7:00's Report

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

May 5th, 2014

Pre 7:00 Look

- Futures are trading modestly lower this morning, as bond prices are higher and fighting in Ukraine escalates.
- Economically it was a quiet weekend/night, as the Markit Chinese manufacturing PMI (not the official government number) was 48.2 vs. (E) 48.0, but down from the flash of 48.3.
- In Ukraine fighting is escalating in several cities, but Russia remains "uninvolved" officially, so it remains somewhat on the back burner for the market.
- Econ Today: ISM Non-Manufacturing PMI (E: 54.2).

Market	Level	Change	% Change
S&P 500 Futures	1867.50	-7.00	-.37%
U.S. Dollar (DXY)	75.55	-.013	-.02%
Gold	1311.90	9.00	.69%
WTI	100.32	.56	.56%
10-year	2.591	-.015	-0.58%

Equities

Market Recap

Stocks were higher last week as most of the M&A news, decent earnings and a rebound in "momentum" sectors offset a very disappointing Q1 GDP report and an acceleration of the bond rally. The S&P 500 was up 1% on the week and is up 1.77% year-to-date.

Stocks were higher Monday-Wednesday and broke above resistance at 1,880 primarily as M&A activity continued to surge. Last week, deals in focus were PFE/AZN, a growing bidding war for Alstom between GE and Siemens, EXC buying POM, and chatter about T buying DTV and S bidding for TMUS later in the summer.

Also helping stocks rally early last week was a rebound in the "momentum" sectors, as both QNET and NBI stabilized last Tuesday and were able to do so despite some disappointing earnings results. That resiliency caught people's attention and we saw "real" money move back into those sectors mid- to late-week.

The rally stalled late in the week, though, as the surprisingly bad Q1 GDP report spooked investors Thursday, while markets largely ignored a blowout jobs number Friday. On Friday specifically, the relentless rally in bonds was one of the main drags on the market. The "bond conundrum" only got worse as bonds traded to new highs for the year and the yield curve flattened.

Stocks closed slightly lower on Friday but still managed solid gains on the week.

Trading Color

The stabilization of the "momentum" sectors was key last week, and if QNET and NBI can continue to rebound, that will be supportive of the market. But, despite that, we didn't see widespread buying of cyclicals compared to defensives, as earnings continued to muddle the sector trading last week.

Telecom, which we got long on Wednesday morning, traded very well last week (up 4%) thanks to M&A chatter and decent earnings. Meanwhile, other defensive sectors including utilities, REITs and consumer staples again made new 52-week highs last week.

So, despite the positive moves in "momentum" sectors, we still are seeing broad strength in the defensive sectors. (This isn't what you want to see with a market making new highs. If cyclicals can rebound and start to out-

Market	Level	Change	% Change
Dow	16512.89	-45.98	-.28%
TSX	14765.15	101.08	.69%
Brazil	52980.31	1353.62	2.62%
FTSE	6822.42	13.55	.20%
Nikkei	14457.51	-27.62	-.19%
Hang Seng	21976.33	-284.34	-1.28%
ASX	5462.22	4.17	.08%

Prices taken at previous day market close.

perform, that will be a nice confirmation of the strength in stocks.)

Activity was busy and there was definitely "real" money buying the Internet stocks and biotechs late last week (a good sign), although it would be a stretch to say that the market moved higher last week with a ton of conviction. (Volumes away from earnings weren't materially stronger than the recent trend.)

Market	Level	Change	% Change
DBC	26.26	.05	0.19%
Gold	1299.90	16.50	1.29%
Silver	19.492	.503	2.65%
Copper	3.069	.0475	1.57%
WTI	99.82	.40	0.40%
Brent	108.61	.85	0.79%
Nat Gas	4.677	-.042	-0.89%
RBOB	2.9453	.0065	0.22%
DBA (Grains)	28.95	-.18	-0.62%
Prices taken at previous day market close.			

On the charts, the S&P 500 broke above 1,880 and held that breakout. If bonds can start to sell off this week, we could see a run to 1,900 in the short term. But I'd be surprised if there's much more room above that. Generally this market remains largely range-bound (1,850-1,885).

This Week

It's a pretty quiet week economically, as Fed Chair Janet Yellen's testimony before the Joint Economic Committee on Wednesday is the highlight.

Earnings season is winding down and there are several larger companies reporting this week. But for all intents and purposes, earnings season is "over" from a macro standpoint. Overall it was pretty good, although no one is significantly upping numbers because of it (119/share remains the consensus '14 S&P 500 EPS).

