7:00's Report

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

September 16th, 2014

Pre 7:00 Look

- Futures are slightly lower this morning but that's masking some pretty decent weakness internationally as everyone gets cautious ahead of the FOMC.
- China was the big laggard as Shanghai dropped 1.8% on growth concerns (nothing new just some delayed reaction to the soft IP).
- Europe is moderately lower in sympathy, although the only economic report, the German ZEW Survey, wasn't as bad as feared (Business Expectations fell to 6.9 vs. (E) 4.0).
- Econ Today: PPI (E: 0.0%).

Market	Level	Change	% Change
S&P 500 Futures	1973.50	-2.50	-0.13%
U.S. Dollar (DXY)	84.38	-.018	-0.02%
Gold	1240.3	5.20	0.42%
WTI	92.70	-.22	-0.24%
10 Year	2.591	-.023	-0.88%

Equities

Market Recap

Stocks closed little-changed to start the week, and again support at 1,980 held as investors looked ahead to the FOMC Wednesday and Scottish independence vote Thursday. The S&P 500 declined -0.07%.

Stocks started the week lower in quiet trading. A busy day of M&A couldn't help the market to overcome the general anxiety surrounding the FOMC meeting. Worries about Chinese economic growth were also a bit of a headwind, although it's important to note that despite the incrementally worse data, no one is really worried about a "hard landing" at this point.

NADL: North American Drilling has gotten killed this month as sanctions on Russia put a major contract in doubt. But, this is a real company, and worth a closer look at these levels.

The biggest catalyst of the day yesterday turned out to be the August industrial production report, which surprisingly missed estimates (more on that later – it wasn't as bad as it seemed). But, given the Fed is the major influence on the market right now, the soft IP was viewed as a buying opportunity by fast money and day traders. The 10 a.m. print of 1,978 on the S&P 500 ended up being the low tick of the day.

Much like last week, the remainder of the trading day was dominated by faster-money-type accounts fighting over a 5-point range in the S&P 500. Importantly, 1,980 held two more tests, and this led to short-covering into the afternoon. The S&P 500 finally turned positive after 2:30.

But – there was simply no follow-through from either the bulls or the bears yesterday, and stocks drifted back to flat during the final hour of trading and closed little-changed.

Market	Level	Change	% Change
Dow	17,031.14	43.63	0.26%
TSX	15,482.56	-49.02	-0.32%
Brazil	57,948.76	1020.95	1.79%
FTSE	6,777.62	-26.59	-0.39%
Nikkei	15,911.53	-36.76	-0.23%
Hang Seng	24,136.01	-220.98	-0.91%
ASX	5,445.36	-28.10	-0.51%
Prices taken at previous day market close.			

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Trading Color

Yesterday was a strange day – because while the S&P 500 and Dow Jones Industrials were flat, the Russell 2000 and Nasdaq got hit hard – both falling more than 1% (it's the second straight day the Russell 2000 was down more than 1%).

Market	Level	Change	% Change
DBC	23.87	.04	0.17%
Gold	1233.70	2.20	0.18%
Silver	18.64	.034	0.18%
Copper	3.09	-.0165	-0.53%
WTI	92.84	.57	0.62%
Brent	96.86	-.25	-0.26%
Nat Gas	3.92	.063	1.63%
RBOB	2.5353	.0165	0.66%
DBA (Grains)	25.42	-.08	-0.31%
Prices taken at previous day market close.			

And, not to bring up bad memories, but the "momentum" sectors of biotech and Internet stocks led on the way down, with QNET and NBI falling -2.20% and -1.53%, respectively. Additionally, SPHB fell -0.85%, further confirming the cyclical underperformance.

Most likely the selling was due to investors lightening up ahead of the FOMC and other catalysts, and the low volumes exacerbated the moves. But it was a bit disconcerting to see those sectors underperforming .

Hawkish/Dovish Scenarios for FOMC "Dots"			
Year	Average Expected Fed Funds Rate at June Meeting.	Its "Hawkish" above:	It's "Dovish" below:
2015	1.25%	1.50%	1.25%
2016	2.50%	2.75%	2.50%
2017	3.25%	3.50%	3.25%

We also saw an unwind of the "higher rate" rotation ahead of the FOMC tomorrow (and, more broadly, a bounce-back from recent underperforming sectors). Energy dead-cat-bounced +0.71%, helped by some covering and a rally in natural gas and oil. Meanwhile utilities also caught a small bid (up +0.31%). Conversely, banks gave back some ground yesterday (KRE down -1%, KBE down -0.48%). But, at this point with the FOMC looming, this feels a lot more like book-squaring ahead of the meeting than any sort of reversal of the recent trends.

