

Philadelphia Stock Exchange World Currency Options Trading

Currency Option Fundamentals

Currency Market Analysis

Currency Option Trading

Al Brinkman, Director, Derivatives Marketing, Philadelphia Stock Exchange

Jack Crooks, President, Blackswan Capital & Editor, World Currency Options Alert Newsletter



The Underlying Currency Market

Like many other investments, Foreign Exchange trading carries a high level of risk and may not be suitable for all investors

Foreign Exchange trading requires constant monitoring and an understanding of the relationships between currencies, as well as what factors influence the currencies value.

You will need to understand fully the market and some of its unique features.

Any strategies discussed, including examples using actual securities and or price data, are strictly for illustrative and educational purposes only and are not to be construed as an endorsement, recommendation, or solicitation to buy or sell



Trading Currency Options

Options involve risks and are not suitable for everyone. Prior to buying or selling options, an investor must receive a copy of *Characteristics and Risks of Standardized Options*. Copies may be obtained by contacting your broker or The Options Industry Council at One North Wacker Drive, Chicago, IL 60606.

In order to simplify the computations, commissions, fees, margin interest and taxes have not been included in the examples used in these materials. These costs will impact the outcome of all stock and options transactions and must be considered prior to entering into any transactions. Investors should consult their tax advisor about any potential tax consequences.

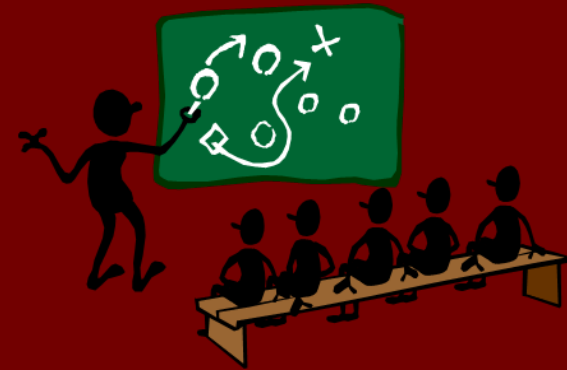
Any strategies discussed, including examples using actual currencies/securities and price data, are strictly for illustrative and educational purposes only and are not to be construed as an endorsement, recommendation, or solicitation to buy or sell securities. Past performance is not a guarantee of future results.



World Currency Option Trading Concepts & Strategies

■ Currency Options

- Utilized to implement a “longer” term view of exchange rate movements
- Possible applications
 - Trending of currency pair
 - Anticipation of economic events or other news
 - Hedging currency exposures
- Provide a leveraged instrument with risk (capital) management capabilities
 - Spreads
 - Long positions



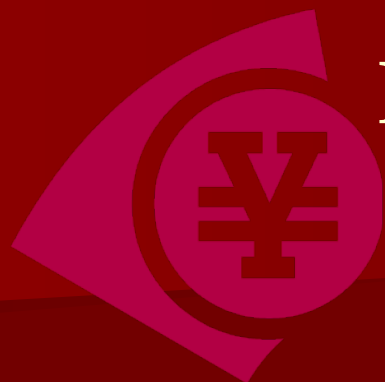
PHLX World Currency Options

- British Pound /Aussie Dollar/ Swiss Franc/Euro/Canadian
 - Trading Symbol XDB – XDA – XDS – XDE - XDC
 - Contract Size 10,000 units of underlying currency (GBP)
 - Exercise Style European
 - Settlement US Dollars
 - Expirations Date Saturday following the third Friday of the Expiration month
- Full Contract Specs found at: www.phlx.com



Note: All examples do not include commissions and are not intended to be recommendations.





PHLX World Currency Options

■ Japanese Yen Options

- Trading Symbol XDN
- Contract Size 1,000,000 units of underlying currency (Yen)
- Exercise Style European
- Settlement US Dollars
- Expiration Date Saturday following the third Friday of the expiration month



Note: All examples do not include commissions and are not intended to be recommendations.






PHLX World Currency Options

- Quoted in terms of terms of U.S. Dollars per unit of the underlying currency (British pounds, YEN, CAD, etc)

EUR / USD ← How many of these does it take
to get one of those



- Long WCO call options – “Long” Foreign Currency / “short” USD – anticipating Foreign Currency to strengthen vs. USD
- Long WCO put Options – “Short” Foreign Currency/ “long” USD – anticipating Foreign Currency to weaken vs. the USD



Note: All examples do not include commissions and are not intended to be recommendations.





