# 7:00's Report

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

**July 15th, 2014**

## Pre 7:00 Look

- Futures are only slightly lower this morning as Yellen's testimony is helping distract markets from the fact that European equities have resumed their declines.
- Economically we got more disappointing data from Europe as the German ZEW Business Expectations Index missed, falling to 27.1 vs. (E) 28.0.
- Asia traded broadly higher in sympathy with the gains in the US Monday. The Bank of Japan rate announcement went as expected with no change to policy or outlook and the yen is flat in response.
- Econ Today: Retail Sales (E: 0.6%), Empire State Manufacturing Survey (E: 17.80). Fed Speak: Yellen (10:00 AM).

| Market | Level | Change | % Change |
|---|---|---|---|
| S&P 500 Futures | 1967.75 | -3.25 | -0.16% |
| U.S. Dollar (DXY) | 80.295 | .065 | 0.08% |
| Gold | 1311.40 | 4.70 | 0.36% |
| WTI | 100.40 | -.51 | -0.51% |
| 10 Year | 2.549 | .029 | 1.15% |

## Equities

*Market Recap*

Stocks rebounded Monday thanks to some stabilization in Europe, more M&A activity and decent C earnings. The S&P 500 rose +0.48%.

Yesterday's rally was really just the market working off an oversold condition. But there were also a couple reasons supporting the gains. First, it was a "Merger Monday" with deals in pharma (MYL/ABT), food (Lindt/Russell Stover), tech (ACM/URS) and energy (WLL/KOG). Additionally, we saw some settling in Europe as Banco


***The Dow hit a new intra-day high yesterday, recouping all of last week's losses and furthering the performance gap between large cap and small cap this year.***

Espirito Santo announced a management change that was generally seen as favorable (although the bank's bonds fell further on the news). Finally, C earnings were better than expected (particularly fixed income trading revenues were better than feared, as the main area of concern for financials this reporting season) and they announced a finalized $7 billion settlement with the government.

Stocks gapped higher right on the open, but seeing as all the good news hit before the open, the market basically spent the entire day at those levels. From 10 AM till the close, the range on the S&P 500 was just 2 points.

*Trading Color*

It wasn't exactly a "high beta"-led rally yesterday, broadly speaking, as the Dow Industrials hit a new intraday high while the Russell 2000 and Nasdaq basically traded in-line (the Russell 2000 remains well off the highs of two weeks ago).

Sector-wise, there was selling of utilities ahead of the Yellen testimony today and tomorrow (more on that

| Market | Level | Change | % Change |
|---|---|---|---|
| Dow | 17055.42 | 111.61 | 0.66% |
| TSX | 15171.23 | 45.73 | 0.30% |
| Brazil | 55743.98 | 958.05 | 1.75% |
| FTSE | 6736.93 | -9.21 | -0.14% |
| Nikkei | 15395.16 | 98.34 | 0.64% |
| Hang Seng | 23549.96 | 113.29 | 0.49% |
| ASX | 5511.30 | -0.10 | 0.01% |
| Prices taken at previous day market close. | | | |

below), as there's a fear in the market she might be "hawkish."

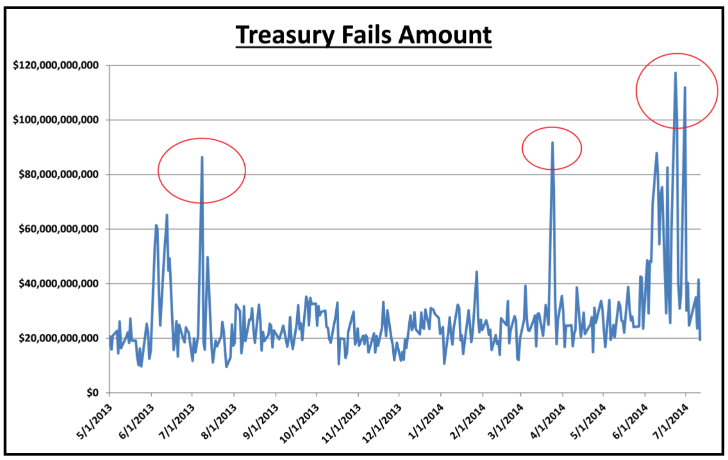
Energy and tech were the best performers thanks to a bounce in WTI crude and the M&A news. Meanwhile, banks initially traded higher off the C results but then came back in throughout the day (sentiment definitely has improved toward bank earnings since Friday given the WFC and C results).

| Market | Level | Change | % Change |
|---|---|---|---|
| DBC | 25.83 | .08 | 0.33% |
| Gold | 1309 | -28.40 | -2.12% |
| Silver | 20.965 | -.496 | -2.31% |
| Copper | 3.253 | -.016 | -0.49% |
| WTI | 100.97 | .14 | 0.14% |
| Brent | 106.75 | .09 | 0.08% |
| Nat Gas | 4.154 | .008 | 0.19% |
| RBOB | 2.9275 | .019 | 0.65% |
| DBA (Grains) | 26.34 | .22 | 0.84% |
| Prices taken at previous day market close. | | | |

Materials stocks also gave back some recent gains (gold miners got hit on lower gold prices) and I'm watching the materials/miners to potentially buy a further dip.

