7:00's Report

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

January 6th, 2014

Pre 7:00 Look

- Futures are little changed this morning after a quiet weekend. Economic data out o/n was mostly in line and isn't moving markets materially.
- EMU December service sector PMIs largely met expectations, although there were some slight disappointments in individual countries (France in particular).
- The Nikkei fell more than 3% Monday, although that's a bit misleading as it was closed late last week and was playing "catch up" to last week's global market declines.
- Econ Today: ISM Service Index (E: 54.8).

Market	Level	Change	% Change
S&P 500 Futures	1828.00	2.50	.14%
U.S. Dollar (DXY)	80.955	0.00	0.0%
Gold	1237.00	-1.60	-.13%
WTI	94.49	.53	.56%
10 Year	2.995	.010	0.34%

Equities

Market Recap

Stocks finished 2013 basically on the highs, but then opened 2014 with a thud. The market suffered its worst sell-off in weeks on Thursday, before bouncing Friday thanks to another reiteration of "low for long" interest rates from outgoing Fed Chairman Ben Bernanke. After two trading days, the S&P 500 is down 0.92% year-to-date.

Stocks rallied Monday and Tuesday of last week mostly on year-end window-dressing, but Thursday was the key day last week. That was when pent-up selling from money managers who held positions into 2014 to avoid incurring taxes combined with very low volumes to send markets down 1% on the first trading day of the year.

The soft Chinese PMIs released Thursday and Friday were also cited for the sell-off, but that's a bit of a stretch, and Thursday's declines were more about portfolio re-allocations than anything else. Point being the declines weren't fundamentally based, so be sure to resist the urge to read too much into it.

How stocks trade this week, now that all the desks are back at full staff, will be a lot more important than how stocks traded Thursday.

Trading Color

As has been the case for the entire second half of December, the hallmark of trading last week was very low volumes and lack of participation by "real money" funds. So, there is not a ton of insight to glean from the market internals last week.

The drop in oil prices led to outperformance by the airlines (DAL raised operating margin guidance, too). Plus, the influence of expected higher interest rates was again visible as financials outperformed (on higher interest rates and some upgrades). Meanwhile defensive and "bond proxy' sectors like utilities, telecom and consumer staples again underperformed. This rotation remains the strongest trend within the market, and has been carrying on throughout December regardless of what the broader market has doing.

The soft Chinese data resulted in the materials and industrials underperforming late in the week, while tech got hit Thursday by a drop in Samsung (SSNLF), as concerns about its earnings weighed on the stock.

Market	Level	Change	% Change
Dow	16,469.99	28.64	0.17%
TSX	13,547.69	-46.51	-0.34%
Brazil	50,981.09	639.84	1.27%
FTSE	6731.25	0.54	.01%
Nikkei	15908.88	-382.43	-2.35%
Hang Seng	22684.15	-133.13	-.58%
ASX	5324.88	-25.22	-.47%

Prices taken at previous day market close.

We did see a bit of a late-week pause in the "out of safety, into cyclicals" rotation that has been occurring for the last few weeks (and months). But as long as the market expects interest rates to move higher and the economy to continue to grow, it's just a matter of time till that rotation out of safety and into cyclicals begins again in earnest.

Market	Level	Change	% Change
DBC	25.13	-.16	-0.63%
Gold	1236.60	11.30	0.92%
Silver	20.145	.017	0.08%
Copper	3.3535	-.028	-0.83%
WTI	94.21	-1.23	-1.29%
Brent	106.98	-.80	-0.74%
Nat Gas	4.32	-.001	-0.02%
RBOB	2.6556	-.0394	-1.46%
DBA (Grains)	24.44	.27	1.12%
Prices taken at previous day market close.			

This Week

It's a busy week beyond just the economic reports (the most-important of which is the jobs report on Friday).

From a Fed standpoint, Janet Yellen should be officially confirmed as the new Fed chair today.

On the microeconomic front, it'll be a big week for retail. We'll get December same-store sales on Thursday and Signet Jewelers (SIG) will offer a holiday sales recap also on Thursday while Tiffany (TIF) will provide its update on Friday.

Also, this week is the start of another earnings season. Samsung will provide preliminary results tomorrow, while Alcoa (AA) officially kicks off earnings season on Thursday, although the bulk of reports don't start until late next week and the week of Jan. 20.

Bottom Line

Given the low volumes and year-end window-dressing, last week can largely be disregarded (as can the week before that). However, I do think there's an important takeaway from Thursday's sell-off, although it's probably not the one you think.

