7:00's Report

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

February 19th, 2014

XOP: Natural gas E&Ps have finally broken out, and with natural gas prices remaining elevated, these stocks can move much higher.

Pre 7:00 Look

- Futures are modestly lower after a quiet night of economics, as markets drift lower on negative headlines in the Ukraine and ahead of critical economic data tomorrow.
- The fighting in the Ukraine is weighing peripherally on emerging markets, although as of yet it isn't a materially negative influence on markets.
- Economically things were quiet o/n. UK Labour Market report came in slightly better than expected.
- Econ Today: Housing Starts (E: 950K), FOMC Minutes (2:00 PM). Fed Speak: Bullard (1:00 PM), Williams (6:15 PM).

Market	Level	Change	% Change
S&P 500 Futures	1830.75	-6.75	-0.37%
U.S. Dollar (DXY)	80.035	-.011	-0.01%
Gold	1319.90	-4.50	-0.34%
WTI	102.39	.29	0.28%
10 Year	2.711	-.035	-1.27%

Equities

Market Recap

Stocks again shrugged off another dose of disappointing economic data Tuesday to finish mildly higher in very quiet trading. The S&P 500 rose 0.11% and is now fewer than 10 points from the all-time highs.

It was a very quiet day yesterday, as most of the headline-grabbing news was international in nature. And in a stark departure from earlier this year, none of the foreign headlines caused much movement here in the U.S. (Neither the surge in the Nikkei nor the PBOC draining liquidity affected European or U.S. stocks positively or negatively.)

Soft economic data (Empire State manufacturing and the housing market index) saw stocks temporarily decline and hit their lows of the day right after 10 a.m. But weather continues to be an asterisk on pretty much every economic report, and stocks shrugged off the data and rallied off the lows, turning positive just before lunchtime. The afternoon session was uneventful, and markets spent most of the rest of the day running in place. Stocks closed quietly and basically unchanged.

Trading Color

It was very much a wait-and-see day yesterday. Trading was holiday-like from a volume and participation standpoint, as volumes were well-below recent averages and trading desks weren't well-populated (apparently it's winter break at many schools in the Northeast).

Despite the low volumes, though, we did see both the Russell 2000 and Nasdaq handily outperform (up 1% and 0.7%, respectively) while the S&P was flat and the Dow actually slightly declined, as it was weighed down by KO

Market	Level	Change	% Change
Dow	16,130.40	-23.99	-0.15%
TSX	14,073.69	18.93	0.13%
Brazil	46,599.76	-976.57	-2.05%
FTSE	6,774.01	-22.42	-0.33%
Nikkei	14,766.53	-76.71	-0.52%
Hang Seng	22,664.52	76.71	0.52%
ASX	5,408.24	15.42	0.29%
Prices taken at previous day market close.			

and PG.

It has to be considered amid lower volumes, but yesterday continues the trend from late last week of cyclical outperformance, and it'll give some comfort to the bulls (for a day at least, until we get the manufacturing PMIs Thursday morning).

Market	Level	Change	% Change
DBC	26.17	.39	1.51%
Gold	1323.70	5.10	0.39%
Silver	21.905	.484	2.26%
Copper	3.2845	.02	0.61%
WTI	102.63	2.33	2.32%
Brent	110.49	1.31	1.20%
Nat Gas	5.552	.338	6.48%
RBOB	2.8385	.0332	1.18%
DBA (Grains)	26.15	.61	2.39%

Prices taken at previous day market close.

Sector wise, there wasn't much insight to glean as most of the ten S&P 500 sub-sectors were little changed, and those that did move traded off specific, localized news events. Homebuilders were the big laggard yesterday, thanks to the weak Housing Market Index, while healthcare continued to outperform thanks to M&A activity in the pharmaceuticals space (ACT/FRX merger).

On the charts nothing changed: Resistance remains at the all time highs of 1850, and it feels as though we'll need a break of that level to get buyers re-engaged, while support sits at the 50 day MA (1812).

Bottom line

There's not a lot to say about yesterday as markets basically were in neutral ahead of the manufacturing PMIs tomorrow morning.

With emerging markets stable (minus the political deterioration in Ukraine, which is tragic but isn't really effecting global markets so far), the key to this market is now economic growth, plain and simple. The disappointing data has been given a "pass" because of the weather, but we're entering a key stretch for monthly data now starting with the flash PMIs tomorrow, so look for the level of anxiety to rise materially if the data continues to disappoint (recall it was the Chinese flash manufacturing PMI miss that initiated the correction).

Generally, sentiment remains very skeptical of the rally, which is a positive, but for this market to materially break through 1850, the data needs to start to stabilize (or better yet, actually improve).

Economics

Empire State Manufacturing Survey

- General Business Conditions Index for February was 4.48 vs. (E) 8.50.
- February New Orders fell 11 points to a reading of –0.20.

Takeaway

The Empire State manufacturing survey, which is the first piece of economic data for the month of February, continued the recent trend of missing estimates. The headline General Business Conditions Index fell to 4.48 (which was worse than the low end of the analyst consensus range) from a reading of 12.51 in January. The details of the report were mixed. New orders, which is the leading indicator in the report, fell to -0.2, a drop of 11 points from last month, and the third negative reading in the last four months.

