7:00's Report

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

June 2nd, 2014

Pre 7:00 Look

- Futures are flat this morning while international markets rallied off economic data. Japan outperformed, up 2% on the expected announcement of positive economic reforms.
- China's official government manufacturing PMI rose to 50.8, beating expectations, and further implying the pace of growth is stabilizing.
- In Europe, the final May PMIs were mixed (France beat, Germany and EU slightly missed), but they were generally in line and reflective of a continued recovery.
- Econ Today: ISM Manufacturing PMI (E: 55.5).

Market	Level	Change	% Change
S&P 500 Futures	1922.75	1.25	0.07%
U.S. Dollar (DXY)	80.56	.156	0.19%
Gold	1245.90	-.10	-0.02%
WTI	102.93	.21	0.20%
10-year	2.457	.010	0.41%

Equities

Market Recap

Stocks grinded steadily higher last week and hit new all-time highs thanks mostly to month end positioning in what was very quiet trading. The S&P 500 rose 1.2% last week and is up 4.07% year-to-date.

Despite the gains, last week was really "the week of nothing" from a news or catalyst standpoint. Volumes and activity were borderline anemic, but still stocks moved steadily higher Tuesday through Friday. Thursday was their best day, as stocks traded higher on the back of in-line economic data and continued merger news (AAPL buying Beats and the bidding war for HSH between TSN and PPC). Stocks drifted slightly higher Friday in very slow trading to finish the week basically at the highs.

Trading Color

Last week was a nice rally in an absolute sense, but it lacked any real, positive fundamental catalysts, and we didn't see the significant outperformance by the Russell 2000 (basically flat last week) or "momentum" sectors that helped push stocks higher earlier in May. And, because there was no cyclical outperformance and very low volumes, that's what leads me to believe the rally was mostly month end positioning.

There was broad strength in the market last week as most sub-sectors traded higher, but "defensives" outperformed cyclicals last week. Utilities surged higher, while consumer staples hit a new 52-week high and telecom traded to a new, multi-week high. Energy and industrials (which are cyclicals, but not "growth" stocks) also traded well as energy hit a new 52-week high.

On the flipside, banks and consumer discretionary/retail stocks continued to underperform. Banks are getting hit not only by a flatter yield curve, but both C and GS came out last week saying trading revenues would be very poor in Q2, thanks to the lack of volatility in the market.

Bottom line is we're still not seeing leadership from growth-oriented sectors in this market. Until we start to see "cyclicals" outperform "defensives" like we did last summer and fall, market internals will remain a non-confirmation on the rally.

Volumes were very, very low last week, and there is simply no conviction at all in this market. Last week's rally occurred on low volume, and smaller traders con-

Market	Level	Change	% Change
Dow	16717.17	18.43	0.11%
TSX	14604.16	15.21	0.10%
Brazil	51239.34	-1000.00	-1.91%
FTSE	6862.76	18.25	0.27%
Nikkei	14935.92	303.54	2.07%
Hang Seng	23081.65	71.51	0.31%
ASX	5518.46	25.92	0.47%
Prices taken at previous day market close.			

tinue to have an outsized effect on the averages due to a lack of liquidity.

On the charts, the S&P 500 is at all-time highs; resistance lies lower around the 1,900 level.

Bottom Line

The bottom line is that the fundamentals continue to get incrementally more supportive of stocks, even as sentiment toward the market and rally remains very, very skeptical.

Market	Level	Change	% Change
DBC	25.99	-.23	-0.88%
Gold	1246.60	-10.50	-0.84%
Silver	18.68	-.334	-1.76%
Copper	3.1255	-.019	-0.60%
WTI	102.72	-.86	-0.83%
Brent	109.43	-.54	-0.49%
Nat Gas	4.544	-.015	-0.33%
RBOB	2.9965	-.0171	-0.57%
DBA (Grains)	27.72	-.27	-0.96%
Prices taken at previous day market close.			

Last week, economic data domestically and globally was largely in-line with expectations of a global economic recovery, the geopolitical situation improved with the de-escalation of the Ukraine situation, and merger activity remains elevated.

Those things, in an absolute sense, are positive for equities, and the valuations of the S&P 500, while elevated at 16X '14 EPS and 14.8X '15 EPS, simply aren't at levels that would send up caution flags at this point. So, broadly speaking the path of least resistance for stocks remains higher.

All that said, I don't think we're about to see a '13 style linear rally, and although things are improving, I think this "frustratingly flat" market will continue (but with bullish undertones). I'd not be surprised to see stocks give back some of last week's rally now that it's June, but the key to outperforming remains sector selection, and I don't think that's going to change any time soon. This simply isn't a market where we can buy the SPY and expect double digits by December, and I continue to like telecom, sectors linked to the "global reflation trade" Japan and select commodity linked sectors (natural gas E&Ps).

