7:00's Report

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

January 24th, 2014

Pre 7:00 Look

- Futures are decisively lower and most international markets saw sharp declines as selling continued overnight.
- Weakness in the emerging markets is being blamed for the sell off o/n but mostly this is just a continuation from yesterday, as China remains the key concern.
- There was no econ data o/n nor any domestically today.
- With emerging markets in focus, watch CEW, EMB and PCY today as they are the gauge of EM health.
- Earnings Today: BMY (E: $0.43), HON (E: $1.22), PG (E: 1.22), XRX (E: $0.29).

Market	Level	Change	% Change
S&P 500 Futures	1809.25	-15.00	-.84%
U.S. Dollar (DXY)	80.31	-.215	-.27%
Gold	1269.80	7.50	.60%
WTI	96.88	-.44	-.45%
10 Year	2.773	-.087	-3.04%

Equities

Market Recap

Stocks fell sharply Thursday as soft economic data from China and the U.S. as well as emerging-market concerns weighed on the averages. The S&P 500 fell 0.89%.

The "macroeconomic" returned Thursday with a vengeance to dictate market action. Equities were lower to start trading yesterday, thanks to the soft Chinese manufacturing PMIs, but then took another leg down after U.S. manufacturing PMIs missed estimates. Stocks hit their lows shortly before 1 p.m. on reports that Argentina may be facing another default crisis. Finally, to boot, the "debt ceiling" popped back up again, as Treasury Secretary Lew sent a letter to Congress saying the U.S. would run out of borrowing capacity in mid-February, earlier than expected.

Stocks stabilized around 1 o'clock when the litany of negative news finally stopped, and slowly drifted higher into the close to finish off the lows. Despite the drift higher, there was no attempt by the bulls to rally the market yesterday, which makes yesterday's sell off a bit different than recent ones. So, with futures down again this morning, it's going to be interesting to see if buyers step in shortly after the open.

Trading Color

From an internals standpoint, despite the large nominal drop in markets, we didn't see typical "risk off" trading as the more-cyclical indices outperformed. The Nasdaq was actually the best relative performer of the major averages, falling just 0.59%, while the Russell 2000 also relatively outperformed the S&P 500 and the Dow (which was *again* the laggard, down 1.07%). So, the fact that we didn't see that textbook cyclical underperformance is notable and encouraging.

Sector-wise, earnings took a backseat yesterday and instead we saw some of the biggest recent outperformers lag the market, implying the selling was more profit-taking than anything else.

Banks, airlines, Internet stocks and biotechs all badly underperformed, while defensive sectors like utilities and telecom relatively outperformed but still finished negative. Oddly, homebuilders were about the only sector to finish green yesterday (and barely so) as they were helped by the in-line existing home sales number.

Volumes and activity definitely picked up yesterday, as

Market	Level	Change	% Change
Dow	16197.35	-175.99	-1.07%
TSX	13932.97	-55.23	-.39%
Brazil	48320.64	-979.02	-1.99%
FTSE	6709.75	-63.53	-.94%
Nikkei	15391.56	-304.33	-1.94%
Hang Seng	22450.06	-283.84	-1.25%
ASX	5240.93	-22.06	-.42%
Prices taken at previous day market close.			

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things were busy during the morning session as both fast money hedge funds and vanilla mutual funds were selling. The selling was dominated by the fast money shops, but even so I think it's worth noting that there was some "real money" selling yesterday.

On the charts look for support at 1812 this morning (the 50 day MA). If that breaks, selling could accelerate.

Bottom Line

Yesterday was a nasty day but needs to be kept in perspective. First, it wasn't even the worst day of the year (two Mondays ago, the S&P 500 fell more). As disappointing as the start of 2014 has been, the S&P is down just 1.1% and the Russell and Nasdaq are both positive.

The China situation is concerning and seems to be turning into a bit of a game of "Whac-A-Mole," as one problem subsides (liquidity crunch), and another pops up (growth concerns). But, at this point China probably seems worse than it is given the perma-China bears screaming "This is It!" and "It told you so!" all over the TV yesterday. Chinese growth and liquidity remain a macro risk, but keep in mind Chinese policy-makers aren't about to let the economy implode while they try to implement structural reforms.

In truth, yesterday's selling seemed like it came more out of frustration toward the market's inability to continue the '13 rally than anything else, and the "reasons" listed earlier for the sell-off were more excuses. China we covered, the U.S. PMI miss wasn't bad, and if the threat of an Argentinian default had the ability to break rallies, we would know from one of the other times the market has dealt with this issue over the past few decades (Argentinian default isn't exactly something new).

