# 7:00's Report

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

***May 20th, 2014***

## Pre 7:00 Look

- Futures are flat while most international markets are seeing a rebound from Monday after another quiet night.
- Economically data was sparse: German PPI met expectations while UK CPI and PPI were slightly higher than estimates.
- Geo-politically Thailand is in the news, as the military has declared martial law. But it's not as ominous as it sounds (yet) because unrest has been occurring there for months.
- Econ Today: No economic reports today. Fed Speak: Plosser (12:30 PM).

| Market | Level | Change | % Change |
|---|---|---|---|
| S&P 500 Futures | 1881.00 | -1.25 | -.01% |
| U.S. Dollar (DXY) | 80.105 | .057 | .07% |
| Gold | 1292.80 | -1.00 | -.08% |
| WTI | 102.27 | .17 | .17% |
| 10-year | 2.536 | .018 | 0.71% |

# Equities

*Market Recap*

Stocks started the week grinding steadily higher throughout trading Monday, pulled higher by a nice rally in small caps and a sell-off in Treasuries. The S&P 500 rose 0.38%.

Yesterday started off looking pretty ominous. There was broad global weakness and, early in the day, U.S. futures were modestly lower. But, really, the U.S. was just down in sympathy with international markets, as there wasn't any real fundamental negative catalyst.


***Utilities: If bonds are to stay buoyant going forward, then why is the most "bond like" equity sector selling off so hard?***

The drop in the appreciation of Chinese property prices was the single-most-cited negative Monday. But the news wasn't that bad and, for the last two-plus months, bad news in China has stayed largely contained to Chinese and Asian markets, and not spread west.

If I had to pinpoint two "reasons" for the rally yesterday, it'd be the improvement in the Russia/Ukraine situation (more on that later) and this Reuters article saying how cheap small caps are link here.

Markets opened slightly lower and, despite the day being very quiet, they slowly moved higher throughout the morning and afternoon session. The S&P 500 managed to go out just off the highs. The true "reasons" for the grind higher was a morning rally in the Russell 2000, and an afternoon sell-off in Treasuries.

*Trading Color*

The "right" sectors outperformed yesterday, which is why the tone of the market was positive. The Russell and Nasdaq both handily outperformed the S&P 500, QNET and NBI rallied 1.5% each, and Treasuries dropped throughout the afternoon and actually closed basically

| Market | Level | Change | % Change |
|---|---|---|---|
| Dow | 16511.86 | 20.55 | -0.12% |
| TSX | 14514.74 | 74.15 | 0.51% |
| Brazil | 53353.10 | -622.66 | -1.15% |
| FTSE | 6809.79 | -34.79 | -0.51% |
| Nikkei | 14075.25 | 68.81 | 0.49% |
| Hang Seng | 22834.68 | 130.18 | 0.57% |
| ASX | 5420.35 | 11.38 | 0.21% |
| Prices taken at previous day market close. | | | |

on the lows.

Sector-wise, it was the same thing, as banks (KBE) and semiconductors (SOX) were the two best-performing sectors, while basic materials also traded higher, as did industrials. Conversely, "safety" sectors like utilities, REITs and consumer discretionary all finished the day negative (and utilities in particular got hit hard, off 1.5%).

| Market | Level | Change | % Change |
|---|---|---|---|
| DBC | 26.26 | -.01 | -0.04% |
| Gold | 1294.30 | .80 | 0.06% |
| Silver | 19.36 | .03 | 0.13% |
| Copper | 3.1650 | .018 | .57% |
| WTI | 102.64 | .62 | 0.61% |
| Brent | 109.38 | -.37 | -0.34% |
| Nat Gas | 4.471 | .058 | 1.31% |
| RBOB | 2.9665 | -.007 | -0.24% |
| DBA (Grains) | 28.35 | .00 | 0.00% |

Prices taken at previous day market close.

So, from a market internals standpoint, yesterday was a stronger day than the overall gain in the S&P 500 would imply. The rebound in small caps and "momentum" names continued from Friday, and the market has now recouped the Thursday sell-off.

But, yesterday was the lowest-volume day of the year (on the NYSE), so clearly this market still lacks conviction, and these gyrations remain mostly trading "noise."

