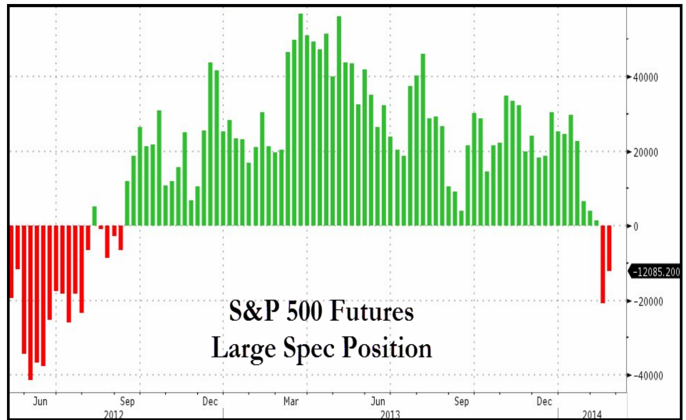
7:00's Report

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

February 25th, 2014



This chart, courtesy of my anarchistic friends at ZeroHedge, shows that speculative net longs are negative in S&P 500 futures, proving just how skeptical investors are of this rally.

Pre 7:00 Look

- Futures are mildly weaker this morning after a quiet night of news.
- In Europe, the EU has pledged support for the Ukraine but there have been no real changes to the situation.
- In Asia, the Nikkei had a nice rally, following gains in the US, but Chinese shares underperformed as the yuan again traded lower vs. the dollar.
- Economically it was quiet as German GDP met expectations while UK Distributive traders (retail sales) beat.
- Econ Today: S&P Case-Shiller HPI (E: 0.6%). Fed Speak: Tarullo (10:10 AM)

Market	Level	Change	% Change
S&P 500 Futures	1843.00	-3.25	-.18%
U.S. Dollar (DXY)	80.16	-.065	-.08%
Gold	1334.90	-3.00	-.22%
WTI	101.94	-.88	-.86%
10 Year	2.75	.016	0.59%

Equities

Market Recap

Stocks rallied to new all-time highs Monday as thin liquidity and a break of technical resistance led to investors chasing stocks higher. The S&P 500 rose 0.62%.

Stocks were higher throughout the entire pre-market session Monday, as the market ignored a new round of China concerns (more on that later) and more uncertainty in Ukraine. The gains seemed to feed on themselves throughout the pre-open trading session and stock futures extended the rally right up to the opening bell and once trading started, resistance at 1,850 was broken before 10 AM. That break out pulled in more buyers, and stocks hit their new intraday highs at 1,858 right around lunchtime.

But, my friend Kenny Polcari called it spot-on during the noontime "Fast Money" when he said he thought stocks wouldn't be able to sustain the gains. Although there weren't any really negative catalysts, stocks slowly drifted lower throughout the afternoon and suffered a mild sell-off during the last 90 minutes of trading to finish solidly positive, but below the 1,850 level.

Trading Color

Stocks made new highs and clearly the technical picture has turned more bullish, but the skeptics will continue to point out that yesterday's rally again came on very, very low volume and participation. And, it seemed the rally was driven more by ETFs and futures rather than single stocks (which implies it's a low conviction move).

Internally, most major averages traded in-line with one another (you would have liked to see the Russell 2000

Market	Level	Change	% Change
Dow	16207.14	103.84	.64%
TSX	14227.08	21.36	.15%
Brazil	47393.50	13.26	.03%
FTSE	6803.47	-62.39	-.91%
Nikkei	15051.60	213.92	1.44%
Hang Seng	22317.20	-71.36	-.32%
ASX	5433.84	-6.38	-.12%

Prices taken at previous day market close.

and Nasdaq outperform). Sector-wise, things were a bit more bullish. Energy, and in particular the natural gas E&P ETFs, surged higher yesterday. XLE gained 1.5% while XOP and FCG rallied 2.5% and 1.6%, respectively. Banks also had a nice day, rising 1.5% mostly on a "catch up" bid (there wasn't any specifically good news out for banks).

Market	Level	Change	% Change
DBC	26.30	.10	0.42%
Gold	1337.00	13.40	1.01%
Silver	22.035	0.253	1.16%
Copper	3.2645	-.0265	-0.81%
WTI	102.72	.52	0.51%
Brent	110.65	.80	0.73%
Nat Gas	5.477	-.658	-10.73%
RBOB	2.8349	-.0005	-0.02%
DBA (Grains)	26.99	.35	1.31%
Prices taken at previous day market close.			

Conversely, utilities were one of two sub-sectors to finish in the red (the other was materials, which declined off the worries about the Chinese housing market). Consumer staples, REITs and retail lagged but finished positive.

On the charts 1,850 has been broken, but I think it'll take a close above that level to really get the buyers "stampeding" in.

