7:00's Report

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

January 30th, 2014

Pre 7:00 Look

- Futures are seeing a modest bounce higher after a quiet night.
- There was nothing materially new on the EM front, as both the lira and rand continue to decline vs. the dollar, which isn't encouraging.
- In the Ukraine, some political progress seems to have been lost, as President Yanukovich has taken sick leave (perfect timing!).
- Econ Today: GDP (E: 3.0), Jobless Claims (E: 327K), Pending Home Sales Index (E: -0.5%).
- Earnings Today: MMM (E: 1.61), CL (E: 0.74), XOM (E: 1.90), UPS (E: 1.25), AMZN (E: .71).

Market	Level	Change	% Change
S&P 500 Futures	1777.50	6.25	.35%
U.S. Dollar (DXY)	80.905	.324	.40%
Gold	1254.40	-7.80	-.62%
WTI	97.78	.42	.43%
10 Year	2.675	-.071	-2.59%

Equities

Market Recap

Stocks resumed their declines Wednesday as emerging market concerns again roiled markets, while the Fed continued its tapering of QE. The S&P 500 fell 1.02%.

The market spent the entire day in the red yesterday, as pre-market futures traded with the Turkish lira, declining as that currency fell vs. the dollar following the moves by the Turkish central bank.

Shortly after the open, though, investors' focus turned to the Fed, and sellers moved to the sidelines fearing a possible September-like "Fed surprise." The markets were able to mount a small rally, although none of the averages got anywhere near flat. Trading was quiet and overall pretty dull.

After the FOMC statement, which contained no surprises, sellers re-emerged and pushed the averages to their lows of the day during the last hour of trading, before a small bounce into the close lifted stocks off the lows.

Trading Color

It was not another textbook "risk off" day yesterday, as the S&P 500, Dow Industrials and Nasdaq all declined about the same. The Russell 2000 was the laggard yesterday (down 1.39% vs. 1.02% for the S&P 500) but you didn't see that huge underperformance from cyclical sectors, which is a small silver lining for the bulls.

Sector-wise, it was a similar story. The worst-performing S&P 500 sub-sector yesterday was consumer staples (down 1.8%), followed by retail and the banks. But, materials were actually the only sub-sector to finish the day higher, thanks in part to DOW earnings. Utilities, REITs and telecom (which shrugged off the T earnings miss) relatively outperformed but still finished in the red.

One thing worth pointing out about yesterday was volumes really dried up, and we did not see the aggressive selling from last Friday or Monday. Instead, the reasons for the declines were a lack of bids, as investors remain reluctant to buy this dip. I point that out because if we consider the less-enthusiastic selling compared to last Friday/Monday, and that the day wasn't typical "risk off," there are some small hints that we may be seeing this selling pressure start to ebb a bit.

On the charts the S&P 500 closed just below 1,775 (the lower range of support, and the more I talk to people

Market	Level	Change	% Change
Dow	15,738.79	-189.77	-1.19%
TSX	13,643.10	-44.56	-0.33%
Brazil	47,556.78	-284.15	-0.59%
FTSE	6522.87	-21.41	-.33%
Nikkei	15007.06	-376.85	-2.45%
Hang Seng	22035.42	-106.19	-.48%
ASX	5188.06	-40.95	-.78%
Prices taken at previous day market close.			

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the more I'm hearing that the S&P will have to test and hold its 100-day MA (1,767) to get people more positive on stocks at these levels.

Market	Level	Change	% Change
DBC	25.03	.00	0.00%
Gold	1263.60	12.80	1.02%
Silver	19.685	.182	0.93%
Copper	3.241	-.012	-0.37%
WTI	97.44	.03	0.03%
Brent	107.84	.43	0.40%
Nat Gas	5.557	.524	10.41%
RBOB	2.6582	.0304	1.16%
DBA (Grains)	24.27	-.05	-0.20%
Prices taken at previous day market close.			

Bottom Line

The potential for emerging market contagion is rising, but to be clear what we are seeing is a EM adjustment right now—this isn't a crisis, yet (although we aren't moving in the right direction).

So, this sell off remains more about positioning than emerging markets (they are the excuse) and hedge funds (which were the sellers again yesterday) and mutual funds getting less "long" in 2014. And, there are some small signs (mentioned above) that we may be seeing that adjustment process period coming to an end.

Bottom line is I remain bullish on equities, and will stay that way unless the 100 day MA at 1767 is decisively broken.

S&P 500: A year long trend line is being put to the test, and that support level coincides almost exactly with the 100 day moving average.

Why are Emerging Market Currencies Declining Despite Higher Interest Rates?

