7:00's Report

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

June 18th, 2014

Pre 7:00 Look

- Futures are flat ahead of the FOMC while Europe is mildly higher and Asia was mixed. News flow was light and markets are largely drifting this morning.
- The Nikkei was the best performer (up 1% o/n) as BOJ minutes reflected some concern over the level of exports and are being interpreted as mildly dovish.
- Bank of England minutes were taken as very mildly hawkish, although the pound is flat this morning.
- Econ Today: FOMC Meeting Announcement/Forecasts (2:00 PM), Fed President Press Conference (2:30 PM).

Market	Level	Change	% Change
S&P 500 Futures	934.00	-0.50	-0.3%
U.S. Dollar (DXY)	80.645	-.071	-0.09%
Gold	1271.70	-.30	-0.02%
WTI	106.16	.29	0.27%
10 Year	2.655	.058	2.23%

Equities

Market Recap

Stocks closed mildly higher Tuesday as strength in financials and small caps pulled markets higher. The S&P 500 rose 0.22%.

Stocks opened slightly lower Tuesday as the initial reactions from a hotter than expected CPI report and a housing start headline miss weighed on stocks.

The CPI report was really the main catalyst yesterday, though, and its biggest effect was to send interest rates higher. This resulted in financials rallying hard immediately after the open, which pulled the entire market higher.

Geopolitically, there was some incremental progress in Iraq, as headlines hit that the U.S. is contemplating sending in about 300 special forces to "assist" in the defense of the embassy. But, more generally, the international community is mobilizing against ISIL, which is positive for the situation.

After rebounding from the lower open, stocks again took a mid-morning dip into the European close, but promptly reversed shortly before 11:30 and slowly rallied throughout the remainder of the day as the broader markets followed financials and small caps higher. News flow was quiet throughout the afternoon.

Trading Color

The real story yesterday was the jump in interest rates, as that was the reason financials and small caps both broadly outperformed. And, to broaden it out, cyclicals handily outperformed defensive sectors, as SPHB rallied +0.89% vs. SPLV +0.17%. The only S&P 500 sub-sectors to decline yesterday were utilities, healthcare (both defensives) and energy, which saw some profit-taking after a big run.

Yesterday was potentially important from a sector standpoint. While it's only one day, rates were the driving factor yesterday, and if rates do continue to rise, the outperformance of cyclicals and banks is something that will continue. Of note, our "Post-ECB Portfolio" saw 9 out of 10 positions higher yesterday (EIRL was the laggard).

Again you can't make a trend out of one day, but it's an important distinction to make because it's totally opposite of what's worked so far this year from a sector and

Market	Level	Change	% Change
Dow	16808.49	27.48	0.16%
TSX	15055.89	15.46	0.10%
Brazil	54299.95	-329.60	-0.60%
FTSE	6793.88	27.11	0.40%
Nikkei	15115.80	139.83	0.93%
Hang Seng	23181.72	-21.87	-0.09%
ASX	5382.72	-17.95	-0.33%
Prices taken at previous day market close.			

allocation standpoint.

Volumes, again were a bit higher than we've seen over the last month, as mornings are busier than they have been recently, but activity slows meaningfully in the afternoon. Despite the uptick, though, the market still isn't trading with any conviction.

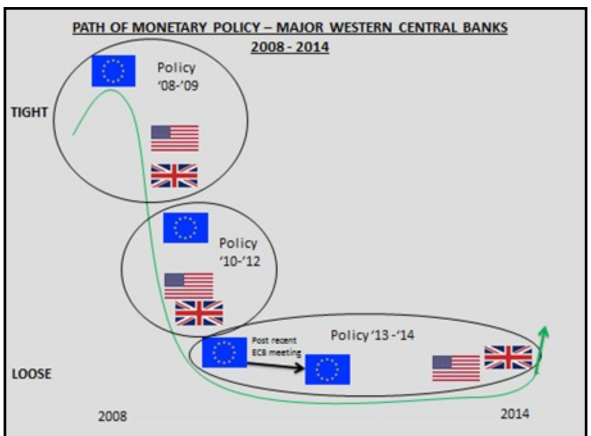
Market	Level	Change	% Change
DBC	26.51	.04	0.15%
Gold	1270.70	-4.60	-0.36%
Silver	19.71	-.005	-0.03%
Copper	3.0615	.0115	0.38%
WTI	106.24	-.66	-0.62%
Brent	113.35	-.06	-0.05%
Nat Gas	4.709	.002	0.04%
RBOB	3.0867	.0149	0.49%
DBA (Grains)	27.43	-.17	-0.63%

Prices taken at previous day market close.

Bottom line is the consolidation of the run higher from mid-May isn't done yet, so a continued sideways grind can be expected unless the Fed surprises "hawkishly" today or in the next few weeks, at which point we'll see a deeper correction. Unless something material changes, though, that'll be a correction to buy.

