TABB GROUP

The Evolution of The Canadian Derivatives Market

Andy Nybo
Head of Derivatives Research

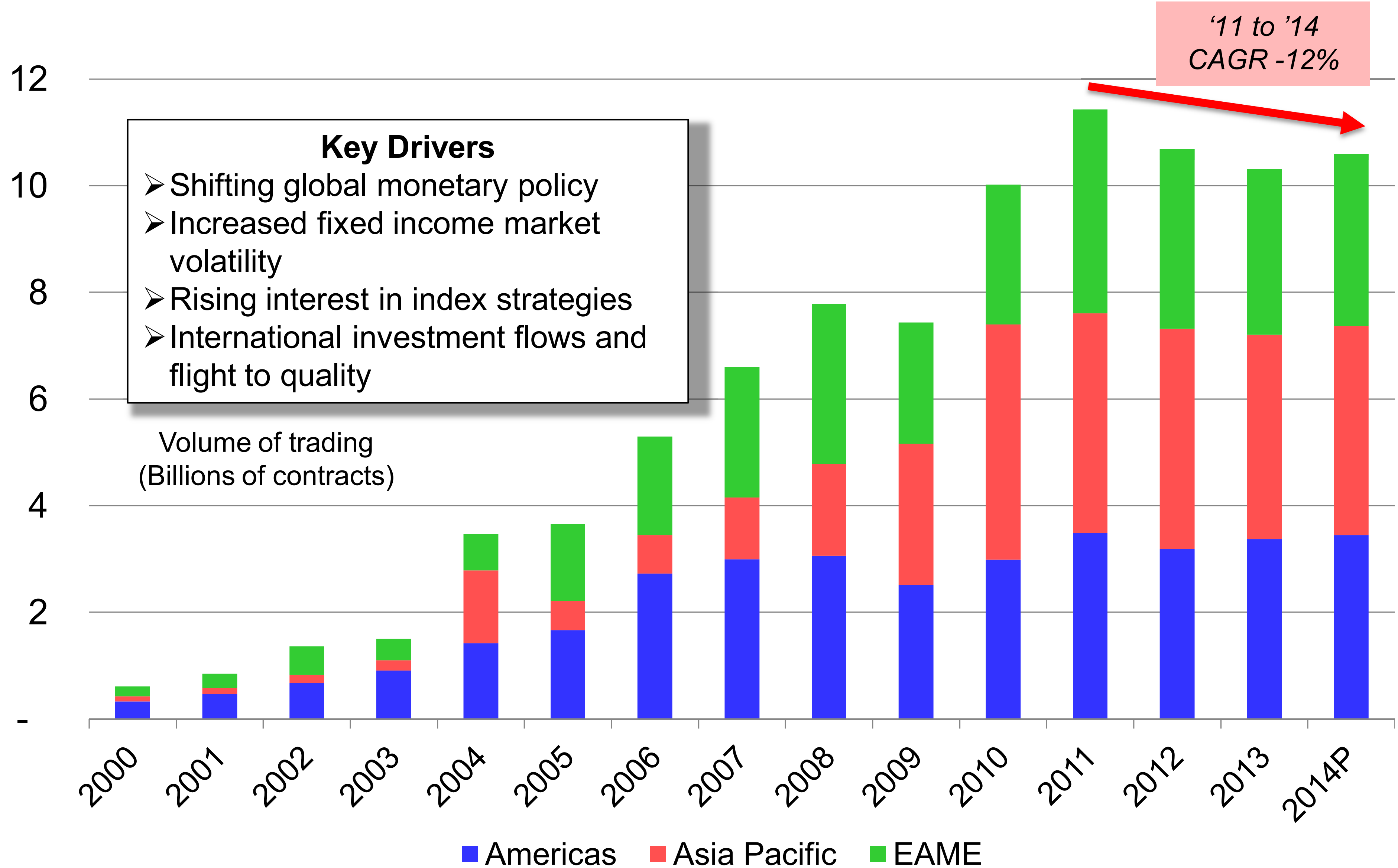
Canadian Annual Derivatives Conference
November 17-19, 2014

Focus

- Introduction
- Trends in global derivatives markets
- Characteristics of Canada
- Future opportunities
- Key takeaways

Trends in global derivatives markets

Global futures volumes are slowly recovering after hitting a record peak in 2011…



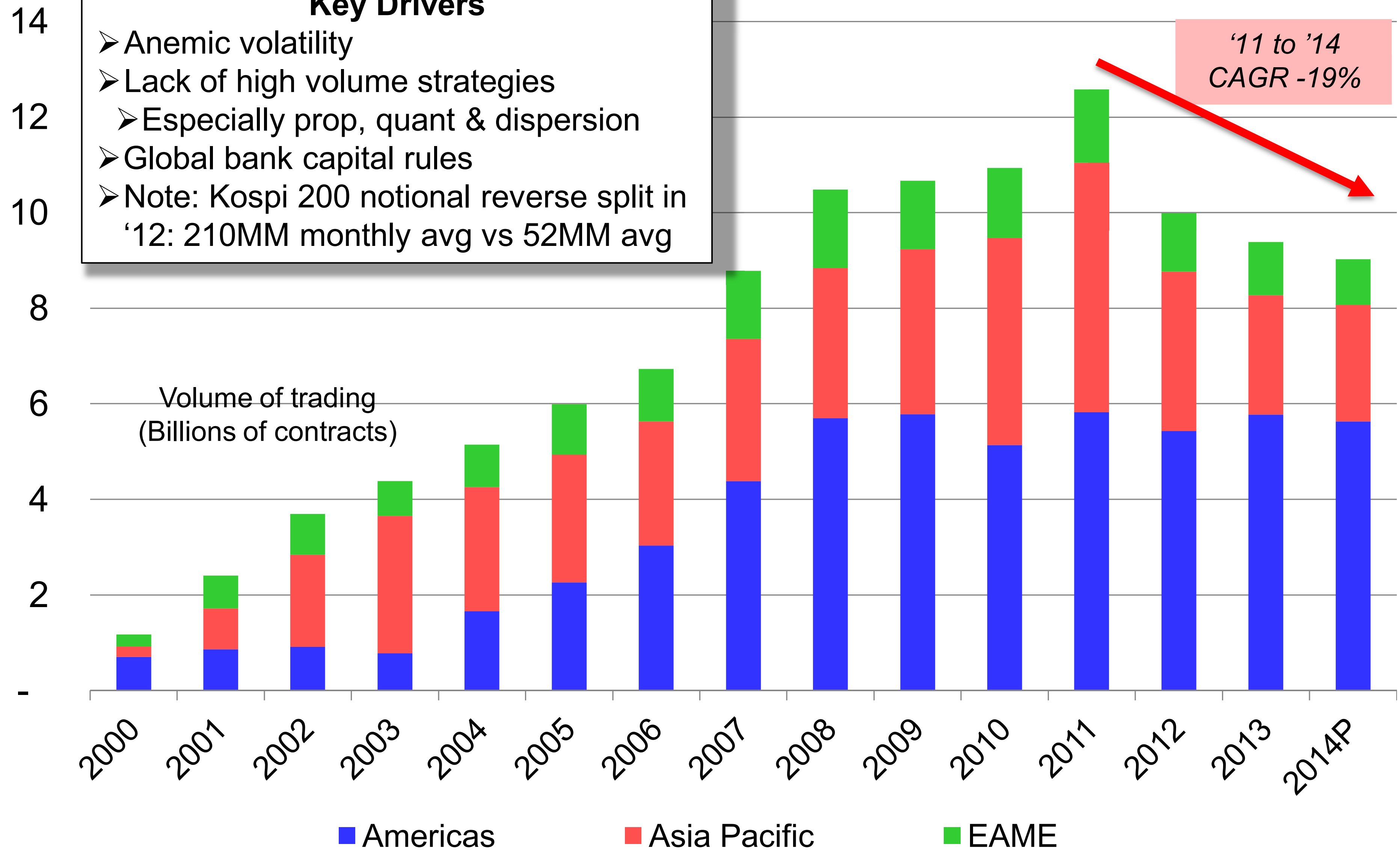
Key Drivers
- Shifting global monetary policy
- Increased fixed income market volatility
- Rising interest in index strategies
- International investment flows and flight to quality

Source: WFE, TABB Group

…yet options volumes remain on a downtrend, primarily a result of anemic volatility in underlying equity markets

