7:00's Report

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

August 4th, 2014

Pre 7:00 Look

- Futures are enjoying an oversold bounce to the start the week after a mostly quiet weekend.
- In a flashback from the EU debt crisis, Portugal has bailed out Banco Espirito Santo, the troubled Portuguese bank. But, unlike the EU debt crisis, this is being viewed as a "one off" event and European markets are higher this morning.
- Economically it was a quiet night, as Great Britain Construction PMI slightly beat estimates, as did July European PPI (0.1% vs. (E) 0.0%).
- Econ Today: No economic reports today.

Market	Level	Change	% Change
S&P 500 Futures	1925.50	7.00	0.36%
U.S. Dollar (DXY)	81.44	.063	0.08%
Gold	1293.10	-1.70	-0.13%
WTI	98.11	.23	0.23%
10 Year	2.505	-.051	-2.00%

Equities

Market Recap

Stocks fell sharply last week as a "tired" market gave way to a confluence of potentially negative events, chief of which was an inflation scare. The S&P 500 fell -2.6% last week and is now up +4.15% year-to-date.

Last week started calmly, as the S&P 500 was flat Monday, but the market continued to act "tired" almost from the outset last week. Monday the S&P 500 was unchanged, but only because it recovered from a midday 10-point decline. Mild selling pressure continued Tuesday and Wednesday. There weren't any "reasons" for the drift lower Tuesday/Wednesday, although broadly the tougher Russian sanctions were blamed. But more striking than the Russia news Wednesday was the fact that the market couldn't muster a rally despite a big Q2 GDP release and strong TWTR earnings.

Thursday was the big day last week, as a tired-acting market gave way for a multitude of reasons. Inflation was the most-cited culprit (via the Employment Cost Index). But we also saw another Argentine default, a massive loss at Banco Espirito Santo in Portugal (stoking fears of a needed bailout), and negative European earnings/commentary toward Russian sanctions. In truth, each contributed to the selling, but none caused it.

Stocks tried to rally Friday following a pretty "Goldilocks" July jobs report that helped quell some inflation fears. But with an empty calendar ahead, there's not a lot of reason to be a hero on the long side here. So, stocks slid into the close to finish the week.

Despite it being a heavy week of earnings, after Wednesday stocks were driven more by "macro" factors than "micro" ones. Some observations from last week's trading:

Asia Was the Only Place to Hide: There weren't many places to hide during the late-week sell-off from a sector or index standpoint in that traditional defensive assets also declined. Bonds were down last week despite catching a nice bid Friday, as was gold. Meanwhile typical "defensive" sectors such as utilities and consumer staples traded broadly in line with the S&P 500, and were actually underperformers until Friday, when they also caught a bid off the decline in interest rates.

The only place to hide last week was in Asia, as China and the region continues to solidly outperform thanks to

Market	Level	Change	% Change
Dow	16,493.37	-69.93	-0.42%
TSX	15,215.26	-115.48	-0.75%
Brazil	55,902.87	73.46	0.13%
FTSE	6708.27	29.09	0.44%
Nikkei	15474.50	-48.61	-0.31%
Hang Seng	24600.08	67.65	0.28%
ASX	5540.88	-15.50	-0.28%

Prices taken at previous day market close.

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better than expected economic data. FXI rallied nearly +2% last week while DXJ was up fractionally. Domestically, telecom (IYZ) rose +0.6%, but that was because of positive single-stock news (TMUS and WIN converting to a REIT). Absent those two positive one-offs, I doubt telecom would have outperformed last week.

Market	Level	Change	% Change
DBC	25.12	-.20	-0.79%
Gold	1295.2	12.40	0.97%
Silver	20.335	-.077	-0.38%
Copper	3.2165	-.0145	-0.45%
WTI	97.62	-.55	-0.56%
Brent	104.63	-1.39	-1.31%
Nat Gas	3.796	-.045	-1.17%
RBOB	2.74	-.0575	-2.06%
DBA (Grains)	26.61	-.20	-0.75%

Prices taken at previous day market close.

The 'Higher Rate' Hedge Worked Well Last Week, until Friday: Through Thursday, hedging the market by being long higher-rate-sensitive sectors or ETFs (KRE, TBT, SJB, STPP) and short the SPY worked great, but it unraveled a bit Friday after the jobs report caused bonds to rally on a reduction in inflation concerns. But, despite the giveback Friday, if we see the stock market continue to correct on inflation/Fed policy concerns, then that hedging strategy should provide cover going forward.

Technicals are Turning More Negative: The way the S&P 500 crashed through 1,950 (rightly) spooked people last week, and it looks like we may have a "double-top" in the Russell 2000.

In the S&P 500, the 1,950-1,985 range is still important. If the SPX can't reclaim that range over the coming days, then look for selling pressure to pick back up as investors de-risk. On the downside, last week's low of 1,916 and 1,900 are the next levels of support.

