrounding ISIS as nothing more than a blip in history and Russia will likely opt for moderation rather than expansionism.

Consumer staples will remain in flux as companies try to find the right mix between bricks and mortar and online exposure. Some retailers will succeed, many will fail as the buying habits of millennials shift and the baby boomer generation becomes less influential.

Potential Option Strategies

The real message for option traders is that we are in a low volatility environment which historically has been bullish for stocks. Look back at past long term bull runs and they are typically accompanied by low volatility patterns.

With premiums at the lower end of the implied volatility spectrum, option buying strategies should remain in the spotlight. Buying longer term calls on Canadian banks seems like a reasonable strategy.

Buying calls in the consumer staples sector also has merit. If you pick the right company, being long calls will generate above average returns. If you pick the wrong company, a long call can hedge your risk by limiting the downside.

In a low volatility environment, the returns from covered call strategies naturally contract. However, if covered call writing is a strategy where your clients are most comfortable, look at options on gold stocks and energy companies. These options generally trade in the top quartile of all implied volatilities which yield some of the more attractive covered writes. It might not sound exciting but if you are holding these sectors in your portfolio, covered call writing can generate some excess tax advantaged cash flow.

Sale of covered call options on shares of Dollarama Inc.

The price of shares of Dollarama Inc. (DOL) is a stone's throw away from its historic peak of $96.67 posted on June 9, 2014. When the market closed on September 26, 2014, DOL was trading at $94.64 and seems to be meeting a lot of resistance above this price. If this is the case, we may see a temporary halt, indeed even a trend reversal, the extent of which cannot be predicted. In such a context, investors with DOL stock in their portfolio could take advantage of this anticipated relative stability and obtain slight protection in case of a decline, while having the opportunity to benefit from a possible upswing by selling covered call options on DOL shares. This strategy involves selling one call option contract for every block of 100 shares held. The strike price level for call options sold is a compromise between the capital gain, time value and degree of protection desired. In the current case, the sale of DOL JAN $92 call options at $5.20 per share would generate a maximum profit of $2.88 per share, including two dividends of $0.16, by the January 2015 expiration month (strike price of $92 - current DOL price of $94.64 + premium of $5.20 + dividends of $0.32), for a return of 3.2% (10.4% annualized). The breakeven point of $89.12 provides protection against a decline of 5.8%. The sale of DOL JAN $96 call options at $3.15 per share provides protection against a decline of 3.7% with a breakeven point of $91.17 and a potential maximum profit (with dividends) of 5.3% (17.1% annualized).

Call ratio spread on shares of XGD

The price of shares of the iShares S&P/TSX Global Gold Index Fund (XGD) fell sharply from its recent peak of $13.04 reached on August 12, 2014. At the time this article was written, at the closing of the market on Friday, September 26, 2014, XGD was trading at $10.64. In the past, the price spread between $9.00 and $10.50 represented a major support zone. While this decline may continue, prices could halt and enter a period of relative stability. Prices could also rebound and come back to test the solid resistance at the $13 level. Investors who would like to take advantage of the relative stability – and potential increase - of prices and who have no qualms about selling XGD shares short in case of a significant rise, could establish a call ratio spread on XGD shares. We are constructing the call ratio spread by purchasing one XGD MAR $10 call option at $1.15 and selling two XGD MAR $12 call options at $0.35 for a net debit of $45 (before commissions) on a basis of one contract. Investors who use a basis of 10 contracts would therefore take a total debit of $450. This strategy helps generate profits as long as XGD remains above the lower breakeven point of $10.45 and below the higher breakeven point of $13.55. The maximum profit of $155 (basis of one contract) will be realized if XGD closes exactly at the $12 strike price at the March 2015 expiration month. Any increase above the higher breakeven point of $13.55 will generate major losses, whereas a maximum loss of $45 (basis of one contract) will be incurred below the $10 strike price. With this strategy, investors could find themselves obliged to sell 100 XGD shares short, in case of a rise above the $12 strike price at the March 2015 expiration month.

Canadian WEEKLY Options

AVAILABLE AS OF DECEMBER 4TH
on 10 listed options classes

Take advantage of volatility around earnings and news. Buy cheap insurance. Generate weekly income.

