# 7:00's Report

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

***July 14th, 2014***

## Pre 7:00 Look

- Futures are modestly higher as global markets are seeing an oversold bounce following a mostly quiet weekend.
- Economically the only report was EMU May Industrial Production, which met expectations (-1.1% vs. (E) -1.2%), and is providing some relief in Europe (because at least the number didn't miss).
- Geopolitically both situations in Iraq and Gaza remain largely static from the end of last week.
- Econ Today: No economic reports today.
- Earnings Today: C (E: $1.08).

| Market | Level | Change | % Change |
|---|---|---|---|
| S&P 500 Futures | 1968.50 | 6.25 | 0.32% |
| U.S. Dollar (DXY) | 80.20 | -.029 | -0.04% |
| Gold | 1322.50 | -14.81 | -1.11% |
| WTI | 100.44 | -.39 | -0.39% |
| 10 Year | 2.521 | -.011 | -0.43% |

# Equities

*Market Recap*

Stocks declined last week as soft global economic data led to a round of profit-taking in small caps and higher-beta sectors. The S&P 500 fell -0.90% and is up +6.45% year-to-date.

Stocks traded lower last Monday mainly on European growth concerns after Erste Bank became the latest European bank to issue a profit warning. The selling continued Tuesday as European banks were again lower on news that BNP Paribas was hit with a $9 billion fine and Commerzbank may be next.

Also contributing to the selling early last week was news that a subsidiary of Banco Espirito Santo (Portugal's largest bank by assets) would miss a debt payment and may be having funding troubles (which was extrapolated out to imply the larger company may also have funding troubles).

Stocks saw an oversold bounce Wednesday helped by better than expected AA earnings and positive margin guidance from AAR. But it was a weak bounce, and the selling pressure resumed Thursday as the S&P 500 was down over 20 points very early in trading, dragged down by Europe.

Stocks lifted off those early morning lows to finish down modestly Thursday as there wasn't a lot of follow-through or conviction to the selling, and an earnings beat by WFC helped stocks bounce slightly Friday in quiet trading.

*Trading Color*

One of the bigger takeaways from last week's selling was that it was much more about profit-taking than it was some broad "risk off" move by investors, although obviously defensive groups outperformed higher-beta names. Utilities, consumer staples and REITs finished positive last week, and more broadly SPLV (which was flat on the week) handily outperformed SPHB (down -2%).

The reason I say the selling last week was much more about profit-taking than anything else was because sectors that have outperformed handily since May (momentum sectors like bio-techs and internet stocks) got hit hard, as did small caps (the Russell 2000 fell -4% last week as it was weighed down by financials, which were sold ahead of earnings, and the aforementioned

| Market | Level | Change | % Change |
|---|---|---|---|
| Dow | 16943.81 | 28.74 | 0.17% |
| TSX | 15125.50 | 11.02 | 0.07% |
| Brazil | 54785.93 | 193.18 | 0.35% |
| FTSE | 6732.56 | 42.39 | 0.63% |
| Nikkei | 15296.82 | 132.78 | 0.88% |
| Hang Seng | 23346.67 | 113.22 | 0.49% |
| ASX | 5511.40 | 24.61 | 0.45% |
| Prices taken at previous day market close. | | | |

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biotech and Internet names).

The reason this distinction is important is because profit-taking-driven selling implies this is more of a consolidation in the markets rather than some sort of a bearish game-changer. Sellers weren't aggressive last week despite the declines.

| Market | Level | Change | % Change |
|---|---|---|---|
| DBC | 25.75 | -.23 | -0.87% |
| Gold | 1337.40 | -1.80 | -0.13% |
| Silver | 21.411 | -.048 | -0.22% |
| Copper | 3.27 | .003 | 0.09% |
| WTI | 100.73 | -2.20 | -2.14% |
| Brent | 106.58 | -2.09 | -1.92% |
| Nat Gas | 4.144 | .024 | 0.58% |
| RBOB | 2.9087 | -.0489 | -1.65% |
| DBA (Grains) | 26.14 | -.17 | -0.67% |
| Prices taken at previous day market close. | | | |

Two other observations from last week: First, not all cyclical sectors got hit, as PICK hit a new 52-week high last Tuesday (helped by AA earnings), and metal & mining stocks bucked the broader market's negative trend as gold traded higher (GDX was up over +3% last week). We could see those sectors dip this week as they are short term overbought, but valuations in the global mining sectors aren't extreme, and there's plenty of upside from here as long as metals prices hang in there and we don't get any materially negative data from China.