The drop Thursday proved to be surprisingly unsettling, and I heard multiple concerns that this was going to set the tone for the entire year. First, this tells me that still, even after a huge 2013, very few people "agree" with the rally, and every substantial drop is still eliciting the "this is it" sentiment with regard to an expected correction. And, I believe that remains an underappreciated tailwind on stocks.

Second, it's actually the first three to five days of trading that are a strong predictor of market performance. So, we'll revisit the predictive powers of January tomorrow and Thursday.

Bottom line is the market narrative remains largely unchanged from mid-December:

- The macroeconomic horizon remains as clear as it's been in years.
- Valuation on the S&P 500 isn't cheap but it's not terribly expensive, either.
- Although people are more bullish than they have been, as mentioned, there's still not a lot of "agreement" with the rally.

All that combines to still make the path of least resistance for stocks higher.

From a "what can go wrong" standpoint, the main threat to stocks remains from higher rates and specifically for the market to lose confidence in the Fed's Zero Interest Rate Pledge (ZIRP), which would cause a substantial acceleration in the rise in interest rates. But, clearly we're not there yet, given Friday's rally in reaction to Bernanke's reiterating the Fed's pledge to keep rates "low for long." All the major indicators for bond-market stress remain relatively well-behaved, and the trend of slowly but steadily higher rates will continue, but it's not by itself a rally-killer.

So, a short-term pause notwithstanding, cyclicals (and banks in particular) should continue to lead markets higher, while the long Japan trade via DXJ and the "short bond" trade via TBT and TBF remain the strongest trends across asset classes.

For contrarians, going long the natural gas equities (via the ETFs FCG or XOP) and long the "global recovery" via large, multi-national industrial miners (via the ETF PICK) remain the two areas of relative "value" in the market.

Economics

Last Week

The highlight from an economic standpoint last week was the release of the December global manufacturing

PMIs. They didn't reveal anything surprising with regard to the U.S. or Europe (both numbers met expectations and implied we're seeing continued growth in manufacturing in both regions). But both manufacturing and service PMIs for December did miss expectations in China, re-igniting concerns about the pace of economic growth.

After a few weeks of calm, concern about the Chinese economy has bubbled back up. It started a few weeks ago with the year-end cash crunch that saw short-term lending rates in China spike.

As expected, that spike was largely transitory, but concern remains about whether China can maintain 7.5% GDP growth in 2014. The December PMI "misses," while both mild, have reminded everyone that China remains an area of potential macroeconomic risk, if that economy slows materially.

In reality, the "misses" from China weren't that bad. December manufacturing PMI was 51.0 vs. (E) 51.3 while the service PMI declined to 54.6 from November's 56.0. So, both numbers are still above 50, indicating expansion. But, in an otherwise-slow news week, it did get people's attention, and sentiment toward the Chinese economy over the last few weeks has turned decidedly more cautious.

Domestically and in Europe, things were relatively boring last week. Pending Home Sales was the only other notable report. While November pending home sales missed expectations, it's important to note that the data did turn positive month-over-month, ending four-straight months of declines. That's important because it further implies that the housing recovery, which has lost some momentum since May in the face of higher rates, may be stabilizing. Economically speaking, that's a big positive.

Market	Level	Change	% Change
Dollar Index	81.02	.232	0.29%
EUR/USD	1.3591	-.0079	-0.58%
GBP/USD	1.6412	-.0039	-0.24%
USD/JPY	104.78	.02	0.02%
USD/CAD	1.0633	-.0039	-0.24%
AUD/USD	.8946	.0041	0.46%
USD/BRL	2.376	-.0114	-0.48%
10 Year Yield	2.995	.010	0.34%
30 Year Yield	3.930	.011	0.28%
Prices taken at previous day market close.			

Overall last week didn't reveal too much new about the global economy. The U.S. is seeing growth accelerate, and the EU is seeing a slow but fragile recovery. The one surprise was China, and the main takeaway from last week was that the sentiment toward China has turned decidedly more cautious, making it a region to watch going forward.

This Week

Everyone is back to work, and it's going to be a busy week. From a context standpoint, although the Fed has begun to taper, all economic data still needs to be viewed in the light of WWFD (What Will the Fed Do). The market's focus has now turned to when the Fed will taper next (expectation is March) and by how much (most expect another $10 billion/month).

From a hard data standpoint, first off, it's jobs week. The December ADP unemployment report comes Wednesday, jobless claims Thursday and the employment situation report Friday. The Street is looking for around 200K jobs added (so, the same as we've seen since August).