PHLX World Currency Options

- Now trade in penny increments!!!
- Effective Jan 2, 2008
- Example:
 - (Old Way) Limit order to buy 10 XDE Mar 147 calls at 1.10 or 1.15
 - (New Way) Limit order to buy 10 XDE Mar 147 calls at 1.11, 1.12, 1.13, 1.14...
 - Tighter spreads, Price Improvement



“Major \$ Scenarios 2008”



Presented by Jack Crooks
President of Black Swan Capital
Editor of World Currency Options Alert



Two Major Dollar Scenarios

- **Orderly Decline #1** – This is what we saw in 2007
 - “Virtuous Circle Down”
 - Dollar Climax (panic) Selling #2 – Still a possibility
 - Dangerous triple-whammy for US assets
- **Dollar Rally #2** – US Centric view
 - Reversals of cyclical and structural stuff



Note:

All examples are not intended to be recommendations.





Dollar Bear Market Drivers In this Cycle

1) Cyclical: Short-term stuff

- Interest Rates
- Economic growth

2) Secular/Structural: Long-term stuff

- Geo-politics and energy
- Global imbalances
- CB reserve reallocation & Pegs





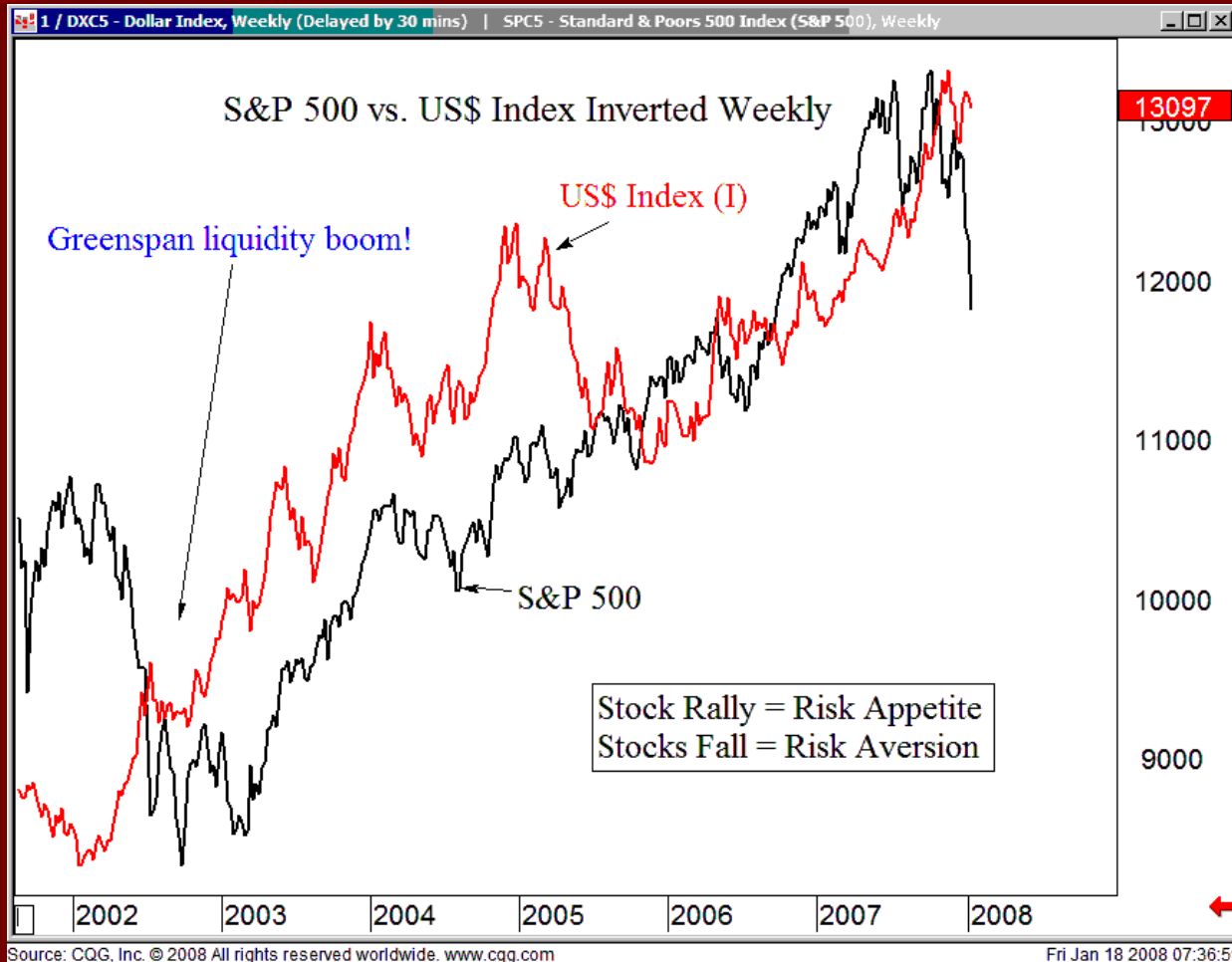
Source: CQG, Inc. © 2008 All rights reserved worldwide. www.cqg.com

