7:00's Report

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

August 5th, 2014

The breakdown in junk bonds ended up predicting last week's declines in stocks. Now we're seeing a bounce, but the $41.00 is key in JNK and if it fails at that resistance, it's a negative signal for equities.

Pre 7:00 Look

- Futures are drifting slightly lower this morning while international markets were mixed overnight.
- Asian shares were mostly lower thanks to the Chinese Service PMI, which surprisingly hit an all time low of 50.0 (data collection began in 2005).
- Europe is mostly higher on strong earnings reports (BMW, Credit Agricole) as traders shrug off mildly disappointing econ data (service PMIs and retail sales slightly missed).
- Econ Today: Factory Orders (E: 0.6%), ISM Non-Manufacturing Index (E: 56.5)

Market	Level	Change	% Change
S&P 500 Futures	1928.25	-3.75	-0.19%
U.S. Dollar (DXY)	81.535	.13	0.16%
Gold	1292.20	3.30	0.26%
WTI	98.45	.16	0.16%
10 Year	2.491	-.014	-0.56%

Equities

Market Recap

Stocks were higher yesterday as markets enjoyed an oversold bounce, helped by the bailout of Banco Espirito Santo (BES) in Portugal. The S&P 500 closed up +0.72%.

Stocks were higher from the outset yesterday, helped by news that BES would be bailed out by the Portuguese government. (This is seen as a positive, as concern about BES being a systemic risk weighed on Europe last week.) Also, China continued to rally and virtually all of Asia was higher Monday except Japan, which was off small.

As is typically the way with oversold bounces, stocks opened stronger but then came under pressure later in the morning, and the S&P 500 briefly turned negative before lunchtime. But, the shorts couldn't break the market and as a result, they started covering. That fed on itself throughout the afternoon session, and the S&P 500 hit its high of the day about 15 minutes before the close.

Trading Color

I'll be joining Stuart Varney on Varney & Co. at Noon EST today to discuss the outlook for stocks.

Most major averages traded in line with one another yesterday, as there was no material outperformance by small caps or the Nasdaq. But cyclicals did manage to play a little bit of catch-up as SPHB was up +0.9% while SPLV was flat (although since last Wednesday, obviously the latter is solidly outperforming).

Looking at the sector trading, utilities were the only S&P 500 sub-sector to finish the day in the red, down more

Market	Level	Change	% Change
Dow	16569.28	75.91	0.46%
TSX	15215.26	-115.48	-0.75%
Brazil	56616.33	713.46	1.28%
FTSE	6706.72	29.20	0.44%
Nikkei	15320.31	-154.19	-1.00%
Hang Seng	24648.26	48.18	0.20%
ASX	5518.56	-22.32	-0.40%
Prices taken at previous day market close.			

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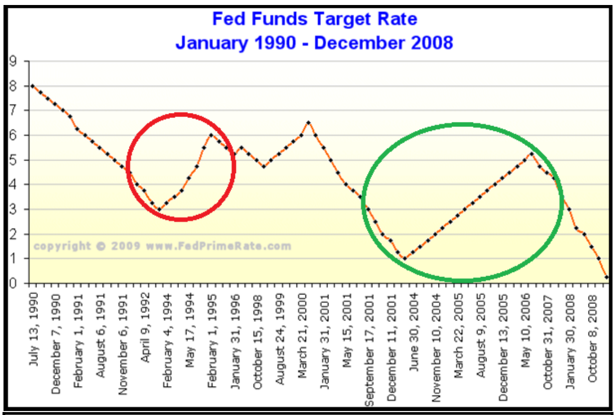
than -0.5%. And, it's interesting to see utilities so weak on a day like yesterday. This I believe speaks to investors' desire to get less exposed to low-interest-rate-sensitive sectors, which is a carryover from trading last week (excluding Friday).

Market	Level	Change	% Change
DBC	25.33	.21	0.84%
Gold	1288.20	-6.60	-0.51%
Silver	20.175	-.196	-0.96%
Copper	3.2485	.034	1.06%
WTI	98.65	.77	0.79%
Brent	105.65	.81	0.77%
Nat Gas	3.844	.046	1.21%
RBOB	2.732	-.0123	-0.45%
DBA (Grains)	26.75	.14	0.53%

Prices taken at previous day market close.

More broadly, defensive sectors underperformed as staples, healthcare and telecom all lagged the S&P 500. I only point that out because—with regard to the defensive sectors providing "cover" during a sell-off—I said last week that given what's going on with interest rates, traditional defensives may not offer protection as they normally do. This played out again yesterday.