Stocks sold off initially on the weak headline, but as has been the case for two weeks, the market largely dismissed the weak data because weather was (again) assumed to have negatively affected business conditions. To a point, this is confirmed by the fact that the six-month outlook for business activity rose to a two-year high. Also helping the market ignore the data was the global flash PMIs looming a bit more than 24 hours away.

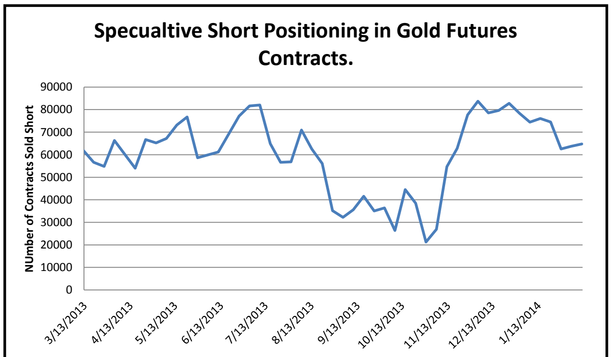
Bottom line is, we can add the Empire State manufacturing survey to the long and growing list of disappointing data points that are being partially ignored because of the horrible winter weather. But, again, the data had better turn positive when the snow stops falling; otherwise this market has a problem on its hands.

Commodities

Commodities were universally higher yesterday as energy was again supported by colder-than-average weather forecasts, while precious metals rallied off the weaker US dollar, which fell courtesy of the poor economic data. The PowerShares DB Commodity Index Tracking ETF (DBC) gained 1.4% on the day.

Starting with the precious metals, gold and silver continue to be the main beneficiary of the weak economic data. Gold and silver were at session lows ahead of the Empire State manufacturing survey and Housing Market Index reports, but both reports missing expectations led gold and silver futures to rally back into positive territory and close near the highs, gaining 0.33% and 2.14%, respectively. The trend of gold and silver trading as a defacto hedge to the recent, poor economic data remains intact.

Looking to the fundamentals in precious metals, the Commitments of Traders report released by the CFTC Friday showed a big increase in the net long positions held by money managers compared to the prior week. Net longs in gold futures jumped 8,434 to 52,086 (a 3-month high). Net long positions are usually a contrary indicator (high and rising net longs are bearish, low and falling net longs are bullish), but the increase was due to new longs coming into the market (chasing the rally) as opposed to shorts covering. So, even though the net longs are higher, the risk of a short-squeeze still exists in gold, and as a result the increase isn't the short term negative that it usually is.



Despite the "net longs" in gold rising last week, the number of shorts in the market remains very elevated, and there's still potential for a short squeeze.

Net longs in silver moved higher by 7,572 to 9,950, but unlike gold the move *was* largely a result of short-covering. Silver is up 14.74% this month now thanks to a rally initiated by technicals and driven higher by the aforementioned short-squeeze, so unlike gold, this shift in the COTs reduces the bullish case for silver in the short term, and if you got long SLV when I pointed it out 2 weeks ago, now might be a good time to book at least some profits if you were just trading it and aren't in it for the medium/longer term. On the charts, silver can rally further with the next level of resistance hovering at $22.80, but clearly it's a bit short term overbought. Support lies at the 200-day moving average ($21.06).

Market	Level	Change	% Change
Dollar Index	80.04	-.139	-0.17%
EUR/USD	1.3757	.0051	0.37%
GBP/USD	1.668	-.0033	-0.20%
USD/JPY	102.31	.39	0.38%
USD/CAD	1.0943	-.0017	-0.16%
AUD/USD	.9035	.0004	0.04%
USD/BRL	2.395	.006	0.25%
10 Year Yield	2.711	-.035	-1.27%
30 Year Yield	3.680	-.020	-0.54%
Prices taken at previous day market close.			

The spot price in gold is trading against some technical resistance at $1,330 and, if that is broken, there is potential for a short-squeeze toward the $1,350 level. Like silver, solid support lies below at the 200-day moving average at $1,305.90/oz.

Moving to energy, natural gas was *again* the best-performing commodity yesterday as it gained 6.75%. I don't mean to sound like a broken record, but weather remains the primary driver of the natural gas market in the short term. But the fundamentals also remain bullish, with the term structure still backward dated and supplies materially shrinking week after week. The strength in natural gas futures continues to support the long argument for the ETFs FCG and XOP.

Elsewhere in energy, crude oil crashed through last week's high of $101.38 and continued the rally throughout the day, closing on the highs at $102.18. The move was partially thanks to the same weather reports that supported the price of nat gas, but supply of distillates (and therefore crude) remains a key factor in the elevated price of crude oil futures.

As both natural gas and WTI crude oil futures continue to move higher, the energy ETF XLE is also poised to see gains. XLE was up 0.44% yesterday, easily outperforming the broader market.

