7:00's Report

"Everything you need to know about the markets by 7a.m. each morning, in 7 minutes or less."™

January 22nd, 2014

Lost in the frustration that the S&P is flat YTD, the Russell 2000, Dow Transports and Nasdaq all made new all-time or 52 week highs yesterday.

Pre 7:00 Look

- Futures are flat this morning after a night of little market moving news.
- The Bank of Japan monetary policy meeting yielded no real surprises, as there was no change to policy.
- UK stocks are slightly lower while the Pound rallied after the December Labour Market Report beat estimates, and the latest BOE minutes were slightly "hawkish."
- Earnings Today: UTX (E: 1.53), USB (E: 0.75), EBAY (E: 0.80), NFLX (E: 0.65), RJF (E: 0.73).
- Econ Today: No Reports Today.

Market	Level	Change	% Change
S&P 500 Futures	1836.50	-2.00	-.11%
U.S. Dollar (DXY)	81.175	-.046	-.05%
Gold	1241.40	-0.40	-.03%
WTI	95.45	.48	.51%
10 Year	2.821	-.006	-0.21%

Equities

Market Recap

The S&P 500 see-sawed from positive to negative and then back to positive again Tuesday during a deceptively slow and unexciting session. The S&P 500 closed up 0.28%.

Stocks opened the holiday-shortened week higher, helped by strength in Asia and Europe, but once again failed to get materially above the 1,850 level in the S&P 500. And, once stocks again failed to break through that resistance around 11 a.m., the averages saw a sharp drop into negative territory and the lows of the day.

But, the selling was never very convicted, and sellers didn't press into the afternoon. Stocks gradually started to lift and the S&P 500 closed ever-so-slightly positive.

There weren't any catalysts other than earnings yesterday, and like last week the results were mixed. But, as has been the case for over a week, a decline in one sector of the market (for instance industrials, which saw follow-through selling from GE's miss on Friday) isn't really affecting other sectors of the market, as correlations continue to decline and the market focuses on the micro vs. the macro.

Trading Color

Continuing the trend of cyclical outperformance, the Nasdaq hit a new 52-week high and the Russell 2000 hit a new all-time high yesterday, rallying 0.6% each, while the Dow fell 0.27%, mostly thanks to weakness in JNJ, TRV and VZ.

Given we're in the heart of earnings season, results are

Market	Level	Change	% Change
Dow	16414.44	-44.12	-.27%
TSX	13951.77	-38.52	-.28%
Brazil	48542.07	-166.34	-.34%
FTSE	6826.17	-8.09	-.12%
Nikkei	15820.96	25.00	.16%
Hang Seng	23082.25	49.13	.21%
ASX	5319.77	-11.70	-.22%
Prices taken at previous day market close.			

largely responsible for the sector trading. Banks were the best-performing S&P 500 sub-sector, as there was follow-through buying in the regionals off last week's strong earnings. Materials stocks also saw nearly a 1% rally thanks in part to JPM's upgrade of AA. Airlines were also very strong thanks to DAL's strong report (the Dow Transports also hit a new all-time high).

Market	Level	Change	% Change
DBC	24.96	.05	0.20%
Gold	1242.10	-9.80	-0.78%
Silver	19.87	-.434	-2.14%
Copper	3.347	.0025	0.07%
WTI	94.83	.46	0.49%
Brent	106.62	.27	0.25%
Nat Gas	4.425	.099	2.29%
RBOB	2.6225	.0021	0.08%
DBA (Grains)	24.122	-.038	-0.16%
Prices taken at previous day market close.			

On the negative side, industrials, weighed down by continued disappointing earnings, homebuilders and retail (which continues to get hammered) all finished in the red.

Finally, very quietly utilities have had a nice January, and the XLU is one of the better-performing ETFs year-to-date, up 1.3%. Utilities—which were widely expected to have a bad January—have been resilient and I think this likely has made any utility shorts nervous, and helped keep some money in the sector that otherwise would have rotated out. But, I'd expect this to be temporary, given my belief that the bond declines will resume sooner rather than later. So, despite the nice start to the year, I would not be allocating new money to utilities right now.

On the charts the picture for the S&P 500 was little-changed (resistance at 1850) although it is a bullish sign that the Nasdaq, Russell 2000 and Dow Transports all made new highs today.

