7:00's Report

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

May 14th, 2014

Pre 7:00 Look

- Futures are slightly lower as are most international markets after a quiet night of digestion of recent gains. The situation in Ukraine remains largely unchanged.
- Economically the UK was in focus, as the April Labour Market report was slightly weaker than estimates (but basically in line), while the BOE Inflation Report is being taken as slightly "dovish" but didn't contain many surprises.
- In Europe, EMU Industrial Production slightly missed estimates (-0.3% vs. (E) -0.2%).
- Econ Today: No important economic reports today.

Market	Level	Change	% Change
S&P 500 Futures	1892.00	-2.25	-.12%
U.S. Dollar (DXY)	80.11	-.103	-.13%
Gold	1302.00	7.20	.56%
WTI	101.94	.24	.24%
10-year	2.618	-.038	-1.43%

Equities

Market Recap

Stocks opened flat and stayed there during a downright boring trading session on Tuesday. The S&P was virtually unchanged, up just 0.04%.

News-wise, there were several items out pre-market including Chinese economic data (which was in line), a U.S. retail sales report (also in line), Indian exit poll data showing a probably "pro-business" party victory and the WSJ Bundesbank article that suggested Germany may be willing to back aggressive ECB stimulus measures. However, none of those items materially changed the fundamental picture, so stocks were largely unchanged pre-market.

Stocks began to rally shortly after the bell yesterday as traders tried to induce another short-covering rally and the S&P actually hit a fresh all-time high at 1,902. But, unlike Monday, there was no follow-through and the rally stalled by 11:00 A.M., as the S&P 500 slipped back below 1900. The S&P 500 virtually flat-lined from 11 o'clock on just under 1,900 and closed very quietly.

Trading Color

Unlike Monday, there was no short-covering in the markets yesterday as the Russell and Nasdaq both took a breather, falling 1.1% and 0.33%, respectively (the underperformance of those to indices was probably the #1 reason we didn't see any follow through covering on yesterday's rally). "Momentum" sectors, NBI and QNET, also stalled as both were down small on the day. So, it appears the jury is still out on whether the multi-week high-beta sell off is over just yet or if the recent pop (which began Friday) has been nothing more than consolidation.

Sector-wise, safety stocks quietly outperformed cyclicals as industrials, utilities, healthcare and energy outperformed. Meanwhile, financials and consumer discretionary lagged. Telecom also underperformed but that was due in large part to a slump in T shares (-1.1%) on news that they are negotiating to acquire DTV.

Elsewhere, very quietly China related sectors and those tied to the global "reflation" trade continue to outperform, as PICK rallied nicely yesterday, as did basic materials and transports.

Volumes were low and activity was even lower in what turned out to be a very quiet session, and while the S&P

Market	Level	Change	% Change
Dow	16715.44	19.97	.12%
TSX	14679.81	24.87	.17%
Brazil	53907.46	-145.44	-.27%
FTSE	6868.28	-4.80	-.07%
Nikkei	14405.76	-19.68	-.14%
Hang Seng	22582.7	230.39	1.03%
ASX	5496.50	-1.70	-.03%
Prices taken at previous day market close.			

500 did make a new intra-day high at 1902, it's a stretch to say yesterday was a "breakout," and I believe 1900 will remain resistance.

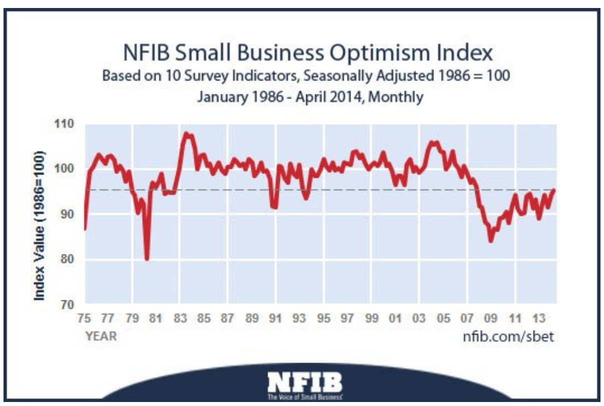
Market	Level	Change	% Change
DBC	26.27	.11	0.44%
Gold	1293.70	-2.10	-0.16%
Silver	19.53	-.013	-0.07%
Copper	3.1295	-.02	-0.64%
WTI	101.78	1.19	1.18%
Brent	109.30	.89	0.82%
Nat Gas	4.365	-.069	-1.56%
RBOB	2.9333	.0187	0.64%
DBA (Grains)	28.62	.11	0.39%
Prices taken at previous day market close.			

