7:00's Report

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

August 1st, 2014

Pre 7:00 Look

- Futures are modestly lower again this morning on follow through selling from yesterday, but it's not as bad as many expected.
- Europe is the big laggard as economic data o/n was mildly disappointing. Final July PMIs were revised slightly lower from the "flash" reading last week for Germany and the EU, capping a disappointing week of data for Europe.
- Asia's losses were modest, though, as China's July final PMIs were better than the flash estimates, further implying economic growth has stabilized.
- Econ Today: Employment Situation Report (E: 233k), Personal Income and Outlays(E: 0.4%), ISM Manufacturing PMI (E: 56.0).

Market	Level	Change	% Change
S&P 500 Futures	1912.00	-12.75	-0.68%
U.S. Dollar (DXY)	81.54	0.17	0.02%
Gold	1285.80	3.10	0.24%
WTI	97.38	-.79	-0.80%
10 Year	2.55	.02	0.08%

Equities

Market Recap

Stocks saw their biggest declines since April Thursday, as a higher than expected reading on potential inflation and soft economic reports led to steep declines. The S&P 500 fell -2.0%.

Futures were decidedly weaker pre-open Thursday mostly on Argentine default angst and the lackluster European earnings. But, it was the one-two punch of a higher than expected Employment Cost Index and very weak Chicago PMI (so, higher inflation and slower economic growth = stagflation) that the sell-off really got going. Support at 1,965 was broken shortly after the open and stocks sold off into lunchtime (a brief rally was attempted following the European close, but it quickly gave out).

The Russell 2000 hasn't been the leading indicator that it typically is so far in 2014, but regardless it was not encouraging to see it smash through the July lows yesterday. This is not a good looking chart.

Selling abated during the early afternoon as the bulls tried to make a stand and attempt to reclaim key support at 1,950. It didn't work and with the S&P below that level at 2:30, we saw the bulls throw in the towel into the close. Stocks went out basically on their lows of the day.

Trading Color

It was a universally bloody day yesterday, as all ten S&P 500 sub-sectors were down by well over 1%, although there was typical underperformance by higher beta sectors and indices (Russell 2000 and Nasdaq both lagged).

The fact that there was widespread selling on a day the SPX is down 30 points and the Dow Industrials is down 300 isn't surprising. But, what was surprising is that typical "defensive" sectors offered no cover yesterday.

Market	Level	Change	% Change
Dow	16563.30	-317.06	-1.88%
TSX	15330.74	-194.08	-1.25%
Brazil	55829.41	-1048.56	-1.84%
FTSE	6647.51	-82.60	-1.23%
Nikkei	15523.11	-97.66	-0.63%
Hang Seng	24532.43	-224.42	-0.91%
ASX	5556.37	-76.54	-1.36%
Prices taken at previous day market close.			

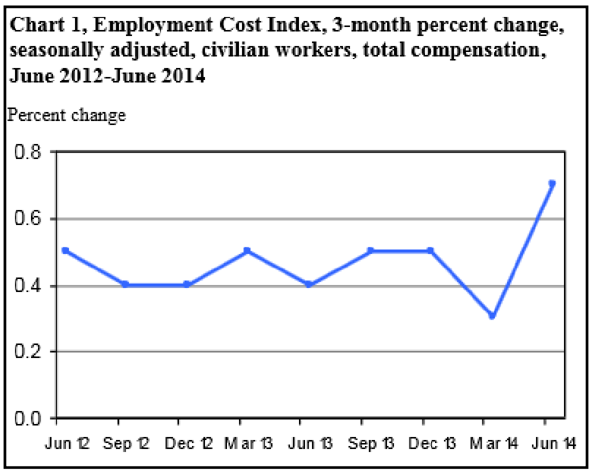
Utilities, consumer staples, telecom and healthcare all fell just as much, if not more, than the broad market, and that's an important point to notice.

Yesterday despite the big losses in stocks interest rates rose. If this correction is being driven by concern the Fed is "behind the curve" then we'll see rates continue to rise, which means typical defensive sectors won't give historical cover, like we saw yesterday.

Market	Level	Change	% Change
DBC	25.32	-.13	-0.40%
Gold	1283.80	-13.10	-1.01%
Silver	20.43	-.167	-0.81%
Copper	3.2285	-.03	-0.40%
WTI	97.70	-2.57	-2.56%
Brent	105.55	-.41	-0.39%
Nat Gas	3.82	.04	0.98%
RBOB	2.78	-.04	-1.22%
DBA (Grains)	26.81	.15	0.56%
Prices taken at previous day market close.			

Again, as we said earlier this week, some of the better ways to hedge a decline in stocks are by getting short bonds (JNK/TBT/STPP), long KRE/short SPY, and long international (DXJ/FXI/VGK) and short SPY.