Bottom Line

The market dynamic remains the same. Cyclical sectors are making new highs (which is bullish), although there is frustration that the S&P 500 is basically flat year-to-date. Earnings season, ex-banks, isn't off to a great start. But it's still very early and so far the results aren't bad enough to spook the broader averages, although risks obviously remain.

Bottom line is the path of least resistance remains higher for stocks. With the flash PMIs looming tomorrow morning I would expect a relatively quiet day. 1850 in the S&P 500 seems to be a new key level, and although I don't think it'll happen today, a break through that resistance could result in buyers once gain chasing to the upside.

Did We Just Find a Canary in a Chinese Coal Mine?

At the end of January, a "bank trust" investment product in China is expected to default. While it's a relatively small product (3 billion yuan or about $490 million), there's the possibility the default could have negative ramifications for the Chinese banking sector.

To give a bit of background, these "bank trust" products are high-risk investments, usually in property or mining projects. They are created by a trust company and sold through banks to high-net-worth individuals.

The specific trust in question, known as "Chengzhijinkai No. 1," was supposed to invest in a coal mine. But, the head of the project promptly absconded with the money, and currently inhabits a small cell somewhere in China. Point being, though, is the "bank trust" is maturing and there is obviously no money. So, it will default.

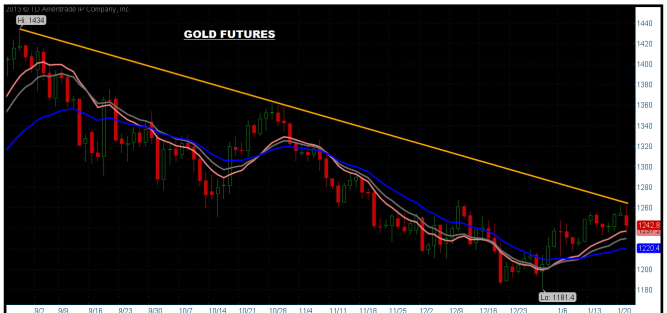
The fact that one of these trusts is defaulting isn't really news. What is news, however, was that last week the Industrial and Commercial Bank of China (ICBC), who sold this specific trust through its branches, said it won't make investors whole, and that they will take losses. Keep in mind that ICBC, like all big banks in China, is owned by the government. So, in effect, the government isn't going to bail out the investors in the trust, which is unusual.

To really understand why this is important, it has to be viewed in the context of ongoing Chinese financial reforms. This is seen as the first real test of Chinese leaders' resolve to institute financial reforms by letting the trust default, and thereby improve the pricing of risk. (As we know, risk gets priced differently when there's an implicit government guarantee.) But, there are potential risks to that strategy.

These trusts are part of a large class of investment vehicles known as "Wealth Management Products." The

"China bears" believe that a lot of the WMPs aren't worth anywhere near what they are valued at. This, combined with other off-balance-sheet products, constitute a "Shadow Banking System" that is a ticking time bomb for the Chinese economy.

The China bears fear (or hope) that if "Chengzhijinkai No. 1" goes belly-up, it'll cause all these WMPs to be "marked to market"—which could have a significant negative effect on Chinese banks' balance sheets and profitability. Even if that doesn't happen and the trust investors are made whole, there is the concern that investors will get spooked and stop investing in these types of vehicles or even demand their money back. This could cause many bank trusts to decline in value, and make the situation worse.



Gold: Despite the recent rally, gold remains capped by a multi-month downtrend, and it'll take an uptick in inflation expectations to break through it.

The macro and China bears want to extrapolate this one trust out to highlight the significant risk to the Chinese financial system from this "Shadow Banking System." But, to their disappointment, I doubt this will have the systemic ripples they think it will. More than likely, the investors will be bailed out by a combination of the issuing company (China Credit Trust), ICBC and some government office. But, regardless of the systemic implications, it's reasonable to assume this is not positive for Chinese bank stocks given the potential risks going forward.

From a "why should I care" standpoint, this could be a further negative for FXI, the main Chinese stock ETF, seeing as more than 50% of its holdings are in financial services. Bottom line is the China bears are always looking for the next systemic calamity in China, and one day they may very well be right. But, while this trust default likely isn't it, it is something to watch. That's because it will almost certainly put further pressure on any Chinese ETFs, as financial services likely make up a large portion of the holding. Point being, until this is worked out, I'd avoid the temptation to buy China on this dip.

