7:00's Report

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

September 15th, 2014

Pre 7:00 Look

- Futures are drifting slightly lower this morning on general anxiety regarding the Chinese economy, the Scottish vote Thursday, and the FOMC meeting Wednesday.
- Chinese August industrial production missed estimates (6.9% vs. (E) 8.8%) and fell to its slowest pace in 2 years, weighing on emerging markets and commodity prices.
- Outside of the Chinese data the weekend was quiet, as all eyes turn to the Fed and Scotland later in the week.
- Econ Today: Empire Manufacturing Survey (E: 15.9), Industrial Production (E: 0.3%).

Market	Level	Change	% Change
S&P 500 Futures	1973.25	-3.50	-0.18%
U.S. Dollar (DXY)	84.485	.104	0.12%
Gold	1236.30	4.80	0.39%
WTI	91.58	-.69	-0.78%
10 Year	2.614	.083	3.28%

Equities

Market Recap

The S&P 500 declined -1.1% last week as concerns about an incrementally more hawkish FOMC statement this week weighed on stocks. The S&P 500 is up +7.42% year-to-date.

Despite being down only slightly through last Thursday, stocks traded "heavy" last week. Monday and Tuesday saw the S&P 500 decline back below 2,000 as levels of Fed angst crept higher. The specific catalysts were a San Francisco Fed paper that implied interest rates could rise faster than current market consensus, and growing concern about the phrase "considerable timing" being removed from the FOMC statement (which would mean rates could start to rise within 6 months).

But, with such little actual news last week, trading was dominated by swing traders, day traders and algos. Although they had some success, the fast money was unable to get the stock market to materially sell off, as stocks rallied Wednesday and Thursday once support at 1,980 held in the S&P 500 after two tests.

But, things were different Friday as there was some actual news to trade off of. Retail sales and consumer confidence both beat estimates, and that in turn saw Fed angst levels increase. Not surprisingly, then, the bears were able to engineer the biggest sell-off of the week (the S&P 500 fell -0.6%). The S&P 500 now starts this week sitting on key support at 1,985.

Trading Color

Market internals didn't really "confirm" the weakness in stocks last week, and that's part of the reason why I don't think we can read too much into the declines. (Despite the fact that I'm near-term cautious on stocks, last week's price action didn't further validate my own opinion—it was more consolidation than anything else).

The S&P 500 was the underperformer, dropping -1.1% (which implies a lot of fast-money futures traders were trying to run the index to create a cascade). The Russell 2000, despite dropping -1% on Friday, closed the week down -0.85%. Meanwhile the Nasdaq fell just -0.33% (thanks in part to AAPL).

More to my point, SPHB (the S&P 500 High-Beta ETF) was down just -0.64%. And if the market was selling off because investors were getting more cautious, we would see SPHB significantly underperform.

Market	Level	Change	% Change
Dow	16,987.51	-61.49	-0.36%
TSX	15,532.58	-2.74	-0.02%
Brazil	56,927.81	-1409.48	-2.42%
FTSE	6,788.50	-18.46	-0.27%
Nikkei	15,948.29	39.09	0.25%
Hang Seng	24,356.99	-238.33	-0.97%
ASX	5,473.45	-57.69	-1.04%

Prices taken at previous day market close.

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Looking then at sector trading, there was a very pronounced "higher interest rate trade" in the markets last week.

Market	Level	Change	% Change
DBC	23.83	-.19	-0.79%
Gold	1235.90	4.40	0.36%
Silver	18.68	.074	0.40%
Copper	3.079	-.0275	-0.89%
WTI	91.38	-.89	-0.96%
Brent	96.70	-.41	-0.42%
Nat Gas	3.887	.03	0.78%
RBOB	2.509	-.0098	-0.39%
DBA (Grains)	25.50	-.17	-0.66%
Prices taken at previous day market close.			

Banks significantly outperformed, as KRE (regional bank ETF) rallied +2% (so, outperforming the S&P 500 by +3%), while tech also relatively outperformed.