What we saw in the market yesterday is counter-intuitive: The central banks of both Turkey and South Africa *raised* interest rates, yet both their currencies declined. Weren't we taught in school or training that higher interest rates raise currency values? Yes, we were. But, this is a perfect example of why academics often make very bad traders.

So, here's the reason the lira sold off yesterday (and the principle extends to the rand and any other currency where this trick is tried) ...

Getting a dose of déjà vu, some more-seasoned veterans of the market yesterday told me this seems to be a replay of the same tactic the Turkish central bank tried sometime in the mid-1990s (that date may be a bit off). And, that experiment led to a crippled economy and hyper-inflation – not a desired result.

The huge hike in interest rates by the Turkish CB is designed to attract foreign capital into the country, to stem its growing currency crisis. (Turkey needs lira, and the best way to do that is to entice foreign investors to invest and swap their dollars, euros and yen for lira.) On the surface, that makes sense and should be lira-positive.

But, last time this was tried, foreign investors didn't show up, and here's where the problems start.

You see, hiking interest rates 4.25% overnight isn't good for the economy – in fact it's downright crippling *if* you don't get that foreign investment to help support economic growth. Last time this was tried 15-20 years ago, when the foreign investment didn't come, the Turkish economy collapsed not long after the interest rate hikes. Then the Turkish central bank and government were forced to cut rates and devalue the currency to spur growth — the very economic growth they choked off with the initial interest rate hike. Eventually that led to a devaluation of the lira and hyper-inflation in Turkey.

On the surface, it looks like it's "second verse, same as the first." Now, if the move higher in rates *does* attract foreign capital, then things should work out. But, if it doesn't, we know the ending.

Bottom line is the market is always looking to "what's next." While the move from the CB was welcomed by the market, it's unclear whether they have made the situation better or worse, over the medium/longer term. Based on history, though, the message is don't buy the Turkish bonds – apparently those who were tempted by

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the big yields last time got slaughtered when they devalued the lira later on. There's a reason the rate is 12%. ...

Economics

FOMC Rate Meeting

- No change to interest rates, as expected.
- Further tapering of QE by $10 billion, equally split among Treasuries and Mortgage Backed Securities, as expected.

Takeaway

The Fed meeting went as expected. The FOMC "tapered" its QE program by another $10 billion, reducing monthly Treasury bond purchases by $5 billion per month starting in February to $35 billion, and reducing mortgage-backed security purchases by $5 billion per month to $30 billion.

There's not a lot to say about the statement, as the Fed remains "steady as she goes." They appear, for now, undeterred by the emerging market turmoil, stock market sell-off or recent disappointing data, and seem resolute in further reducing their QE purchases throughout the year (the next meeting is in March, and the expectation is for another "tapering" of $10 billion).

Bottom line is the Fed seems more interested in reducing its balance sheet than addressing the recent risks in the market, so those who were looking for the Fed to lend support yesterday (or anytime over the next two months) will be disappointed. The Fed doesn't seem interested in rising to the rescue of equity investors just yet.

Commodities

Commodities were mostly in the green yesterday as natural gas led the energy space higher while the precious metals caught a "fear bid" as the Turkish lira pared yesterday's substantial gains overnight. The benchmark commodity tracking ETF, DBC, however was unchanged at $25.03 due to broad weakness in the grains.

Market	Level	Change	% Change
Dollar Index	80.60	-.057	-0.07%
EUR/USD	1.366	-.0008	-0.06%
GBP/USD	1.6567	-.001	-0.06%
USD/JPY	102.11	-.84	-0.82%
USD/CAD	1.1155	.0008	0.07%
AUD/USD	.8741	-.0035	-0.40%
USD/BRL	2.4365	.0107	0.44%
10 Year Yield	2.675	-.071	-2.59%
30 Year Yield	3.622	-.050	-1.36%
Prices taken at previous day market close.			

Natural gas exploded higher by 10.41% to close at fresh multi-year highs. The move began around midday and accelerated into the close as speculators bought into the market based on expectations that we are set to see yet another substantial draw in supply due to continued colder-than-normal temperatures across the nation. The average analyst expectations are predicting a draw of 229 Bcf to be reported this morning, which comes after last week's modest draw of just 107 Bcf.

Also, a Reuters article implied we could exit the winter season with just 1.23 trillion cubic feet of natural gas in storage, a very low level. (Remember, several weeks ago I said to watch the 1.2 trillion cubic feet level—that if we got close to it, we could see substantial upside.)

Sticking with energy, the EIA inventory reports were released yesterday morning for crude oil, RBOB gasoline, and distillate supply levels. The results were mixed.

