7:00's Report

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

June 16th, 2014

Pre 7:00 Look

- Futures are modestly weaker and international markets are universally lower on general Iraq inspired caution, following a pretty quiet weekend.
- In Iraq, over the weekend ISIL's advance slowed materially but they are still gaining ground towards Baghdad. More importantly, there is more international activity regarding a response (military or otherwise).
- Economically it was slow, as the only release was a final reading of May EU HICP, which met expectations.
- Econ Today: Empire State Manufacturing Survey (E: 15.0), Industrial Production (E: 0.5%).

Market	Level	Change	% Change
S&P 500 Futures	1923.50	-4.50	-0.23%
U.S. Dollar (DXY)	80.73	-.021	-0.03%
Gold	1280.40	6.30	0.49%
WTI	107.10	.19	0.18%
10 Year	2.604	.018	0.70%

Equities

Market Recap

The S&P 500 declined last week for the first week in over a month as geopolitics weighed on a short-term overbought market. The S&P 500 fell 0.68% on the week and is up 4.75% year-to-date.

Last week started the way the last month had gone—stocks slowly moved higher Monday and consolidated again Tuesday on low volume amid little material news. (Chinese economic data was in-line and there was more M&A last Monday, but that was about it.)

But, the rally, which had gotten a bit overextended in the short term, took a hit starting Wednesday, mostly on geopolitics. Stocks declined slightly Wednesday after House Majority Leader Eric Cantor shockingly lost a primary election, while the World Bank reduced its outlook for global growth.

The declines accelerated Thursday. The S&P 500 had the steepest drop since early May on news that a terrorist group in Iraq was marching toward Baghdad and threatening to plunge the country into all-out civil war. This resulted in oil prices rallying to the highs of the year.

Stocks rebounded a bit on Friday in quiet trading and trimmed the weekly losses after there was some anecdotally positive news regarding Iraq (namely that the army was starting to fight back instead of run away). Markets closed quietly Friday as most eyes by that point were on the FIFA World Cup and the U.S. Open.

Trading Color

Internally there were a few takeaways from last week.

First, cyclicals and growth stocks relatively outperformed, which is an encouraging sign and implies investors are viewing a dip in the market as one to buy. The Russell 2000 soundly outperformed the S&P 500, as it was basically flat on the week, while the Nasdaq also relatively outperformed (down just 0.36%). Also, "cyclicals" generally outperformed "safety" as the SPHB (S&P High Beta ETF) fell -0.73%, while SPLV (S&P Low Volatility ETF) declined just over -1%.

Second, we saw selling in the "bond proxy" sectors. REITs, utilities and consumer staples traded lower, despite bond prices actually rising last week. Combined with the cyclical outperformance, this implies that there is a mild "rotation" occurring, although it's small at this point.

Market	Level	Change	% Change
Dow	16775.74	41.55	0.25%
TSX	15001.61	91.98	0.62%
Brazil	54806.64	-295.80	-0.54%
FTSE	6,759.12	-18.73	-0.28%
Nikkei	14,933.29	-164.55	-1.09%
Hang Seng	23,300.67	-18.50	-0.08%
ASX	5,412.32	7.27	0.13%
Prices taken at previous day market close.			

Looking at specific sectors, most finished lower but energy (XLE) and semiconductors both hit new 52-week highs. (Energy because of the rise in oil and natural gas prices, and semiconductors because of continued good news from the space and momentum.)

Market	Level	Change	% Change
DBC	26.39	0.00	0.0%
Gold	1276.00	2.00	0.16%
Silver	19.66	.13	0.65%
Copper	3.03	.01	0.36%
WTI	106.77	.24	0.23%
Brent	113.35	.33	0.29%
Nat Gas	4.75	-.01	-0.17%
RBOB	3.0590	-.02	-0.80%
DBA (Grains)	27.73	.25	0.91%
Prices taken at previous day market close.			

On the negative side, transports took a big hit last week as airlines sold off hard in the face of rising oil prices. As I pointed out in Friday's issue, it looks like transports are correcting, and if they follow a similar pattern from earlier this year, there could be another 5% downside or so to go before they hit strong support. (So if you're nervous about the market, shorting the transports here might be a decent hedge.)

Volume remains generally low and last week's declines were due to a lack of bids, not aggressive selling. Bottom line: The market still isn't trading with any conviction at these levels. On the charts, the S&P 500 has backed away from the all-time highs (1,950) while support lies at 1,918 (the 20-day moving average).

