7:00's Report

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

June 30th, 2014

Pre 7:00 Look

- Futures are flat this morning ahead of a busy week of data .
- Economically the EMU June flash HICP was released, and it rose slightly to 0.8% vs. 0.7% yoy (meeting expectations). It's a slight positive, but deflation remains a threat and this reading will keep the ECB fully engaged in the fight.
- In Iraq there was some slight political progress as it appears a new government could be formed starting this week, but generally this remains a "back burner" issue.
- Econ Today: May Pending Home Sales (E: 1.0%).

Market	Level	Change	% Change
S&P 500 Futures	1950.75	-1.00	-0.50%
U.S. Dollar (DXY)	80.07	-0.21	-0.03%
Gold	1313.80	-6.20	-0.47%
WTI	105.30	-.44	-0.42%
10 Year	2.532	.007	0.28%

Equities

Market Recap

The S&P 500 closed essentially flat last week as it was quiet from a news standpoint and markets generally digested recent gains. The S&P 500 is up 6.09% year-to-date.

There weren't any major influences on trading last week, and with the exception of last Tuesday (when the S&P 500 reversed from new all-time highs), stocks closed basically unchanged each day. And, news items were used more to explain the thin liquidity moves in the market than they were actual causes.

That said, Iraq worries were blamed for the declines last Tuesday off the highs (reports of Syrian war planes striking ISIS in Iraq). Meanwhile St. Louis Fed President James Bullard making "hawkish" comments (he said rate hikes in Q1 '15 were reasonable) was blamed for the early sell-off Thursday. But, neither one of those two events actually caused stocks to sell off as going forward, Iraq in its current state is not a legitimate market-moving event anymore (oil/energy sold off last week) and the outlook for the Fed remains well-known (and Bullard's comments didn't change that).

The real market driver last week was the lack of liquidity, which resulted in small volumes moving markets a disproportionate amount. In truth stocks spent most of last week digesting the recent rally and holding performance as both the month- and quarter-end approached. (There were buyers on every dip last week, which was likely the result of performance anxiety heading into quarter-end.)

Trading Color

With markets broadly flat there wasn't any real performance differential between cyclicals and non-cyclicals, as the Russell 2000 finished last week fractionally higher while the S&P 500 was fractionally lower.

Sector-wise, most moves were driven by specific news as opposed to some larger rotation or asset allocation. Healthcare was the only S&P 500 sub-index to hit a new 52-week high, helped by a continued rebound in biotechs. Utilities also outperformed last week and remain just under their 52-week highs thanks to a positive mention on the sector from Goldman and bond yields falling. You can't deny that the utilities sector continues to trade well, but given valuations, I'd be cautious about adding exposure here.

Market	Level	Change	% Change
Dow	16851.84	5.71	0.03%
TSX	15094.25	63.51	0.42%
Brazil	53157.30	-349.45	-0.65%
FTSE	6764.03	6.26	0.09%
Nikkei	15162.10	67.10	0.44%
Hang Seng	23190.72	-30.80	-0.13%
ASX	5395.75	-49.31	-0.91%
Prices taken at previous day market close.			

Although utilities were higher last week, there wasn't a definitive "buy high yielding stocks" allocation in the market, as financials and banks held up surprisingly well despite the announcement of the Barclays dark pool lawsuit and a profit warning from Standard Chartered Bank. The resiliency in banks was impressive.

Market	Level	Change	% Change
DBC	26.75	-.04	-0.13%
Gold	1319.60	2.60	0.20%
Silver	21.085	-.023	-0.11%
Copper	3.165	-.007	-0.22%
WTI	105.68	-.16	-0.15%
Brent	113.23	.02	0.02%
Nat Gas	4.422	-.019	-0.43%
RBOB	3.0955	.0099	0.32%
DBA (Grains)	27.84	-.21	-0.73%
Prices taken at previous day market close.			