Fri Jan 18 2008 07:49:38



Two Environments

- 1) Risk Appetite = Dollar Bear Market
- 2) Risk Aversion = Dollar Bull Market?



Dollar Rally 2008

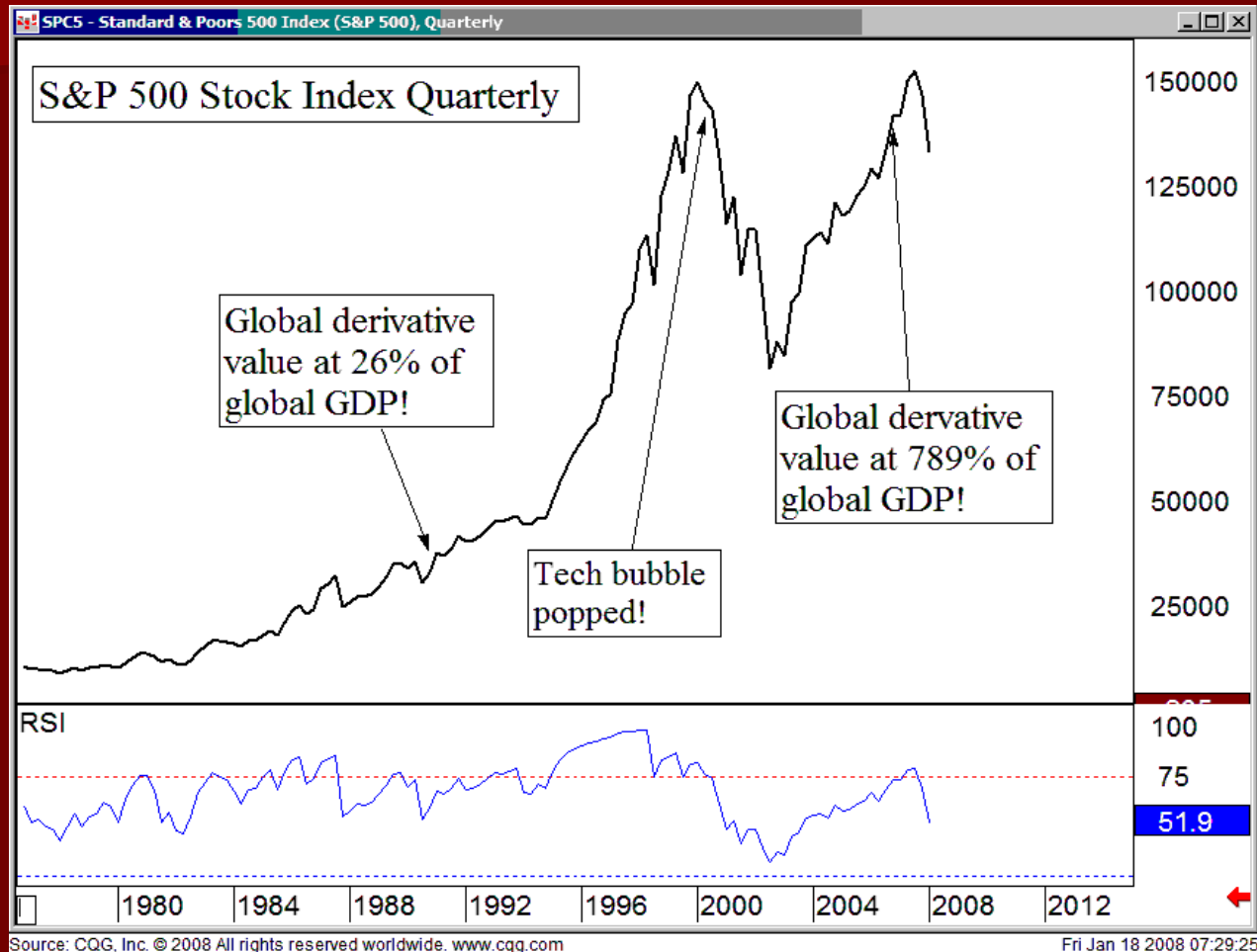
US Centric View

- Credit Wheels Going in Reverse Will Usher in a Sustained Risk Aversion Environment because deleveraging is deflationary.
 - Decoupling idea is history
 - Global growth can't be sustained w/o Mr. US Consumer
