7:00's Report

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

September 19th, 2014

Banks continue to trade very well, and KRE (regional bank ETF) appears to be breaking out to the upside.

Pre 7:00 Look

- Futures and international markets are modestly higher, rising in sympathy with the US and in relief following the failed Scottish independence vote.
- Japan was the outperformer o/n, as the yen decline accelerated and the Nikkei rose 1.6% on that currency weakness. There wasn't any catalyst for the leg down in the yen, and this is more momentum than anything else.
- Economically it was quiet o/n and there is nothing material scheduled for today. All the focus is on BABA, but it is also a "Quad Witch" so we will see some big volumes into the close.

Market	Level	Change	% Change
S&P 500 Futures	2011.00	6.50	0.32%
U.S. Dollar (DXY)	84.66	.23	0.27%
Gold	1222.20	-4.70	-0.38%
WTI	91.93	-.06	-0.06%
10 Year	2.629	.029	1.12%

Equities

Market Recap

The S&P 500 traded to a new, all-time intraday high Thursday as investors embraced the Fed decision as supportive for stocks. The S&P 500 rose +0.49%.

Stocks opened higher and despite jobless claims and Philly Fed both being good numbers, the stock market didn't view them as overly hawkish. With levels of Fed angst receding, stocks hit their highs of the day early and basically stayed there throughout the morning session.

The afternoon got very quiet and, like the last few days, after the initial spike stocks basically treaded water for the remainder of the session (which in this case was almost the entire day).

Fed-wise, both Yellen and Vice Chair Stanley Fischer spoke yesterday, but neither made any comments that moved the markets (as expected following an FOMC meeting).

Stocks meandered for the final hour of trading before closing quietly, just off the highs of the day.

Trading Color

Like the previous two days, we didn't see any material cyclical outperformance. This again implies the rally is more futures- and fast-money driven, and not something that has a lot of conviction, yet.

The Nasdaq and Russell 2000 both were broadly in line with the S&P 500, while SPHB outperformed marginally.

Sector-wise, there once again was pronounced outperformance by higher-rate-sensitive sectors, as financials were the best-performing S&P 500 sub-sector while KRE rallied big, up +1.77%.

Market	Level	Change	% Change
Dow	17,265.99	109.14	0.64%
TSX	15,465.54	6.66	0.04%
Brazil	58,374.48	-733.71	-1.24%
FTSE	6,858.21	38.92	0.57%
Nikkei	16,321.17	253.60	1.58%
Hang Seng	24,306.16	137.44	0.57%
ASX	5,433.06	17.23	0.32%
Prices taken at previous day market close.			

Conversely, utilities again badly lagged, with XLU dropping -0.77% (worst-performing S&P 500 sub-sector). REITs also underperformed, as did homebuilders; both dropped around -1% each. We are definitely seeing the rotation out of "bond proxy" plays into "higher rate"-sensitive sectors.

Market	Level	Change	% Change
DBC	23.77	-.21	-0.88%
Gold	1226.60	-9.30	-0.75%
Silver	18.555	-.179	-0.96%
Copper	3.0965	-.047	-1.50%
WTI	92.01	-1.19	-1.28%
Brent	96.86	.23	0.24%
Nat Gas	3.916	-.097	-2.42%
RBOB	2.5655	-.0037	-0.14%
DBA (Grains)	25.28	-.24	-0.94%
Prices taken at previous day market close.			

On the charts things obviously got more positive, as the S&P 500 hit a new all-time high.

Bottom Line

Basically stocks rallied yesterday on the view that the Fed, while turning more hawkish, isn't going to de-rail the equity rally just yet by raising rates sooner or more quickly in the near term. So, while technically "hawkish," the Fed remains largely accommodative.

But, while the rally has to be respected, I again am not sure where material upside comes from in this current setup. The rallies this week, while legitimate, are almost all index-driven and on little to no volume. As such, despite the new highs, I remain cautious about adding broad domestic equity exposure at these levels.

What Does Low TLTRO Demand Mean for the "Long Europe" thesis?

One of the biggest surprises of the week came yesterday morning, when demand for the ECB's first "Targeted Long-Term Repurchase Operation" came in much lower than expected (82.6 billion euros vs. expectations of about 150 billion euros). And, as a refresher, TLTROs are basically "free"-money, four-year loans the ECB is offering to banks to try and stimulate lending and the real European economy.

On the surface, the lack of demand is a negative. At first glance, it implies that even though the money is "free" (it's not actually free, but the interest rates are very low), there simply isn't a demand for the funds. This means the European economy is even weaker than we thought; that, obviously, is bearish. Immediately following the news, European shares declined and the euro rallied (on deflation fears).