On the charts, the S&P 500 again closed above the 1,880 resistance level, but I seriously doubt this is the breakout we've all been looking for. 1,902 remains ultimate resistance and the all-time high.

*Bottom Line*

Yesterday was encouraging from a performance standpoint and it "felt" decently strong. But there's simply no volume or conviction behind the moves, so we haven't seen the end of "frustratingly flat."

In the very short term (next few days), I could see a small lift into the economic data Thursday, yet I seriously doubt we'll break materially above 1,900 anytime soon.

*Why Are Utilities Getting Crushed?*

It's fair to say that yesterday I read a minimum of 5 articles regarding the 2014 bond rally. Each explained why bonds are rallying, why everyone got it wrong and why it's going to continue (the article about Ben Bernanke's "dovish" outlook was one of the main things cited).

Yet, despite all this bond rally euphoria, I can't help but notice that one of the biggest "bond proxy" sectors of the market, utilities, has been getting killed since May 1 (chart on pg. 1).

Some of the reason was poor earnings, but they didn't cause utilities to crash to a new one-month low yesterday. I can't help but ask the question—if bonds are going to stay elevated, why are utilities getting hit? Not that they are necessarily predictive, but it sure looks like the uptrend that started on Jan. 2, which forecast this bond rally, has come to an end.

*Can the "Chocolate King" Save Ukraine?*

There have been some potentially positive events in the Ukraine over the past few days. First, Vladimir Putin again has agreed to have his troops stationed on the Ukrainian border (return to base). That's a positive headline (assuming it actually is accurate), but that's not the positive I'm referring to.

It appears, at least according to a NYT article, that the front-runner to become Prime Minister in Sunday's elections is Petro Poroshenko, a Ukrainian billionaire known as the "Chocolate King" because he made his fortune in the chocolate business. More importantly than what he means to Ukraine (and his resume is impressive), the "Chocolate King" is viewed by analysts as someone who would be acceptable to Putin. In turn, Putin could relax the pressure on the current Ukrainian government.

Poroshenko has significant business interests in Russia, and is apparently against any sort of referendum on Ukraine joining NATO (this is a major concern of Putin's, and likely the main reason he's exerting so much pressure on Kiev). So, while Poroshenko is pro-Western, he isn't necessarily pro-Europe, and he might just be the right man for the job.

Bottom line here is after two-plus months of turmoil, we may actually be witnessing the beginning of the end of this Ukrainian turmoil, if Poroshenko wins Sunday, which will remove another "macro headwind" from the market.

## Economics

There were no economic reports yesterday.

## Commodities

Commodities were almost universally higher to start the week, although the reasons for the strength were varied as most commodities traded off specific issues, rather than one overarching bullish factor. The commodity ETF DBC closed down slightly at -0.08%.

Starting with the best performer, natural gas continued last week's rally and rose 1.9% as weather once again begins to influence the market. Weather forecasts released yesterday revealed expected hotter than normal temperatures through mid-June for Texas and much of the East Coast (major natural gas consuming regions). And, the fact that gas has been driven higher by these forecasts underscores an important point about the natural gas market that we need to monitor this summer.

Typically during the summer, natural gas prices trade with less volatility as electricity demand wanes and production replenishes the winter draws. But, with natural gas inventories still more than 40% below last year's levels and 45% below the five-year average, the need for a replenishment of inventories before next winter is absolutely critical.

And, with production relatively stable, how much replenishment occurs will be a function of demand. Hotter weather increases electricity demand, and if we get sustained heat waves this summer, we won't replenish the inventory levels. This means we can expect much, much higher prices next fall/winter. So, despite record production of natural gas, risks remain to the upside.

Despite the strength in natural gas, most of the attention yesterday was on the oil markets, and specifically the outbreak of violence in Libya that (potentially) saw the disbanding of the Libyan parliament (called the General National Congress).

But, probably to the surprise of many, the news from Libya didn't result in a spike higher in Brent crude prices, and Brent actually closed down 0.11% on the day. The reason is twofold.

First, Libyan production following the violence yesterday was reported at 200K barrels per day, down from last week's 300K barrels per day. But, Libya, which has production capacity of over 1 million barrels per day, has been producing in the low-100Ks for months, so it's not like the drop was a shock.

Point being, the Brent market never priced in a significant uptick in Libyan production despite recent agreement between the government and rebels. So, in the market's eyes, not much changed. Libya was a mess before this recent violence, and it is a mess afterward.

