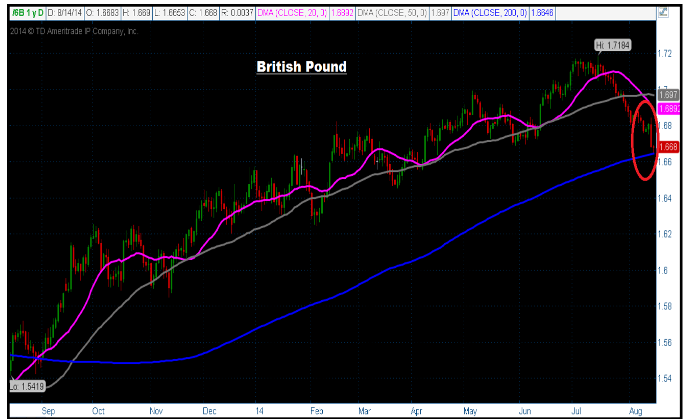
# 7:00's Report

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

***August 14th, 2014***




***The Pound had been bid up all year in anticipation of a "hawkish" BOE, but that's failed to materialize, and an overbought market is now finding more balance.***

## Pre 7:00 Look

- Futures are slightly higher and are bucking the negative trend in Europe as Euro area GDP reports disappointed, but weren't as bad as feared.
- 2Q GDP for Europe wasn't good. French & EU GDP was flat while Germany contracted –0.2% vs. (E) 0.0%. But, there were fears the data would actually be worse, so it's not eliciting a big negative response & the euro is flat.
- Geo-politically, the dreaded Russian convoy has stopped in Southern Russia, other than that things remain static.
- Econ Today: Weekly Jobless Claims (E: 295K).

| Market | Level | Change | % Change |
|---|---|---|---|
| S&P 500 Futures | 1948.25 | 3.50 | 0.18% |
| U.S. Dollar (DXY) | 81.605 | -.052 | -0.06% |
| Gold | 1311.70 | -2.80 | -0.21% |
| WTI | 97.46 | -.13 | -0.13% |
| 10 Year | 2.413 | -.029 | -1.19% |

## Equities

*Market Recap*

Stocks resumed the rally Wednesday despite several pieces of "bad" news, as positioning trumped that actual news. However, the S&P 500 wasn't able to break through resistance at 1,950, but it did rise +5.32%.

At the risk of stating the obvious, stocks rose yesterday because they didn't decline. Yes, some positive things happened yesterday (the Janet Yellen Reuters article, link here, reminded everyone how "dovish" she is; geo-political tensions continued to ease as Iraqi PM Nouri al-Maliki said he would not use military force to protest his ouster; and the dreaded Russian convoy headed to Donetsk still hasn't caused an all-out invasion). But there was much more bad news yesterday morning.

First, Chinese data disappointed—in particular credit creation, which collapsed in July. In Europe, June industrial production contracted vs. expectations of growth. And finally here in the U.S., July retail sales and retailer earnings were bad, as retail sales missed and Macy's (M), which had been the one retailer that performed well, missed earnings and traded down -5.5%.

If I read you that list at 9:29 a.m. yesterday and asked you which direction the stock market was going to go, you'd obviously say "down."

But, the market opened only slightly lower. Once that news failed to elicit the expected decline in stocks, shorts began to cover again after taking a break Tuesday, and investors who reduced long exposure over the past two weeks added on the relative strength.

Stocks rallied throughout the morning as both Fed

| Market | Level | Change | % Change |
|---|---|---|---|
| Dow | 16651.80 | 91.26 | 0.55% |
| TSX | 15262.73 | -11.50 | -0.08% |
| Brazil | 55581.19 | -861.15 | -1.53% |
| FTSE | 6668.01 | 11.33 | 0.17% |
| Nikkei | 15314.57 | 100.94 | 0.66% |
| Hang Seng | 24801.36 | -88.98 | -0.36% |
| ASX | 5548.47 | 33.75 | 0.61% |
| Prices taken at previous day market close. | | | |

speakers (Dudley and Rosengren) provided nothing new, and the S&P 500 hit its high just following the European close. From there, as expected, trading got very quiet and the S&P 500 drifted around in a 4-point range for the remainder of the session, finishing the day just 2 points off the highs.

Point being, the market was driven much more by short-term positioning, technicals and low volumes (which makes the market easy to push around) yesterday than anything fundamental. This continues a trend that's now 10 days old, and it will likely continue into the end of this week.

