7:00's Report

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

July 1st, 2014

Pre 7:00 Look

- Futures are slightly higher this morning after a busy night of data that met market expectations.
- Chinese June manufacturing PMIs were inline at 51.0, further implying the pace of growth has stabilized.
- In Europe the PMIs were a bit more mixed. The French PMI wasn't as bad as feared (48.2), but Germany's PMI slipped to 52.0 vs. (E) 52.4. Despite the mixed data, the outlook for the EU economy remains the same.
- Econ Today: Motor Vehicle Sales (E: 16.4M), ISM Manufacturing Index (E: 55.6).

Market	Level	Change	% Change
S&P 500 Futures	1956.50	4.00	0.20%
U.S. Dollar (DXY)	79.86	.049	.06%
Gold	1326010	4.10	0.31%
WTI	105.71	.34	0.32%
10 Year	2.518	-.014	-0.55%

Equities

Market Recap

It was another slow day Monday, as markets rallied on some positive Chinese policy announcements and stronger than expected pending home sales. But as has been the case, there was no follow-through. Stocks couldn't hold the gains and ended the day flat, again. The S&P 500 fell -0.04%.

What little news there was on Monday was positive: EU HICP was OK and even showed a slight uptick, Chinese officials announced a relaxing of loan/deposit ratios aimed at expanding lending, and pending home sales was a big beat.

Stocks rallied off the news and traded within a few points of the all-time highs by midmorning. But, being the last day of the month and quarter, there was little buyer follow-through at those levels.

Commentary by San Francisco Fed President John Williams was the only real news of the afternoon. He was generally upbeat on the economy (saw >3% GDP growth rest of the year) but at the same time said rates wouldn't rise for "some time." Stocks generally ignored his comments, though, and drifted lower throughout the afternoon in quiet trading to finish the day virtually unchanged.

Trading Color

As is generally the case, the last day of the quarter is a continuation of what has worked and what hasn't during that quarter, as managers "paint the tape" a bit to make their holding sheets look better at quarter end. The Russell and Nasdaq both slightly outperformed the S&P 500 yesterday, while sector wise utilities continued their stellar run (up .8% to a new 52 week high), and homebuilders (XHB) also traded well given the strong Pending Home Sales report.

Banks also rallied yesterday despite the pending announcement of BNP Paribas 9 billion dollar fine. And despite lower bond yields, negative regulatory headlines and several warnings about trading revenues, banks have been resilient recently and I can't help but think that maybe most of the bad news in that space is "priced in" as we approach bank earnings over the next two weeks.

Market	Level	Change	% Change
Dow	16826.60	-25.24	-0.15%
TSX	15146.01	51.76	0.34%
Brazil	53168.22	10.92	0.02%
FTSE	6775.10	31.16	0.46%
Nikkei	15326.20	164.10	1.08%
Hang Seng	23190.72	-30.80	-0.13%
ASX	5375.90	-19.85	-0.37%
Prices taken at previous day market close.			

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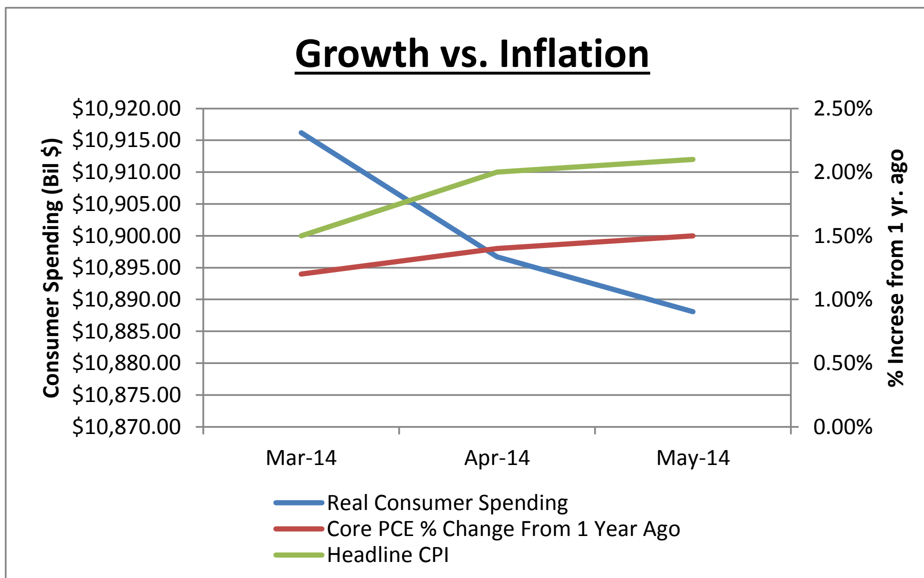
Volumes continued to be anemic yesterday as does volatility, and looking at the charts the S&P 500 continues to tread water just below resistance at the old highs of 1968.