Second, Wednesday the minutes from the December FOMC meeting will be released, and investors and traders will be looking for clues as to when, and by how much, the Fed will taper next. I don't expect a lot will be revealed in the minutes (I don't think the Fed knows when and by how much it'll taper next) but they could move markets, if there are any surprises.

Third, it's a busy week internationally. There are more data from China, and in light of last week's PMI misses, the data this week will especially be in focus. China trade balance comes Tuesday night, while CPI and PPI are released Wednesday night. (The CPI and PPI will be watched to make sure inflation isn't running too hot and, as a result, could potentially restrict efforts by the Chinese central bank to further stimulate the economy.)

It's also busy in Europe. The December "flash" HICP (their version of CPI) is released tomorrow morning. That's important because dis-inflation is a growing concern in Europe. A higher-than-expected HICP number will help alleviate concerns that dis-inflation in Europe is morphing into deflation.

Finally, there are ECB and BOE meetings Thursday morning. Neither central bank is expected to ease policy, but one of the outstanding concerns is the ECB remains very "comfortable" with current policy, and has no intention of easing further. So, the market will be looking for clues as to where the ECB stands with regard to policy—and specifically if it remains as uninterested in further accommodation as the market currently thinks (the answer will almost certainly be "yes").

Commodities

It was a tale of two markets in the commodity space last week, as gold and precious metals saw strong rallies, while energy declined sharply. The weakness in the energy complex weighed heavily on the PowerShares Commodity Tracking Index ETF (DBC), as it fell 1.34% over the shortened trading week.

Gold was the big winner last week, rallying 1.9% and breaking through a downtrend line that dates back to late October. Gold rallied mostly on technical trading, as shorts covered profitable positions now that it's a new tax year. Nothing fundamental really changed for gold last week, but \$1200 has proven to be solid support, and clearly there is substantial physical demand there. A few closes in this 1230ish range will likely open up a run to \$1270/oz., and then things get interesting.

Crude oil got crushed last week, down 6% despite a substantial draw of 7M barrels in supply, according to the delayed release of the weekly EIA report. However, the report was largely written off by speculative and physical traders alike, as its assumed the drop was a result of year-end book-squaring/inventory-shedding for tax purposes. Crude oil futures saw the biggest weekly sell-off in October 2012 and it appears oil traders are concerned with both Libya production sites coming back online as well as an uptick in U.S. production resulting in a glut of crude supplies in the U.S. (and worldwide, for that matter). Support now sites at \$93.91, the low from last week, and given the ferocity of the declines, I'd remain a spectator in the oil markets at the moment.

Natural gas futures spent the week consolidating/drifting lower, but they hard-bounced off the \$4.20 level, as we expected. Traders continue to look to weather forecasts for direction. So, until we see either a revision for colder weather in the 10-day forecasts or a larger-than-expected weekly draw in supply levels, the price will likely continue to hover between \$4.20 and the December highs of \$4.532.

Currencies & Bonds

Currency markets were quiet last week until Thursday, when we saw the Dollar Index rally more than 1% while the euro and pound dropped nearly 1% each. The reasons for the moves were more euro bearish than Dollar bullish, as there was certainly liquidation of euro and pound long positions that were held into 2014 to avoid taxes, as both "long euro" and "Long pound" were very profitable trades in '13. But, data also weighed on both currencies. EMU Manufacturing PMIs were in line Thursday, but a very weak French PMI weighed on the region, sparking fears of a "two speed economy," while a manufacturing PMI miss in the UK led to selling as well.

The data aside, through, the real issue with the euro remains what, if anything, the ECB will do next to stimulate the economy (the expectation is nothing). That context makes this week's HICP reading and the ECB decision Thursday important with regards to the next direction of the euro.

Turning to the bond market, Treasuries were flat on the week, as the Treasury market digested the declines of 2013. The indicators of whether this sell off in bonds is "ok" for other risk assets continued to behave last week as EMB and PCY (emerging market bond ETFs) saw small rallies.

The pressing issues in bonds remain 1) When and by how much will the Fed taper QE again, and 2) If economic growth accelerates, how long before the market calls "BS" on the Fed's "forward guidance." As I see it, the likely outcomes of both issues result in lower bond prices and higher yields, and it's just a question of when the next leg down starts, and how fast the drop is. If economic data suddenly turns for the worse that will change, but for now bonds are just biding their time before the resumption of the declines. And dips in TBT, TBF and STPP should be viewed as opportunities as this trend has a lot longer to run. Have a good week—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	*Stocks opened 2014 with a thud, but that was more positioning than anything else. 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.*

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 rallied last week, but mostly thanks to a weak euro. The Dollar Index should remain largely range bound, as a stubbornly 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.**