 - European economies starting to deteriorate
 - Yield and Growth Differentials Recalibrated
 - US liquidity evaporating
 - Current Account Improvement
 - US Based Fund Managers Hiding in T-paper
 - Crude oil connection could reverse and drive massive dollar buying



Markets Drunk on Credit!

Reverse gear on credit?



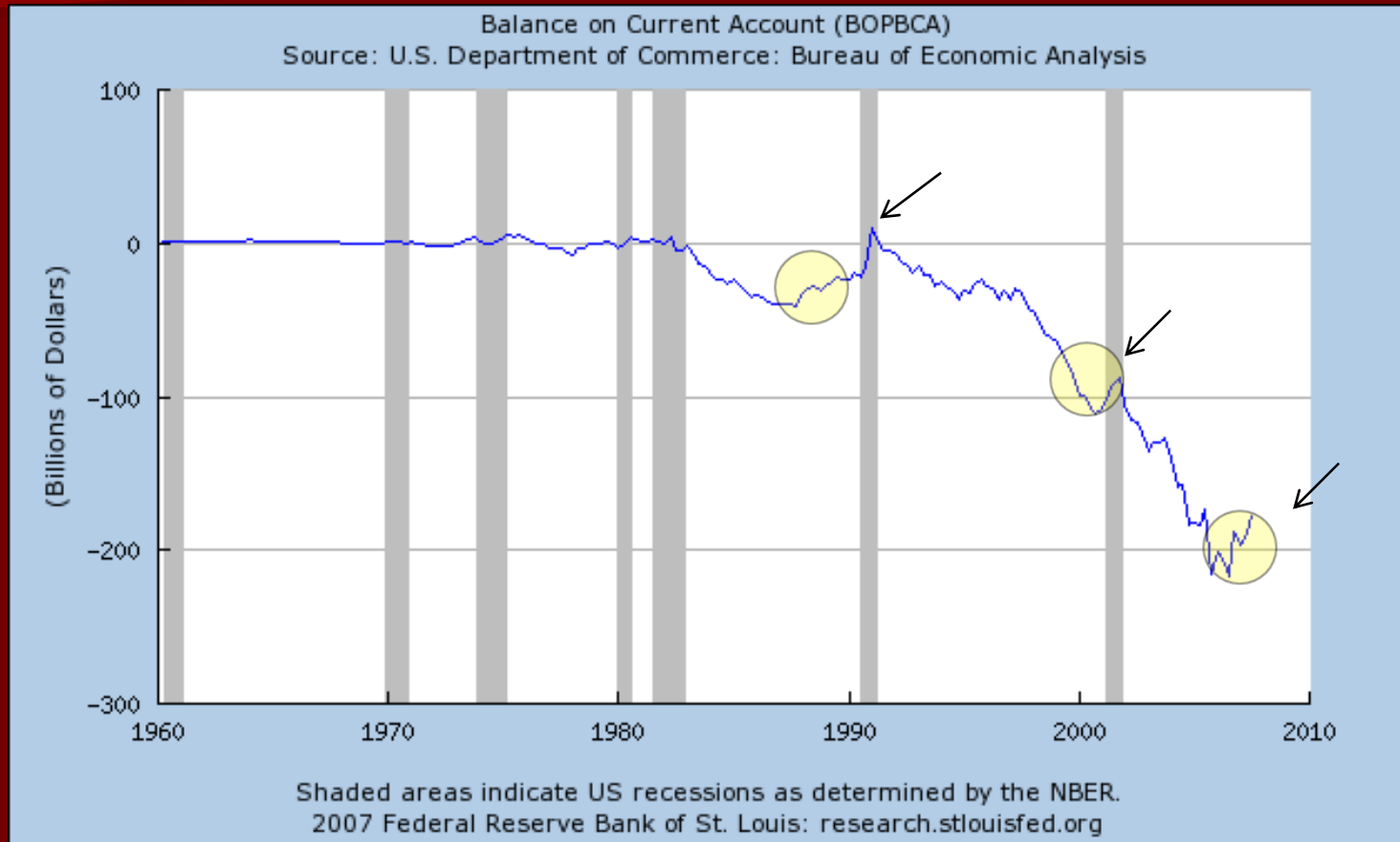
Decoupling Fantasy!

