7:00's Report

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

January 3rd, 2014

Gold looks to have broken its downtrend, and a few closes above $1220 would make me more bullish and open a run to $1270ish.

Pre 7:00 Look

- Futures are unchanged and European markets are bouncing slightly after a quiet night, ex-Asia.
- China was the big laggard o/n, dropping more than 2%, after December Services PMIs declined, echoing the drop we saw in December manufacturing PMI and stoking fears of a further slowing of growth.
- European data was "ok" as the UK Home Price Index and Construction PMI beat expectations.
- Econ Today: No reports today. Fed speak: Stein (10:15 AM, 12:45 PM), Plosser (10:15 AM, 1:15 PM), Lacker (1:30 PM), Bernanke (2:30 PM).

Market	Level	Change	% Change
S&P 500 Futures	1828.25	1.75	0.10%
U.S. Dollar (DXY)	80.745	-.043	-0.05%
Gold	1230.9	5.70	0.47%
WTI	95.37	-.07	-0.07%
10 Year	2.985	-.041	-1.35%

Equities

Market Recap

Stocks started 2014 off with a thud, as the S&P 500 declined 0.89% amid still-quiet holiday trading.

Stocks opened lower Thursday and continued to decline throughout the day, shrugging off decent jobless claims and a strong December ISM manufacturing report.

As far as "why" stocks declined, the truth is most of it was money managers dumping the longs they held throughout the end of 2013 to avoid incurring 2013 taxes, and now that it's the new year they are re-allocating. That, combined with still-holiday-like volumes, made for outsized declines (meaning the selling wasn't as aggressive as the market declines would imply).

If I had to name a reason for the market declines, the most-cited was the Chinese PMI data. But it was barely a miss at 51.0 vs. (E) 51.2, and globally the manufacturing PMIs were pretty good. So, that's a bit of a stretch.

Stocks declined steadily throughout the afternoon, although the market managed to close off the intraday lows.

Trading Color

There were traces of cyclical underperformance yesterday as homebuilders, tech, industrials and energy all underperformed. But it's not fair to say that it was an "out of cyclicals and into safety" rotation, either. Utilities and consumer staples also traded very poorly (so we are seeing continued weakness in the "bond proxy" stocks to start the year).

Market	Level	Change	% Change
Dow	16,441.35	-135.31	-0.82%
TSX	13,588.76	-32.79	-0.24%
Brazil	50,341.25	-1.165.91	-2.26%
FTSE	6720.33	2.42	.04%
Nikkei	16291.31	112.37	.69%
Hang Seng	22817.28/	-522.77	-2.24%
ASX	5350.10	-17.81	-.33%
Prices taken at previous day market close.			

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The Nasdaq was the worst-performing major index thanks to the drop in Samsung (SSNLF), which got hit on concerns about an earnings miss when it reports numbers later in January. Also, Apple (AAPL) was downgraded by Wells Fargo (WFC) and the semiconductor space got cut by Goldman—the PHLX Semiconductor Index (SOX) dropped nearly 1.4% yesterday.

Market	Level	Change	% Change
DBC	25.31	-.35	-1.36%
Gold	1224.30	22.00	1.83%
Silver	20.03	.66	3.41%
Copper	3.3865	-.01	-0.29%
WTI	95.53	-2.89	-2.94%
Brent	107.77	-3.03	-2.73%
Nat Gas	4.32	.09	2.13%
RBOB	2.6969	-.089	-3.19%
DBA (Grains)	24.18	-.07	-0.29%
Prices taken at previous day market close.			

Homebuilders were the other notable laggard, although there was no significantly negative catalyst. It was likely profit-taking by longs, as homebuilders were the best-performing sector in the market in December.

Volumes remained low and it was very much a "holiday" trading atmosphere. And, that should last through today as well.

Bottom Line

I'm not sure we should read anything into yesterday, as most of the weakness was pent-up selling from PMs now that 2013 is over, combined with very low volumes.

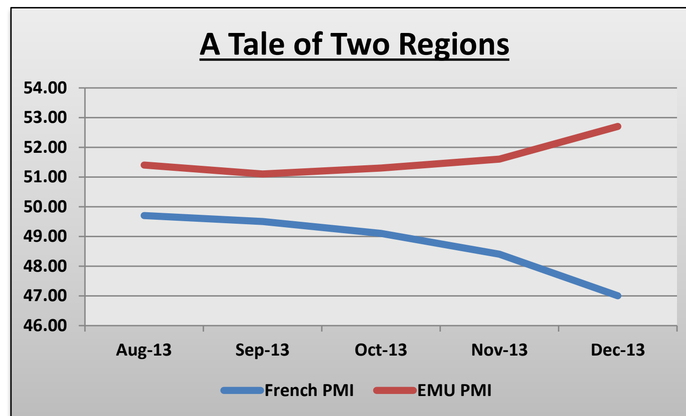
Everyone gets back to work on Monday, and as of right now the market largely remains the same as it was in December. How the market trades next week will be a lot more important than what happened yesterday (or today, for that matter).