Trade weekly options to benefit from their:

- **Flexibility** - with more choices of expiration dates
- **Low cost** - due to less time to expiry
- **High gamma** - to benefit from small movement in the price of the underlying

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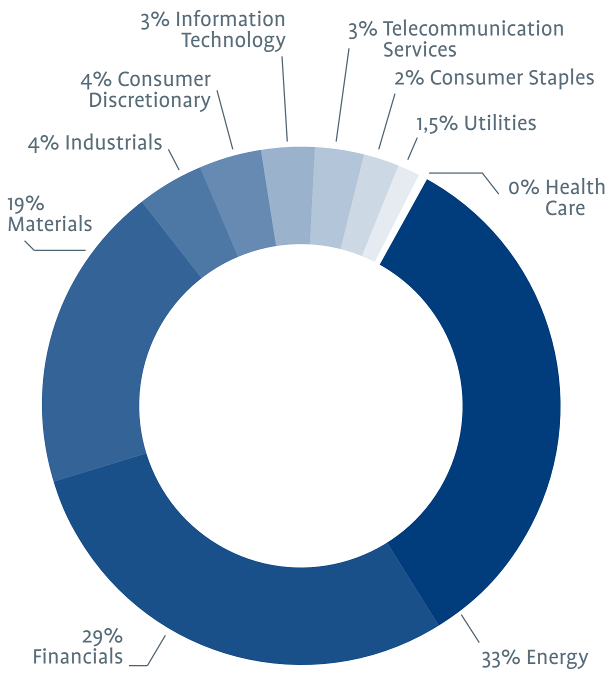
Top 10 Most Active Option Classes (Q3 2014)

RANK	SYMBOL	Q3 2014 VOLUME	INSTITUTIONAL	RETAIL	INSTITUTIONAL %	RETAIL %
1	XIU	544,960	407,501	137,459	75%	25%
2	ATH	271,036	215,502	55,534	80%	20%
3	RY	200,359	97,088	103,271	48%	52%
4	TD	190,803	75,893	114,910	40%	60%
5	MFC	157,897	95,649	62,248	61%	39%
6	ZEB	153,310	148,805	4,505	97%	3%
7	BNS	146,886	64,966	81,920	44%	56%
8	BMO	143,873	66,147	77,726	46%	54%
9	NA	132,484	89,877	42,607	68%	32%
10	TRP	124,494	79,344	45,150	64%	36%

