7:00's Report

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

May 7th, 2014

Russell 2000: The R2K made a new closing low yesterday, and if the April lows are broken, it'll be another "caution" sign for stocks.

Pre 7:00 Look

- Futures are basically flat while global markets are lower in follow through selling from yesterday.
- Economic data was slightly disappointing o/n. Chinese composite PMI was largely in-line, but stayed below the 50 level (49.5). The big "miss" o/n was German Manufacturers Orders, which declined 2.8% m/m (E: 0.3%).
- In Japan, composite PMIs dove to 46.3, reigniting concerns about the sales tax increase (Nikkei was down 2.93%).
- Econ Today: No economic reports today.
- Fed Speak: Yellen (10:00 AM).

Market	Level	Change	% Change
S&P 500 Futures	1864.00	-.25	-.01%
U.S. Dollar (DXY)	79.155	.029	.04%
Gold	1311.30	2.70	.21%
WTI	100.28	.78	.78%
10-year	2.593	-.018	-0.69%

Equities

Market Recap

Stocks suffered their worst daily losses since April 11th as continued strength in the bond market and US Dollar weakness weighed on the equity market. The S&P 500 closed down just under 1%.

Stocks were heavy all day yesterday, as markets opened slightly weaker and bled lower throughout the morning. There wasn't any reasons stocks were lower to start Tuesday (no bad earnings, economic data or deterioration in Ukraine), but stock just traded decidedly lower throughout the morning. The declines accelerated at 1 o'clock (again there was no real reason but some did cite a headline that hit at that point that there was an explosion in Iran, which there was, but it turned out to be a factory fire). The bulls never tried to take a stand yesterday with bonds stronger and the selling continued throughout the afternoon, and markets continued to fall right into the close (the S&P 500 went out on the low tick).

Trading Color

"Momentum" sectors again came for sale yesterday after showing life for the last few days. NBI closed down 1.6% and QNET dropped 2.7% thanks in part to weakness in DATA (earnings) and TWTR (which got hit nearly 10% yesterday on the lockup expiring).

More broadly, the Nasdaq and Russell were very weak, dropping well over 1% each, so we definitely saw a selling of cyclicals and "growth" appear again.

And, that carried over into the sector trading, as banks (courtesy of an ever flattening yield curve) continued to

Market	Level	Change	% Change
Dow	16401.02	-129.53	-.78%
TSX	14612.29	-84.74	-.58%
Brazil	53779.74	333.57	.62%
FTSE	6772.97	-25.59	-.38%
Nikkei	14033.45	-424.06	-2.93%
Hang Seng	21746.26	-230.07	-1.05%
ASX	5435.77	-45.60	-.83%
Prices taken at previous day market close.			

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get crushed this quarter (KBE down 7% QTD). Consumer discretionary also lagged badly and continues to underperform, but the weakness was broad yesterday (not even the defensive sectors like utilities, REITS and telecom could hold up).

Market	Level	Change	% Change
DBC	26.24	.02	0.08%
Gold	1307.40	-1.90	-0.15%
Silver	19.598	.078	0.40%
Copper	3.052	-.0015	-0.05%
WTI	99.68	.20	0.20%
Brent	107.07	-.65	-0.60%
Nat Gas	4.789	.101	2.15%
RBOB	2.8876	-.0216	-0.74%
DBA (Grains)	29.12	.00	0.00%

Prices taken at previous day market close.

Energy was actually the only S&P 500 sub-sector that closed positive on the day, and basic materials stocks also traded well (on a relative basis). Energy specifically, and commodities/materials more generally, very quietly continue to trade well this year.

On the charts it looks like the 1880-1840 range in the S&P 500 has re-asserted itself, but one index I'm going to be watching closely is the Russell 2000. It is sitting very close to the April lows, and if it makes new lows, we can add that to the growing list of "caution" signs in the market right now.

Bottom Line

The "bond conundrum" is becoming a bigger and bigger headwind on the equity market, plain and simple. At it's current state, I don't think it's enough to spur a major market correction, but the longer bonds (both in the US and Europe) stay strong, equities will have a hard time generating any upside momentum.

That said, we are still seeing correlations break down, and sectors where you can make a value argument did hold up well yesterday (specifically basic materials, industrials, miners).