On the charts 1,980 continued to offer strong support, and yesterday felt a lot like Wednesday/Thursday of last week (days when stocks tried to sell off but couldn't). 1,980 is becoming pretty important given how many times it's held now – so a decisive break of that level could lead to an acceleration lower.

Bottom Line

The weakness in cyclicals and continued underperformance of JNK (despite bonds trading higher yesterday) is leaving a bad taste in my mouth regarding yesterday's trading – and further reinforces my "cautious" stand on the market beyond the very near term. But, with regard to yesterday specifically, the level of activity and participation was low enough to chalk to move up to position-squaring and "noise" ahead of the FOMC.

Of note, though, was the fact that Europe (HEDJ) managed to close higher yesterday, and emerging markets continued to decline (EUM up +0.44%). So, we did see some differentiation from a regional perspective, and unless we get a major surprise (hawkish or dovish) out of the Fed this week, that's a trend I think can continue.

Expect a slow day today as we're devoid of any economic data and everyone will stay put ahead of the FOMC. 1,980 remains important support.

FOMC Preview

Tomorrow brings one of the more important FOMC meetings since the tapering began in December, and markets have prepared for a more "hawkish" tone from the Fed. Over the past week: The stock market had declined nearly -1.5%, the yield on the 2-year Treasury, which is more sensitive to expected Fed Funds rate news than longer-dated bonds, has risen to a 3-year high, the yield on the 10-year Treasury rose back above 2.60% briefly.

Point being, we're seeing some potentially significant moves across asset classes in anticipation of the FOMC tomorrow. So, I wanted to make sure that everyone has a "cheat sheet" so they can reference what's expected to change, the market interpretation and what to do once things start moving.

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Why The Market Thinks the Fed Is Going to Be "Hawkish"

The No. 1 reason the market has priced more hawkishness into this statement is because it's expected that the final paragraph in the statement will be altered, and the term "considerable time" will be removed from the following paragraph.

> *"To support continued progress toward maximum employment and price stability, the Committee today reaffirmed its view that a highly accommodative stance of monetary policy will remain appropriate for a **considerable time** after the asset purchase program ends and the economic recovery strengthens." (Emphasis added).*

That's potentially important because "considerable time" is generally thought to mean six months.

So a translation of the above statement would read:

> *"…the Committee today reaffirmed its view rates will stay at 0% for six months after the asset purchase program ends and the economic recovery strengthens."*

And, six months from October (when QE is expected to end) is March – not June, which is the current consensus for when rate hikes will commence. So, the bottom line here is there's a fear the Fed may be telegraphing an earlier-than-expected rate increase.

But, that's not all we need to watch for.

I've been saying for over a month now that the pace of interest rate increases is actually much more important than when the first 25-basis-point increase actually occurs. If the market perceives the Fed as wanting to raise rates faster than current expectations, that will be a massively hawkish event … and a negative on stock prices.

Because of that, the "dots" are important, and tomorrow we get the first look at expectations for where the FOMC members think interest rates will be at the end of 2017.

Bottom line: If we see movement higher in the "dots," that will be a hawkish surprise—regardless of the language of the statement.

Expectations

The market has moved pretty solidly ahead of this meeting, to the point where even if "considerable time" is removed from the statement, we might now see much of a reaction (and it's very much a coin flip if "considerable time" is even taken out).

So, while I do think the trend in interest rates has shifted and is higher, I think there's a risk of a "sell the rumor/ buy the news" reaction unless we see a material shift higher in the "dots." Unless Yellen is outrageously dovish in the follow-up press conference, any sort of a rally in bonds would be one to sell into, as again I do believe the trend has changed.

Economics

Industrial Production

- Industrial Production fell 0.1% in August vs. (E) of a 0.3% rise.

Takeaway

As opposed to the Empire State manufacturing survey, industrial production wasn't as bad as the headline implied. Headline IP in August turned negative for the first time in six months, although automobile production heavily skewed the number. Simply put, automobile manufacturing heavily skewed the number positive in July, and the "payback" weighed on the number in August.

