7:00's Report

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

July 22nd, 2014

Junk Bonds: A breakdown of consequence? Junk bonds broke an 11-month uptrend recently and are trading below the 50-day MA for the first time since August

Pre 7:00 Look

- Futures and foreign markets are higher this morning as geo-political tensions recede a bit during an otherwise quiet night. There were no material economic reports o/n.
- Ukrainian rebels handed over MH 17's black box, and the international community is calling for a cease fire in Gaza, and while neither situation actually changed, both moves are slightly helping sentiment.
- Econ Today: CPI (E: 0.3%), Existing Home Sales (E: 4.99M).
- Earnings Today: MO (E: 0.65), KO (0.63), MCD (E: 1.43), VZ (E: 0.90), AAPL (E: 1.22), MSFT (E: 0.60).

Market	Level	Change	% Change
S&P 500 Futures	1971.75	5.50	0.28%
U.S. Dollar (DXY)	80.805	.178	0.22%
Gold	1306.30	-7.60	-0.58%
WTI	103.14	.28	.27%
10 Year	2.474	-.010	-0.40%

Equities

Market Recap

Stocks saw modest declines to start the week in quiet trading as general geopolitical concerns weighed on the markets. The S&P 500 declined -0.23%.

Stocks were lower all day Monday and the S&P hit its lows mid-morning, down about 10 points. The sell-off was somewhat swift, but there wasn't a specific reason for it (there wasn't any real news out yesterday during trading). The dip was mostly a result of fast money pushing stocks lower.

The market once again found support at 1,965 (this level has been key over the past few days). Once the fast-money selling dissipated, stocks gradually drifted higher throughout the remainder of the session to finish well off the lows. Yesterday's trading was purely flow-driven, in that there was no news that hit the tape after the morning earnings. Monday was a day for the algos and day traders to move markets around.

Trading Color

Like last week, there weren't any real "themes" to how the market traded yesterday. Small caps again lagged but were down only modestly and, like the S&P 500, rallied off the lows of the day.

Sector-wise, the weakness was broad-based but mild, as energy was the only S&P 500 sub-sector to finish positive. Yet, no sector traded down more than -0.5% (consumer discretionary and consumer staples were the laggards based mainly on earnings).

Regional banks continued to get hit yesterday after BBT's earnings miss, and that group continues to suffer

Market	Level	Change	% Change
Dow	17051.73	-48045	-0.28%
TSX	15249.99	-16.58	-0.11%
Brazil	57633.92	621.02	1.09%
FTSE	6784.10	55.66	0.83%
Nikkei	15343.28	127.57	0.84%
Hang Seng	23782.11	394.97	1.69%
ASX	5543.29	3.35	0.06%

Prices taken at previous day market close.

from a rotation out of the regionals into the larger investment banks on a valuation play.

Tech was again one of the relatively better performers, as there was some buying in NFLX ahead of earnings and some very important results later on this week (starting today with AAPL and MSFT).

Market	Level	Change	% Change
DBC	25.66	.12	0.47%
Gold	1314.6	5.20	0.40%
Silver	21.025	.139	0.67%
Copper	3.1995	.015	0.47%
WTI	102.83	.88	0.86%
Brent	107.65	.41	0.38%
Nat Gas	3.850	-.101	-2.56%
RBOB	2.8953	.035	1.22%
DBA (Grains)	26.43	.07	0.27%
Prices taken at previous day market close.			

Activity and volumes were very slow yesterday. On the charts, support at 1,965 in the S&P 500 again held an intraday test, while resistance still sits at the highs of 1,985.

Bottom Line

Geopolitics weighed generally on stocks yesterday, but really this market just continues to consolidate the rally from May on. Selling yesterday, even at the lows, wasn't heavy or convicted.

The Gaza situation seems to be stealing the stage a bit from Russia/Ukraine, and while both bear watching, they aren't going to end this rally in their current state.

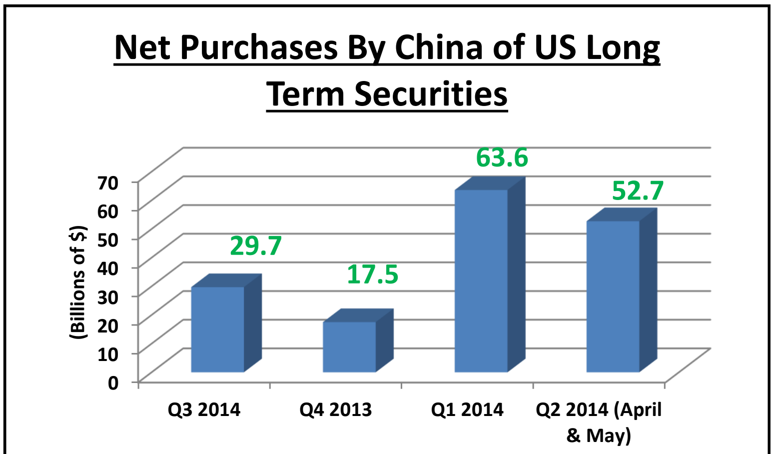
More broadly bulls & bears are stalemated: Earnings and data are good, but there are fears of the Fed getting more "hawkish" and of geopolitics. For now, that means more chop and consolidation.

