7:00's Report

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

August 15th, 2014

Pre 7:00 Look

- Futures are modestly higher as yesterday's rally continued o/n, with all major foreign markets finishing higher despite it being a quiet evening news-wise.
- Economically there was only one report, as Great Britain 2Q GDP met estimates (up 0.8% q/q, 3.2% yoy).
- In Iraq, former Iraqi PM al-Maliki will not further protest his ouster (a positive), while focus in Russia remains on the mysterious convoy, but the situation is unchanged o/n.
- Econ Today: July Empire State Manufacturing (E: 20.0). July Industrial Production: (E: 0.3%). Fed Speak: Kocherlakota (10:45 AM EST).

Market	Level	Change	% Change
S&P 500 Futures	1958.50	5.00	0.26%
U.S. Dollar (DXY)	81.60	-.047	-0.06%
Gold	1314.80	-.090	-0.08%
WTI	95.65	.07	.07%
10 Year	2.400	-.013	-0.54%

Equities

Market Recap

The rally continued Thursday as the S&P 500 was higher all day and broke through resistance at 1,950 thanks to further de-escalation in Ukraine and buyers re-applying long positions. The S&P 500 rose +0.43%.

Stocks were positive from the outset yesterday thanks to multiple factors, the most-cited of which was a somewhat "conciliatory" tone from Vladimir Putin during a speech yesterday morning. That speech continued the marginal de-escalation of the situation in Ukraine.

Additionally, jobless claims oddly were a bit of a tailwind on stocks, as the uptick is seen as helping to keep the Fed from getting too "hawkish." Incidentally the market largely ignored Fed President Bullard yesterday saying he thinks rates should rise in March; then again, he's not a leader in the FOMC. (Honestly since Fed presidents became quasi-celebrities these last few years, I think some of them (Bullard particularly) like to make predictions and bold statements just to get their names in the headlines, but I digress.)

The rally was methodical yesterday as stocks basically went out on the highs of the day after crossing through 1,950 before lunchtime. It felt like the buying was "painful" as managers aren't long enough and begrudgingly added exposure. The afternoon was quiet and stocks basically treaded water from 1:30 into the close.

Bottom Line

FOX BUSINESS

I'll be joining host Stuart Varney during the noon hour today to discuss what's next for the markets. Tune In!

I know geopolitics have been in focus this week, but I believe the real reasons stocks are up +2.5% from the lows of last week is the Fed. Between Fed Vice Chair Fischer's unemployment comments Monday, the Reuters article Wednesday, "dovish" BOE Inflation Report and the lackluster (but not bad) retail sales and jobless claims report, I think the market is a bit more comfortable with the Fed (and other global central banks) not getting as "hawkish" as was previously thought.

Whether that's reality or not we'll see, starting next week with Jackson Hole. But from a market sentiment standpoint, I think some of the "Fed angst" receded this week, and that's why we're back in the 1,950-1,985

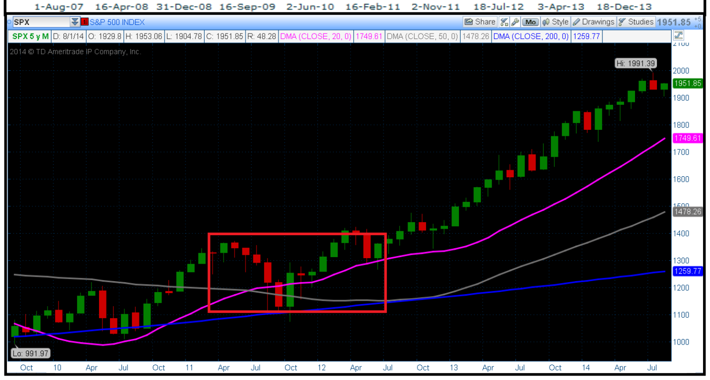
Market	Level	Change	% Change
Dow	16713.58	61.78	0.37%
TSX	15291.18	28.45	0.19%
Brazil	55780.41	199.22	0.36%
FTSE	6728.23	42.97	0.64%
Nikkei	15318.34	3.77	0.02%
Hang Seng	24954.94	153.58	0.62%
ASX	5566.52	18.05	0.33%
Prices taken at previous day market close.			

range in the SPX.

Going forward, though, I still have a hard time seeing how we get materially higher from current levels without more actual clarity from the Fed and a moderation in economic and inflation data (it needs to be Goldilocks going forward).

Market	Level	Change	% Change
DBC	24.85	-.29	-1.14%
Gold	1314.80	.30	0.02%
Silver	19.885	.04	0.20%
Copper	3.09	-.022	-0.71%
WTI	95.62	-1.97	-2.02%
Brent	102.12	-2.94	-2.80%
Nat Gas	3.898	.067	1.75%
RBOB	2.6722	-.0822	-2.98%
DBA (Grains)	26.05	.02	0.08%
Prices taken at previous day market close.			

So, I would not be aggressively chasing and adding long exposure here, as I don't think we're done with Fed "angst"— rather, we just got a little ahead of ourselves. Also, oil is collapsing, as you know … and the correlations between violent moves in oil and stocks have been high over the past few years. I'm not saying it's a reason to get bearish, but supply isn't building *that* much, so this is something to watch.