The nation's crude oil supplies climbed 6.4M barrels, much more than analyst estimates that called for a rise of 2.2M barrels. In the products, RBOB gasoline stocks unexpectedly fell by 800K barrels vs. expectations calling for a build of 1.1M. Meanwhile distillates did the exact opposite, climbing by 4.6M barrels vs. expectations of a 2.6M barrel draw in supplies. We didn't see a substantial move in crude upon release of the EIA number; it really just bounced off the lows and then treaded water ahead of the FOMC announcement.

WTI finished the day up small, rallying from earlier weakness in the late afternoon as the entire energy sector was pulled higher by the jump in natural gas. For all the volatility, though, WTI crude remains largely range-bound between $92 and $98/bbl.

Gold was higher yesterday ahead of the Fed thanks to a global "fear trade" as the reversal and drop in the lira caused investors to move to safe-haven assets like gold and the yen. Gold basically held those gains (up 0.8%) throughout the day until the Fed statement.

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Gold gyrated immediately following the FOMC announcement but it settled down right where it was pre-FOMC, up just under 1%.

Gold is again threatening to break out, but as I've been saying, I've traded gold enough to be skeptical of these "crisis rallies" and would like to see a few more closes above that $1,260 level before joining the apparently growing "bullish" camp.

Currencies & Bonds

Emerging currencies continue to be the "epicenter" of market angst, and it's fair to say that the situation is starting to deteriorate. The Turkish lira, now the critical EM currency to watch, steadied yesterday after a volatile morning session. But it is fair to say that the rate hikes in Turkey didn't have the effect desired from the Turkish central bank (more on that later).

The South African rand was actually the worst-performing currency vs. the dollar yesterday, as it dropped 2% *after* the Reserve Bank of South Africa increased interest rates by 50 basis points.

I said yesterday that the real threat from this EM crisis is centered on contagion, and "Emerging Market FX Contagion" is a term we all need to be watching carefully. And, while we aren't to the point where we really need to worry about an emerging market crisis, we are not moving in the right direction. At this point we are seeing emerging market concerns spreading, which is worrisome, but it's not the type of contagion that would lead you to materially de-risk. And, while I don't personally think we'll get to that point, it is something that is possible, and something we need to watch very, very closely. This EM crisis still isn't a "bearish game-changer" but it is going in the wrong direction.

Despite the big declines in stocks and emerging market currencies, the Dollar Index, along with the euro and British pound, were all unchanged on the day, as the move by the Fed was largely priced in and there was no data from Europe yesterday.

The yen was the big mover yesterday, rallying 0.7% vs. the dollar on a "risk off" bid as stocks declined and EM angst rose. The yen hit a six-week high vs. the dollar on this "risk off" bid, and the yen continues to be the big winner in all this EM angst. (The U.S. dollar and euro are being driven by their respective policy outlooks, which are accurately priced in, not risk on/risk off sentiment.). But, I urge you to keep in mind that longer term, the yen in the low-100s to the dollar is a gift, seeing as Mssrs Abe and Kuroda will not appreciate their hard work being undone by a bunch of overleveraged investors fleeing emerging markets. But, for now "fear" is running the yen.

Bonds caught a bid post-FOMC yesterday, after spending almost the entire day just barely higher. And, the rise in bonds is counter-intuitive to a Fed that seems intent on further tapering QE. But, yesterday's rally was more of a "risk off" move as stocks began to sink, as we saw a resurrection of the typical inverse relationship between stocks and bonds (that is, on days when the market is very weak).

As long as emerging markets are in turmoil, there will be a bid in bonds, and clearly we are now seeing a counter-trend rally that I first mentioned 2-plus weeks ago. How high it goes depends on the emerging markets and data, but we are now above the 50%-62% retracement of the October to early January declines. So, this is either going to roll over in the next day or so, or we are going to test the October highs of 135'24 in the 30-year.

Counter-trend rallies and EM angst aside, though, unless we see the economic data turn materially worse, then this is nothing more than a "shorting" opportunity in bonds—it's just a painful one for us bond bears. Such is the way things go when you are riding long, powerful trends like a decline in the bond market.

Have a good day,

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**	*The market got hit last week on concerns about Chinese growth and emerging markets, and stocks suffered their worst weekly declines in over a year. But, the positive fundamental back drop remains largely in place, and so far none of the events of last week are bearish "game changers."* *I remain bullish above the 100 day MA (1767) while 1800 is resistance.*

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: **Gold is now threatening to break out of a months long downtrend, but given gold has rallied as a "crisis" hedge, I'm skeptical the move can last. A few more closes above the $1260 level would make me more bullish in the short term.**

	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, including the one we are seeing now thanks to emerging market concerns.*

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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