Bottom Line

Last week was painful to be sure, but it's not like the declines came totally out of left field. The market had been trading "tired" for 2+ weeks and has broadly been consolidating/correcting since early July.

With regard to the "why," inflation concerns and a pulling forward of Fed policy are probably the most-legitimate reasons to explain the sell-off, but last week's data wasn't a "bearish" game-changer. Despite the uptick in the Employment Cost Index, expectations for Fed policy remain largely unchanged (the consensus for the first rate hike may have move to July '15 vs. August, but that's it).

And, more broadly, the "reasons" for stocks to rally are intact: For all the angst, the Fed is still committed to being accommodative well into the future. The macro-horizon is relatively clear, and the global recovery is ongoing (although there are some worries about weakness in Europe). Finally, this earnings season was a good one and importantly confirmed the $119 EPS figure for 2014 and $130 for 2015, making valuations elevated but not extreme.

With fundamentals still positive, the biggest problem in the near term for stocks may be the calendar, as there is a void until late August of anything really Fed- or inflation-related. (The Kansas City Fed holds its annual economic conference in Jackson Hole Aug. 20, which is also when the minutes from the July 29-30 FOMC meeting come out.)

Given that, we may see some incremental downside in the near term, and there just aren't a lot of compelling reasons to buy stocks today. That said, though, I don't think anything has materially changed that would warrant a significant change in exposures. This to me still appears to be part of an overall consolidation that's been going on since mid-July. However, I'll feel a lot better about that if the SPX can get back above 1,950 later this week.

Economics

Last Week

Over the past 2+ months, the view of economic data has shifted from the market just caring about economic growth (with the key question being "Is the economic recovery for real?") to the market caring about economic growth *and* inflation (the key question being "We know the recovery is for real, but will inflation accelerate and if so will that make the Fed more "hawkish?").

That subtle shift, which has been ongoing since June, came to a head last week with the inflation scare from the Employment Cost Index. At the end of the day, nothing *really* changed from a Fed standpoint, but the

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major takeaway is that the market is clearly on edge about when the Fed will turn slightly more "hawkish." Despite a lot of other headlines, this market remains all about the Fed.

The most important number last week, as far as trading goes, was a little-followed release called the Employment Cost Index. It shot up +0.7% in Q2 and "spooked" the markets on Thursday that wage inflation was setting in and the Fed will be forced to pull forward rate hikes.

But, just when the market was getting very nervous about inflation, Friday's releases contradicted the Employment Cost Index. Importantly, the "Average Weekly Earnings" sub-component in Friday's jobs report was stagnant month-over-month at 2% annual growth in July, the same as June. So, that contradicts the Employment Cost Index and implies wage inflation isn't accelerating. (Wage inflation causes broader inflation, that's why the market is so obsessed with it right now).

Additionally, although the majority of the focus was on the jobs report, the PCE Price Index—which is the Fed's preferred measure of general inflation and was contained in Friday Personal Income and Outlays Report—was also unchanged from June, up +1.5% year-over-year in June.

Bottom line is last week showed the market is clearly on edge about the prospects for rising inflation. But while there are some signs inflation pressures are starting to build, the data are simply not conclusive enough, yet, to get the Fed to change policy, regardless of how loud the "hawks" become in interviews.

Turning to economic growth metrics, last week was another good week and further implied we're seeing an acceleration of the recovery.

First, the jobs report was a miss vs. the headline, but it was still a strong number at 209K jobs added in July. Additionally, July ISM manufacturing PMIs beat expectations Friday, rising to 57.1 vs. (E) 56.0. Weekly jobless claims ticked slightly higher but remain around 300K, implying incremental improvement in the labor market. And finally Q2 GDP printed at 4.0%, much stronger than expectations. That number isn't as good as it sounds and likely will be revised lower. But the strong GDP print confirmed expectations for an economic bounce-back from the Q1 weather-driven weakness, and it kept previous expectations of full-year 2014 GDP at 3.0%.

Market	Level	Change	% Change
Dollar Index	81.405	-.118	-0.14%
EUR/USD	1.3434	.0004	0.03%
GBP/USD	1.6818	-.0007	-0.04%
USD/JPY	102.53	-.08	-0.08%
USD/CAD	1.0917	.0003	0.03%
AUD/USD	.9308	.0002	0.02%
USD/BRL	2.2571	-.0001	-0.01%
10 Year Yield	2.505	-.051	-2.00%
30 Year Yield	3.297	-.014	-0.42%
Prices taken at previous day market close.			

Turning to the actual Fed meeting, there's not a lot to dissect here. The statement definitely upgraded the outlook of the economy, which is slightly "hawkish." But it also introduced language speaking of still-significant "slack" in the labor market, and that ZIRP (zero-interest-rate policy) would stay in place for a "considerable" period of time after QE ends. So, bottom line, a simple translation of the FOMC statement would be: "Yes things are getting better and we recognize that. But they aren't close to being good enough yet to have us change policy, so steady as she goes."

