7:00's Report

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

January 7th, 2014

Pre 7:00 Look

- Futures and European markets are drifting slightly higher while Asia sold off in sympathy with the Monday declines in the US.
- In Europe stocks are higher as a continued rally in the PIIGS bonds is trumping mixed economic data. Ireland sold debt this morning and demand was strong, while other PIIGS yields also declined.
- Economic data in Europe was mixed, however. HICP missed estimates at 0.8% yoy increase vs. (E) 0.9%, showing dis-inflation remains a risk to the region, although it's not expected to make the ECB act this Thursday.
- Econ Today: No Reports Today. Fed Speak: Rosengren (8:30 AM), Williams (2:10 PM).

Market	Level	Change	% Change
S&P 500 Futures	1827.00	6.25	.34%
U.S. Dollar (DXY)	80.82	.014	.02%
Gold	1238.50	0.50	.04%
WTI	93.94	.51	.55%
10 Year	2.961	-.034	-1.14%

Equities

Market Recap

Stocks finished a slow day Monday with mild declines as soft economic data from China and the US weighed on stocks. The S&P 500 fell .25%.

Stocks opened Monday flattish, but began a slow drift lower immediately after the open, and that drift accelerated after the ISM Non-Manufacturing PMI came in unexpectedly weak.

Stocks hit their lows shortly after that release, but then trading quieted materially, and if you didn't know otherwise, you might have thought it was still the holidays. Markets rallied slightly during the afternoon in quiet trading to close off the lows of the day but still solidly in negative territory.

Trading Color

Even though most of Wall Street was back to work yesterday, you wouldn't have known it from the market. Trading volumes remained low and there was little activity from anyone other than fast money funds and algos. But, more than likely the sluggish start to the week had more to do with the big catalysts looming Wednesday-Friday, and I still expect to see activity pick up into those events.

From a sector standpoint, financials were the largest outperformers yesterday, gaining 0.25%. Banks in particular continue to show momentum as they are up 0.8% already year-to-date, and yesterday were helped by a positive article in the WSJ, while the rest of the market remains in negative territory (down 1%). And, although the broad market is clearly taking a "pause" here to start the year, financials and banks are definitely benefitting from capital inflows and re-allocations.

Telecom also outperformed yesterday not so much on "safe haven" buying, but instead on strength in specific names (TMUS in particular).

Conversely, tech lagged after some names were downgraded (EBAY, FSLR), while airlines also lagged as the absolutely frigid temperatures caused travelling havoc across the nation. JBLU was the hardest hit, given it's large number of routes in the "Northeast Corridor."

On the charts little changed yesterday, and initial support is still sitting at 1815 on the S&P, while resistance is the old higher of 1846.

Market	Level	Change	% Change
Dow	16,425.10	-44.89	-0.27%
TSX	13,496.50	-52.36	-0.39%
Brazil	50,973.62	-7.47	-0.01%
FTSE	6761.60	30.52	.45%
Nikkei	15814.37	-94.51	-.59%
Hang Seng	22712.72	28.63	.13%
ASX	5316.99	-7.89	-.15%
Prices taken at previous day market close.			

Copyright 2013, Kinsale Trading LLC. All Rights Reserved. www.sevensreport.com

Also, I did mention yesterday that the first 3 and 5 days performance of the S&P can be generally predictive of the year. So, that's not exactly encouraging, because through the first three trading days of the year, the S&P 500 is down 1.17%. Lets hope for a rally today and tomorrow to make the 5 day performance a bit more positive!

Market	Level	Change	% Change
DBC	25.19	.06	0.24%
Gold	1238.90	.30	0.02%
Silver	20.16	-.051	-0.25%
Copper	3.359	.004	0.12%
WTI	93.46	-.50	-0.53%
Brent	107.10	.21	0.20%
Nat Gas	4.305	.001	0.02%
RBOB	2.6538	.005	0.19%
DBA (Grains)	24.551	.111	0.45%
Prices taken at previous day market close.			

