CANADIAN EQUITY DERIVATIVES

Quarterly Newsletter - July 2016

MANAGER'S COMMENTARY

CONTAGION EFFECT: WILL CANADA SUFFER FROM A CRISIS IN CHINA?

p.3

THE OPTIONS PLAYBOOK

Covered Call on
Imperial Oil Ltd. (IMO)

Bull Call Debit Spread on
Rogers Communications (RCI.B)

p.6

TMX Montréal Exchange

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2016 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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CONTAGION EFFECT: WILL CANADA SUFFER FROM A CRISIS IN CHINA?

By Patrick Ceresna

On June 9th, the Bank of Canada released its semi-annual Financial System Review. While much of the attention in the report was directed at the red-hot Canadian real estate market, it did highlight some important considerations when looking at the risk to the Canadian economy emanating from China.

Here is the excerpt from the report:

Risk 3: Stress Emanating from China and Other Emerging-Market Economies

The Canadian financial system could be exposed to severe economic and financial stress from China and other EMEs. Potential triggers for this risk include a severe financial disruption or an economic downturn in China. In addition, further slowing in growth in EMEs or a disorderly depreciation of their currencies could lead to corporate or sovereign defaults, especially in EMEs that have large, unhedged debt denominated in US dollars. Such a scenario would weigh on global economic growth and trade, lowering com¬modity prices and leading to significant volatility across financial markets. The rating of this risk remains "elevated." Its probability of occurring is medium, and the impact on the Canadian financial system would be moderately severe if it were to materialize.

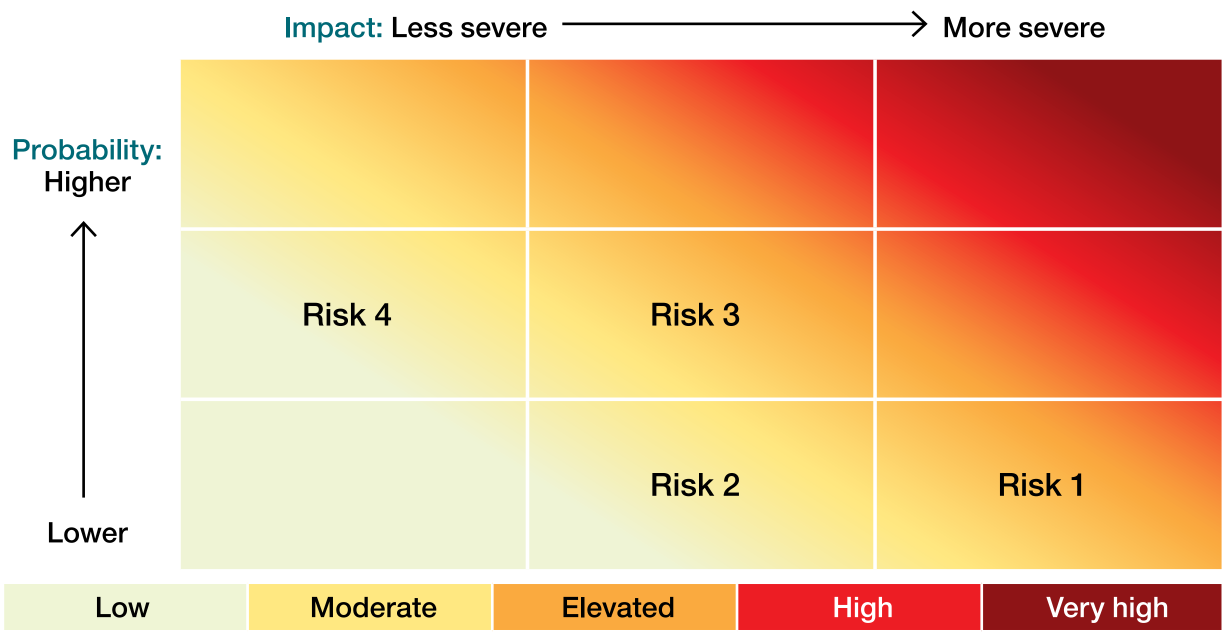
Table 1: Key risks to the stability of the Canadian financial system

