7:00's Report

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

May 19th, 2014

Pre 7:00 Look

- Futures are modestly lower, as are most international markets after a relatively quiet weekend.
- Markets are lower this morning mostly on general caution. In corporate news, the PFE/AZN merger is dead, while T is buying DTV.
- China was the laggard o/n, down 1% after property prices rose more slowly than expected. That's being cited to explain global weakness, but it's coincident, not causal.
- Econ Today: No reports today. Fed Speak: Fisher (12:10 PM).

Market	Level	Change	% Change
S&P 500 Futures	1869.50	-5.25	-0.28%
U.S. Dollar (DXY)	80.01	-.097	-0.12%
Gold	1299.90	6.50	0.50%
WTI	102.16	.58	0.57%
10-year	2.514	.012	0.48%

Equities

Market Recap

Stocks ended last week flat, but trading was volatile as last Tuesday the S&P 500 hit a new all-time high, but then sold off in the back half of the week on growth concerns. The S&P 500 is up 1.6% year to date.

For all the gyrations, last week the market was driven by sentiment and positioning much more than anything fundamental. The S&P enjoyed a strong rally last Monday, but it was almost entirely due to short-covering. The index basically treaded water Tuesday and Wednesday as bonds continued to rally and small caps sold off (again sending ominous "signals" and making sentiment more negative).

The negative sentiment spilled over on Thursday as the S&P 500 sold off hard (down more than 1%) due to a number of factors: David Tepper's "Don't be too freakin' long" comment, the Treasury market hitting new highs, and the Russell 2000 making a fractional new low for the year. The S&P 500 turned negative on the week before stocks stabilized Friday as the Russell appeared to hold Thursday's lows, and bonds declined modestly.

Trading Color

Despite the Dow Industrials and the S&P 500 hitting new all-time highs last week, it is the weakness in small caps and other "growth"-oriented sectors that continues to worry investors. Specifically, the Russell 2000 continues to badly underperform the S&P 500. The Russell 2000 is now down 6% year-to-date, and it made a new intraday low for the year Thursday, before bouncing a bit Friday.

Additionally, banks (KBE) made new intraday lows for the year last week, as an ever-flattening yield curve and concerns about trading revenues continue to weigh on the space (although the former is of greater concern).

But, despite the market focusing on the negative last week, there were some positive signs. The "momentum" sectors (NBI and QNET) both actually managed to close marginally higher last week, thanks mainly to short-covering on Monday—but they didn't get absolutely crushed in the Thursday sell-off, which is a bit of a silver lining. (If they can stabilize, it may be a leading indicator for small caps.)

Sector-wise there was clear outperformance from "safety" sectors, as REITs and consumer staples hit new highs last week and telecom was one of the best per-

Market	Level	Change	% Change
Dow	16491.31	44.50	0.27%
TSX	14514.74	-74.15	-0.51%
Brazil	53975.76	120.22	0.22%
FTSE	6812.37	-43.44	-0.63%
Nikkei	14006.44	-90.15	-0.64%
Hang Seng	22704.50	-8.41	-0.04%
ASX	5408.98	-70.07	-1.28%
Prices taken at previous day market close.			

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formers, thanks to strength in VZ and more chatter about a potential T/DTV merger.

Of note, China and "global reflation trade" sectors traded well last week (and given the weakness in cyclicals, that's a surprise). Basic materials stocks hit new 52-week highs, as did industrials (DIA) and global industrial miners (PICK). Being bullish on the global economy remains a pretty contrarian idea, and there is some value in these sectors, if the global economy continues to recover.

Market	Level	Change	% Change
DBC	26.26	.02	0.08%
Gold	1292.80	-.80	-0.06%
Silver	19.32	-.164	-0.84%
Copper	3.143	-.0015	-0.05%
WTI	102.03	.53	0.52%
Brent	109.78	.69	0.63%
Nat Gas	4.419	-.05	-1.12%
RBOB	2.9731	.0089	0.30%
DBA (Grains)	28.36	-.25	-0.87%
Prices taken at previous day market close.			

Activity and volumes remain very, very low (and that's likely to get worse as Memorial Day looms). There is simply no conviction on either side (long or short) and that lack of liquidity is contributing to the market volatility. Neither rallies nor sell-offs are coming with any sort of conviction of elevated volume.

On the charts, despite making a new nominal high at 1,902, the S&P 500 finished the week back in the 1,840-1,880 trading range that's been in place for almost all of 2014.

This Week

The big event of the week will be the flash PMIs Wednesday/Thursday, but away from economic data it'll be pretty quiet. The other "big" event is the Ukraine election this Sunday (the 25th), but there's a distinct possibility that it could get delayed given the unrest.