What Happens When The Fed Stops Buying?

We covered the shrinking ECB balance sheet earlier this week, but with the end of QE fast approaching, I wanted to see what has happened the last two times the Fed balance sheet contracted.

Since 2009, the Fed's balance sheet has contracted two times: July 2011 to December 2011, and from February 2012 to January 2013.

During the first decline, the S&P 500 fell from 1,292 to 1,257, a 35-point decline or just under 3%. During the second decline, the S&P 500 actually materially rallied, from 1,365 in February 2012 to 1,513 in January 2013. So, based on headline results, the events appear inconclusive.

But, as usual the devil is in the details.

First, the stock market declined ahead of the actual end of both rounds of QE.

The market topped in April 2010, two months ahead of the official end of QE1, and didn't recover those levels until December of that year.

With QE2, the market topped in May 2011, 2 months ahead of the end of QE2, and bottomed in September before taking off on a big rally into the end of the year. But, we have to keep in mind that this bottom coincided with the announcing of "Operation Twist" by the Fed, so even though there was no QE, there was Fed stimulus.

But, I think we need to step back a bit to really glean any insight here. Basically, the Fed's balance sheet stayed more or less static in size from July 2011 (end of QE2) until the end of 2012.

And, importantly, the S&P 500 was basically flat from May 2011 (selling off ahead of the end of QE2) until June 2012, before it embarked on a rally that simply hasn't stopped.

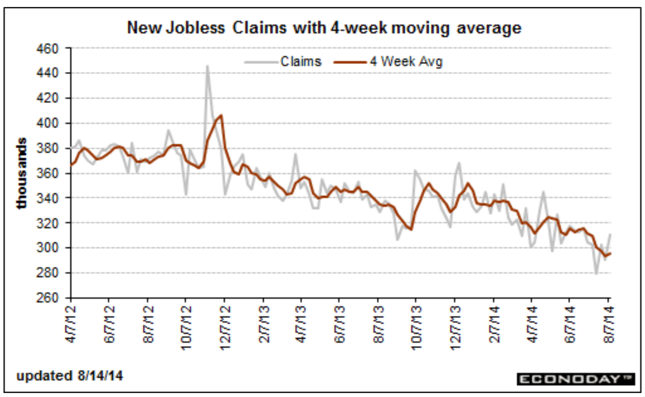
Now, technically the stock market rallied hard from June 2012 into the end of the year, a period when the Fed balance sheet was stagnant. But, starting in June of that year, "QE Infinity" was being very, very heavily telegraphed by the Fed. Although it was announced in September, everyone already knew it was coming and the market rallied ahead of it starting in June. So, although the Fed balance sheet wasn't actually expanding, the market knew another round of QE was coming.

This is obviously not the most scientific analysis, but I don't think we need Ph.Ds. in finance to glean a few takeaways from it:

First, Stocks (as usual) Anticipate: The market sold off ahead of the "end" of both QEs. And while it's true the economy is better now than it was then, I'll point out that the S&P topped basically 2 ½ months ahead of when we all expect QE to end (in late October).

Second, No Stimulus, No Rally (but not a collapse, either): The market seems to have been stagnant from a performance standpoint when the Fed's balance sheet wasn't actively expanding, or wasn't anticipated to materially expand in the near future. Stocks didn't collapse when the Fed's balance sheet was stagnant, but it took the expectation of more QE (or stimulus in the form of Operation Twist) to ignite a rally.

Third, Size Matters: The periods of decline we've seen in the Fed's balance sheet were very small: The $58 billion decline from July 11 to Dec. 11 was less than 2% of the Fed $2.87 trillion balance sheet. The $133 billion decline from February 2012 to January 2013 was just 4.5% of the Fed's $2.93 trillion balance sheet. The Fed's balance sheet is now well over $4 trillion, nearly 30% bigger, and none of us have any idea what will happen once it starts declining by 10%, 20%, 30%, etc.



So, what's the takeaway?

We're likely seeing what we've seen before – the market getting cautious ahead of the end of a Fed QE program, and that process will continue as we approached the end of QE in October.

But, I think this stresses again how important the "pace" of both the decline in the balance sheet and the rate of increases is much more important than the timing. So, just because the Fed stops new QE, all it's meant in the past is the market stops going up. Of course, we've never seen the balance sheet this big before or the market this extended.

Finally, if we begin to see the Fed's balance sheet begin to drop materially, no one knows what the market will do in that instance (although common sense gives me a good idea). While the economy has gotten better, it's not pure coincidence that we've seen this unbelievable rally in stocks that coincided with the Fed's balance sheet rising 30% in less than two years.

Bottom line: Watching the Fed balance sheet is now becoming very, very important from a tactical allocation standpoint, and we will be monitoring changes to the Fed balance sheet once QE Infinity ends.

Economics

No materially important economic reports were released yesterday.

Commodities

Commodities were mixed yesterday as energy badly underperformed thank to weak economic data and bearish supply news. Meanwhile the metals were little-changed but natural gas was the best performer on a bullish inventory report.