Second, energy was a standout underperformer last week, weighed down by WTI crude prices. The XLE chart looks pretty bad at this point, as does FCG and XOP. And, while I remain an energy bull, it looks like this selling has a bit further to go.

Looking at market technicals, the Russell badly violated support last week and traded out a weekly negative "outside reversal," which will have people nervous. The S&P 500 held support at the 1,964-ish level and that will be key again next week, while next support sits below at 1,950.

*Bottom Line*

Last week's sell-off appears to be a normal correction in an upward-trending market more than it is the end of the rally. Stocks have enjoyed a strong and uninterrupted rally since mid-May, and at this point need to consolidate and correct to restore some health.

The soft European economic data and European bank weakness appear to have just provided the catalyst for that normal correction to start, and it likely will last a bit longer depending on earnings season, which kicks into high gear this week.

More broadly, the "4 Pillars" of the rally remain largely intact: globally accommodative central banks, an ongoing global economic recovery, a calm macro horizon, and still-reasonable valuations.

Risk remain to each of those pillars (Yellen speaks on monetary policy Tuesday, the global economic data have softened slightly lately, Israel is threatening to put ground troops in Gaza, and earnings need to confirm $130/share 2015 EPS). But, at this point those are just risks to monitor.

Focus this week turns to earnings, but Europe will also remain the key. I want to be a buyer of cyclicals and Europe on this dip, but I want to see the SX7P (European banking index) stabilize first—as I think that's a leading indicator of when this correction will end.

## Economics

*Last Week*

The biggest thing that happened last week, economically speaking, was that foreign data largely disappointed, and implied we're seeing the global recovery lose a bit of momentum. That, much more than concern about Portuguese banks, was the real reason global shares traded heavily last week.

Chinese trade balance (both exports and imports); German, French and Italian May industrial production; and Japanese machine orders in May all missed expectations. Specifically in Europe, the soft data added to a string of indicators that implied the recovery, while still ongoing, is losing some momentum.

Keep in mind that one of the "four pillars" of the rally is a broad global economic recovery. And, while the data last week didn't imply the recovery is stalling, numbers in Europe have been soft now for a few weeks. So, the global markets now need a bit of a confidence boost that the EU economy is indeed continuing to get incrementally better.

Domestically last week was very quiet, as FOMC minutes

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from the June meeting were in focus. Going into the release of those minutes, it was expected they may be more "hawkish" than the FOMC statement because it was assumed the FOMC would have been extensively discussing exactly how they were going to start to unwind all this historic stimulus.

But, as seems to be the case lately, the market overestimated the Fed's concern about both inflation (which the broad committee doesn't see as a problem right now) and the economic strength (the Fed remains committed to being very accommodative into the future).

Some details of just how the Fed plans to eventually raise rates were discussed, but the Fed seems in the very preliminary stages of figuring out how they will eventually raise rates.

The one big headline out of the minutes was that the Fed will likely end QE in October, but that wasn't a surprise to anyone who's been paying attention. Bottom line with the minutes last week was that they weren't as hawkish as feared, and there were no changes to expected Fed policy.

*This Week*

The calendar gets busy again this week as we get several pieces of economic data and Fed Chair Yellen conducts her "Humphrey-Hawkins" testimony in front of the House Tuesday and Senate Wednesday.

