# 7:00's Report

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

**May 13th, 2014**

## Pre 7:00 Look

- Futures are slightly higher this morning and most international markets rallied overnight ex-China, mostly on momentum from the US close.
- Economically, Chinese data slightly missed expectations, but was largely in line and therefor did not cause a material sell off in stocks (the Shanghai Composite fell .1%).
- In Europe, Italian CPI met expectations while the German ZEW survey came in just above estimates (62.1 vs E 62.0).
- Econ Today: Retail Sales (E: 0.4%). Fed Speak: Lacker (10:30 AM).

| Market | Level | Change | % Change |
|---|---|---|---|
| S&P 500 Futures | 1895.50 | 2.75 | .15% |
| U.S. Dollar (DXY) | 80.13 | .165 | .21% |
| Gold | 1292.00 | -3.80 | -.29% |
| WTI | 101.30 | .71 | .71% |
| 10 Year | 2.656 | .033 | 1.26% |

## Equities

*Market Recap*

Stocks rallied sharply on the open yesterday and continued to grind higher throughout the day as decent news out of China led to short covering. The S&P 500 rose 0.97%.

Stocks jumped out of the gate yesterday, with both the S&P and the Dow almost immediately hitting all-time highs. U.S. equity markets were seen as largely playing catch-up as nearly every global index was higher ex-Japan yesterday.


*Dow Industrials: The Dow made a new all time high yesterday, and for all the worry about the bond conundrum, this is a positive sign for the market.*

There were a multitude of reasons cited for yesterday's strength in the stock market including the announcement of Chinese capital market reform, the Ukrainian situation remaining benign over the weekend, continued speculation that the European Central Bank will ease policy in June, as well as strength in commodities.

However, the real reason stocks rallied yesterday was positioning and sentiment. The market was very short-term negative heading into trading yesterday, and the rally, while impressive, was comprised almost entirely of short-covering. And, as the day wore on and markets slowly grinded higher, the more painful it became for shorts, and they continued to cover, which is why we went out near the highs of the day.

*Trading Color*

The fact that yesterday's rally was mostly short-covering can be seen in the index and sector trading. The Russell 2000 roared back, rallying 2.39%, while the Nasdaq rose 1.77%. The S&P 500 and Dow Industrials were higher but lagged.

| Market | Level | Change | % Change |
|---|---|---|---|
| Dow | 16695.47 | 112.13 | .68% |
| TSX | 14654.94 | 120.88 | .83% |
| Brazil | 54052.90 | 952.56 | 1.79% |
| FTSE | 6849.83 | -1.92 | -.03% |
| Nikkei | 14425.44 | 275.92 | 1.95% |
| Hang Seng | 22352.38 | 90.77 | .41% |
| ASX | 5498.19 | 49.75 | .91% |
| Prices taken at previous day market close. | | | |

Sector-wise it was the same thing. Recently beaten-down segments like the "momentum" sectors of Internet stocks and biotech rallied (QNET up 3.23%, NBI up 2.59%) as did retailers, banks and consumer discretionary (all the recent market laggards).

| Market | Level | Change | % Change |
|---|---|---|---|
| DBC | 26.18 | .08 | 0.31% |
| Gold | 1296.20 | 8.60 | 0.67% |
| Silver | 19.56 | .439 | 2.30% |
| Copper | 3.145 | .062 | 2.01% |
| WTI | 100.61 | .62 | 0.62% |
| Brent | 108.42 | .53 | 0.49% |
| Nat Gas | 4.435 | -.096 | -2.12% |
| RBOB | 2.9178 | .0218 | 0.75% |
| DBA (Grains) | 28.53 | .05 | 0.18% |
| Prices taken at previous day market close. | | | |

Conversely, the recent market leaders were little-changed yesterday (utilities were down on the day, while consumer staples and REITs were only marginally stronger).

Other than obvious short-covering, the only other trend amongst the sectors yesterday was the outperformance of "China-related" names, including basic materials, industrials and global miners (PICK). They rallied off the Chinese capital market reform announcement.


*Copper appears to have quietly broken a multi-month downtrend.*

Despite the nice rally, yesterday was a pretty slow day, as volumes and activity was subdued, and the think market contributed to the big moves in the markets. On the charts, the S&P 500 did trade to a multi-week high, and is now just below the all-time high of 1,897.

