7:00's Report

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

May 6th, 2014

Pre 7:00 Look

- Futures and international markets are little changed this morning as news was quiet o/n and Japanese and Chinese markets were closed for a holiday.
- Economically, there were several reports out in Europe including EU Retail Sales (.3% vs. E: -.2%) and the EU Composite PMI (54.0 vs. E: 54.0). Both were largely in line and are not materially moving equity market this morning.
- The Euro however rallied on the data and broke out of the recent trading range, sending the dollar index to a 6 1/2 month low.
- Econ Today: No economic reports today. Fed Speak: Stein (6:15 PM)

Market	Level	Change	% Change
S&P 500 Futures	1877.75	2.00	0.11%
U.S. Dollar (DXY)	79.245	-.285	-0.36%
Gold	1308.20	-1.10	-0.08%
WTI	99.66	.18	0.18%
10 Year	2.611	.020	0.77%

Equities

Market Recap

Stocks rallied to start the week as more good economic data helped reverse an early sell-off. The S&P 500 closed up 0.19%.

Stocks were decidedly lower early Monday morning as Europe traded lower on follow-through selling from Friday. Ukraine and the weak Chinese data were blamed for the early weakness, but that was more an excuse than a cause.

VXX: The VIX hit a multi-month low yesterday, and it's fair to say that the one thing in this market that is decidedly "cheap" is volatility.

The truth is, Ukraine hadn't deteriorated all that much from Friday, and importantly, Germany is working on getting another Geneva summit together. Plus, the Chinese data didn't change the outlook there at all.

Instead, stocks opened weaker mainly because bonds were again higher. Earnings misses from PFE and TSN (among others) saw selling accelerate, and the market was down over 0.5% shortly after the open.

But, the markets reversed sharply immediately after the ISM non-manufacturing report, as bonds began to sell off and stocks—seeing a shocking sight of bonds actually declining—rallied. Shorts rushed to cover, and stocks were back to flat before 11 a.m.

The remainder of the day was very quiet (remember London and Tokyo were closed), and stocks mostly drifted around before catching a small bid into the close.

While the absolute moves weren't especially impressive, the S&P 500 did rally nearly 20 points off the lows, showing some decent resiliency.

Market	Level	Change	% Change
Dow	16,531.58	18.69	0.11%
TSX	14697.03	-68.12	-.46%
Brazil	53446.17	465.86	.88%
FTSE	6807.70	-14.72	-.22%
Nikkei	14457.51	-27.62	-.19%
Hang Seng	21976.33	-284.34	-1.28%
ASX	5481.38	19.15	.35%
Prices taken at previous day market close.			

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Trading Color

"Momentum" sectors held up well yesterday (with NBI up 1.7% and QNET up 0.35%). More and more, those two sectors are looking as though we've seen the worst of the sell-off.

Market	Level	Change	% Change
DBC	26.25	-.03	-0.11%
Gold	1309.80	6.90	0.53%
Silver	19.56	.068	0.35%
Copper	3.0535	-.0165	-0.54%
WTI	99.57	-.19	-0.19%
Brent	107.76	-.83	-0.76%
Nat Gas	4.693	.019	0.41%
RBOB	2.908	-.0365	-1.24%
DBA (Grains)	29.14	.20	0.69%
Prices taken at previous day market close.			

Looking at the indices, the big ones were little-changed, so there's not a lot to read into there. From a sector standpoint, earnings releases affected trading, but generally we saw continued strength in the "defensive" sectors (utilities bounced back from Friday's earnings-induced beating, while healthcare and REITs were also higher).

Energy and basic materials also continued their recent outperformance (contradicting the "weak Chinese data" excuse for the early equity weakness yesterday).

Gold appears to have broken the downtrend in place since mid-March, and a few more closes above the $1300 level will make the technical picture more attractive.

Of note, banks were some of the worst performers and notched a near-three-month closing low. Worries about trading revenue were rekindled last Friday when JPM said that revenue from equity and fixed income trading will be down about 20% in Q2 compared to a year earlier.

Activity-wise it was a sleepy day. London and Tokyo being closed reduced activity levels, and overall volumes were well below the past several trading days. On the charts the S&P 500 again closed above the 1,880 resistance level, although really the market remains largely range-bound between 1,890-ish and 1,840-ish (a range it's occupied for well over a month now).

Bottom Line

Not much changed yesterday. Bonds are clearly "driving the bus" as they say. And although it dominated the headlines, the situation in Ukraine and the outlook for Chinese growth didn't get worse yesterday (and wasn't a reason to sell).

At the moment, this market is all about the strength in bonds, and until we get a material decline in bonds that validates the strength in equities, we're going to have a hard time trading much above 1,900 in the S&P 500.