A Nasty Day Across the Pond

While it wasn't a very strong session domestically yesterday, it was even worse in Europe. Most European averages fell between 1.5% and 2%, with the benchmark ETF VGK dropping 2.2%. The declines came despite EMU December manufacturing PMIs meeting expectations at 52.7.

In truth I think we saw selling in Europe primarily for the same reasons we saw it domestically—money managers unloading positions they held throughout December to maintain allocations and avoid 2013 taxes. Combine that with very low volumes as most of Wall Street is still on vacation until Monday, and it's not that surprising to see the averages decline.

But, there was another reason cited for the declines in the European stock market yesterday. While most of the EU manufacturing PMIs were strong, the French December PMI was very weak. At 47.0, it hit a seven-month low, dropping from 48.4 in November. To boot, the details of the report were weak, as both employment and new orders fell to multi-month lows.



The reason that the drop in the French PMI would result in pan-European weakness is because some analysts are afraid the French reading reflects a potential "two speed" European economic recovery, where strong countries like the Netherlands and Germany see growth accelerate, while other countries like France and Spain do not. And, to understand why this is a potential problem, consider it in the context of future ECB policy. The ECB seems to have no intention of easing policy further in the near future, and that's not good for countries like France and Spain, which are seeing economic growth stagnate.

While the potential for a "two speed" European economy is real, I think extrapolating the weakness in the French PMI out that much is a mistake. Based on the data, it looks like France is suffering from uniquely French problems—namely that they elected a government that has lumped huge tax increases and regulations on the economy. As history often shows, those two policies will likely serve to restrict growth. In the rising tide of Europe, the French boat is firmly anchored, but it's an anchor they themselves threw out!

The point is that, as of now, I don't believe the soft

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French economy is a harbinger of trouble in Europe—it's just a harbinger of a slow French economy. And, that doesn't mean it'll create a crisis (remember, prior to 2008, recessions didn't usually bring us to the brink of calamity).

I was wrong to exit my "long Europe" trade back when I did in early December, as EWU (United Kingdom), VGK (Europe) and EIRL (Ireland) all moved to highs for the year late last week. But, my reasoning for exiting that trade—that the ECB will not ease further and, as a result, we'll see the European recovery slow in the coming months—still stands and I'd still prefer to be a buyer of "Europe" on a dip from current levels. And, I'd be very happy if concerns emanating from France about a "two speed" European economy provided me that entry point. But, bottom line is I don't think the weak French PMI is bad for anyone in Europe, other than the French, and it doesn't change the fact that I'm a bull on Europe over the medium and longer term.

Economics

ISM Manufacturing PMI

- December ISM Manufacturing Index was 57.0, meeting expectations.

Takeaway

The ISM index showed continued growth in manufacturing through year-end with a reading of 57.0 in December. The details of the report were as strong as the headline, as New Orders, which is the leading indicator in the report, rose 0.6% to 64.2. This was the strongest reading since April 2010 and the fifth-straight reading above 60. Employment also rose to 0.4 to 56.9. A modest increase in prices as well as delayed delivery times help to confirm the broad strength in the report.

Although largely ignored due to the calendar, the ISM PMI refutes some of the weakness we saw in regional manufacturing surveys, and implies the economy is continuing to gather momentum, which is good for stocks. (Remember, good economic news is good again.)

Market	Level	Change	% Change
Dollar Index	80.775	.586	0.73%
EUR/USD	1.3654	-.0098	-0.70%
GBP/USD	1.6428	-.0135	-0.81%
USD/JPY	104.71	-.51	-0.48%
USD/CAD	1.066	.0019	0.18%
AUD/USD	.8909	.0027	0.30%
USD/BRL	2.3874	.0256	1.08%
10 Year Yield	2.985	-.041	-1.35%
30 Year Yield	3.919	-.045	-1.14%

Prices taken at previous day market close.

Commodities

Commodities were mixed yesterday. Precious metals and natural gas outperformed while there was broad selling in the energy space ex-gas. The PowerShares DB Commodity Tracking Index ETF (DBC) was down 1.33% thanks to weakness in the energy sector.

Gold and silver were two of the best-performing commodities yesterday, rallying 1.95% and 3.72% respectively despite a materially stronger dollar. The reasons for the rally were two fold: First, like other markets we saw profit-taking on 2013 positions, as shorts covered now that we are in a new tax year. Second, an uptick in physical demand in China also contributed to yesterday's rally. The premium for immediate delivery of gold was $23/oz. yesterday compared to the December average of $16.21, suggesting a material surge in demand.