On the charts the S&P 500 has recouped nearly all of last week's sell-off (the S&P 500 is 6 points off the highs) and held support at 1,965.

***Why an Uptick in Repo Failures Matters to You.***




Recently you may have heard about an uptick in the failure of "repos" in the Treasury market. Repos (or repurchase agreements) are ways for banks to access short-term liquidity by using Treasuries as collateral. Basically, repos help to create liquidity and leverage in the financial system (good leverage, not bad leverage).

We've seen a spike in repo "failures" lately, which means that either cash or collateral (in this case, Treasuries) wasn't delivered. This has alarmed some people because a spike in failed "repos" also occurred just before the financial crisis in 2008. There are a couple things we need to be aware of regarding this situation.

First, today's increase in repo failures isn't foreshadowing an '08-style crisis (repo failures before the crisis were multiples higher than they are now). But, it does underscore potential unintended consequences of the Fed's multi-year QE and Operation Twist operations.

To that point, concern is growing that the supply of Treasury bonds on the open market is dangerously low. That's the case for two reasons:

1) The U.S. is running a much-lower fiscal deficit than anyone expected, so the Treasury Department doesn't have to borrow as much money to pay the bills, which in turn means less issuance of Treasuries.

2) The Fed now owns nearly 20% of all Treasuries outstanding, so that has drained a lot of supply from the market.

With regards to these repo trade failures, in the vast majority of these cases, the trades have failed because one of the counter-parties couldn't find the right Treasury security to deliver as collateral. And, again that goes back to the point made above, that the supply of Treasury securities is very low, and that may have some significant unintended consequences.

As I said earlier, this increase in repo failures is not the same thing as what was happening in 2008,. So while Zero Hedge is quick to point to these failures as a sign the financial system is again starting to become unglued, that's just not the case at this point.

But, that doesn't mean this isn't something to watch, because the repo market is a key source of short-term liquidity for all sorts of banks and businesses. **And, it underscores the fact that there are going to be a lot of unintended consequences of the Fed's QE and Operation Twist programs, which we are going to learn about in real time. Even more broadly, it's simply unrealistic to think that the "unwind" of this massive multi-year stimulus isn't going to see its share of hiccups and scares. But the key will be being able to differentiate between those that just cause temporary dips, and those that are bearish game-changers.**

If the repo failures were to continue and materially accelerate (and they are already leveling off) then that would represent a lack of liquidity in the market that would negatively (potentially very negatively) affect stock prices. But as of now, the bottom line is this remains an area to monitor and watch — but not a reason to de-risk.

Many bears believe stress in the repo market will eventually cause a crisis. They may well be right, but we'll be able to see that coming. We will continue to watch this for you, and if it does flash "warning," we will let you know.

## Economics

There were no economic reports yesterday.

## Commodities

The recent trend in the commodity space — which has been characterized by weakness in grains and energy, and outperformance in precious metals — reversed yesterday. Grains were the best performers, energy traded slightly higher, and both gold and silver dropped sharply. DBC added +0.3% on the day.

***Gold futures have broken a short term uptrend, but fundamentals remains supportive and support in the $1300-$1310 region is now key.***

Beginning with the worst performers, gold and silver started the week with a thud yesterday as gold fell -2.25% while silver was down -2.54%. Fundamentally, not much has changed, but there is certainly a nervous feel to the markets ahead of Yellen's two-day testimony starting today, so traders are positioning appropriately (the fear is Yellen will be a touch more "hawkish" than the market expects).

| Market | Level | Change | % Change |
|---|---|---|---|
| Dollar Index | 80.225 | -.004 | -0.01% |
| EUR/USD | 1.3618 | .001 | 0.07% |
| GBP/USD | 1.7079 | -.0043 | -0.25% |
| USD/JPY | 101.56 | .20 | 0.20% |
| USD/CAD | 1.0709 | -.0022 | -0.20% |
| AUD/USD | .9393 | .0003 | 0.03% |
| USD/BRL | 2.2115 | -.009 | -0.41% |
| 10 Year Yield | 2.549 | .029 | 1.15% |
| 30 Year Yield | 3.368 | .025 | 0.75% |
| Prices taken at previous day market close. | | | |

If one thing had to be cited for yesterday's sharp sell-off, it would be the failure of the bulls to hold the $1,330 level and continue to push futures to the next level of resistance at $1,355 last week. But, as terrible as the chart may appear at first glance, the only support level that was actually violated was the very steep uptrend line that has been in place since gold made its most-recent bottom at $1,240 back in the middle of June. So technically, gold remains in a broad range between $1,300 and $1,330 (note support was adjusted from $1,310 to $1,300).