Looking at the micro-economic, there are some sell-side financial conferences, and more consumer stock earnings (HD/DKS Tuesday, LOW/TGT Wednesday and BBY Thursday) but overall it should be pretty quiet.

Bottom Line

"Frustratingly flat" trading continues in this market. Several times this year the S&P 500 has threatened to break out (or break down) from the 1,840-1,880 range, but it keeps getting pulled back in.

And, that is likely to continue as the broader market remains largely stalemated between fundamentals that are static and largely supportive of stock prices, and ominous "signals" from the bond market and small caps that imply some big correction is looming on the horizon.

Meanwhile, correlations between sectors continue to break down.

We've been saying the way to outperform in this market remains active sector (or stock) selection. Domestically we continue to like PICK, DIA, IYZ and KOL.

And, banks are once again piquing my interest given that sentiment has turned very negative toward the space, the (although technically the sector looks pretty bad, so I want to do a little more work on it and take a look at exactly where banks are trading on a valuation basis). Additionally, I'll be doing some work on the shippers and tanker companies this week, as there may be some value in those sectors as well.

Economics

Last Week

The economic data last week became a bit of a Rorschach (ink blot) test. Depending what camp you're in (bull or bear), you could see last week's data as supporting your case. But, that aside, the takeaway is that nothing last week changed anyone's expectations for economic growth domestically or internationally.

For the bears, April industrial production and retail sales both missed estimates. By themselves those data points weren't that consequential, as they weren't big misses. But, they were disappointing because they imply that the strong gains we saw in the economy in February and March were just part of a "bounce back" effect from the weather-related drop in December/January. And, now that the "bounce back" is over, we're returning to the recent norm — data that imply 2% GDP growth, not 3% (which is what everyone expects and the stock market needs). So, the IP and retail sales data were taken to potentially mean we're not seeing a sustained acceleration in economic activity.

For the bulls, while the April data were disappointing,

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the May data released last week were strong, implying the economy is picking up speed again. The Empire State and Philly Fed manufacturing surveys (the first two May economic releases) both beat estimates, with Empire State coming in at 19.01 vs. (E) 5.0, and Philly registering 15.4 vs. (E) 14.3. Additionally, jobless claims fell below the 300K mark (297K) for the first time since September (and only the second time for the recovery). So, the current data imply we are seeing re-acceleration in the economy.

On balance, I'd say last week went in the bears' favor, as investors and analysts remain very, very skeptical regarding the U.S. economy's ability to reach "escape velocity" and finally move toward 3%+ GDP growth.

That's important because if the bears are right (and data last week does not make them right) and the economy does indeed return to the recent "new normal" of 2% GDP growth annually (and not the expected 3%), then the stock market is extended and will correct.

So, this remains an economy that is short on confidence. Despite current data coming in strong, until we see a more-extended trend, the benefit of the doubt will remain with the bears (but again, that doesn't mean they are right).

In Europe, the big surprise last week was the weak Q1 GDP report (they can't blame the weather). Q1 GDP was just 0.2% quarter-over-quarter vs. (E) 0.4%, and year-over-year was 0.9%.

That's a touch weaker than the market expected (the market is expecting a little over 1% this year from the EU, so this stoked some fears about a slower than expected EU economy). But, the focus remains more on the ECB and what they'll do next, so this one number didn't really change the outlook.

This Week

There's not a lot of data this week, but Wednesday night and Thursday will be important, especially given the context of the economic confidence problem we seem to have.

Wednesday/Thursday bring the May flash manufacturing PMIs, with China coming Wednesday night and the EU and U.S. Thursday morning. Again, the confidence problem isn't limited to the U.S. There are ongoing concerns about EU growth given the soft Q1 GDP print, and obviously China remains (and will remain) an ongoing concern. So, if these flash PMIs can meet expectations or even beat, that will provide a nice confidence boost for the global economy.

Outside of the flash PMIs, the minutes from the April Fed meeting are released Wednesday, although I don't think there will be too much revealed in those minutes (perhaps some discussion on inflation and how/when to continue to exit QE, but the policy outlook for the Fed shouldn't change). Staying with the Fed, Chair Janet Yellen speaks Wednesday. But it's at the NYU commencement, so I doubt there will be any revelations about monetary policy.

Finally, housing will remain in focus. The housing starts number last Friday looked a lot better than it actually was, so the market remains focused on seeing housing rebound from the winter dip like the other parts of the economy. Existing home sales come Thursday morning, while new home sales come Friday.