Economics

ISM Non-Manufacturing PMI

- April ISM Non-Manufacturing PMI: 55.2 vs. (E) 54.2.

Takeaway

The ISM non-manufacturing (or service sector) PMI continued last week's trend of good data, as the headline beat estimates and rose to an 8-month high (the best reading since August). Additionally, the details of the report were also strong, as the business activity index (the service sector equivalent to the production index in the manufacturing PMI) rose to a 9-month high (best since July) while the New Orders Index (the leading indicator in the report) also rose to an 8-month high.

Interestingly, despite the service sector being the largest part of the economy (by a big margin), the ISM non-manufacturing PMI usually isn't as market-moving as the manufacturing PMI. But that wasn't the case yesterday.

The Dow was down 130 points and bond yields were lower when the report was released, but stocks reversed and climbed back to flat and bonds actually turned negative on the report (sending yields higher). This served to remind everyone that, at least according to the data, the economy *is* actually improving!

More broadly, this report only further solidifies that the economy is recovering from the temporary winter dip. But, until we start to see bonds decline/yields move higher, people will remain skeptical of the economy,

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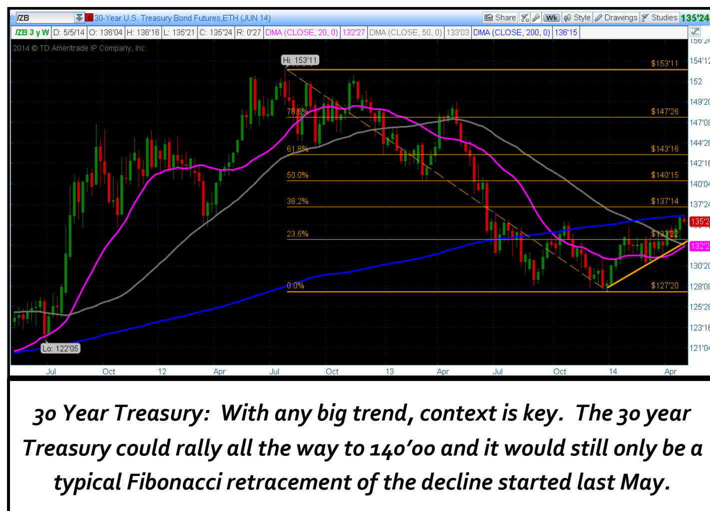
even in the face of good data like the ISM non-manufacturing report.

Commodities

Commodities were mixed yesterday as the selling continued in the energy sector while precious metals extended Friday's gains. The benchmark commodity tracking index ETF, DBC, slightly declined, down 0.11% on the day.

Gold and silver were among the best performers yesterday, adding 0.53% and 0.35%, respectively. Gold continued to rally yesterday and hit a 3-week high in early trading, after futures broke out of a 7-week downtrend on Friday. There are several familiar influences in the market helping to support gold prices, including the Ukrainian fear bid, strength in the bond market, and a choppy/sideways stock market.

On the charts, gold futures continue to oscillate around the $1,300 level and the technicals indicate that this pattern could continue over the medium term. Looking to a shorter time frame, the benefit of the doubt is with the bulls as support has been moved up to the $1,300-$1,305 level while resistance is above at the 50-day moving average at $1,317.



30 Year Treasury: With any big trend, context is key. The 30 year Treasury could rally all the way to 140'oo and it would still only be a typical Fibonacci retracement of the decline started last May.

Crude oil and the refined products all traded lower yesterday as shorts returned to the market. Many short-sellers covered Friday into the weekend (Ukraine being the reason), but returned to the market today as the situation remains largely unchanged (Ukraine has not been a major positive influence in oil prices, and likely won't be unless there is all out war).

Market	Level	Change	% Change
Dollar Index	79.535	-.028	-0.04%
EUR/USD	1.3876	.0006	0.04%
GBP/USD	1.6867	.0002	0.01%
USD/JPY	102.13	-.05	-0.05%
USD/CAD	1.0948	-.0025	-0.23%
AUD/USD	.9276	.0002	0.02%
USD/BRL	2.2414	.0217	0.98%
10 Year Yield	2.611	.020	0.77%
30 Year Yield	3.407	.040	1.19%
Prices taken at previous day market close.			

The "supply bears" continue to overpower the "demand bulls" (and "geopolitical risk bulls"), for now. We expect futures to remain under pressure in the near term.

However, as crude slips toward the $97.50 level, taking a low-risk shot on the long side would be worthy of some risk capital, as the futures continue to be largely range-bound between the mid- to upper-$90s and the $105 level. On the charts, the first level of resistance is now at $99.50 while the bears are focusing on breaking down through last week's lows tick of $98.74.