FOMC Preview

While this meeting will likely be a non-event and largely meet expectations, there is a risk it could be "hawkish" not because of a change to policy, but instead because of the forecasts the Fed presidents have to now give under this more transparent system.



The UK is a leading indicator for the U.S. markets and monetary policy, so the fact that UK markets have sold off since Carney's comments isn't a positive omen should the Fed "hawkishly" surprise.

First, though, the consensus expectations:

Consensus is for no material change to the policy statement, and a continued tapering of QE by an additional $10 billion, which should leave policy expectations right where they've been all year: QE ending by October or December, and the first rate increases in mid 2015.

Now, for the "hawkish" risks to monitor:

"Appropriate Pace of Policy Firming" (aka the dots).

This is the area of greatest potential "hawkish" surprise, because it reveals how quickly Fed presidents think interest rates should rise over the coming years. Keep in mind this is where we got a "hawkish" surprise in March (the "dots" were too high).

- The average target Fed Funds rate as of the March meeting was: No change for '14, 1.125% for '15, 2.43% for 2016, and long run of 3.3875%.
- "Hawkish" Outcome: If the average forecasted Fed Funds rates today rises say more than 25 basis points—so, above 1.4% in '14 and 2.7% in '15—we could see a "hawkish" reaction by markets as that would contradict the "low for long" Fed mantra.
- "Hawkish reaction" = Stocks, bonds and gold lower (likely sharply so), U.S. dollar higher.

Unemployment Rate

- The expected unemployment rate from March for 2014 is between 6.1% and 6.3%. If the forecasts drop below 6% for 2014 or below 5% for 2015, expect a "hawkish" reaction from markets.

Bottom Line

We're not the only ones looking at these thresholds, so I would be surprised if Fed presidents are aggressive in their forecasts, especially after what happened in March. But, like the Bank of England, at some point the Fed will have to acknowledge the improving economy and bottoming of inflation in its forecasts or else risk losing credibility, like has started to happen with the BOE.

More generally, as I look across the markets, the one area of extreme complacency that I can find right now is expectations of Fed policy.

Despite Fed projections to the contrary and a solidly improving economy and bottoming inflation, investors' expectations for the Fed to remain ultra-accommodative long into the future (beyond 2 years) remain firmly entrenched. But, in what may turn out to be somewhat of a warning shot, Marc Carney, head of the Bank of England, surprised (and borderline shocked) markets last Friday when he hinted that the BOE could raise interest rates later this year, which is sooner than the market expects (putting the "low for long expectation" in doubt).

The pound surged to new highs for the year vs. the dollar off his comments. But more importantly, the FTSE fell more than -1% and hasn't traded positive until this morning, despite global markets trading decently well over the past 72 hours.

I've been saying for months now that the UK is a blueprint for the U.S. markets and monetary policy, and the reaction of UK markets to this surprise announcement could well be a "warning shot" we need to monitor.

"Accommodative central bank policy" is one of the pillars of the rally so far this year, and no one is expecting the Fed to turn even incrementally more "hawkish" despite inflation metrics creeping higher (CPI yesterday joined a growing list of indicators implying inflation has bottomed), and economic growth accelerating.

So, much like May of last year, I'm afraid the market may be lining up for a "shock" if and when the Fed acknowledges the economic and inflation reality, and admits interest rates may rise faster than the market currently expects.

The last time we got a Fed "shock" was May of last year, when Ben Bernanke hinted at the Fed "tapering" QE. That totally blindsided the market and, as a result, the S&P 500 fell nearly -8% over a one-month period.

And, the only reason that decline stopped at -8% was because the Fed successfully launched a massive PR campaign that "Tapering isn't Tightening."

So, how is the Fed going to convince markets that "Tightening isn't Tightening"? Point being, there's more potential risk to the downside here.

Finally, it's anecdotal but I want to point out a recent article in the FT, which talked about the Fed contemplating "Exit Fees" on bond funds to make investors less inclined to sell them during periods of "market stress." That's not something you contemplate now if policy is going to stay low for years to come.

Market	Level	Change	% Change
Dollar Index	80.72	.148	0.18%
EUR/USD	1.3541	-.0032	-0.24%
GBP/USD	1.6954	-.0028	-0.16%
USD/JPY	102.16	.33	0.32%
USD/CAD	1.0866	.0024	0.22%
AUD/USD	.9335	-.0065	-0.69%
USD/BRL	2.2617	.0284	1.27%
10 Year Yield	2.655	.058	2.23%
30 Year Yield	3.446	.049	1.44%

Prices taken at previous day market close.

