7:00's Report

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

May 30th, 2014

Pre 7:00 Look

- Futures are drifting very slightly weaker after another uneventful night.
- Economically the focus was on Japan, but data was largely a wash. Inflation was slightly higher than estimates but industrial production missed, and the yen and Japanese stocks were little changed on the news.
- In Europe German retail sales missed expectations, making it the second German data point to miss this week.
- Econ Today: Personal Income & Outlays (E: 0.4%). Fed: Mester (12:30 PM), Lacker (2:00 PM), Plosser (5:00 PM).

Market	Level	Change	% Change
S&P 500 Futures	1916.50	-1.50	-.0.08%
U.S. Dollar (DXY)	80.50	-.04	-0.05%
Gold	1253.00	-4.10	-0.33%
WTI	103.21	-.37	-0.36%
10 Year	2.447	.009	0.37%

Equities

Market Recap

Stocks methodically grinded to new all-time highs yesterday on continued month-end positioning and largely in-line economic data. The S&P 500 rose 0.54%.

Pretty much all of yesterday's catalysts were M&A-related news or economic data, and came pre-open or immediately following the open. First, the merger spree continued as AAPL bought Beats, and TSN ignited a bidding war for HSH with PPC. (Think they are expecting this increase in food prices to continue?)

Second, economic data were largely in-line, as Q1 revised GDP was a shockingly bad headline but the details were actually decent, jobless claims appear to have resumed their downtrend, and pending home sales was a slight miss but positive. All this combined to help stocks drift steadily higher throughout the morning.

From lunchtime on, news flow slowed considerably (Lacker's comments were hawkish as usual). Traders looked to the small caps and "momentum" stocks for guidance, and they were higher and that helped markets lift into the close.

Trading Color

Month-end positioning continues to be the real reason we're seeing the lift in stocks this week, as yesterday's rally again came on very low volume and activity.

Internally, things remained healthier than they have been in months, though. "Momentum" sectors traded well (both NBI and QNET) and the Russell 2000 lagged but only slightly. Point being, there was no large non-confirmation from the cyclical/high-beta sectors, which is a positive, although we'll need to see that last into the beginning of June to prove this isn't all month-end short-covering/chasing.

Sector-wise all 10 S&P sub-sectors were higher yesterday, with basic materials, tech and consumer staples (thanks to the HSH rally) leading the way. There was slight outperformance by cyclical sectors yesterday over defensives, but again the rally was broad and I wouldn't read too much into that, yet.

Volumes, as mentioned, were low again So was activity, and everyone seems paralyzed ahead of the ECB and jobs report next week. On the charts the S&P 500 is now sitting at 1,920 (a new all-time high) while support sits lower at 1,900.

Market	Level	Change	% Change
Dow	16698.74	65.56	.39%
TSX	14588.95	-22.01	-.15%
Brazil	52239.34	-400.41	-.76%
FTSE	6862.24	-9.05	-0.13%
Nikkei	14632.38	-49.34	-0.34%
Hang Seng	23081.65	71.51	0.31%
ASX	5492.55	-28.93	-0.49%
Prices taken at previous day market close.			

Bottom Line

This has been a nice move in stocks this week but I'm certainly not adding material long exposure up here, as a lot of this has to do with month end positioning. Generally things are turning more positive, but I doubt this is the breakout we've been looking for and will ignite a '13 style linear rally—although obviously I hope I'm wrong given I own stocks. For now, though, I am holding what I've got into key catalysts next week (ECB and Fed). I am not buying this breakout.

Market	Level	Change	% Change
DBC	26.23	.01	0.05%
Gold	1254.20	-5.10	-0.41%
Silver	9.00	-.059	-0.31%
Copper	3.147	-.0265	-0.83%
WTI	103.61	.89	0.87%
Brent	110.17	.36	0.33%
Nat Gas	4.572	-.043	-0.93%
RBOB	3.0197	.0138	0.46%
DBA (Grains)	27.96	.21	0.77%
Prices taken at previous day market close.			

Economics

Revised Estimate of Q1 '14 GDP

- Q1 GDP was -1.0% saar vs. (E) -0.5% saar

Takeaway

Revised Q1 GDP fell sharply from a positive 0.1% read in the initial estimate, to a negative 1% read in the second estimate, badly missing expectations. But, while it was a bit of a headline shocker and clearly not a strong number, it wasn't as bad as advertised.

First, most of the drop came from a depletion of inventory and an uptick in exports (so, hardly bad omens for the economy). Looking into the details, personal consumption expenditures (read consumer spending) ticked slightly higher from 3% to 3.1%, while final sales of domestic product (GDP less inventory adjustment) slipped only slightly from 0.7% to 0.6%.