Currencies & Bonds

The dollar was marginally weaker yesterday (down 0.16%) thanks to another helping of soft economic data (Empire State manufacturing and the housing market index). And, with the euro rallying 0.4% vs. the dollar, the only reason the Dollar index didn't decline more was because the weak yen helped hold the index up.

In Europe, the euro was able to shake off a soft German ZEW Business Expectations Index, thanks in part to comments by ECB Governing Council member Ewald Nowotny. He downplayed the possibility of the ECB using negative interest rates, partially contradicting the comments made last week by ECB Governing Council member Benoit Coeure, who said those were a distinct possibility.

So it goes with the ECB. The rhetoric can at times appear dovish, but while the French/Italian/Spanish spirit may be willing to ease policy further, the German/Northern European flesh is weak. And, that is why we won't see any material weakness in the euro until the prospects of more easing (and QE) become a legitimate possibility, and that won't happen until the threat of deflation has grown stronger than current levels. The outlook for European bonds, especially high-yielding sovereigns, remains very attractive in this growing disinflationary environment.

Turning to the yen, you know by now that the BOJ doubled the size of two lending programs, which is why the yen was weaker yesterday. In the face of the seemingly dovish headlines, though, some people I talked to were surprised the yen didn't fall more, and I think there are two reasons for that. First, increasing the lending program isn't really "dovish" because it doesn't make monetary conditions any more accommodative. Second, even with the move Tuesday, the bigger question is whether the BOJ will unleash more monetary accommodation (i.e., more QE) in March or April.

While opinions by various analysts have shifted back and forth, I continue to believe that the BOJ will ease further in the next month or two, and yesterday's move was almost a precursor to "Doing More." And, the reason I believe that is because the Japanese economy needs it – and if the BOJ doesn't act, it will risk losing all the progress it has made over the past year. So, as I've said before, I believe there is an inherent "Abe/Kuroda put" on Japan, similar to the "Bernanke Put" of the last several years.

At the risk of sounding like a very broken record, the Japanese economy will not emerge from decades of stagnation with the yen at 100 to the dollar. Ultimately, whether "Abenomics" works or not remains unclear, but I'm quite sure they aren't ready to give up just yet. To use the Fed analogy from the last few years, the BOJ still has more bullets, and I believe they will use them over the coming months. If they don't, then the Prime Minister and Mr. Kuroda will likely find themselves ultimately unemployed. I continue to like adding to YCS and DXJ here.

Treasuries saw a nice rally yesterday courtesy of the disappointing data, although both the 10- and 30-year finished off their highs of the day (up 0.31 and 0.24%, respectively). The current dynamic in the bond market is fairly stalemated. In the bond bears' favor is the fact that the Fed's strong preference is to continue with tapering of QE, barring some significant deterioration in the economic data. In the bond bulls' favor is the fact that recent data has disappointed, and if that continues or gets worse, the potential for a "tapering of the taper" rises. Bottom line is I'd expect Treasuries to be range-bound for the next several weeks, until we get official February PMIs and jobs report data (which will be the first week of March).

Beyond the next few weeks, though, I expect bonds to resume their declines, as I don't think the economy is taking a significant turn for the worst.

To that point, I got some calls from confused clients on some comments I made in yesterday's Report. I wrote: *"I continue to stress getting 'long' the 10-year at 2.74% and 30-year at 3.7% remains one of the best longer term 'values' in the market."*

I meant getting "long" the yield, which means shorting bonds, and was just trying to point out that a 2.74% 10-year yield and 3.7% 30-year yield remain absurdly low, historically speaking, even despite the recent rally.

Apologies for the confusion – I remain a committed and fervent bond bear and will be more direct going forward.

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)

<table>
<tr><th></th><th>Fundamental Outlook</th><th>Technical Outlook</th><th>Overall</th><th>Comments</th></tr>
<tr><td>Stocks</td><td>Bullish</td><td>Neutral</td><td>Bullish</td><td>Stocks continued their rebound last week, recouping virtually all of the late January correction. 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 1811 (50 day MA), while resistance is the old highs (1850).</td></tr>
<tr><td colspan="5"><u>Trade Ideas</u>

<u>Long Japan:</u> 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.

<u>Long Deep, multi-national Cyclicals and Global Miners</u>: 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.

<u>Long Natural Gas E&Ps:</u> 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.</td></tr>
<tr><td>Commodities</td><td>Bullish</td><td>Neutral</td><td>Neutral</td><td>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.</td></tr>
<tr><td colspan="5"><u>Trade Ideas</u>

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 has now broken out above resistance at $1300/oz., as gold has benefitted from the recent dollar weakness due to soft economic data. Short term I'd only nibble above $1300 on the long side and feel more comfortable around the mid-$1200's, but it appears as though a longer term bottom is "in" in gold.</td></tr>
<tr><td>U.S. Dollar</td><td>Neutral</td><td>Neutral</td><td>Neutral</td><td>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.</td></tr>
<tr><td colspan="5"><u>Trade Ideas</u>

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.</td></tr>
<tr><td>Treasuries</td><td>Bearish</td><td>Bearish</td><td>Bearish</td><td>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.</td></tr>
<tr><td colspan="5"><u>Trade Ideas</u>

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.</td></tr>
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