7:00's Report

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

September 11th, 2014

9/11: The new buildings are beautiful—but when I close my eyes this will always be the skyline I see. Thoughts and prayers for the victims and their families on this anniversary.

Pre 7:00 Look

- Futures are modestly weaker as are most international markets, ex-Japan, following another uneventful night.
- Focus o/n was on China, where inflation was lower than expected. August PPI declined 0.2% while CPI was up 2.0% yoy vs. (E) 2.1%. China declined modestly on the news—but the data isn't changing anyone's outlook on growth.
- In Europe shares were lower this morning but another poll that saw "Nos" winning in Scotland helped turn European stocks mildly positive.
- Econ Today: Weekly Jobless Claims (E: 300K).

Market	Level	Change	% Change
S&P 500 Futures	1989.25	-6.00	-0.30%
U.S. Dollar (DXY)	84.455	-.012	-.01%
Gold	1241.60	-3.70	-0.31%
WTI	90.72	-.95	-1.04%
10 Year	2.534	.34	1.36%

Equities

Market Recap

Stocks rebounded Wednesday and bounced nicely off support around 1,985 during a day that was devoid of any real news. The S&P 500 rose +0.36%.

I'd love to point to some fundamental factors or news headlines that drove yesterday's trading, but in truth there weren't any. Yesterday was a market dominated almost entirely by technicals and short-term trading. Some pointed to a midday headline about a poll result showing the "No's" in the Scotland independence vote were again the majority, but that wasn't any really positive catalyst.

Stocks opened flat (the whole world ex-China was flat) but then sold off quickly through support at 1,985 as shorts tried to press the market lower.

That trick worked when the SPX was north of 2,000, but not so much when the S&P 500 was 20 points below that level. We saw buyers step in around 1,980, and the declines stopped right before 11 a.m.

From there, offers were pulled and stocks rallied methodically for the next two hours, accelerating once resistance at 1,990 (former support) was broken around lunchtime. Buying dried up during the mid-afternoon but there was another push into the close that saw the S&P 500 close basically at the highs of the day.

Trading Color

Yesterday was decent for the bulls, as support held at 1,980 and cyclicals outperformed, although none of the moves were really significant. The Nasdaq bounced

Market	Level	Change	% Change
Dow	17,068.71	54.84	0.32%
TSX	15,469.98	-66.83	-0.43%
Brazil	57,956.16	-720.18	-1.23%
FTSE	6,817.66	-12.45	-0.18%
Nikkei	15,909.20	120.42	0.76%
Hang Seng	24,662.64	-42.72	-0.17%
ASX	5,546.13	-28.16	-0.51%

Prices taken at previous day market close.

back, rallying +0.8% while the Russell was up +0.5%, both outperforming the S&P 500.

Market	Level	Change	% Change
DBC	24.15	-.16	-0.66%
Gold	1248.50	.00	0.00%
Silver	18.97	.05	0.26%
Copper	3.112	.01	0.32%
WTI	91.66	-1.09	-1.18%
Brent	98.21	-.95	-0.96%
Nat Gas	3.955	-.029	-0.73%
RBOB	2.5352	-.0132	-0.52%
DBA (Grains)	25.77	-.37	-1.42%
Prices taken at previous day market close.			

Sector trading was mostly muted but we again saw a definite "higher rate" rotation among the various sectors. Utilities were one of two S&P 500 sub-sectors to finish in the red (energy was the other; more on that in a minute).

Meanwhile REITs got hit very hard, as VNQ was down -1.6% (that is a lot for a REIT ETF). Also, JNK failed to rally despite higher stock prices while emerging markets also lagged (more on that in a minute – I think we can short EMs here).

Conversely, banks bounced back nicely (KRE rose +1.31% on higher rates and a positive mention on the regionals by Jefferies). If KRE can stay above $39.20, I think we could see an acceleration higher.

On the charts the S&P 500 re-took support at 1,990 as mentioned, and this remains a broad consolidation. Support at 1,990 and 1,980 is now important, as clearly there are buyers at those levels, and they'll need to step up again to keep this a consolidation and not a pullback.