Economics

Last Week

Economic data last week was generally in-line with expectations, and ahead of this critical week, none of the data materially shifted the current consensus expectation for slowly rebounding global growth or Fed policy.

The "highlight" of last week was the revised Q1 GDP report, which missed expectations and showed a -1% annual growth rate—the first negative reading in three years. But, as usual, the devil is in the details.

Despite the bad headline, the GDP report wasn't all that bad. PCE (consumer spending) was revised +0.1% higher to 3.1%, while final sales of domestic product (GDP excluding inventories) was little-changed.

The big drop in headline GDP came from inventory depletion (which will be a tailwind for Q2 GDP as manufacturers have to re-stock) and from increased exports (which obviously isn't an economic negative, either).

So, while certainly this wasn't a good report, the market didn't really focus on it that much because the details were better than the headline, and economic data since Q2 started 2+ months ago has trended better.

Speaking of which, the more timely data points released last week were generally "OK" and reflective of a U.S. economy that is seeing the recovery slowly accelerate. April durable goods was a mixed bag—the key subcomponent, non-defense capital goods ex-aircraft, declined slightly. But that was following a sharply revised higher gain in March, which more than offset the decline in April. So, net-net it wasn't a bad number.

The other report, April pending home sales, grew at 0.4% vs. 1.0% expectations. While that was a "miss," the important thing was that there was further improvement in sales. And, it's now safe to say that the April housing data implied that housing may finally be joining other parts of the economy in rebounding from the winter dip.

Finally, there was one other number last week that I want to point out. In Friday's Personal Income and Outlays report, the "Core PCE Price Index" (the Fed's preferred measure of inflation) showed a year-over-year increase of 1.4%, up from 1.2% in March.

That number hit expectations and remains well-below the Fed's 2% "target," but I point it out because it's an-other piece of anecdotal evidence that inflation is slowly starting to tick higher. And, an uptick in inflation would be a significant shock to the market, as it would have implications for Fed policy that no one is pricing in right now.

So, in an effort to point out what's in "left field" so we don't get blindsided, an uptick in inflation remains a potentially surprising occurrence to watch for.

Turning back to the economy at large, the bottom line is nothing last week (internationally or domestically) changed the outlook for U.S., Chinese or EU growth heading into this critical week.

This Week

This is a big week as we will (hopefully) finally have some clarity on what the European Central Bank is going to do about its dis-inflation problem. We'll also get more data that (hopefully) confirms the market's expectations for the major economies: stabilization of growth in China, continued slow recovery in Europe and acceleration of the recovery in the US.

The biggest event all week is the ECB meeting—and its announcement on Thursday, June 5—where the market will finally see what the central bank plans to do to help spur growth.

I'll preview what to expect as we get closer to announcement, but this is critical in regard to the recent bond rally ... and for the potential of a bond sell-off to become a tailwind on stocks.

As a preview to the ECB meeting Thursday, we get the "flash" EMU HICP reading tomorrow. HICP is critical because it's reflective of the dis-inflation threat in the EU. If this number remains low (well below 1% year-over-year), then it'll put more pressure on the ECB to act forcefully on Thursday.

Outside of the ECB, it's also "jobs week" here in the U.S. So, we get ADP Wednesday, claims Thursday and the government report Friday. This report isn't as critical as previous reports have been, because it would take either a huge number or a total disaster to potentially alter the course of Fed tapering. But for a market constantly needing positive reinforcement that the economy is actually getting better, the jobs number matters.

Market	Level	Change	% Change
Dollar Index	80.405	-.135	-0.17%
EUR/USD	1.3535	.0034	0.25%
GBP/USD	1.6761	.0046	0.28%
USD/JPY	101.73	-.06	-0.06%
USD/CAD	1.0842	.0008	0.07%
AUD/USD	.9298	-.0009	-0.10%
USD/BRL	2.244	.0195	0.88%
10-year Yield	2.457	.010	0.41%
30-year Yield	3.314	.010	0.30%
Prices taken at previous day market close.			

We also get the May final global PMIs this week. Manufacturing PMIs for Asia and Europe were out this morning, while we get the U.S. ISM manufacturing PMI at 10 AM, and the global composite and U.S. non-manufacturing PMIs Wednesday.

Again, these numbers represent an opportunity for the market (and investors) to become more confident about the global economy, and to confirm the current growth outlook for each region.

Bottom line is this week could be quite critical to the market. The two large "unknowns" to the market at the moment are "What will the ECB do?" and "Is the global recovery for real?" Data this week will help to more definitively answer those questions. If things go well, we could see a new tailwind for stocks.