Conversely, SPLV (S&P Low Volatility Index) declined -1.8% (!), and although it's just one week, it underscores my point that typically "defensive" sectors like utilities won't provide protection in a market that is selling off along with bonds. XLU (the utilities ETF) fell -3.12% last week.

Outside of that rotation, the only other materially notable movement was from energy, which continued to badly underperform. XLE was down another -3.6% last week as Brent crude seems to have settled below $100/bbl, and WTI crude continues to trade heavy in the low-$90s. Adding to the negative sentiment were comments by Larry Summers that he supports a lifting of the export ban on U.S. crude. This weighed on the refiners (as this could be refiner-negative if it continues to gain momentum).

At some point, energy will be a "Buy" given the domestic economic strength, but the momentum is clearly lower and I'd be more patient.

On the charts the S&P 500 held support at 1,980 and is sitting at 1,985, and both of those levels are important. If they are broken on a closing basis, we could see an acceleration back toward the 1,950 level.

Bottom Line

Last week's trading was dominated by Fed expectations. Levels of Fed angst did rise, but the moves last week were much more about further consolidation than they were negative, as the declines came on low volume and with little conviction. (A lot of trading last week could be properly described as "noise.") Point being, even though I'm cautious on stocks here, I'm not reading too much into last week's declines at this point without some additional significant technical breakdown or negative news.

As far as this FOMC meeting goes, as mentioned I think the market has already priced in "considerable timing" being removed from the statement, and as such think there's the potential for a relief rally.

But beyond that, I continue to remain cautious on U.S. stocks, as the set-up simply appears to be "as good as it gets" for the immediate future. Any better economic data will be met with a "hawkish" Fed. So, for the market to continue grinding relentlessly higher, we need "Goldilocks" economic data and earnings growth (which will lead to margin expansion). And, I'm not saying it won't happen, but I'd prefer to direct incremental capital toward Europe (HEDJ) and Japan (DXJ). They simply are behind us in the recovery cycle and, on a relative basis, have more room for improvement.

With regards to US stocks, continue to watch JNK as a leading indicator for stocks—if we see it drop materially below the lows of last week ($40.56) that could be a cue to get a bit more tactically defensive,

Economics

Last Week

There were just two notable U.S. economic releases last week. Although neither was enough to force a change in the outlook for Fed policy, August retail sales were strong and incrementally viewed as increasing the chances for a hawkish statement change this week. Outside of that, the most important thing that happened last week from a data standpoint was some soft Chinese data renewed some concerns about the pace of growth.

Starting with the U.S., though, the most important number last week was Friday's retail sales report. The headline met expectations (up +0.6% m/m) but it was a better report than that.

The key indicator of retail sales is the "control" group that excludes car purchases, gasoline purchases, building material purchases and food service. As such it gives the best read on true consumer spending.

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The “control” group rose +0.4% in August, but more importantly the July number was revised higher from 0.1% to 0.4%, dismissing the concern that consumer spending had suddenly dropped off during the summer.

Does this number, by itself, mean the Fed will get more “hawkish” this week? No, it doesn’t—but consumer spending was one of the more sluggish sectors of the economy, and incrementally it bolsters the argument for the “hawks” to remove “considerable time” from the statement. So, bottom line, the retail sales report doesn’t mean any expectations of actual Fed policy will change. But for this week’s statement, it was viewed as slightly more “hawkish.” (Silly as it is, these are the things we need to worry about in the age of ZIRP and QE.)

Internationally, European data was almost all second tier last week, although it was better than recent reports. But, nothing last week changed the outlook for Europe (i.e., the continuation of a slow recovery).

There was a lot of Chinese data out last week, though, and generally it was disappointing. CPI and PPI were both below expectations (which is usually seen as a positive). But taken in the context of the soft import numbers two weeks ago, the lower inflation numbers furthered the concern that domestic demand in China is slowing.

Over the weekend, industrial production missed estimates (6.9% yoy vs. (E) 8.7%) while retail sales met. There are some concerns re-emerging about the pace of growth in China, but it’ll take more disappointing data (specifically, a lot more disappointing data) before legitimate concerns about a potential “hard landing” take shape.