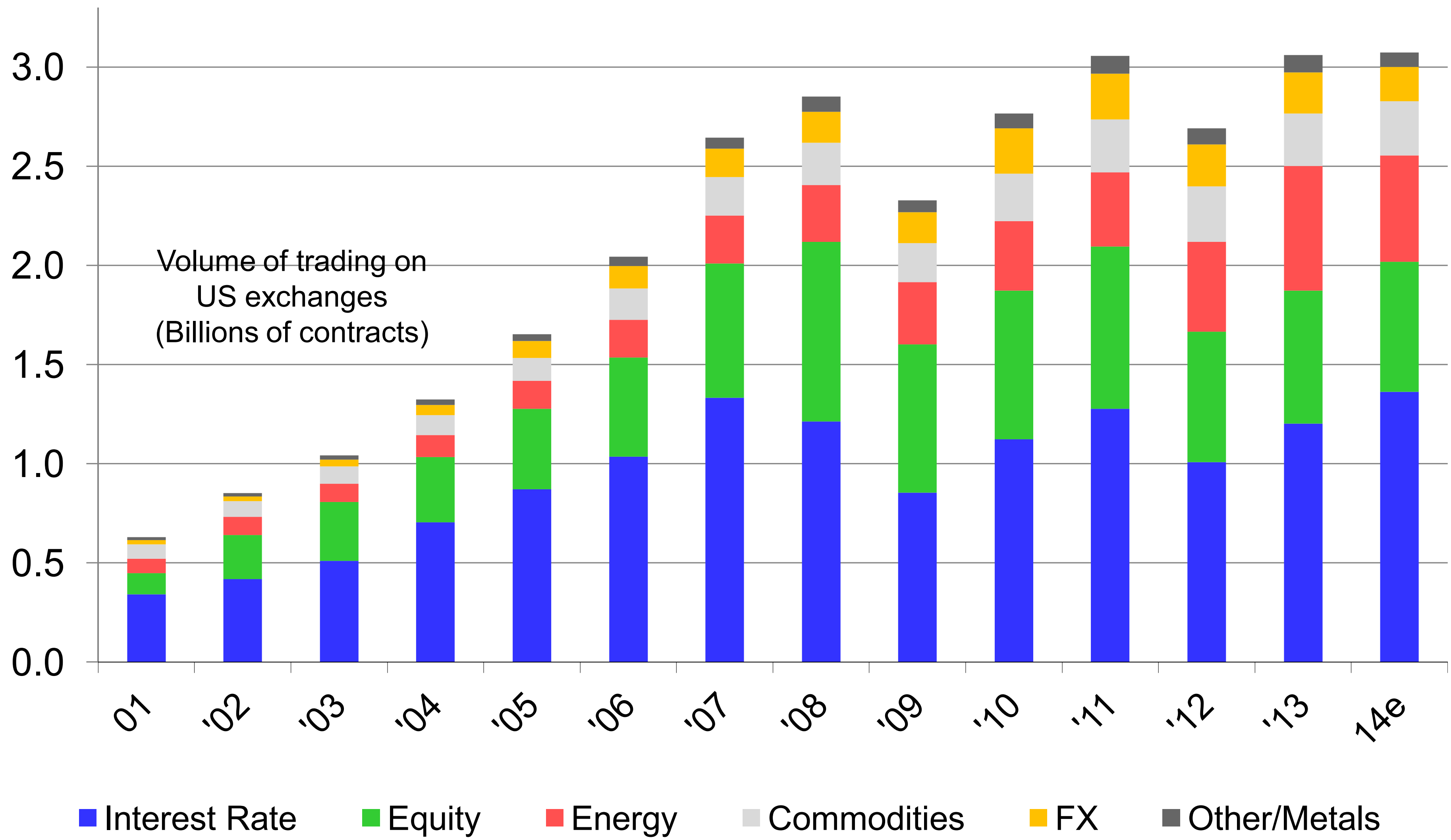
Key Drivers

- Anemic volatility
- Lack of high volume strategies
  - Especially prop, quant & dispersion
- Global bank capital rules
- Note: Kospi 200 notional reverse split in '12: 210MM monthly avg vs 52MM avg



Source: WFE, TABB Group

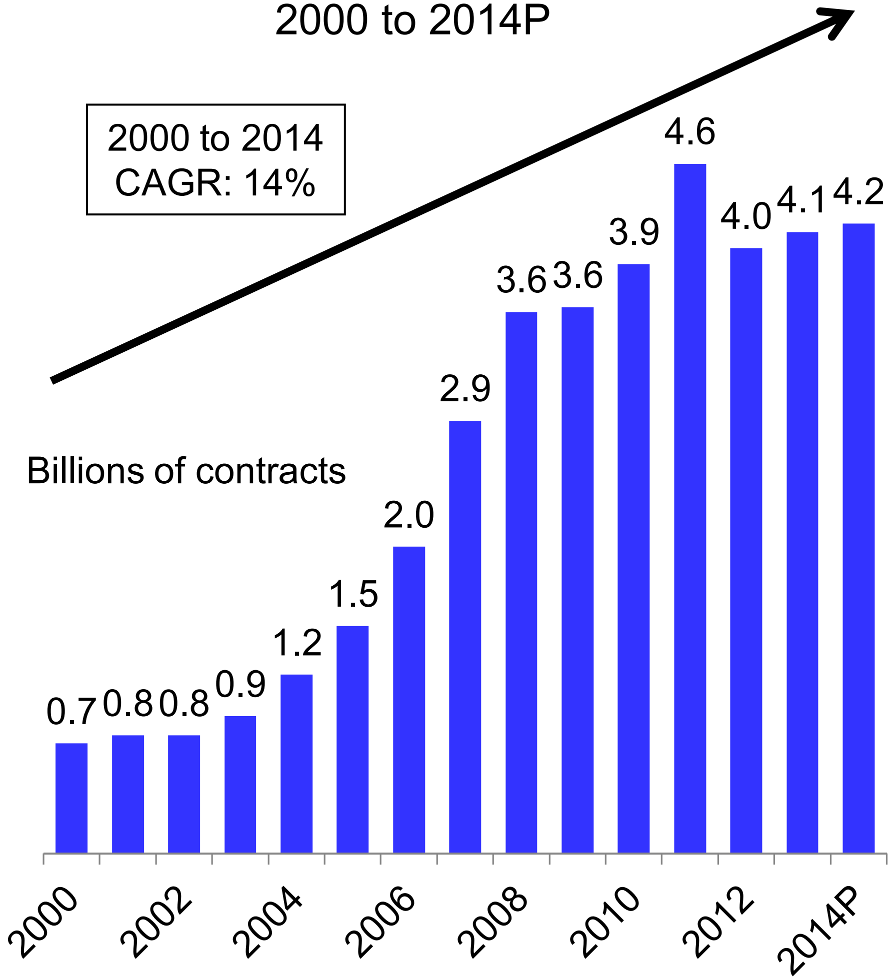
US futures markets are on a tear, no surprise given fixed income product liquidity



Source: FIA, TABB Group

US options trading continues to increase; 2014 volume on pace to reach the second highest level on record

Annual US Options Trading Volume
2000 to 2014P

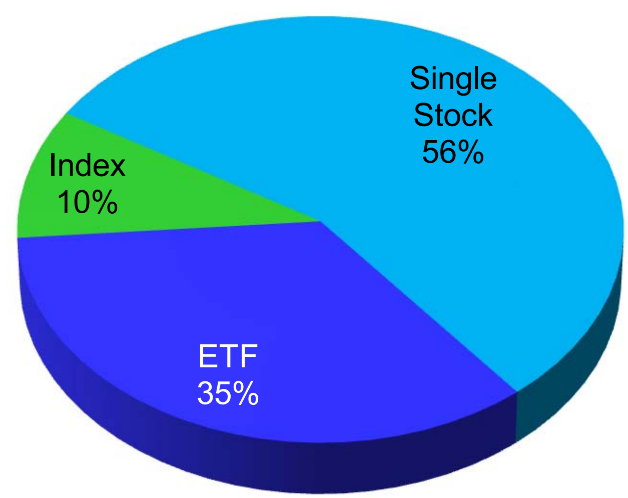


Source: OCC, TABB Group estimates

Key Drivers

- Demand for index and ETF products
- Strong growth in weeklies
- Return of the retail investor
- Insatiable demand for volatility exposure

