# 7:00's Report

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

**May 21st, 2014**

*Japanese Yen: This is a critical time for the yen, as it's threatening to break decisively below the 200 day moving average vs. the dollar for the first time in over a year.*

## Pre 7:00 Look

- Futures are modestly higher this morning while international markets were mixed but little changed after (another) quiet night.
- Focus is on Japan as the yen is rallying vs. the dollar thanks to better than expected export and import data and no change in policy from the BOJ (as expected).
- Econ data ex-Japan was light, as UK retail sales was the only release and it soundly beat expectations (up 1.3% vs. (E) .4%).
- Econ Today: FOMC Minutes (2:00 PM). Fed Speak: Dudley (10:00 AM), Yellen (11:30 AM), George (12:50 PM), Kocherlakota (1:30 PM).

| Market | Level | Change | % Change |
|---|---|---|---|
| S&P 500 Futures | 1871.50 | 3.50 | .19% |
| U.S. Dollar (DXY) | 80.04 | -.053 | -.07% |
| Gold | 1292.50 | -2.20 | -.17% |
| WTI | 103.03 | .70 | .68% |
| 10 Year | 2.509 | -0.27 | -1.06% |

# Equities

*Market Recap*

The see-saw market continues. Stocks sold off modestly Tuesday thanks to weak earnings from retailers and the inability of small caps to hold Monday's gains. The S&P 500 fell 0.65%.

Stocks were mostly flat pre-open, but a slew of retail earnings misses (SPLS/URBN/TJX/DKS) and cautious comments from CAT (down 3.6% yesterday) weighed on markets. Stocks fell steadily throughout the morning, but it was the underperformance of the small caps (again) that caught people's attention.

Some reports blamed comments by the Fed's Plosser for the afternoon acceleration downward (he said the Fed may have to raise rates sooner than expected). But, that wasn't the reason stocks sold off. Plosser is a known "hawk" and he didn't say anything new (besides, bonds didn't sell off and the Dollar Index didn't rally, so you know the sell off wasn't Fed related).

Markets were down 1% at the lows, but there was no conviction to the selling, and as the Russell began to hold levels near Friday's close, buyers stepped in and the market rallied during the final few hours of trading to finish well off the lows of the day.

*Trading Color*

Small caps and cyclicals remain the focus of the market. The fact that the Russell didn't even really make an effort to hold Monday's gains weighed on sentiment yesterday, although it wasn't all bad. The Nasdaq traded in-line with the S&P 500 and "momentum" sectors held up decently (QNET was off small, and banks and the SOX

| Market | Level | Change | % Change |
|---|---|---|---|
| Dow | 16374.31 | -137.55 | -0.83% |
| TSX | 14525.19 | 10.45 | 0.07% |
| Brazil | 52366.19 | -986.91 | -1.85% |
| FTSE | 6794.81 | -7.19 | -0.11% |
| Nikkei | 14042.17 | -33.08 | -0.24% |
| Hang Seng | 22836.52 | 1.84 | 0.01% |
| ASX | 5424.57 | 4.22 | 0.08% |
| Prices taken at previous day market close. | | | |

also showed some resiliency).

Looking at other sectors, consumer discretionary and retail got absolutely hammered yesterday (the MVR Retail Index was down more than 3%), while industrials (courtesy of CAT) also took a hit.

| Market | Level | Change | % Change |
|---|---|---|---|
| DBC | 26.27 | .02 | 0.10% |
| Gold | 1294.60 | .80 | 0.06% |
| Silver | 19.40 | .047 | 0.24% |
| Copper | 3.143 | -.024 | -0.76% |
| WTI | 102.44 | -.17 | -0.17% |
| Brent | 109.65 | .28 | 0.26% |
| Nat Gas | 4.542 | .072 | 1.60% |
| RBOB | 2.964 | -.0006 | -0.02% |
| DBA (Grains) | 28.28 | -.06 | -0.21% |
| Prices taken at previous day market close. | | | |

All 10 S&P sub-sectors were lower. But again, excluding retail and industrials, the selling wasn't too bad.

Activity remained very slow yesterday and volumes—while better than the year-to-date low of Monday—weren't all that much better. So, point is, conviction in this market is non-existent, and stocks are gyrating on low volume and lower liquidity.

On the charts, the S&P 500 is again back in the 1,880-1,840 trading range. With regard to the Russell 2000, 1,082 remains a critical level to watch (it's the low for the year). That level shouldn't be violated for any reason going forward—and if it is, look for the S&P 500 to follow not long after.