Bottom line is yesterday's revisions to Q1 GDP were not quite as bad as the headline suggested, as important indicators such as PCE and final sales of domestic product were only little-changed. And, with economic data in April and May showing a strong rebound, yesterday's GDP report—while disappointing in an absolute sense—won't really have any impact on the market.

Weekly Jobless Claims

- Weekly Claims fell to 300K vs. (E) 317K
- The 4-Week Moving Average declined 11.25K to 311.5K

Takeaway

Weekly jobless claims resumed their recent downtrend last week, falling 27K to an even 300K vs. expectations of 317K. The data from the week prior were revised up 1K to 327K. The smoother look at the data in the form of the 4-week moving average has fallen three weeks in a row now, down 11.25K to 311.5K last week.

So, for now, it appears the spike in claims for the week ending 5/17 was an outlier and the general trend lower is set to continue going forward. This is a clear, positive sign for the labor market and, in turn, the ongoing economic recovery. Keep in mind, however, the week ending 5/17 was the "survey week" for the official government jobs report due out next week. So, even though claims have resumed the downtrend, the whisper number for next week's jobs report will be somewhat less optimistic than the general trend of claims might suggest.

Pending Home Sales

- Pending Home Sales rose 0.4% vs. (E) 1.0%

Takeaway

Pending home sales, a leading indicator to existing home sales, increased by 0.4% in April vs. analyst expectations calling for a 1% rise. Although the headline was slightly disappointing, the report does indeed show that sales growth is continuing after last month's strong rise of 3.4%. It appears we saw a substantial bounce-back of activity in the housing market in March after the weakness this winter.. And, although the real estate market cooled down slightly in April, the data remain positive in a sector that is being very closely watched by the market. Bottom line is the number further implied we're seeing a stabilization in the pace of the housing recovery, which is the most important thing to the market.

Commodities

Commodities were mostly lower again yesterday, with the exception of the energy sector, thanks to some bullish details in the weekly inventory data. Despite the general weakness, the benchmark commodity tracking index ETF, DBC, was little-changed, up 0.05% due to some strength in several agricultural commodities.

Energy was the best-performing sector in the commodity space yesterday thanks to a delayed inventory report being released by the EIA (due to the Memorial Day holiday). The EIA reported a build of 1.7M barrels in crude oil vs. (E) of +100K while there was a draw in RBOB gasoline of 1.8M barrels vs. (E) +200K and a draw in distillates of 200K barrels vs. (E) +600K.

The larger than expected draw in RBOB stockpiles did trigger a rally in gasoline futures (up 0.46% on the day). However, the main cause of the rally in crude oil futures, which gained .87% yesterday, was in the details of the EIA report. As we mentioned earlier in the week, traders were focused on inventory levels at Cushing, Okla., which reportedly fell 1.5M barrels to 21.7M barrels last week, marking the 16th draw in 17 weeks and leaving supply levels sitting dangerously close to the "safe operation" level of ~20M barrels.

Bottom line is, there are 3 things in focus for energy traders:

- Overall supply (which is near all-time highs and has a bearish influence).
- Cushing inventories nearing critical minimum requirement levels (bullish influence on WTI).
- The anticipated rise of gasoline demand (also bullish WTI).

So, as we see the market continue to be pushed and pulled around by short-term traders, WTI futures remain range-bound with a technical bias to the upside (while fundamentals are beginning to lean that way as well).

On the charts, support near the $102.50 level mentioned on Tuesday has held while the bulls have the 2014 highs in their sights at $105.22.

Natural gas futures fell 0.85% after the EIA reported inventories rose 114 Bcf vs. (E) 109 Bcf. Futures surprisingly recovered from the post-report dip and closed only modestly lower (0.85% is modest for natural gas). The nat gas market remains focused on the pace of inventory builds and the weather going forward. Technically speaking, the charts are a bit of a mess; however, a fairly broad trend channel is developing with support rising to $4.41 and resistance up to $4.92.

Copper futures fell for the first day in six yesterday, closing down 0.83%. The newswires were citing the weaker than estimated GDP print; however, based on the charts, that was not the case. Most of yesterday's dip came overnight as traders positioned *ahead* of the GDP report, but more importantly ahead of the Chinese manufacturing data due out Sunday night. Technically the uptrend is still very healthy but the support band at $3.10-$3.12 should not be violated. Resistance is above in the $3.17 area.

