# 7:00's Report

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

**February 10th, 2014**

## Pre 7:00 Look

- Futures are modestly weaker as markets digest Friday's rally amidst a quiet weekend news wise.
- International markets, led by the Nikkei's 1.7% rally, are higher as they play "catch up" to Friday's rally.
- Economically the only releases were Italian and French industrial production, both of which slightly missed estimates, although the results aren't moving markets.
- Econ Today: No Reports Today.

| Market | Level | Change | % Change |
|---|---|---|---|
| S&P 500 Futures | 1787.50 | -6.00 | 0.33% |
| U.S. Dollar (DXY) | 80.75 | -.008 | -0.01% |
| Gold | 1272.50 | 9.60 | 0.76% |
| WTI | 99.42 | -.46 | -0.46% |
| 10 Year | 2.675 | -.027 | -1.00% |

## Equities

*Market Recap*

Stocks surprisingly finished slightly higher last week as Thursday and Friday's rallies helped offset Monday's 2% decline. The S&P 500 is down 2.78% year-to-date.

Economic data, and the outlook for the economy, remained the key catalysts for markets last week. Stocks began last week with the worst single-day decline in over 6 months, as concerns about U.S. economic growth bubbled over with the bad miss from the ISM manufacturing PMI. But, just when it looked like things were going to get ugly, stocks stabilized Tuesday/Wednesday. As emerging markets continued to calm down and economic data started to meet expectations, the market caught shorts off-guard and rallied to end the week.

Friday's jobs report was a miss vs. expectations, but investors took it with a grain of salt and stocks continued to rally as fears of "collapsing" U.S. growth continued to recede. Importantly, the S&P 500 closed back above the 100-day moving average (1,773) on Thursday and Friday. (Every correction over the past year has seen stocks dip below the 100-day MA for just a day or two, and then reclaim it – and that's exactly what happened last week, which is an encouraging technical sign.)

*Trading Color*

Market internals weren't quite as encouraging last week as the overall price action from the market. First, volumes were elevated all week but definitely higher on the Monday sell-off than on the Thursday/Friday rally. Additionally, while we saw cyclical indices badly underperform on Monday's drop (the Russell 2000 was down 3% Monday), the Thursday/Friday rally saw most indices rally in-line with each other. So, there wasn't that definitive cyclical outperformance that you would like to see (that would imply more money being put to work as investors get more confident in the market).

Sector-wise it was a touch more bullish, but not enough to make the internals bullish. Energy, materials, homebuilders and airlines (good corporate data) all outperformed and finished higher last week, while utilities declined and REITs and telecom also lagged. So, there was some general "cyclical" outperformance, but it mostly came from short-covering in beaten-up sectors (retail, energy, materials) as opposed to new money being added to recent outperformers like banks (which lagged),

| Market | Level | Change | % Change |
|---|---|---|---|
| Dow | 15,794.08 | 165.55 | 1.06% |
| TSX | 13,786.50 | 73.10 | 0.53% |
| Brazil | 48,073.60 | 335.51 | 0.70% |
| FTSE | 6,576.39 | 4.71 | 0.07% |
| Nikkei | 14,718.34 | 255.93 | 1.77% |
| Hang Seng | 21,579.26 | -57.59 | -0.27% |
| ASX | 5,222.15 | 55.62 | 1.08% |
| Prices taken at previous day market close. | | | |

biotech and semiconductors. So, again it's not quite as encouraging as it seems.