*Why June 5 Will Be the Most Important Day of the Year*

I spent time in last Friday's issue detailing the potential new "carry trade" we're seeing from Europe, and why that may very well be a major factor behind this bond strength (but it's not the only factor).

But, if we're to agree with the consensus (for the purposes of this discussion) and agree this is all about European money flows, then Thursday, June 5 is going to be the most important day of the year so far for markets.

That's because June 5 is the date of the next ECB meeting, and it is widely expected that the ECB will adopt more accommodative policies to stimulate the economy. If the ECB does indeed take substantial measures to stimulate the EU economy, this "bond carry trade" and this year-long rally in Treasuries could end.

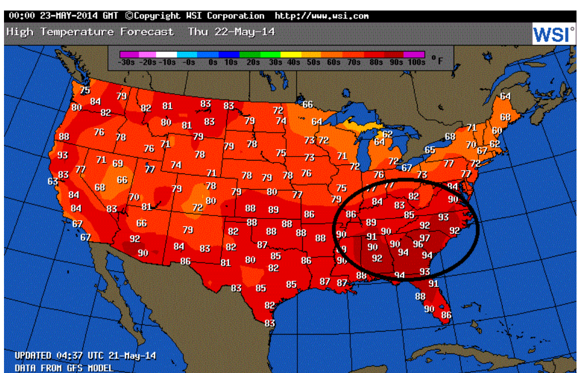
But, that doesn't make sense – doesn't the EU easing policy mean European bonds will rally further and yields will decline, only exacerbating the "carry trade"?

No.

The EU doesn't need low interest rates – interest rates are already too low in the EU; that's why money is flooding over here. The EU needs money to start going into the economy and to chase risk – for the velocity of money to increase – and for bond yields to go UP as money leaves the safety of bonds and chases return.

That will drive prices and inflation up, stimulate the economy and end the growing dis-inflation threat.

It also should kill this carry trade, which will (in theory) end this bond rally — that is, if European money is really the driving force behind the Treasury strength.




*We're getting our first blast of hot summer weather this week, and it's reminding everyone just how tight the supply/demand situation remains in natural gas.*

# Economics

There were no economic reports yesterday.

# Commodities

Overall it was a quiet day in the commodity markets, as most commodities ignored the sell-off in equities and were mostly little-changed. The benchmark commodities ETF, DBC, rose just 0.11%.

Natural gas made it three in a row, rallying 1.5% to again be the best-performing commodity on the screen and the only major commodity to move more than 1% yesterday. And, you know the reason: continued short-covering and speculative buying on expectations of warmer weather. (Specifically, forecasts are coming in suggesting that the next few weeks are expected to be "soupy," so it won't cool off during the evenings, leading to more AC usage. Such are the intricacies of weather-dominated commodities.)

Bottom line is the heat is as much an influence in the commodities markets now as the cold. And, given the low inventories and the relatively slim margin for error, markets will remain on edge as we head into the thick of summer. That's because we need a normal (or ideally cool) summer to significantly replenish inventories.

Oil was little-changed yesterday (WTI and Brent rose just 0.2%) in quiet trading. WTI was flat most of the day ahead of the inventory data this morning (Bloomberg estimates are calling for a 205K bbl drop in inventories), while Brent largely ignored more unrest in Libya.

With regard to Libya, it appears that a retired general (Khalifa Haftar) is gaining support in his efforts to "crush" armed Islamic groups, and the potential for another uptick in nationwide violence is on the rise. But, the oil markets only really care about the oil-producing regions and ports, and the situation there remains largely static.

Again, earlier this month Libya was producing 300K barrels per day; now they're producing 200K. If it falls to 100K, it won't materially affect a global market that consumes over 50 million barrels per day of oil. Libya remains much more of a potential bearish influence on the markets should things (obviously in the future) return to normalcy and capacity moves back toward 1.5 million barrels per day, because at this point it really can't get much worse from a production standpoint. Point being, don't expect Libya to prop up Brent prices, regardless of what the headlines say.

