7:00's Report

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

April 22nd, 2014

Pre 7:00 Look

- Futures are unchanged after another quiet night. Asia was mixed but European markets played "catch up" after being closed yesterday and are all higher by 1% or more.
- M&A is also helping stocks rally as there were two deals in Pharma o/n (NVS bought an arm of GSK and there is a 50 bln bid for AGN).
- There was no economic data released o/n.
- Econ Today: Existing Home Sales (E: 4.56M).
- Earnings Today: MCD (E: $1.23), UTX (E: $1.27), CMCSA (E: $0.64), LMT (E: $2.52), VMW (E: $0.79), YUM (E: $1.70).

Market	Level	Change	% Change
S&P 500 Futures	1865.75	1.25	.07%
U.S. Dollar (DXY)	79.90	-.13	-.16%
Gold	1291.30	2.80	.22%
WTI	103.27	-.37	-.36%
10-year	2.717	-.004	-0.15%

Equities

Market Recap

Stocks saw a modest rally to start the week on the back of decent earnings during a quiet trading session Monday. The S&P 500 rose 0.38%.

Earnings were the key driver for the markets yesterday. "Beats" by HAL and STI, combined with a quiet weekend news wise, helped stocks drift higher right after the open. Other than a mid-morning dip back to flat, stocks spent most of the day drifting gradually higher, and went out on the highs of the day.

RBOB Gasoline: Very quietly gasoline has crept to multi-month highs, a sign of economic strength as the increase has been largely demand driven.

Yesterday was extremely quiet given the lack of economic data, few earnings reports and multiple international markets that were closed. Even referring to the mid-morning "dip" is a stretch, as the S&P 500 traded in just a 7-point range from peak to trough yesterday.

Trading Color

It was a very sleepy day yesterday in the markets, and there wasn't much movement other than specific earnings situations. "Momentum" sectors (QNET and NBI) continued their quest to stabilize. They traded decently yesterday, and were actually helped by a few bits of news. (SRPT rose 40% on drug-related news, and the M&A chatter in pharma around PFE and AZN helped lift all of healthcare. Meanwhile NFLX earnings after the close should help to calm some nerves about Internet stocks.)

Looking at the indices, they were all little-changed so there's not a lot to read into there. From a sector standpoint, healthcare was the leader (up 1.2%), while semiconductors and energy also traded well (HAL earnings helped, as did higher energy prices). Banks (despite the STI beat) and utilities (profit-taking) were the only two

Market	Level	Change	% Change
Dow	16449.25	40.71	.25%
TSX	14493.68	-6.71	-.05%
Brazil	52111.85	911.29	1.78%
FTSE	6689.49	64.24	.97%
Nikkei	14388.77	-123.61	-.85%
Hang Seng	22730.68	-29.56	-.13%
ASX	5479.31	25.08	.46%
Prices taken at previous day market close.			

S&P 500 sub-sectors to finish negative on the day.

Materials were the real laggard yesterday, as steel and metals names were heavy in response to further moderating of Chinese property prices and looming manufacturing PMIs tonight.

Market	Level	Change	% Change
DBC	26.54	-.10	-0.37%
Gold	1289.30	-4.60	-0.36%
Silver	19.365	-.231	-1.18%
Copper	3.0405	-.0045	-0.15%
WTI	103.54	.17	0.16%
Brent	108.83	.09	0.08%
Nat Gas	4.697	-.044	-0.93%
RBOB	3.085	.0303	0.99%
DBA (Grains)	28.49	-.39	-1.35%

Prices taken at previous day market close.

Volumes and activity were very subdued yesterday (volumes were well below levels of last week, including Thursday). Yesterday was definitely a "tread water" day ahead of a much-busier earnings and economic calendar over the next 48 hours.

Fundamentally nothing changed—Russia remains an area to watch. But unless there's an invasion, the markets don't really "care" at the moment.

Why Bonds Have Been So Strong

Determining "why" the bond market has been so well-bid recently is very important for the future direction of all asset classes. Depending on "why" bonds are strong, we're eventually either going to see a "melt-up" in inflation and stock prices, or a collapse lower. So, I want to cover the two potential reasons "why" bonds have been so strong over the past six weeks despite the fundamentals clearly being "bond-bearish."

The "Good" Explanation of Why Bonds are Strong (this one is good for stocks).

One explanation as to why bonds have been so strong since early March has to do with Europe. Over the past several weeks, European officials have "ratcheted up" their rhetoric about doing some form of QE or other "unconventional" monetary policy moves to combat the growing risk of dis-inflation and deflation.

Over that period of time, we've seen European bonds rise sharply and yields fall, as investors are discounting low rates well into the future in the EU.

This broad-based lift in European debt may be having a "spillover" effect into the U.S. Treasury market that's bringing in artificial demand for Treasuries. On a comparative basis, German 30-year Bunds are yielding about 2.4%, and that's more than 100 basis points less than the 30-year Treasury yield (about 3.5%). Additionally, yields on PIIGS' debt have collapsed in recent months, with the yield on the Italian 10-year sitting at just 3.12%, an all-time low!