*Bottom Line*

Sentiment got a bit too negative and pessimistic in the very short term, and the lack of utter chaos in Ukraine following the independence votes over the weekend and some decent news out of China caused a short covering rally that helped to restore some balance (sentiment wise) to the market.

But, despite the nice rally, nothing about yesterday's trading implies the outlook for stocks has gotten materially better. And, I'd be shocked if the S&P 500 can trade materially above 1,900 without the 10-year Treasury note trading lower (and yield higher).

That said, I'd not be surprised to see the bulls try and push through 1900 today to try and gets shorts on the run once again, but I don't think you aggressively buy any move above 1900, as I don't think it will have much staying power without the "bond conundrum" going away.

## Economics

There were no economic reports yesterday.

## Commodities

Commodities traded mostly higher yesterday thanks to strength in China, and the gains were led by the metals (industrial metals outperformed with precious metals close behind). Natural gas and the grains underperformed. (Note: DBA was higher because of a spike in coffee futures.) The benchmark commodity tracking index ETF, DBC, was up a modest 0.27%.

The metals were the best performers and inherently the big story in the commodity space yesterday. Copper futures gained 2.15% to close at a 2-month high ($3.15) yesterday thanks to news of Chinese capital market reforms being announced early Monday morning. As we mentioned in yesterday's Report, buying copper is one of the best ways to "get long China." And, the way copper futures traded yesterday in response to the bullish news out of China further confirms this thesis. So, if the data remains strong and the Chinese economy continues to avoid making a "hard landing," we should see copper futures continue to appreciate. On the charts, there is support around $3.10 while the 100-day moving average presents the first line of resistance at $3.165.

It is worth noting that a commodity analyst at a prominent bank released some comments yesterday that downplayed the recent strength in copper. The statement suggested that the rally in copper has largely been driven by funds "rolling" their short positions from one month to another (so buying the near month and shorting the out month). So, point being, he thinks this move in copper is a head fake due largely to positioning.

Certainly the "roll" has something to do with the rally, but on a fundamental basis, there is a potential opportunity in copper (and other China related sectors) as long as China continues to show signs of stabilization in the pace of growth.

Elsewhere in the metals, gold began to rally overnight thanks to the Ukraine vote over the weekend and also upon the release of the same Chinese capital market reform news that triggered the jump in copper prices. Gold futures, however, gave back over half of the morning gains to close the day higher by 0.65%.

The reversal in gold was largely a result of the stock market trading higher out of the gate yesterday morning, which suggests the inverse relationship between gold and the stock market remains intact.

Bottom line in gold is that futures continue to oscillate around the $1,300 level in a trendless market, and until market conditions fundamentally change (i.e., a stock market correction or a Russian invasion of the Ukraine), gold futures will remain range-bound. On the charts, support remains at $1,285 (100-day MA), while $1,300 is proving to be a near-term resistance level.

Moving to the energy space, crude oil traded higher yesterday, up 0.62% as traders continue to push and pull the market around within the well-established, multi-month trading range of $98-$105. The EIA inventory (tomorrow at 10:30 a.m.) will be a key catalyst this week as the "supply bears" and "demand bulls" continue to butt heads.

For now, it seems $100/barrel seems to be where WTI crude is comfortable. And, until we see greater supply draws (or further builds), or heightened gasoline demand, the current range will remain largely in place.

On the charts for near-term trading, there is a weak uptrend forming and support has been moved up to the $100.10 area, while 101.70 is the next level of near term support.

| Market | Level | Change | % Change |
|---|---|---|---|
| Dollar Index | 79.96 | -.001 | -0.01% |
| EUR/USD | 1.3758 | .0001 | 0.01% |
| GBP/USD | 1.6862 | .0013 | 0.08% |
| USD/JPY | 102.15 | .30 | 0.29% |
| USD/CAD | 1.0892 | -.0001 | -0.01% |
| AUD/USD | .9362 | .0002 | 0.02% |
| USD/BRL | 2.2174 | .0052 | 0.23% |
| 10-Year Yield | 2.656 | .033 | 1.26% |
| 30-Year Yield | 3.492 | .025 | 0.72% |
| Prices taken at previous day market close. | | | |

Positively, though, WTI Crude was able to close above its 50 day moving average overnight.

Natural gas was among the worst performers yesterday, falling 2.15% to close at the lowest level in 3 weeks. The drop in futures was largely the result of natural gas inventories building faster than analysts had initially expected. For three weeks in a row now, nat gas stockpiles have increased more than expected. This has caught many traders off-guard, in turn spurring some unwinding of long positions.

