7:00's Report

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

August 25th, 2014

Pre 7:00 Look

- U.S. futures and most international markets are higher this morning as traders continue to digest the central bank "speak" from Jackson Hole last week.
- Economically, the German IFO Survey was the only notable release o/n (106.3 vs. (E) 107) and the slight miss is putting additional pressure on the Euro this morning.
- Geopolitically, the "spot light situations" remain largely the same as rocket fire continues on the Gaza strip, while a Russian separatist assault was squashed by Ukrainian officials near the Russian border earlier this morning.
- Econ Today: New Home Sales (E: 430k).

Market	Level	Change	% Change
S&P 500 Futures	1993.75	6.00	0.30%
U.S. Dollar (DXY)	82.535	1.58	0.19%
Gold	1278.10	-2.10	-0.16%
WTI	93.84	.18	0.19%
10 Year	2.403	-.004	-0.17%

Equities

Last Week

The S&P 500 traded to new all-time highs last week on the back of strong economic data and a continued reduction in Fed policy "angst." The S&P 500 rose +1.71% last week and is up +7.58% year to date.

Stocks were higher every day last week except Friday, as a continued reduction in geopolitical concerns helped stocks rise Monday. Meanwhile a benign CPI report and better than expected housing starts number pushed markets higher Tuesday.

The S&P 500 was flat Wednesday going into the FOMC minutes release, but rallied after the minutes weren't as hawkish as feared, and the benchmark index closed at a new all-time high. The rally continued Thursday as the SPX broke through 1,990 thanks to strong flash manufacturing PMIs, Philly Fed survey results and jobless claims. But then stocks took a breather and closed fractionally lower into the weekend.

Geopolitically there was another "scare" Friday when the dreaded Russian convoy went into Ukraine without permission. But despite the ominous headlines, the situation remains mostly static. This "humanitarian" convoy is seen mostly as a move by Vladimir Putin to help bolster the Russian separatists ahead of his meeting with Ukrainian President Poroshenko later this week. (So the move was for negotiating leverage, not because Putin wants to engage.)

Trading Color

The S&P 500 hit new highs last week so obviously that's bullish. But it wasn't a really strong rally, as we didn't see material outperformance by the Nasdaq or Russell 2000 vs. the S&P 500 (the SPX and RUT were both up about +1.6%).

But, SPHB handily outperformed SPLV (up +2.6% vs. +1.2%) and I think what that tells us is the underinvested managers who were adding exposure last week still prefer to go into high-beta large-/mid caps (in the S&P) compared to small caps. So even though the market is rallying to new highs, we may not see the "catch up" from small caps just yet that everyone is expecting. Point being, if I'm looking for higher-beta long exposure, I'd still prefer SPHB over IWM despite the performance gap of the latter vs. the S&P 500.

Looking at the sector trading, the retailers were a stand-

Market	Level	Change	% Change
Dow	17,001.22	-38.27	-0.22%
TSX	15,535.55	-20.54	-0.13%
Brazil	58,407.32	-584.79	-0.99%
FTSE	6,775.25	-2.41	-0.04%
Nikkei	15,613.25	74.06	0.48%
Hang Seng	25,166.91	54.68	0.22%
ASX	5,634.89	-10.73	-0.19%
Prices taken at previous day market close.			

out, as last week saw a lot of earnings and generally they were better than expected (HD and TJX were two notable performers). There were negative (TGT and LOW) reports too, but the disappointing results were more about company specifics than universally depressed consumer activity. This is a positive for the broader market. RTH, the retailer ETF, rallied +3.6% to a new 52-week high. This space, even despite the recent run-up, remains largely under-owned and under-loved.

Market	Level	Change	% Change
DBC	24.87	-.04	-0.16%
Gold	1281.80	6.40	0.50%
Silver	19.395	-.02	-0.10%
Copper	3.2045	.0285	0.90%
WTI	93.36	-.60	-0.64%
Brent	102.20	-.43	-0.42%
Nat Gas	3.842	-.047	-1.21%
RBOB	2.737	-.0105	-0.38%
DBA (Grains)	25.93	.05	0.19%
Prices taken at previous day market close.			