Economics

Consumer Price Index

- May CPI rose +0.4% vs. (E) +0.2%

Takeaway

Yesterday's CPI report for May showed a larger than expected uptick in inflation as the headline rose +0.4% M/M vs. analysts' expectations of +0.2%. Looking at core CPI (less food and energy) it edged up +0.3% vs. (E) +0.2%, while the same reading increased +1.9% year-over-year, up from +1.8% in April.

Bottom line, it appears the first "green shoots" of inflation we mentioned back in April are taking hold as multiple inflation indicators have shown an uptick on both the headline and the "core" readings. The monthly increase in the core year-over-year reading rose at the fastest pace since October 2009.

So, while not material enough to affect Fed policy decisions yet, inflation is clearly starting to build momentum, which if it continues will start to complicate the Fed's job. This remains a topic to watch.

Commodities

Commodities were mixed yesterday as the geopolitical backdrop seemed to calm a bit and traders positioned ahead of today's FOMC announcement. DBC rallied +0.3% thanks to continued strength in copper and the refined product futures.

WTI crude oil was one of the worst performers yesterday, falling -0.55% as traders took profits ahead of both the EIA inventory report and the Fed announcement due out today. Fed chatter generally does not materially affect the energy sector; however, we could see futures react to any surprise change in economic outlook by the Fed. The EIA on the other hand will be back in traders' focus as the situation in Iraq has to a degree plateaued. Analysts are expecting a draw of 1.1 million barrels in crude oil and an increase of 200k barrels of RBOB gasoline, and also inventory levels at Cushing will be watched to see if they move closer to the critical 20 million barrel threshold. On the charts, technical levels remain the same with support at $105 and resistance above at $108.

Gold futures hit morning lows in a knee-jerk sell-off following yesterday's CPI report and Housing Starts data being released at 8:30. Futures reversed off those morning lows below $1,260 to trend higher for the remainder of the day, reclaiming the $1,270 level, but closing down -0.35%.

As we have mentioned several times recently, the near-term risk across all asset classes is a hawkish FOMC announcement tomorrow, as it is not priced into the market right now. And, if we see any sort of hawkishness out of the Fed tomorrow, we can expect a near-term decline in gold futures. On the charts futures remain in a broad range between $1,240 and $1,280.

Natural gas futures were essentially unchanged yesterday and are slightly lower on the week. Nat gas futures spiked toward resistance at $4.90 to start the electronic trading week after news broke that Russia had cut off supply to Ukraine. But, since that turmoil is subsiding and last week's heat wave has come and gone, prices are falling back away from resistance. Extended weather forecasts are calling for more moderate weather over the next two weeks, so focus will be on any developments in the Ukraine and the weekly EIA supply data due out tomorrow morning.

On the charts, natural gas futures remain in a broad uptrend channel, which is consistent with market fundamentals. Support lies below at $4.45 while resistance has ticked up to $4.95.

Currencies & Bonds

The stronger than expected CPI report was the main catalyst for Treasuries and the dollar yesterday. Bonds sold off hard as the 30-year Treasury declined -0.6% and closed basically on the lows of the day, while the dollar rallied modestly ahead of the Fed.

The 30-year Treasury is now once again sitting on the uptrend line in place since June as we head into today's Fed meeting, and that 134'30 level remains critical support. Despite good economic data and inflation bottoming, bonds remain in a near-term uptrend as long as that support holds. Obviously today with the FOMC will be key, and I've already covered the "hawkish" scenarios, but I'd be surprised if we see bonds break support given Yellen will have the opportunity to "talk down" rates at the press conference.

The Dollar Index rallied +0.18% thanks to the stronger than expected CPI report. The euro traded exclusively off the dollar (declined -0.18%) and ignored a pretty bad German ZEW Business Expectations Index, which declined from May and further implies the German economy is seeing some weakness. But even with the strong CPI and weak ZEW, with the FOMC looming, traders weren't going to do too much Tuesday.

The real volatility came from the Asian currencies yesterday. The Aussie was the big mover on the day, dropping -0.65% after minutes from the Reserve Bank of Australia meeting were taken as "dovish." RBA governors questioned whether the currency rate policy would be enough to offset the impact in the expected decline in the mining sector (which is a very important sector for the Aussie economy). The Aussie appears to have now put in a "triple-top" just under the $0.94 level, and I'd expect it to trade down to support at the $0.92 level over the next week or so.

Staying in Asia, the yen fell -0.31% and once again fell back from resistance at the 200-day moving average. The "catalyst" as I mentioned yesterday was the formal announcement of Shinzo Abe's "3rd Arrow" of fiscal reforms, although again it's important to realize the details of how much the corporate tax cut will be and how much pension funds will allocate to equities remains unresolved. (So, point being, there is still the potential for both a bearish and bullish surprise.) The expected date for the details to be announced is June 27, and I'd imagine the yen will remain relatively range-bound between 101.50-ish and 102.50-ish until that date.

Have a good day—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

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: **Long Canadian Dollar (FXC)**

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)**