This Week

The Fed and Iraq will dominate the news wires this week, but there are several other events to watch. First, there's a resumption of the Iran nuclear talks today. Given the turmoil in the Middle East, markets will be looking for some incremental progress (but may be disappointed).

Also, politically, House Republicans will vote on a new majority leader on Thursday. Although this won't immediately affect trading, politics is slowly creeping back into market psyche.

Finally, on the "micro-economic" front, there are some earnings to watch, as FDX comes Wednesday night (and will be the most-watched release of the week), while ADBE and ORCL also report (Tuesday/Thursday, respectively).

Bottom Line

Headlines last week were negative (Iraq, Cantor defeat, World Bank growth reductions), but the market reaction they elicited reflected the fact that it's been very quiet recently and the stock market was overextended.

Iraq is a potential problem longer term, but immediately it only matters if the ISIS militant group moves south of Baghdad into the oil-producing/export regions. Cantor's defeat was shocking and reminded everyone of the dysfunction in Washington, but it appears more of a "one off' than a resumption of a massive trend, despite the media pushing it that way. And, the World Bank growth estimate cut was a non-event, as all they did was cut their estimates to the current Bloomberg consensus.

From a "What Can Go Wrong?" standpoint, the greatest risks to the rally remain a slowing of global economic growth, or a material change in the outlook for central bank accommodation (which I believe is the bigger risk, but neither are immediate worries).

So, bottom line is the backdrop remains positive for stocks beyond the very short term. Central banks remain accommodative (although that assumption may be a source of trouble—more on that later), global economic growth continues to slowly rebound, the outlook for Q2 earnings is decent (INTC positively pre-announced last week) and valuations aren't cheap but aren't expensive, either.

That said, the market is short-term overbought and in need of further consolidation, either by deeper declines or a sideways trade. And, given that I'm not hearing enough yelling about how "This is it!" on CNBC, I don't think we're done on the downside yet.

But, any further dip is one I would buy and will look to allocate more to the "post-ECB" portfolio of long European stocks, long domestic cyclicals, long greenback/ short euro, and short bonds.

Economics

Last Week

Last week ended up being a potentially very important week, but not because of the actual data, which slightly disappointed in the U.S. and came in generally in-line in China (further implying the pace of growth is stabilizing).

The most important event of the week came Friday morning, when Bank of England Governor Marc Carney surprised markets by hinting the BOE could raise rates this year, which is sooner than the market expectation (Q1 2015). That surprise comment sent the pound nearly 1% higher vs. the dollar and the FTSE down more than 1%.

Carney's comments matter especially in the context of the Fed meeting this Wednesday. I'm going to flush this out more in the preview of the FOMC, but if there's one thing the market seems too "complacent" on, it's that global central banks are going to keep policy static for quarters to come.

Point being, the stock market has *not* priced in the Fed suddenly upping the time frame of rate increases or an acceleration of tapering. If the broader market is as surprised as London was by Carney, and the prospects of a rate increase become more real, that will be a negative on the market. It's early yet and Carney just "hinted" at rate increases, but it underscores the point that markets are very complacent about the expectation for monetary policy in the UK and U.S., and that is a source of risk we need to monitor.

Turning now to the actual data, there were only two releases worth covering in the U.S.: weekly claims and May retail sales, and both were slight misses.

Claims ticked higher to 317K, while retail sales increased in May by 0.3% vs. (E) 0.6%, while the "control" group, which is the best gauge of consumer spending, was flat in May (which reflects an uninspired consumer). While slightly disappointing, though, the data didn't change the outlook for the economy going forward (GDP estimates for Q2 remain around 3%).

Market	Level	Change	% Change
Dollar Index	80.73	.05	0.06%
EUR/USD	1.3543	.0005	0.04%
GBP/USD	1.6953	-.0002	-0.01%
USD/JPY	102.04	.34	0.33%
USD/CAD	.9189	-.0003	-0.03%
AUD/USD	.9343	.0005	0.05%
USD/BRL	2.224	-.0069	-0.31%
10 Year Yield	2.604	.018	0.70%
30 Year Yield	3.412	.002	0.06%
Prices taken at previous day market close.			

Finally, China was in focus last week as CPI, PPI, Money Supply, Industrial Production and Retail Sales were released. All the reports were basically in-line with expectations, which further confirms the pace of economic growth in China is stabilizing and implies the chances of a Chinese "hard landing" continue to get smaller (so, point being, China isn't a threat to the global rally).

<u>This Week</u>

It gets a bit busier this week from an economics standpoint, with the highlight clearly being the FOMC meeting Wednesday.