Bottom Line

Stocks are definitely starting 2014 more sluggishly than one would have expected, but the lack of volumes and participation so far makes reading too much into this a fool's errand. Stocks have dropped the last few days due to a lack of bids, not aggressive selling, and I also think we are seeing continued influence of beginning of year re-positioning, because anything with big profits from last year continues to trade heavy. So, for now this appears to be little more than the market working off that end of 2013 spike higher ahead of a new set of catalysts Wednesday trough Friday.

Economics

ISM Non-Manufacturing PMI

- Dec. Non-Manufacturing PMI: 53.0 vs. (E) 54.8

Takeaway

The ISM Non-Manufacturing Index, or service-sector PMI, unexpectedly fell 0.9 to 53.0 in December vs. a reading of 53.9 in November. Analysts expected an increase of 0.9 to 54.8 for December.

Looking past the headline of the report, the details were disappointing, specifically the new orders component. New orders, considered the leading indicator of the report, fell from 56.4 in November to 49.4 in December. The dip below 50, which forecasts contraction in the service space, is the first sub-50 reading since July 2009!

Although the headline number was "ok" markets sold off once when analysts discovered the soft details of the report, it weighed on both the equity market and the Dollar Index.

Bottom line is this was a surprisingly weak number, and the first one we've gotten in a while. To keep it in proper context, its just one number and doesn't negate the good data we've gotten elsewhere, but it is an outlier and something to keep an eye on.

Did the Fed Just Get More 'Hawkish' in 2014?

Later in January, the Fed will hold its first FOMC meeting of 2014, and as is always the case in January, the "line up" of Fed governors will change. (The FOMC is made up of six "permanent" Fed Board of Governors members, the president of the New York Fed, and an annual rotation of five regional Fed presidents.) And, as luck would have it, it looks like the FOMC may, on balance, become slightly more "hawkish" this year.

In particular, two ardent "hawks" will get votes on the 11-member committee this year. Richard Fisher of Dallas and Charles Plosser of Philadelphia will become voting members, and while Esther George, another "hawk" will lose her vote, so too will doves James Bullard, Eric Rosengren and Charles Evans.

Keep in mind, though, that it's still an 11-member committee and certainly will still be the "Chairwoman's" Fed, so do not expect any radical departures from current policy. But, on balance the FOMC got a bit more "hawkish" in 2014, and that is another anecdotal negative for bonds. It also furthers my conviction that we will see this downtrend in bonds accelerate throughout the year.

Commodities

Commodities were mixed yesterday as crude oil again traded lower, precious metals were essentially unchanged, and grains outperformed. The benchmark commodity ETF, DBC, was up 0.16%.

WTI crude oil futures fell for the fifth session in a row yesterday, falling 0.53% on the soft Non-Manufacturing PMI and continued momentum selling left over from last week's sharp drop. And, if not for some longstanding

Copyright 2013, Kinsale Trading LLC. All Rights Reserved. www.sevensreport.com

technical support, oil might have fallen more. The spot price of February crude oil futures approached an "uptrend" line that dates back to June 2012, which has been tested on three occasions and held each time. The most-recent bounce (late-November 2013) off this trend line, however, was much-weaker than previous bounces, which may indicate the uptrend is beginning to break down. If the trend line holds, expect more of the same sideways/range-bound trading. But, if the trend is broken, the price has room to fall toward the $85-$87.50 level in coming weeks.

Precious metals were essentially flat yesterday, but that doesn't mean there wasn't some excitement. At 10:14 a.m. yesterday more than 11K contracts traded were sold in one minute—sending the gold plunging from $1,245.50 to $1,212.60 in a matter of minutes.

When I first started on the floor, a move like that was referred to as a "fat finger" trade, insinuating that a trader mis-entered an order that in turn moved the price of a security. That is likely what happened yesterday in gold; however, computer trading has changed the markets in the last decade. And so, with the growing number of algorithms or "black boxes" in the market today, it is possible that there was a technology glitch that sent an algo into a selling frenzy.

