7:00's Report

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

June 10th, 2014

Pre 7:00 Look

- Futures are slightly lower as markets continue to digest the recent rally, while international markets were mixed after a mostly quiet night.
- Economically, focus was on Chinese CPI, which was slightly higher than estimates (2.5% vs. (E) 2.4%), but it wasn't high enough to make Chinese officials worried about inflation.
- In Europe data was good: Italian, UK and French April Industrial Production all beat estimates while Italian GDP was negative, but met estimates (down –.1% q/q).
- Econ Today: No economic reports today.

Market	Level	Change	% Change
S&P 500 Futures	1947.25	-3.00	-0.15%
U.S. Dollar (DXY)	80.915	.138	0.17%
Gold	1252.90	-1.00	-0.08%
WTI	104.77	.36	0.35%
10 Year	2.613	.016	0.62%

Equities

Market Recap

Stocks were fractionally higher yesterday as markets took a breather despite more M&A action and good international economic data. The S&P 500 rose 0.09%.

Stocks were modestly higher pre- and post-open, thanks to M&A news (MRK buying IDIX for a huge premium while TSN won the bidding war for HSH), and more decent global economic reports (Chinese trade balance, Japanese GDP).

IDIX: In what may be the best sign the bio-tech purge is over, MRK paid a 200% premium for IDIX, helping the entire bio-tech space rally hard yesterday.

After the open stocks marched higher, again setting a new intraday all-time high, but yesterday felt as through the market was a bit "tired' and the gains couldn't hold.

Stocks drifted back to flat by the early afternoon and that's where they stayed for the remainder of the session, drifting near unchanged amidst little news and no volumes.

Trading Color

It was a healthy day internally, and we may be seeing some early evidence of that post-ECB sector rotation I referenced in Friday's Report. The Russell 2000 and Nasdaq were strong yesterday, rallying 0.92% and 0.34% respectively and handily outperforming the S&P 500 and Dow Industrials.

From a sector standpoint, things actually were somewhat encouraging as cyclicals continued to handily outperform defensives. Utilities broke down yesterday, as we mentioned they might in Friday's Report, and utility stocks were the worst performers yesterday, falling 0.67%. Other defensives including healthcare and con-

Market	Level	Change	% Change
Dow	16,943.10	18.82	0.11%
TSX	14,871.21	32.31	0.22%
Brazil	54,273.16	1144.50	2.15%
FTSE	6,839.61	-35.39	-0.51%
Nikkei	14,994.80	-129.20	-0.85%
Hang Seng	23,315.74	198.27	0.86%
ASX	5,469.65	5.62	0.10%
Prices taken at previous day market close.			

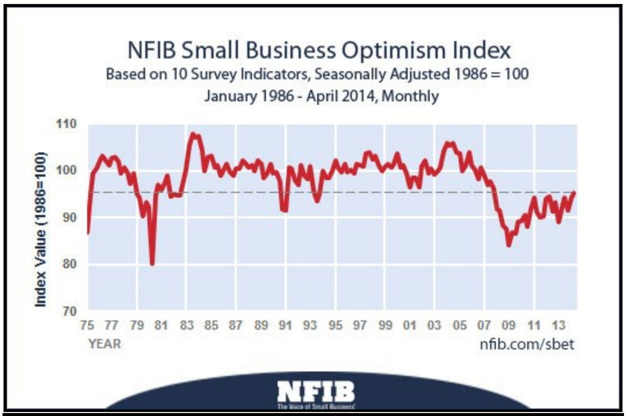
sumer staples also underperformed.

Basic materials also traded lower yesterday, but that was due to lackluster Chinese commodity import data and excavator sales contained in Sunday's Chinese trade balance report.

Positively, financials and industrials handily outperformed (which we also mentioned in Friday's Report) while tech and energy were relatively in-line with the S&P.

Market	Level	Change	% Change
DBC	26.14	.09	0.35%
Gold	1253.7	1.20	0.10%
Silver	19.05	.059	0.31%
Copper	3.0460	-.005	-0.16%
WTI	104.45	1.79	1.74%
Brent	109.90	1.29	1.19%
Nat Gas	4.643	-.067	-1.42%
RBOB	2.9840	.045	1.53%
DBA (Grains)	27.53	-.12	-0.43%
Prices taken at previous day market close.			