Given the focus on the Fed and the expected transition in policy, the Yellen testimony Tuesday will be the highlight of the week. (Her prepared comments will be the same for the Senate testimony, so Wednesday all that matters is the Q&A session.)

The highlight of the week from a data standpoint will be retail sales. Consumer spending hasn't been as strong lately as you would have expected, given the improvement in the labor market. Combined with recently dire commentary on the consumer from some companies (The Container Store last week was the latest to lament a poor retail environment), retail sales will be closely watched to see if the consumer is starting to increase spending.

| Market | Level | Change | % Change |
|---|---|---|---|
| Dollar Index | 80.23 | .06 | 0.07% |
| EUR/USD | 1.3605 | -.0004 | -0.03% |
| GBP/USD | 1.7117 | -.0014 | -0.08% |
| USD/JPY | 101.33 | .02 | 0.02% |
| USD/CAD | 1.0729 | .0082 | 0.77% |
| AUD/USD | .9381 | -.0009 | -0.10% |
| USD/BRL | 2.2215 | .0024 | 0.11% |
| 10 Year Yield | 2.521 | -.011 | -0.43% |
| 30 Year Yield | 3.346 | -.018 | -0.54% |
| Prices taken at previous day market close. | | | |

Second in importance this week will be the first look at July data, via the Empire State Fed manufacturing survey (tomorrow) and Philly Fed manufacturing survey (Thursday). As I've said before, these regional manufacturing surveys have lost some importance since the national flash PMIs started being produced, but the market will want to see that the pace of the economic recovery is continuing in July.

We also get our first look at the June housing data, as housing starts come Thursday. Recent indicators implied the housing market is finally rebounding from the winter declines, and another good round of housing data will help further reduce concerns about the pace of the housing recovery. Finally this week we get May industrial production and the Fed Beige Book.

International data will also be in focus this week given recent concerns about the strength of the recovery, especially in Europe. There's not a lot of data from the continent this week, but the German ZEW Survey will be in focus, especially given the recent weakness in German economic data.

In China we get the latest look at GDP, industrial production, fixed-asset investment and retail sales Tuesday night. Obviously the key here is that the pace of Chinese economic growth remains stable. As long as the numbers are mostly "in-line" with expectations, the market shouldn't react too much.

Broadly this week, the market is looking for Yellen to not say anything surprising and to emphasize that any transition to policy "normalization" will be gradual. From a data standpoint, markets need a bit of a confidence boost, mainly from the EU, but also from China and the U.S.

## Commodities

Commodities finished last week mostly lower, led down by continued weakness in the energy sector as WTI crude oil futures fell a staggering 3.16%.

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DBC, the benchmark commodity tracking index ETF, had its worst week of the year, falling 2.5%. However, one bright spot despite the fairly broad weakness in the space was the continued outperformance of precious metals.

Beginning with energy, crude oil futures crashed through several support levels over the course of the week, starting with the 50 day moving average at $103.60, then the 100 day MA at $102.39, and lastly trend support at $101.25.

As for a reason for the substantial selling pressure, several things were citied including easing tensions in Iraq and increasing exports from Libya. However, these were more excuses to explain the overwhelming momentum that the bears have at the moment rather than actual market driving headlines. All eyes are now on support at the 200 day moving average at $99.96 and the sharp downtrend line that futures have been riding since they topped out in mid-June.

Elsewhere in energy, natural gas futures also continued to sell off last week, falling 5.1%. But, unlike WTI, the selling in natural gas futures lightened up on Friday, and actually closed higher by .5% and importantly, 4 cents above support at $4.10. Cooler weather forecasts and growing inventories are the main reasons for the short term weakness, and despite inventory levels remaining historically low, the outlook for weather remains the driving factor in the near term. But, natural gas is nearing key medium/longer term support levels.

Moving to the outperformers, gold and silver both rallied 1.4% on the week. Both precious metals saw gains mid-week thanks to a "safe haven" during the Portuguese debt flare up. Both gold and silver are trading a bit lower this morning as equity markets bounce, but beyond the near term noise, gold and silver continue to benefit from general global unrest, rising inflation expectations and declining real interest rates.