On a more fundamental note, the weekly Commitments of Traders report was released yesterday, indicating an increase in bullish bets by managed money on both gold and silver. Net longs in gold rose from 11,193 to 17,725 while increasing from 3,325 to 7,812 in silver. While an increase from the very low levels of two weeks ago, historically speaking the "net longs" in gold remain very low, and that is generally supportive. The jobs report looms large for gold, but as long as it can hold in here, I think a run to $1270 is possible in the short term.

Natural gas continued to consolidate amid milder weather forecasts (10-14 day) and ahead of the EIA's weekly inventory report. So, although there are headlines to the contrary, the frigid weather gripping much of the country isn't resulting in a rally in natural gas, as warmer weather is on the horizon. The range in natural gas continues to be $4.20 to $4.532, and it'll take a material drop in inventories to break out of that range to the upside, in the near term.

Currencies & Bonds

The Dollar Index declined 0.17% in relatively quiet trading as strength in the euro and weakness in the ISM Non-Manufacturing PMI pressured the greenback. But, the selling didn't have much conviction behind it, and the dollar finished well off the worst levels of the day.

Much like last week, the Dollar Index traded more in reaction to the euro than it did off fundamentals. The ISM Non-Manufacturing PMI miss certainly didn't help the dollar, but the Dollar Index started yesterday's decline well before that data was released (the drop in the dollar yesterday started around 8 a.m.).

The euro's rally (up 0.3%) was really what weighed on the Dollar Index. The euro rose on a combination of the EMU service-sector PMI meeting expectations, and after a Reuters article suggested that the recent drop in rates from some of the PIIGS countries is only further encouraging the ECB to keep monetary policy unchanged at the meeting Thursday. (Spanish, Greek and Italian 10-year bond yields are all sitting at multi-month or multi-year lows, providing a form of relative economic stimulus to those countries.)

And, that gets to the heart of what's really deciding the direction of the euro beyond the very short term. The main reason the euro has traded to multi-year highs vs. the dollar is because the market's perception of the ECB is that it has little to no intention of easing rates further—and that's a bit concerning given the very, very low inflation readings in the region and the growing threat of deflation.

Market	Level	Change	% Change
Dollar Index	80.81	-.145	-0.18%
EUR/USD	1.3634	.0047	0.35%
GBP/USD	1.6404	-.0009	-0.05%
USD/JPY	104.25	-.57	-0.54%
USD/CAD	1.0652	.002	0.19%
AUD/USD	.8958	.0015	0.17%
USD/BRL	2.3796	.0036	0.15%
10 Year Yield	2.961	-.034	-1.14%
30 Year Yield	3.898	-.032	-0.81%
Prices taken at previous day market close.			

Simply put, the market would much prefer that the ECB

Copyright 2013, Kinsale Trading LLC. All Rights Reserved. www.sevensreport.com

do “more” to stimulate the European economy, but that doesn’t look like it is going to happen anytime soon. The fact that PIIGS’ 10-year yields are falling only makes the ECB less inclined to further cut rates or enact other forms of stimulus. This, in turn, is de-facto euro-bullish (and potentially European-stock-bearish).

So, with the further easing off the table, the focus will now turn squarely to readings on inflation. And, we’re not getting encouraging data. This morning December HICP (European CPI) missed expectations and only rose 0.8% yoy, although that was a touch better than the whisper number of 0.7%, so it’s not causing a material sell off. But, beyond the short term, it’s not a number that makes you less concerned about the threat of deflation in the EU.

And, although it wasn’t really covered very much, late last week we got EMU Money Supply figures that showed bank lending dropped 2.3% year-over-year in November. Meanwhile the broad money supply in Europe, known as “M3,” was just 1.7% higher than November 2012, and dropped 0.2% from its 1.9% YoY increase from October. Both stats are anecdotally representative of an economy suffering from dis-inflation.