Looking internationally, data in Europe were mildly disappointing, in that July HICP remained low, while the final July PMIs were slightly lower than the "flash" estimates. The results don't mean the recovery isn't still ongoing; they just mean it's very slow-going and that we saw no material incremental improvement in inflation or the economy in the EU in July. On balance, the numbers probably make the ECB slightly more prone to do "more" in the coming months.

Conversely, Chinese data continue to surprise to the upside. Official July manufacturing PMIs hit multi-month highs and are solidly above 50, signaling expansion. And, with the government still stimulating growth, it's safe to say there has been stabilization in the Chinese economy (which it why China was such a big outperformer in July).

This Week

Things slow down materially in the U.S. this week, as July non-manufacturing PMI, June trade balance and weekly jobless claims are the only releases worth noting.

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It's a busy week internationally, though, especially in Europe. The global composite PMIs come tomorrow, as will EU June retail sales. Industrial production for Germany is released Thursday and there is also an ECB and Bank of England rate meeting (although neither is expected to change policy). But, the ECB press conference will be closely watched for Draghi's reaction to another round of lackluster growth and inflation data. Finally, in China we get composite PMI tonight, trade balance Friday and CPI/PPI Friday night.

Commodities

Commodities were almost universally lower last week (natural gas was the notable outlier) as the stronger dollar and a general "risk-off" trade across asset classes weighed on the space. DBC fell -2.1%.

Beginning in energy, crude oil futures steadily sold off last week, falling all 5 sessions to finish the week lower by -4.2%. There are 3 bearish influences at work in the crude market: 1) the strengthening dollar, 2) a multi-asset-class "risk off" trade and 3) selling momentum.

Now, the stronger dollar is not likely going to change given the current market dynamics; however the other two forces should be relatively short-lived. Especially considering the most-basic market fundamentals have both recently favored the bulls (higher demand as the economy improves, and larger than expected weekly draws in crude supply). So, over the long term we remain bullish on crude oil on fundamentals. But until we see a shift in momentum as well as the technicals, the path of least resistance remains lower.

Natural gas was the only widely followed commodity to rally last week, adding +1.6%. Nat gas futures do remain in a sharp downtrend; however prices are approaching resistance again, and a close above $3.84 would be technically bullish. And, looking to the fundamentals, a trend of smaller than expected weekly supply injections has formed, which is also supportive of the bullish argument.

Gold continues to trade inversely to the dollar as Fed policy speculation (a "hike" sooner than later) is causing the dollar to rally and having a near-term bearish effect on gold. Gold futures declined -0.97% last week. But again, one of the primary reasons for the "hawkish" Fed policy speculation is rising inflation, which continues to support gold prices and has prevented a material sell-off. On the charts, gold fell through and closed below support at the 50-day moving average ($1,294.80) on Thursday, but recovered that level before Friday's close. So, we will continue to hold our longs unless there is a material breakdown through support his week, at which point we would wait for a better, long entry point.

Currencies & Bonds

There was almost universal U.S. dollar strength last week until Friday, when there was a big reversal on the economic data. Despite the sell-off Friday, the Dollar Index still managed to close up +0.3% on the week and is still sitting basically at the highs of the year.

The euro finished trading last week slightly positive, which is surprising given the lackluster inflation and growth data. But, the euro has been sold hard over the last month, and with the ECB meeting looming Thursday, I'd expect to see some short-covering into that meeting.

We could easily see an oversold bounce continue in the euro, but generally the two currencies will trade almost entirely off central bank expectations as opposed to hard data. As long as the market views the two policies as further diverging (Fed "tighter" and ECB "easier"), then we'll continue to see general support in the dollar and pressure on the euro.

Most of the focus last week was on the dollar and euro, but the yen quietly broke lower early last week after several pieces of disappointing economic data, trading through a multi-month supporting trendline. The yen fell -0.7% vs. the dollar last week despite a bounce-back rally Friday. But as long as the dollar/yen doesn't trade back below 102 this week, I think it'll be safe to say another leg lower in the yen has begun.

Looking at bonds, they got hit hard Wednesday/ Thursday on the inflation data, but bounced back Friday following the jobs report. We'll see increased volatility in the bond market now that inflation is on everyone's radar, but the 30 year held the 2014 uptrend yesterday and despite increasingly negative fundamentals, the short term trend remains higher. Have a good week, 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 8.4.14)

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)

	Near Term Trend	Long Term Trend	Market Intelligence
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)

Best Contrarian Idea: Buy Grains (DBA)

	Near Term Trend	Long Term Trend	Market Intelligence
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)

	Near Term Trend	Long Term Trend	Market Intelligence
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)

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