- The dirty little secret of global growth is it will not exist unless the U.S. consumer participates. America's consumption contributes roughly \$9.5 trillion to global trade. That's huge! China, for instance, is responsible for only \$1 trillion; India, less than that! If the U.S. consumer falls off the table, global growth is in big trouble.



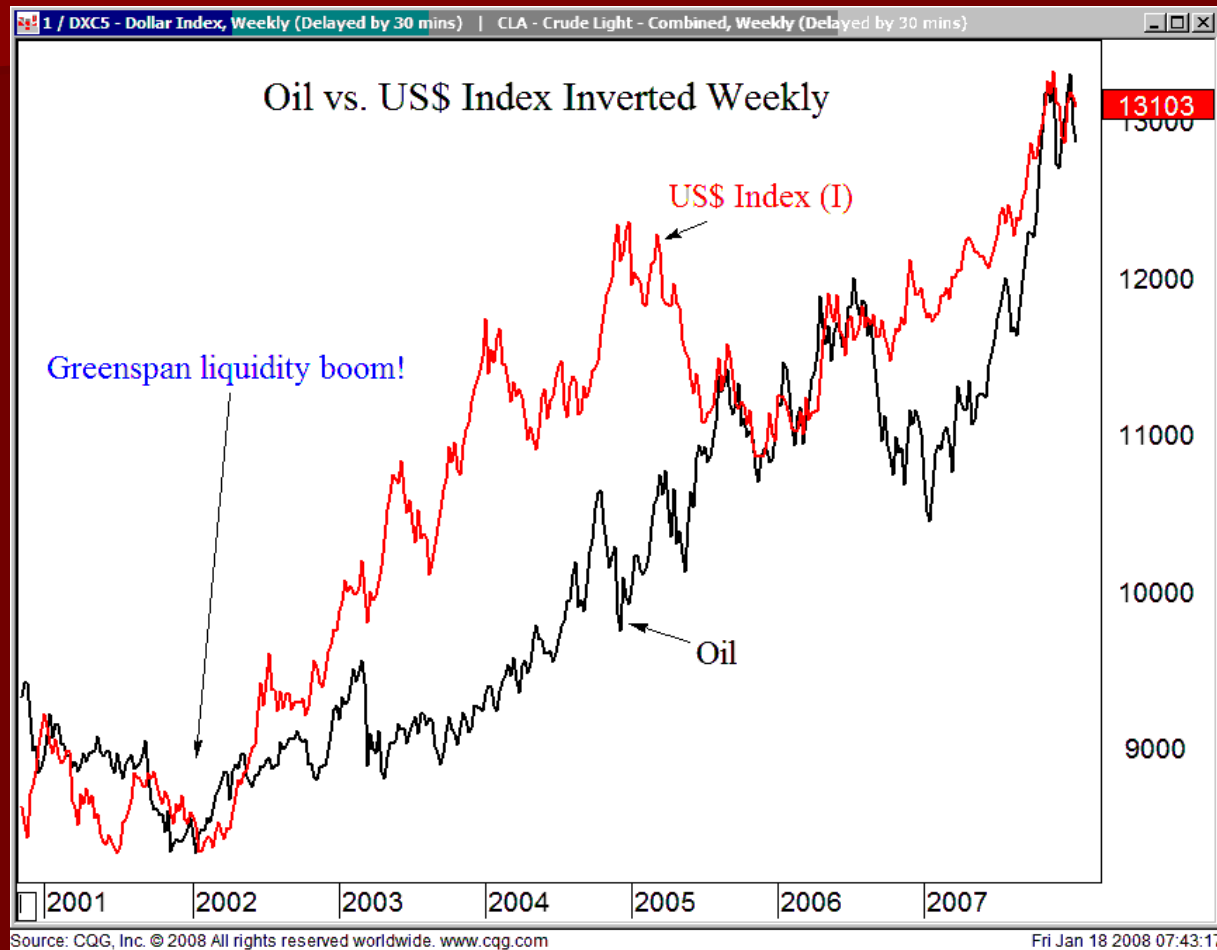
Current A/C Improvement

Be careful what you wish for!



Crude - \$ Connection!

Could be very dollar bullish...