First, it's a meeting with staff projections and a Yellen press conference. That's important, because as we saw in March, there is the chance for a "hawkish" surprise in Fed officials' expectations for the economy, and from Ms. Yellen herself (i.e., the "6 months" comment during the March press conference). Additionally, given the Carney comments last week, markets will be nervous about anything that might be incrementally more "hawkish" than consensus expectations.

Again, the thing the market seems most-complacent with right now is the outlook for Fed policy, so that's an area we need to continue to follow, as surprises usually come from things with the most complacency.

Away from the Fed, we get our first look at June economic data via the Empire State Manufacturing Index (this morning), and Philly Fed Index on Thursday. While neither moves markets the way they used to (given the "flash" PMIs, which will be released a week from today), Empire State and Philly still are important in the context of a market that needs constant re-affirmation that the economic recovery is accelerating.

Also this week we get the first piece of May housing data via Housing Starts on Wednesday. The April data implied we may finally be seeing a "bounce" in housing like we've seen in other sectors of the economy after the winter weakness, so data that further confirm this will be welcomed by the market.

Bottom line is this week will be Fed-dominated, especially in light of the Carney comments. But, the rest of the week's data also matter, because the market does need constant proof that the economic recovery in the U.S. is continuing to slowly gain momentum. Multiple pieces of evidence to the contrary will act as a headwind.

Commodities

Commodities saw a broad rally in aggregate last week as violence in Iraq sent gold and oil prices sharply higher. The commodity ETF DBC rallied 1.3% last week.

Given that Iraq was the main driver of commodity markets last week, it's not surprising that oil was the best performer, as WTI and Brent crude both rallied over 4% on the news that terrorist group ISIL has seized most of the northern portion of the country (which has a lot of untapped oil reserves), and more importantly were striking south towards Baghdad (and towards the oil producing region in Southern Iraq). Oil prices are basically flat this morning as of this writing, as over the weekend ISIL began to encounter resistance from Iraqis, and the international community is now working toward halting the group's advance. Through the headlines keep this in mind: If ISIL gets south of Baghdad, this situation becomes materially worse and oil will rally, but for now the current state of affairs is largely priced into crude, which is at the highs for the year, and I'd continue to look to buy any dips via USO or futures.

Precious metals also caught a bid late last week on geopolitical concerns, as gold rallied 1.75% and silver rose 3.25%, as the headlines in Iraq caused a short squeeze. Gold has rallied nicely off the lows of $1240 over the past few weeks, but it's into resistance now at the 50 day moving average ($1286), and I would be surprised if it can break through without the situation in Iraq getting significantly worse. Inflation remains on the back burner, and perhaps a CPI surprise gets gold through that resistance tomorrow, but I am skeptical, and if you don't own it I'd prefer to be a buyer on more weakness.

Look for Iraq headlines to continue to drive trading in the commodity markets this week, although it'll take the situation getting incrementally worse from the current state to propel oil and gold materially higher from current levels.

Currencies & Bonds

The Dollar Index continued its rally last week, rising slightly less than 0.5% and closing at the highest level since early February, although it closed off its best levels of the week.

The reason for the rally was the weakening euro (nothing "dollar-bullish" happened last week). The euro dropped another -0.7% mainly on comments by ECB member Benoit Coeure last Monday, when he explicitly started rates in the EU would "diverge" from the U.S. and UK over the coming years. The dollar fell late last week and the euro rallied, mostly as both had become too stretched, but generally the trend of dollar strength and euro weakness should re-assert itself once the overbought/oversold conditions are worked off.

Staying in Europe, the Pound was the best performer vs. the dollar, rallying hard Thursday after the Carney comments. The pound remains the most fundamentally bullish currency vs. the dollar, given the BOE will be the first Western central bank to raise rates later this year or early next. It's only a matter of time until the pound makes a new high for the year vs. the dollar.

Turning to Asia, the yen strengthened vs. the dollar last week as there was short-covering going into the BOJ meeting, which went as expected (no change to policy). After last week's rally, the yen is moving into key resistance. As the fundamentals remain static (and yen-bearish), selling yen at these levels via futures or YCS looks attractive either as a standalone trade or to add to a core position.

Treasuries actually rallied last week, catching a bid Thursday thanks to a strong 30-year bond auction and soft economic data. The 30-year so far has helped the uptrend line in place since Jan. 1 of this year. Although the fundamentals are turning more and more bearish in the near term, until that trendline is broken, in the short term the benefit of the doubt remains with the bond bulls (134'28 remains a key level to watch).

Have a good week—Tom.

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Position Sheet

Tactical Trading/Investment Account (Time frame of a few weeks to months).