So, on both an absolute and risk-adjusted basis, Treasuries are looking pretty attractive compared to European alternatives, and that could be supporting Treasuries as European investors buy our debt.

Importantly, if this is the "reason" bonds are rallying, then it's a good thing. That's because it means bonds aren't reflecting an imminent slowdown in the economy that will hurt earnings and cause the stock market to fall. Instead, it's just temporary increased demand due to falling yields in Europe.

So, this European money flow may be supporting Treasuries and, at least temporarily, invalidating my "short bond" call. More importantly, though, the strength in bonds wouldn't be signaling some sort of a bearish game-changer for stocks and other risk assets.

The "Bad" Explanation of Why Bonds are Strong (this one is very bad for stocks).

The other possible reason bonds are so strong is because the bond market is screaming that economic growth domestically is going to falter in the coming months, and that we are in for another deflationary scare. If this is "why" bonds are so strong, then it's a big potential problem for risk assets.

A client sent me in a note last week regarding a speech DoubleLine Capital's Jeffrey Gundlach gave at a recent luncheon, where he basically made the case for deflation and stated there was a "30% chance rates make new lows." Obviously, given that I'm an ardent bond bear, I don't think that's going to happen. But I want to go through the "other side of the trade" so people can make their own decision.

Gundlach's basic premise is that QE has been a failure and that, due to a variety of factors, we are all in for another deflationary spiral—and that's why bonds are rallying. So, this is back to the old inflationist (me) vs. deflationist (him) argument.

And, Gundlach raises points that inflationists like me need to consider. Why hasn't QE worked, why don't we have much-bigger inflation, and why aren't yields higher?

On paper, creating trillions of dollars in excess reserves *should* lead to inflation, as long as demand for money is a function of the cost of money (logic being, as cost goes down, demand goes up). But, it would appear with hindsight that a multitude of factors occurred to reduce the demand for money in the economy since 2008. So, no matter how much money the Fed provided, that money remained on corporate and personal balance sheets and didn't chase goods and services (the "pushing on a string" analogy I'm sure you've heard). So, there was plenty of money, but no demand for it and hence no velocity and no inflation.

Now, why was there no demand for the QE money? I think there is a multitude of reasons.

First, shell shock from the worst financial crisis in a century obviously reduced people's desire to borrow money and take risk (at least for a time – luckily our memories are short).

Second, regulation (and this is a big one). Banks specifically were hit with so much uncertainty since '08—regarding capital ratios, future potential loan write-downs and regulatory-fine risk—that the opportunity cost of lending out this free money from the Fed was simply too high, compared to earning a risk-free 25 basis points at the Fed.

Market	Level	Change	% Change
Dollar Index	80.03	.127	0.16%
EUR/USD	1.3794	-.0019	-0.14%
GBP/USD	1.6799	-.0006	-0.04%
USD/JPY	102.61	.22	0.21%
USD/CAD	1.1013	-.0001	-0.01%
AUD/USD	.9335	.0007	0.08%
USD/BRL	2.236	-.001	-0.04%
10-year Yield	2.717	-.004	-0.15%
30-year Yield	3.520	.003	0.09%
Prices taken at previous day market close.			

Third, I am starting to believe that multiple rounds of QE are a deflationary force on the demand for money (but obviously not the supply).

Here's the logic: If I know that the Fed is going to keep rates at 0% for years, and if the marginal direction of policy is only one way (easier), then what incentive do I have to borrow money now? The answer is none. I can wait and pay the same interest, or even borrow money cheaper at a later date.

Now, I'm not saying QE is deflationary. One round of QE isn't deflationary. But these multiple rounds of QE and "low forever" rate guidance don't incentivize people to borrow money in the present. I believe that has negatively affected the velocity of money.

I believe what the Fed (and many in the investment community) "missed" in this whole QE experiment over the past several years was that demand for money was as much a variable as supply. Even through the Fed increased supply, demand fell and offset the gains.

Now, looking to the future, one of the reasons I'm a bond bear is because I believe the demand for money is finally starting to increase. As the economy recovers, that demand for money is going to start accelerating. When it does, it'll meet this enormous supply (QE).

Combine that with (finally) the prospect of higher interest rates as the Fed becomes less-accommodative, and we will have a potential explosion in the velocity of money … and the big inflation everyone assumed would come several years ago (not hyper-inflation, just substantially higher inflation).

That, obviously, will be bad for bonds.

So, what makes me so nervous about the bond market right now is that, if this strength isn't due to temporary money flow from Europe, then the bond market is implying Mr. Gundlach may be right. If the bond market continues to rise, it'll start signaling recession. Then, my "demand for money" argument will be out the window. If that's the case, then we are in for another bout of deflation. Should that happen, then stocks are going to fall, and fall hard.