But, the bulls were not able to punch through resistance at 1,950, and that will remain a key level to watch for the rest of the week.

*Trading Color*

It was a broad rally yesterday, but the cyclicals didn't materially outperform and it wasn't a tremendously "strong" rally. The Russell 2000 only slightly outperformed (up +0.77% vs. +0.67%) vs. the S&P 500, and SPHB was up only 30 basis points more than SPLV.

All ten S&P 500 subsectors were higher, led by healthcare, which got a boost from biotech, and tech also outperformed. More other sectors traded mostly in line with the broad market, rallying between .3% and .5% in light volume.

On the charts the S&P 500 is now sitting right below resistance at 1950, which is the lower bound of the recent 1985-1950 trading range, and if stocks can break through that resistance, we may see more of a "chase" as managers move to add back previously reduced exposure. Material new highs, however, will only come with some more clarity from the Fed on future policy, and that's not till next week, at the earliest.

## Economics

Retail Sales

- Retail Sales were unchanged in July vs. (E) +0.2%

*Takeaway*

Yesterday's retail sales report was a disappointment, but it wasn't a terrible report. Retail sales in July were unchanged month-over-month vs. analyst expectations calling for a +0.2% rise. The details of the report were also on the disappointing side as the important "control group" (which is retail sales ex-autos, building materials and gasoline stations, and the best gauge of discretionary consumer spending) rose just +0.09% in July.

Stocks and the Dollar Index sold off, while bonds and gold futures rallied sharply upon the release in a broad flight-to-safety move. However, the reaction was likely amplified by the thin-liquidity environment we are currently in. Bottom line, this was the second miss in a row in the monthly retail sales report, but the data isn't bad enough to materially negatively shift the outlook for the consumer. But, this report will likely result in Q3 GDP estimates being adjusted slightly lower (say 3.7% or 3.8% from 4.0%).

| Market | Level | Change | % Change |
|---|---|---|---|
| DBC | 25.15 | -.01 | -0.04% |
| Gold | 1313.50 | 2.90 | 0.22% |
| Silver | 19.87 | -.035 | -0.18% |
| Copper | 3.1145 | -.04 | -1.27% |
| WTI | 97.42 | .05 | 0.05% |
| Brent | 104.89 | 1.00 | 0.96% |
| Nat Gas | 3.820 | -.154 | -3.88% |
| RBOB | 2.7467 | .0122 | 0.44% |
| DBA (Grains) | 26.06 | .02 | 0.08% |
| Prices taken at previous day market close. | | | |

## Commodities

Commodities were mixed yesterday in a session primarily driven by economic reports and supply data. The benchmark commodity tracking index ETF, DBC, was essentially unchanged, down -0.04% on the day.

Beginning with crude oil and the refined products, the EIA released weekly inventory data that were mixed, and WTI futures were little-changed on the day. Crude oil supplies surprisingly increased +1.4M barrels vs. (E) -1.7M, RBOB gasoline stocks fell -1.2M barrels vs. (E) -1.3M, and distillate supplies declined -2.4M barrels vs. expectations calling for a +300K barrel increase. It is worth noting that the surprise draw in distillates led heating oil to be the best performer yesterday, adding +1.92%.

The key takeaway from yesterday's trading session in the energy space is that the downward momentum in crude oil futures has come to a halt (for now anyway) as support has formed and held strong at $97/bbl. I say that because if WTI was going to materially break down through $97, yesterday's surprise build in crude inventories would have been enough reason for the bears to put the selling pressure on and push through the stops.

It is also worth noting that inventories at Cushing, Okla., the delivery point for WTI, also rose last week (up +400K bbls to 18.4M bbls). This is bearish for crude prices as declining supplies there has been supporting the market over the past few months.

Having said all of that, crude oil futures do still have a ways to go and we need to see a breakout above the resisting downtrend line (currently between $99 and $100) before we get full-on technically bullish. However, we remain fundamentally bullish based on our improving domestic economy, which should lead to steadily increasing energy and petroleum demand.

Moving to natural gas, prices got annihilated yesterday. Futures dropped -3.8% as short-term longs took profits and traders positioned ahead of this morning's EIA report. Also, natural gas clearly remains very sensitive to weather reports, as forecasters adjusted their expectations for next week's heat wave that will affect most of the nation. Meteorologists are now saying that a cold front pushing down from Canada will cause the heat wave to be shorter than initially thought.