TIC Data Show More Than Europeans are Piling into Treasuries

It appears China has joined the Treasury-buying party started by the Europeans this year. This is adding more short-term support to bond prices, which continue to utterly ignore fundamentals, thanks to foreign money flows and geo-political concerns. In last Wednesday's TIC report (Treasury International Capital report) for May, we learned that during the first 5 months of 2014, China has added holdings of Treasuries at the fastest pace since records on Treasury purchases started being tracked. Average purchases for the first 5 months of 2014 have jumped to 23.26 billion per month vs. just 7.8 billion through the last 6 months of 2013, more than a 200% increase!

Does that mean the Chinese are wildly bullish on Treasuries? No, it does not.

While European buying of Treasuries was due mostly to European investors reaching for yield (Treasuries continue to be more attractive than German Bunds), China is buying U.S. Treasuries as part of an effort to depress the value of the yuan and help stimulate economic growth. (The yuan is pegged to the dollar, so they have to manage reserves to keep the peg.)



Purchases of Treasuries by China have exploded in 2014, helping fuel the rally in the long bond.

Trading and investing is often a game of monitoring money flows vs. fundamentals (the former can temporarily overwhelm the latter, obviously). And clearly foreign money flows, combined with a low supply of Treasuries (courtesy of low issuance and the Fed buying Treasuries via QE), have resulted in the bond market trading relentlessly higher in the face of growing "bond negative" fundamentals (the latest of which is potential wage inflation which I'll cover in tomorrow's report).

But, in my experience, fundamentals *do* always win out in these instances. And, the more money flows suppress the natural fundamental reaction from asset classes (i.e., the more distorted it becomes), the more violent the reaction when the money flows eventually stop, because they always do.

Taken in the context of about markets beginning to ever so slightly doubt the Fed (the "behind the curve" theme), and with bonds at highs for the year, I think the risks for a potentially violent "snap back" in bond prices is growing.

That may not be for some time yet (remember, easy money kept the tech and housing bubbles afloat long past when everyone thought it should). But, the Fed has spent 3+ years drilling into the markets' head "low for long." If that perception changes because the Fed is perceived as "behind the curve" or sowing the seeds of the next crisis, I shudder to think what will happen to bonds once the sell-off starts—especially combined with reduced Treasury availability and less dealer inventory of bonds courtesy of Dodd-Frank. There is a natural payback coming here, and the longer its delayed, the worse it'll eventually be.

Economics

There were no economic reports yesterday. However, there was a survey release from last week I want to cover:

Commodities

Commodities started the week on a mixed note as the metals and energy sectors traded mostly higher amid ongoing geopolitical concerns, while natural gas and the grains were lower on mild extended weather forecasts. DBC, the benchmark commodity ETF, added +0.47%. Note that DBA, the widely followed agricultural index, was higher yesterday because of sharp rallies in sugar and cocoa futures while the rest of the sector largely underperformed.

Both precious and industrial metals rallied yesterday as geopolitical situations remain in the headlines (Ukraine and Gaza) and economic data looms.

Market	Level	Change	% Change
Dollar Index	80.625	.03	0.04%
EUR/USD	1.3522	-.0002	-0.01%
GBP/USD	1.7072	-.0014	-0.08%
USD/JPY	101.37	.05	0.05%
USD/CAD	1.0734	.0005	0.05%
AUD/USD	.9379	-.0009	-0.10%
USD/BRL	2.2219	-.0026	-0.12%
10 Year Yield	2.474	-.010	-0.40%
30 Year Yield	3.264	-.028	-0.85%
Prices taken at previous day market close.			

Gold futures rallied +0.36% yesterday but closed well off the morning highs near $1,320/oz. Gold continues to be supported by fear bids due to the multiple global conflicts, namely those in the Ukraine and the Gaza Strip. But there was also a noticeable feel of trader positioning ahead of this morning's CPI report.

The situation in precious metals is largely the same as the current underlying theme in the market, that the Fed is "behind the curve"—specifically when it comes to inflation—which continues to support the price. Looking ahead, we remain cautiously bullish with initial support below at $1,305 while last week's highs of $1,326 are the level to beat.

Moving to the industrials, copper traded rather well Monday following our call to initiate long positions in yesterday's Report. Copper futures optimistically held support at the 200-day moving average ($3.18) and then added +0.47% on the session to close back above the $3.20 mark.

Looking ahead, Chinese economic reports will be in focus this week (namely the flash PMIs on Wednesday night). As long as the data doesn't terribly miss, we continue to like copper as one way to get long the global reflation trade. On the charts, initial support is below at $3.18 while there is some resistance toward $3.22.

