7:00's Report

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

February 12th, 2014

Pre 7:00 Look

- Futures are flat and international markets modestly higher after Chinese trade data beat estimates.
- Chinese January exports and imports beat expectations, helping to calm concerns about the state of the economy.
- In Europe it was a mixed bag. EU industrial production missed estimates, falling .7%, while the Bank of England Quarterly Inflation Report showed inflation near its target, prompting expectations of a rate hike within a year.
- Econ: No reports today. Fed Speak: Bullard (8:35 AM).
- Earnings: CSCO (E: $0.46).

Market	Level	Change	% Change
S&P 500 Futures	1814.95	0.75	.04%
U.S. Dollar (DXY)	80.795	.091	.11%
Gold	1287.50	-2.30	-.18%
WTI	100.43	.49	.49%
10 Year	2.719	.041	1.53%

Equities

Market Recap

Stocks surged to a two-week high yesterday as "quasi-dovish" comments by Fed Chair Janet Yellen helped spark a technical breakout in the S&P 500, which pulled buyers in from the sidelines and saw the S&P 500 close up 1.11%.

Stocks started Tuesday slightly higher on anticipation of Yellen, swayed briefly after her prepared remarks were released (and contained no "dovish" language), but then steadied and started to rally hard after her somewhat-dovish comments about the labor market during the Q&A session around 11 a.m. The S&P 500 broke through key resistance at the 1,809 level (the 50-day MA), and that resulted in an acceleration as buyers chased stocks higher and shorts covered.

Stocks hit their highs of the day during the mid-afternoon, helped in part by news that House Speaker John Boehner would bring a "clean" debt ceiling extension bill to the House floor last night, ostensibly ending the possibility of any debt ceiling drama. Stocks cheered the news (although as we said in this Report yesterday it was widely expected) and moved higher still.

The rest of the afternoon was quiet and the market gave back a bit into the close, but markets now sit just over 1.5% off the old highs (and 4% higher than the lows of last Wednesday).

Trading Color

Despite the impressive moves in the headline indices, market internals are still not confirming this rally, and will be fodder for the bears. First, volumes—while elevated from Monday—remain well-off levels from the last two weeks, implying there isn't a ton of conviction behind this move. Second, cyclical indices continue to lag. The Dow Transports, Russell 2000 and Nasdaq all lagged the gains made by the Dow Industrials and S&P 500, and at the risk of sounding like a broken record, that's not what you want to see if you're bullish.

Sector-wise, all 10 S&P 500 sub-sectors were stronger yesterday, led by retail (RTH up 1.56%) and energy (XLE up 1.30%). So, as my boss on the floor of the NYSE used to say, "Good job kid; one in a row."

More generally, there was broad strength among the sectors, but no definitive "out of safety, into cyclicals" pattern that would again imply some stronger market

Market	Level	Change	% Change
Dow	15,994.77	192.98	1.22%
TSX	13,887.26	93.08	0.67%
Brazil	48,462.79	751.97	1.58%
FTSE	6688.62	15.96	.24%
Nikkei	14800	81.72	.56%
Hang Seng	22285.79	322.81	1.47%
ASX	5310.05	55.56	1.06%
Prices taken at previous day market close.			

internals. Basic materials, consumer staples, healthcare, financials and tech all rallied more than 1%, so it was definitely a mixed bag. Homebuilders (the sector was downgraded yesterday) and REITs were the laggards (up 0.4% each).

Market	Level	Change	% Change
DBC	25.51	.14	0.55%
Gold	1291.30	16.60	1.30%
Silver	20.21	.098	0.49%
Copper	3.2315	.007	0.22%
WTI	99.965	-.11	-0.11%
Brent	108.68	.05	0.05%
Nat Gas	4.828	.249	5.44%
RBOB	2.7543	.0295	1.08%
DBA (Grains)	25.27	.036	0.15%
Prices taken at previous day market close.			

On the charts, things definitely got more positive yesterday, as the market re-claimed the 50-day moving average (1,809), which is now support, while the old high (1,850) is resistance.

Bottom Line

Stocks didn't rally *because* of the Yellen comments yesterday, but instead because her comments caused a techincal breakout in stocks that then saw buyers chase the market higher.

For all the gyrations of the past two weeks, this market remains dominated by positioning and sentiment much more so than shifting fundamentals. Two weeks ago most institutional investors were too "long" and quickly brought down exposures, and now after doing that they aren't "long enough" and are chasing stocks higher.

Whether or not this correction truly is over will depend on the data, which needs to turn more positive, so next week is key. If the market is going to roll over, though, it'll happen around here, as stocks will fail to reach the old highs. Watch the 50 day MA on any dip—if 1809 is given back, it'll make people nervous on a technical basis. For now, though, the benefit of the doubt remains with the bulls, I continue to like adding exposure in RTH, XLE, DXJ, TBT/TBF if you're looking to do so.