Yesterday the market saw yet another low-volume, low-conviction session reach fresh all-time highs. This shouldn't be surprising at this point, as it has really just become the stock market norm. (I say that because if you've been worried about low-volume and low-breadth rallies, you've missed about 200 points in the S&P 500. I don't think they should be ignored, but for whatever reason volumes and breadth just aren't the predictors they used to be, at least for right now.)



Small business optimism returned to prerecession levels last month (finally) and is expected to move higher this morning.

On the charts it's a broken record. The S&P 500 rallied to a new all-time high, while support remains much lower than current levels (1,930-ish and 1,907 initially).

Bottom Line

The fundamental backdrop for stocks continues to improve, but in the very near term we've largely climbed the "wall of worry" constructed by small cap underperformance, the breakdown in momentum stocks, bond strength and Europe dis-inflation. And, yesterday sentiment seemed much more bullish resigned to a continuation of the rally than I've seen in a while. And, that probably means a nice sharp pullback (20 points) in the S&P 500 is needed sooner rather than later (although keep in mind corrections in this market usually appear as a sideways grind).

Regardless, I'm looking to allocate more to cyclicals and higher growth names over the coming weeks, regardless of whether we see a sideways grind or needed dip, as I think select cyclical sectors can play "catch up" to the rest of this market.

Economics

There were no economic reports yesterday.

Commodities

Commodities began the week mixed yesterday, but with a slight bias to the upside as WTI crude oil as well as the refined products outperformed. The benchmark commodity tracking index ETF added 0.35% on the day.

The energy sector handily outperformed the commodity space yesterday as crude oil, RBOB gasoline and heating oil futures all rallied more than 1%. Strong global economic data, specifically the Chinese trade data over the weekend, helped energy futures rally yesterday. Traders and analysts speculate higher demand as global economic growth continues to accelerate. But, the situation in the U.S. remains status quo as the same primary market forces seem to be at a stalemate:

- Overall supply levels sit near record highs (bearish),
- Cushing, Okla., inventories hover just above the required minimums for safe storage (low time frame bullish), and
- Gasoline demand is steadily rising (bullish).

Over the medium term, however, the technicals do favor the bulls—especially with the consistent improvement in global economic data—so buying dips toward $100-$102 is both a fundamentally and technically sound trade. On the charts, $105 remains the level to beat while there is support below at $102.50.

Precious metals trading was rather uneventful yesterday as gold and silver were little-changed, up 0.1% and 0.31% respectively. Gold actually traded inside a $3 range all day yesterday, unable to break more than 0.2% from the open price. Since gold futures fell out of the tight trading range around the $1,300 level late last month (thanks to the breakout in the stock market as well as an easing geopolitical setting), we are seeing the market establish a new trading range between $1,240-$1,270.

Although the technicals are becoming neutral and futures are seeming to fall into a new range, gold continues to trade inversely to equities. So, buying dips is one of the best ways to purchase some protection in the seemingly overextended stock market. The low time frame technical levels to watch are resistance at $1,258 and support around $1,247.

Technicals aside for a minute, there has been a fundamental development worth noting over the past month.

The weekly Commitments of Traders report published by the CFTC indicated that net long gold positions held by money managers has fallen from roughly 90K to 38K since the first week of May. (Note: The 52-week high is 121K; the 52-week low is 10K.) Now, not only are the net longs getting relatively low, which as a contrarian indicator is generally bullish. But just about the entire drop has been a result of new short positions (of the 52K drop in net longs, 43K was a result of "new shorts").

So, bottom line, with over 40K new shorts in the market over the past month, and only a small change in net long positions, the near-term risk in the market is for a short-squeeze rally back toward the $1,300 level.

Currencies & Bonds

With economic data being sparse yesterday and over the weekend, currencies mostly continued to digest the events of last week, notably the ECB decision. The Dollar Index added 0.32% yesterday.