Idea #1: Japanese yen (**Bullish**)

- Most fundamentally undervalued currency
- Yen carry trade unwinding = rocket fuel
 - (In 1998 a 20% in 1-mo. on \$138 billion; now an estimated \$1 trillion)
- Chinese yuan proxy trade

Macro Trigger

Risk Aversion = Carry trade unwind



Japanese yen: 1998 vs. 2007

Asian Financial Crisis vs. Credit Crunch



Target:10000 Time frame: 3-6 months

Note:

All examples are not intended to be recommendations.



Idea #2: British pound (**Bearish**)

- Fundamentally most overvalued $\approx 30\%$ PPI
- UK consumers feeling the strain
- Housing market vulnerable
- Banks have subprime mortgage exposure

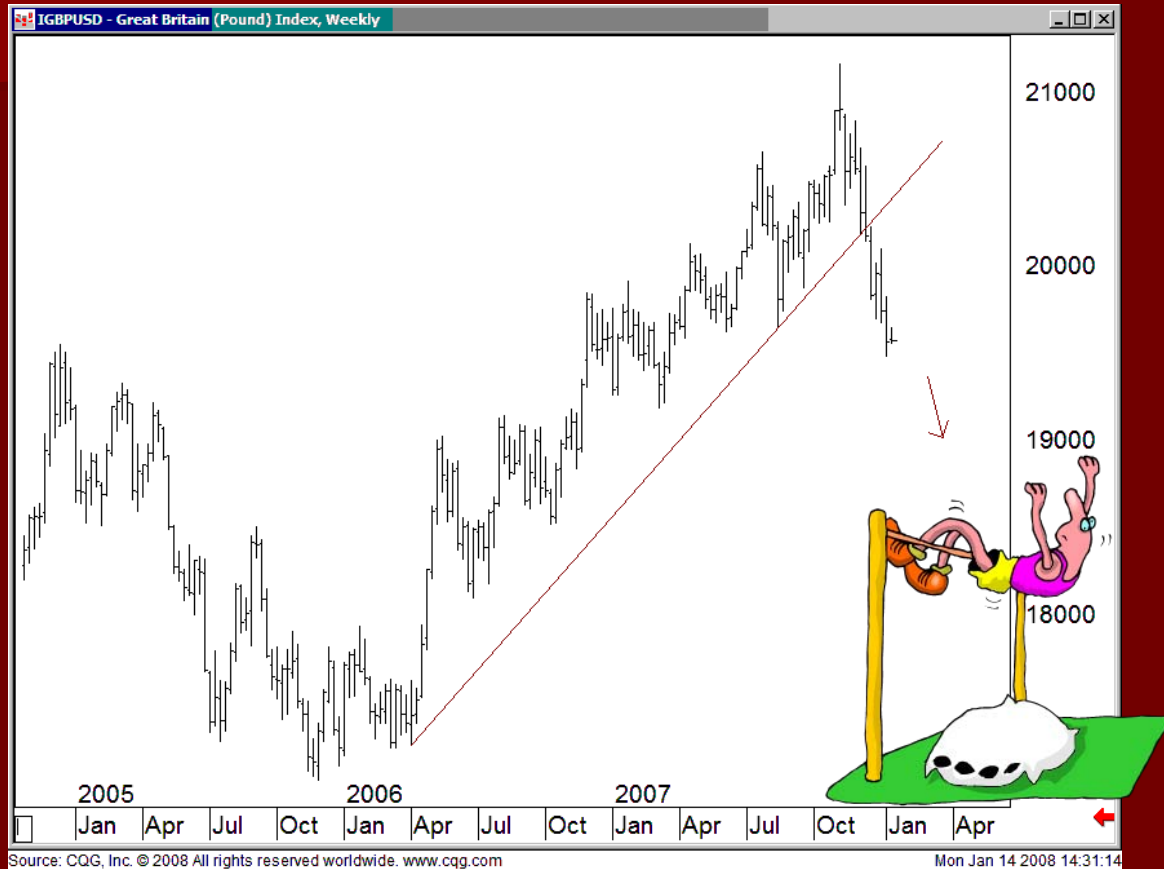


Macro Trigger (s)

Swing in rate and growth expectations



British pound Weekly *Much further to fall...*



...Don't expect a soft landing!

Target: Below 190 Time frame: 3-6 month

Note:

All examples are not intended to be recommendations.



Summary – 2008 Scenarios



- If the US muddles through and the CBs win the credit battle, the dollar is likely to continue lower on cyclical factors – rates and growth.
- If the CBs lose the credit battle, the game could change for a lot of asset classes, and especially the dollar.