Economics

Yellen Testimony

There was a slightly volatile reaction to the prepared remarks and Q&A from Fed Chair Yellen, but in the end, as expected, she didn't alter the expectations for Fed policy going forward.

Initially, with the release of the prepared remarks at 8:30, the market sold off as Yellen failed to be "dovish," as the market had hoped. Generally her remarks stuck to the script of the last FOMC meeting, as expected.

But, once the Q&A started, Chair Yellen made some comments toward the labor market that the market *did* take as "dovish." Specifically, she said she was "surprised" by the weak December and January reports (keep in mind most Fed speakers said they generally expected some weakness due to weather, so her comments imply things were a bit weaker than she expected), and that the labor market, despite seeing improvement, wasn't yet back to "normal."

Those comments were considered incrementally "dovish" and helped stocks rally to the highs of the day, but the bottom line is that the outlook for Fed policy is unchanged (tapering of $10 billion in March is still widely expected, unless the February jobs report is another dud).

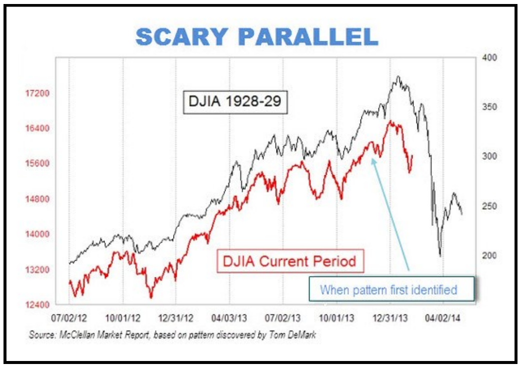
Perhaps most importantly, Yellen consistently stressed continuity in Fed policy – which the market will welcome more than anything. (I read one note that called Yellen "mini-Bernanke" and "Bernanke 2.0." Regardless of your opinion of the policies, continuity is always something the market welcomes from the Fed.)

Was Yellen Really "Dovish"?

Most of the focus of Fed Chair Yellen's testimony yesterday was on her comments about the labor market still not being "normal" and that a 6.5% unemployment rate isn't a "trigger" for higher rates. And, seeing that the current unemployment rate is just 0.1% above the Fed's 6.5% threshold for potentially raising rates, those comments are especially prescient.

The problem with the Fed's (and the Bank of England's) "Forward Guidance" is that the unemployment rate has dropped much faster than anyone thought possible. But, as we all know, the unemployment rate has dropped for the wrong reason (decreased labor participation rate) and, as such, is overstating the health of the labor market.

But, the Fed has said for more than a year that an unemployment rate at 6.5% would likely result in the FOMC considering a hike in Fed Funds. So, now that we are basically there, what is the Fed to do?



Well, in all likelihood, the Fed is simply going to "drop" the unemployment threshold of 6.5%, and simply say they'll raise rates when the economy is strong enough or when inflation increases substantially.

Some analysts and market participants are going to tell you that this potential "drop" in the unemployment rate threshold is incrementally "dovish." After all, if the Fed drops the unemployment rate threshold and the inflation rate remains well-below the Fed's inflation threshold, then clearly we can assume rates will stay low for longer than they otherwise would have been.

That logic is part of why stocks rallied yesterday. But, that logic is dead-wrong, and I don't want you to believe someone who says dropping the unemployment rate threshold is "dovish" from the standpoint of where the bond market is going.

The reason this logic is false is because unemployment, whether it's 6.5% or 4.5%, was never going to cause the Fed to raise rates. The bond market is going to force the Fed to raise rates as bonds drop and yields rise, steepening the yield curve. And, that will happen because the economy is stronger and there is a higher demand for money – and that will coincide with a drop in the unemployment rate as more people get back to work.

Dropping the unemployment rate threshold won't delay the date of the first rate hike because the Fed is no longer in control of interest rates. Rates will rise with the economy, and force the Fed higher regardless of the unemployment rate. So, don't let anyone tell you a removal of the unemployment threshold is dovish or bond-bullish; it is not. And if bonds move higher in a knee jerk reaction off that news when it's announced in the next meeting or two, that rally would be something to sell into.

Market	Level	Change	% Change
Dollar Index	80.71	-.017	-0.02%
EUR/USD	1.3636	-.0008	-0.06%
GBP/USD	1.6446	.0046	0.28%
USD/JPY	102.63	0.39	0.38%
USD/CAD	1.1006	-.0048	-0.43%
AUD/USD	.9031	.0085	0.95%
USD/BRL	2.3997	-.0083	-0.34%
10 Year Yield	2.719	.041	1.53%
30 Year Yield	3.685	.022	.60%
Prices taken at previous day market close.			