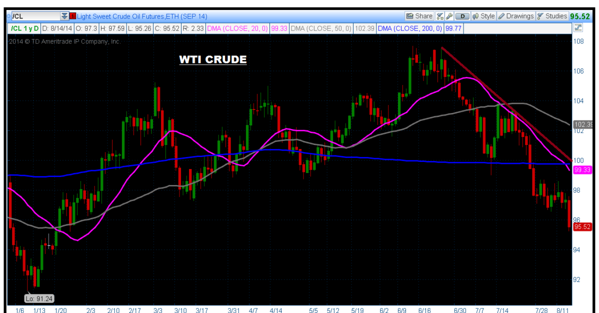
Natural gas futures bounced back nicely yesterday, adding +2.15% and making up much of the losses seen on Wednesday. Natural gas prices plummeted Wednesday as spec longs, who were betting on increased demand as a result of warmer weather in the forecast, closed positions on news that temperatures will not be as hot as initially expected.

Market	Level	Change	% Change
Dollar Index	81.65	-.007	-0.01%
EUR/USD	1.3366	.0002	0.01%
GBP/USD	1.6683	-.0003	-0.02%
USD/JPY	102.45	.04	0.04%
USD/CAD	1.0904	-.0006	-0.06%
AUD/USD	.9317	.0015	0.16%
USD/BRL	2.2695	-.01	-0.34%
10 Year Yield	2.400	-.013	-0.54%
30 Year Yield	3.192	-.049	-1.51%
Prices taken at previous day market close.			

But, as is normally the case with natural gas, there is a very close relationship between weather, inventories and prices. And, the results of last week's inventory report (that was released yesterday) were bullish and traders reacted accordingly. Natural gas inventories rose a smaller than expected 78 Bcf (analysts were calling for an 86 Bcf build). Bottom line, natural gas inventories remain 19% below the five-year average. With the possibility of market-moving weather events looming (namely heat waves and hurricanes), there remains a risk for further short-covering as well as a fundamental price rally as we approach the “draw season.”

Crude oil crashed through the recently formed support level that most energy traders were eyeing at the $97 level yesterday, finishing the day down -2.01% with a $95 handle amidst disappointing economic data and bearish supply news.

Brent prices were hit even harder, down -2.88% as the trend of poor economic data in the EU continues as well as headlines that Libya exported the first shipment of oil from the Ras Lanuf terminal since last year. Additionally, exports from the country’s largest oil port, Es Sider, are set to resume next week.



WTI Crude has collapsed in the last two months and is nearing the lows of the year.

So, a handful of bearish news out recently is taking a toll on the energy markets over the near term; however, barring any material reversal in domestic economic growth metrics, WTI futures remain a value at these levels as demand is set to rise in lockstep with further economic expansion.

On the charts, we are looking to the psychological $95 level for initial support while technical support lies below at $94.78 in the Nymex contract. However, futures remain in a steep downtrend and we need to see that downtrend broken before becoming near-term technical bulls.

Gold futures were again flat yesterday, up a nominal +0.03% on the day. But it is worth noting that we again saw a knee-jerk reaction to economic data as the weekly jobless claims disappointed on the headline, warranting another $10 spike in price. Futures did recover and the takeaway is that trading in precious metals remains thin ahead of the key inflation data (CPI) and even more important Fed-speak next week (Jackson Hole). On the charts, it looks like more of the same as futures are drifting sideways just above the $1,300 mark with no clear bullish or bearish trend in place.

Currencies & Bonds

Bonds rallied yesterday mostly thanks to universally weak global economic data. 2Q GDP reports for France and the EU were flat while German GDP fell -0.2% vs. (E) 0.0%. As a result the German 10-Year Bund yield fell below 1.0% for the first time ever, and U.S. Treasuries rose in sympathy. The 30-year bond closed up +0.43% while the 10-year note finished up +0.11% with a yield of 2.40% even. As long as there is significant buying pressure on German bunds, Treasuries will have a hard time declining.

After a volatile couple of days, currency trading was downright boring yesterday. The big mover on the day the Aussie which rallied +0.19% on the day (so that tells you how slow it was). The rally was mostly just some mild short-covering as the Aussie is squarely in the middle of the now months-long $0.92-$0.94 trading range.

Despite not moving yesterday (it was literally unchanged) the euro was the most interesting currency yesterday. By now you know the EU GDP numbers were a disappointment in the absolute, but the euro clearly had already priced in this “stall” in the EU recovery. So, in order for the euro to go materially lower from current levels, we’ll have to see one of three things: 1. The economic data worsening and expectations growing that the ECB will do more. 2. The ECB hints it’ll do more (this is unlikely without the latter occurring, because what the ECB announced in June isn’t even in place yet. 3. Expectations for the Fed get materially more “hawkish,” which would see the euro decline solely as a result of dollar strength.

Given that fact, unless EU economic data turn materially worse (and seasonally we should be entering a period when it get better), I think the euro will try to hold the upper 1.33 level for now.

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	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 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 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.) **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) **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) **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) **Best Contrarian Idea:** Short High Yield Bonds (SJB)			