Bottom Line

Yesterday seemed a lot like Friday where the market failed to decline and that, in turn, led to a low-volume sprint higher as offers were pulled.

Point being, yesterday was nice for all of us who are long stocks, but it doesn't change my opinion that we may be in for a bit of a pullback here, perhaps back into the mid-1,900s before it really gets interesting.

A Falling Bond Playbook

Yesterday I talked about how both stocks and bonds could decline if we see a material pullback in the market. Given most of us are "long" both, that's a little concerning, seeing as they historically tend to hedge each other. Bonds are bouncing today, but I wanted to provide a bit of a "playbook" so people can have a plan in place, if we start to see bonds/stocks sell off materially.

1. The "right" way to short bonds: This seems obvious, but if you asked most people how to do this, they'd say to buy **TBT**. TBT works, but also consider **SJB** (the short junk bond ETF), as that will get hit much harder and give you more volatility (which is important when you're trying to hedge equity exposure). Also, **STPP** (the Treasury yield curve steepener ETN) will rally in a material bond sell-off—so it's more than just TBT to get the right mix of exposure.

2. Active Sector Selection: For the last several years, buying SPY has been the easiest way to produce strong returns while still consistently working on your golf game. But, if we get a material move higher in rates, that joyride will come to an end and sector selection will be much more important. Sectors with positive exposure to higher rates are mostly financials (so overweight **KRE/KBE/XLF**, but tech has also statistically outperformed the market, so **XLK** is another to be overweight). The big thing here is what to be underweight/short if you want to do a pairs trade: **XLU (utilities), IYZ (telecome), VNQ (REITS ETF**), **Consumer Discretionary (XLY)**. The reason I point this out is because I imagine allocations are somewhat reversed after the past several years, as investors have reached for yields from "Bond proxy" sectors. Consumer discretionary lags because of more expensive financing. Takeaway: **defensives won't protect during a bond/stock decline like we think they will.**

3. Long DXJ & HEDJ, Short Emerging Markets (EUM): International exposure is important here, especially when you have Japan and Europe easing further (or at least potentially easing policy further). DXJ and HEDJ are the ways to play both markets as they hedge out the negative impact on returns from a falling currency. Also, the fact that emerging markets aren't in a steep decline is somewhat surprising, given the strength in the U.S. dollar, the collapse in commodity prices and the turn in interest rates. But, if we get a material increase in European yields

and Treasuries, emerging markets will get hit hard—plain and simple (look back to January of this year).

Economics

There were no economic reports yesterday.

Commodities

The bleeding continued in the commodity space yesterday as most products traded lower, with the exception of the industrial metals which bounced modestly on short-covering. The broad-based commodity tracking ETF, DBC, fell -0.9%.

Energy was the worst-performing sector in the space yesterday, trading lower mostly thanks to the EIA report that was universally bearish. WTI crude oil fell -1.22%, hitting fresh 17-month lows on the data. The release stated that stockpiles in WTI crude fell -1M barrels vs. (E) -1.2M, RBOB gasoline supplies increased +2.4M barrels vs. estimates for no change, and distillate inventories grew +4.1M barrels vs. (E) +600K.

Additionally, the EIA adjusted U.S. production forecasts to show that domestic output would rise to 9.53M barrels/day in 2015, the highest level in 45 years, which they expect will put pressure on prices and decrease demand for imports going forward. Their current forecast for 2014 is 8.53M barrels/day, which is up from 7.45M in 2013.

Bottom line, bearish production and supply forecasts are outweighing the potential for a bullish uptick in demand as global economies continue to recover. Going forward the bears have momentum on their side, and the steep downtrend dating back to June remains very much intact. On the charts, yesterday's low of $91.22 is the level to watch to the downside while $91.90 is initial resistance.

Natural gas pulled back -0.70% yesterday after surging on Tuesday. Tuesday's +2.6% move higher came after futures printed a bullish outside reversal on Monday, drawing a slew of technical bulls into the market.

Looking to the fundamentals, the story is largely the same. Supply levels remain well below the 5-year average range, and weekly supply builds are not currently on pace to restore inventories by the time we enter the draw season late next month. The EIA will report weekly inventory data this morning at 10:30, with analysts expecting an 86 Bcf build.

