7:00's Report

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

June 3rd, 2014

Pre 7:00 Look

- Futures are slightly weaker this morning after a busy night of data, but most of it was in-line and the market narrative remains the same (everyone waiting on the ECB). Asia was higher on follow through buying from Monday, while Europe is mixed.
- EU HICP in May slipped again, falling to 0.5% yoy, although the German inflation data telegraphed the drop yesterday, and the euro is actually marginally higher this morning after unemployment fell to 11.7% vs. (E) 11.8.
- In Asia, the Markit final Chinese PMI dropped slightly from the "flash" estimate to 49.4 vs. 49.7 (E), but its being largely ignored.
- Econ Today: No reports. Fed Speak: George (1:50 PM)

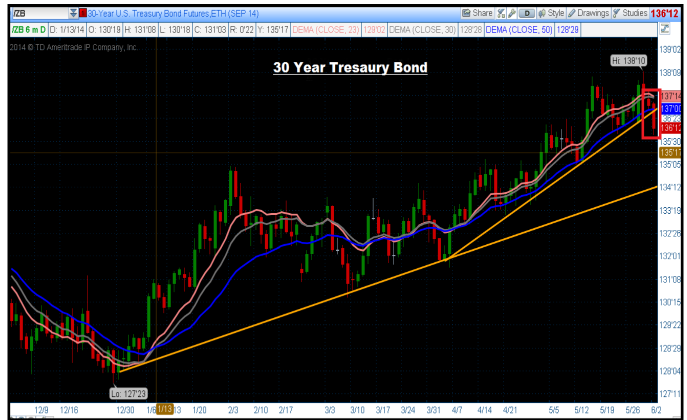
Market	Level	Change	% Change
S&P 500 Futures	1919.25	-2.50	-0.13%
U.S. Dollar (DXY)	80.665	-.025	-0.03%
Gold	1245.70	1.70	0.14%
WTI	102.41	-.06	-0.06%
10 Year	2.534	.077	3.13%

Equities

Market Recap

Stocks hit a marginal new intraday high but ultimately finished flat during another quiet session (excluding ISM-induced volatility midday) as the S&P 500 rose 0.07%.

Stocks were slightly higher on the open yesterday, helped by better than expected Chinese manufacturing PMIs. The averages drifted slightly higher following the open into the ISM manufacturing report, and that's when the "fun" began.



Bonds: While the trend clearly remains higher, the uptrend in place since late March was broken yesterday.

The initial ISM manufacturing report surprised everyone by badly missing expectations and showing a decline in May. Stocks sold off immediately, turning negative shortly after 10 a.m. and hitting their lows for the day down 8 points in the S&P.

But, the dip into negative territory was short-lived, as at 11 a.m. it was announced the ISM data was incorrect, and they released a revised, and substantially higher, May PMI. Stocks quickly recovered and traded positive.

The fun wasn't over, however, as there was one more revision from the ISM—this time reducing the revision. But by that point stocks had become numb to the number games, and markets basically traded around flat for the remainder of the day, before closing little-changed.

Trading Color

That wasn't a lot of sector performance deviation yesterday, although the Russell 2000 and the Nasdaq underperformed (Russell down 0.49%, Nasdaq down 0.13%). The former just drifted lower and the latter was weighed down by GOOG and AAPL.

Sector-wise the big outperformers were the basic mate-

Market	Level	Change	% Change
Dow	16743.63	26.46	0.16%
TSX	14680.76	76.60	0.52%
Brazil	51605.83	366.49	0.72%
FTSE	6840.75	-23.35	-0.34%
Nikkei	15034.25	98.33	0.66%
Hang Seng	23291.04	209.39	0.91%
ASX	5479.68	-38.78	-0.70%

Prices taken at previous day market close.

rials/global reflation linked sectors, which rallied thanks to the Chinese data. (The Chinese data was probably the most important influence on markets yesterday.) Banks, semiconductors and industrials also rallied small, while "defensive" sectors took a breather. (Utilities and consumer staples were slightly lower, while telecoms got hit on weakness in SBAC and FTR.)

Market	Level	Change	% Change
DBC	26.01	-.02	-0.10%
Gold	1243.5	-2.50	-0.20%
Silver	18.725	.043	0.23%
Copper	3.1685	.045	1.44%
WTI	102.41	-.30	-0.29%
Brent	110.35	-.09	-0.08%
Nat Gas	4.602	.06	1.32%
RBOB	2.9542	-.0177	-0.60%
DBA (Grains)	27.52	-.19	-0.69%

Prices taken at previous day market close.

The low-volume, low-activity environment continued even through the ISM whiplash, as it was mostly algos and program trading moving markets around yesterday. This likely will be the case until Thursday (the ECB meeting).

On the charts the S&P 500 has made a another new intraday high at 1,925, while support lies lower around 1,900.

