7:00's Report

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

July 7th, 2014

Pre 7:00 Look

- Futures are fractionally negative and most foreign markets are mildly weaker this morning as everyone digests recent gains following a uneventful long weekend.
- Europe is trading lower after German Industrial Production badly missed estimates (down 1.8% vs. (E) 0.1%), adding to the string of disappointing German numbers.
- The only real news from last Friday's trading was a profit warning by Erste bank (a European bank) that caused some mild weakness in Europe on Friday.
- Econ Today: No economic reports today.

Market	Level	Change	% Change
S&P 500 Futures	1974.75	-0.75	-0.04%
U.S. Dollar (DXY)	80.33	.049	.06%
Gold	1314.80	-6.50	-0.49%
WTI	103.83	.06	0.06%
10 Year	2.648	.20	0.76%

Equities

Market Recap

Stocks surged to new highs last week on the back of strong U.S. and global economic data. The S&P 500 rose +1.3% last week and is up +7.4% year-to-date.

Sometimes it's hard to identify the real driver behind shorter-term market movements. But that was not the case last week, as trading was driven almost entirely by economic data. Stocks started last week flat last Monday because it was the last day of the quarter, but traded sharply higher Tuesday after global June manufacturing PMIs confirmed that U.S. economic growth is accelerating, while China's growth appears to have stabilized. (The Chinese data was the biggest positive surprise) last in week in the markets). Meanwhile, Europe has lost a bit of momentum but still remains in a slow recovery.

After hitting a new high Tuesday, the S&P 500 treaded water Wednesday despite a blowout ADP jobs report, as there was a bit of buyer exhaustion from Tuesday's rally and people were hesitant to do too much ahead of the jobs report Thursday. Fed Chair Yellen gave a speech on Wednesday, but she didn't shed any new light on the policy outlook and nothing she said moved markets.

As you know, the jobs report Thursday was much better than expectations (and the details of the number were also strong). Despite it only being a half-day for the markets, the S&P 500 grinded steadily higher throughout the morning hours to reach another new all time intra-day high and closed just off the that level.

Trading Color

Last week was a healthy rally from a composition standpoint, as cyclical stocks solidly outperformed defensive stocks. Broadly, the Russell 2000 and Nasdaq were up +1.6% and +2.0%, compared to +1.27% for the S&P 500.

Sector-wise, consumer discretionary (XLY), basic materials (XLB), tech (XLK), financials (XLF) and healthcare (XLV) all hit new 52-week highs after playing massive "catch up" last week. (Most of those sectors rallied well over +2%.) Healthcare is the one historically defensive sector to hit a new 52-week high, but that outperformance is being driven by a rebound in the biotechs (which are traditionally higher-beta than other healthcare sectors).

Even more impressive than the cyclical outperformance last week was the collapse of the utilities. XLU traced out a weekly bearish "outside reversal" in that it hit a new

Market	Level	Change	% Change
Dow	17068.26	92.02	0.54%
TSX	15214.96	7.85	0.05%
Brazil	54055.90	181.32	0.34%
FTSE	6854.44	-11.61	-0.17%
Nikkei	15379.44	-57.69	-0.37%
Hang Seng	23540.92	-5.44	-0.02%
ASX	5518.91	-6.07	-0.11%
Prices taken at previous day market close.			

52-week high last Monday, but then fell nearly 4% Tuesday-Thursday to close at a 2-week low. Additionally, on Friday XLU broke the uptrend in place for all of 2014.

So, clearly there was a rotation out of defensive sectors and into cyclicals, and that is likely to continue. (Utilities are a very over-owned sector, and I would still consider reducing exposure there as this decline likely isn't over. Even with last week's drop, utilities are still up nicely year-to-date.)

Market	Level	Change	% Change
DBC	26.40	-.05	-0.19%
Gold	1320.60	.10	0.01%
Silver	21.089	.00	0.00%
Copper	3.273	-.0065	-0.20%
WTI	103.79	-.27	-0.26%
Brent	110.65	.01	0.01%
Nat Gas	4.344	-.062	-1.41%
RBOB	3.0134	-.0064	-0.21%
DBA (Grains)	27.38	-.09	-0.33%
Prices taken at previous day market close.			

Given last week was a holiday week, volumes were very low, although there was a legitimate uptick in activity during the first few hours of trading Tuesday following the global PMIs. (It was also the start of a new quarter, but there was some real buying that morning—something we haven't seen a lot of lately.)

Looking at the technicals, they are bullish. The S&P 500, Russell 2000 and Dow Industrials each made new all-time highs last week, and the Nasdaq sits at multi-year highs (closing in on 5K, if you can believe it). Support on the S&P 500 lies lower at 1,955 (20-day moving average).

This Week

Focus turns to the "micro-economic" this week as AA kicks off earnings Tuesday after the close, while WFC Friday is the first big name to report.

Geopolitically, Iraq remains a mess, as the Iraqi Parliament failed to choose a new Prime Minister when it met last Tuesday, and Nouri al-Maliki said this week he wants to stay in power. But, it is generally expected that a new PM will be chosen over the coming weeks (the next chance is this Tuesday), but Iraq remains very much on the back burner for markets at the moment.

