7:00's Report

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

September 17th, 2014

DJIA: The Dow Jones Industrials (barely) made a new all time intra-day high yesterday, and although I remain cautious on stocks, that is a positive sign.

Pre 7:00 Look

- Futures are flat ahead of the Fed but international markets are higher following the strong US close. China outperformed thanks to reports of more "targeted" stimulus.
- Economically data was good from the UK. The August Labour Market report was better than expected (jobless claims declined by 37k vs. (E) 32k). The pound is only marginally higher though due to Scotland uncertainty.
- Econ Today: Consumer Price Index (E: 0.0), Housing Market Index (E: 56). FOMC Meeting: Fed Statement and Forecasts (2:00 PM), Fed Chair Press Conference (2:30 PM).

Market	Level	Change	% Change
S&P 500 Futures	1992.25	0.50	0.03%
U.S. Dollar (DXY)	84.225	-.006	-0.01%
Gold	1238.20	1.50	0.12%
WTI	94.82	-.06	-0.06%
10 Year	2.589	-.002	-0.08%

Equities

Market Recap

The S&P 500 surged back to 2,000 Tuesday thanks to a "dovish" comment from the WSJ's Jon Hilsenrath and a targeted Chinese economic stimulus package. The S&P 500 closed up +0.75%.

It looked like it was going to be a bit of a messy day early Tuesday. Global markets were decidedly in the red, dragged down by China, which declined on general economic growth concerns. But, the looming FOMC meeting cut sellers' conviction levels.

By the time stocks opened in the U.S., the averages were close to flat, where they remained for most of the morning, until shortly after 11.

At 11:15, though, a "dovish" trade occurred as the S&P 500 and Treasuries rallied sharply while the U.S. Dollar Index dropped. It was because of a prediction by the WSJ's Jon Hilsenrath during a webinar that the Fed will keep the "considerable time" phrase in their policy statement (a potentially dovish event – although it wasn't as dovish as it seemed, but more on that later).

Also helping stocks move higher was an underfollowed report that the Chinese central bank (People's Bank of China) had issued 500-billion-yuan credit lines to five major banks—ostensibly conducting a "targeted QE program" and flooding those banks with liquidity to help stimulate the economy (that's a positive move but doesn't materially change to outlook for China to materially bullish).

Shorts were totally caught off-guard and the S&P 500 proceeded to grind steadily higher throughout a mostly quiet afternoon. The S&P 500 briefly traded back above

Market	Level	Change	% Change
Dow	17,131.97	100.83	0.59%
TSX	15,510.54	27.98	0.18%
Brazil	59,114.66	1165.90	2.01%
FTSE	6,816.60	24.36	0.36%
Nikkei	15,888.67	-22.86	-0.14%
Hang Seng	24,376.41	240.40	1.00%
ASX	5,407.25	-38.11	-0.70%
Prices taken at previous day market close.			

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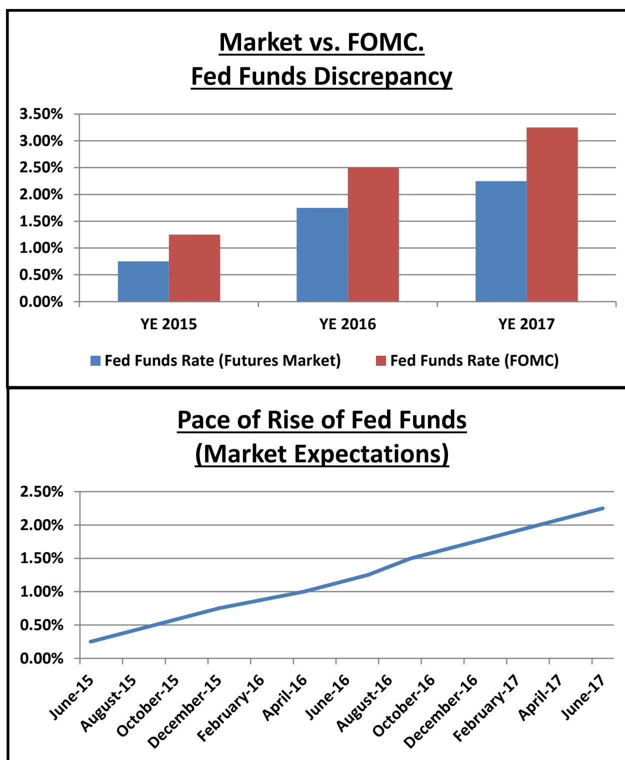
2,000 before giving a bit back into the close to finish just off the best levels of the day.

Trading Color

Market	Level	Change	% Change
DBC	24.09	.23	0.96%
Gold	1235.90	.80	0.06%
Silver	18.715	.095	0.51%
Copper	3.1595	.074	2.40%
WTI	94.78	1.86	2.00%
Brent	96.86	.21	0.22%
Nat Gas	3.988	.057	1.45%
RBOB	2.5582	.0274	1.08%
DBA (Grains)	25.46	.04	0.16%
Prices taken at previous day market close.			

