

7:00's Report

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

February 13th, 2014

Pre 7:00 Look

- Futures and international markets are modestly weaker on continued digestion, soft CSCO margins, and Italian political drama.
- In Italy, the government might collapse again after an internal power struggle in the majority PD party is threatening Prime Minister Letta's coalition.
- CSCO earnings were "ok" but analysts were concerned about margins, while CEO Chambers remained sanguine on the emerging markets.
- Econ Today: Weekly Jobless Claims (E: 330K), Retail Sales (E: -0.1%), Fed Speak: Yellen (Postponed due to weather).

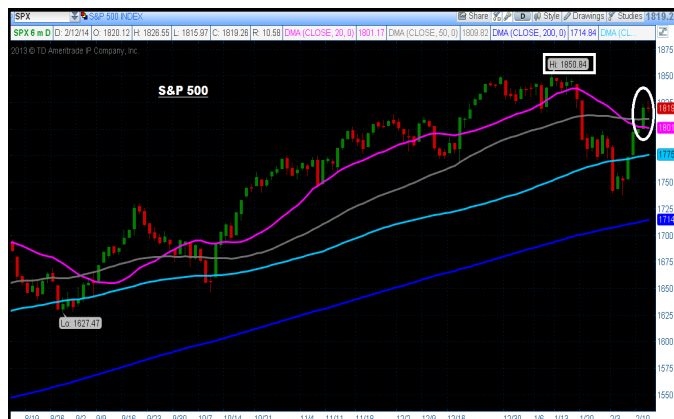
Market	Level	Change	% Change
S&P 500 Futures	1806.75	-10.25	-0.56%
U.S. Dollar (DXY)	80.385	-.356	-0.44%
Gold	1292.50	-2.50	-0.19%
WTI	99.61	-.76	-0.76%
10 Year	2.763	.044	1.62%

Equities

Market Recap

Stocks were flat Wednesday as markets paused to digest the gains of the last week amidst no "new" news. The S&P 500 declined 0.18%.

Stocks opened stronger Wednesday thanks in large part to the better-than-expected Chinese trade data for January. Keep in mind that the soft Chinese "flash" manufacturing PMI back in January was the initial catalyst to the recent correction, so seeing some stabilization in the data there is encouraging.



S&P 500: We've seen a nice rally off the lows, but it's not a foregone conclusion that we're done with this correction. 1809 (the 50 day MA) needs to hold or look for sentiment to get more negative, and quickly.

Markets were mildly higher but then took a mid-morning dip after St. Louis Fed President James Bullard made comments that implied the Fed may be a bit more committed to tapering QE than the market believed up until yesterday, and stocks hit their lows right around noon.

But, there was no follow-through to the selling, and markets lifted off the lows and gyrated in a 3-point range for the rest of the afternoon, before closing in the middle of the day's trading range.

Trading Color

Volumes and market internals are going to keep the bulls uneasy for a little while yet. Volumes were again low yesterday, as most traders were in a "wait and see" mode, while internals continued the trend of being less than bullish. The Russell 2000 and Nasdaq did outperform yesterday, but both were only barely higher and it was nothing that would imply there was intense "buy demand" under the surface.

Looking at the sector trading, it was again a mixed bag. Semiconductors remain one of the 2014 standouts, as

Market	Level	Change	% Change
Dow	15963.94	-30.83	-.19%
TSX	13902.15	21.16	.15%
Brazil	48216.89	-245.90	-.51%
FTSE	6,629.84	-45.19	-0.68%
Nikkei	14,534.74	-265.32	-1.79%
Hang Seng	22,165.53	-120.26	-0.54%
ASX	5,308.10	-1.95	-0.04%

Prices taken at previous day market close.

the SOX rallied 0.85%, while homebuilders also bounced back, rallying 0.75%. Financials were flat; retail and energy gave back a bit of Tuesday's rally; and consumer staples, utilities and REITs lagged. But, no S&P 500 sub-sector moved more than 1% on the day, so like the broader averages, it was a day of digestion among the sectors.

On the charts the situation remains the same: To get the bulls more confident, the S&P has to take out the old highs (1,850) while a break below 1,809 will get people nervous we're putting in a "lower low."

Bottom Line

Sentiment and positioning remain the key in the short term, and it seems like we've gone from too negative one week ago, to a bit too positive as of yesterday, meaning we may need to see a few more days of digestion and chop.

Fundamentals remain supportive but the bulls need to take out 1850 to validate their argument, while the bears get a boost below 1809. While the market has calmed down since last week, I still don't think we're going to see an easy ride higher, and would continue to be selective on adding to the long side.

Economics

There were no economic reports yesterday.

Commodities

Commodities were mostly higher yesterday thanks to strength in the industrial metals, most notably copper. The PowerShares DB Commodity Index Tracking ETF (DBC) gained 0.37% on the day.