Market	Level	Change	% Change
Dollar Index	84.38	-.001	-0.01%
EUR/USD	1.2937	-.0027	-0.21%
GBP/USD	1.6233	-.0033	-0.20%
USD/JPY	107.17	-.15	-0.14%
USD/CAD	1.1052	-.004	-0.36%
AUD/USD	.9026	-.0011	-0.12%
USD/BRL	2.3415	.0025	0.11%
10 Year Yield	2.591	-.023	-0.88%
30 Year Yield	3.341	-.010	-0.30%
Prices taken at previous day market close.			

But, even stripping out the effect of autos, it still wasn't a good number, mainly because of the revisions. The manufacturing component ex-autos was revised downward from 0.4% in July to 0.1%, and that growth rate remained the same in August (0.1%).

This number actually moved markets and there were buyers on the "soft" number, although again on an abso-

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lute basis the manufacturing sector of the economy remains healthy. Nothing in yesterday's reports would make the Fed even think about changing policy – and as for the market reaction yesterday, it was driven by fast-money and algos, not real money.

Commodities

Commodities were mixed to start the week. Natural gas, WTI crude oil and gold all rallied while Brent crude, copper and the grains underperformed. The broad-based commodity tracking ETF, DBC, edged up +0.17%

Natural gas was the best-performing commodity yesterday, rallying +1.92% and encouragingly closing near the highs of the day. Fundamentally, traders are continuing to focus on supply levels and speculating where inventories will be when we enter the draw season in late October. And, as we've been saying for a while now, the weekly supply injections are not currently on pace to see stockpiles fully replenished to normal seasonal levels. From a sentiment standpoint, speculative traders are currently the most-bearish they've been in 9 months according to the CFTC's Commitments of Traders report. This presents the risk of a short-squeeze.

The technical picture in natural gas is less clear at the moment. On the bullish side, futures have broken out above two longstanding downtrends on the daily chart as well as established solid support at $3.80 dating back to the middle of August. However, on a bearish note a head-and-shoulders pattern is forming on the daily time frame, leaving many technicians confused.

Going forward, there are a few key levels to watch. First, aforementioned support at $3.80 is very important. If we see a close below that level, it would be rather bearish. Meanwhile, resistance at the $4 mark is the first "level to beat" for the bulls.

Crude oil futures were mixed yesterday, with Brent falling -0.26% and WTI gaining +0.67%. The moves were largely the result of economic reports. Specifically, Chinese and EU data missed over the weekend, which weighed on Brent. But industrial production and the Empire State manufacturing survey here at home were in-line to better than expected, which sparked a rally in WTI. Also adding to WTI bids was more chatter of the outright repeal of the ban on exporting crude oil from the U.S. Looking ahead, energy traders will continue to focus on the very comfortable global supply situation.

In the metals, industrials fell thanks to the light global economic reports while gold consolidated recent losses. Copper was down -0.5% and appears to be rolling over here thanks growth concerns in China. And, it appears there is room for futures to fall further, back toward $3.

Gold saw a "dead cat bounce" yesterday, rallying +0.20% as shorts covered and the dollar gave back morning gains after the economic data stirred a dovish reaction from the markets. It was the first daily rise in 5 sessions, however, and with gold futures continuing to be in a sharp downtrend the path of least resistance remains lower. On the charts $1,240 is now acting as resistance while $1,200 is the next target to the downside.

Currencies & Bonds

Aside from some small movement yesterday from the Dollar Index in reaction to the soft IP report, both currency and bond markets were very quiet. And, that will in all likelihood continue today. The Dollar Index finished the day essentially flat while the euro and pound were little changed.

Despite the flat trading for most major currencies (euro, pound, yen) the Australian dollar continuing to decline to new lows. Aussie declined further below the $0.90 mark yesterday thanks to the soft economic reports out of China (IP particularly). Since breaking through support at $0.92 last week, the Aussie basically fell in straight-line and now sits at 6 month lows. I'd expect a bounce of some sort short term, but clearly the trend is lower. Looking ahead, concerns over the pace of growth of the Chinese economy will continue to weigh on the Aussie as Chinese demand for commodities would likely fall.

Turning to the bond market, we saw some covering and dip buying following the headline miss in US Industrial Production, and that is continuing this morning as recent shorts book profits ahead of the FOMC. I'd expect this small bounce to continue into the FOMC tomorrow morning, where things will then get decidedly more interesting. 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
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*
7/21/14	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 overbought and in need of a correction, the trend in the Dollar remains firmly higher.*

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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