7:00's Report

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

May 16th, 2014

Pre 7:00 Look

- Futures are slightly lower this morning as international markets held up surprisingly well o/n following yesterday's sell off.
- Excluding Japan, which was down 1%, most international markets are only modestly lower.
- Economically EMU trade balance was the only release, and both imports and exports declined (missing expectations). The euro is off small on the news.
- Econ Today: Housing Starts (E: 980K). Fed Speak: Bullard (11:50 AM)

Market	Level	Change	% Change
S&P 500 Futures	1863.00	-4.25	-.23%
U.S. Dollar (DXY)	80.14	.076	.09%
Gold	1293.90	.10	.01%
WTI	101.26	.13	.13%
10 Year	2.502	-.041	-4.64%

Equities

Market Recap

Stocks declined sharply Thursday as cautious comments by hedge fund manager David Tepper, ho-hum economic data and continued strength in the bond markets weighed on the markets. The S&P 500 fell 0.94%.

Stocks were heavy from the onset Thursday, and a multitude of factors were blamed, including: Tepper's "don't be too friggin' long" comment, soft EMU GDP, industrial production and housing market index misses, and weak retail earnings (WMT).

Stocks hit their lows within an hour of the open, and basically treaded water for the remainder of the day. (That's a growing trend in this market—stocks move in the first 90 minutes and then flat line the rest of the day.)

There was a slight lift into the close as the Russell 2000 rebounded a bit in the afternoon, but the lift was due to a lack of stocks for sale rather than increased buying activity.

Trading Color

Yesterday wasn't a great day, but there were some silver linings. First, the Russell 2000 made a new low for the year (fractionally), but it did catch a bounce into the afternoon and the Russell and Nasdaq actually relatively outperformed the S&P.

Additionally, momentum sectors QNET and NBI also caught a bid into the afternoon, and finished off their worst levels of the day.

Sector-wise it was pretty standard cyclical underperformance, as consumer discretionary (courtesy of WMT earnings) lagged, as did financials, semiconductors, energy and basic materials. (The latter two gave back some gains from earlier in the week.) PICK, natural gas equities and KOL relatively outperformed (but still finished marginally lower).

Conversely, safety outperformed, and telecom (IYZ) was the only S&P 500 sub-sector to finish the day in the green (up 0.02!). Utilities, consumer staples and REITs (all "bond-proxy" sectors that again rallied on lower yields) were down small.

Despite the losses, activity remains very, very subdued, and the lack of liquidity is contributing to this volatility. On the charts, the S&P 500 is once again safely in this

Market	Level	Change	% Change
Dow	16446.81	-167.16	-1.01%
TSX	14588.89	-84.84	-.58%
Brazil	53855.54	-557.00	-1.02%
FTSE	6829.21	-11.68	-.17%
Nikkei	14096.59	-201.62	-1.41%
Hang Seng	22712.91	-17.95	-.08%
ASX	5479.04	-31.80	-.58%
Prices taken at previous day market close.			

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1,880-1,840 range it's occupied for months.

Bottom Line

Market	Level	Change	% Change
DBC	26.25	-.15	-0.57%
Gold	1295.70	-10.20	-0.78%
Silver	19.51	-.265	-1.34%
Copper	3.1445	-.0155	-0.49%
WTI	101.50	-.87	-0.85%
Brent	110.43	.25	0.23%
Nat Gas	4.455	.088	2.02%
RBOB	2.9587	-.0106	-0.36%
DBA (Grains)	28.62	.04	0.14%
Prices taken at previous day market close.			

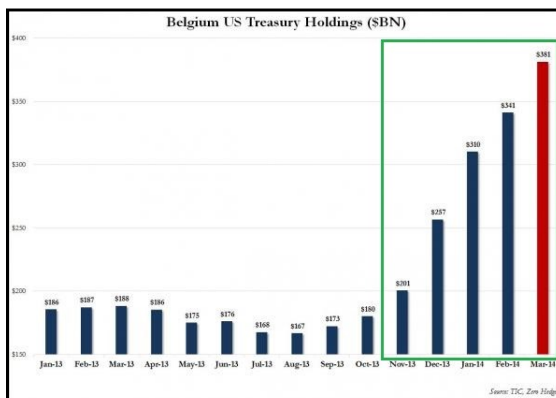
Yesterday was a nasty day but this market remains much more sentiment-driven, as fundamentals remain static. Economic data yesterday were actually, on balance, good, and there are more signs inflation is starting to tick higher (a good thing).

But, the signals from the bond market and small caps continue to weigh on sentiment, which is now very, very negative.

Regardless, "frustratingly flat" remains the best description of this market, and that will continue. Sector selection remains the only way to outperform, as correlations are breaking down further (that's the opportunity in this market).

Is There a New Carry Trade On?