Industrial metals were the best performers yesterday as copper, palladium and silver gained 1.31%, 1.70% and 0.78%, respectively. Starting with copper, the strength

was a result of the better-than-expected Chinese trade data that showed both imports and exports improved

Market	Level	Change	% Change
DBC	29.59	.09	0.37%
Gold	1291.30	1.50	0.12%
Silver	20.215	.062	0.31%
Copper	3.2545	.0395	1.23%
WTI	100.34	.40	0.40%
Brent	108.80	0.12	0.11%
Nat Gas	4.838	.014	0.29%
RBOB	2.7583	.0057	0.21%
DBA (Grains)	25.48	.21	0.83%
Prices taken at previous day market close.			

dramatically in January. Most importantly, imports grew 10% vs (E) 5.4%, a very supportive statistic given China consumes 40% of the world's copper. Exports also rose, up 11% year-over-year vs (E) 0.1%, which suggests China has seen an uptick in consumer demand from Western countries. The China bears will argue that these num-

bers, if accurate, are the result of increased one off demand and production due to the "Golden Week" celebration of the Chinese New Year. But, even accounting for that, these numbers were still good.

Silver, which is a bit of a hybrid in the trading world because it has both industrial and precious metal uses/characteristics, was another outperformer—adding 0.78% yesterday. Like copper, silver caught a bid on the stronger-than-expected data in China, but more broadly, as we've been saying since last week, continues to trade better on the charts. Silver has now traded higher nine sessions in a row, ever since revisiting support at \$19.00/oz. Toward the end of the trading day yesterday,

there was some selling in silver which is carrying over this morning, and again I'm looking for a bit of a dip to buy SLV, as fundamentals and technicals continue to improve.

Gold traded to fresh three-month highs, just short of the \$1,300 level, yesterday despite a flat dollar and unchanged stock market. We are seeing a shift in the price action of gold.

Gold futures were acting as a "fear hedge," trading inversely to the stock market, but now traders are again focused on extended "dovish" Fed policy, evident by the fact that both the stock market and gold rallied more than 1% yesterday. Gold is now trading comfortably above the 100-day moving average and seems to have its sights set on \$1,300, but I remain skeptical of this re-



cent breakout, despite being a gold bull. I don't think the Fed is any more "dovish" than it was last week, and unless your time horizon is long and you can stomach the volatility, like silver I'd prefer to buy a dip in gold to add to positions, rather than up here.

Shifting to energy, heating oil was one of the worst-performing commodities yesterday thanks to the EIA reporting higher-than-expected supply levels. The weekly inventory data showed that distillate (heating oil) supplies fell just 0.7M barrels vs. estimates calling for a draw of 2.1M barrels.

As we mentioned at the end of last week and earlier this week, heating oil has been in the spotlight and generally supportive of the entire energy space as supplies were near historic lows. And, as winter weather starts to moderate, the "heating oil" bid in the market seems to be reversing a bit, as WTI crude gave back most of its gains on the day, falling more than a dollar post-EIA report. Also weighing on oil was the fact that the EIA reported a larger-than-expected build in crude supplies, up 3.3M barrels vs. (E) 2.5M barrels. WTI Crude is still trying to conclusively break out above that \$100.75 level (it broke through temporarily yesterday) but I remain unconvinced, and would look to buy a pull back into the high \$90's or a definitive breakout above \$100 per barrel, and would not add longs in this "no mans land."

Inventories of RBOB gasoline were the outlier in the EIA report, falling 1.9M barrels vs. analyst estimates that called for a draw of just 200K barrels. Initially prices moved to new highs, but soon after sold off as RBOB has become a bit of a slave to crude and heating oil futures prices. RBOB finished the day close to the flat mark, up just 0.28%.

Finally, natural gas remained the most volatile of all commodities, rallying 2% intra-day Wednesday before selling off and trading back to flat ahead of the inventory data later today (that's the same pattern we've seen the last two Wednesday's). Analysts expect a drop of 220 BCF in inventories this week, and while that's another big drop in an absolute sense,

the market will trade off expectations in the short term, as it's done for the last month. Regardless of the short term, though, the fundamental situation in natural gas continues to get more bullish, and I continue to like longs on FCG and XOP over the medium term.

Currencies & Bonds

Currency markets finally moved yesterday for the first time all week, although the Dollar Index remains basically unchanged. The moves came from Europe, as the euro dropped 0.36% while the pound was the biggest mover on the day vs. the dollar, rallying 0.8%.

Starting with the latter, the reason for the pound's big move higher was the release of the Bank of England's Quarterly Inflation Report. That report had several pieces of "hawkish" information in it, but the biggest positive catalyst for the pound was that estimated 2014 UK GDP was upped to 3.2%, much higher than last quarter's 2.8% and well above estimates.

Obviously the uptick in expected GDP implies that interest rates will rise sooner rather than later. The BOE in its report confirmed market expectations that rates will likely begin to rise sometime in the second quarter of 2015, as long as all goes according to plan. If the UK economy continues to accelerate, I imagine we'll see rate hikes before then, but regardless it looks like the UK will be the first major central bank to officially begin "normalizing" policy over the coming year.