Materials and "China"-related sectors also traded well yesterday, continuing the trend. Basic materials were the best-performing S&P 500 sub-sector, up +1.2%, while FXI rallied just under +1% and is just off recent 52-week highs. While the China-related names are short-term overbought (and it's worth considering to book profits here, going into data during the back half of the week), the "global" reflation story remains an important one. Basic materials sectors and PICK continue to trade well in a tough tape.



The Fed: How quickly the Fed hikes is more important than when it starts. A gradual '04 style hiking program the rally could likely survive, a '94 style ratchet higher, it likely could not.

Bottom Line

As with most oversold bounces, it came on very little volume and was totally driven by day traders and programs/algos.

Nothing fundamentally changed yesterday (obviously) and 1,950 remains the key for the S&P 500. Until we can get back above that level in the short term, the technicals remain biased negative.

If we can re-take 1,950, then this goes from an oversold bounce to something more. But until then, the very short-term outlook is neutral at best, and a test of 1,916 (the lows of last week) can't be ruled out.

Economics

There were no economic reports yesterday, so I want to cover a bit more what happened with the Fed outlook last week.

It's Not 'When' the Fed Hikes; It's How Fast

For all the volatility and inflation "angst" of last week, the net effect seems to have been (according to Fed Fund futures) that the consensus date of the initial interest rate hike may have been slightly pulled forward from August 2015 to July 2015.

Now, is that a reason for the market to go down -2% or to get less-bullish on stocks?

No, of course not.

So, it's fair to say that while last week's sell-off is being "blamed" on shifting Fed expectations, they really didn't shift all that much – at least, not enough to warrant a 2% sell-off. And, that's part of the reason I said I believe this is more part of an ongoing consolidation/correction than a bearish game-changer.

But, last week does highlight how "Fed-sensitive" the market has become, and I maintain that shifting Fed expectations remain the No. 1 risk to the rally. But, it's not so much a shift in *when* the Fed starts to tighten that's the risk, but instead a shift in the expected *pace* of that tightening once it begins.

So, it's important to realize there are two ways to consider Fed tightening: 1) When it will start and 2) How fast it goes once it's started. The second is much more important than that first.

Current expectations are for the Fed to start raising rates in mid-2015 and for the Fed to raise rates 25 basis points

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per hike for a couple of years, until rates get somewhere in the 3% to 4% range. It's not dissimilar to what the Bernanke Fed did after the '02 recession, where rates went from 1% in June 2004 to 5.25% in July 2006, a period of 2+ years.

Assuming a similar pattern, that means it would be 2017 before rates returned to "equilibrium" here in the U.S.

This assumption—that whenever the Fed starts to raise rates, it'll do so similarly to what we saw from '04 to '06—is key to a continued rally. So, with regard to inflation pressures and Fed policy, we need to watch for clues as to how quickly the Fed implies it's going to raise rates once it starts.

And, there's the potential here for some dislocation because market expectations and Fed expectations aren't in agreement on that pace. Case in point, Fed Fund futures show that the consensus expectation is for Fed Funds to be below 0.75% at the end of 2015. So, that basically means two rate hikes in 2015. But, in June FOMC projections, Fed officials had a consensus expectation of 1.13% Fed Funds at the end of 2015, or more than 30 basis points higher. So, we've got a bit of a gap there (either an additional hike or one of the hikes is 50 bps).

Bottom line, moderate inflation pressures are "OK" for the market as long as they simply "pull forward" the start of Fed tightening by a month or two (even if it moves to May, it probably isn't that bad). But, if inflation accelerates to the point that the Fed starts talking about how it may have to start to raise rates *faster* than the current expectation (which I believe will become a distinct possibility), this will be a significant event and potentially remove the Fed as being supportive of stocks.

Commodities

Like most other risk assets, commodities saw a bit of a "dead cat bounce" yesterday with the notable exception being the precious metals, which steadily declined over the course of the day. DBC added +0.88% on the session while the dollar was little-changed, up +0.03%.

Market	Level	Change	% Change
Dollar Index	81.405	.028	0.03%
EUR/USD	1.342	-.0009	-0.07%
GBP/USD	1.6857	.0037	0.22%
USD/JPY	102.54	-.07	-0.07%
USD/CAD	1.0906	-.0008	-0.07%
AUD/USD	.9332	.0026	0.28%
USD/BRL	2.2575	.0003	0.01%
10 Year Yield	2.491	-.014	-0.56%
30 Year Yield	3.295	-.002	-0.06%

Prices taken at previous day market close.