Banks were another sector that did well last week, as both KBE and KRE (the broad bank ETF and regional bank ETF) rose +2.7% and +3.0% respectively. Most of that was due to a breakout Thursday resulting from the BAC settlement with the Justice Department, but there was also a subtle "higher rate" trade on late last week. Utilities, telecom and other "bond proxy" sectors lagged, while banks and homebuilders traded higher. I continue to like KRE at these levels.

Volumes and activity were again depressed last week despite the strong rally (I feel like I say that every week) but part of that was the calendar. On the charts the S&P 500 is inching toward 1,900 while support sits at 1,985.

Bottom Line

Despite all the geopolitical, economic and Fed-related headlines, this market remains driven much more by positioning and sentiment than any material changes to the fundamental backdrop.

From a fundamental perspective, nothing has really changed with regard to the "4 Pillars of the Rally." 1. Central banks remain historically accommodative, and while there is growing concern about changes at the margin, even when the Fed and BOE raise rates, it'll be very, very slowly. 2. The macro horizon remains mostly clear, as Russia/Ukraine and Iraq are getting better but even at their worst weren't a material threat to the rally. 3. The global economy is still recovering, although Europe is an area of concern). 4. And valuations remain elevated but not unreasonable (S&P 500 at 14.52X 2015 $130/share earnings).

The most recent correction was in response to increased Fed angst, and those types of temporary dips will continue. But in aggregate nothing has changed over the last month.

Instead, the market simply needed to consolidate. As has happened multiple times over the last two years, investors decided the most recent correction was "it," and they de-risked … only to find themselves not long enough when the market rebounded.

Point being, last week's rally was much more about positioning and investors' charge to add exposure than a reaction to any new, positive news.

Going forward, this week will be slow. While sentiment and positioning still favor the bulls, it's a lot less now than it was. I continue to think another period of consolidation/chop is needed, although a slight drift higher to at least test 1,900 this week wouldn't shock me. I continue to like new allocations to SPHB, KRE and Europe, which I think can outperform in Q4.

Economics

Last Week

Despite being a busy week of economic data and Fed events, not a lot changed. Economic data domestically continued to be good but not too good, Europe remains a concern as the recovery has lost positive momentum, and the outlook for Fed policy remains static. Yellen and the FOMC minutes could be called ever so slightly "hawkish," but it's not changing anyone's expectations of when or how quickly rates will rise.

Starting first with the Fed, the FOMC minutes are being referred to as "hawkish" but that's mainly because there was more discussion about the economy getting closer to the Fed targets for inflation and employment. But there wasn't enough of a discussion by enough members to warrant a significant pulling forward of when the Fed will hike rates (still mid-2015) or, more importantly, how quickly the rate hikes will occur. (It's still expected to be a very, very gradual process.)

Turning to Yellen's speech at the Jackson Hole conference, it was a non-event. Like the minutes, some analysts are trying to spin it as "hawkish," but it wasn't. She again stated clearly that the issues affecting the labor market are "cyclical" not "structural"; and as a result, they can be at least partially fixed via policy (meaning the Fed will stay easy for a long time).

The "hawkish" interpretations come from the fact that she wasn't as emphatically "dovish" in her comments as she normally is. But, she does have to acknowledge the improvement in the economy to some degree to keep legitimacy.

Bottom line with the Fed is that the outlook is still for rate hikes in May-September 2015, and a very gradual increase once they start. It seems the market is more focused on the latter than the former, and correctly so (the pace is more important than the start date).

Going forward, we need to watch wages with regard to the Fed—any signs of wage inflation will be the key economic catalyst for the Fed legitimately getting more hawkish—but for now it's steady as she goes.