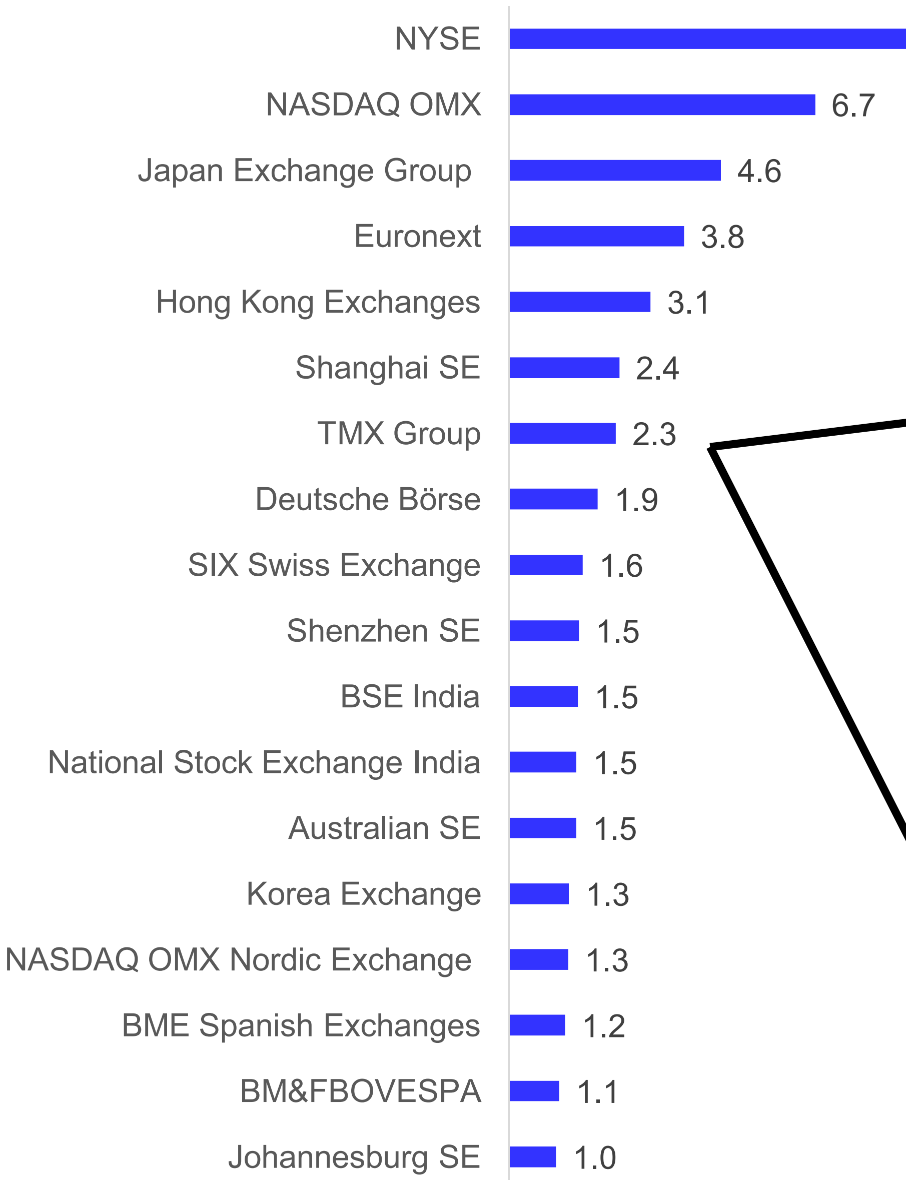
Volume by type of option
2014:H1



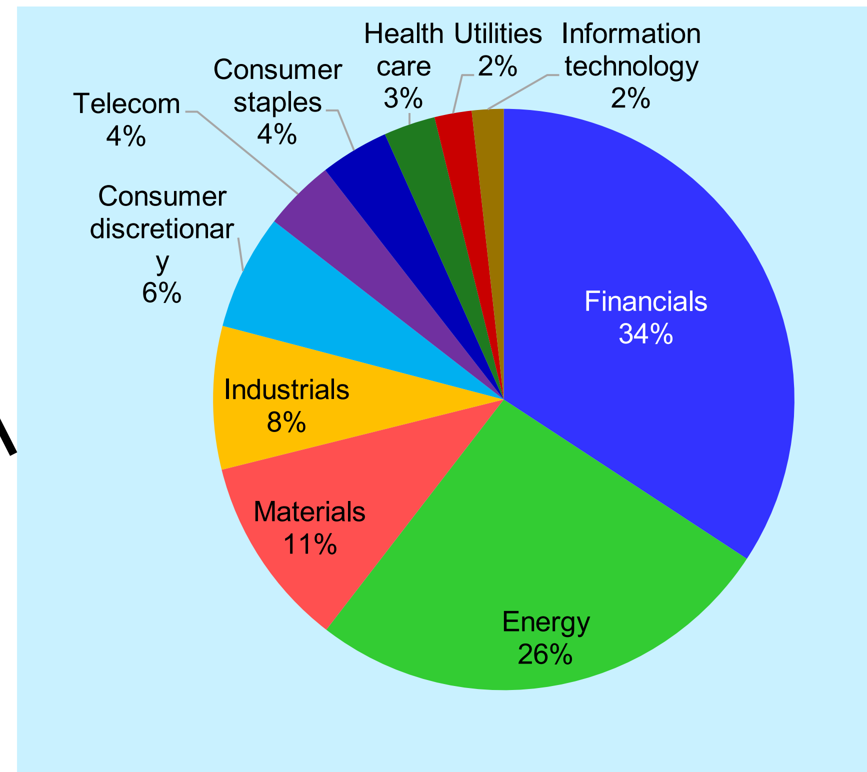
Source: OCC

Characteristics of Canada

Although Canada's markets are often overshadowed by the US, its equity markets rank seventh in terms of market cap

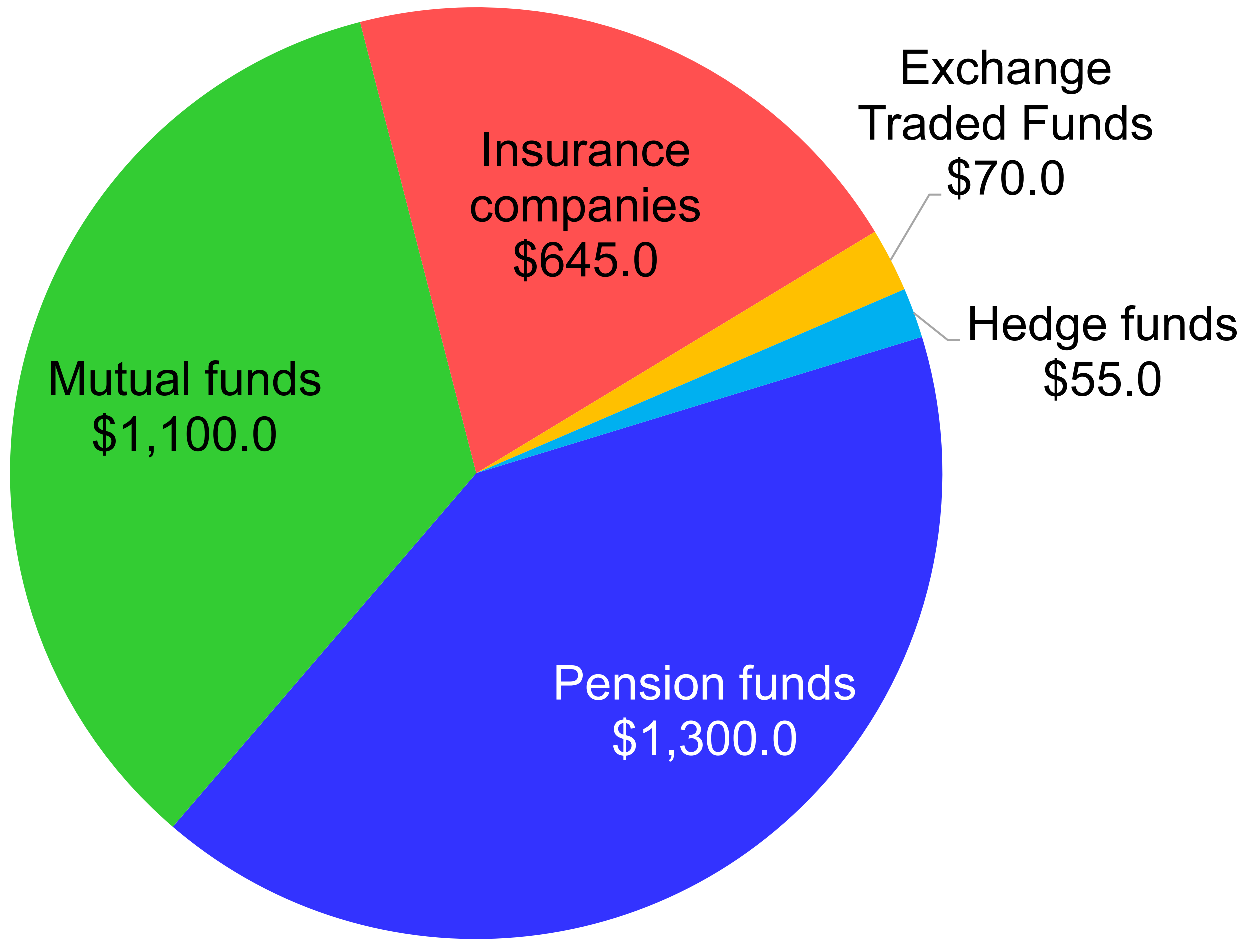


Concentration in finance, energy and natural resource sectors provides benefits *and* challenges



