7:00's Report

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

August 7th, 2014

Despite new highs in bonds, investors are wary of future higher interest rates, as utilities have collapsed since late June, and haven't offered any protection during this correction.

Pre 7:00 Look

- Futures are holding on to small gains this morning despite modestly weaker foreign markets following a mostly quiet night.
- Economic data from Europe again disappointed, as German June Industrial Production missed estimates (0.3% vs. (E) 1.2%). Focus will be on Draghi this morning to see if his press conference offers any hints of more stimulus.
- Geopolitically, Russia retaliated with sanctions banning all food imports from the US and EU, putting further pressure on the EU economy (it won't matter to the US).
- Econ Today: BOE Rate Decision (E: No change to policy), ECB Rate Decision (E: No change to policy). Weekly Jobless Claims (E: 305K).

Market	Level	Change	% Change
S&P 500 Futures	1917.75	3.00	0.16%
U.S. Dollar (DXY)	81.545	.038	0.05%
Gold	1305.70	-2.50	-0.19%
WTI	96.58	-.34	-0.35%
10 Year	2.474	-.009	-0.36%

Equities

Market Recap

Stocks were flat Wednesday but importantly finished well off the lows as support at 1,920 again held on a closing basis. The S&P 500 was unchanged on the day.

Stocks were weaker to start Wednesday thanks to a multitude of reasons: More soft European data (Italian GDP in particular); weak European markets; more anti-"inversion" talk—in particular, news that WAG was backing out of its tax inversion; and the abandoning of two big potential mergers: TWX/FOX and S/TMUS.

But, despite the negative start, stocks actually hung on pretty well throughout the morning session and turned positive about an hour after the open.

Stocks drifted mildly positive for a few hours until another Russia-related headline weighed on stocks. This time it was NATO officials and the U.S. defense secretary Chuck Hagel saying a Russian invasion of Ukraine was indeed possible. (Again, nothing new there, but it still caused temporary market jitters.)

But, true to the saying that the market never discounts the same information twice, stocks recovered the losses later in the afternoon to finish unchanged.

Trading Color

It was a very quiet day yesterday, and while it is encouraging that the market didn't go down more, trading yesterday was on very low volume. Nothing in the price action makes me think this was the bottom (unfortunately it felt to me like a pause in the selling, not a defending of support).

Market	Level	Change	% Change
Dow	16443.34	13.87	0.08%
TSX	15202.09	14.38	0.09%
Brazil	56487.18	285.08	0.51%
FTSE	6621.94	-14.22	-0.21%
Nikkei	15232.37	72.58	0.48%
Hang Seng	24387.56	-196.57	-0.80%
ASX	5509.01	-2.99	-0.05%
Prices taken at previous day market close.			

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The Russell 2000 again outperformed (up +0.36%) vs. a flat S&P 500, although SPHB traded in line with SPLV. But, at least so far this week, we haven't seen continued significant underperformance by cyclical and high-beta sectors. That's a bit of a silver lining.

Market	Level	Change	% Change
DBC	25.36	.17	0.67%
Gold	1309.00	23.70	1.84%
Silver	20.06	.227	1.14%
Copper	3.164	-.0405	-1.26%
WTI	97.00	-.38	-0.39%
Brent	104.84	.23	0.22%
Nat Gas	3.946	.49	1.26%
RBOB	2.7436	.0281	1.03%
DBA (Grains)	26.89	.28	1.05%
Prices taken at previous day market close.			

Sector-wise, it was a mixed bag as 5 S&P 500 sub-sectors were down (tech, healthcare, industrials, consumer discretionary and utilities) while five were up (consumer staples was the outperformer, along with basic materials, energy and financials).

In a continuation of the recent theme, we again saw significant underperformance by XLU (utilities). XLU fell -1.28% yesterday and is basically back at levels last seen in March! Conversely, banks traded well despite lower rates (KRE up +0.5%), although part of the bank outperformance was a result of BAC being allowed by the Fed to up its dividend, and the stock rose +1.33%).

Junk bond yields have crashed to all time lows in recent years.

So, although interest rates remain under pressure, from a sector standpoint we are seeing both a continued rotation out of utilities and continued positive trading action in bank stocks. (Utilities are the most exposed to higher rates on the downside while banks will outperform in that environment.)

On the charts the S&P again held support at 1,920 but the 100-day moving averages remains the key (1,913). I would be shocked if we don't test that level over the next few days. If that's broken, then 1,900 is next.