With all of that in mind, the line in the sand for the bulls is the late-July low of $3.72. Today, the primary focus will be on the EIA number (out at 10:30 AM), and a surprise either way vs. estimates (E: +86 Bcf) could see futures test that support level or the opposite—potentially causing a squeeze-style rally back toward the $4 mark. Near term we remain cautiously bullish, as yesterday's sell-off was an ugly one. But over the longer term, we continue to believe natural gas is a value at these levels.

Moving to the metals, gold futures were little-changed yesterday, up just +0.22%. Most of the move higher came early in the day as a result of the disappointing retail sales report that hit at 8:30 a.m. Lately gold prices have not been making material moves on economic data, as speculation of Fed policy remains the primary driver and traders simply seem to be sitting back and watching economic data.

But, liquidity is clearly thin as "headline reading" algorithms spurred the nearly $10 rally upon the data release. Bottom line, gold traders are waiting on the more-important data/Fed releases due out next week (CPI and Jackson Hole). Until traders start to position next week, we are likely going to tread water around the $1,300 mark.

Copper futures also took a hit yesterday, falling -1.27% on more weak Chinese economic data. It was not so much the slightly soft retail sales or FIA reports but rather data regarding credit creation, which saw a steep drop.

Looking ahead, copper will continue to trade with great sensitivity to Chinese (and, to a lesser degree, U.S.) economic data. And, we don't believe that a slight pullback in data is enough to materially change our view on copper just yet. So, we continue to be cautiously bullish on copper and will be paying close attention to upcoming Chinese economic reports.

## Currencies & Bonds

The big mover in the currency space yesterday was the pound, which plunged -0.75% vs. the dollar to trade to a multi-month low following a "dovish" inflation report. The report was dovish for two reasons: First, wage inflation, which ultimately begets broader inflation, was much more subdued than expected. This makes it less likely the Bank of England will have to raise rates in the near term in response to a growing inflation threat.

| Market | Level | Change | % Change |
|---|---|---|---|
| Dollar Index | 81.665 | .11 | 0.13% |
| EUR/USD | 1.3365 | -.0004 | -0.03% |
| GBP/USD | 1.6689 | -.0123 | -0.73% |
| USD/JPY | 102.40 | .15 | 0.15% |
| USD/CAD | 1.0917 | -.0006 | -0.05% |
| AUD/USD | .9303 | .0039 | 0.42% |
| USD/BRL | 2.2809 | .0044 | 0.19% |
| 10 Year Yield | 2.413 | -.029 | -1.19% |
| 30 Year Yield | 3.241 | -.025 | -0.77% |
| Prices taken at previous day market close. | | | |

Second, with regard to the pace of rate hikes: BOE Governor Carney stressed that once rates begin to rise, the rise will be extremely gradual. (In other words, that pace vs. time distinction differentiation we talked about with regard to the Fed in the Report last week.)

Was the Inflation Report really dovish? No, not really.

But, the pound had been bid up to multi-year highs on the expectation that the Bank of England was about to turn materially more hawkish, and possibly raise rates by the end of this year. But, this Inflation Report somewhat contradicts that notion, as clearly the BOE, for now, is more dovish than the market expected. And, given that investors were very "long" the pound, we are now seeing the market restore some balance.

Stepping back, we could see the pound fall further vs. the dollar as the outlook for each central bank changes at the margin (the BOE slightly more dovish; the Fed slightly more hawkish). The 200-day MA at 1.6642 will offer some support, but I think patience is required now in the "long pound" trade.

The BOE will still likely be the first major developed central bank to raise rates, but the gap between when they are expected to move and when the Fed is expected to move is narrowing, and that'll be a further headwind on the pound.

Turning to the yen, it was the other currency that moved decently yesterday, as it fell -0.25% but finished well off the lows. The catalyst there was a horrid headline Q2 GDP report, that saw Q2 GDP fall by 1.7%% and 6.8% year-over-year (saar).

But, the numbers were actually slightly better than expected, and the big drop in Q2 GDP was a reflection of the implementation of the higher national sales tax. Bottom line is yesterday's data, while shocking on the headline, doesn't really change anyone's outlook for the Japanese economy or the yen, as we should see a big bounce back in GDP in Q3.

More broadly, the next area of focus in the "short yen/ long DXJ" trade is on financial reform and the shift in allocations for Japanese pension funds into domestic equities. They are expected to come later this fall, and until we get more color on those issues, I'd expect the dollar/yen pair to continue to trade in the 101-103 range.