Source: WFE, TMX, TABB Group

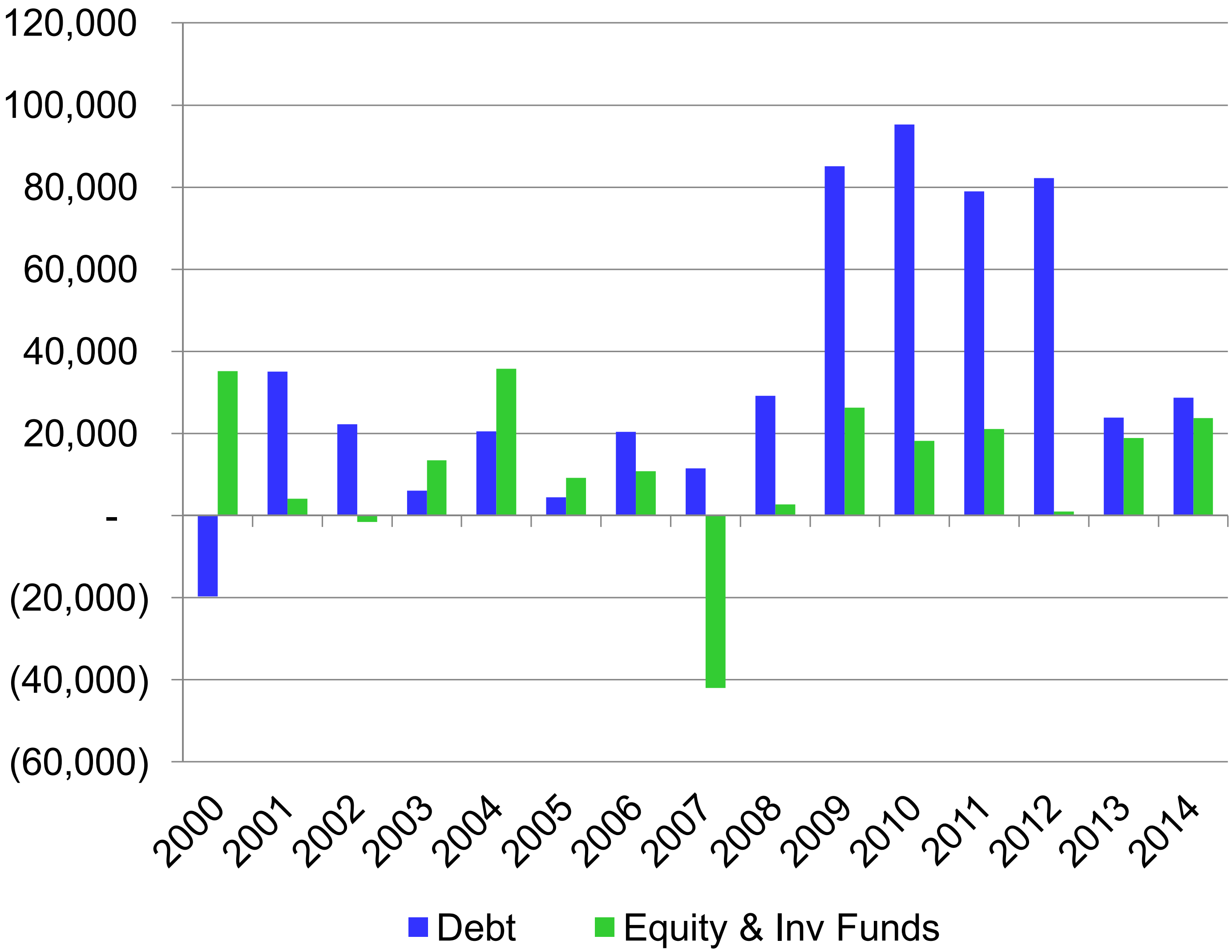
Canadian capital markets benefit from a substantial domestic institutional investor base



Total Assets under Management $3.2 Trillion

Source: CLHIA, IFIC, Statistics Canada, ETFInsights, TABB Group estimates

International investment flows have been consistent, with significant flows coming from both the US and Europe

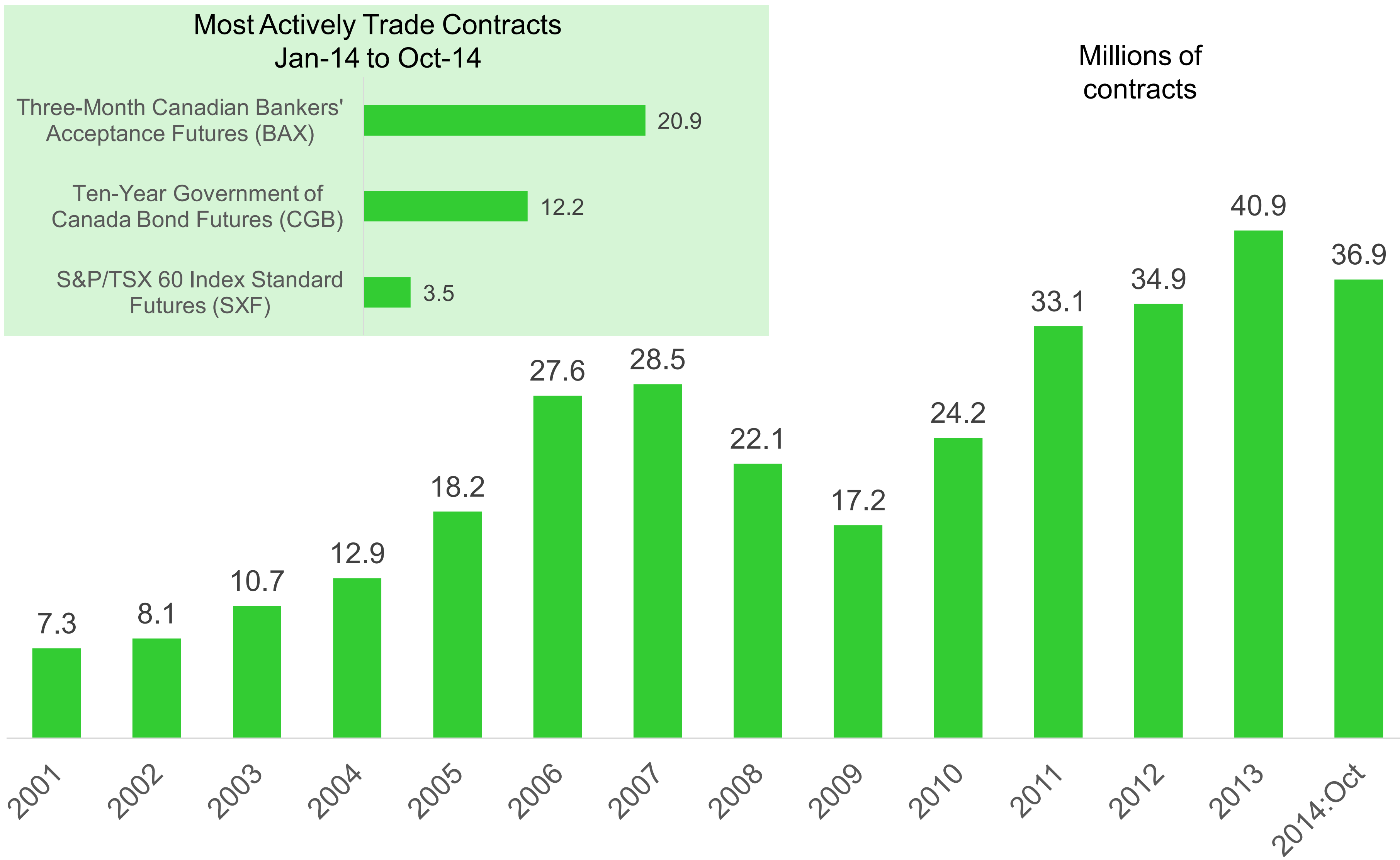


Source: Statistics Canada

Countries with AAA Rating

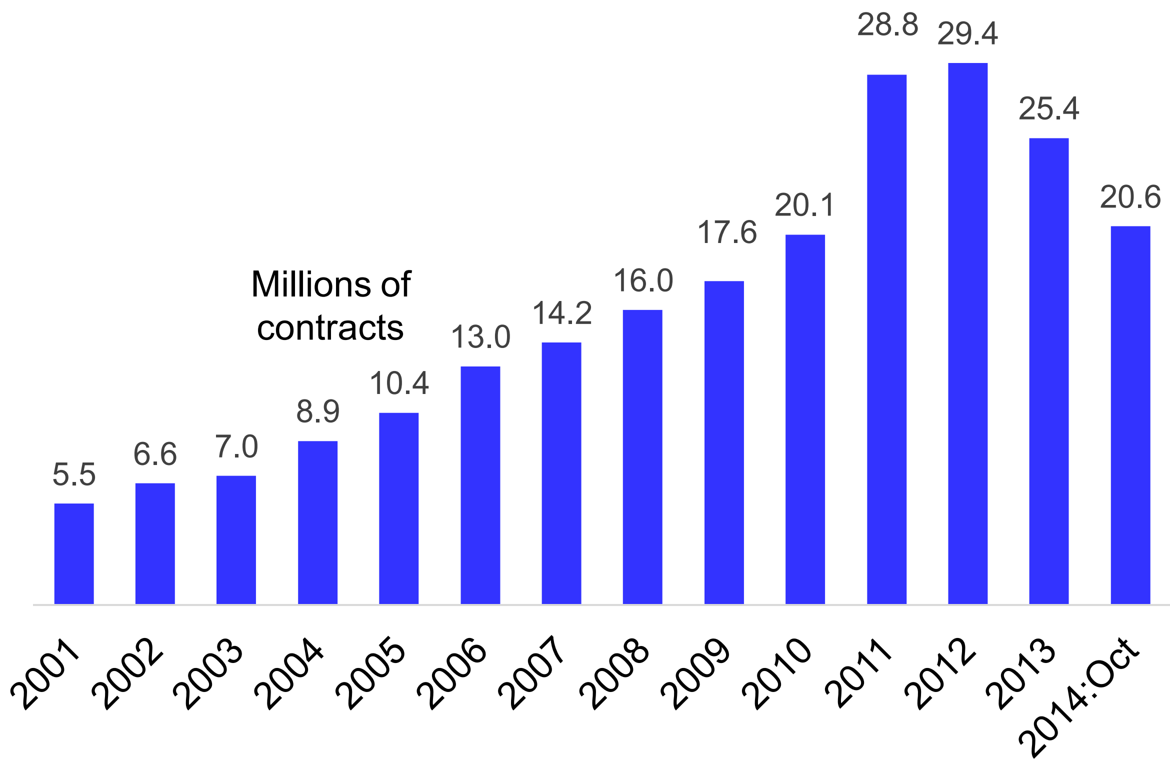
Australia
Canada
Denmark
Germany
Luxembourg
Norway
Singapore
Sweden
Switzerland

