7:00's Report

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

February 4th, 2014

S&P 500: Clearly the uptrend line was badly violated in yesterday's sell-off, and if stocks can't reclaim that level in the next few days, 1707 will be a likely target.

Pre 7:00 Look

- Futures are seeing a very mild bounce after yesterday's drop, while Asia collapsed (Nikkei down 4%) and Europe is moderately weaker in reaction to yesterday's selloff.
- News-wise if was quiet. UK construction PMI beat estimates and was the only notable release.
- Emerging markets and their respective currencies are calm this morning and up small versus the dollar.
- Econ Today: No reports today. Fed Speak: Lacker (8:30 AM), Evans (12:30 PM).

Market	Level	Change	% Change
S&P 500 Futures	1740.00	7.25	.42%
U.S. Dollar (DXY)	81.215	.105	.13%
Gold	1254.10	-5.80	-.46%
WTI	96.41	-.02	-.02%
10 Year	2.590	-.078	-2.92%

Equities

Market Recap

Stocks collapsed Monday as a surprisingly soft ISM manufacturing PMI stoked worries about U.S. economic growth while major technical support was broken, exacerbating the declines. The S&P 500 fell 2.28%, its worst day since June of 2013.

Stocks started Monday relatively flat, as global January manufacturing PMIs came in at or above expectations. But, the day changed when the January ISM manufacturing PMI badly missed expectations (soft auto sales also weighed on stocks, but it was a secondary factor). While the bulls tried to explain it away based on poor weather, after a delayed reaction stocks began to sell off shortly after 10 AM. The declines accelerated significantly when that critical support level I have been pointing out (1,769-ish) was broken, as was the uptrend in the S&P that's been in place for over a year.

Stops were elected and sell programs engaged, and before we knew what happened, the S&P was down nearly 2% by lunchtime.

Things quieted in the afternoon from a news standpoint, but disconcertingly stocks never even attempted a rally, as there is no one who wants to step in and buy stocks at these levels. Stocks stayed basically at their lows all afternoon and actually went out on the lows, another troubling sign.

Trading Color

It was a very ugly tape yesterday. Cyclical indices badly underperformed as the Russell 2000 fell 3.2% while the Nasdaq dropped 2.6%.

Market	Level	Change	% Change
Dow	15,372.80	-326.05	-2.08%
TSX	13,486.20	-208.74	-1.52%
Brazil	46,147.52	-1,491.47	-3.13%
FTSE	6,441.83	-23.83	-0.37%
Nikkei	14,008.47	-610.66	-4.18%
Hang Seng	21,397.77	-637.65	-2.89%
ASX	5,097.07	-90.85	-1.75%
Prices taken at previous day market close.			

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Volumes were elevated and selling came from both hedge funds and larger vanilla mutual funds. Instead of looking to buy a dip, investors yesterday were more focused on selling into rallies, a definitive change in short term sentiment.

Market	Level	Change	% Change
DBC	24.88	.00	0.00%
Gold	1259.80	20.00	1.61%
Silver	19.405	.285	1.49%
Copper	3.176	-.021	-0.66%
WTI	96.49	-1.00	-1.03%
Brent	106.10	-.30	-0.28%
Nat Gas	4.894	-.049	-0.99%
RBOB	2.6084	-.023	-0.87%
DBA (Grains)	24.96	.07	0.28%
Prices taken at previous day market close.			

Sector-wise, all 10 S&P sub-sectors finished the day negative, with banks, homebuilders, consumer discretionary and materials all down by more than 2%, while utilities (down 0.8%), REITs (down 1.6%) and energy (down 1.7%) relatively outperformed.

On the charts, support at the 100-day MA was broken. While the S&P traded below that number a few times in 2013, it was never for more than a day or so. Point being, unless we get a big rally today or tomorrow, the technical situation will have turned materially more negative. There's not a lot of support between here and the 200-day MA (1,707).

Bottom Line

Yesterday was very ugly from a trading standpoint, and the market has gone from "not trading well" (what I said yesterday) to trading outright poorly. And, fundamentally, things potentially got more serious yesterday because if we are going to start to question the pace of economic growth here in the U.S., then we are now talking about a potential rally-killer.

I have said for months (and reiterated again last Wednesday and in yesterday's issue) that economic growth remains the key to this market, and yesterday's shocker ISM miss does raise concerns about growth. But, before we all get bearish, I want to point out a few things that can help calm our nerves and client nerves.