Market	Level	Change	% Change
Dollar Index	81.235	-.127	-0.16%
EUR/USD	1.3556	.0006	0.04%
GBP/USD	1.6476	.0047	0.29%
USD/JPY	104.24	.08	0.08%
USD/CAD	1.0977	.0033	0.30%
AUD/USD	.8798	-.0011	-0.12%
USD/BRL	2.3626	.0186	0.79%
10 Year Yield	2.821	-.006	-0.21%
30 Year Yield	3.737	-.020	-0.53%
Prices taken at previous day market close.			

Economics

There were no economic reports yesterday.

Commodities

Commodities were mixed yesterday as weakness in the precious metals offset gains in energy. The benchmark commodity tracking ETF, DBC, ticked higher by 0.2%.

There was broad strength in the energy space yesterday as crude oil, RBOB gasoline, heating oil, and natural gas all posted gains. Natural gas was the best performer, adding 2.29%, the largest one-day rally since mid-December. The move higher, as you would expect, was mostly a result of expected, continued frigid weather.

In the short term, natural gas futures are nearing the top of the range at $4.53, and it'll likely take another huge draw in supplies to break above that level, so we could be in for a short-term pullback. But, natural gas does indeed remain in a well-defined uptrend and the contract remains in backwardation (a sign of very strong demand) through January 2015. I continue to want to accumulate natural gas equity ETFs, either FCG or XOP, on dips.

Crude oil futures rose 0.49% yesterday in a session primarily dominated by algos and technical traders. However, the better-than-expected economic data in China, as well as the IEA increasing its demand forecasts for developed economies for the first time since 2010, supported prices.

The takeaway here is that both of these data releases are supportive of the global reflation trade and basically, as we see the world's leading economies continue to grow, we can expect demand to increase accordingly. On the charts, crude oil futures are still a mess. Technicals show a weak short-term trend higher since the lows of last week. But, until crude futures make a material move one way or another, we are stuck in a holding pattern here in mid-$90s/bbl. range.

Gold and silver were the worst-performing commodities yesterday, falling by 0.95% and 2.21%, respectively. The moderate sell-off was initiated by gold prices running into that downtrend line we mentioned in yesterday's Report. The selling pressure increased thanks to a stronger dollar early in the day, which took out a handful of weak traders' "sell stop" orders. This sent the spot price of gold below $1,240 for part of the day.

However, gold was able to rally off the lows and close above $1,240, which will act as the first line of support for the very short term.

As far as demand for precious metals goes, the Commitments of Traders report released by the CFTC indicates that bullish bets on gold and silver by money managers increased last week. Net long positions rose by 16.6% in gold and 16.45% in silver—indicating a healthy, steady rise in buyer interest. That's a big contrast to the contrarian indication we were getting back in early December when the market was being "over-shorted."

Simply put, the levels of "net longs" in gold aren't screamingly bullish like they were, but they are still pretty depressed. On the charts, major support lies at the $1,200 level, where I continue to recommend taking a shot on the long side with stops just below $1,180. Meanwhile, the level to break through to make a run higher is between $1,255 and $1,260.

Currencies & Bonds

The Dollar Index initially rallied Tuesday but then reversed mid-morning to close slightly lower (down 0.17%). The reason for the volatility wasn't because of the dollar; it was because of the euro.

The soft ZEW business expectations index weighed on the euro early, but then short-covering started ahead of the flash PMIs that are released tomorrow. As the euro rallied from modestly negative to modestly positive (the euro finished up 0.22% vs. the dollar), the Dollar Index sold off. Really, though, trading in both currencies was more about short-term positioning than anything else. The much-larger question about what, if anything, the ECB will do next to combat dis-inflation remains unanswered. Until it is, the euro remains relatively trendless.

The biggest winner vs. the dollar yesterday was the Aussie, which rallied 0.5% thanks to the in-line Chinese economic data, which in turn prompted a small short-covering rally. Looking at the other commodity currency, the "Loonie," it was flat ahead of the Bank of Canada's rate meeting today at 10 AM. Given the beating both commodity currencies took last week, as I mentioned we could see a decent bounce post BOC meeting and global flash PMIs, but those would be bounces to short.