Risk 1: Household financial stress and a sharp correction in house prices

Risk 2: A sharp increase in long-term interest rates driven by higher global risk premiums

Risk 3: Stress emanating from China and other EMEs

Risk 4: Prolonged weakness in commodity prices



The probability of financial stress in China and other EMEs remains medium

Considerable uncertainty surrounds the structural transition of the Chinese economy and financial system. In the first quarter of 2016, China’s GDP grew at a rate of 6.7 per cent on a year-over-year basis, suggesting that China is gradually slowing to a more sustainable pace of growth. At the same time, however, China has experienced rapid credit growth, mainly in the corporate sector (Chart 11). Firms are also using new debt to refinance maturing debt, which has the potential to mask growth of non-performing loans in the banking sector. Increasing financial sector vulnerabilities against a backdrop of slowing economic growth could pose a challenge for Chinese authorities, who are trying to facilitate a smooth transition.

The impact on Canada would be moderately severe

If this risk were to materialize, stress would be transmitted to Canada through lower commodity prices, slower global trade, higher financial market volatility and greater risk aversion. Over the past year, global financial markets experi¬enced short-lived episodes of heightened stress spilling over from China and other EMEs. These episodes suggest that financial linkages, including those to Canada, are stronger than previously thought. As China’s financial system becomes more integrated with the global financial system, potential transmission channels are likely to become stronger.

(for the full report http://www.bankofcanada.ca/2016/06/fsr-june-2016/)

While the Bank of Canada must distill the risks professionally and objectively, I feel I can offer some insights with some of my personal bias.

China's Serious Credit Issues

China is a fascinating story to observe. After the 2007-2009 crisis, we witnessed the single biggest credit expansion in history by a country. In fact, its bank assets have grown over 1,000% in less than a decade. A number of macro hedge fund managers like Kyle Bass and George Soros very well documented this. Like all credit systems, expansions lead to misallocated capital and eventually a loan loss cycle. There is plenty of evidence that this negative credit cycle is already underway.

So what does that mean for Canada?

A material economic slowdown in China could lead to a currency devaluation. This would affect Canada twofold. First, it would heighten the risk of a further global economic slowdown pressuring commodity prices to remain weak (BoC's 4th major risk). Secondly, it may materially curtail the flow of Chinese money into the Canadian real estate market. This could prove to be a perfect storm that few investors are prepared for. While it is far from being a certainty, there is increasingly elevated risk that a China economic contagion should have advisors and their investors paying attention.

Investment Risks

The investment concern lies with the current levels of the TSX and its sector breakdown. Year-to-date, the S&P/TSX 60 is up 8.58%. This is driven by a substantial rise in the energy sector (YTD 18.22%) but more extraordinarily is 50%+ higher off its mid-January lows. The rebound in energy has diminished the concerns about the loan loss cycle the banks would have to endure from a series of energy loan defaults. This has allowed the financial sector to rally (YTD 4.11%) and 18.86% higher off its mid-January lows.

The financial and energy sector exposure in the S&P/TSX 60 Index is disproportionate at 58.21%.

In our mind, there is an asymmetric risk building against the Canadian investor. Why? Like the Brexit referendum, which the markets were priced for the "stay" vote, we consider the current bank and energy share prices to be already priced for the more optimistic outcome of economic stability. It is therefore likely that there is only a marginal upside on the markets, most likely in the low single digits in the second half of the year.

Alternatively, if the situation in China deteriorates further and the contagion spills into Canada with lower commodity prices and lower global economic activity, risk adverse investors can send the markets quickly down to the January 2016 lows or lower, which could open the window for a further 10-20% decline.

Our perspective is based on the simple idea that rather than directly taking the financial stance of having to pick an anticipated outcome, you can simply use the options market to hedge the outlier risk.

Hedging Outlier Risk

As an advisor or portfolio manager, this is where you can consider buying options as a hedge. While buying put options outright can often dilute returns if the timing is off, there are many more neutral strategies that can reduce volatility. One of those techniques is the implementation of a collar strategy. This involves the selling of covered calls on the underlying investments owned and using the proceeds to finance the purchase of the put protection. This is also known as a hedge wrap. With the consideration of dividends and the natural volatility skew that prices in a premium for out-of-the-money put options, one can still implement some effective strategies to reduce risk and volatility.