There was also an article in the WSJ that cited the recently rising coal prices as a reason for the weakness in nat gas, as speculators anticipate that many convertible power plants are switching from more-expensive natural gas to the cheaper option, coal.

Bottom line is, the last three builds in natural gas have been in-line with the five-year averages. This has calmed many speculative traders' concerns that summer production would fall short and supply levels would remain under pressure going into the winter months (or primary draw season, in which natural gas is used for home heating).

## Currencies & Bonds

Currency markets were little-changed Monday, as news flow was relatively light and traders digested last week's volatility. The Dollar Index was basically unchanged, as slight strength in the euro was offset by a decent drop in the yen. But, the Dollar Index is continuing higher this morning, and has broken back above the 80 level for the first time in a month on a report that the staunchly anti-inflation German central bank (the Bundesbank) will back "unconventional" stimulus measures at next month's ECB meeting to combat the growing deflation threat. The euro is down another .3% and is trading at fresh one month lows.

Looking at trading yesterday, starting with the euro, it traded fractionally higher vs. the dollar yesterday, but it wasn't a strong day, as the euro ended well off the highs. Initially, Monday morning the euro was enjoying a nice oversold bounce (keep in mind the euro collapsed late last week), but two ECB members made comments that reiterated the ECB is likely to ease policy further at the June meeting.

Specifically, ECB member Ewald Nowotny implied that the ECB would consider a “package” of policy changes in June as opposed to something singular like a rate cut. This isn’t exactly anything new, but it again shows the ECB isn’t afraid of putting a “bull’s eye” on the June meeting, and the market will be expecting something more than just a small rate cut.

Regardless, as I said yesterday, don’t expect any material weakness (like trading down towards 1.35 or something) in the euro into the meeting, however. Ultimately no one expects measures taken at the June meeting to materially improve the growing deflation problem, and the market will keep pressure on the ECB to continue down the road toward QE, eventually.

The yen was the big mover in the currency space yesterday, as it dropped 0.4% vs. the dollar and traded back above 102 yen/dollar. The catalyst for the weakness was the “delicate” comment Prime Minister Abe made when discussing whether or not the BOJ should ease policy further. (Reading between the lines, obviously Abe is concerned about the economy and “Abenomics.”)

Expectations for when the BOJ eases further have quietly been creeping forward, with most penciling in July as the potential date for more stimulus. However, the conviction around that date isn’t very high, as we simply don’t know how much of an effect the increased sales tax is having on the economy at this point. That will likely be the difference-maker on when the BOJ eases again.

Elsewhere things were rather boring, as the commodity currencies were up small versus the dollar ahead of the Chinese economic data that came overnight, while the pound was also flat in quiet trading.

Turning to bonds, the 30-year sold off decently yesterday, down 0.35%, mostly in reaction to the higher stock market. But, the declines aside, you would expect more than just a 0.35% move lower in the 30-year on a day when the S&P 500 and Dow were higher than 1% and both either made or threatened all-time highs.

So, point being, the bond market remains buoyant, although again we are (hopefully) seeing some cracks in this short-squeeze. But, as I said, until the yield on the 10-year starts moving toward 2.80% and ultimately toward 3%, I’d be very, very surprised if stocks can get materially above 1,900 in the S&P 500.

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 | *Gradual economic improvement domestically and globally is a tailwind on stocks, and as earnings season has largely com in "ok," the path of least resistance remains broadly higher. But, the strength in bonds and flattening yield curve is starting to weigh on stocks in the near term and any move beyond 1900 is likely capped until bonds start to sell off.*<br>*The S&P 500 remains largely in a trading range between 1890-1840.* |

**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) 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). I'm added IYZ (Telecom ETF) to this "market losers" basket this week, as its trading at a valuation discount and has underperformed other defensive sectors recently.**

***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, 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. I added a long gold trade two weeks ago with a stop at $1277 in futures or $123.11 in GLD.**

| | 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 | *Bonds remain shockingly buoyant despite economic data confirming the winter slowdown in the economy was temporary, while the Fed has confirmed it intends to continue tapering. The longer term trend remains lower, but the counter trend rally in bonds is continuing in the short/medium term.* |

**Trade Ideas**

***Buy:*** **TBF (unleveraged short 20+ year Treasurys) and TBT (2X leveraged short 20+ year Treasury).**