Japan Update

The original thesis of our "long Japan" call back in November 2012 was based on the fact that then-newly elected Prime Minster Shinzo Abe would release "three arrows" of economic stimulus: Fiscal (government spending), Monetary (QE) and Regulatory reforms.

Abe shot the first two arrows (fiscal and monetary) in 2013. Largely because of his efforts, Japan has its first decent chance to break out of deflation in nearly two decades. But, the "third arrow" of "Abenomics," the regulatory reforms, has been much more difficult to implement. This lack of implementation is one reason why we've seen the Japan trade stall and the Nikkei underperform this year.

Well, it looks as though Abe finally may be able to shoot his "third arrow," and if the reforms are what the market wants, it could spark the next leg higher in this "long Japan" trade.

Yesterday, the Nikkei surged 2% and the yen dropped sharply (nearly 1% vs. the dollar) after a 60-page draft of Abe's proposed regulatory reforms was leaked to the media. I won't bore you with the details, but here's what you need to know.

The market is looking for two things from this "third arrow." The first is corporate tax reform, which would obviously be a positive for Japanese companies and their stocks. The second is a change in how the General Pension Investment Fund of Japan (GPIF) invests its money.

The GPIF is a huge pool of money, and the idea is that Abe will direct the GPIF (either directly or implicitly) to allocate up to $200 billion away from Japanese bonds (which is the majority holding) and into foreign stocks and bonds. If enacted, this would depress the yen and Japanese bond prices.

The idea behind this re-allocation, much like the ECB, is to get the pension fund to take on incremental risk. This would be done with the hopes that other institutions will follow and put their money to work in riskier assets, and not leave it sitting in Japanese government bonds where it's yielding no interest (and not helping the real economy). Like Europe, Japan needs higher interest rates, not lower rates.

These two moves (corporate tax reform and changes to GPIF allocations) are potentially bullish for Japanese stocks (so, positive for DXJ) and negative for the yen (positive YCS).

The reason is this: If the GPIF has to allocate to foreign investments, it has to sell yen and buy the other currency before it invests in those foreign assets. *This selling will weigh on the yen.* To that point, Japanese investment banks Nomura and Mitsubishi UFJ Morgan Stanley expect the yen to decline between 10% and 8% respectively if these reforms are announced later this month. That would bring the yen toward the $110 yen/dollar level, which I and others have always thought was the Bank of Japan's and Abe's target.

With the prospects for the "third arrow" to be released, this "long Japan" trade may once again have legs, because either: 1)Economic reforms help spur growth while pension fund shifts depress the yen, or 2)The economy falters and the BOJ acts, depressing the yen and (presumably) helping Japanese stocks.

The negative wildcard is if Abe does not release this "third arrow," and that's the downside scenario to watch.

Finally, keep in mind that the Nikkei is still down 8% year-to-date, making it the big laggard in 2014. It's trading at the lowest P/E valuation of any major developed market (13.5X this year's earnings and 12.2X nest year's earnings, compared to 16.7X and 15.0X in the U.S., based on the MSCI Index). Point being, there's also a value argument to be made for Japan, … as long as Abe shoots the "third arrow."

Economics

ISM Manufacturing Index

- The May ISM Manufacturing Index was 55.4 vs. (E) 55.5.

Takeaway

One of the things I love about this business is that no matter how long you're in it, there are always "firsts" lurking around the corner.

Yesterday, the ISM initially released an incorrect May PMI that showed a drop in manufacturing activity, only to have a private research firm uncover the seasonal adjustment error a few hours later. This prompted the ISM to release a "corrected" version mid-morning ... which was then corrected again at lunchtime.

So, we got three ISM manufacturing PMIs yesterday, which is a first. With that sort of accuracy, you would have thought it was a government-run institution!

The (final) ISM manufacturing index rose to 55.4 in May, relatively in-line with analyst expectations of 55.5. The headline improved 0.5 from the April reading of 54.9.

The details of the report were mixed, but overall constructive. The leading indicator, new orders, rose to 56.0 from 55.1. Meanwhile the production component surged, rising to 5.3 points to 61.0—the best reading of the year. This production component is especially noteworthy because it reinforces that we are seeing a lot of re-stocking of inventories after Q1 inventory depletion. (Remember, that was the main reason Q1 GDP was so weak.) The employment component was disappointing, however, falling from 54.7 in April to 52.8 in May.

Despite the erroneous release and whiplash it caused, the takeaway here is that the ISM manufacturing PMI clearly shows the manufacturing sector is seeing continued expansion. It also implies we should see a powerful bounce-back in the economy in Q2, as expected. Overall, this was a good number.

One final but key takeaway is that this is jobs week. Normally the employment figures within manufacturing reports are largely ignored, but the employment component was a standout weak point in the ISM report. Add in the fact that there was a spike in weekly jobless claims during the week of the survey for the official May jobs report, and it's possible that the whisper number for Friday's official BLS report may slip a bit.