China is transforming its economy, and that’s going to produce periods of slower growth. But the Chinese central bank and administration remain committed to around 7%-7.5% annual GDP growth. As long as that’s the case, China shouldn’t be a major macro headwind (although it will weigh on emerging markets, which is a positive for EUM).

Market	Level	Change	% Change
Dollar Index	84.465	.084	0.10%
EUR/USD	1.2924	-.004	-0.31%
GBP/USD	1.6247	-.0019	-0.12%
USD/JPY	107.21	-.11	-0.10%
USD/CAD	1.108	-.0012	-0.11%
AUD/USD	.9016	-.0021	-0.23%
USD/BRL	2.3392	.0002	0.01%
10 Year Yield	2.614	.083	3.28%
30 Year Yield	3.351	.097	2.98%
Prices taken at previous day market close.			

This Week

Obviously the FOMC meeting is the highlight this week, and the entire focus seems to be on whether the wording “considerable time” will be removed from the statement released at 2 p.m. Wednesday. Keep in mind, though, this is one of the meetings where we’ll get the Fed forecasts (the “dots”) and the Fed chair press conference.

I’ll preview it in Wednesday’s Report, but the bottom line is “considerable time” is the focus of the meeting. There is a definite fear the Fed will get very, very slightly more hawkish in tone (and given this Fed’s propensity to stay “dovish,” I’m worried the market may be a touch ahead of itself and we could see a “sell the rumor, buy the news” reaction).

Part of the reason the market expects this shift is because of the Chair’s press conference—the FOMC can remove “considerable time” from the statement and then she can refute that the Fed is getting more “hawkish” at the press conference. If they don’t do it here, the next press conference isn’t until December.

Outside of the Fed, we get our first look at September economic data via the Empire State manufacturing survey (this morning) and Philly Fed (Thursday), and in all likelihood they’ll both show that manufacturing activity in their respective regions continues to grow at a good pace. (However, activity in those regions has gotten pretty hot, so don’t be surprised by a dip in the numbers –but on an absolute level, activity should stay brisk.)

The other notable domestic release is the August housing data, with housing starts Thursday. The market will be looking for confirmation that the acceleration in the rebound we saw in the July data is continuing.

Internationally it is a very quiet week in both Europe and Asia. The German ZEW survey (out tomorrow) is probably the highlight. If the survey can surprise to the upside, this could help investor sentiment toward Europe as we approach the implementation of the ECB’s

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Targeted Long-Term Refinancing Operation (TLTRO) and private-market QE program (which starts in October).

Commodities

Commodities continued to decline last week as the dollar held recent gains. The benchmark commodity tracking index ETF, DBC, fell 3.2 %.

WTI crude oil fell 1.39% thanks to a bearish EIA report and a relatively stagnant geopolitical arena. Traders remain focused on the fact that supply levels remain very comfortable while global demand forecasts have been adjusted lower in recent weeks. The short term technicals however have shifted to favor the bulls as there was a bullish outside reversal on the daily chart on Thursday of last week. But, despite the bullish move and the possibility of a near term "pop," crude oil futures remain in a sharp downtrend that dates back to the middle of June and until we see that break, the path of least resistance remains lower. On the charts, $90.43 (last weeks low) is the level to watch on the downside while a close back towards $94 would be seen as bullish.

Natural gas futures rallied .81% and importantly held the $3.80 level last week despite the fact the EIA reported that inventories rose more than expected. We continue to believe that natural gas is currently a value as supply levels are still well below the 5 year average, and weekly injections are not on pace to replenish stockpiles to the "normal" levels for entering the winter "draw season." Technically, $3.80 has become solid support and is now the level to watch as a close below would be bearish.

Moving to the metals, both the industrial and precious varieties were under pressure last week as copper fell 2.2% and gold dropped 3.2%.