Bottom line is investors are more frustrated thank bearish, and we are all waiting for a positive catalyst, and right now there just aren't any. (Earnings season isn't really bad, but it's not a positive catalyst, either, given valuations.)

Given that the macro back drop, excepting China, remains largely supportive, I view this as a continuing consolidation in an upwards trending market, and wouldn't de-risk materially until something, technically or fundamentally, changes.

Market	Level	Change	% Change
DBC	25.07	-.02	-.08%
Gold	1262.40	23.80	1.92%
Silver	20.03	.19	.94%
Copper	3.28	.06	-1.72%
WTI	97.29	.57	.59%
Brent	107.20	.11	.10%
Nat Gas	4.74	.05	1.09%
RBOB	2.66	.02	.60%
DBA (Grains)	24.27	.09	.37%

Prices taken at previous day market close.

Economics

There were multiple pieces of economic data out yesterday, but only one was market-moving. Weekly jobless claims and December existing home sales met expectations, and neither altered the outlook for the labor or housing market. The labor market has basically stayed status quo since August, while the housing market has seen the recovery slow over the past several months, but there are signs that the pace of recovery is stabilizing. The economic report that did move markets yesterday was the December flash manufacturing PMIs.

'Flash' Manufacturing PMIs

- December flash Manufacturing PMI 53.7 vs. (E) 55.0

Takeaway

The December PMIs were soft compared to very high readings in December, and although the market seemed to key on the "miss" vs. expectations, overall the PMIs are still at good levels. So, the takeaway here is that the PMI wasn't as bad of a number as it seemed yesterday. That said, clearly there was slowing in the pace of growth in the manufacturing sector, as both the headline and most major sub-components (including New Orders) declined. But, again, the headline and all the important sub-components remained above the 50 level, signaling growth.

Some slowing was expected in January (the economy was humming along at a somewhat unsustainable rate late in '13) and that's what the number represents—not an increasing threat of a slowing in growth. (The same can't be said, though, for China.)

Commodities

Commodities were mostly higher Thursday as precious metals and energy rallied, while copper fell thanks to a

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weak U.S. dollar and soft Chinese manufacturing PMIs.

Gold was the big winner in the commodity space yesterday, rallying more than 2% to close at a six-week high. There were multiple reasons for gold's rally (the weaker U.S. dollar, soft flash manufacturing PMI), but really the key catalyst was the progression of worry toward China. (It's part of the reason that gold rallied more than silver yesterday, 2% to 1%.) As worries about Chinese liquidity and the pace of economic growth grew throughout the day, gold extended its gains and finished at the highs of the day.

Gold has now technically broken above that downtrend line I referenced earlier this week, but I've learned the hard way that buying gold when it rallies as a "crisis hedge" is a bad idea, as most crises never materialize. So, while the price action is positive, I'd like to see a few more closes above this downtrend line before getting enthusiastically bullish.

Staying in the metals, copper was the worst-performing commodity yesterday, dropping 1.5% off the disappointing Chinese PMI data. Copper is now sitting right at key support at $3.29, and a material break of this level would be a negative sign for the global macro-economy.

Turning to energy, it took a backseat to the metals on a volatility basis yesterday, but that doesn't mean interesting things didn't happen.

WTI crude extended its rally, rising by more than 1% to close just under $98.00/bbl. Crude rallied thanks to weekly inventories showing a slightly smaller build than expected (1 million vs. 1.2 million). Also helping crude was strength in heating oil, which remains in short supply and undoubtedly is putting some upward pressure on WTI as the market incentivizes refiners to produce product.

Also in energy, the Brent/WTI spread, which is a loose proxy for refiner margins, dropped below $10 for the first time in months yesterday. So, that's a peripheral negative for the refiners, if you own any. (And it'll become much more negative if the spread continues to compress, so this may be a time to book some profits.)

Finally, natural gas extended its rally for a fourth-straight day yesterday, although it closed up "just" 1.8% after trading up as much as 3.5%. The weekly inventory data showed an inventory draw of 107 Bcf, slightly below the 110 Bcf expectation. But, as always the market is looking forward, and really the next market-moving inventory report will be next week, as that will reflect this week's frigid temperatures. We could easily see a dip in natural gas early next week as late longs book profits ahead of that inventory report. But, any material weakness in FCG and XOP as a result of that would be a buy.

Currencies & Bonds

Currency markets were again busy yesterday, even away from the Argentina news (more on that later). The euro had a huge rally yesterday (up 1%), thanks to short-covering following the stronger-than-expected flash EU Manufacturing PMIs. Not only was the aggregate EU number good, but almost as importantly, France's PMI improved from December and separately Spanish GDP was a pleasant surprise. Those two reports helped to allay, for now, concern that the sluggish economies in France and some of the "PIIGS" would cause more instability in the euro.