Bottom Line

At the risk of sounding dense, the real "reason" stocks rallied yesterday morning was because they didn't decline off the China or Ukraine news. When traders came in and saw Asia sharply lower and Europe slightly in the red, but US futures buoyant, it elicited buying. More importantly, yesterday's price action underscores the point that during the past two weeks, markets have kept international issues contained to the specific country.

For instance, last week the 3% drop in the Nikkei didn't bring international markets lower. The drop in the Ukrainian currency and bonds only temporarily weighed on the emerging markets. And on Monday, the concerns about the Chinese housing market only made the Shanghai and Hang Seng markets drop. So, local problems are staying "local," and that's a positive for markets.

With regards to "Where do we go from here," although rally skeptics are right about low volumes and participation, I was taught early on that the first rule of trading is: "Buy what's making new highs, and sell what's making new lows." This market remains absurdly resilient, yet skepticism of the rally remains very, very high (evidenced by S&P futures speculative net longs being negative) and that combines to make the "pain trade" higher still.

The economy remains a concern (data out yesterday wasn't good, again) as do the emerging markets. But for now the benefit of the doubt remains with the bulls, and I'd hold allocations. A close above 1850 will further pull in sideline buyers.

Ukraine Update

There were some unsettling headlines from the Ukraine late yesterday (the new president said the economy was "heading into the abyss" without international aid, and the Ukraine is in "pre-default"). But, despite the calls for assistance, the financial situation remains stable in the short term. Unless things materially change, Ukraine shouldn't cause the next emerging-market debt scare that will shake the broader markets.

Details have to be worked out, but for now the IMF, EU and U.S. look to be putting together an aid package that will help the Ukraine avoid default. And, although the situation both politically and economically remains very fluid, for now it remains largely a Ukrainian problem (i.e., no contagion risk at the moment).

Why the Chinese Yuan Was the Most-Important Currency Yesterday.

Yesterday, Chinese markets were down more than 1% after reports surfaced that China's Industrial Bank had stopped lending to property/housing-related projects, and the rise in home prices in China showed signs of slowing in January.

As a bit of background, the China bears have long warned that there is a huge real-estate bubble in China that will eventually pop. When it does, it could take the entire market down with it and we'd see a repeat of the housing bust that we saw here in the U.S. in 2008. So, any negative China real estate news is usually a short-term negative, as it was yesterday.

While that was the focus of markets, the more important event in China lately is the fact that the Chinese yuan very quietly fell 1.3% vs. the dollar last week, and dropped sharply again last night. That is a bit of a curious occurrence, given that 1) the Chinese government dictates the value of the yuan vs. the dollar and 2) it has been trending steadily higher for the last several years.

The Chinese yuan has suddenly reversed its rally vs. the dollar (the chart is inverse), and that's not to be ignored.

If the yuan were free-floating, you could understand why it would decline, given that China's economy is seeing growth slow and China is undergoing a massive policy shift that likely will result in slower growth for years to come as this export-driven economy shifts to a more-balanced economy.

But, the yuan isn't free-floating; it's "fixed" every day by the Chinese government, and it's not allowed to trade more than 1% away from that daily "fixing."

The bulk of the yuan's declines came last Friday when the government surprisingly "fixed" the value of the yuan sharply lower vs. the dollar. The question, reasonably, is why did they do that?

The answer is the same as it has been for pretty much every other policy decision lately from the Chinese government and PBOC – they are trying to slowly and carefully reduce the amount of liquidity in, and pegged to, the Chinese economy. Lowering the value of the yuan is one way to do that.

Here's how it works: The yuan trades in China, where it adheres to the 1% band from the "fixed" price every day. But, it also trades outside of China, where the market does not have to adhere to the 1% band (think of it like an offshore market for yuan). Given that, for the last several years, the value of the yuan has been steadily pushed higher vs. the dollar by the Chinese government, a Chinese "carry trade" has developed.

Market	Level	Change	% Change
Dollar Index	80.23	-.04	-0.05%
EUR/USD	1.3733	-.0004	-0.03%
GBP/USD	1.6662	.0048	0.29%
USD/JPY	102.44	-.08	-0.08%
USD/CAD	1.106	-.0049	-0.44%
AUD/USD	.9035	.0061	0.68%
USD/BRL	2.3417	-.0036	-0.15%
10 Year Yield	2.75	.016	0.59%
30 Year Yield	3.711	.015	0.41%
Prices taken at previous day market close.			

Investors can borrow dollars at 0% (thank you, Fed), and lever up and buy yuan that generally appreciate. It's not dissimilar from what was done in the emerging markets. And, since the value of the yuan is manipulated, you can feel pretty safe about the trade. (The "offshore" yuan is heavily influenced by the official fixing and can't stray too far from it; otherwise an arbitrage would develop.)

And, last week Chinese officials sent a "shot across the bow" for investors with the "China carry trade" on, letting them know it's time to unwind those positions.