Date	Position	Open Price	Stop	Strategy
6/11/14	VGK EWP EIRL EWI	61.24 43.58 37.42 18.14	60.59 42.23 36.78 17.54	*Long Europe. Part of the "Post ECB Decision" portfolio of what should outperform if bond rally is done. Original Issue*
6/11/14	SPHB KBE	32.73 33.40	17.14 32.23	*Long domestic cyclicals. Part of the "Post ECB Decision" portfolio of what should outperform if bond rally is done. Original Issue*
6/11/14	UUP EUO	21.55 17.46	21.14 17.14	*Long Dollar. Part of the "Post ECB Decision" portfolio of what should outperform if bond rally is done. Original Issue*
6/11/14	TBT STPP REK	63.41 38.32 23.00	59.54 36.84 22.34	*Short Bonds. Part of the "Post ECB Decision" portfolio of what should outperform if bond rally is done. Original Issue*
4/30/14	IYZ	28.99	28.88	*Telecom trading at a value to the market, has lagged other safety sectors. Original Issue*
3/3/14	XLI IYM/ PICK DIA	52.19 83.06 19.48 164.28	None	*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. Original Issue*
12/13/14	FCG XOP	18.97 65.62	None	*Natural gas supplies low, increased demand, E&Ps at a value. Original Issue.*

Longer Term Macro-Trend Investment Account (Long term time frame of months/quarters).

Date Initiated	Strategy	Position (s)	Investment Thesis
November 2012	**Long Japan**	**DXJ/YCS**	*The election of Prime Minster Abe in late 2012 resulted in massive monetary and fiscal stimulus designed to break Japan out of decades long deflation and stagnation. The resulting efforts will be yen negative/Japanese stock spositive for yeasr to come.*
Strategy Update (6/4/14): Focus on this trade has shifted to Abe's "3rd Arrow" of fiscal reforms, and if enacted, it could lead to a material decline in the yen/rally in DXJ.			
April 2013	**Short Bonds**	**TBT/TBF/ STPP/KBE**	*The 30 year bull market in bonds is over, as the Fed begins to gradually remove stimulus, the economy recovers, and inflation slowly begins to increase.*
Strategy Update (6/5/14): The ECB decision to stimulate the EU economy should end the massive inflow of foreign money into Treasuries, which should result in a gradual resumption of the decline in bonds/rise in yields.			

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Asset Class Dashboard

(Updated 6.16.14)

This page is meant to provide a general outlook for the path of each major asset class and is updated at the start of each week.

Near Term Trends are provided primarily for tactical and trading accounts (Time Horizon of weeks and months).

Long Term Trend is provided for longer term asset allocation models/retirement accounts (Time Horizon of Months/Quarters).

The "Best Idea" represents our best idea at the moment. Not all best ideas are trades we make—they are provided for idea generation.

	Near Term Trend	Long Term Trend	Market Intelligence
Stocks	**Higher but Overbought**	**Bullish**	*After rallying hard since mid-May, markets are now taking a healthy pause. The "reasons" for the dip last week were politics (Eric Cantor loss) and geo-politics (Iraq), but more importantly the larger backdrop for stocks remains positive: Central banks accommodative, global economic recovery, skepticism towards the rally, decent valuations.*

Best Idea: **Long Europe (VGK/EIRL/EWP/EWI)**

Best Contrarian Idea: **Buy Retailers (XRT)**

Commodities	**Neutral**	**Neutral**	*Geo-politics dominated commodities last week as violence in Iraq sent WTI and Brent crude to new highs for the year, while gold also rallied to multi-week highs. Beyond short term geo-politics, though, the outlook for commodities remains mixed and it'll take the situation getting much worse in Iraq to push commodities materially higher from here.*

Best Idea: **Long Oil (USO)**

Best Contrarian Idea: **Buy Gold (GLD)**

U.S. Dollar	**Higher but Overbought**	**Bullish**	*The Dollar Index rose last week to a multi-month closing high thanks to continued weakness in the euro. The dollar is short term overbought, but the trend higher should re-assert itself after a short period of consolidation.*

Best Idea: **Buy the Pound (FXB).**

Best Contrarian Idea:

Treasuries	**Neutral**	**Bearish**	*Treasuries have traded heavier since the ECB decision two weeks ago, and there are signs that the influx of foreign capital is ending, which should be bond bearish. But, the uptrend in place since January again held last week, so until 134'28 is broken in the 30 year, the shorter term trend remains higher.*

Best Idea: **Short long bonds (TBT)**

Best Contrarian Idea: **Short High Yield Bonds (SJB)**