Market	Level	Change	% Change
Dollar Index	80.53	-.78	-.95%
EUR/USD	1.3693	.0147	1.09%
GBP/USD	1.6623	.0054	.33%
USD/JPY	102.53	-.72	-.70%
USD/CAD	1.1087	-.00121	-.11%
AUD/USD	.8661	-.0103	-1.18%
USD/BRL	2.4306	.0341	1.42%
10 Year Yield	2.773	-.087	-3.04%
30 Year Yield	3.681	-.078	-2.08%
Prices taken at previous day market close.			

So, point being, the data yesterday made it less likely that the ECB will take any further action to ease policy anytime soon. (And if you ask me, there's never been much of a chance the ECB will act again in '14, but I digress.)

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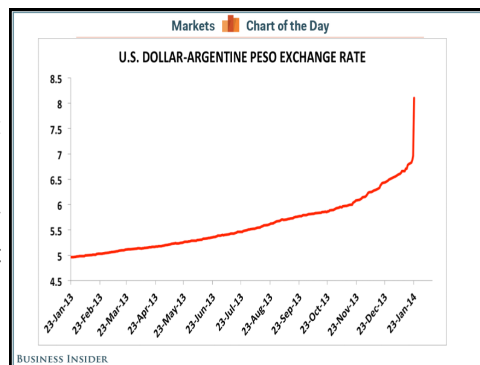
In Asia, most currencies traded off the China news. We saw more than a 1% jump in the yen on nothing more than a "risk off" trade, as concern primarily about China, and a bit about Argentina, sent shorts covering and scared investors into the defensive currency.

A bit further south, the Aussie dropped 1% on the Chinese data (remember, as China goes, so goes Australia). The Aussie has now hit a new multi-year low, and will likely hit the Reserve Bank of Australia's target of $0.85 sooner rather than later. The bounce in the Aussie lasted all of one day, and the downtrend has now resumed in earnest.

Treasuries rallied hard yesterday thanks to the soft PMIs and general "risk off" sentiment. (When the Dow is down 200+, bonds will be up—I don't care how much of a long-term downtrend they are in.) Yields on the 10-year dropped below 2.7% for the first time since November, while yields on the 30-year dropped below 2.7%.



A week ago I pointed out that the 30-year bond had rallied and broken through a downtrend line extending back to May 2012. And, I said this implied that we may see the start of another counter-trend rally in bonds, like we saw in September & October. But, I hedged that by saying I would be more confident when the 10-year also broke its downtrend. Well, yesterday it didn't quite break it, but it is sitting right against it, so this is something to watch. For now, though, I'd hold both long-term and short-term, "short" bond positions.

<u>Forget Condos in Vancouver, Estancias in Argentina are Coming Our Way</u>

Yesterday the Argentine peso dropped 13% after the Argentine government limited its citizens to two foreign Internet purchases per year. They claimed it was to protect local industry, but really it was to keep pesos in Argentina, as the country is running dangerously low.

And, like all well-intentioned government programs, it backfired and caused a rout in the peso, which will only exacerbate its citizens' desire to get rid of them.

This news was referenced as one of the "reasons" for the drop in stocks, but it really wasn't. First, the flight of capital out of Argentina has been a problem for months. Second, the market is very used to threats of "Argentine defaults." In fact, the news brought me back to when I was an intern at Merrill.

We had to pair up with another intern and, before the open, present a recap of what happened in the markets overnight to senior staff. Sometimes we would get questions, generally of the "lay up" variety, as the senior staff knew we were trying to get jobs.

But, I'll never forget when my buddy Chris and his partner gave their presentation the during the Argentine default in the summer of '01. Chris got a question from a managing director that basically asked "How do you fix Argentina?" Seldom have I subsequently seen so much squirming or heard so much stuttering.

Hopefully markets won't stutter and squirm again today, although futures aren't off to a good start.

Have a good weekend,

Tom

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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 50 day MA (1812).*

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.**

	Fundamental Outlook	Technical Outlook	Overall	Comments
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).**

	Fundamental Outlook	Technical Outlook	Overall	Comments
U.S. Dollar	Neutral	Neutral	Neutral	*The Dollar Index largely range bound as the market has priced in Fed tapering, while the question of what, if anything, the ECB will do to combat rising dis-inflation remains unanswered.*

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.**

	Fundamental Outlook	Technical Outlook	Overall	Comments
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.**

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