__A Note About a Popular Chart Making the Rounds__

Yesterday a client asked me to comment on the chart above, as one of his clients was worried about the similarities. This has become a popular chart amongst the investing public, so I thought I'd share my thoughts, for what it's worth.

Hi Tom,

One of my larger clients asked me to respond to this chart and article. I'm pretty quick to dismiss it, but I wanted to ask you if you've seen it. …

Mark

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Hi Mark,

I've seen this chart sent around several times, and while obviously there is a big visual similarity, the key with this is to point out that the percentage moves are nowhere near equal.

In the 1920s line, the market rallied nearly 80% from where the chart starts (from approximately 200 to about 375-ish).

But, from 7/2/12 till today, the market has only rallied about 25% (12,772 to 16,016) so obviously the gains are significantly less, and as such we're not seeing the type of "blow-off top" that they saw in the mid-1920s.

Like you, I'm dismissive of it. But, quasi-perma-bears like Kass, and others, are pushing it around. I wish figuring out the market was as simple as overlaying charts on tracing paper, but we both know different.

Let me know if you need anything more.

Thanks,

Tom

The point I'm trying to make is that stocks may indeed fall from these levels, but likening this market to 1929 fails on multiple levels. And, just as an aside: Taking in the differences in the scale of the two charts, even if we did see a magnitude drop the size of the one on the 1929 chart, it'd still only be a 24% decline from the highs, not the 44% collapse in 1929 (obviously not good, but you get my point).

Commodities

Commodities were mostly higher yesterday with the exceptions of crude oil and copper, which both finished the day essentially flat. The commodity tracking index ETF, DBC, gained 0.55%.

Natural gas was again the most-volatile commodity yesterday, rallying 5.61%. There were reports of revised weather forecasts contributing to the rally, which most people would probably believe because, lately, it seems that the weather reports are becoming as volatile as natural gas futures themselves.

The real reason for the rally in nat gas was when news broke of a natural gas well fire in Southwestern Pennsylvania around 7 a.m. Eastern. The news initiated speculative buying. It wasn't because traders were concerned with the effect the small Chevron fire would have on supply levels but, rather, the effect it would have on well regulations—a thought very familiar to most after seeing the result of the BP oil spills in 2006 and 2010. Natural gas futures reclaimed both technical support levels that were temporarily compromised on Monday (support of $4.73 and the supporting uptrend line dating back to December when futures really started to accelerate). That level of $4.73 is initial support while $5.00 is both psychological and technical resistance.

Elsewhere in energy, we saw a mirror image yesterday of the price action on Monday. Crude oil underperformed, closing the day ticks away from the flat mark while RBOB gasoline and heating oil gained 1.09% and 0.94%, respectively. The moves were mostly a result of speculative positioning ahead of the EIA inventory report due out this morning at 10:30 a.m. and technical trading noise. Analysts are forecasting a build of 2.5M barrels in crude supplies and a draw of 2.25M barrels in distillates (heating oil), while they expect no change in RBOB gasoline supplies.

Gold and silver both rallied yesterday, gaining 1.30% and 0.49%, respectively. Gold was trading higher in the premarket as a result of a very slight but noticeable "dovish trade" affecting all asset classes. Upon the release of Yellen's testimony notes at 8:30, gold futures fell sharply because there were no dovish surprises like many traders had hoped. But, when Ms. Yellen began to speak, the spot price of gold broke to fresh highs.

Currencies & Bonds

Further confirming that yesterday's rally wasn't because of Yellen's anecdotally "dovish" comments, the bond market fell as both the 10 and 30 year dropped .3%. If Yellen really was "dovish" bonds would have rallied. Point being, the stock market may have rallied off the comments, but the bond market didn't buy it because it's clear that tapering is still on schedule.

With emerging markets stabilizing further and risk being embraced, it looks like this counter trend rally in bonds may be ending, although we'll need some better economic data to truly confirm that.

Moving to the currency markets, it was a choppy day for the greenback, which oscillated back-and-forth around the unchanged mark and finished essentially there, down 0.03%. The euro also spent the day drifting sideways and finished down 0.03% as well.

Elsewhere in Europe, the pound rallied 0.31% as a result of better-than-expected retail sales data released yesterday morning.

Moving to Asia, the Aussie was materially higher, up 1% thanks to higher-than-expected home prices. According to a government report, home prices were up by 3.4% in Q4-13 vs. expectations of 3.0% while Q3 figures were also revised higher. The Aussie closed above $0.90 for the first time in months. If it makes it to the mid-$0.90s, I would be a seller as the Reserve Bank of Australia will not allow the currency to appreciate further.

The yen fell for the 3rd day in the last 4 yesterday as part of a greater risk-on trade in the market. I would look to add to shorts on yen rallies because, again, nothing has changed fundamentally.

Have a good day,

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.* *Support now lies at 1809 (50 day MA), while resistance is the old highs (1850).*

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.**

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.**

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.**

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.**