Market	Level	Change	% Change
Dollar Index	80.675	.248	0.31%
EUR/USD	1.3587	-.0054	-0.40%
GBP/USD	1.6793	-.0007	-0.04%
USD/JPY	102.52	.05	0.05%
USD/CAD	1.0908	-.0024	-0.22%
AUD/USD	.9349	.0017	0.18%
USD/BRL	2.2278	-.0187	-0.83%
10 Year Yield	2.613	.016	0.62%
30 Year Yield	3.450	.013	0.38%
Prices taken at previous day market close.			

Beginning with the currency that was obviously most affected by the ECB decision, the euro resumed its sell off yesterday, falling 0.45% on the session thanks to central-banker chatter. The euro remained stubbornly elevated late last week even after the ECB and Mario Draghi delivered everything the market expected (and then some) on Thursday. But, that was because, as we noted late last week, the euro was just very oversold ahead of the ECB announcement (which was indeed euro bearish). And any asset that becomes too short-term oversold is going to find it nearly impossible to extend losses through longstanding support.

But, the downtrend resumed yesterday and is continuing this morning after yesterday's comments from the ECB's Benoit Coeure—in which he stated European interest rates will "diverge" from those in the United States and in the UK (meaning they will stay very low while US and UK rates rise, which is obviously euro bearish).

The euro finished the day comfortably below the 1.36 mark, and is currently trading at a 4 month low this morning.

With regards to where the euro goes from here, the answer is lower (as long as the ECB is effective). I keep reading/hearing that 1.30 is the "target" that the ECB has in mind, and while it'll likely take some time to get there, clearly the trend in euro is lower going forward (and Dollar Index higher).

Elsewhere in Europe, the pound was little-changed in the UK as the market is already looking ahead to tomorrow's employment report, which will almost certainly move markets.

Moving to Asia, the yen was higher yesterday morning thanks to the better than expected economic data. Both revised Q1 GDP and Consumer Confidence reports were released Monday, and both were better than expected (Consumer Confidence actually rose for the first time in 6 months), helping the yen to rally. But, the yen later gave those gains back as a general "risk on" trade came into the market, characterized specifically by the U.S. stock market rallying out of the gate.

There's a BOJ meeting looming later this week (Thursday) but we shouldn't expect any material developments. Policy won't be changed, and the market's focus is now squarely on Abe's "Third Arrow" of fiscal reforms, which should be announced sometime later in June (remember, the keys to watch for are a corporate tax cut and change in how the GPIF, General Pension Investment Fund, is allocated).

The bond market was choppy yesterday but Treasuries eventually finished the day slightly lower as the 10-year fell 0.13% and the 30-year finished down 0.07%. News wise it was quiet (the only notable occurrence was the Fed bought 1 billion worth of 30 year bonds yesterday), and mostly we're seeing the bond market digest last week's moves from the ECB.

As far as the outlook for the bond market, I believe the immediate effect of the ECB will be to put a "top" in, in the bond market. But, I don't expect an immediate or violent sell off. Instead, I expect bonds to roll over more gradually and gain momentum on the downside, assuming economic data remains decent.

Point being, those who were looking for the ECB to cause a huge reversal and stampeded to the exits in the bond rally will be disappointed, but I never thought that was a realistic expectation. Instead, I believe the ECB measures will "cap" the rally, and it'll break over the coming weeks from it's own weight. Point being, if you're looking to get some exposure to sectors that benefit from higher yields (TBT, banks, cyclicals) we've got some time, as while I think the uptrend is broken, we're not on a verge of a waterfall decline.

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**	*Market fundamentals have been quietly improving for the past few weeks with both domestic and global economic data coming in better than expected, central banks continuing to be very accommodative, and valuations remaining reasonable. And, sentiment toward the market remains skeptical, keeping the pain trade higher. However, the S&P 500 is overbought and in need of a sell-off to restore some short term health.* *The trading range in the S&P 500 has bumped up, to 1920-1950ish.*

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'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 one 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 saw a strong rally in late May, but sharply reversed off of the 200 day moving average (while at the same time, 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).**