Bottom line is this bond "conundrum" (why bonds won't decline) remains a "caution" light on the markets. Until bonds start to sell off and "confirm" what we're seeing in stocks, they'll remain a "caution" light that must be monitored.

Economics

There were no economic reports yesterday.

Commodities

Commodities were mostly lower yesterday, led down by the metals while energy was mostly flat on the day. The benchmark commodity tracking index ETF, DBC, slipped 0.37% on the day.

Metals traded heavily yesterday thanks to follow-through selling in platinum group of metals (palladium was down 4% on improved labor relations in South Africa) while gold sold off on general Asian weakness and an unwind of the “fear bid.”

Gold futures traded down 0.4% yesterday, reaching a near-three-week low as the situation between the Ukraine and Russia eased slightly over the weekend. Futures fell to $1,281.80/oz. in overnight trading, dipping to within $5 of a critical support level at the early April lows of $1,277.40, which is the level to watch this week to the downside. Meanwhile, resistance is above at the 200-day moving average ($1,299.70/oz.).

Energy trading was rather quiet yesterday with crude finishing the day marginally higher, up 0.16%, while gasoline managed a 1% rally. As we move to the June futures contract, crude oil remains largely range-bound between $102 and $105. But the benefit of the doubt is still with the bulls thanks a gradually improving economy and expected increases in energy demand.

RBOB gasoline futures remained strong yesterday, rallying 1% as U.S. demand remains increases. According to the EIA, demand for gasoline over the last four weeks has risen 4.6% on a year-over-year basis. And, as I’m sure you commuters have noticed, the Lundberg Survey shows gasoline prices rose 8.5 cents in the past two weeks to a fresh 13-month high—largely matching the uptick in demand.

Bottom line is, the move higher in gasoline prices (both in futures and at the pump) is in-line with an improving economy. As the economic data continue to meet or beat expectations, we can expect the energy space to march steadily higher.

Currencies & Bonds

Currency and bond markets were very quiet yesterday (keep in mind most of Europe, Hong Kong and Australia were closed Monday).

The Dollar Index drifted slightly higher (up 0.19%) while the euro was slightly lower and the pound was unchanged.

The big “mover” on the day was the yen, which dropped for the sixth day in a row on the back of disappointing export data in March. Exports rose just 1.8% vs. (E) 6.5%, thanks mostly to reduced shipments to China. Imports rose 18.1% vs. (E) 16.7%, although that number is probably skewed a bit because of “front loading” of imports before the national consumption tax increased on April 1.

The declines in the yen were modest (down 0.2%) but quietly the yen has been drifting lower over the past week. The next major catalyst in this trade comes a week from tomorrow, when we get the next BOJ meeting and the government’s updated outlook for inflation and growth.

Turning to bonds, Treasuries spent most of the day higher and actually hit their highs around midday (up 0.2%). But as stocks grinded higher throughout the afternoon, bonds sold off and the 30-year closed down fractionally on the day. (So from a price action standpoint, yesterday wasn’t a very impressive day, especially following last Thursday’s sharp declines.)

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	*The S&P 500 saw a nice rebound last week off support at 1815, and is now back in the middle of a month long trading range. Gradual economic improvement domestically and globally is a tailwind on stocks, and unless earnings season is very, very disappointing, the path of least resistance remains broadly higher.* *The S&P 500 remains in the 1880-1840 trading range.*

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 and banks. I think coal stocks (KOL, ACI) are now attractive, given positive fundamentals thanks to 1) high natural gas prices, 2) low inventories and 3) an attractive entry point due to China related basic materials sell off last week. I'd also look to allocate to deep cyclicals like industrials (DIA), basic materials (IYM) and global industrial miners (PICK).**

Long Japan: **"Hawkish" comments by BOJ Governor Kuroda sent the yen spiking higher vs. the dollar and DXJ near the lows for the year. I remain a fundamental bull on Japan, but a decisive break of 44.66 in DXJ will see me exit this trade, despite the fundamentals.**

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

Gold: **The outlook for gold remains unclear, and I'm not sure last week's jobs report was as "dovish" as Friday's reaction. But, gold has acted as a decent equity hedge all of 2014, so if you're nervous about the stock market here, buying gold isn't the worst idea. Use a stop at $1277.**

	Fundamental Outlook	Technical Outlook	Overall	Comments
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. **Similarly to DXJ, the yen caught a big rally this week after nearly breaking down to new lows just two weeks ago. If the yen were to trade below the low for the year, 100.26 yen/dollar, I would exit this trade as the trend will have clearly changed.**

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 longer term trend remains lower. For those non-futures traders, shorting FXA or buying CROC is the easiest way to put this trade "on."**

	Fundamental Outlook	Technical Outlook	Overall	Comments
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.**

Buy A Steepening Yield Curve: **STPP and KBE give positive exposure to a steepening yield curve, as the 10's-2's spread appears to have bottomed and should rally from here. 2.20% in that spread is my stop on STPP and KBE longs.**