So, from a risk/reward standpoint, buying natural gas on dips continues to be one of the best ideas in the commodities space at this time. On the charts, the bulls would like to see a close above $4 while some solid support has formed at the $3.80 level.

Moving to the metals, gold finished the day little-changed yesterday but did trade down to a fresh 3-month low during intraday trade. Futures have quickly approached support at the early June lows of $1,240 as the dollar continues to strengthen and "Fed angst" is rising ahead of next week's FOMC meeting. And, if support at $1,240 is broken, there is a pretty clear path for futures to quickly trade down to the $1,200 level.

Looking to copper, futures bounced +0.37% yesterday mostly on short-covering after support at $3.10 held on Tuesday. Copper has become rather volatile recently and although the uptrend line dating back to March remains intact as of now (barely), there was a bearish cross in the moving averages earlier in the week (which was part of the reason we recommended taking profits on Monday). So, bottom line, we are paying close attention to the technicals due to the fact that the fundamentals have introduced heightened volatility. Having said that, the technicals are currently favoring the bears.

Market	Level	Change	% Change
Dollar Index	84.425	.005	0.01%
EUR/USD	1.2904	-.0031	-0.24%
GBP/USD	1.6193	.0088	0.55%
USD/JPY	106.81	.63	0.59%
USD/CAD	1.0943	-.0036	-0.33%
AUD/USD	.9158	-.0042	-0.46%
USD/BRL	2.287	.001	0.04%
10 Year Yield	2.534	.34	1.36%
30 Year Yield	3.269	.036	1.11%
Prices taken at previous day market close.			

Currencies & Bonds

The yen and the pound were the big movers yesterday as the euro and Dollar Index took a rest (both were little-changed). There was little news in the markets yesterday with regard to either currency, other than ECB Governing Council member Yves Mersch saying the ABS/covered-bond purchases don't equate to QE. But, everyone knows that's not true; they are private market QE, and he's just saying that to appease the Germans.

With Europe mostly quiet, we were focused on the dollar/yen, which rose to levels not seen since the mid-2000s—rising +0.58% to 106.84), and it's done so with little fanfare thanks to all the noise from Europe (ECB and Scotland secession worries).

The catalyst yesterday for further yen weakness was economic data, which as we've been detailing here has quietly turned for the worse over the past few weeks (more on that below).

Looking at the pound, it did the opposite of the yen – it rallied +0.70% midday yesterday after a new poll came out that showed the "Nos" for Scottish independence had regained the upper hand, although barely. Polls will be volatile between now and the vote one week from today, but the chances of a Scottish secession remain slim – polls always tighten and there are so many unknowns about the logistics of Scottish Independence, the "Nos" have the "fear" factor working for them.

Lost in all this is the fact that, over the past few days, BOE Governor Mark Carney has strongly hinted that rates may rise in the UK early next year. Point being, a lot of the "froth" that was built into the pound, based on expectations of rate increases this year, has now been taken out. On a trading basis, the pound vs. the dollar looks decently attractive here, but the real opportunity is in buying the pound vs. the euro (assuming Scotland doesn't actually vote for independence).

The Bank of England will almost certainly raise rates in the next 6 months, and the ECB will almost certainly engineer a further drop in the euro – so the directions of the two currencies are totally opposite. The same can't be said for the pound/U.S. dollar, where both central banks will tighten policy; it's just a question of who goes first.

Getting long the pound vs. the euro is actually easy, if you trade futures. The CME has a euro/pound futures contract and all you'd do is sell that contract (it's euro/pound, so you'd sell it to get long pound/euro). For us non-futures-trading mortals, you could construct it by selling FXE (euro ETF) and buying FXB (pound ETF) in equal amounts. While that should generally work, it's not quite as clean as the futures trade, because basically you're putting on two independent trades. Nonetheless, it's better than nothing.

The Yen Is at A 7-Year Low - And No One Seems to Have Noticed (And It's Not Done Declining, Either).