Finally, people will be watching Ukraine, and certainly things are deteriorating there. But, unless there is an invasion or the Russian/Ukrainian militaries start actively fighting, this will remain on the back burner for markets (although obviously it's a risk that needs to be monitored).

Bottom Line

Generally speaking the macro-economic backdrop remains supportive of US and foreign equity prices, although I think any material upside (say beyond 1900 in the S&P 500) is capped until bonds start to sell off. Despite the Ukraine headlines and human tragedy, the strength in the bond market and flattening yield curve now are the biggest near term risk to the rally, and we saw that on Friday: The strength in bonds was the main reason stocks couldn't rally Friday (it wasn't Ukraine, although there was some de-risking going into the weekend). And, the longer bonds remain buoyant, the more of a headwind they will become on equities.

Strategy wise, I continue to think time is best spent finding specific sectors that are trading at a value or have positively turning fundamentals and allocating to them, as I think trying to identify the next major positive "macro" catalyst that will spark a big rally in the market is relatively futile at this point. "Frustratingly flat" is likely going stay for the broad markets for a while, and as correlations between sectors continues to fall, outperformance will continue to be driven by buying the "right" sectors.

Economics

Last Week

There was a lot of economic data last week, and with the exception of Q1 GDP, it was largely better than expected. I could spend the entire Report recapping the data, but the bottom line is that both international and domestic data last week further confirmed that: 1)The U.S. economy is still on track for 3% growth, and the Q1 dip in the economy was weather-related and temporary. 2) The economic recovery is progressing in Europe and slowly accelerating. 3) The pace of growth in China is showing signs of stabilization.

Importantly, that macro backdrop is generally supportive of risk assets.

Looking at some of the specific takeaways from last week, one of the overlooked but important releases last week was the big increase in Pending Home Sales (up 3.4% in March vs. (E) 0.6%. That's important because housing has not bounced back from the winter slowdown the way other parts of the economy have, and concerns are growing that the slowdown in the housing recovery may not be temporary.

So, this big bounce-back in Pending Home Sales helps alleviate (to a point) those concerns. If other data can show the housing recovery is starting to pick up steam again, that will be an unanticipated positive tailwind on the economy.

Other than the jobs report (which I'll get to in a minute), the other "big" number was Q1 GDP, which badly missed estimates at 0.1% vs. (E) 1.1%. And, the details of the number were generally as weak as the headline. To boot, given the construction data and factory order releases of last week, we may well see Q1 GDP revised to negative growth next month.

The number was ugly (and again may get uglier) but the important thing is that economic data in the present is trending much better. So even though Q1 was worse than everyone thought, we should see a big bounce-back in Q2. As it stands, the GDP number isn't changing the outlook for the economy.

Turning to the jobs number, we all know it was a blowout (288K vs. (E) 215K), but the market focused on the fact that the labor participation rate dropped to a 36-year low (the lowest since 1978). I'll let the economists debate the minutiae, but the important takeaway here is that job growth is improving. The rolling three-month average of job adds is now over 230k, which is pretty good.

The big question surrounding this jobs report is whether it'll cause the Fed to accelerate tapering or pull forward when it raises rates. According to how bonds reacted Friday, the answer is "no" and I concur (although I was astonished by the bond market's reaction).

We'll need to see some consistency of job adds above 200K before the Fed accelerates the taper. But if these types of numbers continue over the next two months, then I do think that the outlook for Fed policy will change, although it hasn't happened, yet.

Market	Level	Change	% Change
Dollar Index	79.56	-.019	-0.02%
EUR/USD	1.3871	.0002	0.01%
GBP/USD	1.687	-.0021	-0.12%
USD/JPY	102.23	-.09	-0.09%
USD/CAD	1.0972	.0018	0.16%
AUD/USD	.9264	-.001	-0.11%
USD/BRL	2.2203	-.0127	-0.57%
10-year Yield	2.591	-.015	-0.58%
30-year Yield	3.368	-.037	-1.09%
Prices taken at previous day market close.			

Bottom line is we can debate participation rates, hourly wage growth, etc. But stepping back, all the indicators say we're seeing incremental improvement in the labor market, and that is a good thing for the economy and stocks.

Finally, looking internationally, the three big releases last week—Bank of Japan growth and inflation outlook, April EU HICP, and the official April manufacturing PMI—all met expectations.

With regard to the policy outlook for the BOJ and European Central Bank, not much changed. The BOJ didn't increase its 2015 inflation estimates (which is mildly dovish). Generally the consensus remains that they will ease further this summer (July now seems to be the expectation).