Bottom Line

Stocks may be in the midst of a "virtuous cycle." The U.S. economy is clearly getting better, the global economic recovery is gaining steam (and importantly, the chances of a Chinese "hard landing" are shrinking), and global central banks—despite accelerating growth and bottoming inflation—show no signs of reducing historic monetary accommodation.

So, when clients ask "What has to happen next to keep the rally going?" the answer, at least at the moment, is "Nothing." It'll keep going as long as things stay generally the same and until we either get a hit to one of the 4 pillars of the rally or valuations get extreme.

And, to that point, the S&P 500 is now trading at 16.5X 2014 $120 EPS and 15.2X 2015 $130 EPS. Those multiples are not cheap, but given the backdrop and where interest rates are, there's no reason these multiples can't expand further.

There are risks to the rally: a jarring change to the outlook for Fed policy (i.e., the Fed starting to tighten sooner than currently expected), earnings that badly miss expectations and call the $130 '15 number into question, and geopolitics. But, the benefit of the doubt remains with the bulls.

Given the global backdrop, I continue to like European equities (primarily the PIIGS), domestic cyclicals/high-beta sectors, and banks as destinations for incremental capital. And, I'm also looking closely at resource stocks, as they have rallied hard in the slight uptick in inflation and acceleration of growth, but they have a long, long way to go before they get "expensive." I already own PICK, but that's a name I'm going to look to add to throughout this week.

Economics

Last Week

The most-important thing that happened last week was that the June jobs report and the June ISM manufacturing and non-manufacturing PMIs further implied the US economy is close to achieving "escape velocity" (meaning ending the era of around 2% GDP growth).

Other than the obvious (that an accelerating economy is good for stocks), the strong data and implication that we're finally breaking out of this slow-growth economy is key for two reasons:

First, the strong data of the past few weeks are helping to remove any worry about the economy being able to recover from the Q1 hole. Second, the debate about whether the Fed is "behind the curve" (which is a term that just means the Fed may be too accommodative at this point, given what appears to be happening in the economy and with inflation) was reignited last Friday. If the market starts to believe the Fed is behind, look for inflation-linked assets/sectors to outperform going forward.

Turning to the data, ISM manufacturing and non-manufacturing PMIs actually slightly missed estimates last week. (Manufacturing: 55.3 vs. (E) 55.6, Non-Manufacturing: 56.0 vs. (E) 56.2.) Regardless, both were strong numbers and solidly above the 50 level that implies expansion.

And, the June jobs report was a blowout of 288K vs. (E) 213K. And, beyond the June report, for the first six months of 2014 we've seen average monthly job gains of 231K—which is the best 6-month stretch since the crisis of 2008. Additionally, the unemployment rate fell to 6.1% while the labor participation rate remained at 62.8% (meaning the unemployment rate likely declined because unemployed people found jobs, not because they dropped out of the labor force).

Bottom line is last week was an important week of data, and it implied that economic growth is accelerating. While last week's data alone won't result in a material change in Fed policy expectations, it does put some more pressure on the Fed to begin to explain their exit strategy. For now, we remain in a sweet spot of an easy Fed and accelerating growth. But if things continue at this pace, Fed outlook will have to change—but that's a problem for another day.

Market	Level	Change	% Change
Dollar Index	80.325	.34	0.43%
EUR/USD	1.3592	.00	0.00%
GBP/USD	1.7159	.0001	0.01%
USD/JPY	102.10	.00	0.00%
USD/CAD	1.065	-.0003	-0.03%
AUD/USD	.9358	-.0001	-0.01%
USD/BRL	2.213	.00	0.00%
10 Year Yield	2.648	.20	0.76%
30 Year Yield	3.483	.17	0.49%
Prices taken at previous day market close.			

Last week wasn't all about the U.S., though, as there were also a lot of global data. The biggest positive surprise came from China, as both the private Markit and government June manufacturing PMI were above 50, while June service sector PMI in China surged to 53.1, up from 50.7 in May. Bottom line is the PMIs, along with other recent data, confirm that the pace of growth of the Chinese economy has stabilized above 7%, which is a general tailwind for global markets and the economy.

Finally, turning to Europe, there were a ton of data last week (flash June HICP, June manufacturing and composite PMIs, retail sales and an ECB meeting). Bottom line on all of it is that while there are some pockets of weakness (German data have been a bit soft the last few weeks, which is disconcerting), the consensus is that the slow recovery in Europe is continuing. The ECB, as expected, made no changes to policy and will wait to see the effectiveness of the June measures before moving again.

This Week

It is a very quiet week economically for both the U.S. and the rest of the world. Jobless claims (Thursday) is the only number to watch here in the U.S., while internationally the "highlight" will be Chinese CPI/PPI (tomorrow night) and trade balance (Thursday). Inflation is always a concern in China, because an uptick in inflation will cause the government to pull back stimulus (which puts economic growth at risk). But no one is expecting a major uptick in inflation this week.