Yesterday the monthly TIC (Treasury International Capital) System data was released, and it showed a continuation of a very surprising trend—that the country of Belgium is devouring U.S. Treasuries.



The TIC data is published monthly and generally it isn't widely followed. (The last time I really followed the TIC data was back in the summer/fall of '08, when we were watching to see if indeed we were witnessing cyclical a run on U.S. assets following the collapse of Lehman and AIG.)

Last month I went back to TICs to see if there was any real proof of this "foreign buying" of Treasuries, and the data from Belgium shocked me.

Since last March, Belgium has more than doubled the amount of Treasury holdings (from 166 billion in August, to 381 billion as of March). Belgium is now the third-largest holder of U.S. Treasuries in the world, behind only China and Japan.

And, the move from November of last year has simply been astonishing, as Belgium has gone from holding $200 billion of Treasuries in November, to again $381 billion in March.

While this will make the conspiracy theorists go crazy, I'm trying to figure out a more rational explanation of why this is happening.

And, my thinking has led me to the idea that perhaps we are seeing the birth of a new carry trade, one where investors sell German bonds (which yield virtually nothing) and buy U.S. Treasuries, netting a tidy 1.3% spread.

Here's the logic: German bonds have now become the funding vehicle for the latest carry trade, replacing the yen and U.S. Treasury. That's occurred because—with the Fed tapering, and the BOJ deliberately trying to manufacture inflation (and apparently being more successful at it)—the ECB becomes (going forward) the global central bank most likely to further ease policy. So, that means we're not going to see rates rise in the EU anytime soon (the same can't be said for the U.S. and, to a lesser degree, Japan).

So, here's how it would work.

I'm a European investment fund, and I've got to earn a decent return and Bunds won't cut it. I can't take sovereign credit risk, so I can't go heavy into PIIGS or emerging markets. So, I'm going to sell the German 10-year at (approximately) 1.35%, and I'm going to buy the 10-year Treasury at 2.55%, netting a cool 1.20%. But, now I'm going to lever the trade as many times as my broker will let me (3X-5X?), so my 1.2% becomes 6% — all with no credit risk.

And, if I can absorb some credit risk, I'll sell the bund and buy emerging-market bonds again (so, in effect, the German bund has replaced what the Treasury was over the past 3+ years). Not coincidentally, emerging-market bond indices (EMB) are at multi-month highs.

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I've got to think about this a bit more about the investment implications of this potential new carry trade, but initially the most direct investment implications of this are positive for the emerging markets debt (which, incidentally, everyone hates right now). More on this next week.

Economics

Empire State and Philly Fed Surveys

- Empire State General Business Conditions Index for May was 19.01 vs. (E) 5.00
- Philadelphia General Business Conditions Index for May was 15.4 vs. (E) 14.3

Takeaway

Both the Empire State and Philadelphia Fed surveys were released yesterday morning and both were better than expected. The Empire State data however was a huge beat, and a nice reversal after the weak April report. The Empire State General Business Conditions index rose nearly 20 points from 1.29 to 19.01 in May.

Looking to the details of the report, New Orders, which is a leading indicator, jumped out of negative territory and rose 13 points to 10.44. The increase was not quite as strong as the headline, but a nice move nonetheless.

Another bright spot in the details of the report was Employment, which was one of the best components of the survey, up 13 points to 20.88.

Looking to the Philadelphia survey, the General Business Conditions Index was 15.4 vs. (E) 14.3, a beat of expectations, but a slight drop from April's headline of 16.6. The details of the report remain strong, but not quite as good as the April report.

New Orders slipped 3 points but were still strong at a respectable 10.5. It is worth noting that much like the Empire survey, employment was rather strong, increasing by 1 point to 7.8, a decent number for the Philly survey.

Market	Level	Change	% Change
Dollar Index	80.065	-.07	-0.09%
EUR/USD	1.3715	.0001	0.01%
GBP/USD	1.6796	.003	0.18%
USD/JPY	101.51	-.36	-0.35%
USD/CAD	1.0875	-.0012	-0.11%
AUD/USD	.9356	-.0017	-0.18%
USD/BRL	2.219	.0175	0.79%
10 Year Yield	2.502	-.041	-4.64%
30 Year Yield	3.337	-.038	-1.13%
Prices taken at previous day market close.			

Bottom line is the Fed surveys contradicted the IP report yesterday. But importantly this is May data, as opposed to the April IP report. After seeing a bit of volatility following the extreme weather-driven slump this winter and the bounce that followed, the surveys seem to be steadily trending for the better now, indicating continued strength in the manufacturing sector of the economy.

Industrial Production & Capacity Utilization

- April IP declined 0.6% vs. (E) 0.0%.

