7:00's Report

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

June 4th, 2014

Pre 7:00 Look

- Futures are flat after another busy night of data, but like yesterday it largely met expectations and international markets are mixed but little changed as everyone looks ahead to the ECB tomorrow.
- Focus is again on Europe, as May composite PMIs were mixed. German and EMU composite PMIs slightly missed expectations, while UK PMIs beat. The data isn't changing anyone's outlook, but it is giving the ECB even more reason to ease tomorrow.
- Econ Today: ADP Employment Report (E: 210k), ISM Non-Manufacturing PMI (E: 55.3).

Market	Level	Change	% Change
S&P 500 Futures	1919.00	-3.00	-.016%
U.S. Dollar (DXY)	80.65	.057	0.07%
Gold	1245.00	.50	.04%
WTI	103.32	.66	0.64%
10 Year	2.593	.059	2.33%

Equities

Market Recap

Stocks were flat again yesterday as markets largely ignored more strong economic data and the S&P 500 never moved more than a few points from unchanged. The S&P 500 closed down 0.04%.

Stocks opened higher Monday following stronger than expected May auto sales, which printed well above expectations, and better than expected factory orders (0.7% vs. (E) 0.5%). However, the data failed to spur much of a move higher, and stocks spent most of the morning trading marginally weaker, as buyer apathy ruled the day.

Stocks started to rally after the European close, and markets rallied slowly throughout a quiet afternoon to get back to near-breakeven by the end of the day.

Catalyst-wise, comments by Fed Governor Esther George were about the only news item in the afternoon (she was predictably hawkish but didn't say anything new), and the S&P 500 slowly grinded higher into the close to finish flat.

Trading Color

In a market so flat and quiet, there again wasn't much sector differentiation Tuesday. The Russell 2000 technically underperformed, but only very slightly so (down 0.18%), while "momentum" sectors were mixed. Sector-wise, not one of the 10 S&P 500 sub-sectors moved more than 1%. Only one, the semiconductors, moved more than 0.5%, as the SOX rallied 0.9% to hit a new high for the year.

Despite the jump in rates, we didn't see defensive or "bond proxy" outperformance, as utilities traded slightly higher while REITs were flat.

Banks, however, did catch a small bid (up 0.5%) mostly on short-covering into the European Central Bank announcement coming Thursday. But the other recent market whipping boy, retailers, couldn't muster much of a rally. Overall it was a slow day characterized by positioning ahead of the major catalysts coming tomorrow and Friday (ECB and jobs report).

Activity and volumes were again predictably low, and it remains a very sleepy (and somewhat tired-feeling) market. On the charts, the S&P 500 is sitting right below the highs at 1,925, while resistance remains lower around

Market	Level	Change	% Change
Dow	16722.34	-21.29	-0.13%
TSX	14734.69	53.93	0.37%
Brazil	52032.38	426.55	0.83%
FTSE	6814.92	-21.38	-0.31%
Nikkei	15067.96	33.71	0.22%
Hang Seng	23151.71	-139.33	-0.60%
ASX	5444.83	-34.85	-0.64%
Prices taken at previous day market close.			

1,900.

Bottom Line

We've got a market running in place until the ECB and jobs report, but meanwhile the fundamentals continue to quietly get better and better. Auto sales and factory orders were strong yesterday, and although they were largely ignored, that's another piece of data that implies the economic recovery is accelerating.

Market	Level	Change	% Change
DBC	25.97	-.03	-0.12%
Gold	1246.70	2.70	0.22%
Silver	18.82	.081	0.43%
Copper	3.14	-.0305	-0.96%
WTI	102.76	.29	0.28%
Brent	110.35	-.09	-0.08%
Nat Gas	4.613	.001	0.02%
RBOB	2.9515	.0016	0.05%
DBA (Grains)	27.45	-.06	-0.24%
Prices taken at previous day market close.			

But, the market feels a little tired here and unless we get a strong upside surprise from the ECB or the jobs report, I'd expect this market to remain largely range bound for the very near term.

Economics

ECB Meeting Preview

This is the biggest event for the markets in a couple of months, so I want to make sure everyone knows what's expected, what the upside/downside scenarios are, and what constitutes a "victory" for ECB President Mario Draghi.