Trading PHLX World Currency Options



Trading World Currency Options

- Direction
 - Potential weakness in British pound vs. USD
- How much
 - Target: below 190
- How Long
 - 3 - 6 months
- Volatility
 - Slight increase over current levels



Trading World Currency Options

- **British pound outlook is negative (Pound decrease in value vs. USD) in intermediate term**

- **Long Put Example**

- **Exchange rate 1.9650 (196.50)**

- **(\$1.9650 USD = 1 British pound)**

- **Forward rate 1.9517 (195)**

- **Swap rate to June expiry -133 bp**

- **ATM June option = 1.95 (195)**

The “forward” or swap rate takes into consideration the interest differentials between the two currencies from today and the forward or expiry date of the options

Note:

All examples do not include commissions and are not intended to be recommendations.



Trading World Currency Options

■ XDB Put Option Quotes

■ June 08 195.00 put

■ 4.30 – 4.50

■ June 08 200.00 put

■ 7.20 – 7.40

Note:

All examples do not include commissions and are not intended to be recommendations.



Trading World Currency Options

■ 195.00 Put – analysis

- Cost – (1 Contract) $-4.50 \times 100 = \$450.00$
- Risk in the trade - \$450 per option purchased
- Breakeven: 195 strike minus cost of put 4.50 = 190.50 (195.00 - .0450)
- Approx 1% down move in GBP vs. USD to reach BE

■ 200.00 Put analysis (ITM)

- Cost – (1 contract) $- 7.40 \times 100 = \$740.00$
 - IV=\$3.50 TV= 3.90
- Risk in the trade - \$740 per option purchased
- Breakeven : 200 strike minus cost of put 7.40 = 192.60 (2.000 - .0740)
- Approx 2% Down move in GBP to reach BE

Note:

All examples do not include commissions and are not intended to be recommendations.

Trading World Currency Options

■ Long XDB June 195 Put

- Cost per option 450 ticks or \$450.
- June 195 Put - 47 Δ option
- Move by spot to 1.8900 (189) by expiration
 - Put worth 6.00 (195-189) or \$600 IV
 - Profit on trade @expiry = \$150
 - (600-450)

■ Long XDB June 200 Put

- Cost per option 740 ticks or \$740
- June 200 Put 63 Δ
- Move by spot to 1.8900 (189) by expiration
 - Put Worth 11 (200 – 189) or \$1100 IV
 - Profit on trade @expiry \$360
 - (1100 – 740)