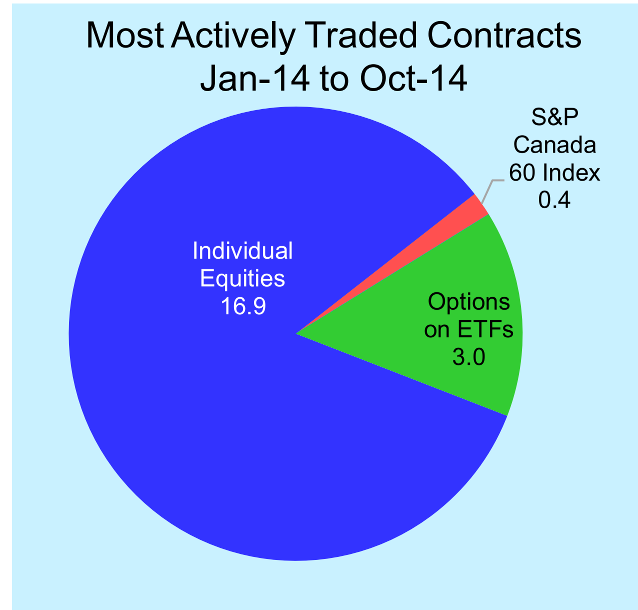
Futures markets in Canada have benefited from many of the same trends impacting global markets

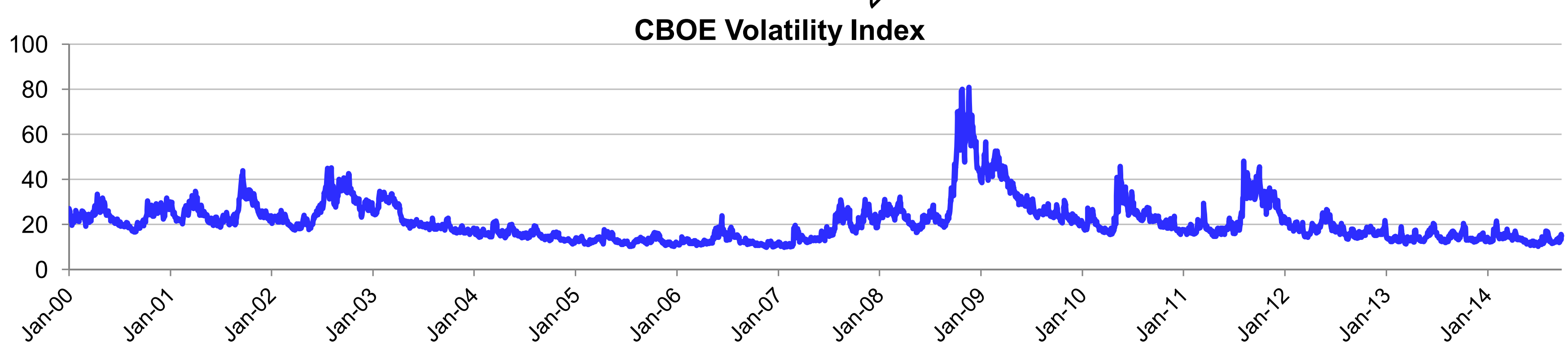


Source: Montreal Exchange

Options markets have seen declining volumes, lack of volatility and weakness in natural resource sector are impacting demand







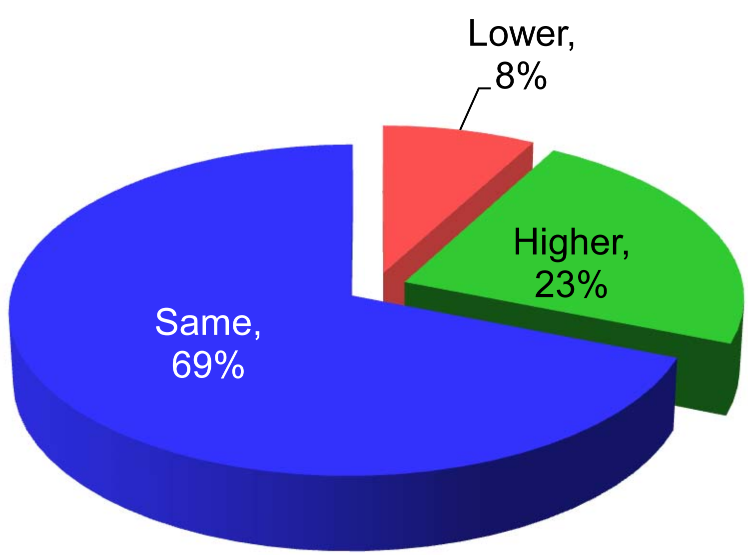
Source: Montreal Exchange, CBOE

TABB GROUP

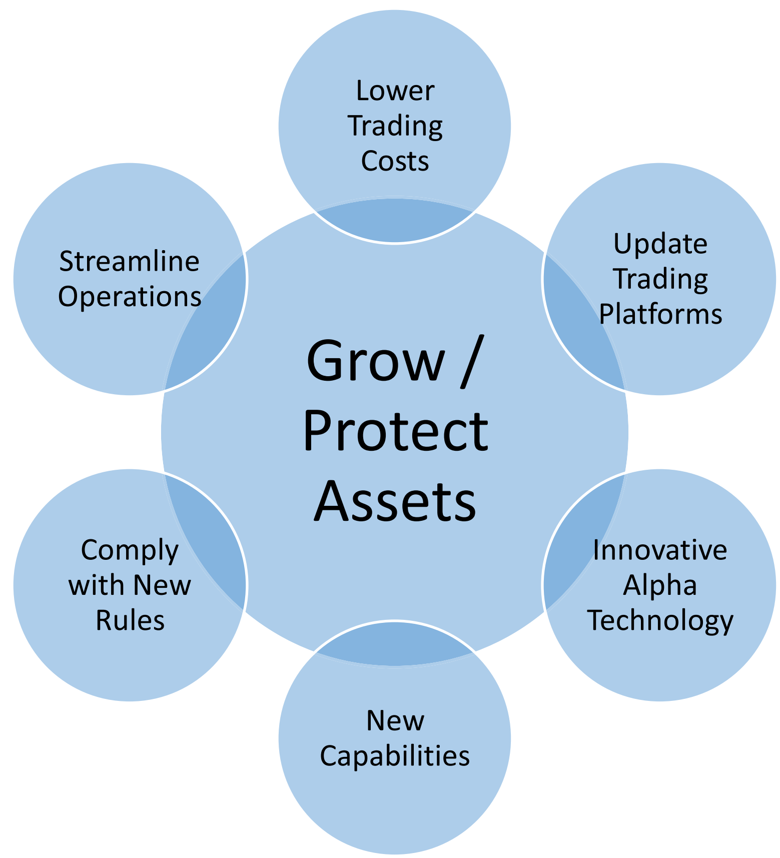
Future opportunities

The buy side will continue to grow their use of equity index derivatives with strategy expansion a natural evolution of activities

How will you derivatives activity change in the next 12 months?