You can’t correctly analyze Europe without starting with those two issues, because while the EU economy has gotten better, risk of dis-inflation and deflation are growing. Until it’s clear that the either 1) the ECB is ready to act to solve the problem or 2) economic growth is stoking inflation, investment in Europe remains precarious at these levels.

Turning to the yen, it was actually the best-performing currency vs. the dollar yesterday, rallying 0.4%. The yen has rallied nicely so far in 2014, from just under 105 yen to the dollar at the start of the year to just under 104 currently. But, the rally has been little more than a “dead cat bounce” as Japan has been closed all but one day of 2014. Really, all we are seeing is an extremely oversold market regaining some semblance of balance ahead of the jobs report Friday (shorts are covering) and amidst a weaker stock market. (Remember, the yen still will catch a bid when the stock market goes “risk off,” which it did on Thursday.)

At this point, with the yen trading just below 104 yen/dollar, additional stimulus from the BOJ in Q1 2014 is already “priced in,” so to a point there are a lack of near-term catalysts in Japan to further weaken the yen. So, for the yen to head materially lower vs. the dollar in the very short term, it’ll take U.S. dollar strength, as opposed to a drop in the yen.

The jobs report Friday is one of those potential catalysts that could cause a rally in the dollar and a resulting drop in the yen. But barring that, I’d expect more consolidation in the yen around the 103-105 yen/dollar area, with any material dips beyond that viewed as buying opportunities over the medium and longer term. Ultimately 110 yen to the dollar is a conservative target.

Bonds traded modestly higher to start the week, with the 10- and 30-year Treasuries rallying 0.25% and 0.36%, respectively. Some short-covering ahead of the jobs report Friday and the ISM Non-Manufacturing miss were the reasons for the strength in the bond market, although much like the yen we’re just seeing an oversold market gain a bit more balance.

As far as near-term catalysts, obviously the jobs report will be a potential market-mover. Although, given the decline we’ve seen in bonds lately, it’ll take a pretty strong number jobs number to create significant weakness in the near term. Before that, though, there will be 10- and 30-year bond auctions Wednesday and Thursday, and it’ll be interesting to see demand for those issues now that the Fed has embarked on QE “tapering.”

Have a good day,

Tom

Copyright 2013, Kinsale Trading LLC. All Rights Reserved. www.sevensreport.com

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.**

Copyright 2013, Kinsale Trading LLC. All Rights Reserved. www.sevensreport.com

Disclaimer: **The 7:00's Report is protected by federal and international copyright laws. Kinsale Trading, LLC is the publisher of the newsletter and owner of all rights therein, and retains property rights to the newsletter. The Newsletter may not be forwarded, copied, downloaded, stored in a retrieval system or otherwise reproduced or used in any form or by any means without express written permission from Kinsale Trading LLC. The information contained in the 7:00's Report is not necessarily complete and its accuracy is not guaranteed. Neither the information contained in The 7:00's Report or any opinion expressed in The 7:00's Report constitutes a solicitation for the purchase of any future or security referred to in the Newsletter. The Newsletter is strictly an informational publication and does not provide individual, customized investment or trading advice to its subscribers. SUBSCRIBERS SHOULD VERIFY ALL CLAIMS AND COMPLETE THEIR OWN RESEARCH AND CONSULT A REGISTERED FINANCIAL PROFESSIONAL BEFORE INVESTING IN ANY INVESTMENTS MENTIONED IN THE PUBLICATION. INVESTING IN SECURITIES, OPTIONS AND FUTURES IS SPECULATIVE AND CARRIES A HIGH DEGREE OF RISK, AND SUBSCRIBERS MAY LOSE MONEY TRADING AND INVESTING IN SUCH INVESTMENTS.**

Copyright 2013, Kinsale Trading LLC. All Rights Reserved. www.sevensreport.com