Crude oil futures rallied to begin the week yesterday, adding +0.85% on the session. Oil continues to trade "better" since finding support at the 200-day moving average last week. Geopolitics have definitely been supportive of oil prices recently, but the real underlying driver of the market is heightened domestic demand here in the U.S. According to the EIA, refineries operated at the highest rate in 9 years in the week ending 7/11/2014. We still have not been able to materially build supply levels, which means demand is higher than most people think.

Additionally, there was another dip in inventories at Cushing, Okla., the delivery point for WTI futures contracts. So, that will remain a concern going forward as supplies are approaching the minimum required levels for safe storage (~20M barrels). On the charts, support has formed at around $101.80 while $103 is proving to be a difficult level to beat.

Elsewhere in energy, natural gas remains a "falling knife" as futures lost -2.43% yesterday. There is some support on the chart at $3.80, but the important thing to watch is the sharp downtrend line that has been in place since mid-June. Until that breaks, the path of least resistance remains lower. Having said that, the risk remains that a warmer-than-expected weather report could sharply reverse futures higher as speculators anticipate a spike in demand for natural gas to produce power to satisfy cooling needs.

Currencies & Bonds

The currency markets were very, very quiet yesterday. Only the Aussie dollar moved more than 0.1%, as there was no market-moving economic data out or central bank chatter. The Dollar Index was little-changed on the day, up just +0.04%.

Looking ahead, today's CPI report (8:30 AM) will be in focus as investors continue to speculate as to whether Yellen and the Fed are "behind the curve" with their current policy views. A higher than expected CPI print could potentially spark a rally in the dollar as investors' expectations for a rate hike are edged forward. Housing data will also be closely watched as the real estate market remains one of the largest concerns of the U.S. economy.

In Asia, we have Australian CPI out later tonight (9:30 PM), and Japanese PMIs out tomorrow night (9:35 PM). Before those two report releases, the respective currencies will probably drift sideways as traders position.

The bond rally continued yesterday as Treasuries moved to new highs for the year thanks to some positioning ahead of the CPI report (likely the few shorts left in the market are covering) and more general geopolitical concern. Of course, it seemed yesterday that the escalation of fighting in Gaza was more responsible for the general angst compared to Russia/Ukraine.

The 30-year traded up +0.27% and was helped by the Fed buying $1.06 billion worth of the long bond yesterday at 11 AM, but Treasuries were higher before the purchases on general geopolitical concern. The yield curve flattened further as the 10-year was little-changed.

As discussed earlier, bonds continue to be pushed higher by money flows driven by foreign buying and geopolitics, but regardless of the "why," the short-term trend remains higher.

You Know Interest Rates are Near the Bottom When ...

There was an interesting article from Reuters that hit last Friday that detailed how the Treasury is gauging interest from Wall Street firms for a 50-year bond! Regardless of the near-term strength in bonds, you know we're nearing the end of this era of low rates if the Treasury is looking to lock in cheap money for 50+ years.

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
7/21/14	JJC	Buy on open	None	*Copper has benefitted from the rebound in the global economy and now there is an attractive entry point given last week's correction. We will initiate a small position today and look to add to it on further weakness.*
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	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*
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 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 (7/21/14): Geo-political concerns and foreign money flows sent bonds to new highs for the year last week, and the gap between deteriorating fundamentals and price action is widening. For now, though, the trend is higher and more patience is required in this long term trade.			

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Asset Class Dashboard

(Updated 7.21.14)

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 finished last week mildly positive although there was significant volatility. Geo-political events continue to grab headlines but MH 17/Gaza aren't enough to de-rail the rally, and generally the market continues the consolidation that has occurred since the July 3rd highs. The benefit of the doubt remains squarely with the bulls.*
Best Idea: Buy global industrial miners (PICK, FCX, RIO, etc.) **Best Contrarian Idea:** Buy Retailers (XRT)			
Commodities	**Neutral**	**Bullish**	*Commodities broadly continued to correct last week as DBC ended lower for the 4th straight week, weighed down by natural gas and gold. WTI Crude managed to hold support at $100/bbl on geo-political fears while copper traded back towards support as well.*
Best Idea: Long Oil (USO) **Best Contrarian Idea:** Buy Grains (DBA)			
U.S. Dollar	**Neutral**	**Bullish**	*The Dollar Index traded modestly higher last week on a combination of good economic data, a "Risk off" trade given geo-political headlines, and euro weakness. The Dollar Index is near the upper end of it's 79-81 trading range and unless CPI is high, I don't expect the Dollar Index to break out.*
Best Idea: Buy the Pound (FXB) **Best Contrarian Idea:** Long Canadian Dollar (FXC)			
Treasuries	**Bullish**	**Bearish**	*Treasuries rallied big last week, driven higher by geo-politics and a "Risk Off" bid Thursday. Bonds are now at new highs for the year despite further deteriorating fundamentals.*
Best Idea: Short long bonds (TBT) **Best Contrarian Idea:** Short High Yield Bonds (SJB)			