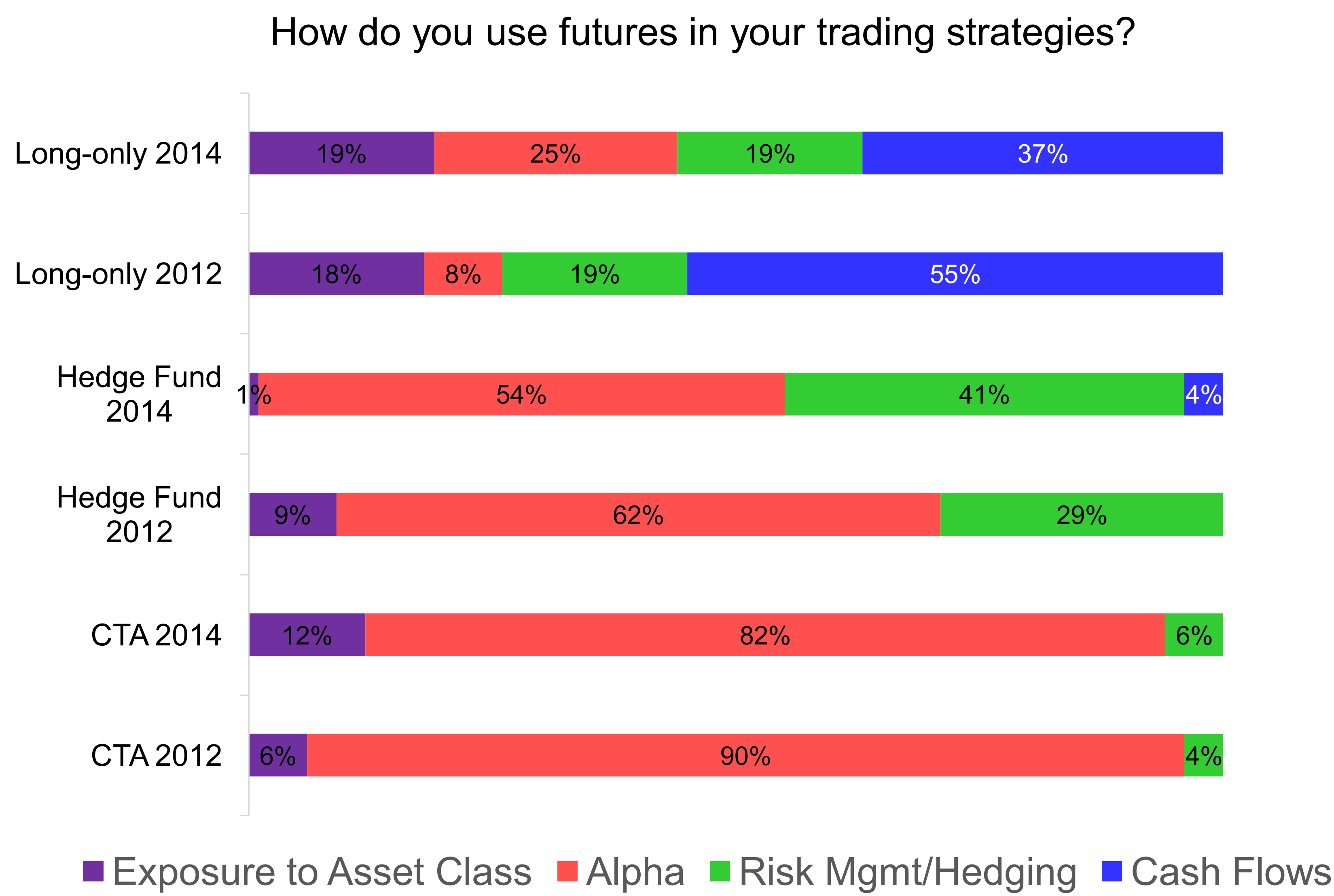


Factors driving increased adoption



Source: TABB Group, "US Equity Index Derivatives: The Next Phase of Institutional Discovery"

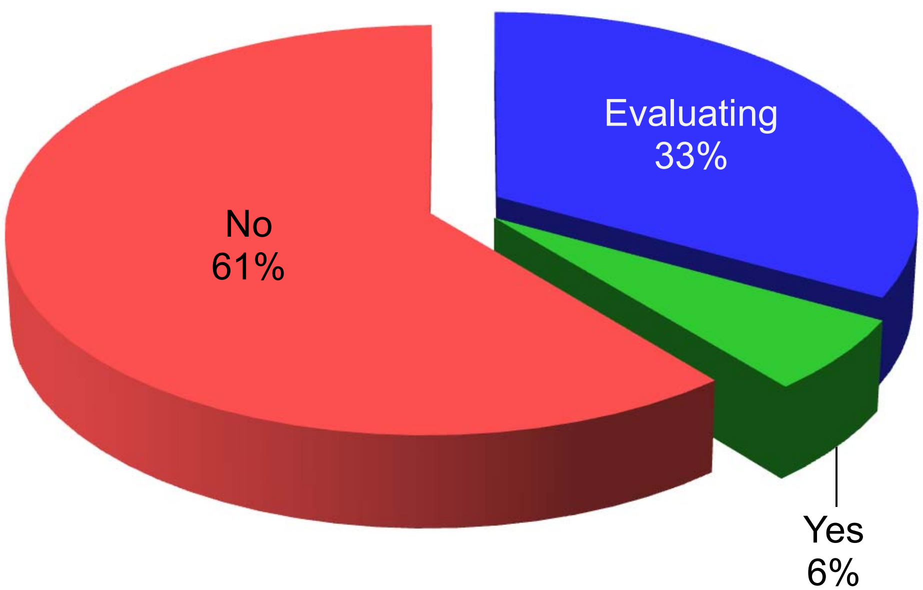
Strategies are evolving as need to generate alpha, regulation and capital scarcity impact investment goals



Source: TABB Group, "US Equity Index Derivatives: The Next Phase of Institutional Discovery"

Global regulatory initiatives will eventually impact the types of derivatives used by the buy side

Will you change the derivatives products you use as a result of regulatory change?



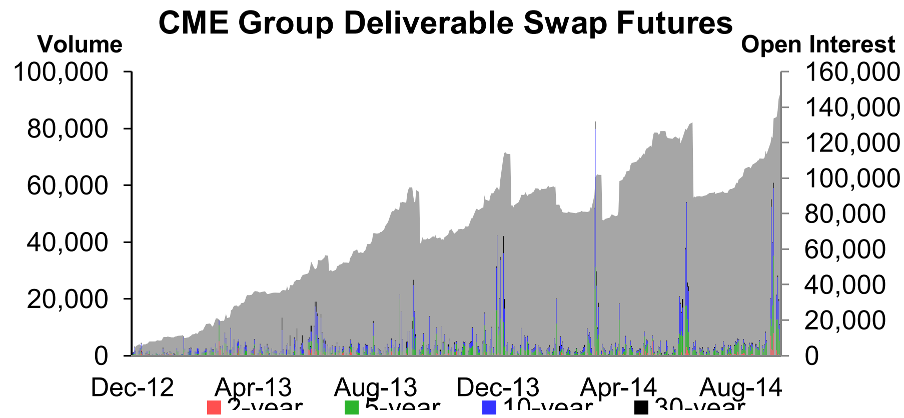
- Most regulatory initiatives have focused on interest rate products
  - Credit default swaps
  - Interest rate swaps
- Trading is slowly moving to exchanges and organized trading facilities
  - Transparency is a primary goal
  - Surveillance and oversight
- Stricter capital rules will shift equity OTC markets to listed products over time
  - Basel III will force brokers to ration capital
  - Mitigating systemic risk is a key goal
- Buy side needs to manage and hedge exposures
  - Brokers will proactively monitor client exposures
  - Portfolio margining rules will attract greater attention

Source: TABB Group, "US Equity Index Derivatives: The Next Phase of Institutional Discovery"

One area of promise is swap futures as a replacement for OTC swaps but the process will take time…

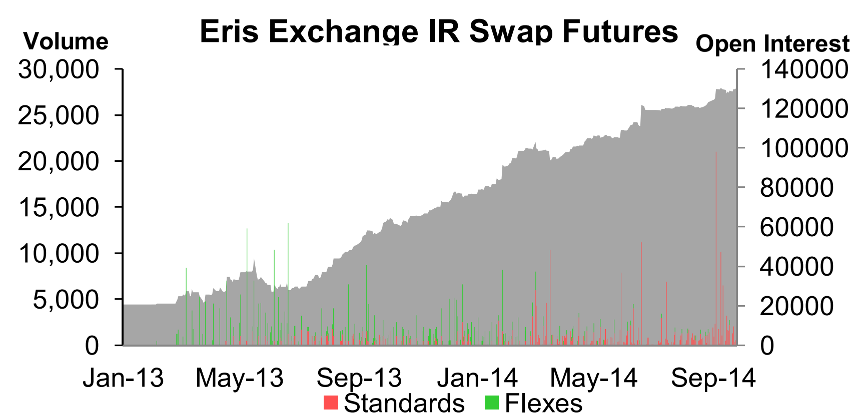
Will you trade swap futures instead of swaps?