What's Expected and Priced into the Market:

- ***Refi and Deposit Rate Cuts:*** At a minimum, the ECB needs to cut its refinance rate and deposit rate by 10 to 15 basis points, which importantly will take the deposit rate into negative territory. This is almost a universal expectation of the market and is completely priced in at these levels.

What Likely Will Happen (and is largely priced in):

- **End of SMP sterilizations**: Since the European crisis, the ECB has been buying peripheral countries' European debt (think the PIIGS) to keep rates low. But it's been offsetting those purchases by selling other debt it owns, thus negating the inflationary effects of buying the debt and pushing money into the EU economy. If the ECB ends sterilizations, it'll make Securities Markets Program (SMP) purchases more inflationary.
- **A New "Conditional" LTRO (Long-Term Refinancing Operation):** Think of this like a version of the UK's "Funding for Lending" scheme. The ECB doesn't just want to provide cheap money to banks; it wants that money to get into the real economy. Under this program, the ECB would lend money to banks for years at very low interest rates, as long as the bank can prove that the money will be loaned to the "real" economy and not just sit on the bank balance sheet. A similar program in the UK was very effective at generating growth. The expected size (per German media) is 40 billion euros.

The Upside Surprise (Hoped for but not guaranteed):

- **Asset-Backed Securities Purchases by the ECB:** Think of this as private sector QE. The ECB would promise to buy asset-backed securities (loans backed by physical or financial assets) from banks, thus freeing up capital from the banks and making them much more likely to lend money to businesses to grow and expand. ***This is what the market is hoping for.*** Additionally, the ECB doesn't have to necessarily announce this tomorrow, as long as Draghi strongly hints that it's coming in the future.

Bottom Line

It's very important to know what the "positive" outcome is out of this meeting. The "positive" outcome is that European bonds and Treasuries decline and yields move higher, the euro falls and stocks move higher. That's what we want to happen. If the ECB disappoints, we'll see the opposite—European bonds (and Treasuries) will rally, yields will fall, the euro will rally and stocks likely will decline also (especially in Europe).

All that said:

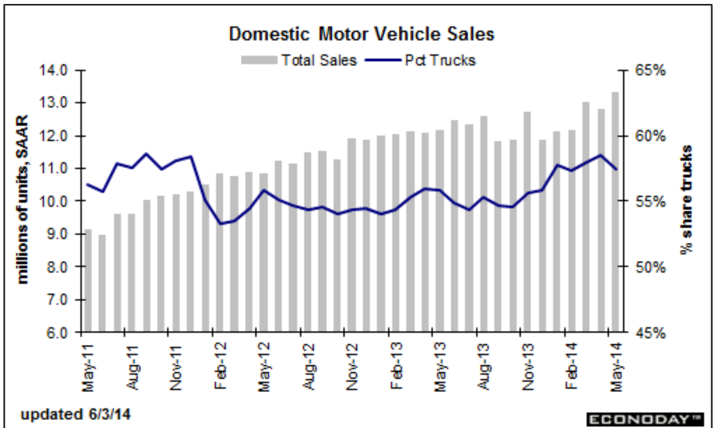
- If we see the refi and deposit rate cuts and either a new LTRO *or* halting/sterilization of SMP, it'll be taken as mildly disappointing.
- If we see rate cuts *and* both, it'll be mildly positive.

- Finally, if we see a rate cut, halting sterilization *and* a new LTRO *and* an ABS program (or the strong implication one is coming), that's the upside surprise and best possible outcome for the bulls.

Commodities

Commodities were little-changed yesterday in very quiet trading. The widely held commodity ETF, DBC, fell 0.1%, as strength in precious metals and oil offset a drop in base metals and grains.

Underscoring how quiet trading was, the grains and copper were the only commodities to move more than 1% yesterday, and both declined. Starting first with copper, it was down 1% mostly on profit-taking, but it was the slightly worse than expected Markit Chinese manufacturing PMI (49.4 vs. (E) 49.7) that provided the excuse for longs to sell.



Auto sales are surging and recently hit a new multi-year high, which is another subtle sign the economic recovery is gaining more traction.

One day aside, though, the trend in Chinese data remains toward the stabilization of GDP growth somewhere between 7% and 7.5%, which is what the market expects. And, with Chinese officials committed to "fine-tuning" growth as need be, the possibility of a Chinese "hard landing" continues to recede, which should be positive copper going forward A further dip toward $3.08-ish would pique my interest on the long side.