Turning to the yen, it was flat yesterday and remains so this morning as the January BOJ meeting yielded few surprises. The meeting statement did highlight the fact that the rise in inflation has slowed, and some are taking that to imply we will see more stimulus from the BOJ in the coming months, but that's what the market expects already, so there wasn't much effect on the yen.

Treasuries were also little-changed yesterday, as bonds continue to consolidate ahead of the next major set of macro catalysts (the FOMC meeting next week and the January jobs report). The 30-year rallied small, thanks in part to the Fed buying $1.390 billion worth of 30-year bonds, while the 10-year finished very slightly lower. The short end of the curve was little-changed, so we did see miniscule flattening of the yield curve, although it wasn't consequential.

Bonds continue to consolidate ahead of the next strong of macro catalysts (flash PMIs tomorrow, January FOMC meeting next week, January jobs report in two weeks).

Have a good day,

Tom

The 7:00's Report Asset Class Dashboard

(Outlook on the primary trend for major asset classes over the next month)

	Fundamental Outlook	Technical Outlook	Overall	Comments
Stocks	**Neutral**	**Bullish**	**Bullish**	*After a sluggish start to 2014, stocks once again moved to new all time highs last week. Skeptical sentiment towards the rally and a strengthening economy remain tailwinds on the market, and as long as the short end of the yield curve remains anchored, the path of least resistance remains higher.* *Resistance appears to be forming at 1850, while support lies at the 20 day MA (1834).*

Trade Ideas

Long Japan: **The yen has broken through 104 yen/dollar level, and DXJ is at multi-month highs. Although we could see a pause, that trend should continue over the coming months, and there remains more money in this trade.**

Long Deep, multi-national Cyclicals and Global Miners: **Domestically, I'd look to allocate to deep cyclicals like industrials (XLI), basic materials (IYM) and global industrial miners (PICK). It's a bit of a contrarian idea, and over the past few weeks these sectors have lagged. But, they most exposed to the "global economic recovery" thesis.**

Long Natural Gas E&Ps: **Term structure in the natural gas markets has turned bullish, as its in backwardation out nearly a year, implying a structural increase in demand. But, natural gas equities remain under pressure, and could potentially offer some value in the market over the medium/longer term. FCG and XOP are the two "pure play" ETFs in the natural gas E&P space.**

Commodities	**Bullish**	**Neutral**	**Neutral**	*The outlook for commodities remains mixed, as the global economy remains mired in stagnant growth. Given the severe underperformance of commodities this year, though, the asset class remains on of the last corners of value in the market, if the global recovery can accelerate.*

Trade Ideas

Long Industrial Commodities: **Industrial commodities have stalled lately, as economic data, especially in the US, has shown a loss of some positive momentum, and it bears close watching as to whether this is a temporary blip, or a bearish game changer. But, if you believe the global economy Is recovering, the commodity space, and the ETF DBC, is one of the best "values" in the market, and a pretty contrarian idea right now.**

Long Gold: **I'm dipping back into the well here with the gold trade. The near term outlook is mixed to negative, but medium term I think $1200 represents a fair risk/reward set up on an acceleration of inflation. I would initiate a small long position around the $1200 level with a stop at the old lows ($1179).**

U.S. Dollar	**Neutral**	**Neutral**	**Neutral**	*The Dollar Index traded to a new 2 month high last week, while the euro looks to be breaking a 6 month long uptrend. Given the threat of dis-inflation in the EU, though, I remain skeptical we'll see material euro weakness in the near future.*

Trade Ideas

Short: **Japanese Yen. The yen has been supported mostly by extreme dollar weakness, and with tapering expectations being pulled forward, the yen should resume its decline vs. the dollar. YCS remains the best non-futures way to play the trade.**

Treasuries	**Bearish**	**Bearish**	**Bearish**	*With the Fed tapering QE and shift to "forward guidance" as the main policy tool, the case for the bond bears has gotten stronger. Continue to short any rallies in the bond market.*

Trade Ideas

Buy: **TBF (unleveraged short 20+ year Treasurys) and TBT (2X leveraged short 20+ year Treasury). Finally, with the Fed committed to holding down near term rates, the yield curve will steepen dramatically, so STPP should continue to do well.**