	Yes	No
2012	8%	92%
2013	17%	83%
2014	29%	71%



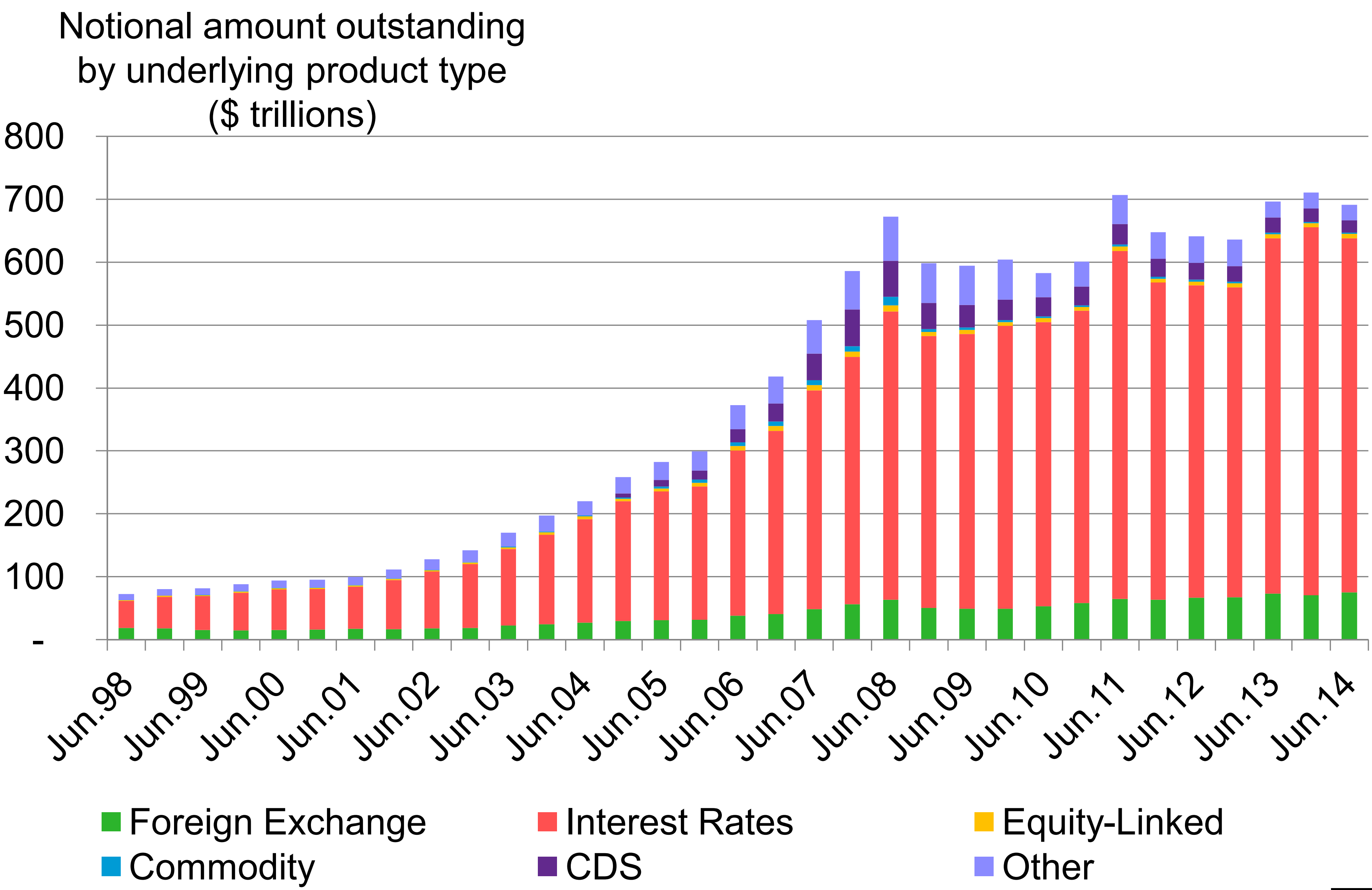
Contributing Factors

- As existing OTC swap portfolios turnover, the decision to use swaps or futures will include alternative products that allow users to reduce clearing costs, especially as mandated clearing for swaps is implemented.
- Liquidity in swap futures as evidenced by open interest and trading volumes has increased steadily; volume growth around quarterly rolls is evidence of continued adoption.



Source: TABB Group, CME Group, Eris Exchange

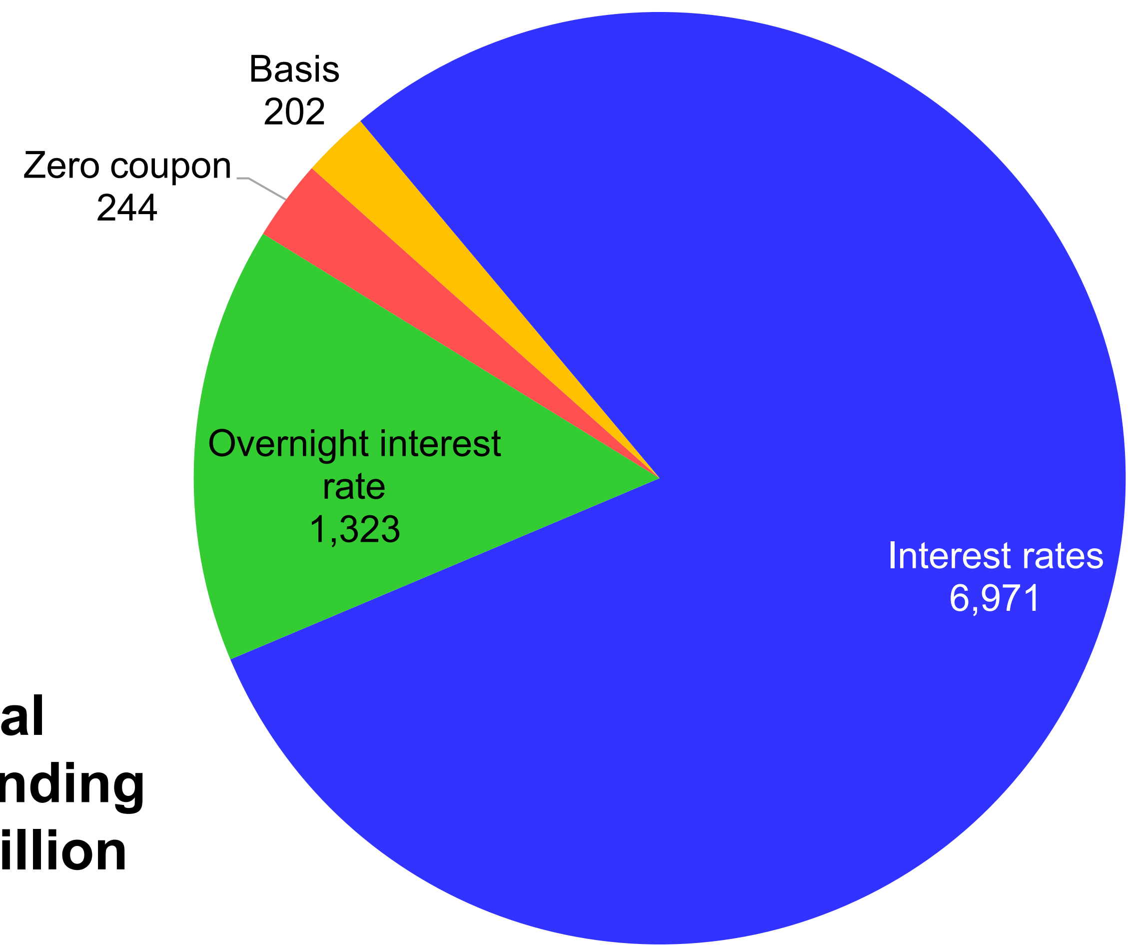
…as global OTC derivatives markets continue to expand; especially in foreign exchange and interest rate instruments



Source: BIS, TABB Group

The Canadian dollar swap market represents a future source of demand for listed derivative products

Notional amount outstanding of Canadian dollar swaps



Total Outstanding $8.9 trillion

All amounts in billions of dollars

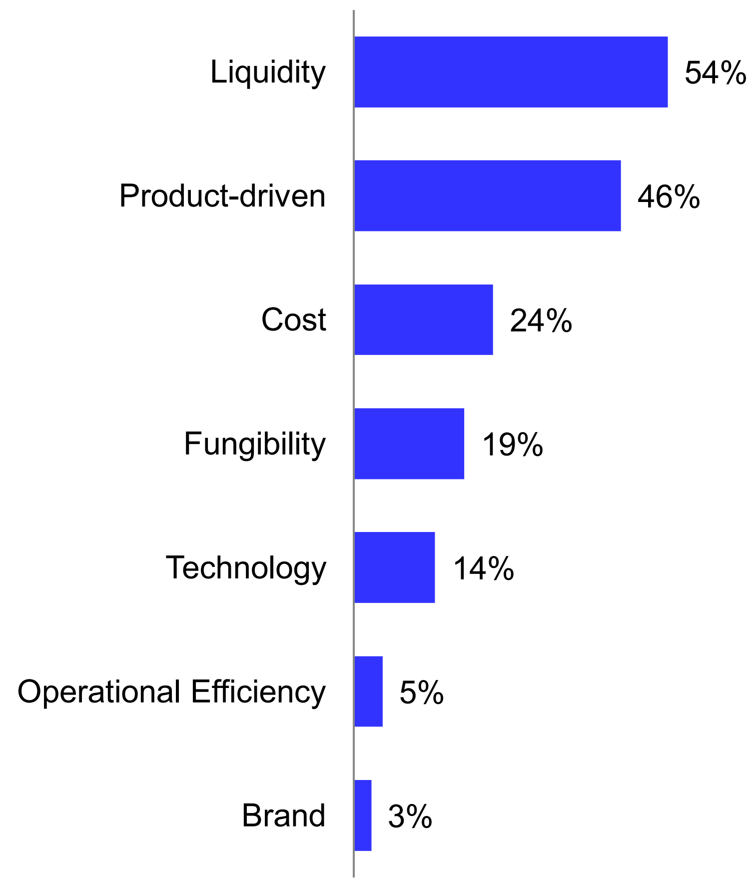
Source: SwapClear

Attracting trading interest in new products is an intricate process, with building liquidity a key determinant of success