Bottom Line

Fundamentals in this market remain static. Decent economic data is being offset by worrisome "signs" from the bond conundrum and weakness in high beta sectors. So, given we're at a stalemate, sentiment is the main driver of equities in the near term. A short squeeze potential exists in this market given the negativity, but a material move above 1900 in the S&P won't come until bonds start to sell off.

Is Small Business About to (Finally) Join the Recovery?

It's often said that small business is the engine of growth for the U.S. economy. And, we all know a lot has been said about how small business has been left behind in the recovery. Well, yesterday we got some small signs that this might finally be ending, and if that's true, we could see a big "catch-up effect" that would be a big positive for the economy.



Every month I read the National Federation of Independent Business Index of Small Business Optimism as a measure of small business confidence. Normally I don't write about it in the Report, but yesterday's release for May was notable for several reasons.

First, the index moved above 95 for the first time since October 2007. So, we have now, finally, totally retraced the entire financial crisis. Encouragingly, the primary driver of the increase in the index was an uptick in expected business conditions.

More importantly, though, 24% of small business owners said they have positions they are not able to fill (also a high for the recovery). That speaks to the point I made a few weeks ago about small signs of potential upward wage pressures and "green shoots" for wage inflation. Finally, the survey showed that loan availability for small business is at its highest level since the financial crisis.

So, to boil it down: Increased confidence in the business outlook + a tightening labor market + easier access to money = an economy that could be set to see growth accelerate in the coming months as business investment expands and wages (finally) increase for a reason other than government mandate. Here's to hoping.

Economics

Retail Sales

- Retail Sales gained 0.1% vs. (E) 0.4% in April

Takeaway

Yesterday's retail sales report for the month of April was soft and missed expectations. The headline number showed a month-over-month gain of 0.1% vs. (E) 0.4%. However, the main reason that the headline missed expectations on a month-to-month basis was due to relatively strong revisions to the March data. The headline number for March was revised up to 1.5% from an initial reading of 1.1%.

But, the details of the April report matched the disappointing headline as the "control" group (retail sales ex-autos, building materials and gasoline stations) slipped 0.2% after a 1.4% gain in March (the control group is the best indicator of true consumer discretionary spending).

Stock futures sold off to pre-market lows while gold and bonds rallied toward session highs upon release of the report. Bottom line is that yesterday's retail sales report was skewed on the headline because of revisions to last month's data, and otherwise would have been largely in-line with expectations. The data suggest that, after seeing a strong "bounce back" in March from the weather-related slump in retail sales in the beginning of the year, there appears to be some consolidation occurring. But, yesterday's report had no effect on the outlook for the economy, and the recovery is still ongoing, albeit at a slow pace.

Commodities

Commodities were again mostly higher yesterday as crude oil and the refined products outperformed ahead of this morning's EIA inventory report. However, copper fell on profit-taking following relatively in-line Chinese economic data. Overall, the benchmark commodity tracking index ETF, DBC, added 0.32% on the day.

Natural gas was the worst-performing commodity yesterday for the second session in a row as futures fell 1.67% on follow-through selling. As we mentioned in yesterday's Report, the recent pressure on natural gas prices has been largely a result of the past three EIA inventory reports, which indicated larger-than-expected builds in supply. The recent builds have eased traders' concerns that, even with increased production, inventories will not be restored to the necessary levels generally needed to make it through the winter draw season.

On the charts, we are looking for the next level of support between $4.29 and $4.30 while resistance has been adjusted down to the 50-day moving average at $4.55. Thursday's EIA inventory report will again be very closely followed as the market is being driven by supply-side fundamentals.

Elsewhere in energy, both refined products (RBOB gasoline and distillate fuel) and crude oil futures traded higher. Most of the 1.15% gains in crude oil came in premarket trading as stops began to get hit and a short-squeeze-style rally ensued. The initial reason for the rally that pushed the price through those stops was speculation that this morning's EIA inventory report will show national stockpiles falling for a second week in a row.

Market	Level	Change	% Change
Dollar Index	80.19	.225	0.28%
EUR/USD	1.3701	-.0055	-0.40%
GBP/USD	1.6825	-.0042	-0.25%
USD/JPY	102.26	.15	0.15%
USD/CAD	1.0906	.0012	0.11%
AUD/USD	.9354	-.0003	-0.03%
USD/BRL	2.2153	.0018	0.08%
10-year Yield	2.618	-.038	-1.43%
30-year Yield	3.454	-0.38	-1.09%
Prices taken at previous day market close.			

According to Bloomberg, analysts are estimating a draw of 250K barrels. However, traders will watch the supply levels at Cushing, Okla., just as closely, if not more so.

Bottom line in crude is that futures remain in the same upper-$90s to $105 range that has been in place for months. However, an uptrend has formed on the charts and, based on the calendar, a test of the 2014 highs could easily happen in coming weeks.

