7:00's Report

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

March 13th, 2014

KOL (the coal stock ETF) has gotten hammered on peripheral China concerns. But with natural gas prices so high, coal fundamentals are improving.

Pre 7:00 Look

- Futures are slightly higher this morning despite Chinese economic data universally missing expectations o/n.
- February Chinese industrial production, fixed asset investment and retail sales all missed estimates, but Asian shares traded "ok" as the weak data is increasing expectations of a reserve ratio cut by the PBOC in the very near future.
- Elsewhere things were quiet o/n. There was no progress in Ukraine (all eyes are on the Kerry/Lavrov meeting Friday).
- Econ Today: Weekly Jobless Claims (E: 330K), Retail Sales (E: 0.2%).

Market	Level	Change	% Change
S&P 500 Futures	1871.25	3.50	.19%
U.S. Dollar (DXY)	79.455	-.264	-.33%
Gold	1371.10	.60	.04%
WTI	98.31	.32	.33%
10-year	2.726	-.040	-1.45%

Equities

Market Recap

Stocks were resilient again Wednesday as markets recouped China-angst-inspired losses to close fractionally higher. The S&P 500 rose 0.03%.

It looked like Wednesday was going to be a bit ugly early on, as Asian markets got clobbered and Europe was down 1%. But, futures here in the U.S. were pretty buoyant. In trading action that was similar to Monday's, sellers tried to push and engineer a decline during the first hour of trading, only to have support at the 1,850 level hold (the low yesterday was 1,853). From there, again like Monday, stocks began a methodical recovery, with the major averages turning positive momentarily right before 11 o'clock. For the remainder of the day, the S&P 500 traded in a 6-point range (1,862-1,868) in predictably quiet conditions, before it caught a bid into the close to finish basically at the highs of the day. As I said, much to the surprise of the bears, the U.S. market again acted very resiliently.

As far as "reasons" for the early-morning weakness, it was definitely angst surrounding the Chinese economy. The "rally" off the lows came after the announcement that Secretary Kerry and Russian Foreign Minister Lavrov will meet on Friday, and that helped raise the expectations for a potential compromise prior to the Crimean elections Sunday (although there wasn't anything other than speculation on that).

Trading Color

It was another quiet day yesterday. Volumes and activity remain low, and there seems to be little to no conviction

Market	Level	Change	% Change
Dow	16,340.08	-11.17	-0.07%
TSX	14,319.00	51.77	0.36%
Brazil	45861.81	164.19	.36%
FTSE	6614.32	-6.58	-.10%
Nikkei	14815.98	-14.41	-.10%
Hang Seng	21756.08	-145.87	-.67%
ASX	5412.61	28.42	.53%
Prices taken at previous day market close.			

to the sell-offs or the rallies (sellers didn't push hard yesterday, nor did buyers step in and aggressively buy the dip).

Market	Level	Change	% Change
DBC	26.00	-.08	-0.30%
Gold	1368.00	21.30	1.58%
Silver	21.30	.485	2.33%
Copper	2.96	.008	0.27%
WTI	97.96	-2.07	-2.07%
Brent	108.10	-.45	-0.41%
Nat Gas	4.497	-.108	-2.35%
RBOB	2.9543	-.0127	-0.43%
DBA (Grains)	28.745	-.0149	-0.05%
Prices taken at previous day market close.			

The indices were little-changed, while from a sector standpoint there was some defensive outperformance. Utilities (XLU) was the best performer on the day, up 1.25%, while REITs and consumer staples also outperformed the markets. Generally speaking, cyclicals lagged as banks, retail and industrials declined. Semiconductors were the outlier, as the SOX rose 0.85%, but that was because TSMC positively pre-announced.

The materials and industrial mining stocks finally stabilized yesterday after their vicious drubbing early in the week, with IYM flat and larger miners like FCX, X, BHP and RIO catching a bit of a bid.

On the charts, the S&P 500 has now fallen 30 points peak to trough from the highs of last week (1,887 to 1,853). Support at 1,850/1,852 (it's the 20-day moving average) held yesterday, so that's a level to watch, while 1,867 and 1,887 are now resistance.

Coal—The Next Phase of the Natural Gas Trade

One of the potential beneficiaries of this huge multi-month rally in natural gas may be a sector that's been largely left for dead: Coal.

You likely know the negative thesis on coal: First there's the "War on Coal" from a policy standpoint, courtesy of the environmentalists. Second, the previously low natural gas prices offered a cheaper and cleaner alternative to coal. The two combined to reduce demand and send coal stocks to multi-year lows. But, things may be changing.

- First, these high natural gas prices have made switching to coal a more-attractive alternative, which could result in increased demand.
- Second, thermal coal inventories have been depleted thanks to the absurdly cold winter, and coal prices are on the rise. (Powder River Basin coal has rallied from 11.73 per short ton to 12.15 as of last week, while Central Appalachian Coal has risen from 57.44 to 60.27.)
- Third, the coal stocks, after putting together a stealth rally throughout early 2014 on these improving fundamentals, have gotten killed in China-based selling of broad basic materials.