Validating yesterday's sharp corrective sell off was the fact that speculator positioning in the precious metals approached "froth" levels last week, according to the CFTC. In the Commitments of Traders report released on Friday, the CFTC reported that net longs in gold futures held by money managers rose 7.8K to 133.8K (the highest since December 2012) while net longs in silver increased 7.75K to 43.95K (the highest we have on record since we began collecting data at the Sevens Report). And, both increases were largely a result of new long positions being opened.

Bottom line, precious metals became near-term over-extended; however, 3 of the 4 reasons we initiated the trade remain intact, as the 23- and 30-day exponential moving averages remain above the 50-day EMA, net long positions continue to climb (and although elevated, I imagine a lot of longs got stopped out yesterday) and the underlying "inflation" bid is still in the market (although traders will be listening closely to Yellen's testimony today and tomorrow). But, the sharp uptrend that has been in place for nearly a month was indeed broken. So, going forward all eyes will be on the $1,300 level in gold. As long as futures can hold up (most importantly on a closing basis), we will remain cautiously long.

Moving to the energy space, crude oil futures dipped to a fresh 2-month low early yesterday morning before oscillating most of the day as traders attempted to feel out a bottom. But, encouragingly (for the bulls) WTI closed near session highs just below $101 for a gain of +0.16%. The steep downtrend remains intact, however, and we would like to see that ($101.60) level broken before initiating longs.

Moving to natural gas, futures briefly traded through support at $4.10 yesterday morning, but sharply reversed as buyers defended that level. Futures continued to rally throughout the day and closed near the high ticks just below $4.16. Weather continues to be the dominant force in this trade, and natural gas has traded lower on the relatively balmy summer, and that was made worse by another "Polar Vortex" that is pushing temperatures in the mid-West and northeast well below normal averages. But, at $4.10 the current below-average temperatures have already been priced into the market and reports looking 10+ days out are now showing a bit of an uptick in temperatures, and warmer weather will definitely reinforce our $4.10 argument.

So far $4.10 is proving to be solid support, and we continue to recommend buying dips in natural gas via UNG or outright futures near that level with a stop below $4.00 on an intra-day basis, or a close below $4.10.

## Currencies & Bonds

It was a pretty uneventful start to the week in the currency markets yesterday, as the Dollar index finished almost perfectly unchanged as Fed Chair Yellen's testimony loomed over the markets.

Ms. Yellen's counterpart in Europe, Mr. Draghi, provided testimony to the European Parliament. I'm sure much to his disappointment the euro rallied steadily throughout the day yesterday to close up +0.1%. As I detailed last week, a weakening euro means the ECB is achieving its intended goal, and a strengthening euro means its policies aren't working. The ECB and pretty much all of Europe want to euro to weaken, so I'm sure Mr. Draghi noted that his efforts to "talk" the euro down by saying the ECB's TLTRO will pump 1 trillion euros of low-cost loans into the EU economy failed to elicit a result (it wasn't any "new" news, just a big headline number designed to elicit a reaction). But, as the market has clearly demonstrated, it's going to take more than just "talk" to get the euro moving materially lower – it's going to likely take some form of QE in Europe. Until the ECB admits that and just does it, the euro will likely stay buoyant.

Elsewhere the pound and yen fell -0.25% each vs. the dollar on a general drift lower, while the Aussie was flat ahead of the RBA meeting minutes released overnight.

Finally, the Loonie bounced back after taking a little-noticed beating on Friday, as June employment data badly missed expectations. June employment decreased 9,400 vs. (E) 24K increase, and the unemployment rate rose to 7.1% from 7.0%. While that figure overestimates the weakness (a lot of the jobs losses were part-time), it's still the second month of declines out of the last three, and certainly will give the BOC pause on raising interest rates.

The Loonie has enjoyed a strong rally since mid-March, but it looks as though it'll test support at the $0.9250-ish level sooner than later. If that support is broken, the Loonie will be a short (fundamentally the outlook remains negative for the currency).

Turning to bonds, they declined modestly yesterday ahead of Yellen's testimony as the 30-year traded down -0.25% while the 10-year yield inched up to 2.55%. The market's expectation (and reason bonds sold off yesterday) is for Yellen to be slightly "hawkish," although it seems the market keeps assigning a "hawkish" tone to the Fed because of recent data and inflation, but it simply doesn't seem to come.

Perhaps today will be different, but I'd be surprised if Ms. Yellen's comments differ materially from those she made in mid-June at the last FOMC press conference. Regardless, bonds remain well-bid and just under highs for the year at 138'10.

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<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 7.13.14)**

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.* |

**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)