First, JPMorgan had an excellent note out in December and reiterated it again yesterday that the ISM PMI was way ahead of itself in the high-50s, and that the current level (51.3) is much more consistent with 2.5% to 3.0% GDP growth, which is the expectation for Q1 '14.

Second, the Markit manufacturing PMI yesterday was 53.7, 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. While obviously not a good number, the market reaction isn't exactly in-line with the reality of the hard data (although keep in mind the market is a leading indicator). Growth is certainly now a concern, but it's not collapsing as bad as the market would imply.

From a "Where could this stop?" standpoint, here are some things I'm watching. The last drop of this magnitude was the "taper" correction of last June, and the decline in the S&P 500 stopped at 14.5X current year earnings. That's up from previous corrections that stopped at 14.3X and 13.7X. So, we are seeing higher highs as to where investors find "value" in the market. Using $118 as the 2014 EPS, 14.5X gets us to 1,711, which is very close to the 200-day MA (1,707). So, that would become a substantial line in the sand.

I try to focus investment strategy on the medium term, because I have learned the hard way that real money is made by identifying powerful trends in the market and **then riding them out over quarters and years.** This market is trading worse and worse, but unless you or your clients are truly nimble, which most aren't, I would continue to hold equity allocations here, as I don't think this rally is over. I also think that, beyond the next week or two, re-allocating out of stocks and into anything else would be an error over the medium/longer term (although admittedly I'm more-uncomfortable with that stance than I was late last week).

Simply put, this market needs some good news, and we haven't gotten any. But, there are a few potential places we could see some good news later this week: First, there's a chance the ECB could act to ease policy further to combat dis-inflation. Second, the jobs report is now critical. If it's a "beat," that will be a badly needed confidence boost.

Bottom line is this decline entered a potentially more serious phase with U.S. economic data now showing signs of growth materially slowing, but I still think it's too

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early to materially de-risk. And, to be clear—I'm not a perma-bull. When the facts change, I change—I just don't think the facts have changed enough to make this anything more than a correction, yet.

Economics

ISM Manufacturing PMI

- January PMI plummeted to 51.3 vs (E) 56.0
- New Orders fell 13.2 percentage points to 51.2

Takeaway

Not only was the ISM manufacturing PMI for January a big miss vs. analysts' expectations, but the details of the report were also bad. New orders, the leading indicator within the report, were materially lower—down 13.2 percentage points to a barely positive reading of just 51.2. There was also weakness in the production and employment components, which fell to 54.8 (-6.9) and 52.3 (-3.5) respectively. I will point out though that most of the key components in the index remain above the critical 50 level, which indicates expansion, albeit at a slower pace.

The market responded to the huge miss with heavy selling as the S&P fell more than 10 points, making new session lows and trading to levels not seen since mid-November. The sell-off, however, was not initially as bad as many would have thought, as weather once again appears to be contributing to the very soft data. The report contained the following qualifier: "A number of comments from the panel cite adverse weather conditions as a factor negatively impacting their businesses in January, while others reflect optimism and increasing volumes in the early stages of 2014."

Market	Level	Change	% Change
Dollar Index	81.175	-.228	-0.28%
EUR/USD	1.3521	.0036	0.27%
GBP/USD	1.6300	-.0132	-0.80%
USD/JPY	101.04	-.99	-0.97%
USD/CAD	1.1093	-.0033	-0.30%
AUD/USD	.8756	.0003	0.03%
USD/BRL	2.43	-.0097	-0.40%
10 Year Yield	2.590	-.078	-2.92%
30 Year Yield	3.550	-.072	-1.99%
Prices taken at previous day market close.			

So, the frigid weather is once again being used to (hopefully) explain the miss, just like it was for the new and pending home sales misses last week. Certainly the weather had some effect on the economy in January, but this is starting to get a bit silly (it can't explain every bad number).

Bottom line is, weather aside, the evidence is mounting that the economy continued to slow in January, and now the jobs number looms very large on Friday. The market will need not only a good January number, but also substantial positive revisions to the December data to regain some confidence.

Commodities

Commodities in aggregate were unchanged Monday, as the rally in non-industrial commodities was largely offset by the decline in industrial commodities. As you can imagine, given that market dynamic, the major influence over the commodity space yesterday was the big miss in the ISM manufacturing index.