I mentioned Friday, and want to reiterate again, that retailers saw a good bounce last week, and there are several anecdotal signs the sector might finally be "washed out." The retail sales report looms, but perhaps some risk capital to RTH, if you're looking to add long exposure, isn't the worst idea here. I'm already a well-known natural gas E&P bull, but more broadly the energy sector (via XLE) has piqued my interest here. We saw a decent rally last week, but it remains well off the highs. Given the recent WTI rally and elevated natural gas prices, the fundamentals for energy are looking up.

| Market | Level | Change | % Change |
|---|---|---|---|
| DBC | 25.51 | .29 | 1.15% |
| Gold | 1266.80 | 9.60 | 0.76% |
| Silver | 19.98 | .052 | 0.26% |
| Copper | 3.246 | .017 | 0.53% |
| WTI | 100.14 | 2.30 | 2.35% |
| Brent | 109.57 | 2.38 | 2.22% |
| Nat Gas | 4.772 | -.159 | -3.22% |
| RBOB | 2.7442 | .0612 | 2.28% |
| DBA (Grains) | 25.22 | .12 | 0.48% |
| Prices taken at previous day market close. | | | |

On the charts it was a volatile but encouraging week. The S&P 500 held Monday's lows (1,739) and, as mentioned, closed above the 100 day MA (1,773) after spending two days below it. 1,800 is now the next level of resistance, while the 100-day MA is initial support.

*This Week*

Focus this week will be on new Fed Chair Janet Yellen's first testimony before Congress (Tues/Thurs). Obviously her comments will be scrutinized, but she'll likely spend most of her time reciting the familiar Fed refrain: *Tapering isn't tightening ... it's occurring because the economy is getting better … interest rates will remain near zero for a very long time ... and the Fed will remain flexible*. I imagine some will expect her to be incrementally "dovish" in her comments, but her comments likely won't reveal anything new.

Staying in Washington, headlines surrounding the debt ceiling should increase this week, although it remains a very, very low-probability event that we'll have an October-like scare, regardless of any headlines to the contrary. In all likelihood, Republicans will cave on the issue and pass a "clean" debt ceiling bill, so take any uptick in debt-ceiling hysteria with a grain of salt.

Finally, although the Q4 earnings seasons is over (and was better-than-expected), we get some important January quarter-end earnings, chief of which is CSCO. CSCO reports Wednesday, and as always CEO John Chambers' comments will be closely followed because his commentary on the global economy is usually spot-on (for instance, he warned about emerging markets last quarter).

*Bottom Line*

Despite all the recent volatility, concern and worry, the macroeconomic backdrop remains very similar to how it was in late 2013, which was medium-term bullish for stocks. We have seen legitimate concerns rise over the pace of economic growth in China and the U.S. over the past month, and the continued adjustment of emerging markets to Fed policy is something to monitor closely. But in their current state, none of those risks are bearish "game-changers."

Positioning, and quick and violent changes in sentiment, are mostly responsible for market gyrations in 2014, not materially changing fundamentals. And, it's safe to say that most investors remain very skeptical and distrusting of this market, despite its absurd resiliency over the past few years. (I heard many times over the past two weeks that "this is it" with regard to the market finally breaking now that the Fed was tapering.)

All that said, this won't be as easy as 2013, as earnings will have to rise if we are to see multiple expansion carry stocks higher. In the near term, I'd suspect 1,800 to be some intermittent resistance. Bottom line, though, is the benefit of the doubt remains with the bulls over anything other than the short term, and I'd continue to hold current exposures and look for opportunities to selectively add exposure in some beaten-up sectors. (I mentioned RTH and energy earlier, but DXJ is also down big this year, as is TBF.)

## Economics

*Last Week*

Last week was book-ended by two pieces of disappointing data. But reflecting just how confused this market currently is, the first piece of disappointing data (ISM manufacturing PMI) helped cause the worst sell-off in eight months, while the second piece of disappointing data (the January jobs report) helped spark a rally that undid all the damage from Monday.

Starting with the jobs report, by now you know the details: January jobs adds were 113K vs (E) 181K, and the weak December figure was revised 1K higher to 75K. So, overall it was a very disappointing print. So, why didn't the market sell off as we all expected it would? There are a few reasons. First, the household survey (the jobs report is a compilation of two separate surveys on employment. One survey targets employers, the other employees) was much-stronger than the headline "establishment" survey, implying things might not be as bad as the headline. Second, the unemployment rate dropped to 6.6% while the labor participation rate held firm (so the drop was for the right reasons). Finally, although December and January were weak job adds, the rolling three-month average is still decent at 154K, while the rolling six-month is 179K.