Bottom line: This week won't definitively alter the outlook for the global economy, but given the continued strength in the bond market (and the potential signal it is sending), strong flash manufacturing PMIs will help give investors a badly needed boost of confidence.

Commodities

Market	Level	Change	% Change
Dollar Index	80.11	.046	0.06%
EUR/USD	1.3695	-.0015	-0.11%
GBP/USD	1.6816	.0029	0.17%
USD/JPY	101.47	-.09	-0.09%
USD/CAD	1.0868	-.0017	-0.16%
AUD/USD	.9364	.0008	0.09%
USD/BRL	2.213	-.0071	-0.32%
10-year Yield	2.514	.012	0.48%
30-year Yield	3.341	.004	0.12%
Prices taken at previous day market close.			

Commodities broadly rallied Monday through Wednesday last week before giving back much of those gains on Thursday and Friday. The benchmark commodity tracking index ETF, DBC, added 0.34% on the week.

Copper was the best performer in the commodity space last week, rallying an even 2%. The reasons cited for the move, however, were mixed. Some said the jump in futures was largely short-covering by

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funds and longer-term commodity traders, while others attributed the rally to new longs in the market based on fundamentals, namely stabilizing Chinese economic data.

It's still too early to tell if this strong rally is a "head fake" or not; however, the technicals are promising. And, even if this reversal began as short-covering, if Chinese economic data continue to improve (or even just stabilize), an opportunity lies in getting "long China" (or long the global economy) through buying dips in copper futures. On the charts, there is solid support in copper's $3.10-$3.12 band while the 100-day moving average is proving to a stubborn resistance level at $3.15 (which we are through as of this writing, but we'll see if we can hold it).

Moving to energy markets, crude oil futures have been range-bound between $98 and $105 and are little-changed since early February, but the technicals in WTI favor the bulls. This is evident by the "higher lows" on the daily chart dating back to the beginning of the year.

But, for now, crude oil remains a trader's market and will remain that way until we see a shift in fundamentals capable of pushing prices through resistance (i.e., continued rise in gasoline demand, developments from lawmakers regarding the potential for exporting crude oil, further draws in Cushing, Okla., supply levels, etc.) On the charts, support has been adjusted higher to $100.50.

Of note, Libyan rebels stormed the Libyan Parliament last night. The headlines are pretty ominous, but it doesn't look like that much of a disruptive event (yet), and Brent is only up small off the news.

Natural gas was the worst performer last week, falling 2.67%. Futures did however close above $4.40, well off the intra-week lows of $4.29. Natural gas remains a supply-driven market, clearly evident by the way futures sharply reversed 20 cents off the Thursday lows upon release of the EIA inventory report. Going forward, we can expect traders to continue to focus on supply as we enter the build season. On the charts, support lies at $4.35 while the 50-day moving average is the first line of resistance at $4.54.

Currencies & Bonds

Treasuries surged again last week, with the 30 year hitting levels last seen in June 2013, as US economic data was at best a mixed bag, and the ECB all but rented a billboard promising the easier policy at the June 5th meeting (furthering the flow of money from Europe into Treasuries).

The strength in bonds remains a growing headwind on stocks (it was one of the major factors that led to the stock market's reversal last Wednesday), and even though there is clearly an influence from foreign buyers on the Treasury rally, the strength in bonds is still being interpreted as a potential ominous signal on the US economy.

Bottom line is until this bond rally/short squeeze begins to break (regardless of the reasons for it), bonds will remain a headwind on stocks. 2.80% on the ten year, which is nearly 30 basis points higher from where it is currently, is needed sooner rather than later if stocks are to move materially higher from current levels.

In currency markets last week, the Dollar Index closed above the 80 level for the first time since early April, thanks mostly to continued weakness in the Euro. The euro dropped modestly last week, closing below 1.37 vs. the dollar for the first time since early March, as again the ECB is all but guaranteed easier policy at the June meeting. But, that is now largely priced into the market, so I would expect a relatively range bound trade in the dollar/euro into the June 5th meeting.

The other big mover in the currency markets last week was the yen, which appears to have broken resistance vs. the dollar at 101.50. The reason for the strength was economic, as Q1 GDP beat estimates, and the yen is trading higher again this morning on the back of strong machine orders. There is a BOJ meeting this week but nothing is expected, and this market remains all about when the BOJ will ease policy next (current expectation is this summer, but that is slipping a bit). 100.74 yen/dollar remains a "line in the sand" as that's this year's low, and it shouldn't be violated if the "long Japan" trade is still on.

Have a good day,

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.**

	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).**

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