Turing now to the euro, it dropped vs. the dollar after ECB member Benoit Coeure told Reuters that a negative deposit rate, where EU banks would be charged interest

on money kept at the ECB, was a "very possible option." The news saw the euro drop 0.5% vs. the dollar initially, although it rallied to finish off the worst levels of the day.

This is the latest in "possible" options the ECB is considering to provide fur-

ther stimulus for the EU economy, but there are two things you need to know.

Market	Level	Change	% Change
Dollar Index	80.745	.041	0.05%
EUR/USD	1.3594	-.0042	-0.31%
GBP/USD	1.6593	.0145	0.88%
USD/JPY	102.44	-.19	-0.19%
USD/CAD	1.0995	-.0009	-0.08%
AUD/USD	.903	-.0006	-0.07%
USD/BRL	2.4255	.0255	1.06%
10 Year Yield	2.763	.044	1.62%
30 Year Yield	3.723	.038	1.03%
Prices taken at previous day market close.			

First, the ECB remains relatively intransigent about providing more accommodation, so for now the benefit of the doubt remains with the “hawks,” as there have been many mentions of policy options by ECB members over the past few months, but nothing actually happened.

Second, even if the ECB set the deposit rate negative, it would not have that positive an effect on the economy. (Yes it would encourage lending, but at the same time it would cost banks money, which would likely be recouped in fees to consumers.)

The bottom line is as long as deflation remains a risk in the EU, the market will push for the ECB to do QE, which remains highly unlikely. As a result, I continue to expect the euro to remain buoyant, and think high-yielding European sovereign debt (and to a point corporate debt, although that’s obviously a lot more specific) remains the best place to be in fixed income right now, if you can stomach the added risk.

In Asia the yen rallied small (up 0.15%) vs. the dollar, although it finished well off the highs of the day. The macroeconomic situation in Japan remains stable, and it continues to vacillate based on perceptions of risk in the global economy. Short yen at these levels still makes sense to me for anything other than the very, very short term.

Treasuries continued their post-Yellen declines yesterday, as global macro concerns continue to recede. Also helping push bonds lower yesterday were comments by Fed Governor Bullard, who reiterated that the Fed remains committed to tapering QE and that, unless something drastic happens, tapering will continue. Finally, completing the bearish influences on bonds yesterday was a poor 10-year Treasury auction, which saw a bid to cover of 2.54—well below the 2.68 in January and the 2.71 average for all of 2013. The yield on the offering was the lowest in several months, implying that buyers again are somewhat content to wait for forthcoming higher yields.

I know I pound home this point too often, but as I look around the macro landscape, “getting long” the 10-year yield at sub-2.80% and the 30-year yield at sub-3.8% (so, going short bonds) remains one of the bigger values in

the market over the longer term.

If Forward Guidance Doesn’t Work, Just Abandon It

You know by now that I’ve been pointing to the Bank of England as a “blueprint” for Fed policy going forward, specifically how the central banks will try to convince markets that interest rates will stay “low for long” when all the measurable evidence shows the economy is getting stronger and stronger. Well, yesterday the BOE took the next step in evolution regarding forward guidance by basically throwing it out.

The BOE said that instead of relying on unemployment and inflation as the “thresholds” for when rates might start to rise, they are now using *eighteen* separate statistics to measure “spare” capacity in the economy.

Translation: “Our forward guidance didn’t really work because we’re already at the point (7% unemployment) where we should start raising interest rates. So, now we’re going to make it so complicated to try and figure out when we’ll decide to raise rates that there’s no chance the market will be able to front-run us and push rates up ahead of us, because it won’t know what we’re looking at.”

It’s a nice trick, and I’m sure it works in theory. But to reiterate my point, the market isn’t waiting for the BOE or the Fed. The BOE and Fed could use a Magic 8-Ball and it wouldn’t make a difference – the market will force the BOE and Fed to move higher on rates, it’ll be because the economies are stronger and the demand for money is increasing, and it’ll be a good thing.

From a practical point of view, there are two takeaways here. Number one – The pound is probably going to be the strongest currency vs. the dollar over the coming year, and I imagine new highs are just a matter of time. Number two – expect the Fed to use a similar tactic of redefining the “thresholds” for when rates will rise, likely in the next few meetings (and remember that it won’t be a “dovish” occurrence).

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)

	<u>Fundamental Outlook</u>	<u>Technical Outlook</u>	<u>Overall</u>	<u>Comments</u>
Stocks	Bullish	Neutral	Bullish	<p>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 least resistance higher for stocks.</p> <p>Support now lies at 1809 (50 day MA), while resistance is the old highs (1850).</p>

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 Cyclical and Global Miners: Domestically, I'd look to allocate to deep cyclical 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	<p>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.</p>
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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	<p>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.</p>
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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	<p>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.</p>
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Trade Ideas

Buy: TBF (unleveraged short 20+ year Treasuries) 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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