Bottom line is the jobs report wasn't good. But, if you're looking for a silver lining to back up a positive thesis, there were some straws you could grasp, which seems to be what most investors did Friday.

Turning then to the first "bad" report of the week, the January ISM manufacturing PMI, it was a big miss—dropping to a multi-month low at 51.3 from December's 56.5. The market didn't give this number the benefit of the doubt, though, and it was a major catalyst for the 2% drop in stocks on Monday.

Seemingly in the reverse of the jobs report, though, there were some legitimate silver linings that made the ISM PMI "not so bad."

First, in November and December, the ISM manufacturing PMI was way ahead of itself in the high-50s relative to actual GDP growth, and the current level (51.3) is much more consistent with 2.5% to 3.0% GDP growth, which is the expectation for Q1 '14.

| Market | Level | Change | % Change |
|---|---|---|---|
| Dollar Index | 80.735 | -.267 | -0.33% |
| EUR/USD | 1.3635 | .0045 | 0.33% |
| GBP/USD | 1.6411 | .0089 | 0.55% |
| USD/JPY | 102.30 | .1900 | 0.19% |
| USD/CAD | 1.1032 | -.0038 | -0.34% |
| AUD/USD | .8959 | .00 | 0.00% |
| USD/BRL | 2.3792 | -.0027 | -0.11% |
| 10 Year Yield | 2.675 | -.027 | -1.00% |
| 30 Year Yield | 3.665 | -.010 | -0.27% |
| Prices taken at previous day market close. | | | |

Second, the Markit manufacturing PMI (which is another private-sector version of the official ISM PMI) was 53.7 in January, down slightly from 55.0 in December, which was an 11-month high. Point being, the Markit PMI never got as lofty as ISM, so we're not seeing such a correction.

The rest of the data last week was ancillary compared to the two big releases, but it was anecdotally important. ISM non-manufacturing PMI largely met expectations at 54.0, while weekly jobless claims fell to 331K, and both those data points helped to calm investors' nerves that we were seeing a material contraction in the pace of economic growth.

Bottom line is last week conclusively showed us that the economy is cooling from the October and November pace, **but it is not collapsing**. That's the key difference (and why stocks walked back off the ledge midweek). But, risks remain.

From a Fed standpoint, their policy outlook remains unchanged. They will continue to taper $10 billion at each meeting unless data gets materially worse. (Don't believe people who tell you stocks rallied because the Fed might "taper the taper" off the jobs report; that isn't the case.)

*This Week*

There's not a lot of data coming this week, and what does won't materially alter the current view that economic growth is cooling, not collapsing. But, the data is still incrementally important and, given the slow week, could move markets.

Retail sales come Thursday, and that will be especially important for the retail sector (if the number is "OK," we could see a continuation of the bounce). Industrial production on Friday is the other notable number this week, and it'll be interesting to see if IP confirms the soft January ISM manufacturing PMI.

## Commodities

Commodities were almost universally higher last week, sending the benchmark commodity tracking ETF, DBC, higher by 2.5%.

Starting with one of the few commodities that did not rally, however, natural gas was the worst-performing commodity last week, as it closed down 1.6% for the week, but nearly 17% off the intraweek highs of $5.73. Fundamentally, inventories remain historically low while the term structure is still bullish, with the front-month contract trading at a 28-cent premium to the back-month contract. That is, however, well off the recent highs of 98 cents and could be an indication we are set to see some consolidation here as the price may have become short-term overextended.