Yesterday's rally was more a function of faster money being caught "off sides" than it was anything materially positive. Most professional trader's expectations have been for the next move in stocks to be lower, so most of the fast money has been positioned for a decline. The Hilsenrath comments caught those accounts off guard, and resulted in a sharp short covering rally for the S&P 500. But, there was no real money behind the rally yesterday, and this market remains dominated day to day by fast money and algos.



Cyclicals traded basically in-line with the S&P 500 as the Nasdaq ended the day up +0.8%, as did SPHB, while the Russell again mildly underperformed (up +0.40%). So, while it was a good headline rally, there wasn't any confirmation via cyclical outperformance (which again speaks to the lack of conviction in the rally).

Given the "dovish" headlines, it wasn't surprising we saw a reversal of the "higher rate rotation" that's been ongoing for well over a week. Utilities, healthcare, REITs and energy (all the biggest laggards recently) outperformed and rallied more than +1% each, Conversely, we saw banks continue to underperform, with both KBE and KRE falling about -0.5%.

The "momentum" sectors (biotech and Internet stocks) bounced back yesterday following Monday's drubbing, but the moves were relatively muted and reinforced yesterday was mostly a day of repositioning in light of surprisingly "dovish" headlines.

Bottom line is the market was a touch unbalanced with expectations of a "hawkish" result from the FOMC, and yesterday helped to restore some balance. But, with that said, the risk now is that the Fed is mildly disappointing at today's meeting (not outright hawkish, but not dovish, either).

Bottom line, this market continues to feel "heavy" to me. 1,980 is key support; if that's broken today (I know it's a bit lower than where we are right now), look for an acceleration lower. I still think we've got more consolidation to work through between 1,980 and 1,950.

The Fed's Perception Problem (and why it's Hawkish)

If the FOMC does indeed become incrementally more "hawkish" today, it'll likely be because of the growing fear among Fed officials that the market views the Fed as simply being too "dovish."

We've heard several Fed presidents reference this, and last week there was a San Francisco Fed paper citing this potential problem.

And, the worry that the market doesn't "believe" the Fed isn't some general "feeling" – it's actually backed up by hard data.

Fed Funds futures, which trade on the CME and can be accessed via this link, reflect the market consensus of where the Fed Funds rate will be at the end of each month. And, simply put, the market is reflecting a much more dovish Fed than what FOMC members are stating.

The Fed Funds futures prices shows a much slower and more gradual increase in interest rates than the official

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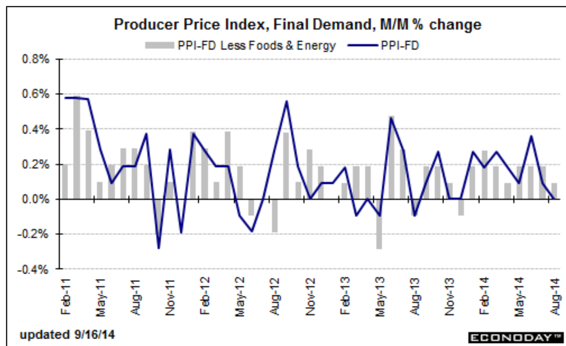
Fed projections – plain and simple. And, frankly, this type of discrepancy is significant.

And, it's a problem for the Fed.

If the Fed isn't being taken seriously (as a hawk) then that poses a potentially serious problem. While the Fed wants to start to restrain the risk-taking and the unbridled "chase for yield" it's manufactured over the past several years, if the market doesn't believe the Fed will actually raise rates, then the excessive risk-taking will continue—potentially resulting in bubbles.

Point being – there is some room here for the Fed to give the markets a bit of a "hawkish" dose of reality today – if not via the removal of "considerable time," then via other means, including the "dots" as we described yesterday, or via Yellen's press conference.



Point being, the propensity for the Fed to give us a "hawkish" surprise is rising. While that won't guarantee the bond declines will continue in the near term, the simple fact is that the setup is for the Fed to, finally, be slightly more hawkish. That is, until the market, as reflected by Fed Fund futures, starts to believe rates will rise sooner than is currently the consensus.

Finally, I've mentioned frequently that the pace of the increase in rates is more important than the date rates start to rise. You can monitor both via Fed Fund futures (or you can just let us do it … we're watching it either way). The way it works is you subtract Fed Fund futures from 100 to get the implied Fed Funds rate. So, right now the market anticipates the first rate increase to occur in June 2015 – and if that changes tomorrow, one way or the other, Fed Funds futures will let us know.

Market	Level	Change	% Change
Dollar Index	84.22	-.178	-0.21%
EUR/USD	1.2959	.0019	0.15%
GBP/USD	1.6273	.0042	0.26%
USD/JPY	107.14	-.02	-0.02%
USD/CAD	1.0968	-.0085	-0.77%
AUD/USD	.9093	.0066	0.73%
USD/BRL	2.3266	-.0156	-0.67%
10 Year Yield	2.589	-.002	-0.08%
30 Year Yield	3.354	.013	0.39%
Prices taken at previous day market close.			

Scotland: The Only Poll We Need to Watch

There are all sorts of conflicting polls regarding whether the Scots will vote "yes" for independence or "no." But, I've learned over the years that the best way to get a gauge on these types of geopolitical events is to follow the money. InTrade used to be the preferred prediction market to watch, but that got shut down, so now I watch Paddy Power, Irish book makers who make odds on just about anything.