Energy got hit hard last week as there was a definite unwind of the "Iraq" trade, combined with lower natural gas prices and a collapse in refiners, thanks to the announcement the U.S. is slightly easing the ban on crude exports. Broadly, the energy sector (meaning XLE) looks like it needs to correct after this recent surge, so I'd look to be a buyer on a dip from here (although I'm holding FCG and XOP for now). Within energy, though, there may be a potential long opportunity in the refiners, as they got smoked last week (some down 8%-10%), and I'm in the middle of research trying to see if they are a "buy." More on that throughout the week.

Looking at the charts, the S&P 500 traded a bearish "outside reversal" last Tuesday, which will have the chartists nervous. Support is at 1,946 while resistance is last week's high (1,968).

Bottom Line

The backdrop for stocks didn't change last week and remains broadly positive: The economy continues to recover; global central banks remain historically accommodative (i.e., still tons of easy money); geopolitics, namely Ukraine and Iraq, are more distractions at this point than any sort of major headwind; and valuations are "OK" (S&P trading at 15.07x 2015 estimates of $130/share).

So, the fundamental setup is there for higher stock prices as long as those four pillars of the rally remain. Very short term, though, sentiment seems pretty optimistic. As such, I think we will continue to see a grind sideways or slight correction in the market (either would help restore health and make higher stock prices less "inevitable" than the current consensus seems).

Beyond the very short term, though, the rally should continue based on those four pillars. With regard to risks to the rally, the biggest one remains that central banks (specifically the Fed) imply they will become less accommodative than expected (removing the "central banks remain historically accommodative" pillar). But. any real chance of that remains at least 2 months away.

As a result, I continue to like incremental allocations to cyclicals and Europe (specifically the PIIGS), and I'm starting to warm to the idea of constructing a "long inflation" portfolio of stocks, commodities and other assets. Inflation remains "cheap" right now, although as we and others have noted, it appears the trend is now higher. We'll likely see a short term moderating of inflation indicators in the next month or two given the recent gains, but I believe that's a dip you buy.

Economics

Last Week

There were three important economic takeaways last week: First, housing appears to be finally bouncing from its winter dip. Second, capital spending (businesses buying a new machine or some other high-cost investment) continues to *not* rebound like the rest of the economy has since the winter. Third, inflation has clearly accelerated over the past three months, but economic growth doesn't appear to be keeping pace with the recent acceleration in inflation.

Of the three, the final point is by far the most important. While it's very early yet, if the economy can't keep pace with accelerating inflation, then we risk stagflation, which is bad for most assets (bonds and stocks). We aren't anywhere close to stagflation, but after the data last week, it's something we need to keep an eye on.

Looking at the actual data, the Personal Income and Outlays report was the most important release last week, and the main cause of the "stagflation" worries. Core PCE, the Fed's preferred measure of inflation, rose

+0.2% in May and is now up +1.5% year-over-year (yoy), and that met expectations. More importantly, though, Core PCE has gone from rising +1.1% yoy in February to +1.5% in May. If we annualize the last three months' gains, we get an annual core PCE increase of +2.1%, basically at the Fed's target. This recent acceleration confirms what we're seen recently in CPI.

At the same time, though, while the economy is continuing to recover, it's not matching the gains in inflation over the past three months. Case in point: May consumer spending slightly missed expectations, increasing +0.2% vs. (E) +0.4%, and real consumer spending (consumer spending less inflation) was actually negative in April and May. So, the key here isn't that the economic recovery has stalled—it has not. But, over the last few months, the economy hasn't grown as quickly as inflation has.

Capital spending, however, still isn't seeing the rebound in activity that other sectors of the economy have enjoyed since April. The May Durable Goods report headline declined, but the real number to watch (Non-Defense Capital Goods Excluding Aircraft) rose +0.7% and the three-month rolling average showed a +1.5% gain. But, while it's a positive number, it's not strong growth.

With housing now showing clear signs of a rebound, capital spending (again, think investment by businesses in machines, etc.) is the one sector of the economy that still hasn't gotten a bounce. This probably reflects continued caution by businesses on the future of the economy (i.e., things are getting better, but not enough to make large investments because people aren't confident in revenue visibility).