Trading World Currency Options

Long Yen Calls



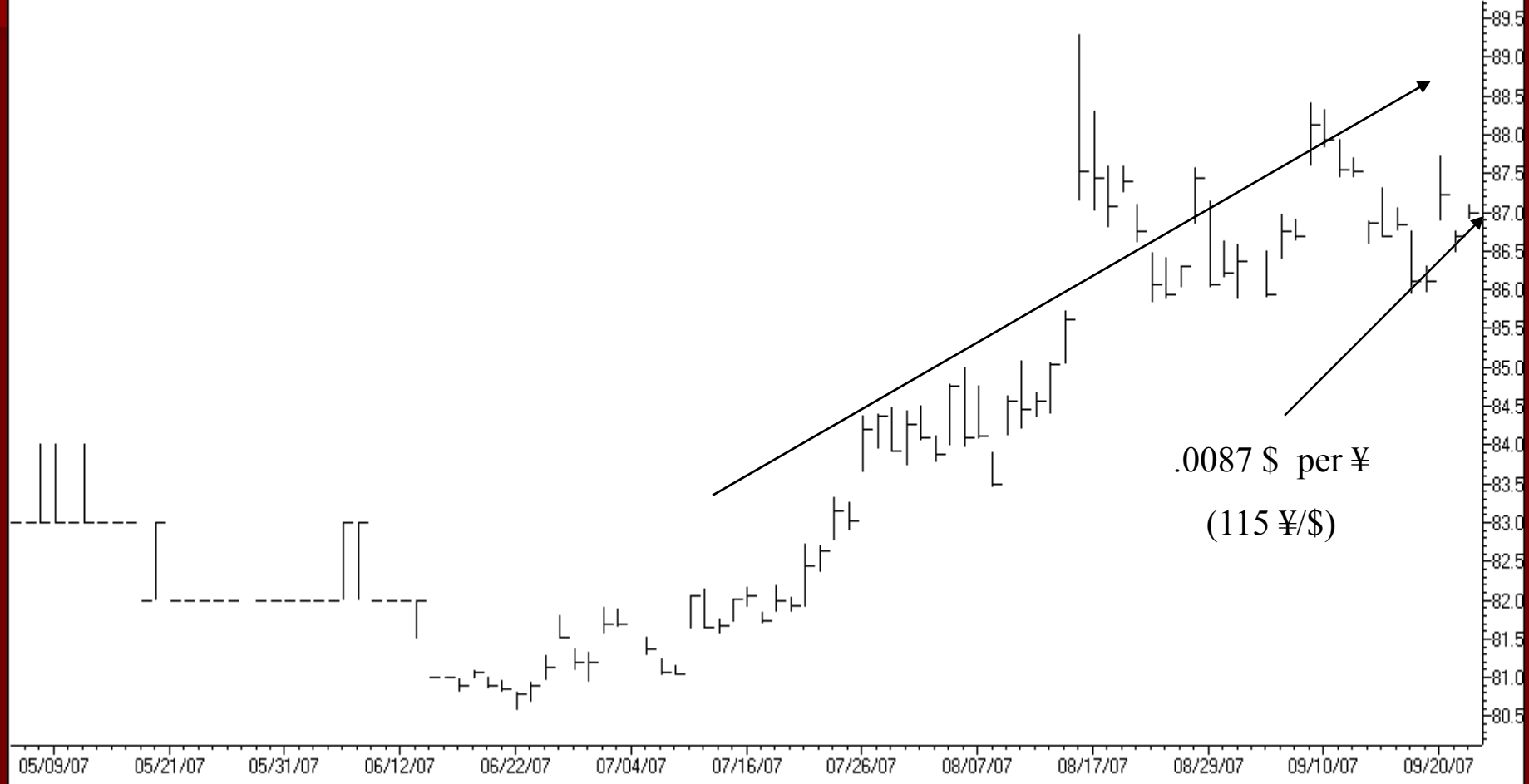
Trading World Currency Options

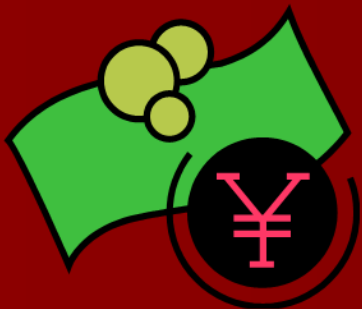
- Direction
 - Potential strength in Yen vs. USD
- How much
 - Target: 1.0000 (+)
- How Long
 - 3- 6months
- Volatility
 - Slight increase over current levels



PHLX – Yen Quoting – USD per Yen

Daily > XDN-X C: 86.98 Chg: 0.28





Trading World Currency Options

■ Long Yen Call Example

- Current Spot .009290 Current Forward Rate .009410
- ATM Vol: 11.4%
- View:
 - Bullish on Yen vs. USD in intermediate term
 - Want to take a position with limited risk and cash outlay
- Action:
 - You buy the XDN June 94 PHLX World Currency call for \$2.80 (\$280- per contract)





Note: All examples do not include commissions and are not intended to be recommendations.

Trading World Currency Options

Spot Value at Expiration	Long 94 Call Value at Expiration	Long 94 Call Initial Cost	Total Profit (Loss)
1.0200	8.00	(\$2.80)	\$5.20
1.0000	6.00	(\$2.80)	\$3.20
. 9900	5.00	(\$2.80)	\$2.20
. 8900	0	(\$2.80)	(\$2.80)
. 8700	0	(\$2.80)	(\$2.80)
.8500	0	(\$2.80)	(\$2.80)



Trading World Currency Options

■ Review & Summary

- PHLX World Currency Options (WCO) can be traded in an options approved account (approved for foreign currency options)
- All option strategies can be done with WCO (except the covered call)
- Expiration is the same as equity options
- Expiration style is European
- Long WCO call = Long Foreign Currency/Short USD
- Long WCO Put = Short Foreign Currency/Long USD
- Options are US Dollar cash settled (think index options)



Thank you!

Additional Information

- World Currency Options Alert Service
 - Weiss Research
 - www.moneyandmarkets.com
- Philadelphia Stock Exchange World Currency Options
 - <http://www.phlx.com/market/WorldCurrencyOptions.asp>
 - www.phlx.com
 - **?Questions?: currency@phlx.com**
- Black Swan Capital
 - www.blackswantrading.com
 - info@blackswantrading.com