Gold is now sitting on the uptrend in place since early June, so for those looking to trade it, buying this dip makes sense on the charts. Use a tight stop though ($1316ish).

## Currencies & Bonds

The Dollar Index was flat last week, as the greenback initially declined in response to the "dovish" FOMC minutes, but then caught a bid late in the week on a "risk off" bid. The Dollar Index did manage to hold support above the 80 level, despite the choppy trading.

The euro also was surprisingly flat despite general risk reduction, disappointing data and Portuguese banking worries. Oddly, though, euro strength is now a reflection of things not "working" in the EU. The goal of the ECB (and the euro bulls) is to see the EU economy grow, bond yields rise gradually, and the euro fall. But, when the market doesn't think the ECB policies are working or the economy is growing, they will buy euro out of deflation fears. So, trading in the euro is not all that dissimilar from the yen at this point—a weaker euro is a sign things are "working" in Europe. Clearly, things weren't working last week.

Turning to the yen, things aren't working there, either. The yen rallied to a 5-month closing high vs. the dollar despite weak economic data (again, the yen is pricing in potential low inflation/deflation concerns). 100.74 remains the key level to watch in the dollar/yen—if that is violated, then calls that "Abenomics" is failing will get louder, and we'll have to significantly re-evaluate the "long Japan" thesis. I can't believe, though, that the BOJ won't try to put pressure on the yen as there's a BOJ rate meeting early this week.

The bond market surged higher last week and completed one enormous head-fake, as the 30-year is now just a few ticks from the highs for the year. Lackluster economic data, a dovish Fed, and foreign buying helped push bonds higher. Astonishingly this uptrend isn't over. 138'10 is the high for the year, and I'd be very surprised if that isn't tested early this week. At some point this bond rally will end, but I'm now becoming convinced that it won't be until ECB policies in the euro zone start "working" and this enormous Treasury carry trade starts to reverse. Until then, the short-term trend remains higher.

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 |
|---|---|---|---|---|
| **6/30/14** | GLD<br>SLV | 127.30<br>20.15 | None | *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. Original Issue* |
| **6/11/14** | SPHB<br>KBE | 32.73<br>33.40 | 30.32<br>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<br>STPP<br>REK | 63.41<br>38.32<br>23.00 | 59.53<br>36.83<br>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<br>IYM<br>PICK<br>DIA | 52.19<br>83.06<br>19.48<br>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<br>XOP | 18.97<br>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 positive for years 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 7.14.14)**

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** | **Neutral** | **Bullish** | *The S&P 500 fell from record highs last week as global economic data disappointed and a drop in European banks dragged global markets lower. Last week's dip appears to be a consolidation/correction that's needed after the rally since May, as the fundamentals for this market remain broadly bullish. 1964 is key near term support in the S&P.* |

**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** | *We saw continued bifurcation in the commodity markets last week as energy continued to decline on expectations of an increase in output and reduction in geo-political tensions, while metals continued to rally. Broadly, though, the outlook for commodities is improving as global inflation bottoms and the global economic recovery continues.* |

**Best Idea:** Long Oil (USO)

**Best Contrarian Idea:** Buy Grains (DBA)

| | Near Term Trend | Long Term Trend | Market Intelligence |
|---|---|---|---|
| **U.S. Dollar** | **Neutral** | **Bullish** | *The Dollar Index was flat last week as "dovish" FOMC Minutes countered a late week "Risk off" bid. Going forward the dollar should remain range bound given uncertainty over Fed and ECB policy specifics.* |

**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 big last week, driven by European buying and short covering, and are now just off highs for the year. Despite the direction of future Fed policy clearly being "hawkish," money flows into Treasuries are continuing to support bonds.* |

**Best Idea:** Short long bonds (TBT)

**Best Contrarian Idea:** Short High Yield Bonds (SJB)

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