

7:00's Report

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

February 5th, 2014

Pre 7:00 Look

- Futures are flat while Asian and European markets are mixed after economic data was inconclusive o/n.
- In Europe composite PMIs were basically inline but Retail Sales were disappointing which weighed on stocks.
- Econ Today: ADP Employment Report (E: 170K), ISM Non-Manufacturing PMI (E: 53.9).
- Fed Speak: Plosser (12:30 PM), Lockhart (1:40 PM).



Not Everything Has Corrected: The "Ag" Commodities, represented by the ETF DBA, have surged lately on increased demand and frigid/dry weather.

dent Jeffrey Lacker and Chicago Fed President Charles Evans) but they didn't say anything that changed the altered the current outlook for Fed policy. So, there weren't really any market-moving catalysts yesterday. As a result, stocks drifted slowly higher throughout the morning session, hitting their highs at 1 p.m., up a touch over 1%. Positively, the markets held those gains throughout most of the afternoon, before giving back a bit of ground into the close.

Trading Color

Yesterday was just about the most textbook "oversold bounce" in a market that I've seen in some time. Yes stocks rallied, but that's what they normally do a day after falling 2%, and there was little to no conviction in yesterday's trading. The only silver lining, as mentioned, was that stocks didn't sell off into the close.

From an internals standpoint, pretty much all the averages traded in-line with one another, so there was no cyclical outperformance to speak of (which, had it happened, would have been encouraging because it would have

Market	Level	Change	% Change
S&P 500 Futures	1742.25	-1.50	-0.09%
U.S. Dollar (DXY)	81.18	-.044	-0.05%
Gold	1258.50	7.30	0.58%
WTI	97.89	.70	0.72%
10 Year	2.624	.043	1.67%

Equities

Stocks tried to stabilize Tuesday, but it was a very low-conviction move as buyers licked their wounds and everyone looked ahead to the key catalysts coming during the rest of the week (ADP today, ECB tomorrow, jobs report Friday). The S&P 500 rose 0.76%.

Stocks opened Tuesday slightly higher, bouncing from Monday's beating, as they normally do. News flow was quiet Tuesday, with factory orders the lone economic release. While it was positive, it's not really followed. There were also two Fed speakers (Richmond Fed Presi-

Market	Level	Change	% Change
Dow	15,445.24	72.44	0.47%
TSX	13,504.48	18.28	0.14%
Brazil	46,964.22	816.70	1.77%
FTSE	6,461.90	12.63	0.20%
Nikkei	14,180.38	171.91	1.23%
Hang Seng	21,269.38	-128.39	-0.60%
ASX	5,070.31	-26.75	-0.52%

Prices taken at previous day market close.

implied some dip-buying). The Russell 2000, Dow Transports, S&P 500 and Nasdaq all traded within 10 basis points of each other, while the Dow Industrials lagged slightly.

Sector-wise it was a bit more “pro cyclical” as banks, homebuilders and consumer discretionary (sectors that have badly underperformed lately) all rallied more than 1%, while utilities (the star sector of the market year-to-date) was the only S&P 500 sub-sector to finish in the red, falling on profit-taking.

Volumes were again elevated compared to recent weeks, but we continue to see volume significantly higher on “down” days than “up” days, and that happened again yesterday. Nothing in the volumes yesterday implied there was any conviction to the rally.

On the charts, 1,770 (the 100-day MA) has now become resistance (it was support) while the Monday lows of 1,739 are initial support, but more and more I hear people pointing to 1,707 (the 200-day MA) as the key level that needs to be tested.

Is the ‘Long Japan’ Trade Over?

The Nikkei so far this year has been one of the worst-performing stock markets on the globe, and is now down more than 14% from the December highs. As many of you know, I've been a big champion of the “long Japan” trade since late 2012. And even with this recent giveback, the “long DXJ / short yen via YCS” trade has been very a profitable one over that time frame.

But, obviously now there's reason to ask whether this trade is “over.”