Turning to the grains, they were sharply lower yesterday (corn, soybeans, wheat all down around 1.5% each) as the summer is shaping up to be a potentially perfect growing season. As of Monday's USDA report, 95% of the corn crop has been planted, compared to 90% last year, while 80% of the crop so far is rated "good/excellent" compared to just 63% last year!

The numbers are similar for soybeans and wheat. The market is simply reflecting the fact that, after two tough growing years, farmers could finally be getting a break this year. That's bearish for crop prices going forward.

In the energy space, natural gas continued to drift slightly higher in quiet trading, as it neared resistance at a two-month high ($4.665) ahead of inventory data. The "reasons" cited for the rally were the usual suspects: hot weather, leftover buying from the EPA decision Monday, and an uptick in the expected number of hurricanes from Colorado State University (from 9 to 10).

But, natural gas was mostly drifting higher into the inventory data out tomorrow. If the injections are bullish (which isn't likely, given the production we've seen recently), natural gas could take out that two-month high and accelerate. But in all likelihood, we're still looking at a range-bound market, as we all wait and see how inventory replenishment goes this summer.

Elsewhere in energy it was very quiet, as both Brent and WTI crude were little-changed (both up small) during quiet trading ahead of inventory data. Expectations are for a 100k bbl drop in WTI, a 300k rise in RBOB, and a 700k bbl rise in distillates, but it'll be the Cushing, Okla., inventories that everyone is watching.

Market	Level	Change	% Change
Dollar Index	80.585	-.105	-0.13%
EUR/USD	1.3623	.0029	0.21%
GBP/USD	1.6745	.00	0.00%
USD/JPY	102.52	.16	0.16%
USD/CAD	1.0909	.001	0.09%
AUD/USD	.9252	.0006	0.06%
USD/BRL	2.2777	.0012	0.05%
10 Year Yield	2.593	.059	2.33%
30 Year Yield	3.435	.058	1.72%
Prices taken at previous day market close.			

Inventories at Cushing sit at just 21.7 million barrels, and most people have 20 million penciled in as the level that could cause a bullish move in WTI. So, that number, more so than the national inventory report, could move markets tomorrow.

Finally, gold and silver were little-changed (gold up 0.14%, silver up 0.33%) in very quiet trading, as both metals tread water ahead of the ECB meeting tomorrow.

Currencies & Bonds

Currency markets were mostly quiet yesterday as the euro was the big mover, rallying 0.2% vs. the dollar on short-covering into the ECB meeting. That aside, though, the Dollar Index continues to trade well, as it was down only marginally after Monday's big rally (down just 0.1%).

It rallied off the lows of the morning following the better than expected factory orders report and strong auto sales (which further imply we're seeing the economic recovery accelerate).

Away from the euro, most currencies were little-changed vs. the dollar. In Asia the yen started the day slightly higher, bouncing from Monday's drop, but it drifted lower throughout the day as anticipation builds for the announcement of Prime Minster Shinzo Abe's financial reforms (the "Third Arrow"). The yen is now near a six-week high, and if it can break through 102.70-ish vs. the dollar, the decline in the yen could accelerate.

Finally, in Australia, economic data was largely in-line with expectations, as retail sales and the Reserve Bank of Australia's announcement contained no surprises. With regard to the RBA, they remain unconcerned about inflation and more (generally) concerned about growth.

I expect the RBA to be quietly in favor of a weaker Aussie going forward, as that will be a tailwind to economic growth. A break of $0.92 vs. the dollar should see the decline in the Aussie accelerate and that would be a "sell" signal (or a "buy" signal on CROC).

Finally, Treasuries got hit hard again yesterday. Over the last four days, the 30-year has traded to a three-week low, as longs book profits ahead of the ECB Thursday. (The good economic data are also helping, but they didn't cause another -0.7% drop in the 30-year yesterday.)

Despite the declines, keep in mind this is mostly positioning ahead of the ECB. If you were lucky enough to catch this drop, I'd consider booking some profits ahead of the ECB, unless you're adding to a longer-term position. The trend in bonds is still higher, and will remain so until 134'12-ish is broken in the 30-year.

It's all on the ECB now ...

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).**