Finally, the metals were little-changed after gold caught a bid after the stock market open as stocks sold off. Gold rallied about $8 to turn positive on the day and basically held the mid-$1,290s for the remainder of the day. Gold remains a decent option as an equity hedge in the current environment as long as support at $1,270 holds. But gold is lacking a near-term positive catalyst, as Fed policy is stagnant and inflation, while appearing to have bottomed, isn't exactly on anyone's radar screen yet. $1,270-ish remains key and shouldn't be violated for any reason if gold is eventually going to resume its uptrend.

| Market | Level | Change | % Change |
|---|---|---|---|
| Dollar Index | 80.09 | .042 | 0.05% |
| EUR/USD | 1.3699 | -.0008 | -0.06% |
| GBP/USD | 1.684 | .0029 | 0.17% |
| USD/JPY | 101.27 | -.22 | -0.22% |
| USD/CAD | 1.0895 | .0021 | 0.19% |
| AUD/USD | .9254 | -.0075 | -0.80% |
| USD/BRL | 2.215 | .0095 | 0.43% |
| 10 Year Yield | 2.509 | -0.27 | -1.06% |
| 30 Year Yield | 3.375 | -.008 | -0.24% |
| Prices taken at previous day market close. | | | |

## Currencies & Bonds

Currency markets were relatively quiet yesterday despite a fair bit of chatter out of several central banks including the RBA, BOJ, ECB and our own Fed. The Dollar Index was little-changed, up 0.06% ahead of the FOMC minutes due out this afternoon at 2:00 ET.

The dollar continues to be range-bound on the week as traders have been looking ahead to, and positioning in front of, the FOMC minutes due out this afternoon as well as the 4 Fed officials speaking today.

The big mover in the currency markets yesterday was the Aussie dollar, which fell 0.8% on the day. The initial reason for the weakness was the release of the minutes from the most recent RBA meeting, which were surprisingly more cautious on the outlook for the economy than expected.

The minutes revealed that, while Australian central bankers are content with certain aspects of the economy — such as the labor market, consumer spending and housing — there are concerns about export growth, as fiscal policy is being a bit of a near term headwind. Additionally, the RBA did not touch upon some areas of the economy that many analysts and investors were hoping to hear about, including inflation and specifics regarding the current value of the Aussie dollar. All told, the minutes, while not dropping any bombshells, definitely gave the impression that the RBA was more cautious than expected.

Adding to the selling in the Aussie, there were also rumors circulating desks yesterday that Standard & Poor's is re-evaluating Australia's AAA credit rating following the recent changes in fiscal policy.

Combine all of that with an Aussie dollar that has seen a big counter-trend rally over the past month-plus, and it's at least fairly valued (if not overvalued) vs. the dollar in the mid $0.90s, and the bottom fell out quickly.

Additionally, the technicals are turning in favor of the bears here as it looks like we've got a double-top at $0.94 and there is a clear stop for shorts above the 2014 highs of $0.9450. Fundamentally (and now technically), shorting the Aussie remains one of the soundest trades out there at the moment.

Elsewhere in Asia, the yen traded higher for the fifth session in a row yesterday, gaining 0.2% against the dollar ahead of the BOJ decision that came overnight.

The BOJ (unsurprisingly) took no policy action and kept language regarding the economy unchanged from last month (and relatively upbeat). Additionally, both export and import data from April beat estimates, and as a result the yen is rallying further, and importantly has broken below 101 to the dollar and below the 200 day moving average for only the second time in a year. If the dollar/yen closes below that 200 day MA at 101.14 for a day or two, it'll send a strong signal that the trend in the yen is changing, and we will be forced to act accordingly.

Moving to Europe, the euro was little-changed, down 0.06% yesterday in quiet trading. There were three ECB speakers: Finland's Erkki Liikanen, Austria's Ewald Nowotny and Spain's Luis Linde. Each held the company line, strongly implying that the ECB is going to ease policy in June. But, none of them revealed anything new, so that market largely ignored the monetarily accommodative innuendos.

The pound rallied slightly, adding 0.17% yesterday following a better than expected UK CPI report (1.7% vs. E 1.6%). The unexpected increase is a move in the direction of the general goal of 2%, at which point the BOE will be close to raising key interest rates. And, since the BOE will be the first major central bank to raise rates, and the currency remains the most-bullish fundamentally against the U.S., it is safe to expect the rally in the pound to continue.

Moving to the bond markets, Treasuries rallied yesterday as the 10- and 30-year added 0.16% apiece. There was not much of a reason behind the move other than trading noise and positioning ahead of the FOMC minutes as well as money flows from a general "risk off" day in the markets.

For what it's worth, I am a bit surprised that — with the Dow and S&P 500 down more than 1% each at one point during the day, and the Russell resuming its declines — bonds couldn't really muster much of a rally at all yesterday, even at the stock market lows. A few days doesn't break a trend, but that's the second day this week that bonds have traded weaker than they have recently.

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.**

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