Commodities

Commodities traded mostly lower last week as crude oil failed to break out above resistance at $105, copper longs trimmed exposure ahead of economic data, and gold plummeted more than $50 thanks to easing geopolitics and broad strength in equities The broad based commodity ETF DBC dropped sharply last week to a 2 month low, falling 1.5%.

Gold was the big story last week as we finally saw futures break away from the $1,300 level, where prices have been corralled in a compressed trading range since March.

When traders returned from the long weekend last Tuesday—and saw stocks hit fresh all-time highs out of the gate and headlines that suggested tensions had eased between the Ukraine and Russia—longs unwound and shorts piled on.

Gold fell all 5 sessions last week and closed at levels not seen since the first week of February. Going forward, inflation remains the key catalyst in gold. Although there are signs that inflation is bottoming (not only domestically, but globally), it's not enough to initiate a move higher in gold just yet.

WTI crude oil threw a bit of a head fake at us last week as futures pushed up against resistance near the $105 level and threatened to break out to new 2014 highs. But, the bears regained control at the last minute and WTI prices remain range-bound. However, the bottom end of that range has been adjusted higher to the $100 mark, while $105 remains the level to beat.

Going forward, the 3 primary drivers behind the crude oil market are: The near-record national supply levels (bearish), the critically low inventories at Cushing, Okla., the delivery point for Nymex futures (bullish) and elevated expectations for summer gasoline demand (bullish).

So, on balance the fundamentals and technicals skew slightly bullish, so we'd be a buyer of further dips and expect resistance at $105 to be broken over the coming weeks, as long as the economic data doesn't deteriorate.

Copper fell with the majority of other commodities last week, losing 1.4% over the course of the week. But, copper does remain in a solid, well-defined uptrend on the charts. The dip in futures was a result of longs taking some profits and shedding exposure going into the weekend and ahead of last night's stream of Chinese economic data.

Currencies & Bonds

Last week in the currency markets saw most traders in a "wait and see" mode ahead of a critical week of data this week. The Dollar Index rallied mid-week to basically a two month high, while the euro slipped below 1.36 vs. the dollar for the first time mid-February, as traders and investors positioned ahead of the ECB meeting later this week. All told, though, the moves were pretty small, as the Dollar Index rose .19% last week while the euro fell .18%.

Going into the ECB meeting, forceful ECB action has now been "priced in" to the euro at 1.36, so there is definitely the possibility of a "sell the news" reaction if the ECB disappointments the market and doesn't act forcefully enough.

Staying in Europe, the British Pound was the big mover in the currency space last week, falling .4% vs. the dollar on technical selling (it appears an uptrend is breaking) and off some weak economic data. The dip, though, will likely be short lived. Yes, the pound has seen a huge rally vs. the dollar, and is in need of a correction, but the fact remains the BOE will be the first major central bank to raise rates later this year or early next, so any material dips in the pound should be bought, as it remains fundamentally the most bullish major currency.

Turning to Asia, the yen rallied small vs. the dollar last week as economic data was largely in line with expectations, and the situation on Japan remains one big "waiting game" as to whether the BOJ will ease further later in the summer. Consensus opinions continue to shift the date of incremental easing "out" on the calendar, but it'll largely depend on the data coming in over the next few weeks, as we get color on the impact of the sales tax. Bottom line, though, is I believe the long Japan trade remains very much "on" in this environment, based on the simply fact that if the BOJ doesn't ease further, it'll be because its strategy is working, and the economy is getting better than inflation is accelerating (so good for Japanese stocks, bad for the yen).

Turning to bonds, Treasuries finished the week flat, but only after a late week sell off as mid week the ten year yield hit a new 10 month low while the 30 year bond hit a new high for the year. The rally came despite good data from the US, and again the consensus reason for the rally was disappointing German economic data (which raises the probability the ECB will act forcefully).

This week is critical for this bond rally, because we should know just how much of an influence European buying of Treasuries has been on this rally once the ECB decision is digested. As I said last week, if this rally is mostly because of Europe, then it likely will end shortly after the ECB meeting this week, as long as the ECB acts forcefully to stimulate the economy.

Have a good week—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**	*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 material move beyond 1900 is likely capped until bonds start to sell off.* *The trading range in the S&P 500 has bumped up, to 1910ish—1860ish.*

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. But, KOL has gotten hit lately ahead of this EPA announcement this morning, so given sentiment turning more bearish and less attractive valuations, I'd look to exit KOL if we get any sort of "sell the news" reaction to the official government announcement. 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 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.**

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 rallied to start the week last week but sharply reversed off of the 200 day moving average mid week (while 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).**