WTI crude, copper, palladium and RBOB gasoline all fell modestly yesterday (down less than 1%) on economic worries courtesy of the ISM PMI. Meanwhile gold, silver, platinum, heating oil and grains all rallied modestly (gold, silver and wheat were the only commodities to rise more than 1%). So, despite the big moves in the equity markets, commodities were, by comparison, relatively tame.

Gold was the best-performing commodity yesterday, rallying 1.4% to re-take the $1,260 level, as gold rose on the weaker U.S. dollar and on a renewed "fear" bid thanks to the 300+ point plunge in the markets.

Short term, gold is trading almost perfectly inverse to stocks, so this is very much a risk-on, risk-off trade—and you all know by now that I'm not in favor of buying gold when it's being pushed higher by a "crisis bid." A close above $1,279 (the high from two weeks ago) would likely change my opinion as it'd be bullish technically.

Other than inflation, the other potentially bullish scenario emerging for gold is if gold starts to trade on the market's shifting expectations of Fed policy—in other words, the soft data causing the Fed to "taper" the taper. If that's the case, then gold can and will move higher, but

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the next Fed meeting isn't until March and I'm not sure this string of bad data is enough to dissuade the Fed from tapering, at least not at this point.

So, although I am a medium-/longer-term gold "bull" (not "bug"), I don't think gold is necessarily a great place to "hide" during the stock sell-off.

Crude traded down as much as 1% at the lows yesterday but recovered to close down just 0.7%. There was little fundamental reason for the movement and mostly oil sold off in sympathy with risk assets. WTI crude remains very much in the middle of the $92-$100/bbl. range that has capped oil for months.

Finally, natural gas caught a bid midday to finish well off the lows (at one point, natural gas was trading in the mid-$4.80s, down 4%). But, new weather reports that called for more cold temperatures helped natural gas rally. Of note, Goldman Sachs upped its 2014 price target on gas to $4.50 from $4.25, and cut expected natural gas storage levels at the end of winter to just 1,198 Bcf.

The price bump confirms what I said late last week, in that we should begin to see E&P price targets upgraded as sell-side research firms up their price decks for natural gas, which should be bullish for the shares. The stock market is obviously a headwind in the near term, but beyond that, fundamentals are continuing to improve for natural gas equities, and the ETFs XOP and FCG.

Currencies & Bonds

The Dollar Index fell modestly yesterday (down 0.32%) in reaction to the poor ISM manufacturing PMI, and if not for the euro, the weakness in the Dollar Index likely would have been much worse. Although the euro did rally 0.3% vs. the dollar yesterday thanks to better than expected January PMIs, the euro is fighting against the overhang of the ECB meeting later this week and the quickly shifting expectations for what to expect from that meeting.

There is a growing chorus of analysts who expect the ECB to further ease policy by cutting rates another 10-15 basis points, or by no longer "sterilizing" open market transaction (which in effect has made the ECB buying of EU government bonds non-stimulating for the EU economy). And, until we see what, if anything, the ECB will do next, I'd expect the Dollar Index and the euro to remain relatively flat over the next few days.

One currency that was not flat vs. the dollar yesterday was the yen, which simply exploded higher, rallying 1.3%. There were two reasons it rallied: First, on a continued (and accelerating) "risk off" bid as emerging markets remain strained and the U.S. economic picture gets more-muddied. Second, given the strong data from Japan recently—which showed the economy and the inflation picture are picking up—the certainty of more accommodation from the BOJ in April is being called into doubt. And, those two factors are causing a big rally in the yen, which yesterday hit a 3 month high vs. the dollar below 102 yen/dollar.

Momentum is clearly in the yen's favor at the moment, and things get very interesting around the 100 level (there is decent resistance in the form of a trendline at that level).

Turning to bonds, Treasuries surged yesterday on short-covering and rotation thanks to the soft ISM PMI (bonds were up small prior to that release). The yield on the 10-year note fell below 2.60% for the first time since late October, and I don't like that from a "risk on" standpoint in the short term. The three-month low in the 10-year is 2.47% (it held that level twice in late October, so that is now a key level to watch). If 2.47% is "given," my outlook for stocks in the short term will deteriorate significantly.

Have a good day,

Tom

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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 continuing to undergo a correction as domestic economic growth concerns joins a growing chorus of worries for the market (emerging markets & China growth). Technical support has been violated, but more broadly fundamentals remain positive, and unless data deteriorates further, the rally remains in tact.* *Support now lies at 1707, while resistance is 1770.*

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.**

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