Takeaway

Industrial Production was the one disappointing release yesterday. The headline IP number is a bit misleading because a reduction in utility production (due to the warmer weather) skewed the number down. But the manufacturing sub-index, which is the key number to watch, also unexpectedly declined.

Bottom line: Much like the retail sales release earlier this week, IP implies that we're seeing a moderation in activity after a big bounce-back in February and March. So, manufacturing activity plunged in December/January due to the harsh winter, then played catch-up in a big way in February and March (March IP was revised to 0.9% from 0.7%), and now we're seeing that pace of acceleration slow a bit, which to a point is to be expected.

So, while a disappointing number, it'll take a few more months of disappointment before we need to start worrying about the pace of growth in manufacturing again.

Commodities

After seeing general strength for the first 3 days of the week, commodities pulled back yesterday with the sole exception of natural gas. The PowerShares DB Commodity Tracking Index ETF, fell 0.57%.

Beginning with the outlier, natural gas rallied 2% yesterday on a smaller than expected build in inventories. For three weeks in a row, the EIA reported builds that exceeded analysts' estimates, and traders

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were expecting to see that trend continue. When the EIA reported that stockpiles grew by 97 Bcf rather than the expected 101, there was some speculative short-covering in futures. Looking at the big picture, though, natural gas stockpiles are sitting at 1,160 Bcf, nearly half of the 5-year average (2,119 Bcf), so the overall supply situation remains a concern and a quietly bullish influence on the market.

Also, there were headlines that Vladimir Putin has made threats to disrupt shipments of natural gas to Europe, which introduced another bit of a geopolitical fear bid as speculators weigh the odds that Europe would need to import nat gas from the U.S. But, the situation in the Ukraine remains largely the same and until any action is taken, it should not materially affect natural gas prices.

Elsewhere in energy, there was a bit of a pullback in Nymex crude oil prices yesterday as futures slipped 0.85%. The selling was mostly profit-taking after the several-percent move we have seen since the early May lows were established around $99. Crude remains largely range-bound with a technical bias to the upside. On the charts the first line of support lies below at the 50-day moving average of $100.85 while the level to beat is Wednesday's intraday high of $102.65.

Gold prices did not react as one might have expected yesterday, falling 0.77% despite a weaker dollar, a decent sell-off in the stock market and bond prices hitting multi month highs. Trading was volatile as futures fell from morning highs around $1,305 to nearly $1,290 after the release of the better than expected weekly jobless claims report, sharp increase in the Empire State manufacturing survey, and CPI report that showed an uptick in inflation. Gold futures briefly revisited $1,300 on the weak IP print, but were unable to hold the bounce. One day doesn't necessarily change our view on gold, however, but the way gold traded yesterday was different than it had been trading (inverse to equities). Major support continues to sit in $1270's.

Currencies & Bonds

For the first time in a week, the Dollar Index actually traded off U.S. economic fundamentals, and not the outlook for the euro, yen, pound or other currency. The Dollar Index finished the day down 0.05% in a volatile trade. The greenback, which was stronger pre-market, sold off hard from 8:30 to 11 a.m., which coincided with the release of the soft IP report and housing market index. Interestingly, the Dollar Index keyed off those two releases, and largely ignored the uptick in inflation via the CPI, and the better than expected Empire State and Philly Fed reports. The dollar traded briefly below the 80 level just before lunchtime, but bottomed there and rallied during the afternoon to again close above 80 (third close above 80 in a row).

Turning to the euro, for the first time this week we didn't have any "ECB speak" about what they might do at the June meeting, and instead the euro traded off economic data. Q1 GDP in the euro-zone missed expectations (0.2% vs. 0.4% expectations) and that got the euro well below 1.37 to the dollar early yesterday before it rebounded courtesy of the dollar sell-off.

Bottom line (still) is the Dollar Index and the euro remain largely range bound as the market tries to figure out what the ECB will do next. Since March, the euro has traded in a range from the high 1.36s to the high 1.39s vs. the dollar, and the Dollar Index has traded between (basically) between 79.50 and 80.50. And, until we know *how* committed the ECB is to easing policy further, that range likely will hold. Finally, do not think just because the ECB is going to act in June that this will result in a decidedly lower euro. The market has now priced in some sort of action by the ECB, but the question to keep in mind isn't whether the ECB will act; it's whether the ECB will act forcefully. That remains an unknown. So, if the ECB does not, don't be surprised to see the euro rally out of that June meeting.

Looking at the bond market, the 30-year again hit a new multi-month high, trading above 138'00 for a time before giving just a bit back into the close. Bonds were strong all day, but got a boost from the equity market sell-off and the soft economic IP and housing data. Treasuries largely ignored the positive CPI, jobless claims, and Philly Fed and Empire State surveys (which again just underscores how strong this market is at the moment). Bottom line is this counter-trend isn't over.

Have a good weekend, Tom.

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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).**

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