Drivers of Product Demand

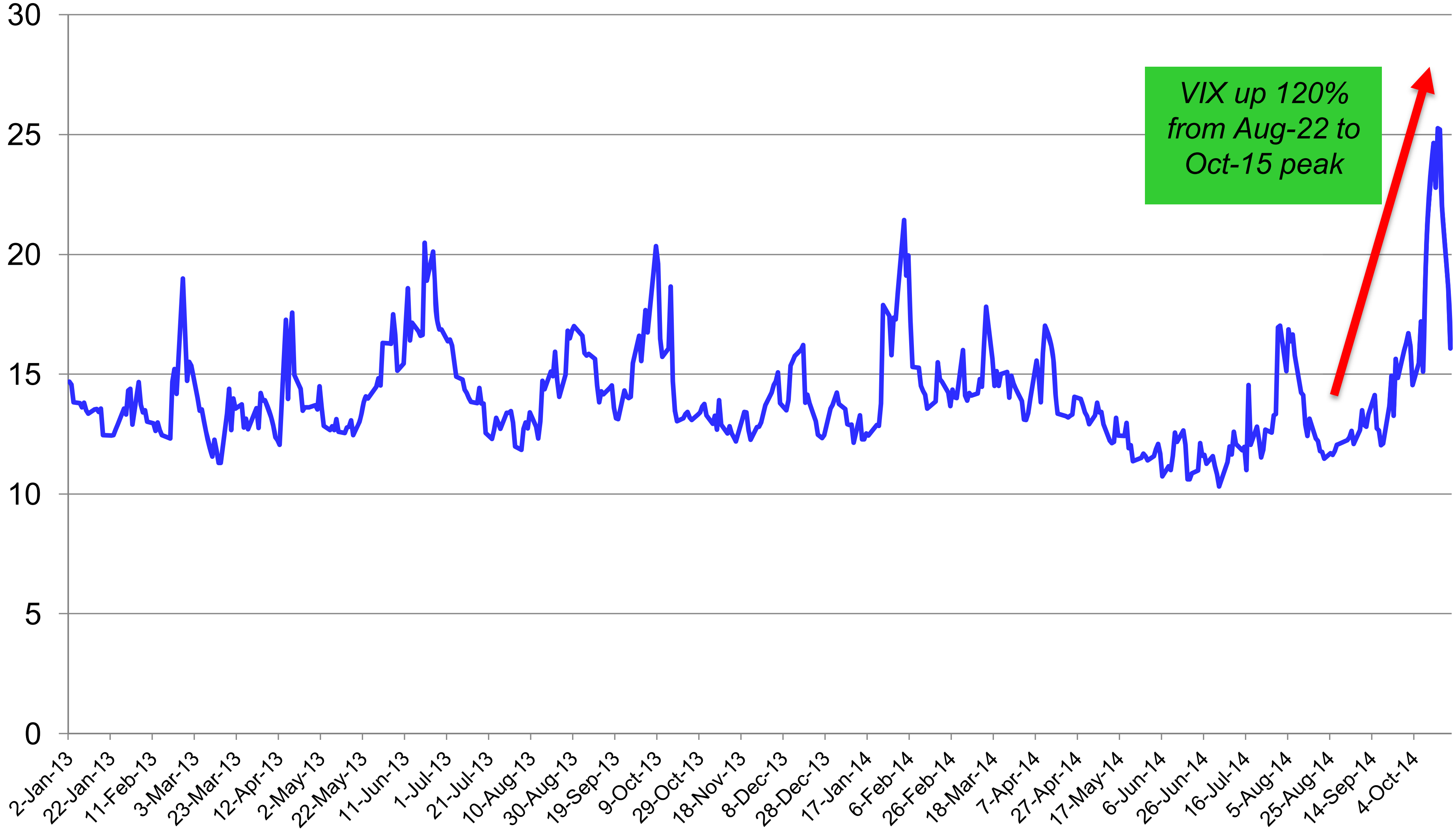
- Liquidity is always the biggest factor dictating success; getting out of a trade is even more critical
- The decision to trade at a specific venue is driven by a range of factors
  - Innovative product design
  - Low trading costs
  - Comprehensive technology capabilities
  - Ease of access
  - Exchange support
- Capital requirements are becoming more important
  - Margin requirements
  - Comprehensive clearing infrastructure
  - Low fees

What would be the most important incentive to trade a new product on an exchange?



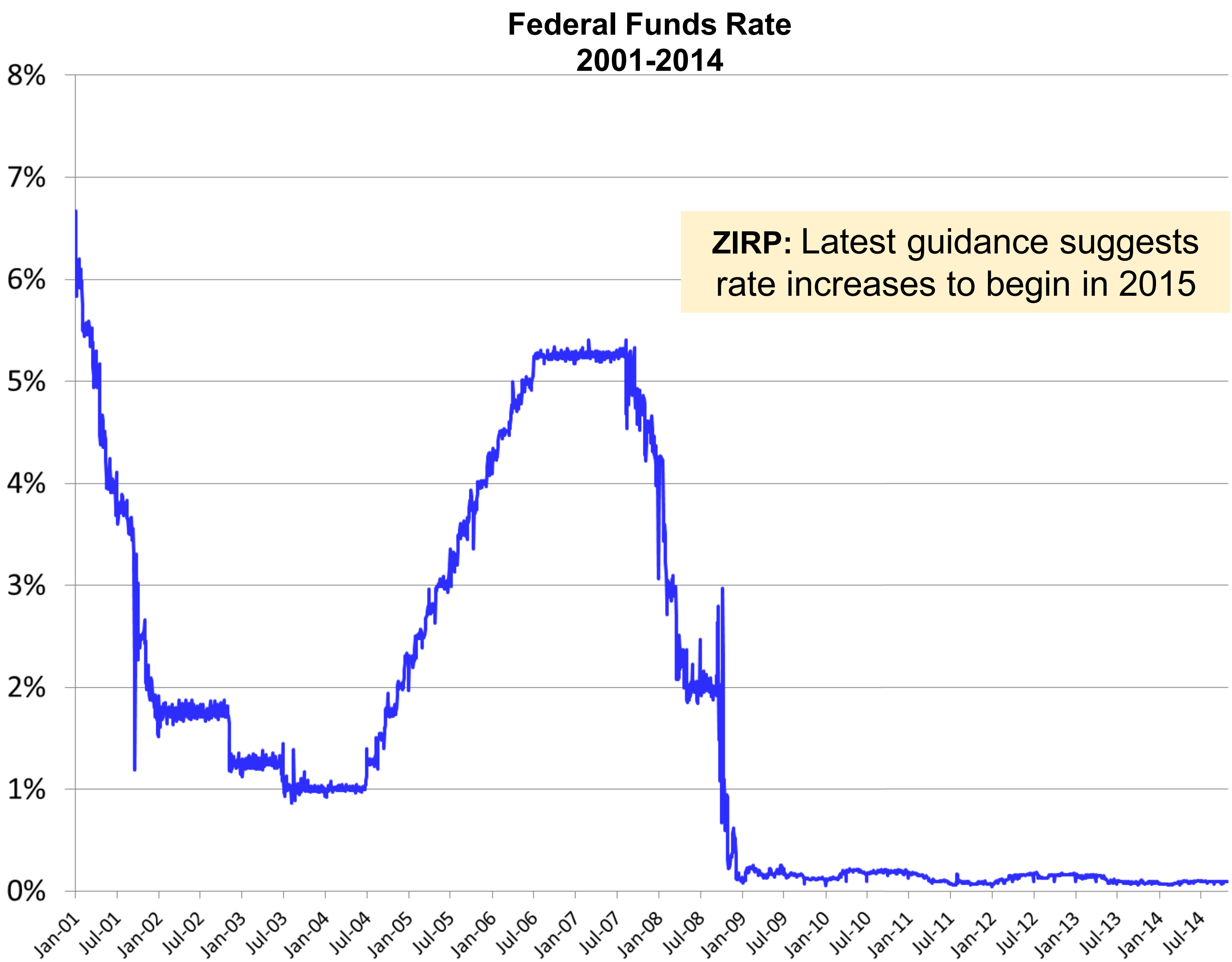
Source: TABB Group, "US Equity Index Derivatives: The Next Phase of Institutional Discovery"

Renewed volatility will also have a measurable impact; recent VIX spikes are providing renewed impetus to trade



Source: Chicago Board Options Exchange

Monetary policy intended to keep interest rates low (ZIRP) are suppressing volatility, what happens when QE3 stops?



Source: Federal Reserve

Key takeaways

- Canada represents an attractive investment target for global investors
  - Importance of natural resource sector both a benefit and a challenge
  - Dependent on global economic recovery; long term prospects positive
- Fiscal conservatism and strength of financial sector are prime attractions
  - Canada is 1 of 9 countries with a AAA rating from 3 major credit agencies
  - Prudent fiscal policy allowed it to emerge from 2008 crisis with little financial fallout
- Global economic recovery will result in renewed investor demand
  - Recovery in commodity and energy sectors will attract investor inflows
  - Shifts in global monetary policy will drive demand for interest rate products
- Derivatives markets have significant room for growth
  - Regulatory pressures to shift trading to central clearing and exchange traded products
  - Higher volatility will incent aggressive trading strategies, especially in listed options
  - Organic growth from domestic investor base exploring the use of derivatives

For more detailed information and a copy of the report, please look out for a post-conference email…

Canadian Derivatives Markets:

Co-Existing in the Shadow of a Giant

The US and Canada are indelibly intertwined. Sharing a 5,525 mile border, acting as primary trading partners and having symbiotic economies that ebb and flow in tandem has resulted in two distinct yet highly correlated capital markets that are actively traded by investors around the world. Although Canadian securities markets operate in the shadow of the world's largest capital market, distinct differences in Canada's marketplace appeal to both domestic and international investors.

Canadian derivatives markets hold special appeal to investors. A thriving domestic investor base is increasingly participating in the listed futures and options markets, even as international regulators seek to move over-the-counter derivatives into central clearing mechanisms and onto organized exchanges around the world. This slow moving but ongoing shift, along with the eventual recovery of global economies, will drive continued growth in Canada's exchange-traded derivatives markets.

Andy Nybo
V12:062
November 2014
www.tabbgroup.com

TABB GROUP

The Evolution of The Canadian Derivatives Market

Andy Nybo
Head of Derivatives Research

Canadian Annual Derivatives Conference
November 17-19, 2014