Looking at the data last week, it was good but not so good that it pulls forward Fed expectations (so "Goldilocks"). Housing importantly showed signs of life as housing starts and existing home sales bounced back nicely from June weakness. Importantly the single-family component numbers rose in July (single-family metrics are the best gauge of the "housing" market).

Manufacturing activity continued to be strong, as Philly Fed beat expectations (28.0 vs. 20.0) while flash August manufacturing PMI also beat (58.0 vs. 56.3). The New Orders component in Philly did decline, however, which means we may see a moderation of this pace going forward. On an absolute level, manufacturing activity remains strong.

Market	Level	Change	% Change
Dollar Index	82.375	.167	0.20%
EUR/USD	1.3242	-.0039	-0.29%
GBP/USD	1.6572	-.0008	-0.05%
USD/JPY	103.95	.10	0.10%
USD/CAD	1.0943	.0002	0.02%
AUD/USD	.9317	.0014	0.15%
USD/BRL	2.2775	.0088	0.39%
10 Year Yield	2.403	-.004	-0.17%
30 Year Yield	3.157	-.035	-1.10%
Prices taken at previous day market close.			

Finally, July CPI showed that the uptick in inflation we saw from March to May slowed, giving the Fed some cover, while jobless claims dropped back below 300K. So, all in all it was a good week of data.

Internationally, Chinese flash manufacturing PMIs were the surprise negative, dropping to a 3-month low but importantly staying at the 50 level. And, while a miss, the Chinese economy remains stable (and better than it was earlier this year).

In Europe, the flash PMIs had gives and takes (France was bad, Germany was good). But overall, the data met expectations. Plenty of reasons remain to worry about the EU recovery, as it has lost momentum and is only barely moving forward at this point. Europe remains the biggest area of economic concern globally.

This Week

It'll be a pretty slow week, which is part of the reason I chose it for my "vacation."

In the U.S. we get new home sales this morning, July durable goods tomorrow, and on Thursday a revised look at 2Q GDP (the revision should not differ materially from the first look, but if it's a print in the mid- to low-3%, that may spook markets a bit) as well as weekly jobless claims.

With the exception of GDP, none of those numbers should have much of an effect on the overall outlook for the economy—unless they are huge misses (or beats), which is unlikely.

Oddly, the most-important day this week will be Friday. First, we get the latest flash HICP from Europe (their CPI), and given the growing concerns about the EU economy, that'll be the most-watched number this week.

In the U.S., personal income and outlays will be released Friday morning. That's important because it contains the Fed's preferred measure of inflation, the PCE Price Index. Given the moderation in CPI, we should see something similar in Friday's report, but it'll still be worth keeping an eye on.

Bottom line, though, between the lack of data and attendance at trading desks/offices, this week should mostly be a non-event from an economic/policy standpoint.

Commodities

Commodities were mixed last week. Copper and natural gas futures outperformed on a bullish research report and speculative buying, respectively. Meanwhile crude oil and gold prices fell amidst economic data, Fed-speak and geopolitics. DBC fell -0.28% on the week.

Copper traded very well last week, finishing as the best performer in the space, adding +3.4%. Much of the rally in futures was seen on Wednesday as a result of the research report released by commodities “powerhouse” Glencore that cited favorable fundamentals in the copper market. And, even more importantly, copper futures held onto Wednesday’s gains (and then some) Thursday despite a soft Chinese manufacturing PMI. Bottom line, a steady uptrend has formed on the daily chart that dates back to the March lows ($2.87), which is finally agreeing with the bullish fundamentals of industrial metals (due to steady global economic growth).

Natural gas also traded well last week, gaining +2.6%. The delicate supply situation remains in focus and it is becoming apparent that there are plenty of value and spec buyers in the market at these levels. On Thursday the EIA reported a slightly larger than estimated build in supplies (88 Bcf vs. E: 86 Bcf). Prices dropped on the release, but the sell-off was short-lived as the “dip buyers” defended support at $3.80. Going forward, we remain bullish NG as the supply situation is bullish while the technicals are also shifting to favor the bulls.