Options Trading Volume by Sector

September YTD 2014



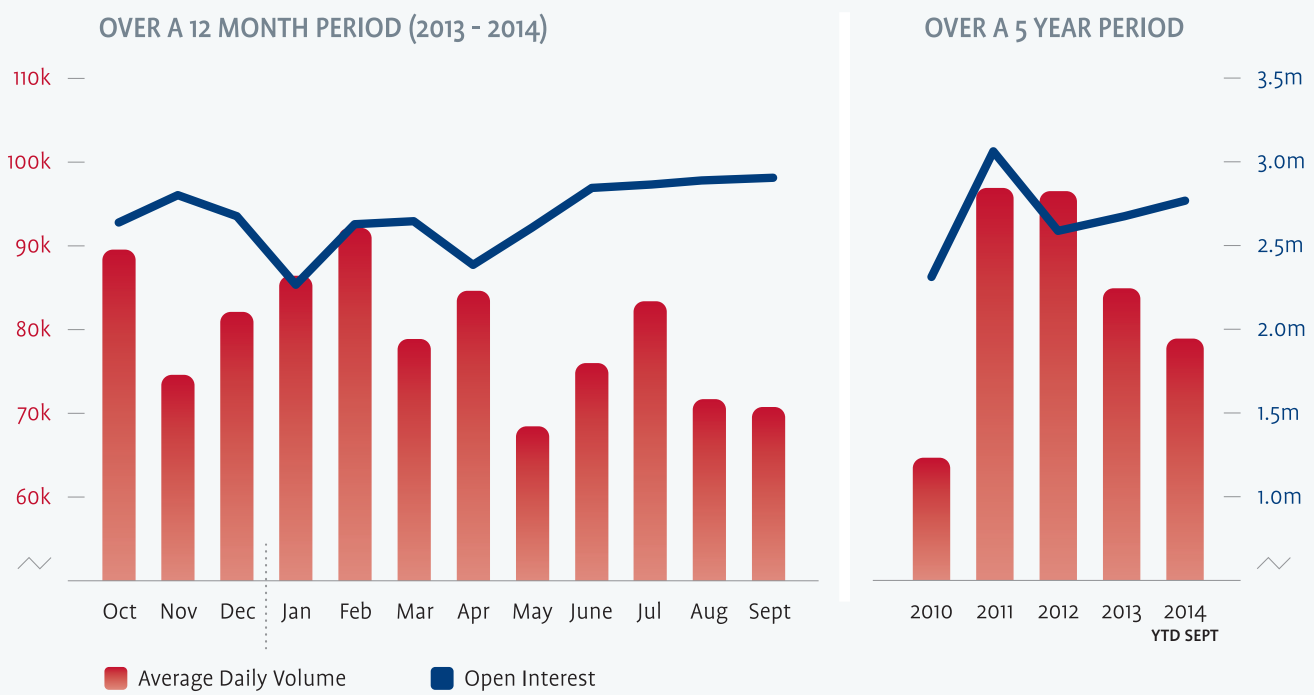
Source: Bloomberg

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

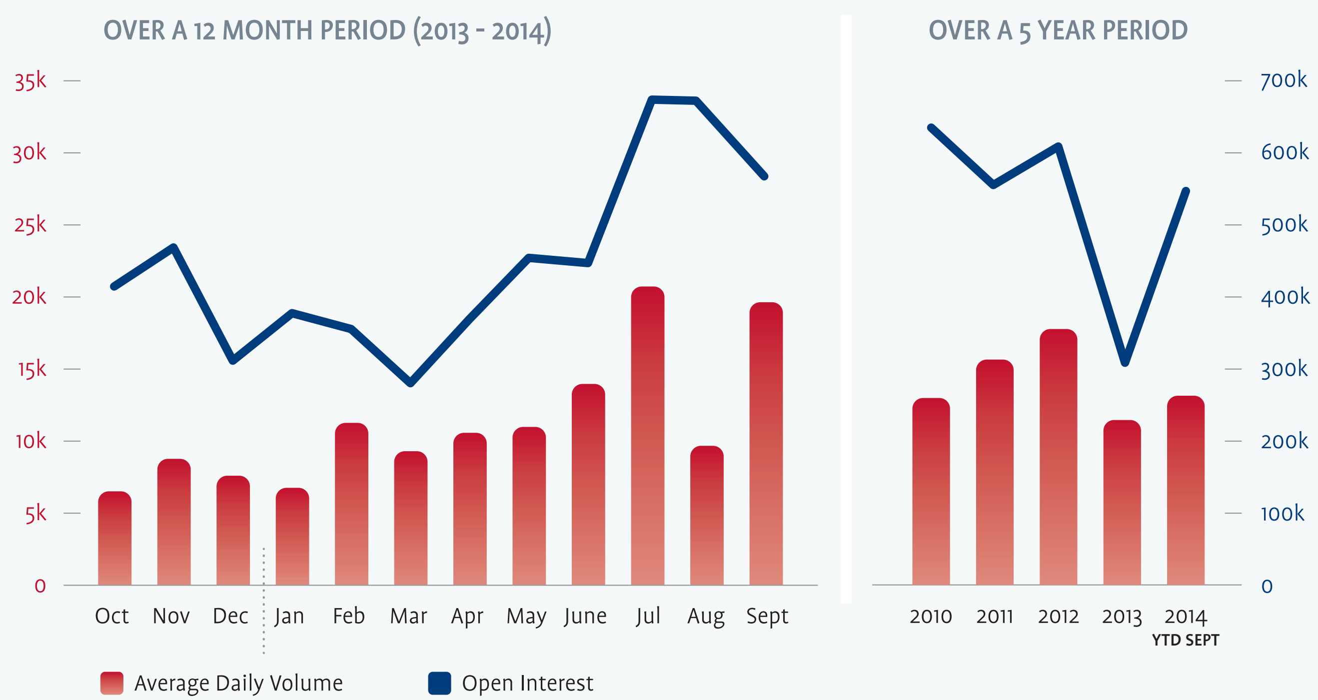
Most Crossed Option Classes

RANK	SYMBOL	CROSS VOLUME
1	XIU	407,501
2	ATH	215,502
3	ZEB	148,805
4	XFN	111,202
5	RY	97,088
6	MFC	95,649
7	XEG	94,605
8	NA	89,877
9	TRP	79,344
10	TD	75,893
11	BMO	66,147
12	BNS	64,966
13	SLF	63,614
14	ENB	52,163
15	ELD	51,782
16	XGD	51,455
17	DGC	47,187
18	ATD.B	43,527
19	CNQ	40,923
20	GWO	40,388

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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