Covered Call on Imperial Oil Ltd. (IMO)

Energy stocks have been one of the hottest investments through the start of 2016. In spite of that, Imperial Oil gets to carry the label as the dog in the energy sector virtually trading just a few dollars from its January lows. While that does not sound like a vote of confidence for those seeking capital gains, it does put the stock in a unique position for creating options income. When investors sell covered calls on an underlying stock, being able to assess the downside risk is an important consideration. In this case, with IMO having found considerable support in the $38.00-$40.00 area over the last 6 months, it provides a solid base from which to consider the position.

Breaking down the trade:

- Imperial Oil is trading at $40.92 (July 7, 2016)
- The January 20th 2017 call option is bidding $2.20 ($220.00 for each 100 shares)
- An investor that buys the shares and sells the covered call earns a 5.38% income over 6 months (over 10% annualized) for the obligation to potentially sell the shares at $42.00.

Under the circumstances that the shares remain weak, the premium collected reduces the average cost base to $38.72, which lies at the stocks 52 week lows. This is a reasonable proposition for those seeking to enhance their income on a blue chip brand name Canadian energy company.

Bull Call Debit Spread on Rogers Communications (RCI.B)

Over the last 6 months, we have seen the start of a defensive sector rotation from the high beta cyclical names to the low beta, higher dividend paying defensive names. In Canada, that is limited to a small number of telecom and utility names. One of those names that has been benefiting is Rogers Communications.

How can an investor participate while still managing risk effectively?

A long only investor that is buying the shares may have a hard time justifying the risk/reward proposition as the stock has already risen $5.00 in the last month. However, the stock may have the potential for a solid $2.00-$4.00 rise from here. This is where an option strategy like the bull call debit spread can redefine the risk and allow the investor to continue to participate on further strength.

Here is how the trade would look:

- Rogers Communication is trading at $53.58 (July 6, 2016)
- The $54.00 August 19h 2016 call option is asking $1.10 ($110.00 a contract)
- The $56.00 August 19h 2016 call option is bidding $0.40 ($40.00 a contract)

You open the spread by buying 1 August $54 call option and selling 1 August $56 call option at the net debit of $0.70 ($1.10-$0.40). This is $70.00 for every 100 shares of exposure.

While an equity investor is exposed to unlimited downside risk, the investor that opens the spread knows that the risk is limited to $0.70 a share regardless of how low the shares trade. As to the upside potential, the investor has positioned himself or herself to profit from a rise in the RCI.B share price within the $54.00-$56.00 range. If by expiration the stock is at or above $56.00 dollars, the spread will be worth $2.00 or a $1.30 profit on the $0.70 cost or a 186% return on capital risked.

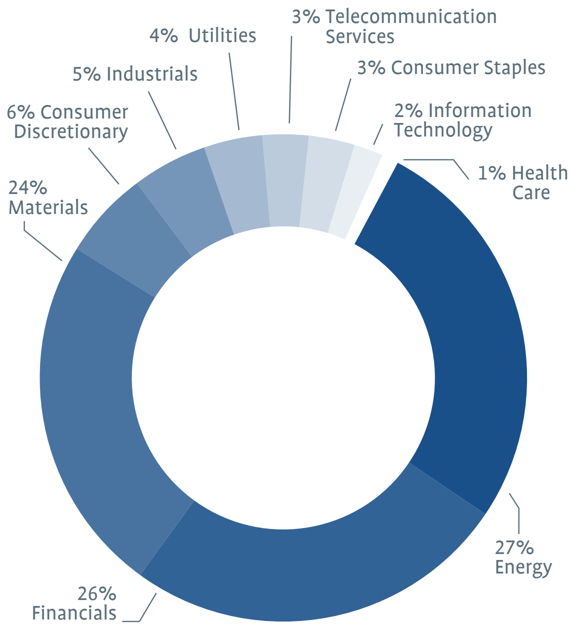
In our mind, the debit spread is a valuable strategy for investors to be able to participate in the late stages in a rally while being able to define the worst-case scenario and manage the risk associated with the outcome.