Commodities

Commodities were mixed yesterday as copper continued to quietly rally and natural gas extended last week's gains while the rest of energy was down. The benchmark, broader commodity ETF, DBC, fell 0.2%

Copper was one of the best performers yesterday, trading up 1.5%. Copper rallied exactly as you would expect after a stronger than expected Chinese manufacturing PMI (50.8 vs E 50.6) was released over the weekend.

Bottom line in copper is that futures remain in a well-defined uptrend with support at \$3.12 while the first line of resistance is above at the 200-day moving average (\$3.19). We expect copper to continue to trend higher as long as global economic data shows continued stabilization, specifically from China.

Market	Level	Change	% Change
Dollar Index	80.69	.286	0.36%
EUR/USD	1.3596	-.0034	-0.25%
GBP/USD	1.6744	-.0006	-0.04%
USD/JPY	102.43	0.65	0.64%
USD/CAD	1.09	.0059	0.54%
AUD/USD	.9243	-.0066	-0.71%
USD/BRL	2.268	.0277	1.24%
10 Year Yield	2.534	.077	3.13%
30 Year Yield	3.377	.063	1.90%

Prices taken at previous day market close.

Natural gas was the other big mover yesterday, adding 1.3% on the day. One of the reasons (in addition to weather reports) for yesterday's rally was Obama's proposition to cut power plant emissions by 30% by 2030. Included in the plan is promoting the use of "clean" natural gas technology as opposed to older, "dirty" coal-burning energy-production methods.

Bottom line: Obama's statements were not necessarily a reason to go buy natural gas futures right now. However, they were certainly supportive of the bullish natural gas argument on a longer-term time frame.

On the charts, natural gas futures have established a technical, rising trend channel with the supporting trendline rising to \$4.42 while the resistance trendline is above at \$4.92.

Trading in gold was rather slow yesterday as futures fell 0.2%. Fundamentally though, there was a substantial move in the Commitments of Traders report, released by the CFTC on Friday. Net long positions held by money managers fell by 22.6K to just 57.6K, a near-4-month low. The majority of the shift was a result of new short positions, which rose 21.3K while net longs were only down about 1K. So, although the market is not critically oversold, the risk for a short-squeeze did materially increase last week with all the new shorts in the market.

Currencies & Bonds

The dollar reigned supreme against other currencies yesterday, as the Dollar Index rose 0.35% and closed at a four-month high, thanks to better than expected economic data and weakness in other currencies.

The dollar was strongest in Asia, as the yen dropped 0.7% vs. the dollar off the leak of Abe's 60-page financial reform speech and expectations of his "third arrow," while the Aussie dropped 0.06% despite the Chinese manufacturing PMIs beating expectations (which would normally be bullish). But, it was the little-followed Chinese steel PMI, which dropped below 50 to 46.4, that weighed on the Aussie. (Iron ore, a major export of Australia, is used to make steel, and it didn't help that iron ore prices hit a multi-month low yesterday, either.)

Also pressuring the Aussie was selling ahead of retail sales last night and the RBA decision (neither contained any surprises), and GDP tomorrow. Fundamentally the Aussie remains a "sell" for a multitude of reasons, and I would look to sell it (either by selling futures or buying CROC) on a close below \$0.92 vs. the dollar, as that would likely open up an acceleration to the downside.

Turning to Europe, the euro dropped 0.3% vs. the dollar thanks to German CPI missing estimates (this is the third-straight data point from Germany to miss expectations). The reason for the drop in German CPI was due mainly to a fall in the cost of vacation packages to southern Europe (I'm being serious). The larger point, though, is that it's further proof that dis-inflation is creeping across Europe, and it just adds more pressure on the ECB to act forcefully in Thursday. Interestingly, this morning May HICP came in under estimates (0.5%), but the euro is seeing a small bounce, mainly because it was already priced in after the German data yesterday. The bottom line is the ECB has every statistical excuse needed to dramatically ease policy Thursday, but the question remain "Will They?"

Treasuries tumbled yesterday, with the 30-year dropping 0.9% and the 10-year yield rising back above 2.50% for the first time in a week. There wasn't any specific catalyst for the decline (U.S. data was decent and European data was actually bond-bullish, which in this environment usually results in a rally).

So, it wasn't fundamentals at play yesterday in bonds, and the reason for the decline was plain old profit-taking. I said last week that Treasuries were being squeezed higher thanks to month-end positioning, and that was validated by yesterday's drop. That was due to bond longs booking gains ahead of the ECB meeting Thursday, which is a day this whole bond rally could indeed go "poof."

Interestingly, the bond market did take a technical hit yesterday, as the uptrend in place since mid-March—when this bond rally really accelerated—was broken. And, while the uptrend in place since the beginning of the year lies much lower, yesterday was the first positive technical day for the bond bears in a long time. With this rally, we'll take what we can get. It would take a break of 134'00 in the 30-year, though, to say the year-long rally is broken. And that's a long way from here.

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	*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'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).**