Finally, turning to the Dollar Index, it ended the day slightly higher (up +0.13%) as weakness in the pound and yen helped offset the weaker retail sales report and helped the Dollar Index finish slightly higher. The euro, meanwhile, was slightly weaker ahead of the key GDP reports this morning.

Euro-area GDP was slightly weak this morning, as French and EU Q2 GDP both were flat vs. (E) 0.1% growth, while Germany actually contracted in Q2 (-0.2% vs. (E) 0.0%).

Clearly the GDP reports confirm what we all expected—that the recovery in Europe has lost momentum. But, importantly, the euro is fractionally higher this morning, and that again confirms my point made yesterday that a lot of this loss of momentum is already priced into the euro, and in order to get the euro materially weaker from current levels, we'll need to see data get even worse……..or the Fed turn more hawkish and send the dollar higher. Short of those two things, I think we'll see a near-term pause in this euro decline.

Looking at bonds, the soft retail sales report combined with the Reuters article that reiterated Yellen is very scared of raising rates too soon (nothing new, but a nice reminder to the market) helped put upward pressure on Treasuries, as the 30 year bond rallied .31%. The 10-year yield was down again and remains just above 2.40%, while junk bonds rallied as JNK retook the $41.00 level, which is a good omen for stocks if it can hold.

Fundamentally there was a solid 10-year Treasury auction ($24 billion) that saw a bid to cover (measure of demand) of 2.83, the third highest this year. Although there were a high number of bids, the bidding itself wasn't too aggressive (the final yield was about a ½ basis point higher than the "When Issued," showing slightly soft bidding). Regardless, though, clearly there remains a decent appetite for the 10-year even with this low yield. Given the economic data and marginally shifting Fed outlook, that continues to puzzle and worry me.

Money flows and momentum continue to trump fundamentals in the bond market. One day, we will all likely make a boatload of money shorting bonds. But that's not today, and we will have to wait for the break. Until then, I remain on the sidelines for anything other than long-term positions.

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 |
|---|---|---|---|---|
| **7/28/14** | 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** | UNG | 20.98 | None | *We are replacing the "long copper" trade on the tactical sheet with our "long natural gas" call because of the time frames of the two trades. Copper is a long term fundamental play dependent on continued global economic growth (namely in China) while buying nat gas is a medium term trade based on smaller supply injections and warming weather patterns. "Long Copper" has been moved to the ACD. Original Issue.* |
| **6/11/14** | SPHB | 32.73 | 30.32 | *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<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 (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 8.11.14)**

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 suffered its biggest weekly decline in a long time last week, and although fears of faster than expected Fed tightening were the main "cause," really this remains part of a larger correction/consolidation that has been going on since early July. Stepping back, though, the outlook for Fed policy didn't change, and with still strong fundamentals the benefit of the doubt remains with the bulls.* |
| **Best Idea:** Buy global industrial miners (PICK, FCX, RIO, etc.)<br>**Best Contrarian Idea:** Buy Retailers (XRT) | | | |
| **Commodities** | **Neutral** | **Bullish** | *Commodities broke down badly last week after WTI Crude plunged 4% on general "risk off" sentiment and dollar strength. The stronger dollar is becoming a headwind for broad commodities in the near term, but with global growth improving further and inflation bottoming, longer term the set up is still bullish.* |
| **Best Idea:** Long Oil (USO), Long Copper (JJC)<br>**Best Contrarian Idea:** Buy Grains (DBA) | | | |
| **U.S. Dollar** | **Bullish** | **Bullish** | *The Dollar Index traded basically to the highs of the year last week before giving some back after Friday's jobs report. The Dollar Index is overbought here and in need of some very short term digestion, but with inflation now squarely in focus of the market, the upward trend should continue.* |
| **Best Idea:** Sell the Yen (YCS)<br>**Best Contrarian Idea:** Long Canadian Dollar (FXC) | | | |
| **Treasuries** | **Bullish** | **Bearish** | *Treasuries actually declined last week on rising inflation concerns, although the 30 year again held a test of the 2014 uptrend thanks to Friday's jobs report. Fundamentals continue to turn negative for Treasuries, but the near term trend remains higher.* |
| **Best Idea:** Short "long" bonds (TBT)<br>**Best Contrarian Idea:** Short High Yield Bonds (SJB) | | | |