To that end, I went on PaddyPower.com yesterday to check the odds. "Against Independence" was the prohibitive favorite, at 2/7 (so wager 7 to get 2). "For Independence" was a distant 11/4 (wager 4 to get 11). Point being, according to the "market," Scotland isn't going anywhere.

Economics

There were no material economic reports yesterday.

Commodities

Commodities were mostly higher yesterday, led by energy and metals partially thanks to the Chinese "stealth QE" headlines but also by the article from the WSJ's Hilsenrath that spurred a sell-off in the dollar. The benchmark commodity ETF, DBC, rallied +0.96%.

Copper led the commodities space higher yesterday, with futures rallying +2.3% thanks to the news that the PBOC was set to unleash a 500-billion-yuan private QE program. Copper futures actually had to be temporarily halted midday as algorithms drove prices up almost +4% in true short-squeeze fashion. Keep in mind there were a lot of relatively new shorts in the market thanks to the recent pullback in Chinese economic data.

On the charts, downtrend resistance held through the short-lived spike and futures closed well off the highs of the day. The technical picture is neutral for the near term; however, a solid downtrend has formed on the daily chart so the path of least resistance remains lower. Near-term support lies below at \$3.11 while there is resistance above at \$3.19

Gold futures spiked higher on the Hilsenrath article that

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was initially seen by the market as dovish. But much of those gains were given back over the course of the afternoon, and futures closed higher by only +0.11%. Gold futures have broken down through former support at $1,240, and that level is now acting as resistance as we approach the FOMC meeting announcement and Yellen's speech later today.

On the charts, gold continues to be in a sharp downtrend, largely thanks to the recent strength in the dollar. However, like copper, there are a fair number of "young shorts" in the market and the potential for a corrective rally exists. But, over the medium term, $1,220 is the next target to the downside.

Moving to energy, WTI crude oil futures were already higher yesterday morning thanks to some bullish supply-side data. First, Nigerian oil workers went on strike, which could potentially affect the nation's crude production (average of 2.3M barrels/day in August) if an agreement is not reached quickly. And second, OPEC's secretary general mentioned a possible cut in 2015 output targets. Later in the morning, futures accelerated higher on the Chinese stimulus news and held gains into the close, finishing the day up +2.01%.

Looking ahead, the EIA report will be in focus this morning, with analysts forecasting 1.2 million barrel draw in supplies, while RBOB is expected to be unchanged and distillates to rise by 400k barrels. Also, the technicians are going to be watching price action closely for the rest of the week, as WTI seems to have formed a bottom on the charts at the $92 level and the bulls threatened resistance between $95 and $96 yesterday.

Natural gas rallied +1.58% to close just short of resistance at the $4 mark. A tight 20-cent range has been established between $3.80 and $4.00; however, a series of "higher lows" on the daily chart and the fundamental situation continues to favor the bulls. So, we remain bullish on natural gas futures.

Currencies & Bonds

It was a reversal day in the currency markets yesterday, as the "long dollar/short everything else" trade was wound too tight short term and it was primed for some unexpected event to cause an unwind. That unexpected event was the "dovish" commentary from Hilsenrath about the "considerable time" phrase staying in the statement. When that hit at about 11:15, we saw an immediate, sharp sell-off in the dollar (it fell -0.5% almost instantly) and a rally in nearly every other currency.

But, while the moves were initially violent, they didn't last all that long, as markets realized the Hilsenrath comments weren't all that "dovish" after all. The Dollar Index ended the day down -0.2% (which isn't that much, considering the relentless rally we've seen over the past several weeks) while the euro and pound were up +0.2% and +0.3% respectively (again, not that much considering the declines we've seen recently).

As has been the case lately, the big volatility came from the commodity currencies. The Aussie rallied +0.76% to close back above $0.90 thanks to a 1-2 punch of the dollar weakness and the aforementioned Chinese targeted stimulus. Meanwhile the Loonie also saw a decent rally (+0.7%) after BOC Governor Poloz forcefully denied trying to engineer a weaker Loonie. "A floating loon is a think of beauty, and so is a floating Loonie" he said. The comments helped peripherally, but the bounce in the Loonie was mostly in sympathy with commodities and because of dollar selling. Mr. Poloz's comments, while quirky and funny, won't materially change the bearish outlook for the Canadian dollar, especially if the Fed is anything other than "dovish" tomorrow.

Finally, turning to Treasuries, the 30-year bounced on the Hilsenrath prediction, but in yet another sign this market has turned, it couldn't hold the gains and the 30-year closed down fractionally on the day.

There are two takeaways from yesterday in the currency and bond markets. First, the initial reaction to Hilsenrath shows this market is a little too "dollar-bullish" so there is a definite chance for a "sell the news" reaction from the Fed for the dollar ("buy the news" in Treasuries). But, beyond any short-term counter-trend move, fundamentals continue to turn in favor of a higher dollar and (potentially substantially) lower bond prices.

Have a good day and Happy Birthday to my Dad!

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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