Crude oil futures seem to be looking for a bottom after seeing sharp declines since the June highs. But, until we see trend resistance broken, we will remain sidelined in the trade. Crude fell -1.87% last week.

Gold broke down a bit last week as futures fell -1.7% on the general “hawkish Fed interpretations,” which in turn led to fresh highs in the dollar and gains of +1.1% on the week in DXY. Near term, the stronger dollar will continue to be a headwind for gold; however, potentially rising inflation remains in focus and will continue to offer an underlying bid.

This week, the PCE component of the personal incomes and outlays report will be closely watched while the technicians will have an eye on support at gold $1,270.

Currencies & Bonds

Is “King Dollar” back? Not yet, but the Dollar Index surged to new highs for the year last week, trading above 82 thanks to strong U.S. data and lackluster foreign data (the yen and euro in particular traded poorly vs. the dollar).

The euro broke down through 1.33 last week for the first time since November on the aforementioned U.S. and EU data. Meanwhile the dollar/yen broke through resistance at 103 and kept going late last week, rallying to just under 104 by Friday’s close. The decline in the yen came in reaction to strong U.S. data, as well as a soft trade balance and rising general expectation that the BOJ will have to ease further, as the economy isn’t proving as resilient as hoped following the national sales tax increase.

Finally, the dollar also rallied vs. the pound, which is now at May lows vs. the dollar. This is thanks to follow-through selling as expectations for when the BOE will raise rates continue to get pushed back (and a very crowded trade becomes more-balanced). The pound also ignored “hawkish” BOE minutes where two dissenters wanted to raise rates in the UK in August.

Turing to bonds, Treasuries declined last week, but that was mostly because they ended two Fridays ago at the highs for the year. Despite strong U.S. economic data and the perceived “hawkish” FOMC minutes and Yellen speech, Treasuries rallied as German bund yields continue to fall. This made Treasuries irresistible on a yield differential basis. Also, the headline about the Russian convoy helped Treasuries rally Friday.

This market remains a classic case of money flows trumping ever-increasing bearish fundamentals. And, at some point the fever will break and the market will trade back to the fundamentals. But until German bunds start to decline, Treasuries will have a hard time selling off materially.

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 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 8.25.14)

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	**Bullish**	**Bullish**	*The S&P 500 traded to new highs last week as economic data was strong and the outlook for Fed policy remained stagnant. Positioning was the main reason stocks were higher last week, as investors chased and added long exposure. A period of consolidation is necessary (again) but the trend remains higher.*
Best Idea: Buy Regional Banks (KRE). **Best Contrarian Idea:** Buy Small Caps (IWM).			
Commodities	**Neutral**	**Bullish**	*Commodities traded lower again last week as WTI Crude is again acting as an anchor on commodity indices. But, most other commodities also declined given the reduction in geo-political tensions and after lack luster Chinese and EU economic data, which is casting some (small) doubt on the global recovery.*
Best Idea: Long Oil (USO), Long Copper (JJC) **Best Contrarian Idea:** Buy Grains (DBA)			
U.S. Dollar	**Bullish**	**Bullish**	*The Dollar Index surged to new highs for the year last week on good data and a not dovish Fed. The Dollar Index is now above 82, and while we need to see some sort of consolidation in the Dollar, with the path of policy between the US and Europe diverging materially, the trend in the Dollar should stay higher.*
Best Idea: Sell the Yen (YCS) **Best Contrarian Idea:** Long Canadian Dollar (FXC)			
Treasuries	**Bullish**	**Bearish**	*Treasuries actually declined last week but only marginally so, despite more strong data and a "not dovish" Fed. But, this market isn't being governed by fundamentals at this point, and as long as German Bunds continue to rally, the short term trend in Treasuries will be higher.*
Best Idea: Short "long" bonds (TBT) **Best Contrarian Idea:** Short High Yield Bonds (SJB)			