Market	Level	Change	% Change
DBC	26.59	-.15	-0.56%
Gold	1327.30	7.30	0.55%
Silver	21.095	-.039	-0.18%
Copper	3.2045	.0365	1.15%
WTI	105.42	-.32	-0.30%
Brent	112.47	-.83	-0.73%
Nat Gas	4.458	.049	1.11%
RBOB	3.0486	-.0256	-0.83%
DBA (Grains)	27.45	-.39	-1.41%
Prices taken at previous day market close.			

Growth vs. inflation

For the 2nd half of the year, it's important to shift the way we view the economy, as we now have a "growth vs. inflation" fight to monitor. Whether or not growth can keep pace with inflation will determine whether stocks can continue to rally the rest of the year.

For the last 4+ years, any incremental acceleration in economic growth was a positive for stock prices for one obvious reason (economic growth was very low compared to historical measures, and more growth is obviously positive for stock prices) and one less-obvious reason (statistically, inflation was near generational lows, so any incremental economic growth equated to the same amount of "real" growth—i.e., inflation didn't detract from the benefit to the economy of GDP rising from 1% to 2%).



But, that calculus is starting to change.

Economic growth starting in the 2nd half of the year should be viewed more in the "relative" than absolute sense. And, that's because inflation is picking up, so it's going to start to reduce the benefit of incremental economic growth going forward.

Most analysts and market professionals, with the exception of Jeff Gundlach and some others, believe this whole QE and zero-interest-rate experiment ends in inflation – and I agree with them.

But, the inflationists can be split into bulls and bears. The "inflationist bulls" (I'm one of them) think that we get inflation along with accelerating economic growth, and in turn see higher asset prices and lower bond prices (i.e., everything goes up except bonds). The "inflationist bears" instead see stagflation – rising structural inflation coupled with a slow-growth economy. And, in that scenario, stocks and bonds will decline.

And, as I pointed out in yesterday's issue, the bearish inflationists, or stagflationists, got some fodder for their argument last week when inflation moved higher over the past three months, while consumer spending in real terms (so, consumer spending adjusted for inflation) declined. It's just a few months, so you don't want to extrapolate too much out of it yet, but that's what stagflation would look like if it took hold.

The key here isn't that the economic recovery would stop – it wouldn't. But, it wouldn't keep pace with rising inflation. So, a potential worst-case scenario is that we get 2%-3% annual inflation and just 2% annual GDP growth. This would then cause the Fed to begin to raise rates, which puts further pressure on the economy, causing a recession.

Why This Matters

This matters because basically it's going to mean the difference between higher stock prices over the coming months/quarters, and lower stock prices. And, while I

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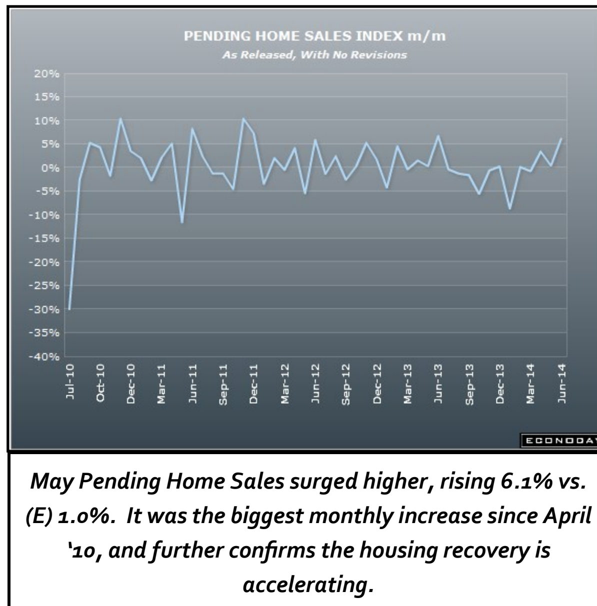
don't think we'll see stagflation, this business is about being prepared for all scenarios, so we're working on a "stagflation" portfolio of assets and sectors that can do well in that type of environment.