So, we have a sector that is:

1) Unloved,
2) Seeing improving fundamentals, and
3) At an artificially discounted price.

Now, those who are reading this and thinking I'm crazy will say coal stocks are down on China concerns because of reduced demand for metallurgical coal (which is used to turn iron ore into steel). And, you may be right. But, that has nothing to do with demand for thermal coal – which is where the opportunity is. (Specifically, thermal coal is used in domestic power plants, and that's where the opportunity lies.)

I'm not a coal analyst, but ACI (Arch Coal) and BTU (Peabody) are two of the more "thermal" heavy coal producers (especially ACI). Or, you could just keep things easy and go with the ETF KOL. It's not going to be a 100% pure play on the investment idea, but if I'm right about coal being an opportunity here, KOL is going to rally.

And, from a trade standpoint, things look attractive. The 52-week low in KOL is $17.16, roughly 2% below current levels. The recent high is near $20.50, almost 20% from here. So, risking one to make 9 or 10 is a pretty good setup.

ACI isn't quite as attractive, but still worth a look. The recent low is $3.89, about 7% below current levels. But, if this stock starts to move, a reasonable target could be $4.75 or $5.25-ish (the September highs), a nearly 15% and 26% move higher.

Coal is one of those sectors, like gold miners, that's been left for dead. But, this huge natural gas rally has given some life into the sector, and with clearly defined risk, this is worth a shot.

Economics

There were no economic reports yesterday.

Commodities

Commodities were mixed yesterday as industrial metals saw a "dead-cat bounce," gold continued to rally on technicals and geo-politics, and the energy sector fell for the third day in a row following the EIA inventory report. The benchmark commodity tracking index ETF, DBC, fell 0.3%.

Beginning with the metals, the industrial metals seemed to begin to process of trying to find a bottom yesterday. Copper gained 0.29% to close at $2.96 after falling over 7% to start the week. The modest pop was largely a result of profit-taking as the price is now below $3.00 at multi-year lows, leaving the technical traders without much to go on.

Silver switched hats yesterday from trading as an industrial metal to trading more like a precious metal. Silver outperformed gold, gaining 2.33% on the day (it was the best performing commodity on the day) . The primary reason silver traded the way it did was because it has largely underperformed over recent weeks, and traders are looking for a way to benefit from the rally in gold without adding exposure at current levels. The thought process is that gold can only rally so far without silver before the naturally more-volatile sibling (silver) begins to play catch-up (much like we saw in the beginning of the year).

Gold futures continued to grind higher yesterday, adding 1.58% and trading to fresh six-month highs. Gold moved higher initially as shorts began to get squeezed out as gold broke resistance at $1360 and then buyers chased the market higher, sending futures up nearly 2% at the highs.

Market	Level	Change	% Change
Dollar Index	79.69	-.155	-0.19%
EUR/USD	1.3908	.0049	0.35%
GBP/USD	1.6619	.0004	0.02%
USD/JPY	102.64	-.36	-0.36%
USD/CAD	1.1114	.0011	0.10%
AUD/USD	.8984	.0012	0.13%
USD/BRL	2.3568	-.0071	-0.30%
10-year Yield	2.726	-.040	-1.45%
30-year Yield	3.667	-.042	-1.13%
Prices taken at previous day market close.			

Gold is strong, and while certainly part of this rally is geo-political inspired given the tension surrounding the Ukraine, there are also other factors at work here.

$1375 is the next level of resistance (we're a few dollars below that as I write), and unless we get material improvement in the Ukraine situation (which is possible given the Kerry/Lavrov meeting tomorrow) I'd expect that level to me tested over the coming days.

The energy sector was the weakest among all commodities yesterday amid mixed inventory data. The EIA reported that crude oil inventories increased by 6.2M barrels vs. (E) 2M, RBOB gasoline inventories fell by -5.2M barrels vs. (E) -1.6M, and distillate (heating oil) inventories fell by -0.5M vs. (E) -0.4M.

The bigger-than-expected build in crude proved to be the dominant catalyst in the energy market, as it weighed heavy on WTI as well as the products. Even RBOB, which saw a draw four times larger than expected, fell 0.43% on the day.

Bottom line is we are seeing the unwinding of the "heating oil bid" continue. And that, combined with the eighth build in supply levels in a row, is really bringing in some selling pressure.

The bears remain in control for the time being and, until the majority of refineries are serviced and recalibrated to start producing summer-grade gasoline, the bears will maintain that control. On the charts the nearest levels of support lies at $97.00 (albeit weak support) while resistance is above toward the $100/bbl area.