In Europe it's also quiet (the biggest number of the week was German industrial production, which we got this morning). The Bank of England meets Thursday, but there will be no change to policy. And, seeing as the BOE makes no statement at its rate meetings (unlike the Fed or ECB), this will be a non-event. After a very busy holiday-shortened week, last week, we generally get a break economically over the next several days.

Commodities

Commodities were mixed last week as crude oil fell through technical support at $105 while both industrial and precious metals finished the week higher. The benchmark commodity tracking index ETF, DBC, had one of its worst weeks of the year as it dropped -1.05%, mostly as a result of the heavy selling in energy futures, which make up a large portion of the fund's portfolio. Year-to-date DBC is now up +2.89%.

Beginning with the worst performer, WTI crude oil futures broke down through a longstanding technical uptrend line that has been in place since January. WTI traded lower all 5 sessions last week for a total loss of -1.8% on the week.

First, "Iraqi fear bids" are continuing to be unwound as the chances of the situation escalating to the point where the southern oil fields would actually be threatened are slim. Second, news broke midweek of an agreement between Libyan rebels and the government that will reopen two critical oil ports, and essentially triple the current level of exports in coming weeks. This is obviously supply-side-bearish, and WTI fell in sympathy with Brent prices. Lastly, crude oil simply became overbought in recent weeks as a result of the turmoil in Iraq, along with the misleading headlines regarding the possibility of U.S. oil exports.

Going forward, oil still has room to fall further before hitting support at the 50-day moving average at $103.36. But, looking past the near-term volatility, crude oil and refined-product prices are going to remain elevated as long as the global economy continues to recover, which obviously leads to higher demand. Bottom line is the market got too overbought and is now corrected, but I would look to be a buyer of oil and energy stocks (XLE) on a further dip towards $100/bbl.

Moving to the metals, gold and silver traded well last week, adding +0.34% and +0.66%, respectively, despite strong economic data and US Dollar strength. Gold and silver futures have both rallied for the past 5 consecutive weeks now as trader focus has shifted to inflation, which seems to have bottomed here in the US.

Gold futures did sell off upon release of the strong jobs number Thursday, but buyers were quick to step in, but the selling wasn't as heavy as you would have expected, and gold rebounded to close nearly $10 off the morning lows. We continue to like buying gold on dips here as there are both fundamental (inflation speculation) and technical (23-day and 30-day EMA crossing the 50-day EMA on June 26) reasons supporting the long trade.

Currencies & Bonds

The good economic data of last week also drove trading in the currency markets as the dollar rallied from last Tuesday on and closed the week up .3%, courtesy of the strong ISM PMIs and jobs report. The Dollar Index appears to have broken the short term downtrend in place since the June 10 highs.

The euro dropped a more substantial .7% last week and is trading back below 1.36 this morning on a combination of strong US data and generally "dovish" commentary from the ECB at the meeting last week, and the euro appears to have broken the uptrend in place since June 10th.

Going forward, I think the Dollar Index will trade with a slight upward bias and the euro with a slight downward bias, but with so much dependent on the Fed, ECB and inflation readings, I think both currencies will remain largely range bound in the near term. The two levels to watch going forward are resistance at 81.00 in the dollar and support at 1.3516 in the euro. If those levels are broken, look for acceleration in a dollar rally or euro decline.

Turning to the bond market, the 30 year traded sharply lower last week following the strong economic data, and importantly the long bond closed below the 2014 uptrend for the first time all year, appearing to decisively break that trend line. Given the economic data and techincals, I think we've seen the end of this 2014 rally in bonds, although I do not think that means we're going to see a waterfall decline like we did last June. There are still factors supporting bonds (European demand and very "dovish" forward guidance from the Fed), but I think this rally is over, the trend has changed, and going forward we should see both the yield curve steepen and the long end of the curve underperform. If you've enjoyed this rally in bonds for 2014, now is a very good time to look to shorten duration or simply book profits.

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 SLV	127.30 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	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*
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 positive for years to*
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 7.7.14)

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 thanks to strong economic data (PMIs and jobs report). Despite being short term overbought, the outlook for stocks remains favorable as the global economy is accelerating while central banks remain very accommodative. Focus now shifts to earnings, but the path of least resistance remains higher.*

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 Grains (DBA)

U.S. Dollar	**Neutral**	**Bullish**	*The Dollar Index rallied last week and broke a three week downtrend thanks to the strong economic data. Given the data and recent sluggish economic readings out of Europe, I expect the dollar to trade with a slight upward bias going forward.*

Best Idea: Buy the Pound (FXB)

Best Contrarian Idea: Long Canadian Dollar (FXC)

Treasuries	**Neutral**	**Bearish**	*Treasuries sold off hard last week on the strong economic data, and the 30 year bond broke the 2014 uptrend, likely signaling this 2014 rally has ended. I don't expect a sharp drop in bonds, but I believe this 2014 rally is over.*

Best Idea: Short long bonds (TBT)

Best Contrarian Idea: Short High Yield Bonds (SJB)