Stepping back, the $1,200 level is key, and the fact that $1,200 held support last week is undoubtedly making some shorts nervous, and as a result they are covering.

Gold now appears to have broken its multi-month downtrend, although given how poorly this market has traded, I'd like to see a few more closes above the $1,220 region before getting outright short-term bullish and adding more to my position.

Natural gas also rallied, up 2.13%; however, it still seems to be drifting sideways in consolidation mode. Yesterday's price movement was mostly fast-money trading noise along with some hedging and first of the year positioning mixed in.

On the charts, $4.20 remains solid support while the recent high of $4.532 is resistance. However, it will take a substantial draw in supplies or an extended very cold weather forecast to revisit and break those highs in the short term.

Elsewhere in the energy space, there was broad weakness. Crude oil fell 2.94% (the largest single-day sell-off

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in over a year) while RBOB gasoline and heating oil were down 3.19% and 2.33% respectively.

The weakness in WTI was in part due beginning of year positioning (selling profitable longs), but there were also fundamental reasons. Brent crude, the international benchmark, sold off on news reports that Libya is finally preparing to increase output from its El Sharara site. Libyan output was just 210K barrels of oil equivalent per day in December, down from a monthly average of 1.28M boe/d in the first half of 2013.

The EIA is set to release a delayed inventory report this morning, with analysts expecting a draw in crude supplies (-2.2M Bbl). However, I spoke with a good friend yesterday who is an energy broker on the NYMEX floor, and he said there is a lot of chatter about inventories actually building, which led to some follow-through selling by speculative traders yesterday.

Finally, Copper was slightly lower yesterday, down just 0.29%, but traded well given the Chinese Manufacturing PMI "miss." Copper futures have been consolidating over the last few sessions but holding on to recent gains, which is encouraging for the global economy and makes me more confident in my "global reflation trade" investment thesis.

Currencies & Bonds

Like most other markets, 2014 started off totally opposite from 2013 in the currency markets. Thursday the Dollar Index rallied 0.7%, and although most financial press outlets cited the strong ISM Manufacturing PMI as the "reason" for the rally, that doesn't really hold water because the dollar was up nearly 1% well before the PMI was released Thursday morning.

Instead, the main catalyst for the dollar rally was euro weakness. The euro traded sharply lower yesterday, dropping 1% on a combination of investor positioning (investors lightening up their euro longs from 2013) and the soft French PMI data. The euro broke through support and traded all the way to a one-month low yesterday morning, before bouncing a bit into the close.

Yesterday's break in the euro was somewhat violent, and while concerns about the French economy loomed yesterday, I think the euro decline was mostly due to positioning and light volumes. But, although the policy outlook for the ECB remains unchanged, it does appear on the charts that the euro is "capped" at about 1.38 vs. the dollar, as it's failed to rally through that level three times in the last few months.

Given the run in the euro late last year, I'd not be surprised to see a bit more of a correction, perhaps down to the 1.3550 level. But unless the policy outlook for the ECB becomes materially more "dovish" over the coming weeks (and I don't think it will), we are not on the verge of a material trend change in the euro (meaning I don't think this is the start of a material downtrend).

Elsewhere in Europe, the pound sold off hard vs. the dollar, also falling almost 1%. Certainly an exiting of pound longs contributed to some of the selling, as the pound was just about the best-performing currency vs. the dollar in 2013, but also the UK December Manufacturing PMI missed estimates, at 57.3 vs. (E) 58.7. But, like the euro, I'm not convinced we're seeing a material trend change in the pound, as the UK economy continues to grow and BOE policy isn't about to become materially more "dovish" anytime soon.

In Asia, despite the Japanese markets being closed for the remainder of the week, the yen caught a bid vs. the dollar (it was the only major currency to rally against the dollar yesterday). But like most things, that was likely the result of book-squaring now that it's a new year (the "short yen" trade was very, very crowded, and likely you are seeing some people book profits now that it's a new year). And, this could continue for another couple days/weeks.

Turning to the bond market, Treasuries rallied small yesterday (10-year up 0.1%, 30-year up 0.22%) in quiet trading. Treasuries rallied mostly on start of the year positioning, although the fact that the market was down 100+ points didn't hurt either (remember when stocks used to go down, and they did used to go down, bonds would rally in response). The 10-year yield dipped back below 3%, but largely the bond market is in digestion mode.

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**	*Stocks traded to new highs last week amidst thin, holiday trading. Sentiment towards the market 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.* *Stocks are at all time highs, while first support site at 1828 in the S&P 500.*

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 declined small last week, but mostly thanks to a strong euro. The Dollar Index should remain largely range bound, as a strong euro caps any material upside.*

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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