Tuesday it was PPI and machine orders that missed estimates, but the bigger theme here is this: The national sales tax increases that went into effect earlier this spring appear to have hit the Japanese economy harder than many thought. While the tax increase hasn't derailed the recovery, it has made PM Shinzo Abe "double down" on Abenomics by re-shuffling his cabinet, and putting incremental pressure on the BOJ to potentially ease policy further should the recovery lose further momentum. And, that has resulted in the yen breaking down materially, and DXJ hitting a 16-month high (it was up +2% yesterday).

The yen is oversold now and Japanese stocks are overbought, so there will be some sort of a consolidation or correction to restore some health to the market. But, beyond that, I do believe we are entering the second phase of this multi-year trade, following nearly 18 months of consolidation. Jeff Gundlach said earlier this week that he thinks the yen could trade to 200 over the next several years – and I'm not going to argue with that. But in the near term, remember that 110 has always been the rumored target for Abe & Co. with regard to dollar/yen. If past is prologue, it'll go a bit further beyond that before they start to care about it. Point being, we've got more to go in this trade in both the near and longer term.

Have a good day,

Tom

Position Sheet

Tactical Trading/Investment Account (Time frame of a few weeks to months).

Date	Position	Open Price	Stop	Strategy
9/4/14	HEDJ EUFN EWI EWP TBT	59.35 24.67 16.44 41.34 56.59	None	*"Long Europe" Portfolio: The move by the ECB to start a private market QE program, combined with the impending TLTROs, should give the European economy a significant boost over the coming months. Given the sour sentiment towards the region and relative attractive valuation we are committing capital to the trade. HEDJ remains the best way to hedge out a falling euro, while higher beta sectors of the EU economy (financials, Italy, Spain) should rally the hardest. Finally, the moves should end the German bond mania, which should weigh on Treasuries.*
7/28/14	DBC	25.65	None	*We have initiated long positions in DBC here as we believe many components of the benchmark index have become oversold, namely in the energy space. The potential target to the upside is close to the $27 mark. 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*
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 (9/8/14): After spending most of 2014 in trading range, the yen have broken down to new lows as expectations for pension reforms (allocation more Japanese pension funds away from Japanese bonds and into stocks) as well as the rising potential for more stimulus have weighed on the yen. It appears after nearly a year of consolidation, this trade is back "on."			
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 (9/8/14): One of the biggest positive influences on bods in 2014 has been buying from Europe, as German bunds and peripheral European debt saw mania buying on rising fears of deflation. Those money flows overwhelmed negative bond fundamentals in the US and sent Treasuries soaring. But, with the ECB engaging in QE, the European bond mania should break, and Treasuries should now resume their declines.			

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Asset Class Dashboard

(Updated 9.8.14)

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 traded to new highs again last week thanks to a big Friday rally in response to the softer than expected jobs report (it lowered levels of Fed angst). Despite the new highs, though, stocks traded a bit heavy last week and a period of consolidation looks in order, although beyond the very near term the back drop remains favorable.*
Best Idea: Buy Regional Banks (KRE). **Best Contrarian Idea:** Buy Small Caps (IWM).			
Commodities	**Bullish**	**Bullish**	*Commodities traded lower last week as a decline in WTI Crude oil and gold weighed on the complex. Both gold and oil are now at critical levels of support, but with the US economy accelerating and the growing potential for inflation, expect buyers to defend current levels.*
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 (again) after the ECB shocked everyone and unveiled private sector QE. Also helping the dollar rally was disappointing economic data out of Japan (the yen hit a new low for the year). While overbought, the path of monetary policy between the US and most of the rest of the world is diverging (US tight, everyone else loose), and that is dollar bullish.*
Best Idea: Sell the Yen (YCS) **Best Contrarian Idea:** Long Canadian Dollar (FXC)			
Treasuries	**Neutral**	**Bearish**	*Treasuries declined last week despite the disappointing jobs report, as the positive influence from Europe waned after the ECB announced private market QE. The 30 year Treasury is now below the 2014 uptrend, but before getting outright bearish short term, I'll want to see it close a few more times below that support level—as this 2014 rally deserves the benefit of the doubt.*
Best Idea: Short "long" bonds (TBT) **Best Contrarian Idea:** Short High Yield Bonds (SJB)			