Top 10 Most Active Option Classes (Q2 2016)

RANK	SYMBOL	VOLUME	INSTITUTIONAL	RETAIL	INSTITUTIONAL %	RETAIL %
1	XIU	1,831,358	1,707,632	123,726	93%	7%
2	XEG	426,755	376,966	49,789	88%	12%
3	RY	233,888	85,666	148,222	37%	63%
4	ABX	209,338	47,927	161,411	23%	77%
5	SU	204,686	98,123	106,563	48%	52%
6	BMO	202,410	124,744	77,666	62%	38%
7	BNS	196,344	76,853	119,491	39%	61%
8	TD	193,485	72,520	120,965	37%	63%
9	MFC	184,480	101,190	83,290	55%	45%
10	TRP	176,618	134,098	42,520	76%	24%

Options Trading Volume by Sector

Q2 2016



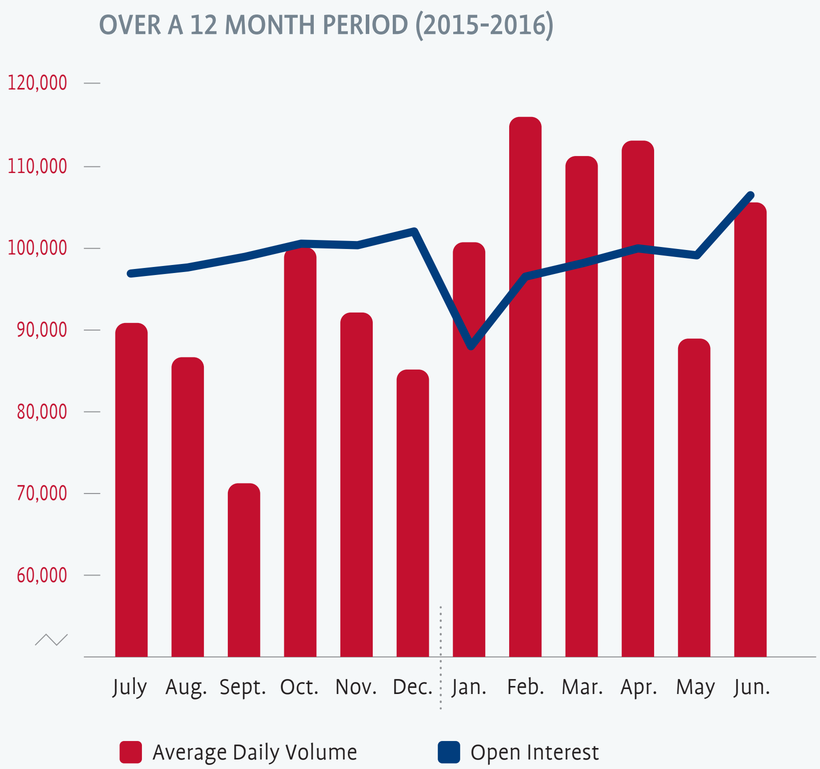
Source: Bloomberg

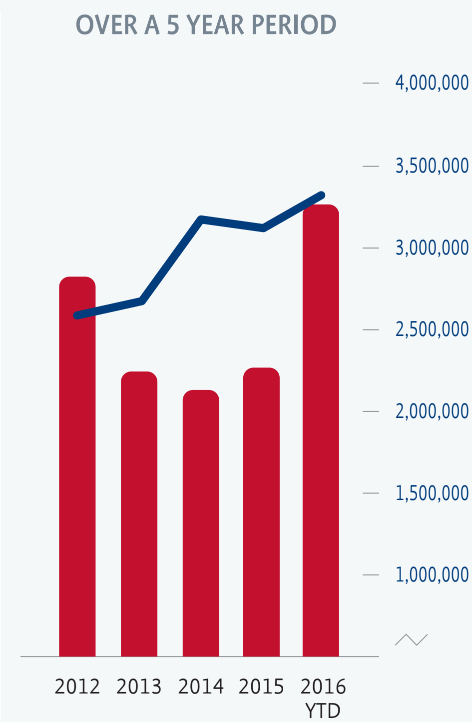
Note: Options volume from delisted or acquired companies are excluded.