Bottom Line

The market seems a bit stalemated here, as buyers are reluctant to step in given the Fed is the main reason for concern and we won't get any clarity there until August. And, we're not cheap enough yet to elicit any material "buy on the dip" move. As a result, in the very near term, the path of least resistance is probably sideways at best or negative. Of course, again, short of some sort of Russian invasion or interest rate shock, I don't think this market will go materially below 1,900. Unless it's a tactical account and you're already less long, I'd hold positons here and wait to buy a bit more of a dip.

Why We All Need to Watch JNK Going Forward

Two and a half weeks ago, we pointed out that there was a rather significant breakdown in junk bonds (via JNK), and that it was a potential warning sign for equities and other risk assets. And, as it turns out, that breakdown in junk bonds (JNK hit its high on 6/24, exactly one month before the SPX hit its recent all-time high) was forecasting a consolidation/correction in stocks.

Since we initially pointed out the breakdown in junk bonds, watching JNK has become a popular thing to do on the Street, and rightly so. But, why are we, and others, so focused on a relatively small segment of the bond market?

Because they may think (and I agree) that junk bonds are the leading edge of the market's appetite for risk. As a result, if junk bonds start to materially decline, then stocks will decline with them.

So, putting it in context of the theme of "the Fed is behind the curve," the junk bond market is being viewed as the leading edge of Fed-inspired volatility – in that it'll hit the junk market before it hits other risk assets.

At its core, concern the Fed is "behind the curve" is just an extrapolation of a feeling many people on Wall Street have – namely that the Fed is largely responsible for this massive, multi-year rally in stocks. On top of that, once the Fed stops QE and stops expanding its balance sheet, the clock will strike midnight and the market will turn back into a pumpkin.

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And, if that's going to happen, then junk bonds will get hit first, because the junk market has benefited the most from a Fed-inspired reach for yield from investors. Drawing the cautious analogy to subprime, that segment of the housing market benefited most from cheap money and low lending standards because it 1) offered the most yield and 2) was most leveraged to a rising housing market. Flash forward to 2014, and the junk bond market 1) offers the higher yield and 2) is most leveraged to a rising bond market.

And, there is plenty of evidence of froth in the junk bond market. Yields on the BAML Junk Bond Index hit an all-time low of 4.9% in June, And, spreads between junk and Treasuries have compressed consistently under 4% for an extended period, which is well under historical norms.

Point being, there is evidence to suggest that risk has been ignored in the junk bond market in this Fed-inspired reach for yield ... and that once the Fed stops QE, investors will stampede out of junk bonds and this will cause a shock to the system.

So, why does this matter to you? Two reasons …

First, this current sell-off in stocks is still all about the Fed and the fact that we're entering a transition period of no more QE and higher interest rates. It is not about Russia, ISIS, Portugal, Europe, etc.

Second, because of that, JNK is now something all of us need to have on our quote screens. Any real Fed-inspired correction or sell-off going forward will hit JNK early and hard, just as it has over the last month. So, that's the indicator we need to watch as the Fed nears the end of QE and the normalization of policy.

More importantly though, JNK will be the single-best indicator to tell us when this correction is over. And the range we'll be watching is $40.00 to $41.00. Whichever level is broken first will be a clear sign that the sell-off isn't done, or that we've bottomed and are heading higher.

Economics

There were no material economic reports yesterday (trade balance didn't move markets).

Commodities

Commodities traded mostly higher yesterday led by wheat, which rallied on the threat of more extensive Russian sanctions (remember that the Ukraine is one of the world's largest wheat producers). Gold was up on short-covering triggered by the poor EU economic data and geopolitical unrest. And copper underperformed for the second day in a row because of weakness in China. The broad-based commodity tracking index ETF, DBC, added +0.67%, assisted higher by the weaker dollar (-0.15%)

The metals remain divided as gold rallied +1.88% yesterday, which in turn spurred some buyer interest in silver, which added +1.17% but copper fell -1.23%. The reason for the move in precious metals was a combination of things that occurred in the current market environment.

First, regarding the "environment," it has been a volatile couple of weeks in the precious metals market as a result of economic data (specifically inflation metrics) and Fed-speak, which has led to a lot of investor repositioning, specifically in gold.