Beginning in energy, crude oil futures rallied +0.79% to start the week yesterday after touching a 6-month low ($97.09) on Friday. Yesterday's rally however was largely a part of the aforementioned "dead cat bounce" after crude futures fell more than -4% last week.

Looking at the fundamentals of the market, plenty of analysts pointed out that crude oil was falling as stocks and other risk assets came for sale on Thursday. The correlation is obvious, but there was a key difference in the moves. Stocks sold off mostly thanks to the unexpectedly high wage inflation data released Thursday morning, but crude oil speculators were much more concerned with the Argentine bond default.

Here is the simple reason why ...

The four largest South American petroleum consumers (which includes Argentina) account for around 25% of product exports from the United States. And, if the Argentine bond default were to cause a bigger problem across South American markets, this 25% of U.S. product demand would potentially be at risk.

So, while our own economy and inflation metrics remain in focus, there are other underlying fundamentals at work, and they heavily weighed on crude prices last week.

Bottom line, as long as the Argentine bond default does not cause a contagion effect in South America, we should see prices recover some of last week's losses. But, having said that, the near-term momentum continues to be with the bears. Friday's low tick of $97.09 is a key level to watch as support, while there is resistance at the 200-day moving average at $99.77.

Elsewhere in energy, natural gas futures rallied a respectable +1.32% yesterday and importantly closed above the steep downtrend that has been in place since the middle of June. Fundamentals are relatively neutral at the moment as supply levels are being restored faster than initially expected

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(bearish), but we have seen inventory injections slow a bit in recent weeks (near-term bullish). So, primarily based on technicals, there is an opportunity to get long natural gas via futures or the Natural Gas ETF (UNG), as there is good potential for a short-covering rally back to the $4 area. On the charts, there is initial resistance above toward $3.90 while the "line in the sand" is last week's low of $3.728.

Moving to the metals, copper continues to outperform as global economic data remain "good to better than expected," suggesting strong demand for the foreseeable future. Copper futures were one of the best performers yesterday, rallying +1.04%. We maintain our long call on copper based primarily on the fundamentals; however the technicals are favoring the bulls as well. There is solid support at $3.20 while initial resistance is toward $3.26.

Moving to precious metals, both gold and silver traded heavy yesterday, falling -0.51% and -0.96%, respectively. Specifically, gold failed to hold support at the 50-day moving average ($1,294.70) and now seems to be trending lower. There are a couple levels of support left: the 200-day moving average at $1,286.40 and last week's low of $1,281. Although we remain fundamentally bullish and will hold some gold positions in longer-term accounts, it appears there is room to move lower over the near term. Bottom line while gold is trying to hold support, there's simply too much risk of catching a $20 dollar decline in the teeth here, so we'd prefer to buy strength at a later date. As such, we would recommend closing long positions in tactical trading accounts, and waiting for a better opportunity to get long in the near future.

Currencies & Bonds

The Dollar Index was unchanged yesterday, although that was a bit deceiving. That's because every major currency vs. the dollar was slightly stronger, except for the euro, which was slightly lower.

It was a touch surprising yesterday that the euro didn't get any sort of a bid following the Banco Espirito Santo bailout news. (It wasn't that big a deal, but given the rally we saw in Portuguese bonds, I thought we'd get a bit of a bounce in the euro.) But, there was clearly caution ahead of the July composite PMIs and rightly so, as they generally disappointed and this morning the euro is back below 1.34 as focus now turns towards the ECB Thursday.

The best performer yesterday vs. the dollar was the Aussie, as it rallied +0.25%, on short-covering ahead of the Aussie trade data and RBA decision out last night, although both were relatively non-events and "Aussie" is fractionally lower this morning, although we appear to be heading towards support at .92.

Overall Monday was a quiet day in the currency markets, and that makes sense given this is a busy week for non-U.S. central banks (the RBA, BOJ, BOE and ECB all have rate decisions). More broadly, the major trend in the currency markets remains that of dollar strength. While we may see a pause in the dollar rally given it's overbought, this trend will likely continue over the coming weeks amidst a relatively quiet Fed backdrop.

The bounce in Treasuries that started Friday continued yesterday, as Treasuries were up small on the day (30-year up +0.14%). Bonds were higher as investors had a chance to digest the fact that last week wasn't the material Fed game-changer the markets pretended it was last Thursday. The Fed buying $1 billion worth of 30-year bonds yesterday didn't hurt the rally, either.

Bonds remain a classic case of positive money flows countering further deteriorating fundamentals, and that remains the case as bonds are still holding the 2014 uptrend. Until that is broken, the near-term trend remains higher.

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	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)**

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)**

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)**

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