All of those trades except long VGK/short SPY would be positive this week since we mentioned them Tuesday, and they remain an effective way to hedge if we are going to see continued equity weakness amid rising rates. Point being, typically "defensive" sectors may not offer the protection we're all used to going forward.



Volumes were heavy yesterday but that's to be expected anytime the market is down so much. But, while selling wasn't panicked there was decent activity by "Long Only's" lightening up some exposure, which marks a change from the last week where it was mostly day traders and algo pushing stocks around. If the selling by mutual funds gathers steam, that speaks to more downside in the near term and is something to watch.

On the charts there was some pretty big damage done yesterday in the very short term. 1950 is the key today. If we can close back above that level today than to a point yesterday's decline can be forgiven. On the downside, we're sitting on an uptrend line from the early February lows in the S&P 500, so the 1930ish area is key, and beyond that 1900 is the next major line in the sand.

Bottom Line

Yesterday was an ugly day but it wasn't like it came out of left field. The market has been trading heavy for well over a week since it failed to break through 1985.

As far was "why' stocks sold off yesterday, yes it was the Employment Cost Index and Chicago PMI, but I also think the calendar has something to do with it. After today things get very, very quiet from a macro standpoint for the next month, so there aren't any materially positive catalysts on the horizon, and as a result that may have spurred people to book some profits, which fed on itself.

More broadly, though, this remains, in my opinion, all part of a larger consolidation/chop sideways. I believe I'm one of the loudest people warning that a change in market expectations of Fed policy remains a risk to the rally, but that did not all of a sudden materially change yesterday (we know that because the dollar didn't really react to the Employment Cost Index report).

Fundamentally the Fed remains very easy and hesitant to rock the boat, economic data is good and getting better (yesterday's Chicago PMI notwithstanding), earnings season was one of the best we've had in years from a revenue standpoint, and the macro-economic horizon remains clear. And, until those factor change, then the benefit of the doubt remains with the bulls.

Economics

Employment Cost Index

- June Employment Cost Index surged 0.7% in Q2 2014, higher than expected.

Takeaway

Simply put, this was the real reason stocks were lower yesterday. We've been talking about this for a while now, but we're seeing more evidence that wages are increasing. This has potentially significant implications on inflation.

Taken in the context that the Fed knew these numbers during the meeting last week and still was not at all "hawkish," this is giving further rise to the idea that the Fed is indeed starting to get "behind the curve" from a growth and inflation standpoint. At some point it will have to make a break from the expected path of policy or risk losing credibility.

Given this report, we'll likely see intense focus on the wages portion of the jobs release today. This number may actually be more important to the market than the actual headline. (I'm exaggerating for effect a bit, but you get my point.)

Jobs Report Preview

Given the data yesterday and the market's reaction, there are now two key things to watch in this morning's release: the headline number and the wage data.

- **The Too Hot Scenario: > 300K.** Given the jitters from yesterday's wage data, a print above 300K would only further concern that the Fed will have to react to a surging labor market. This will elicit the same market reaction we saw for most of yesterday: everything down, U.S. dollar up.
- **Just Right Scenario: 200K-290K Jobs Added.** As long as the wage data behave, this will be the "sweet spot" for the market. It would imply a continued strengthening in the jobs market, but one that's not hot enough to warrant the Fed to materially pull forward policy. In this instance, likely market reaction will be positive, as we should see stocks rebound while the Dollar Index and bonds would likely be flat. Gold, which is under pressure, could see some more selling.
- **The "Too Cold" Scenario: <200K.** I don't think many people are expecting this, and it would likely elicit more of a confused reaction than an outright negative one. In this instance, look for bonds and gold to rally and the Dollar Index to sell off (potentially hard). Meanwhile equities likely won't move materially on the news, as again it may be disregarded as a "one-off" by stocks.

Market	Level	Change	% Change
Dollar Index	81.53	.014	0.02%
EUR/USD	1.3391	-.0002	-0.01%
GBP/USD	1.6879	-.003	-0.18%
USD/JPY	102.93	.08	0.09%
USD/CAD	.9159	-.0004	-0.004%
AUD/USD	.9266	-.003	-0.32%
USD/BRL	2.2636	.0179	0.80%
10 Year Yield	2.55	.02	0.08%
30 Year Yield	3.31	.01	0.03%

Prices taken at previous day market close.

As for the wage data ...

- **"Too Hot" Wage Data > 2.3% year-over-year.** After reading the initial headline, most everyone will go right to the year-over-year wage data. Last month it was up 2% year-over-year. A decent uptick would elicit a similar reaction in markets to what we saw yesterday, regardless of what the headline is. If the wage increases jump, look for the "behind the curve" talk to start getting louder.

Commodities

Commodities were universally lower yesterday, led lower by another sharp drop in WTI crude prices, which was the worst performer on the day. The broad based commodity ETF declined -0.5%.

