7:00's Report

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

May 15th, 2014

Pre 7:00 Look

- Futures are flat this morning and international markets were mixed following another very quiet and uneventful night.
- Economically, data from Europe disappointed for a second straight day, as Q1 EMU GDP was 0.2% q/q vs. (E) 0.4%. The euro is down modestly on the news.
- Econ Today: Weekly Jobless Claims (E: 317K), CPI (E: 0.3%), Empire State Manufacturing Survey (E: 5.00), Industrial Production (E: 0.0%), Philadelphia Fed Survey (E: 14.3).
- Fed Speak: Dudley (8:30 AM), Yellen (6:10 PM).

Market	Level	Change	% Change
S&P 500 Futures	1884.00	-1.25	-.07%
U.S. Dollar (DXY)	80.33	.195	.24%
Gold	1305.10	-.80	-.06%
WTI	102.06	-.31	-.30%
10 Year	2.543	-.075	-2.86%

30 Year Treasury Bond surged to a new high for the year yesterday, sending yields below 3.4%.

Equities

Market Recap

Stocks fell Wednesday as a big rally in the Treasury market and continued weakness in the Russell 2000 and Nasdaq weighed on stocks during the final few hours of trading. The S&P 500 fell 0.47%.

Stocks opened slightly lower Wednesday amidst a total dearth of news. After the open, stocks resumed the flat line trading we saw Tuesday afternoon. Stocks basically traded in a 2-point range around 1,894 from the open till about 2:30.

Interestingly, stocks were able to hold up pretty well despite big-time strength in Treasuries and a slow deterioration in the Russell 2000. But at 2:30, the weight of both those factors was too much to bear, and the S&P 500 fell during the last 90 minutes of trading. At the lows the S&P 500 was down almost 0.75%, although it managed to bounce a bit into the close to finish a few points off the lows.

Trading Color

"Growth" continues to underperform, and the longer it goes on, the more it's becoming a bigger "caution" signal for markets. The Russell 2000 fell more than 1% yesterday, while the Nasdaq also lagged.

"Growth" also lagged "value" in the sector trading, as we saw the "bond proxy" sectors (utilities, telecom, REITs) trade higher on the drop in Treasury yields, while consumer staples also traded well.

Conversely, banks, tech and consumer discretionary all continued to lag (banks lower because of a flattening yield curve, software down in sympathy with internet

Market	Level	Change	% Change
Dow	16613.97	-101.47	-.61%
TSX	14673.73	-6.08	-.04%
Brazil	54412.54	505.08	.94%
FTSE	6876.15	-2.34	-.03%
Nikkei	14298.21	-107.55	-.75%
Hang Seng	22730.86	148.09	.66%
ASX	5510.84	14.34	.26%

Prices taken at previous day market close.

stock weakness, and retailers lower on margin concerns).

Looking at "momentum" sectors, internet stocks (QNET) were again weak but biotech (NBI) actually caught a bid, thanks to positive news from AMGN, ISIS and BMY/CLDX.

Of note, CSCO beat earnings overnight and the stock should open sharply higher. Importantly CEO John Chamber's commentary on the global economy was pretty upbeat (thinks US has stabilized but he's not doing "backflips" while Europe is recovering and emerging market remain difficult. All in all it was decent commentary).

Activity wise things were very, very quiet yesterday (as they have been all week), and volumes were low. On the charts, we're back towards that 1880 high end of the recent trading range, while 1902 remains resistance in the S&P) 500.

Bottom Line

Sentiment and positioning remain the primary drivers of this market, as fundamentals remain largely static, and yesterday's late sell off was simply traders de-risking as bonds remained inexplicably buoyant and the Russell and Nasdaq began to break down. So, nothing fundamentally negative happened, but more than more these cross market and cross asset signals are worrying investors.

But, while the market is caught between the stalemate of "signals" and reality, which has resulted in a this "frustratingly flat" market, there remain ways to make money as correlations continue to fall.

Specifically, despite a almost universally negative outlook, "China" and global-reflation-linked sectors are trading well, as PICK rallied 1.6% yesterday (new highs) while KOL and IYM also rallied. So, point being, there are things that are working in this still "frustratingly flat" market, and sector and investment selection remains the key to outperforming.

Market	Level	Change	% Change
DBC	26.38	.10	0.38%
Gold	1305.10	10.30	0.80%
Silver	19.765	.218	1.12%
Copper	3.155	.0195	0.62%
WTI	102.19	.49	0.48%
Brent	110.11	.87	0.80%
Nat Gas	4.381	.023	0.53%
RBOB	2.9684	.0382	1.30%
DBA (Grains)	28.56	-.03	-0.10%

Prices taken at previous day market close.