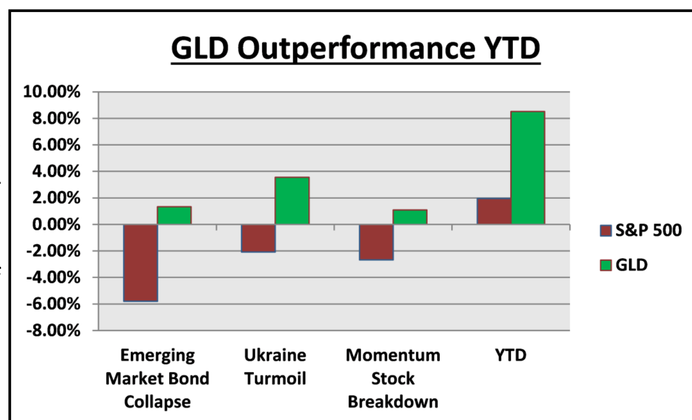
Explaining the "Gold/Equity Hedge" a Bit Further

The strength in bonds has caused stocks to stall over the past week. Given the multiple conflicting signals in the markets right now, identifying an effective hedge for a possible market decline is prudent. And, although it's somewhat counter-intuitive, gold has been a good way to hedge against declines in stocks this year.

First, gold is up 8.53% vs. 1.05% for the S&P 500.

Second, during the three drops in the stock market this year (the emerging-market turmoil of late January/early February, the Ukraine turmoil of early March, and the momentum-stock-led sell-off in early April), gold has rallied, as evidenced by the chart below.

Now I'm not normally a fan of hedging "apples with oranges" but again the facts don't lie: Gold has been an effective equity hedge so far in 2014. Given that the dominant force in the market is the "bond conundrum," that outperformance should continue.



If the strength in bonds is forecasting an impending slowdown in the economy and either a stagflationary environment or a deflationary environment (the "bad" outcome from the bond conundrum), gold will be able relatively outperform stocks.

So, the point I'm trying to make is that in thinking about reasons to own gold, don't look at it just based on gold fundamentals (admittedly the fundamentals are mixed on gold in the near term), but also as a potential "hedge" against any potential equity declines.

Economics

There were no material economic reports yesterday.

Commodities

Commodities were little-changed yesterday (with the exception of natural gas) despite the materially weaker dollar (-0.5%). The PowerShares DB Commodity Tracking Index ETF, DBC, rose 0.08%.

Despite the small relative moves in the general commodity space, the energy sector saw some important developments. Natural gas handily outperformed thanks

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to resurfacing supply concerns, while crude oil futures broke through and closed above a technical resistance level.

Natural gas was the biggest mover yesterday as futures rallied 2.15% to close back toward the top end of the recent trading range ($4.60-$4.85). The leg higher was largely a result of concerns surrounding the nation's supply levels, which remain critical near an 11-year low. Weather forecasts have been revised warmer than initially forecast across the U.S., and that will theoretically lead to heightened energy demand (much of which is natural-gas driven). This led to the rally.

Analysts have suggested that natural gas production will need to be upward of 50% higher than the 5-year average this "build season" (late spring and summer) in order to restore inventories to levels sufficient for handling typical winter demand. The bottom line is, production already needs to be much higher than it has been in recent years. And, if warm weather spurs higher energy demand (for A/C) this summer, that will be a headwind for restoring inventories to the needed levels.

Technically speaking, the price of natural gas is continuing to trend higher toward the $5 mark. As a result the natural gas E&P ETFs, XOP and FCG, have continued to outperform the broader market. And, based on the fundamentals, that trend should continue.

On the charts there is support at the 100-day moving average at $4.80 while last week's high tick of $4.852 is resistance.

Elsewhere in energy, WTI crude oil futures rallied 0.2% on the session but closed well off the highs thanks to a sharp selloff in the last hour of trading. Futures closed about 90 cents off the highs due to traders positioning ahead of this morning's weekly inventory report.

However, the modest rally in futures was enough to cause a break above a recent downtrend on the daily chart that has been in place since the mid-April highs around $105.