Starting with WTI crude, it plunged -2.2% yesterday and traded to nearly a 5-month low on technical (the selling accelerated when support at $99 was broken) and general de-risking. Also weighing on WTI was a poor Chicago PMI, which surprisingly dropped 10 points in July to 52.6 from June's 62.6. And, that reading helped put further pressure on WTI (Brent crude was little-changed on the day, so the decline in WTI was not some global supply-related issue).

Going forward, the next level of support beyond $98.00 is $96.50-ish (March lows). For now, I'm chalking up this decline in WTI to general risk aversion across asset classes. I've learned over the past 10 years of trading commodities that as oil goes, so too (generally) go the equity markets. Supply is not the problem, so if this decline in crude continues at the current pace, it'll make me more nervous about the economy and equity prices.

Staying in energy, natural gas bucked the trend yesterday and actually closed positive by +1.27% after the weekly inventory injections were less than expected (88 Bcf vs. (E) 92 Bcf.). And, the smaller than expected injections these last two weeks serve as a reminder that natural gas inventory levels remain more than 20% below historical averages, and we're starting to move toward the end of summer. The supply situation has improved, but longer term I believe there's value in natural gas in the high-$3s.

Turning to metals, yesterday was a perfect example of why trading gold is so frustrating. The stock market declined big time (which, year-to-date, has been positive gold). The reason stocks declined was because of a potential uptick in inflation (which is positive gold). Even the Dollar Index didn't rally that much (positive gold). Yet, gold fell -1% to break through support at $1,294.

And, the reason is pretty simple—gold doesn't trade immediately off positive inflation numbers. Instead, in the short term, it's focused on the fact that the Fed will have to get "tighter" sooner rather than later. Longer term, was yesterday's inflation data positive for gold? Yes. But that takes time for the market to realize. So, unless gold can get back above that $1,294 level sooner rather than later, we'll exit the short term positions and look to buy a deeper dip.

Currencies & Bonds

Bonds were one of the bigger stories yesterday. Despite the S&P 500 falling -2% and the Fed buying $1.3 billion worth of long bonds yesterday morning, the 30-year still ended the day negative (down -0.18%), although off the worst levels of the day.

That decline was obviously reflecting the higher wage inflation numbers previously discussed. I'm very hesitant to make something out of one day, but between the bad breakdown in junk bonds and the past 48-hour performance of the long bond, I believe we are seeing cracks emerge in this bond market as fears of the Fed getting "behind the curve" gather steam.

In an almost-unbelievable replay of last month, the 30-year is once again sitting on the 2014 uptrend heading into a jobs number. Watch 137'00, as a definitive break of that level could signal the uptrend is finally over.

Turning to currencies, despite the carnage in equities, currency markets were relatively stable yesterday. The Dollar Index was flat as it largely ignored the wage data (that tells me the equity market overreacted to the report). The euro was also unchanged as it ignored another underwhelming HICP (their CPI) report, although the reason markets didn't react was because it was largely priced in at a sub-1.34 euro. Bottom line is both currencies continue to be focused on data and central-bank policies. Despite the equity market reaction to the wage data, it's not going to (by itself) change central bank policy. That's why the Dollar and euro didn't really move that much.

Have a good weekend,

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
7/28/14	DBC	25.65	None	*We are going to look to initiate long positions in DBC here as a low risk-high reward opportunity has presented itself. In DBC, support has formed at $25.50 while potential target to the upside is close to the $27 mark. So, you will be risking about 20 cents for a potential return of $2 dollars. Original Issue*
7/21/14	JJC	39.17	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 have initiated a position and look to add to it on further weakness. Original Issue*
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 7.28.14)

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 traded to new intra-day highs last week, although stocks couldn't hold their gains and finished flat. In the very near term stocks feel a bit "tired" and this period of consolidation/correction should last a bit longer. More broadly, though, fundamentals remains bullish and the path of least resistance higher.*
Best Idea: Buy global industrial miners (PICK, FCX, RIO, etc.) **Best Contrarian Idea:** Buy Retailers (XRT)			
Commodities	**Neutral**	**Bullish**	*Commodities in aggregate appear to be trying to bottom, and while that process will take some more time, the outlook for commodities is improving as the global recovery is continuing while inflation (globally) appears to be bottoming.*
Best Idea: Long Oil (USO) **Best Contrarian Idea:** Buy Grains (DBA)			
U.S. Dollar	**Bullish**	**Bullish**	*The Dollar Index broke out to a multi-month high last week, trading through 81 on a combination of good economic data and weakness in other currencies. Broadly the dollar appears to be gaining some momentum as currency traders are starting to price in the potential for the Fed to finally normalize policy.*
Best Idea: Buy the Pound (FXB) **Best Contrarian Idea:** Long Canadian Dollar (FXC)			
Treasuries	**Bullish**	**Bearish**	*Treasuries rallied again last week, driven higher by geo-politics and a "Risk Off" bid. 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)			