It is worth noting that wheat prices also continue to rally as a result of the unrest between the Ukraine and Russia. Speculators are buying up wheat futures, which hit a 13-month high yesterday as violence spreads through eastern Ukraine, threatening the export of wheat (if rebels take the eastern ports and rail hubs, the fear is the wheat crop may not be able to get out). Outside of Ukraine wheat fundamentals haven't improved materially over the last several weeks, so at this point there's a big "geo-political risk premium" in wheat, and depending on how things go in Ukraine, there may be an opportunity in wheat for futures traders over the coming weeks (if things turn out to be not as bad as feared).

Currencies & Bonds

Bonds actually sold off yesterday thanks to good economic data, although the decline was small (-0.3%) considering the strong jobs report Friday and big ISM non-manufacturing report beat yesterday. Treasuries were higher pre-ISM Monday, with "Ukraine" the most-cited excuse (in reality it was just follow-through buying from Friday's strong day). But, a dose of rationality entered the bond market for the first time in a week as Treasuries did reverse lower immediately following the ISM non-manufacturing report, although the declines were muted. (The 10-year closed the day basically flat, thanks in part to the Fed buying 2.5 billion

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of 8-10 year Treasuries at 11 a.m.)

Despite the dip in bonds yesterday and slight steepening of the yield curve, bonds remain buoyant and elevated. Until they begin to decline and reflect the economic reality the data says we are in, then stronger bond prices will continue to be a growing headwind on stocks.

Currency markets remained quiet yesterday thanks to both London and Tokyo being closed, while trading in the euro is focused on the ECB meeting Thursday (it should be a quiet trade going into that meeting). The Dollar Index, euro and pound were all flat on the day, while the yen was the big mover, rallying 0.14% vs. the dollar.

Looking at the commodity currencies, they were slightly higher vs. the greenback yesterday (up 0.2% each) on light short-covering ahead of several pieces of data in each country (trade balance and a Reserve Bank of Australia rate announcement in Oz, and trade balance and Ivey PMI Index north of our border).

The Dollar Index, despite the strong data, couldn't mount any sort of a rally yesterday, and that extends a recent trend. Like the "bond conundrum," the lack of strength in the Dollar Index is counterintuitive. Yes, the euro and yen have been buoyant vs. the dollar as it's unclear when (and, to a point, if) those central banks will ease policy further. And, strength in those two currencies will depress the value of the Dollar Index given their heavy weight in the index.

But the dollar has also been weak vs. the pound, Aussie and Loonie over the last 1-3 months. So, there is something else going on here other than the euro and yen rallying, because it's unclear whether or not those central banks will indeed ease further.

Point being, the lack of Dollar Index strength again undercuts the "European money" rotation for an explanation as to why the bond market is so strong. After all, if the money was flowing into the U.S. to buy Treasuries, we'd be seeing the greenback at least maintain some value vs. major trading partners (foreign investors have to buy dollars before they buy Treasuries). Instead, we've seen widespread weakness. And, this morning the Dollar Index traded to a new low for the year and support at 79.06 is now in focus.

Bottom line is, given the recent economic data and the fact that the Fed seems intent on further tapering of QE, the Dollar Index shouldn't be this week, and that low of 79.06 should not be violated for any reason, even if the ECB is mildly "hawkish" at its meeting Thursday (which is a remote possibility). Given the outlook for Fed policy and economic data, if the Dollar Index breaks to new lows, we'll have a "dollar conundrum" to go along with our "bond conundrum" … and another headwind on stocks.

Have a good day,

Tom

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The 7:00's Report Asset Class Dashboard

(Outlook on the primary trend for major asset classes over the next month)

<table>
<tr><th></th><th>Fundamental Outlook</th><th>Technical Outlook</th><th>Overall</th><th>Comments</th></tr>
<tr><td>Stocks</td><td>Bullish</td><td>Neutral</td><td>Bullish</td><td>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.</td></tr>
<tr><td colspan="5"><u>Trade Ideas</u>

<u>Long Market "Losers":</u> 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.

<u>Long Japan:</u> "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.

<u>Long Natural Gas E&Ps:</u> 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.</td></tr>
<tr><td>Commodities</td><td>Bullish</td><td>Neutral</td><td>Neutral</td><td>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.</td></tr>
<tr><td colspan="5"><u>Trade Ideas</u>

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.</td></tr>
<tr><td>U.S. Dollar</td><td>Neutral</td><td>Neutral</td><td>Neutral</td><td>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.</td></tr>
<tr><td colspan="5"><u>Trade Ideas</u>

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."</td></tr>
<tr><td>Treasuries</td><td>Bearish</td><td>Bearish</td><td>Bearish</td><td>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.</td></tr>
<tr><td colspan="5"><u>Trade Ideas</u>

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.</td></tr>
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