Bottom line with last week: Nothing resulted in a material change in the outlook for the economy or Fed policy. But the recent acceleration in inflation/less than impressive consumer spending report (and extrapolating it out to potential stagflation) bears watching.

This Week

It is going to be a busy holiday-shortened week (the market closes at 1 p.m. EST Thursday and Friday is off).

Probably the most important number of the week has already been released, and it was the European flash HICP for June (their CPI). The annual inflation rate ticked slightly higher to 0.8% vs. 0.7% in May (meeting expectations) so that's slightly encouraging, but overall the deflation threat in Europe remains and this will keep the ECB fully "engaged" in the deflation fight.

Turning back to the future data, it's "jobs week" this week, although be aware the May jobs report will be released Thursday at 8:30, at the same time as weekly claims. Prior to that we get ADP on Wednesday. The jobs report isn't as critical as it has been in recent months, but it still is important. In the context of our "stagflation" point earlier, markets will be watching for jobs growth in line with recent reports (so around 200K). If there is an increase in wages and hours worked, this will imply tightening in the labor market (which is both inflationary and positive for consumer spending).

Tomorrow we get global official June manufacturing PMIs, which should continue to confirm the consensus that: The pace of economic growth in China has stabilized, Europe's economy continues to slowly recover, and the manufacturing sector of the U.S. economy is seeing the recovery accelerate.

The biggest risk of disappointment in this report is in Europe, as France's flash PMI was pretty bad (47.8) while the overall EMU was stagnant.

Finally, as if all that wasn't enough, Fed Chair Janet Yellen speaks Wednesday (we can expect similarly "Dovish" remarks like the last FOMC meeting) and there is an ECB meeting. But, after their attempt to "shock and awe" the market last month, this meeting should be a non-event.

Market	Level	Change	% Change
Dollar Index	80.085	-.194	-0.24%
EUR/USD	1.365	.0039	0.29%
GBP/USD	1.7016	.0002	0.01%
USD/JPY	101.39	-.34	-0.33%
USD/CAD	1.066	-.0028	-0.26%
AUD/USD	.9421	.0012	0.13%
USD/BRL	2.1964	-.001	-0.05%
10 Year Yield	2.532	.007	0.28%
30 Year Yield	3.365	.021	0.63%
Prices taken at previous day market close.			

Commodities

Commodities traded heavy for the most part last week despite a weaker dollar, as gold, oil, and natural gas all tested support with the first two holding and the ladder breaking down. The benchmark commodity tracking index ETF, DBC, fell 0.7%.

Natural gas was one of the worst performing commodities last week as futures fell 1.9% but most importantly violated and closed below long standing technical support at the lower end of the "up-trend channel." The reason for the move was the seventh consecutive 100+ Bcf weekly injection to inventories being reported by the EIA. But, looking at the bigger picture, supplies are still historically low (31% below the 5 year average) and we are now entering the peak of summer, so the potential for heat waves to increase demand is rising. Bottom line, the shift in technicals is more neutral than bearish as we are looking at a largely range-bound market. On the charts, the 200 day moving average will be looked to for support at 4.34 while there is resistance above at 4.52.

Gold violated support at $1310 intra-day several times last week but, but each time rebounded that same day closed well off the lows and comfortably with-in the current $1310-$1330 range, finishing the week little changed. Inflation continues to be the underlying influence on price speculation in gold countering a reduction in geo-political risk premium as Iraq fears subside.

Technically speaking, there was a bullish cross of the 50 day moving average by both the 23 and 30 day moving averages last week, which is generally a low risk entry point to initiate a long position. And fundamentally, data compiled by the CFTC indicates a steadily growing number of net longs in the market since the short squeeze rally from $1240 earlier this month, which historically coincides with a rally in gold. So, bottom line, adding some gold or silver via the ETFs GLD and SLV or futures, to portfolios at this level is a sound trade as both the technicals and fundamentals are supportive. We will do so this morning via GLD and SLV.