Also counteracting the Libyan news were the potentially positive headlines from Russia (Putin pulling troops back and a potential Poroshenko victory Sunday). If we see legitimate improvement in Ukraine, we likely will see a reduction in the geopolitical risk premium in Brent crude (although it likely won't be more than a few dollars).

WTI crude finished trading yesterday up 0.7% to close at a near one-month high, as it largely ignored the geopolitics and drifted higher with other commodities and risk assets. We remain broadly positive on oil on the basis of expected future increases in gasoline demand, although we would be happier buying dips back toward $100 than at these levels, as the current supply/demand outlook remains broadly balanced.

Turning finally to the metals, gold and silver started the day markedly stronger, as gold traded back above $1,300 while silver was up more than 1% thanks to equity market and Dollar Index weakness. But, gold was also higher on the hopes that the new ruling party in India, the BJP, will reduce the gold import duty and in turn stoke new demand.

Despite the good start to the day, though, gold couldn't hold the gains and closed the day basically flat (as did silver) as the stock market and Dollar Index rallied throughout the

| Market | Level | Change | % Change |
|---|---|---|---|
| Dollar Index | 80.04 | -.067 | -0.08% |
| EUR/USD | 1.3713 | .0021 | 0.15% |
| GBP/USD | 1.6821 | .0008 | 0.05% |
| USD/JPY | 101.33 | -.16 | -0.16% |
| USD/CAD | 1.0866 | .0011 | 0.10% |
| AUD/USD | .9326 | -.0035 | -0.37% |
| USD/BRL | 2.2067 | -.0071 | -0.32% |
| 10-year Yield | 2.536 | .018 | 0.71% |
| 30-year Yield | 3.383 | .036 | 1.08% |

Prices taken at previous day market close.

day. Also, the "Indian bounce" faded as any reduction in the import duty likely won't come until later this year (if at all). Gold remains largely range-bound between 1,280-ish and 1,300-ish, as gold lacks any near-term catalysts.

## Currencies & Bonds

Currency markets were mostly quiet yesterday, as the Dollar Index finished little changed (down .09%), after rallying throughout the day from early morning lows.

The main negative catalyst for the Dollar Index yesterday was the Reuters Bernanke article, where he is apparently telling investors at 250k plate dinners that the Fed will keep rates lower than most expect (he is reported as saying he doesn't expect to see 4% on the Fed Funds Rate in his lifetime). The headline weighed on the dollar, but throughout buyers stepped in to bring the greenback to virtually flat by the close.

Turning to Asia, the yen rallied to a 3-month high yesterday as traders positioned ahead of the BOJ announcement that was released earlier this morning. Also cited as moving the market was a report on machine orders, which came in several times better than expected (19.1% vs. E 6.3%). The report, however, has to be taken with a grain of salt because the data were collected before the institution of the new national sales tax, so it is expected there was a bit of a "run up" ahead of the cost hike.

Although the yen traded higher yesterday, it closed well off the highs of the day and the 200-day moving average proved to be solid resistance (support in the USD/JPY pair). And, looking ahead, we should not see a close below that technical level, which is sitting at 101.11. However the ultimate line in the sand remains the 2014 USD/JPY low of 100.74.

Elsewhere in Asia, the Aussie fell 0.3% on the weaker than expected Chinese property prices data. Prices rose a solid 6%; however that was a material drop from the previous month's number of 9%.

In Europe, both the euro and the pound were largely flat, however the euro did bounce in early trading mostly thanks to weakness in the dollar.

Looking to the bond market, price action yesterday was mildly encouraging for us bond bears. Treasuries were higher yesterday morning thanks mostly to the dovish Bernanke comments, but bonds peaked yesterday right at the European close (11:30). And, they continued to sell off for the remainder of the session, closing the day near the low ticks.

That's (cautiously) positive for two reasons: First, the peak coinciding with the European close implies European buyers remain a large force behind demand for Treasuries. Second, the bond sell off accelerated during the afternoon, something we haven't seen in a while. One day doesn't make a trend change, but price action in bond yesterday was different than it has been over the past month. Now it just needs to continue (bonds flat this AM).

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.**

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|---|---|---|---|---|
| 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).**