Stepping back, WTI does remain largely range-bound and therefore it's currently a traders-only market. Having said that, for those who do trade futures, taking a shot on the long side here looks attractive, as the risk/reward is about $1 for $6. But, I would not recommend taking a position ahead of the EIA report this morning because supply remains the primary focus of the market, and any surprises in the report could materially move futures.

Traders will be eyeing the EIA report and the estimates are for a 1.2 million barrel build in oil inventories, a 100k barrel build in RBOB gasoline inventories, and a 1.2 million barrel build in distillate inventories.

Also today, watch the supply levels at Cushing, Oklahoma. Analysts are calling for the 13th draw in 14 weeks at Cushing, which is the delivery point for futures traded on the WTI. Supplies are being drawn out of Cushing as oil travels south via pipeline to the gulf to be refined into product, and it's not being replaced fast enough.

There is a minimum level that the tanks need to maintain for safety reasons (if the contents of storage tanks fall below a certain level, there is a risk for an explosion). The minimum level for Cushing to maintain is said to be between 20M and 25M barrels. Per the most recent EIA report, supply levels are sitting at 25.4M barrels. So, oil's reaction to the inventory number could depend more on the Cushing supply levels than the national supply levels, so don't be surprised if we potentially see a bigger than expected national inventory build, but a bullish reaction from oil (obviously depending on Cushing inventories).

Market	Level	Change	% Change
Dollar Index	79.125	-.405	-0.51%
EUR/U.S.D	1.3934	.006	0.43%
GBP/U.S.D	1.6983	.0121	0.72%
U.S.D/JPY	101.57	-.56	-0.55%
U.S.D/CAD	1.0882	-.0071	-0.65%
AUD/U.S.D	.9358	.0089	0.96%
U.S.D/BRL	2.2254	-.0175	-0.78%
10-year Yield	2.593	-.018	-0.69%
30-year Yield	3.380	-.028	-0.82%
Prices taken at previous day market close.			

Currencies & Bonds

The dollar weakness accelerated yesterday, as there was a lot of news in the currency markets and almost all of it was positive for other currencies.

The dollar declined 0.45% and was weaker vs. every major trading partner. The Dollar Index hit an intraday low of 79.09, fractionally above the 52-week low of 79.06, which will remain in focus as we head into

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the ECB meeting.

The Dollar Index broke down overnight following the better-than-expected EU composite PMIs, although the Dollar Index did get a small boost from the release of the U.S. March Trade Balance. (The trade balance was less than expected, which will further weigh on Q1 GDP. But both exports and imports rose, implying some strength in March.)

The Dollar Index is sitting basically at 52 week lows, which shouldn't be given strong economic data and a tapering Fed.

The pound rallied 0.63% vs. the dollar yesterday and hit a new multi-year high vs. the greenback following the better-than-expected services PMI. However, it wasn't the best-performing currency vs. the dollar.

That award goes to the "Aussie," which rallied 0.83% thanks to decent trade balance data and a Reserve Bank of Australia announcement that widely met expectations. (Remember, the Aussie had been sold going into the meeting, so there was a bounce-back.)

Finally, the yen rallied 0.45% thanks to broad dollar weakness (nothing pro-yen occurred in Japan). In Canada, the Loonie rose 0.58% on the back of decent trade balance data and a "better-than-headline" Ivey Purchasing Managers' Index. (The headline was weak but that was due to seasonal factors, and the employment sub-index was strong.)

Bottom line is there were positive economic readings for most of the developed economies yesterday, but there have also been strong readings for the U.S. lately, and there is more going on with the broad dollar weakness than just decent foreign economic data and a indecisive ECB or BOJ.

Support held yesterday, but if 79.06 is "given," then we'll have a "dollar conundrum" to go along with our "bond conundrum." In that case, both the currency and bond markets will be tossing up "caution" signs for stocks.

Turning to bonds, they were higher yesterday in quiet trading. The 30-year Treasury rose 0.25% and the 10-year rose 0.08% (and the yield curve flattened). There wasn't any particular reason for the strength in bonds (they caught a bid off the U.S. trade data, but in truth they were strong all day, methodically rallying basically into the close). The bond market remains strong, and that's a caution sign for risk assets.

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)

	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).**

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