But, generally speaking, you want to allocate to certain commodities (not all of them, and not as much gold as you'd initially think) as well as sectors and companies where demand for their services is relatively inelastic (but that doesn't mean just defensive sectors).

Bottom line is the most important thing to monitor right now is the fight between "growth" and inflation. Growth winning means higher stock prices, while inflation winning means lower stock prices, and the fight is just beginning.



May Pending Home Sales surged higher, rising 6.1% vs. (E) 1.0%. It was the biggest monthly increase since April '10, and further confirms the housing recovery is accelerating.

Economics

Pending Home Sales was the only material release yesterday, and it handily beat expectations.

Commodities

Commodities were under pressure to start the shortened trading week yesterday, which led to a drop of -0.56% in the benchmark commodity tracking index ETF, DBC. The grains underperformed thanks to a bearish USDA report, WTI prices tested support at $105 yet again (and held), while natural gas, gold and copper finished the day with modest gains.

Gold futures opened lower but steadily grinded higher yesterday before accelerating to a 2.5-month high after the Comex close. Gold finished the day with gains of +0.55%. All of the fundamentals as well as the technicals continue to support the long gold argument we wrote about in yesterday's Report. However, the Commitments of Traders report released by the CFTC on Friday showed a substantial rise in net long positions held by money managers.

Market	Level	Change	% Change
Dollar Index	79.83	-.256	-0.32%
EUR/USD	1.3693	.0046	0.34%
GBP/USD	1.7103	.007	0.41%
USD/JPY	101.27	-.09	-0.09%
USD/CAD	1.0669	.0004	0.04%
AUD/USD	.9425	.0006	0.06%
USD/BRL	2.213	.0196	0.89%
10 Year Yield	2.518	-.014	-0.55%
30 Year Yield	3.343	-.022	-0.65%
Prices taken at previous day market close.			

Net longs in gold nearly doubled week-over-week from 53.6K to 99.9K, a move that consisted of 25.4K shorts covering, and 21K new longs in the market.

But, 99k net longs remains well below levels that would considered "frothy" (that's net longs above 150k).

The trend higher should continue with the next target being $1,350 (once $1,330 officially breaks of course). However, as the number of longs increases, so too does the risk for a profit-taking pullback.

Silver, which is more volatile in every aspect of trading, ended the session only little-changed yesterday after opening down nearly -1.75%. Looking to the fundamentals, net longs held by money managers in silver actually quadrupled last week, rising from 6.2K to 24.5K as a result of 12.4K shorts covering and 5.9K new longs coming into the market. Like gold, while net logs are elevated, they still remain below levels that would be considered "frothy" (net longs above 30k is where you start to think the market may be a bit overzealous).

On the charts, silver futures are in a well-defined, steep uptrend with support at $20.75 while last week's high of $21.25 is the resistance.

Bottom line is while we saw an definite uptick in sentiment towards the precious metals last week, positioning remains below frothy levels, and with technicals and fundamentals supportive, we initiated longs in both GLD and SLV yesterday.

In industrial metals, copper futures continued higher yesterday, adding +1.15% on the day. Because of the debacle in China over using copper as collateral to acquire loans, we have been avoiding copper, as volatility has been high and the

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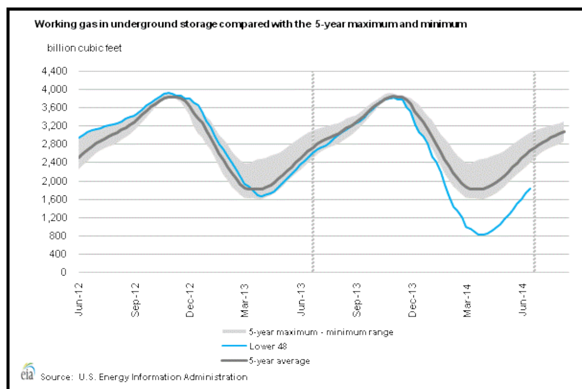
underlying trends have been broken.