Elsewhere in energy, natural gas fell 2.35%, which by this winter's standards would not be a notable move. However, the futures price decidedly broke through and closed below the very trendline that has been intact since the rally began back in the beginning of November. This morning's EIA inventory report will be closely watched as there is a draw of 195 Bcf being forecast. And, if the actual number materially misses one way or another, the possibility for a sharp move corresponding to the data is very good.

Currencies & Bonds

It was another pretty quiet day in the currency space Wednesday. Currencies, and specifically the yen, continued to be the best barometers of "China risk," and to a large degree the stock market took its intraday cues from the yen (rallying when the yen sold off, and selling off when the yen rallied). Initially we saw a continuation of that "risk-off" trade that appeared Tuesday, as the yen was higher Wednesday morning while the Aussie and equity futures continued to decline.

But, the chatter that Chinese authorities were prepping to stimulate growth (if needed) helped sap some of that "risk-off" momentum, and the yen traded back to flat mid-morning while the Aussie turned positive. The afternoon saw the trading in both currencies dominated by short-term trader positioning ahead of the Chinese economic data that came overnight. Both the yen and the Aussie finished the day slightly higher vs. the dollar (up 0.2%), as traders squared books ahead of the release (we saw short-covering in both currencies).

Turning west, there was actually some movement in the euro yesterday, which rallied 0.3% vs. the dollar and closed back above the 1.39 level. The reason for the rally was ECB-speak. ECB Governing Council member Benoit Coeure said that "We don't see any deflation in the euro zone." He somewhat hedged his comments by saying they see it as a possible risk, but Coeure is one of the more "dovish" ECB members. So, if he's saying they don't see deflation, then it's a blunt reminder that there's little chance of the ECB easing anytime soon.

The euro is now just a few ticks below the 1.3915 52-week high, and a break of that level will likely see the euro target 1.40 vs. the dollar. Although, with the Fed decision now less than a week away, I'd be surprised if we see material upside in the euro.

Turing to the bond market, Treasuries were surprisingly strong yesterday, and there were several "reasons" cited by the financial press. First, there was a very strong 10-year Treasury auction (Santelli gave it an "A"), and nominated Fed Vice Chair Stanley Fischer released his prepared remarks ahead of his Senate confirmation testimony early this morning. Fischer, predictably, advocated continued monetary stimulus. But, while the auction gave bonds a boost and some traders likely bought ahead of Fischer's testimony tomorrow, the truth is bonds were stronger all day Wednesday, and never really wavered.

Bonds were the one outlier yesterday (they were up big despite nothing else really trading "risk-off"), and that can't be ignored given the geopolitical or macroeconomic situation. Perhaps it was just some traders trying to get long ahead of the Chinese data in case it was a big miss – but I always consider the bond market the "smartest" market. And the fact there was such strength there yesterday makes me nervous we may not be done on the downside in stocks.

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**	**Bullish**	**Bullish**	*The S&P 500 traded to a new all time high last week, although the gains came on low volumes and with little conviction. But, the broadly speaking the positive backdrop for stocks (macro-economic calm, accommodative central banks, growing economic recovery, skeptical sentiment) remains, so the benefit of the doubt remains with the bulls.* *Resistance is now the all time highs at 1876, while support is the 50 day MA at 1820.*

Trade Ideas

Long Market "Losers": **So far in 2014 the right strategy has been to buy beaten down sectors that offer some value, as opposed to the broad market. It has worked with utilities and most recently the retailers. Now, the banks seem to be the sector that has lagged recently, and if the market continues to rally, we should see them play catch up. KBE remains one of the "easiest" ways to get broad bank exposure. I'd look to allocate to deep cyclicals like industrials (DIA), basic materials (IYM) and global industrial miners (PICK).**

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 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**	*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 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 around the mid-$1300's and would prefer to buy more towards $1300/oz. But, short term timing aside, it appears as though a longer term bottom is "in" in gold.**

U.S. Dollar	**Neutral**	**Neutral**	**Neutral**	*The Dollar Index remains largely range bound, as a stronger euro will hamper any ability for the US Dollar Index to rally, despite continued tapering of QE.*

Trade Ideas

Short: Japanese Yen. **This year has been choppy for the yen as there have been several macro-inspired "risk off" episodes, most recently with the Ukraine. But, with the BOJ expected to ease policy further, fundamentals for a weaker yen remains in place, and I would view this rally as a longer term entry point in a still down trending yen.**

Short: Aussie Dollar. **Aussie saw a big short covering rally last week on better than expected data, but with risks to Chinese growth skewed to the downside and the Reserve Bank of Australia wanting a weaker Aussie, the trend remains lower. For those non-futures traders, shorting FXA or buying CROC is the easiest way to put this trade "on."**

Treasuries	**Bearish**	**Bearish**	**Bearish**	*Economic data has turned a bit more positive and it appears as though the counter trend rally in the bond market is ending. The primary trend remains lower, as the Fed seems intent on further "tapering" of QE.*

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.**