Most Crossed Option Classes

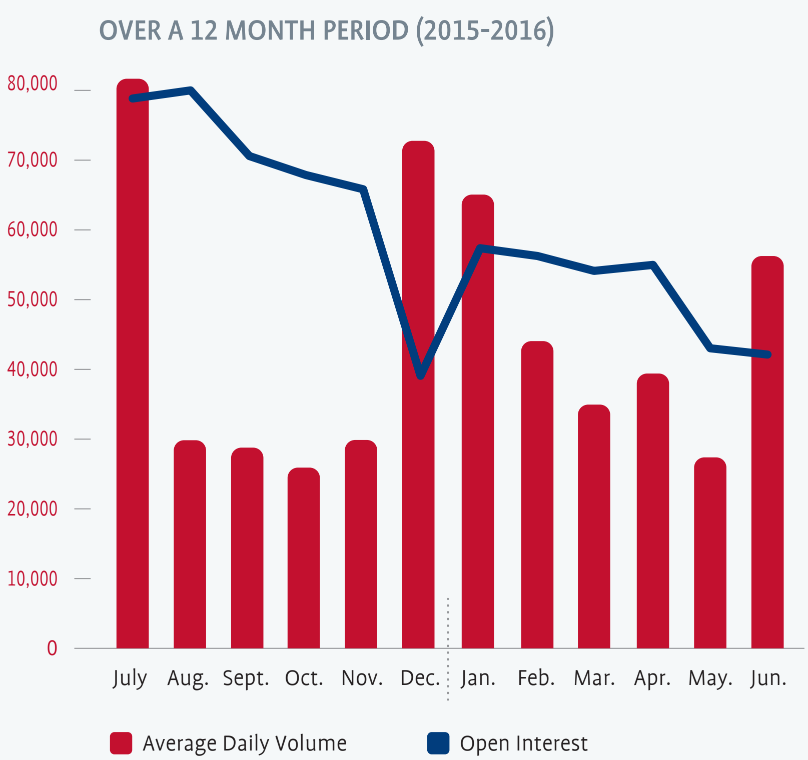
RANK	SYMBOL	CROSS VOLUME
1	XIU	1,707,632
2	XEG	376,966
3	TRP	134,098
4	BMO	124,744
5	TX60	111,319
6	MFC	101,190
7	SU	98,123
8	ZEB	89,065
9	RY	85,666
10	XGD	79,226
11	BNS	76,853
12	NA	73,476
13	BCE	73,161
14	TD	72,520
15	ENB	68,792
16	HSE	60,007
17	LUN	59,671
18	SJR.B	59,369
19	CM	59,340
20	TRI	53,397

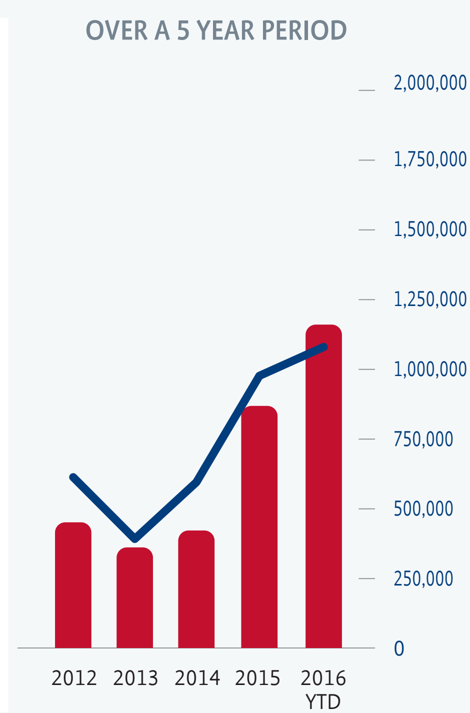
Equity Average Daily Volume and Open Interest





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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