With the ECB, the bounce-back in HICP removes any potential of radical action at this week's meeting. But the expectation remains that the ECB will have to do "more" soon. This should come via negative deposit rates or another interest rate cut. QE, while possible, remains well off in the future.

But, importantly, both central banks remain committed to staying "easy" and, if anything, getting more-accommodative. This is supportive of Japanese and European stocks, and I continue to like being long both at these levels.

This Week

There is a decent amount of data this week, but it's mostly international. Unless the data badly misses expectations, none of it should really change anyone's outlook on the global economy.

Domestically it's quiet, with April non-manufacturing PMIs (this morning) the highlight, although jobless claims will be watched to see if the two-week jump starts to reverse itself (it should).

Internationally, the ECB and Bank of England meeting Thursday are the highlights of the week, although likely both will be non-events. The BOE almost certainly will do nothing. Given last week's HICP report, the ECB will likely wait to do further accommodation.

Global composite PMIs hit tomorrow morning (China tomorrow night), while Chinese trade balance, CPI and PPI (all Thursday) will be watched for further signs of growth stabilizing.

Commodities

Commodities were broadly lower last week as selling in crude oil futures continued while multi-month support levels were tested (and held) in gold. The benchmark commodity tracking index ETF, DBC, fell 1.2% on the week, thanks mostly to the weakness in energy. However, DBC is up 4.6% year-to-date, handily outperforming the S&P (+1.77%).

Crude oil fell -0.5% last week thanks to another bearish EIA weekly inventory report that showed national supply levels hitting yet another all-time high. But, WTI futures did close well off the lows after an 0.8% rally on Friday, which was largely driven by short-covering ahead of the weekend as well as escalating tensions in the Ukraine bringing back a bit of a geopolitical fear bid to the market.

Bottom line in crude oil is we are seeing futures continue to trade in a range between the mid- to upper-$90s and the mid-$100s. The "supply bears" and "demand bulls" are pushing and pulling the market back and forth as they fight for control, and in the near term this is a trendless, traders market.

But, looking ahead, gasoline demand will likely become the focus of the market as we approach the summer driving months, and we can expect rising demand for products to generally support crude oil prices (so I wouldn't be an aggressive seller here and broadly speaking would prefer to buy dips for anything other than the very short term).

Moving to the metals, gold futures were trending lower last week, down 4 days in a row before popping 1.32% on Friday to close back above the $1,300 level. Escalating tensions in the Ukraine were cited as one of the key drivers of the market; however, the resilient bond market and fragile stock market also contributed to gold rallying as traders look to the metal as a fear hedge. And, that's continuing today as gold is up another 1%.

Fundamentally the picture is mixed for gold in the near term, as inflation remains low but there are some signs we're starting to see an increase ("Core PCE," ticked up last month), while obviously geo-politics are a near term positive (but that's fluid and volatile).

Bottom line, though, is that gold has been and remains a decent equity hedge at current levels, so if you're looking for a way to hedge equity exposure, gold has done as good a job as anything this year and that looks to be continuing this morning (futures down, gold up).

Currencies & Bonds

Bonds moved to new highs for the year last week, despite better than expected economic data and more optimistic language from the Fed regarding the economy, as the "bond conundrum" got worse and the strength in bonds became a headwind for equities.

Bonds surged on short covering Thursday and shockingly rallied Friday despite the 288k jobs report (Ukraine and the low participation rate were blamed). But, bonds breaking from the (apparent) economic reality started in early March, and data has gotten better since then and the Fed has signaled further that QE is ending and interest rates increases are coming. So, this isn't about Ukraine.

Bonds are stronger again this morning and the bottom line is whatever the reason for this strength, it is now starting to weigh on equities prices. Bond strength remains a major "caution" sign for risk assets.

Currency markets were relatively clam last week. The Dollar Index declined .5% last week despite generally good economic data, as the Dollar Index was influenced by strength in the euro following the better than expected manufacturing PMIs and bounce in HICP (they significantly reduced the chance of the ECB easing further this week. 79.375 is major support for the Dollar Index, and key the key catalysts for currencies this week will be the ECB and BOE meeting (it's somewhat quiet other than that).

Have a good week—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).**

Buy A Steepening Yield Curve: **STPP and KBE give positive exposure to a steepening yield curve, as the 10's-2's spread appears to have bottomed and should rally from here. 2.20% in that spread is my stop on STPP and KBE longs. 10's—2's hit a new low od 2.18 on Friday as the yield curve continues to flatten, and I'm exiting the trade.**