Economics

There were no economic reports yesterday.

Commodities

Commodities were mostly higher Wednesday, with the energy sector leading the way, despite a slightly bearish headline in the EIA crude oil inventory report. Precious metals also gained amid growing concerns about potential stock weakness. The benchmark commodity tracking index ETF, DBC, gained 0.38% on the day.

Crude oil added 0.78% yesterday despite a mixed EIA inventory report that showed crude oil supply levels unexpectedly grew. According to the report, crude oil stockpiles increased by 900K barrels vs. estimates of a 250K-barrel draw. Meanwhile gasoline inventories fell 800K barrels vs. (E) +100K barrels, and distillates fell by -1.1M barrels vs. (E) +600K.

Supply levels at Cushing, Okla. (the delivery point for WTI futures traded on the Nymex), which have been closely watched recently as inventories approach minimum required levels for safe storage, fell to 23.4M from 24M the week prior. The dwindling supply levels at Cushing continue to have a bullish influence on the oil market.

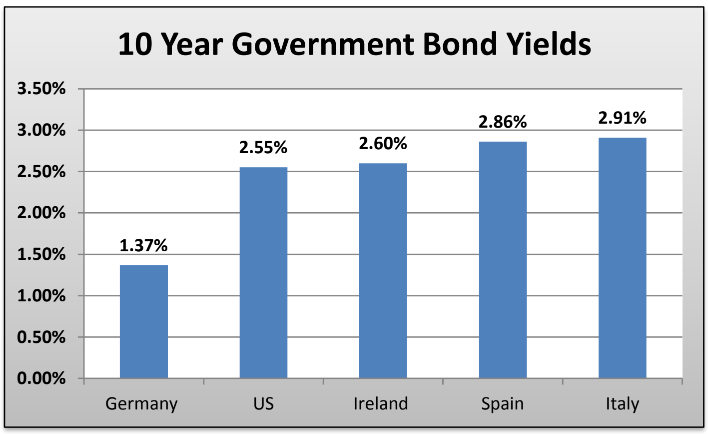
Also helping WTI Crude prices rally yesterday was news that the ban on U.S. oil exports is under review by lawmakers. Any change won't come soon, but if there is a change in policy and producers are able to export oil, that would obviously have significant effects across the energy spectrum (although it wouldn't automatically mean higher oil and gas prices here, despite what people say).

The review process has just begun and, like with anything in the government, it will likely be a while before any decisions are made … and even longer before any actions are taken in the matter But it is certainly something to watch in the energy markets.

Natural gas prices saw a bit of a dead-cat bounce yesterday, gaining .95% on the session. Yesterday's rally was largely a result of short-covering along with bottom-feeders opening new long positions, evident by the lower than average volumes.

Natural gas prices have now fallen 9.2% from last week's highs as speculative traders anticipate national supply levels will be replenished faster than initially expected. Speaking of which, today is inventory day for natural gas. As always, the EIA report will be closely watched and any surprises will be market-moving. Expectations are for a 101 Bcf build in supplies.

Moving to the metals, copper extended its recent rally yesterday, gaining 0.65% on the day. Copper futures bounced off the upper area of the support band we mentioned in yesterday's Report ($3.10-$3.12) and traded up to a fresh 2-month high thanks to short covering and Chinese officials again reiterating that they are committed to helping "boost" economic growth (it was nothing new, but still a general positive).



Copper is set to continue higher as long as the Chinese economy remains stable/ doesn't materially deteriorate. On the charts, copper has formed a steady uptrend from the March lows, and has been able to break through several technical resistance levels. The first line of support remains intact at $3.12 while the 100-day moving average is resistance at $3.16.

Gold gained 0.83% yesterday to reclaim the $1,300 level. But, the story remains largely the same. Gold continues to trade as a decent hedge to stocks, rallying on any material weakness in the stock market. But, technically, prices are set to continue oscillating in the broad $1,280 to $1,320 range.

Market	Level	Change	% Change
Dollar Index	80.135	-.078	-0.10%
EUR/USD	1.3708	.0006	0.04%
GBP/USD	1.6768	-.0057	-0.34%
USD/JPY	101.79	-.46	-0.45%
USD/CAD	1.0873	-.0029	-0.27%
AUD/USD	.9376	.0019	0.20%
USD/BRL	2.2083	-.006	-0.05%
10 Year Yield	2.543	-.075	-2.86%
30 Year Yield	3.375	-.079	-2.29%
Prices taken at previous day market close.			

Currencies & Bonds

By far the most important thing that happened in markets yesterday was the rally in bonds. Bonds surged to new multi-month highs yesterday as the short-squeeze continues. Interestingly, nearly everything I read yesterday blamed this inordinate bond strength on "foreign money."

