7:00's Report

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

May 22nd, 2014

Pre 7:00 Look

- US Futures are flat this morning after Asian stocks enjoyed broad gains overnight while European markets are mixed.
- Economically, Chinese Flash PMIs were stronger than expected, rising to a 5 month high of 49.7 from April's final reading of 48.1.
- In Europe, German Flash PMIs missed estimates (52.9 vs. E 54.1) while France dipped below 50 (49.3 vs. E 51.0).
- Econ Today: Weekly Jobless Claims (E: 310K), Flash PMI (E: 55.9), Existing Home Sales (E: 4.69M). Fed Speak: Williams (4:00 PM)

Market	Level	Change	% Change
S&P 500 Futures	1886.25	1.25	0.07%
U.S. Dollar (DXY)	80.18	.03	0.04%
Gold	1297.30	9.20	0.71%
WTI	104.01	-.06	-0.06%
10 Year	2.537	.028	1.12%

Equities

Market Watch

Stocks staged a nice comeback rally Wednesday as strength in bank stocks and outperformance from momentum sectors helped push the market higher during another slow session. The S&P 500 rose 0.81%.

Stocks were strong out of the gate yesterday, bouncing back from Tuesday's sell-off. They were helped by "not as bad as Tuesday" retail earnings (TGT and TIF specifically helped sentiment, and the latter hit an all-time high).

After the open things got quiet (as has happened all week), and stocks grinded steadily higher as the lineup of Fed speakers yesterday (there were four) didn't really elicit much of a reaction from stocks.

Markets treaded water from 11 a.m. into the FOMC minutes. But other than a quick algo-related sell-off, the minutes didn't really move markets. Stocks continued to grind higher into the close, hitting the highs of the day shortly after 3 p.m. and closing right at that level.

Trading Color

Tuesday wasn't as bad as it seemed, and unfortunately yesterday wasn't as good as it seemed. Positively, we did see strength in banks, semiconductors and the "momentum" names (QNET rose 1.7% and tech held up well despite the CRM sell-off). So, that was a positive for the market as these cyclical sectors rebounded.

But, the bigger issue remains the small caps. The Russell 2000 closed higher but badly lagged (up just 0.52%) and it remains not far off last week's lows.

Sector-wise there was broad strength, and the "safety" sectors did underperform (utilities, consumer staples and telecom all were positive but lagged), while retail was flat (this space can't seem to catch a break, as it couldn't even bounce after Tuesday's beating).

Activity and volumes remain almost as important as the sector trading, and yesterday was again very slow. To say conviction is nonexistent may be an understatement.

These 15-point swings in the S&P are being totally driven by fast-money funds and day traders, and real investors are sitting firmly on the sidelines. (So, the moves in the market appear much more important than they actually are.)

On the charts the S&P 500 has again broken out above

Market	Level	Change	% Change
Dow	16,533.06	158.75	0.97%
TSX	14,649.86	124.67	0.86%
Brazil	52,203.37	-162.82	-0.31%
FTSE	6,825.22	4.18	0.06%
Nikkei	14,337.79	295.62	2.11%
Hang Seng	22,953.76	117.24	0.51%
ASX	5,479.93	55.37	1.02%
Prices taken at previous day market close.			

the 1,880-1,840 range, although again I don't expect any sort of material move higher without a backup in yields. 1,902 (the all-time high) remains resistance in the S&P 500.

Market	Level	Change	% Change
DBC	26.34	.04	0.15%
Gold	1290.60	-4.00	-0.31%
Silver	19.38	-.019	-0.10%
Copper	3.123	-.022	-0.70%
WTI	103.90	1.57	1.53%
Brent	110.42	.73	0.67%
Nat Gas	4.48	-.072	-1.58%
RBOB	2.99	.026	0.88%
DBA (Grains)	28.29	.01	0.04%
Prices taken at previous day market close.			

The path of least resistance in the near term may be to test 1,900 (if data can remain good). But without a protracted sell-off in yields, the chances of a real breakout in stocks remains slim. This remains very much a "sector-picker's" market.

Economics

Fed Minutes

There weren't many surprises in the minutes, and they certainly didn't change anyone's outlook for Fed policy going forward.

Regarding the economy, the Fed remained cautiously optimistic. Apparently, though, the lack of a housing rebound is catching some Fed officials' attention, so housing remains a key area to watch (reports coming out today and tomorrow are important). But, overall there appears large agreement that the economy was rebounding from a weather-induced slowdown in Q1.