For the near term though, we are looking for the first line of support at the 50-day moving average at $100.86 while $102 is the first level of resistance.

Moving to the metals market, copper fell 0.62% from a two-month high yesterday following Chinese economic reports that slightly missed estimates. Copper remains well above the technical resistance levels that futures broke out through on Monday, but the possibility of this recent spike being a short-covering "head fake" does exist. Key levels to watch are the $3.10-$3.12 support band while resistance is above at the 100-day moving average at $3.16. Chinese data will obviously continue to be the key driver of the copper market over the short to medium term.

Gold continues to trade mostly flat and in close proximity to the $1,300 level. Gold futures were lower yesterday morning as the inverse relationship with global equities (more specifically, the U.S.) remains intact. But, futures reversed and rallied straight up to session highs following the disappointing retail sales headline. On the charts, gold continues to trade in a compressed range between $1,290 and $1,310.

Currencies & Bonds

The euro once again was the focus of the currency markets Tuesday, as it fell another 0.4% vs. the dollar, and broke below the 1.37 level for the first time in 5 weeks, thanks mainly to articles in the WSJ and Bloomberg that reported the German central bank (the Bundesbank) will support more easing from the ECB in June (although that support is conditional — more on that later).

With the euro down 0.4%, it's not surprising that the Dollar Index rallied, rising 0.3%. But, the dollar didn't rise just because the euro was weak; the greenback was stronger vs. the pound, yen, Aussie and Loonie. Dollar bears are seeing the weakness in the euro and covering, while the dollar bulls are stepping in and buying what appears to be "value."

The Aussie was the only other currency with fundamental news out Tuesday, and it was mixed at best. On the negative side, the Chinese economic data slightly missed expectations, while Australian residential property prices rose more slowly than expected. On the flipside, the home loans came in better than expected. Bottom line is the Aussie continues to tread water around that $0.93 level, and this remains a level that I believe, over time, will be viewed as a good short entry point, as lower Chinese and emerging market growth will weigh on Australian exports.

In that environment, the way to a stronger Australian economy is through a weaker Aussie, and the RBA knows that. It may take a few more months, but I'd certainty expect to see a "8" handle on Aussie rather than it trade above par vs. the dollar.

Finally, turning to the pound, it has fallen over the past few days vs. the dollar after hitting a new 52-week high last week, and the reason is the euro. The pound is being dragged lower by the selling in the euro (there is no real fundamental reason; it's just money flows). Given the outlook for the Bank of England and the pound, this drop is likely a buying opportunity via forex, currency futures or the FXB, although I'd want to see the euro stabilize first. But, that's something to keep an eye on.

Turning to Treasuries they were strong Tuesday as the 30-year rallied 0.44% and the yield curve flattened. The retail sales report, which was initially taken as slightly soft, helped push Treasuries higher. But really it was the comments about the Bundesbank that sent European bond yields lower, which in turn spilled over into the U.S.

The fact that the low and falling yields in Europe is spilling over and supporting Treasuries can't be denied — we know by the Treasury International Capital data at a minimum that it's happening. But, what we don't know is whether that's the *only* reason Treasuries have remained so buoyant despite strong economic reports. Regardless, the reason for bond strength at this point isn't the key – bonds need to start to fall (for whatever reason) if equities are going to move materially higher from here.

Did the Bundesbank Just "OK" QE? No.

There was some dis-information circling about this yesterday so I want to clear it up a bit. First, while the Bundesbank articles did increase the likelihood of the ECB acting in June, it didn't guarantee it, and it doesn't materially increase the chances of a Fed-like QE program in Europe.

First, the Bundesbank (which is staunchly anti-inflation and normally against more stimulus) has agreed to support more stimulus, but only if the ECB staff reduces their inflation expectations at the June meeting (and that's not a guarantee).

More importantly, the Bundesbank is said to be in support of another cut to interest rates, a potential negative deposit rate, and potentially small asset-backed security purchases by the ECB (which is sort of like a smaller, private QE). They did not sign off on Fed-like QE, and that remains well into the future if ever. But, clearly there is a greater possibility of the ECB doing more stimulus at the June meeting.

That's important because it's positive for our bullish European equity call (EIRL, EWP, EWU, VGK, FEZ) as well as our "long high-yield" European bond call (IHY, HYXU). Point being, with the Bundesbank now coming around, it appears that the ECB may finally be willing to use more than just rhetoric to try and ease policy and combat growing dis-inflation.

Now, whether or not those efforts are successful remains to be seen, but in the meantime we have an equity market and bond market that appears to have a central bank tailwind, and for now, at least, that's a good thing. I remain bullish on Europe (equities and especially high-yield bonds).

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.* *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.**

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.**

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."**

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).**