But, copper broke out to a 4-month high yesterday and closed well-above the 50-day moving average ($3.188). I believe it is safe to say we missed this trade but will be looking to initiate a long position when an opportunity presents itself.

Moving to the energy markets, Nymex crude oil tested support at $105 for the 5th-straight session yesterday. But the bulls defended the level once again, and futures importantly closed well above $105. The story is largely the same in crude as the geopolitical risk bids (because of Iraq) continue to unwind, but "econo-bulls" are picking up the slack as they are betting on higher demand as the economy continues to grow. On the charts, WTI remains range-bound between $105-$108, but another intraday violation of support at $105 is possible and should not be overly alarming.



Natural Gas: A little context is needed, because while inventories have been rising faster than expectations, we are still significantly below historical levels.

Natural gas bounced off support at the higher end of the $4.34-$4.37 support band yesterday, but remains largely range-bound for the time being. Futures did rally +1.2% on an extended weather forecast that suggested July temperatures may be hotter than initially thought. And you know the drill: Hotter temps mean more A/C demand, which spurs demand for nat-gas-driven electricity. So, if we do indeed see a series of heat waves this month, expect natural gas prices to move higher.

Currencies & Bonds

The dollar was weaker against every major currency except the Loonie yesterday, as an uptick in European HICP combined with technical selling once the Dollar Index broke 80 resulted in the index declining -0.33% and hitting nearly a two-month low.

The big news of the day in currencies was the June European HICP data, which was a mixed bag. On one hand, the year-over-year increase rose to 0.8% from 0.7% in May, but given that German CPI released on Friday rose +1% yoy, there was some disappointment that there wasn't more of an increase in the EU number.

Regardless, though, the slight tick higher will certainly keep the ECB on hold for the foreseeable future (they would likely have been on hold anyway given the measures they took in June, but this just confirmed it). The euro rallied +0.35% and hit a 5-week high (and is now trading well above the level prior to the June 5th ECB meeting, which isn't going to make the ECB very happy, as a stronger euro weighs on economic growth). Additionally, we were stopped out of our EUO trade yesterday, although UUP is still on, for now.

Bottom line here is that despite the blatant intent of the ECB to devalue the euro to spur economic growth, the Fed has done (and continues to do) a much better job convincing the market that their willingness to destroy the currency and risk inflation is much greater than that of the ECB. As long as that is the case, the euro will continue to be more buoyant than fundamentals say it should be.

Away from the euro, virtually every other currency traded higher vs. the dollar on technical trading, as when the Dollar Index broke through 80, the rally accelerated. There wasn't any real positive news for the pound (up +0.5% vs. the dollar on momentum-buying as it hit yet another multi-year high), yen (up +0.06% on general dollar weakness) or Aussie (up +0.04%).

Turning to bonds, it was another rally as the 30-year rose +0.16% despite the strong pending home sales data (no real reason for the bond strength yesterday). Bonds started Monday slightly lower, but rose gradually throughout the day as the slightly disappointing EU HICP report supported Treasuries (it would appear that demand for Treasuries from Europe is returning as inflation levels stay relatively low and economic data there waver a bit). Bottom line is the trend in bonds remains higher, despite accelerating inflation and economic growth.

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
6/30/14	GLD SLV	127.30 20.15		*Long Precious Metals: This is mostly a technical trade, as both gold and silver have seen a positive cross of the 23 & 30 day EMA's rising above the 50. But, fundamentals aren't negative, as inflation is bottoming.*
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	21.55	21.13	*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)

	Near Term Trend	Long Term Trend	Market Intelligence
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)

	Near Term Trend	Long Term Trend	Market Intelligence
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)

	Near Term Trend	Long Term Trend	Market Intelligence
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)

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