The other focus of the meeting was on the Fed's exit strategy from QE. I think that reflects two things: First, it's going to take a big negative shock to the economy to derail tapering of QE, and the outlook for Fed policy (end of QE in October/December, first rate increases mid-2015) is about as set in stone as the Fed outlook can be.

Second, with the Fed policy outlook relatively "known," the market's focus is going to shift more to the specifics of the Fed's "Exit Strategy" from QE. And, yesterday's minutes implied that the Fed doesn't really know how it's going to "normalize" policy and its balance sheet (i.e., raise rates while they own so many Treasuries).

I suppose every plan begins with a conversation, and it seems that the FOMC has started the conversation about normalizing policy – now they just need to come up with a plan. Assuming the economy stays level through the coming months, Fed exit policy is going to become a more-important topic for the markets.

Know Where the (Fed) Exits Are

Current (and about to be ex) Fed Vice Chair William Dudley made some comments Tuesday about the Fed exit strategy that were generally viewed as "dovish." But, that interpretation is incorrect, and Dudley's comments may be one reason we saw some bond weakness Tuesday and Wednesday.

The media focused on the fact that Dudley said the "equilibrium" interest rate (a rate that isn't accommodative or too tight) might be lower going forward than it had been in the past (so say well below 4%). There are many reasons for that but basically his main thesis is that the economy simply doesn't have the growth potential it used to (due to demographics and other things).

That is a "dovish" statement, but it's not something new.

Instead, the important part of Dudley's speech had to do with the Fed exit strategy. Dudley said he believes the Fed should continue to reinvest principal payments from its QE purchases into other bonds, even after it begins to raise rates (presumably this will soften the blow). If that opinion reflects the consensus of the FOMC (and Dudley usually does) then that's a change, as the Fed previously stated it would halt re-investment of QE purchases prior to raising rates.

Now, before your eyes glaze over, this is important because this change in policy may put more upward pressure on rates.

Here's why: If the Fed stopped re-investing principal payments, that would remove artificial demand from the bond market, and bonds would decline/interest rates would rise faster than if the Fed was reinvesting. So, <u>not</u> reinvesting principal is a mild form of tightening.

If the Fed is going to continue to reinvest, though, then any tightening of policy the Fed wants to achieve will have to come solely from interest rate increases, because the rate increases will have to counter the reinvestment of principal payments.

Again, I know this is pretty boring stuff, but understanding Fed policy is key, especially with regard to the expected direction of rates.

Commodities

Commodities were largely mixed in what turned out to be a pretty active day in the space thanks to the EIA inventory report and a plethora of "Fed-speak." The supply data caused a spike in energy futures (ex-nat gas), while the metals fell as traders positioned ahead of the release of the FOMC minutes. The benchmark commodity tracking index ETF, DBC, gained 0.22%.

Beginning with energy, crude oil was the big winner yesterday, gaining 1.5% on the day. WTI futures jumped to an intraday high of $104.29 and closed at a 2 1/2 month high in a rally fueled by supply data.

First, the American Petroleum Institute released their weekly figures at 4:30 on Tuesday afternoon, indicating that stockpiles fell a staggering 10.3M barrels last week. That report was responsible for much of yesterday's rally, as futures were up by 1% ahead of the EIA report.

The EIA reported a draw of 7.2M barrels in crude oil stocks, which initially caused some profit-taking as spec longs were disappointed it wasn't in-line with the API's 10M figure. But the bulls regrouped and futures continued to grind higher for the rest of the day.

The EIA reported builds in gasoline and distillates of 1M and 3.4M barrels, respectively, which also may have been responsible for some of the profit-taking around the time of the EIA release (as they were bearish vs. expectations).

Having said that, here is something to consider when analyzing the current situation in our domestic energy market.

We have been saying for months now that there has been an ongoing battle between the "supply bears" and the "demand bulls." Based on the technicals, we established the bulls have had the upper hand. Now, the fundamentals behind the demand bulls' argument are confirming their thesis.

In the last month, we have seen 40M barrels of gasoline produced and, in that time, we have seen stockpiles rise by less than 4M barrels. Point being, although we are producing gasoline at record levels, we have not been able to build any supplies (and that includes a slight rise in imports and decline in exports) because of sharply rising demand. And, the "summer driving season" has not even officially started yet. So, as we shift into summer mode, we can expect that trend of rising energy demand to continue … and therefore an increase in prices both at the pump and by the barrel.

On the charts, crude oil broke through some near-term resistance at $103, which will now become the first line of support while resistance remains the same at the 2014 highs near $105.