The major catalyst for the bond rally yesterday (apparently) was the continued capitulation of the staunchly anti-inflationary Germans with regard to unconventional monetary policies in the ECB. It started with comments from the German Bundesbank Monday and continued with remarks from (German) ECB members Peter Praet and Jens Weidmann yesterday.

That rising expectation of action by the ECB in June is (presumably) leading to money pouring into the U.S. Treasury market from European investors hunting for yield. And, that money coming is causing a massive short-squeeze in Treasuries. Additionally, I saw many analysts lumping in the Japanese and Chinese buying of U.S. Treasuries as a reason for this bond strength (so, not just Europe).

As I said yesterday, there is no doubt in my mind that we are seeing significant buying in Treasuries by foreigners (both governments and investors). And, that's because on an arbitrage basis, U.S. Treasury yields are attractive in a global market that is starved for yield.

Indeed, sovereign bonds with much more inherent risk aren't trading at a significant premium to U.S. Treasuries (see chart), while countries with similar risk profiles (Japan and Germany) are trading at substantial discounts.

But, again, I have a hard time rationalizing that all this foreign money is pouring in at such a fevered pace that it's causing this massive rally. After all, if Japanese and European investors were pouring money into the U.S., then why has the yen remained buoyant vs. the dollar, and the euro has only now declined modestly after the ECB basically guaranteed action at the June meeting?

Disconcertingly, the one explanation I'm not hearing about this rally in bonds is that it may be forecasting another "false start" for the U.S. economy, and the analytical complacency surrounding this inordinate strength in bonds continues to bother me. I hope I'm wrong, but I doubt this is all foreign money and short-covering.

Regardless, bonds have traded to new highs and clearly this counter-trend rally isn't over, despite the fact that we are seeing consistently better U.S. economic growth, and more "green shoots" regarding inflation (yesterday's PPI being the latest). Keep in mind, this bond rally hasn't occurred in an economically stagnant period — data has been consistently better during the last two-plus months, and inflation is showing signs of bottoming — and those negative bond fundamentals haven't slowed this rally one bit. I hope this is all foreign money, but I believe something else is going on here.

Turning to the currency markets, yesterday was a busy day, despite the fact that the Dollar Index was little-changed, again closing slightly above the 80 level. First off, although the euro managed to stabilize yesterday, there was another article (this time from Reuters) that all but guaranteed the ECB will cut interest rates at the June meeting (likely 10 basis points) and strongly implied that we'll see negative deposit rates and potentially a new LTRO or a halt to the sterilization of the Securities Markets Program (remember, that was the EU bailout fund).

For now, though, most of that expectation is priced into the euro, and again I'd be shocked to see more material weakness in the single currency between now and the June meeting (meaning a run down toward 1.35 vs. the dollar).

Staying in Europe, the pound was actually the only major currency to decline vs. the dollar yesterday, as it fell 0.4% after the Bank of England Inflation Report was taken as slightly dovish. That interpretation was in spite of the Bank of England increasing its outlook for economic growth (which is hawkish) and lowering the expected 2017 unemployment rate (which is hawkish) by 0.4% to 5.9% — well below the 7% unemployment threshold that the BOE was using earlier this year and late last year.

But, in a feat of central bank wizardry, the Bank of England, while acknowledging the expected improvement in the economy, at the same time changed its expected "equilibrium" employment rate from a range of 6.0% to 6.5% down to 5.25% to 5.75%.

In other words, they moved the goal posts about when the labor market would return to normalcy (and when we can expect policy to return to normalcy). In effect they said: *The economy will do better, but we've decided to make the normal employment rate much lower. So, even though the economy is better, it doesn't mean we'll raise rates sooner than you thought.*

So, the Bank of England seems intent on keeping rates low (or at least saying they will keep them low) despite the economy picking up more and more steam. That, at least for now, should be bullish for UK equities, as the economy there is humming along, and the BOE seems to be intent on not stopping the party. EWU is the easiest way to play strength in the UK stock market, and is certainly worth a look as a shorter-term trade.

Turning to the yen, it was very strong yesterday, rallying 0.5% despite any news. Broadly the yen remains in a 102.50 to 101.50 range, but yesterday's declines were about the yen not holding support at 102. The yen also fell off of a WSJ article that cited BOJ sources, who that said if current CPI can stay at about 1%, then the BOJ will be very hesitant to ease policy further.

Who knows whether that report is right, but it's the first mention that the BOJ may not ease policy at all (the universal question is "when" they will ease policy, not "if"). I and most others expect the BOJ to ease this summer, but the idea of no further accommodation spooked currency markets yesterday. 101.50 remains near-term support.

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).**