Gold slipped again yesterday, down 0.41% for the fifth decline in a row thanks to good economic data and general follow-through selling. Futures traded down to a 16-week low early yesterday morning. Economic data also contributed to some of the selling yesterday, as jobless claims fell back to a desirable 300K, the details of the GDP report were better than the headline suggested, and pending home sales remain positive. On the charts, there is some weak support near $1,240/oz while resistance will replace former support at the April lows near $1,270.

Market	Level	Change	% Change
Dollar Index	80.545	-.075	-0.09%
EUR/USD	1.3602	.0013	0.10%
GBP/USD	1.6716	.0006	0.04%
USD/JPY	101.72	-.11	-0.11%
USD/CAD	1.0839	-.0032	-0.29%
AUD/USD	.9293	.0058	0.63%
USD/BRL	2.2235	-.0086	-0.39%
10 Year Yield	2.447	.009	0.37%
30 Year Yield	3.304	.016	0.49%
Prices taken at previous day market close.			

Currencies & Bonds

In a reversal from Wednesday, the Dollar Index was almost universally weaker in trading Thursday, but only modestly so, as it declined just 0.11%.

In Europe trading was quiet, partly due to a holiday that had several European countries closed (Ascension Day), and partly due to trader digestion of the recent steep decline in both the euro and pound.

Both rebounded slightly vs. the dollar (0.07% and 0.05%, respectively) on little more than an oversold bounce.

The real action yesterday in the currency markets came from Australia, as the "Aussie" rallied 0.75%, making it by far the biggest gainer vs. the dollar. The catalyst for the rally was greater than expected capital expenditures reported by Australian firms, who looked to spend 137 billion Aussie dollars in capex over the coming year, compared to a previous estimate of 125 billion. Combine that surprise good news with an oversold Aussie (down from a high just under \$0.94 three weeks ago to \$0.92 this week) and a short-covering rally was on.

But, with China slowing, commodity demand flat (at best) and a central bank still wary of the negative effects of a stronger Aussie, I believe the right way to play yesterday's bounce would be to sell it. A break of \$0.92 in the Aussie, which has held several tests of support since April, would signal an acceleration of the decline.

Finally, the yen was modestly higher despite a disappointing April retail sales number (down 4.4% vs. (E) 3.3%). But, despite generating a lot of headlines, that number was largely ignored by the market, as there was a front-loading of retail sales in March (up 11%) because of the impending sales tax increase. So, the April number can largely be written off. Much more important, though, was the data out last night.

Turning to bonds, Treasuries hit new multi-month highs (and yields multi-month lows) Thursday, but reversed shortly after 1 o'clock to finish the day slightly negative (the 10-year Treasury was down 0.06%; the 30-year fell 0.18%). Fed President Lacker, a well-known hawk, was speaking on CNBC around the time of the reversal and was predictably hawkish, and also there was a 7-year Treasury auction that saw just average results. Both may have contributed to the reversal in bonds, but in truth this is all just trading noise and the next major decision point in bonds will be the ECB next Thursday (followed by jobs report Friday).

About 10 days ago, I sent analysis suggesting that June 5 should be the end of this bond rally, *if* indeed bonds are rallying because of European money flows (which is the consensus) and not because bonds are signaling some ominous global economic slowdown.

Since I wrote that analysis, there have been several economic and geopolitical events that have been "bond-negative" and removed support for the bond market.

In light of that, the bond rally should end on June 5 for four reasons:

- ECB action (assuming they act forcefully) will already have been priced into the market, so we could see a "buy the rumor/sell the news" reaction.
- Geopolitical concerns have been reduced in the wake of Ukrainian elections and the victory of the "Chocolate King."
- Domestic economic data have remained strong, evidenced by May flash manufacturing PMIs last week, which rose to a multi-month high.
- Inflation in the U.S. is showing clear signs of bottoming as CPI and PPI have recently started to (slowly) trend higher, while wages have also started to rise, and investors are noticing (there was very strong demand at last week's otherwise little-followed TIPS auction).

So, *if* this now-six-month-old bond rally is primarily because of deflation concerns out of Europe and a result of that new "carry trade" I explained a little over a week ago, *then* this huge rally should end shortly after June 5, assuming the ECB deploys substantial measures to stimulate growth.

Finally, as we approach the ECB decision next week, keep in mind that the goal of the ECB is to see interest rates increase, not fall. 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.

Have a good weekend,

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 material move beyond 1900 is likely capped until bonds start to sell off.* *The trading range in the S&P 500 has bumped up, to 1910ish—1860ish.*

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've added IYZ (Telecom ETF) to this "market losers" basket, 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 remains 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.**

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. **The Yen rallied to start the week last week but sharply reversed off of the 200 day moving average mid week (while the Nikkei quietly rallied 2.5%) suggesting the short yen/long DXJ trade is hanging in there. But, 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).**