And, when deciding if a trend-based trade is over, I always first look back to why I put on the trade in the first place. The basic thesis behind the “long Japan” trade was that Prime Minister Shinzo Abe was going to use massive monetary and fiscal stimulus to finally break deflation in Japan. In doing so, he would materially devalue the yen, and between a devalued yen and growing economy, Japanese stocks would surge. That thesis proved correct, but how much more room does it have

to run?

Market	Level	Change	% Change
DBC	25.03	.15	0.60%
Gold	1252.90	-7.00	-0.56%
Silver	19.42	.011	0.06%
Copper	3.1945	.011	0.35%
WTI	97.20	.77	0.80%
Brent	105.78	-.26	-0.25%
Nat Gas	5.340	.435	8.87%
RBOB	2.6054	-.0015	-0.06%
DBA (Grains)	25.15	.19	0.76%
Prices taken at previous day market close.			

Well, there is proof that the economy is getting better in Japan and some signs that inflation is starting to tick higher, but it's still a very long way from “Abenomics” achieving its goals. I've said it before and I'll say it again: There is no way Abe and BOJ Governor Haruhiko Kuroda will achieve the type of economic growth they desire with the yen to the dollar

at or near 100.

That's because, as the yen rallies and the Nikkei falls, it hurts the Japanese economy. I don't know the men personally, but I highly doubt they are going to let all the progress they have made go up in smoke because emerging markets are dysfunctional and economic growth in the U.S. has potentially become a question mark in the market.

Combine that with the fact that Japan is instituting a consumption tax in April that will be a drag on the economy, and I'd imagine the prospect for more stimulus from the BOJ is higher now, not lower.

Basically, I believe we have an “Abe put” and a “Kuroda put” in Japan. If the yen rallies and threatens economic growth, the BOJ will ease further. If the yen stays low and the economy and inflation get better, stocks (and DXJ) will rise. And, nothing I have seen so far makes me think the “Abe put” is off the table.

Margin clerks are in charge in the short term, so we could easily see more weakness in DXJ & YCS, but I don't think the fundamental thesis has changed. As a result, I remain bullish on Japan, and view this as a buying opportunity into a trend that should last several more quarters (if not years) into the future.

Economics

There were no economic reports yesterday.

Commodities

Commodities were mostly higher yesterday with the ex-

ception of the refined products and gold futures. The PowerShares DB Commodity Tracking Index ETF (DBC) added 0.60%.

Natural gas was once again the best-performing commodity yesterday, as it gained 8.87%. Nat gas futures began to rally early in the morning and accelerated higher into the close, thanks to revised weather forecasts that are calling for frigid temperatures across the country to last through the middle of the month—longer than initially expected.

The colder-than-average temperatures will put additional pressure on supply levels that are already sitting near multi-year lows. Seven of the ten largest “demand days” on record for natural gas were logged in January, which led to it becoming the highest “demand month” ever recorded.

We first pointed out the fact that supply could become a bullish factor for natural gas several weeks ago. And, as we said back then, the key level to watch is 1200 bcf—if we exit the winter with less than 1200 bcf in storage, prices could move materially higher even from current levels.

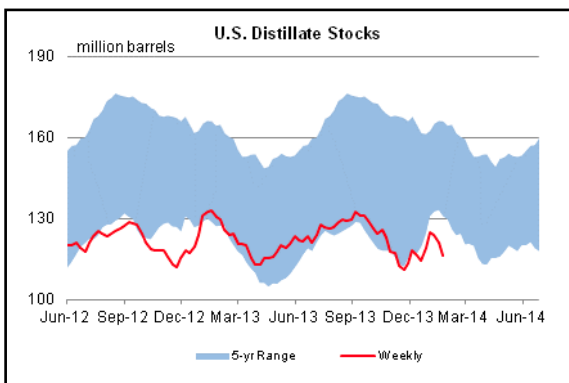
I’ll let those more brave than I guess the next 10% move in the commodity, and I’ll continue to look to accumulate the natural gas E&P ETFs (FCG and XOP) on dips, as it appears higher natural gas prices are indeed here to stay.

Turning to oil, the EIA is set to report weekly inventory levels this morning, with analysts expecting a build of 2.55M barrels in crude supply, a draw of 2.5M barrels in distillate supply, and a 1.15M barrel build in gasoline supply.