As a result, a lot of short positions have been initiated (despite the fact that inflation is looming on the horizon) because economic growth appears to be accelerating faster than initially estimated. So, the risk in the market was for a moderate short-squeeze. And yesterday, the disappointing economic data released in Europe overnight, namely the big miss on German manufacturers' orders as well as the rather disappointing Italian GDP, paired with the escalation between Russia and Ukraine, was enough to ignite that short-covering rally.

Bottom line, the precious metals market remains volatile and senseless at the moment as the technicals are a mess and traders continue to try to

Market	Level	Change	% Change
Dollar Index	81.50	-.111	-0.14%
EUR/USD	1.3378	.0003	0.02%
GBP/USD	1.685	-.0034	-0.20
USD/JPY	102.04	-.55	-0.54%
USD/CAD	1.0909	-.0049	-0.45%
AUD/USD	.9346	.0044	0.47%
USD/BRL	2.2701	-.0114	-0.50%
10 Year Yield	2.474	-.009	-0.36%
30 Year Yield	3.277	-.002	-0.06%

Prices taken at previous day market close.

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read the underlying fundamentals. The threat of a potentially larger than expected increase in inflation continues to have a bullish influence on the market, however, so we continue to recommend holding gold in longer-term accounts. On the charts, support has clearly held just above $1,280, while there is resistance toward $1,310. But it remains to be seen whether that range will be broken in the near term.

Meanwhile copper was among the worst-performing commodities as tactical traders continue to take profits after recent Chinese economic data disappointed, especially after the quick appreciation we saw after making the "long copper" call. Looking ahead and considering the medium time horizon, we continue to like buying copper as one of the best "pure plays" in getting long China and the global economy.

Moving to energy, it was inventory day for crude oil and the refined products yesterday. Once again, the data were mostly bullish. According to the EIA, crude oil stocks fell -1.8M barrels vs. (E) -1.7M, RBOB gasoline supplies dropped -4.4M barrels vs. (E) +100K, and distillate inventories decreased by -1.8M barrels vs. (E) +600K.

The headline crude number obviously met expectations. However, one reason for the weakness in WTI futures was the fact that inventories at Cushing, Okla. (the delivery point for oil futures traded on the Nymex), increased for the first time in a month (up from 17.9M bbls to 18.0M bbls) and the recent draws there have been helping support the market. Going forward, the bears remain in control as yet another low was established yesterday. However, the "bigger" and longer-term fundamental picture is bullish as demand for refined products will continue to increase as the economy continues to grow.

Elsewhere in energy, natural gas futures outperformed yesterday, rallying +1.18% for the third gain in a row ahead of weekly EIA supply data released later this morning (10:30). Analysts are forecasting a supply injection of 83 Bcf, and you know the drill—a material surprise either way could spur a substantial move in futures. On the charts, support has edged up to $3.88 while initial resistance lies above at yesterday's highs.

Currencies & Bonds

Treasuries rallied yesterday, with the 10-year note adding +0.09% while the 30-year bond rallied +0.11%. Bonds started off higher yesterday morning thanks to the generally disappointing economic data in Europe, specifically the poor Italian GDP and the big miss in German manufacturers' orders.

But, bonds reversed off the highs once the stock market rallied out of the gate and the 30 year steadily drifted lower for the remainder of the day. JNK, the Barclays high-yield bond ETF, rallied a modest +0.14%, but the move was little more than further consolidation after the -2.5% drop it has seen since it began selling off last Thursday. Bottom line, while the bond market does continue to trade somewhat "heavy" on an intra-ay basis, money flows from Europe and elsewhere are still supporting Treasuries, and the 2014 uptrend remains in tact.

Currency trading was again volatile yesterday, as we saw yet another mid-day reversal in the dollar, which finished the day down -0.15%, after reaching yet another 11-month high in pre-market trading. The dollar finished the day weaker against every major currency except the pound.

We again saw a violent and quick sell off in the dollar around mid-day yesterday versus the yen and Aussie. It occurred promptly at 12:15 and only lasted about 3 minutes, but it accounted for 20% of the daily volume and most of the 0.5% daily move in yen futures. The consensus reasoning behind the move was that a very large carry trade was unwound very quickly, and the market-making algorithms couldn't keep up with the move. The dollar is short term overbought and in need of a pause, so maybe this is large funds booking profits, but beyond the short term the trend remains toward dollar strength.

Focus this morning will be on the euro, and in particular how much ECB President Draghi talks about the potential for more easing at the press conference. Unless he shocks with a "dovish" statement, I'd expect a bounce in the euro today. Have a good day—Tom.

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*
6/11/14	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 8.4.14)

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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