WTI crude fell 1.9% last week as traders took profits and the geo political fear bids (due to the Iraqi conflict) continued to unwind. But, importantly futures held the $105 support level as traders that missed the initial rally bought the dip. Near term, Iraq will continue to be a concern for traders, but the true underlying driver of the market is the growing global economy, so the longer term trend remains higher. On the charts, there is solid support at the aforementioned $105 level (former resistance) while resistance is above at $108.

Currencies & Bonds

The Dollar Index declined -0.5% last week as slightly soft economic data (consumer spending and headline durable goods) offset "hawkish" comments by Bullard. The euro rallied +0.3% vs. the dollar in reaction to the soft U.S. data, and after stronger than expected German CPI released last Friday. But, both currencies are simply retracing the big gains/losses of early June, as the market looks for clarity on growth/inflation trends in each region.

The biggest contributing factor the dollar decline last week was the strength in the yen. The yen broke through resistance at the 200-day moving average, after PM Shinzo Abe's formal announcement of his "3rd Arrow" didn't contain any critical specifics, and also after May CPI was weaker than expected—implying inflation isn't rising as fast as initially thought. The yen is now at a critical juncture, and the next catalyst will be the Tankan survey Tuesday. I'm not ready to abandon my "short yen" thesis just yet, as fundamentals remain yen-negative and I think there's a good chance the BOJ will try and talk it back down, but I'll admit I'm nervous about the position.

If the yen can't get back above that 200-day MA and restore some technical health in the next day or so, the 101.90 and 100.74 (the low for the year) levels are the last lines of support.

Turning to Treasuries, they rallied hard last week. The 30-year held support on the '14 trendline and traded to a two-week high before selling off Friday. Despite the uptick in inflation and Bullard's hawkish comments, the bond market rallied on the soft economic data.

I remain a fundamental bond bear, but the truth is the market is always right in the short term. Until that 2014 uptrend is broken (currently at 135'18) in the 30-year, the trend remains higher. Although I think there's a ton of money to be made shorting bonds, we have to wait till that trendline is broken before acting with conviction.

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	59.60 42.22 35.41 16.89	*Long Europe. Part of the "Post ECB Decision" portfolio of what should outperform if bond rally is done. Original Issue* ****A note about VGK: last week it went "ex dividend" and paid out .984/share, dropping the price below the stop level. It's been adjusted here—and if you were stopped out, I think it is worth buying back in at these levels.***
6/11/14	SPHB KBE	32.73 33.40	30.32 31.97	*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	21.13 17.13	*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	59.53 36.83 22.33	*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	28.32	*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*
12/13/13	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 6.30.14)

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 slightly Overbought**	**Bullish**	*The S&P 500 hit another new high last week in thin trading, but generally the outlook for stocks remains positive, as global central banks remain accommodative, valuations are stretched but not expensive, and the global recovery is ongoing. Sentiment is getting a touch too bullish, so a correction or churn sideways for a few weeks would be healthy, but beyond that the outlook remains favorable.*

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

Best Contrarian Idea: Buy Retailers (XRT)

Commodities	**Neutral**	**Neutral**	*Commodities came under some pressure last week as the Iraq geo-political premium came out of the energy markets while gold digested recent gains. Near term the outlook is neutral, but longer term with the global recovery accelerating and recent inflation readings moving higher, the outlook for commodities is improving.*

Best Idea: Long Oil (USO)

Best Contrarian Idea: Buy Gold (GLD)

U.S. Dollar	**Neutral**	**Bullish**	*The Dollar Index declined last week off slightly disappointing economic data (consumer spending/durable goods), but will remain largely range bound until we get more clarity on trends for inflation here and in the EU.*

Best Idea: Buy the Pound (FXB).

Best Contrarian Idea: Long Canadian Dollar (FXC)

Treasuries	**Neutral**	**Bearish**	*Treasuries rallied off the soft economic data and ignored the uptick in inflation last week. The uptrend in place since January again held a major test, so until 135'18 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)