Crude oil futures rallied 0.80% yesterday, mostly in sympathy with the bounce in risk assets, although the energy space has been elevated

recently due to unusually cold weather plaguing the nation, adding to general energy and heating demand. Distillate supply levels in particular are already well-below the five-year range, and that has been helping to float the price of crude oil recently. (Analysts are expecting the fourth weekly supply draw in a row in distillate inventories).

Gold was the worst-performing commodity yesterday as it continues to trade inversely to the stock market, acting as a “crisis hedge” for investors. Gold futures fell 0.56% in response to the moderate bounce we saw in equities. And remain in a relatively tight range of \$1,240 to \$1,280/oz.



Currencies & Bonds

Most major developed-market currencies (the Dollar Index, euro and pound) were unchanged yesterday as they look ahead to ADP this morning, ECB tomorrow and the jobs report Friday. Instead, the action in currency markets yesterday

remained in the emerging markets and Asia, although the moves were opposite of what we’ve come to expect over the last few weeks.

Starting with the Aussie dollar, it surged 2% higher vs. the dollar on short-covering after the Reserve Bank of Australia surprisingly turned neutral on its outlook for interest rates at Tuesday’s monthly interest rate meeting. In particular, the RBA said the economy had shown enough progress that no more rate cuts would be

needed, and no longer referred to the Aussie dollar as “uncomfortably high.” From a market standpoint, the broad expectation was for no policy changes, but no one expected such a change in commentary.

I’ve been a big Aussie bear since April of last year, and

that opinion was predicated on slowing Chinese economic growth and pressure on the Aussie by the RBA,

Market	Level	Change	% Change
Dollar Index	81.225	.115	0.14%
EUR/USD	1.3515	-.0009	-0.07%
GBP/USD	1.6324	.002	0.12%
USD/JPY	101.65	.68	0.67%
USD/CAD	1.1071	-.0045	0.40%
AUD/USD	.8934	.0187	2.14%
USD/BRL	2.4052	-.0345	-1.41%
10 Year Yield	2.624	.043	1.67%
30 Year Yield	3.593	.053	1.50%
Prices taken at previous day market close.			

which wanted the currency lower to help spur growth. That thesis is no longer as strong as it was, clearly, but I'm not convinced we're about to see a material rally in the Australian dollar either. China remains a headwind, and clearly the RBA won't tolerate any significant strength in the currency.

So, it's likely that the big trend lower for the Australian dollar has now ended, and it'll likely become more of a trader's market. Despite the rally yesterday (which could last a few more days), I wouldn't be buying the Aussie here, and for those looking to trade it, I'd wait for a rally back above \$0.90 to short.

Turning to emerging markets, we saw significant strength from the most-beleaguered currencies yesterday, as the Turkish lira and South African rand rose 1.7% and 1.5% vs. the dollar, respectively. There wasn't any major, single catalyst for the strength, as it was mostly just the emerging markets digesting the idea of growth potentially slowing in the U.S. (The thinking goes like this: If growth is slowing in the U.S., then the Fed will eventually pause on tapering QE, which is good for emerging-market currencies.)

Importantly, the lira is now at a two-week high vs. the dollar, and while it's still too early to tell whether the moves by the Indian, Turkish and South African central banks last week were "successful," some stabilization in the emerging markets is welcome. Now, the key is whether it can last if and when the market sells off again. But, for now we'll take what we can get.

Bonds fell, as you'd expect, following their big rally on Monday. The 30-year declined 0.59% and the 10-year 0.22%, but both are higher on the week and their relatively muted declines yesterday, compared to the rally Monday, is another sign that yesterday's rally was little more than a bounce. The yield on the 10-year thankfully climbed back above 2.60%, and that remains a critical level to watch (if the yield moves decisively below 2.60%, that will signal to me the outlook for risk assets is deteriorating materially). Watch that level if and when stocks test their recent lows.

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><i>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.</i></p> <p style="text-align: right;"><i>Support now lies at 1707, while resistance is 1770.</i></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><i>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.</i></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><i>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.</i></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><i>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.</i></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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