Technically, natural gas has broken through some support this morning trading down to lows of $4.62. The level to watch today is $4.70, and if the spot price is unable to reclaim that level, we could see the price correct further with the next line of support being the 50 day MA at $4.47. Bottom line is that with the price of natural gas still much higher than most equity analysts factored in when forecasting revenues and profits for natural gas producing companies, opportunity remains in getting long natural gas stocks and I continue to like buying dips in FCG and XOP.

Crude oil was one of the better-performing commodities last week, as it rallied for the fourth week in a row—adding 2.8% and closing above $100/bbl for the first time this year. The energy space in general has been supported by the much-colder-than-average weather this season, which has led to increased demand. Fundamentally, crude remains in backwardation with the front-month contract trading at a 57-cent premium to the back-month, confirming heightened demand. The CFTC reported a 4.5-month high in net long positions by money managers, showing that smart money is taking a bullish stance on crude (but this also poses a risk for a violent sell-off if they change their minds). On the charts, WTI has not yet broken out, but is sitting just a few ticks below the high end of a multi-month range at $100.75.

Moving to the precious metals market, gold futures were up 2% for the week while silver added 4.6% mostly on dollar weakness and covering in base metals ahead of Chinese markets opening for the first time in a week last Friday. This morning gold is trading slightly above the $1270 resistance level, and if gold can close above that level for two or three days the technical situation will have become more bullish, and I'll have to re-think my skepticism towards this rally.

## Currencies & Bonds

The Dollar Index fell nearly 1% last week on a combination of euro strength and "ho-hum" economic data throughout the week while the euro rallied just over 1% to a two week high, after the ECB again provided no economic stimulus despite the ever increasing threat of deflation. And, seeing as both the Fed and ECB remain relatively comfortable with current policy, expect the Dollar Index and the euro to remain range bound near current levels for the foreseeable future.

The biggest moves in the currency markets last week were the emerging market currencies, and the moves were positive. The Turkish lira, which has been the epicenter of this latest round of emerging market angst, rallied to a two week high versus the dollar, implying we are seeing stabilization in the emerging markets, which was an underappreciated positive influence for stocks last week.

Looking at the bond market, Treasuries had a volatile week but the 30 year managed to close very slightly lower, while the ten year closed slightly higher. Treasuries continue to trade on a combination of risk appetite and economic outlook, and as risk subsided late in the week and economic data came in not as bad as feared, Treasuries declined late in the week. Bonds remain a key barometer for stocks, and 2.60% in the ten year yield remains a critical level. Any material break of that support will represent an escalation in risks to stocks. The ten year got below it for one day last week but then quickly rallied, and it remains a key level to watch as things get much more negative if the ten year yield moves below 2.60%.

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 | Bullish | Neutral | Bullish | *Stocks stabilized last week after markets decided late in the week that economic growth was cooling, not collapsing. The pace of economic growth and the continuing adjustment in emerging markets remain potential threats to stocks, but for now the rally remains intact and the path of lease resistance higher for stocks.* <br> *Support now lies at 1773 (100 day MA), while resistance is 1800.* |

**Trade Ideas**

***Long Japan:*** **DXJ has gotten hit hard as the yen has rallied, due mostly to emerging market angst. But, the Japanese economy is improving, and seeing as I don't think this latest EM angst is a bearish game changer, I believe the yen will resume its declines and DXJ is not done rallying.**

***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 last 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:*** **The yen is seeing a massive "risk off" rally that can brought it below 102 dollar/yen. But, the fundamentals for a weaker yen remains in place, and I would view this rally as an entry point in a still down trending yen.**

| | Fundamental Outlook | Technical Outlook | Overall | Comments |
|---|---|---|---|---|
| Treasuries | Bearish | Bearish | Bearish | *Treasuries have seen a decent "counter trend rally" and traded to multi-month highs, as emerging market angst put a "fear bid" into bonds. But, with the Fed intent on tapering and inflation likely having bottomed, the larger downtrend remains in place, and I would use this bounce to add to "short bond" positions.* |

**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.**