Like most things, this is healthy in moderation. But, it could become a problem if the decline in the yuan becomes prolonged. First, it'll cause significant losses for anyone who has this "China carry trade" on, which could potentially be destabilizing. Second, it could imply the Chinese economy is worse than we thought and the Chinese officials are trying to lower the value of the yuan to spur exports. Finally, if the decline in the yuan were to become protracted, China would effectively be exporting deflation across the globe—considering prices would drop for all the goods that come from China, and companies could squeeze margins in an effort to increase sales.

Chinese real estate remains a concern, but the more-pressing issue to monitor is the yuan. It's unlikely this will become a protracted decline, but if it does, that's a potential negative not a lot of people are considering.

Bottom line, though, is despite the China perma-bears screaming the end is nigh, Chinese officials are doing a pretty good job of managing the situation, and China is weathering this massive adjustment period pretty well, so far. I would be more inclined to "buy China" via FXI or something similar on any further material weakness than I would be to sell it here.

Economics

There were no economic data report yesterday.

Commodities

Commodities were mixed yesterday as precious metals moved higher and natural gas materially sold off. The benchmark commodities tracking ETF, DBC, was up 0.46%.

Precious metals continued their grind higher yesterday as gold rallied 1.13% while silver added 1.32%, both hitting multi-month highs, thanks to technical buying off gold's break of $1,333 (last week's high) and peripheral Ukrainian concerns.

Fundamentally, the Commitments of Traders report was released on Friday, indicating net long positions held by money managers in both gold and silver moved materially higher. Net longs in gold futures jumped 16,684 to 68,770 with 2/3rds of that move coming from short-covering. In silver, net longs more than doubled from 9,950 to 20,220 and the move was entirely a result of short-covering as long positions actually fell by 498.

Importantly, last week's moves were largely a result of short-covering, which suggests the "easy" part of the precious metals rally is over. What I mean is that the short covering rally in gold, and definitely in silver, is over. And, in order for the rally to continue, we need to see some follow-through buying from investors who want to be long, and not just close out shorts. On the charts, silver is trading comfortably above support at the 200-day moving average ($21.03) while some technical resistance hovers above at $22.75. In gold, futures broke out and closed above the greater downtrend line that was acting as resistance last week, and that level is now support at $1,325. The first line of resistance is now at $1,360.

In the energy space, natural gas was the notable underperformer yesterday as it fell 11%, closing over a dollar below the intraday (and fresh multi-year) high of $6.493. Natural gas traded differently yesterday as the spot price fell for a reason other than just extended weather reports and inventory levels. The front-month futures (for March delivery) expire this week, and as a result we saw substantial profit-taking. After all, natural gas was up 49% YTD at the beginning of the trading day yesterday, so some profit-taking shouldn't be a big surprise.

The fundamentals in natural gas remain favorable over the medium/longer term, but there's evidence building that this parabolic move higher may be over.

On the charts, nat gas printed a massive bearish outside reversal yesterday, hitting a new intraday high but closing below Friday's low. Bottom line is that $6.493 may be a high that holds for now as we near the end of winter. But, prices are set to continue trading at much-higher levels than most equity analysts had in their forecasts. It's important to note that, even though natural gas was down sharply yesterday, FCG and XOP were materially higher.

Crude oil quietly rallied to a new 4.5-month high of $103.45 per barrel yesterday but closed off the best levels, gaining just 0.5%. WTI continues to be supported by the cold weather, but for now WTI appears largely range bound. On the charts, support lies at the 200-day moving average ($99.70) while resistance sits above, between $104 and $105.

Currencies & Bonds

It was a mostly quiet day yesterday in the currency and bond markets. The Dollar Index, euro, pound and yen all moved less than 0.1% in very quiet trading.

With regard to the Ukrainian situation, emerging-market currencies traded well overnight, as the lira rose 0.25% vs. the dollar and the South African rand jumped nearly 2%. The Ukrainian hryvnia slumped 4%, but that's because it'll likely be devalued if the Ukraine accepts a bailout package from the IMF. That aside, emerging-market currencies are implying that, for now, any Ukrainian financial concerns remain contained in the Ukraine, which is a positive for risk assets.

Turning to Treasuries, we saw both the 10- and 30-year decline small (0.06% and 0.09%) mostly in reaction to higher stock prices. Treasuries remain range-bound and I'd expect a very quiet trade ahead of several auctions later this week (2-year tomorrow, 5- and 7-year Wednesday/Thursday) and the Yellen testimony Thursday (although again, that shouldn't yield any surprises).

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 are at an inflection point, as they have recouped all of the late January/early February correction. Concerns about US and global economic growth remain, but generally the fundamentals remain supportive of higher equity prices, so the benefit of the doubt remains with the bulls.* *Key levels to watch will be the 50 day moving average (1814) and the old all time highs of 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.**

	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 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.**

	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 are stalemated in the short term as weak economic data is supportive, but the Fed clearly favoring continued tapering of QE, baring a big drop in economic data, has caused the counter trend rally to stall. Longer term, though, fundamentals remain negative and I view current levels as great entry points for 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.**