Natural gas was the sole outlier in the otherwise very strong energy space yesterday. Futures fell 1.5% ahead of today's EIA inventory report. Analysts are calling for a build of 108 Bcf after seeing a build of 105 Bcf last week. The story in nat gas is largely the same in that the overall supply level remains critically low, and short-term weather patterns (heat waves) will cause price spikes as speculators anticipate disruptions in the supply-building process. On the charts support is at $4.40 while the 50-day moving average is acting as resistance at $4.53.

Looking to the metals market, precious metals were lower yesterday largely due to trader positioning ahead of the FOMC minutes release at 2 p.m. But, after the release proving the minutes to be a non-event, there was a bit of a bounce-back in gold futures. Our outlook on gold remains the same as futures continue to oscillate around $1,300 in a trendless market. And, that will continue until there is a material change in the markets capable of causing a breakout of the narrowing trading range of $1,280 and $1,310.

Market	Level	Change	% Change
Dollar Index	80.14	.047	0.06%
EUR/USD	1.3683	-.0019	-0.14%
GBP/USD	1.6893	.0056	0.33%
USD/JPY	101.43	.12	0.12%
USD/CAD	1.0914	.0008	0.07%
AUD/USD	.9235	-.0006	-0.06%
USD/BRL	2.2075	-.008	-0.36%
10 Year Yield	2.537	.028	1.12%
30 Year Yield	3.418	.043	1.27%

Prices taken at previous day market close.

Currencies & Bonds

The Dollar Index finished Wednesday flat, but it was a disappointing day for the dollar bulls as the buck finished well off the highs of the day. The greenback actually hit a high yesterday just under 80.40 (which would be a six-week high), before the Dollar Index reversed hard shortly after 1 p.m. Part of the reversal was due to positioning ahead of the FOMC minutes (which came out at 2 p.m.). The other coincident event with the dollar's reversal was the release of comments by Fed President Kocherlakota. The usually dovish president of the Minneapolis Fed made several dovish comments, but what seemed to get the market moving was his admission that he doesn't "know" whether or not the Fed will end QE in October or December.

The market took that as "dovish" but I think that's more a reflection of just how over-obsessed the market was with Fed-speak intraday, than it is any sort of revelation on the direction of policy (keep in mind Kocherlakota dissented with the March vote to taper $10 billion of QE).

Regardless, the market keyed off the comments, and despite the FOMC minutes being largely neutral, the dollar selling continued through the afternoon. The Dollar Index went out at the lows of the day, and just above the 80 level.

The euro finished trading yesterday down fractionally, as it basically traded inverse to the dollar. News in the euro zone was quiet yesterday. The euro hit its lows just after 1 p.m. (coincident with the Dollar Index high) but then spiked higher as the dollar sold off, and rallied throughout the afternoon to close at the highs of the day, just under 1.37. Again, there was no news in the euro zone; it was just reacting to the dollar.

The same can't be said for the pound, which rallied 0.38% and was the best performer vs. the dollar. The pound rallied thanks to much stronger than expected April retail sales (and March was revised higher). Plus, the minutes from the April Monetary Policy Committee meeting showed certain MPC members were starting to view interest rate decisions as "more balanced." That is central bank speak for "we have to start considering that we need to raise interest rates in the future."

The pound remains the fundamentally strongest currency vs. the dollar, and unless we see growth slow in the UK, the BOE will be the first major developed central bank to raise rates, likely late this year or early next.

Finally, turning to Asia, we saw some significant intraday volatility in the yen, which ended a volatile session down 0.13% vs. the dollar. In yesterday's Report I pointed out in the chart on pg. 1 that the yen/dollar was in danger of breaking down through the 200-day moving average (101.16). For the last year-plus, the 200-day moving average has acted as major resistance for the yen/dollar, so a break of that would be significant (positive yen/negative dollar). But, clearly there are traders willing to defend that level, and the yen declined steadily vs. the dollar all morning Wednesday, despite the lack of any fundamental reason. The yen/dollar closed back below the 200-day MA at 101.39.

Regardless, the outlook for more easing from the BOJ is becoming more unclear as the economy remains more resilient than most would have thought. I remain a yen bear/DXJ bull, but if the yen/dollar does break decisively through the 200-day MA, my conviction in that position will take a serious hit. For now, though, I'm holding firm.

Finally, Treasuries were weak again, as they were under pressure all day. Except for a small post-FOMC minutes bounce, they never showed much life. The 30-year traded down 0.39%, although it ended off the worst levels of the day. Although this week bonds have traded a bit heavy, the market remains strong, and three days of relative weakness aren't enough to break this uptrend, yet.

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).**