The price action of gold was rather bearish last week as futures dropped over 3% while the dollar was little changed. Gold prices dropped to 9 month lows as investors continue to speculate Fed policy decisions and the consensus expectations remain hawkish. Looking ahead, support at $1240 has been broken and we are looking to the $1200 level for next support. As we have been saying for some time now, the near term trend for gold prices remains lower however on a long term basis, the threat of rising inflation will continue to be an underlying bullish influence.

Currencies & Bonds

There were big (and important) moves in the currency and bond markets last week, and really what happened there was more important than what we saw in the equity markets.

Starting with bonds, as I said on CNBC on Friday, it appears as through the great "Bond Buying Fever of 2014" is breaking, as Treasuries continued to decline last week. Two-year Treasuries hit their highest yield since June 2011 (signaling some legitimate Fed "angst") while the yield on the 10-year is back above 2.6%. Finally, the 30-year was down every day last week and dropped -2%.

The reason for the declines was twofold: first, rising levels of Fed angst ahead of the FOMC, and second, continued selling of European bonds as the ECB targets inflation and economic growth. The decline in Treasuries is a bit ahead of itself going into the FOMC meeting, but even if they "dovishly" surprise, it would appear the trend in bonds has, finally, turned downward.

Looking at currencies, the Dollar Index surged again last week, rising +0.6% despite the fact that the euro also rose last week. Instead of a collapsing euro sending the dollar higher, last week it was the collapsing yen and "commodity" currencies. The yen violated key technical levels and dropped to a multi-year low vs. the dollar (and dollar/yen closed about $107), while the Australian dollar broke down through $0.90 after some lackluster economic data, and is now sitting at a 6-month low.

Bottom line is all these moves last week were violent for currencies. And again, the Fed being "hawkish" this week is at least somewhat priced in (so, there could be a relief rally in the aforementioned currencies vs. the dollar). But, the trend of dollar strength/broad global currency weakness will be with us for some time going forward.

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
9/11/14	EUM	24.05	None	*Short Emerging Markets. With the dollar surging higher and the global bond yields rising, this should put pressure on the emerging markets, as money rotates out of those economies back towards developed markets. Original Issue*
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. 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. Original Issue*
7/28/14	DBC	25.65	None	*Original Issue Closing Trade this Morning.*
7/21/14	UNG	20.98	None	*Natural gas is a supply/demand based trade. While injections over the summer have replenished supply, we are still 15% below historical levels, with the winter heating season drawing near, Natural gas in the highs $3.00's appears to be a value. 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 9.15.14)

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 declined 1% last week as markets consolidated ahead of the FOMC meeting later this week. The main "reason' for the declines was concern the Fed may get incrementally more "hawkish" by removing the term "considerable timing" from the statement. Until there's more clarity from the Fed, I expect a continuation of the consolidation we saw last week.*
Best Idea: Buy Regional Banks (KRE). **Best Contrarian Idea:** Buy Small Caps (IWM).			
Commodities	**Bearish**	**Bullish**	*Commodities traded lower , again, last week as a decline in WTI Crude oil and gold weighed on the complex. Dollar strength is the main negative influence on the commodity space, as are renewed worries about Chinese growth. Longer term there is value here, but for now the trend is lower.*
Best Idea: Buy Natural Gas (UNG) **Best Contrarian Idea:** Buy Grains (DBA)			
U.S. Dollar	**Bullish**	**Bullish**	*The Dollar Index surged to new highs for the year (again) but it wasn't driven higher by euro weakness last week. Instead, a sharp decline in the yen and commodity currencies helped push the Dollar Index higher, as did fears of a more "hawkish" Fed. While very*
Best Idea: Sell the Yen (YCS) **Best Contrarian Idea:** Long Canadian Dollar (FXC)			
Treasuries	**Neutral**	**Bearish**	*The decline in Treasuries accelerated last week, as the thirty year bond dropped 1% while the yield on the 2 year hit it's highest level since June 2011. The declines in bonds were global, as European bonds also fell, as the fundamentals of a ECB targeting growth and inflation and a more hawkish Fed are finally setting in.*
Best Idea: Short "long" bonds (TBT) **Best Contrarian Idea:** Short High Yield Bonds (SJB)			

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