But, as usual, there's more to it than meets the eye. Certainly the lack of demand from banks could be indicative of the factors mentioned above (namely, there's just no end-user demand for money in the EU economy).

But, there are some other reasons demand at this initial auction might have been so low. First, there are EU stress tests looming in October. And, what banking regulators on both sides of the Atlantic haven't yet figured out is this: You can't put banks' balance sheets under constant scrutiny and hold the prospect of demanding capital ratio increases—while at the same time offering them an abundance of cheap capital—and wonder why they don't take it. So, point being, demand may have underwhelmed because of looming stress-test concerns.

Second, there's a 10-basis-point spread between the current rate offered on the TLTROs, and the EU refinance rate. That's important because the original LTROs, which were 3-year loans made to banks at the depths of the euro crisis in December 2011, have an interest rate equal to the refinance rate.

So, let's say a bank borrowed 1 billion euros on the original LTRO in December '11. That loan is coming due this December, and it's at a rate 10 bps cheaper than the new TLTRO. So, it would make sense for me to hold onto that cheaper capital for the remaining three months, and then take advantage of the 2nd offering of the TLTRO in December. It saves me 10 bps over three months – and when you're talking about billions, it adds up.

Point being, there is more at work here logistically that might have suppressed demand for the initial TLTROs. But, it puts a lot more importance on the December offering, because these logistical quirks won't exist any longer.

Interestingly, though, despite the underwhelming demand, the market took the "bad news as good." The soft demand was seen as increasing the chances for ECB QE, and the euro declined after that initial rally and EU stocks rose. That's because, at the end of the day, the

ECB *has* to do everything necessary to fight off deflation. If the EU falls into deflation, there's a good chance the whole union will break up in the coming years. Simply, the ECB can't fail – the market knows that, and if that means they will grudgingly do QE, so be it.

So, despite the lackluster demand, this doesn't change my outlook on my "long Europe" call. And, if anything, this setup reminds me of the U.S. in the fall of 2011, when David Tepper famously pointed out: "If the economy falters further, they do more QE and stocks go up. If the economy picks back up, stocks go up." It's never quite that easy, but it seems to be close to a similar setup in Europe.

Economics

Philadelphia Fed Manufacturing Survey

- Sept General Business Conditions were 22.5 vs. (E) 23.0

Takeaway

Despite dropping 5.5 points from the August reading of 28.0, Philly Fed was still a strong report. The headlines were in line with expectations. New orders, the leading index in the report, rose slightly to 15.5 and employment surged to 21.2 vs. 9.1 in August.

There were some spinning this report as disappointing given the drop from August, but it's the absolute level of data that matters now, not the incremental change. As long as economic data stay in the current absolute range, the prospects for the Fed to become more "hawkish" increase with each passing month. So, it's the absolute level, not the direction of change, that matters now with economic data and the Fed.

Market	Level	Change	% Change
Dollar Index	84.435	-.051	-0.06%
EUR/USD	1.2915	.005	0.39%
GBP/USD	1.6373	.01	0.61%
USD/JPY	108.77	.40	0.37%
USD/CAD	1.0951	-.0045	-0.41%
AUD/USD	.8981	.0023	0.26%
USD/BRL	2.3656	.0075	0.32%
10 Year Yield	2.629	.029	1.12%
30 Year Yield	3.359	-.005	-0.15%

Prices taken at previous day market close.

Weekly Jobless Claims

- Weekly Claims plummeted to 280K vs. (E) 305K

Takeaway

Initial jobless claims dropped a volatile 36K to 280K last week vs. expectations of 305K. The 4-week moving average, which offers a smoother look at the data, encouragingly fell back below 300K—down 4.75K to 299.5K. There were no special seasonal factors that would have skewed the report, and although the weekly data remain volatile, the recent rise in claims (that led the 4-week moving average back above the 300K mark) has been reversed by last week's report. It is worth noting that last week was the "sample week" for the BLS jobs report, which will certainly up the "whisper number" for the September report.

Commodities

Commodities were almost universally lower yesterday with the sole exception being Brent crude, which held on to a fear bid ahead of the Scottish independence vote and finished the day marginally higher (the ongoing strike in Nigeria also supported prices). The benchmark commodity tracking index ETF, DBC, fell -0.92%.

Natural gas was the worst performer yesterday, falling 2.4% on the backside of an EIA inventory report that almost exactly matched expectations (90 Bcf vs. E: 89 Bcf). There was a pretty sharp sell-off on the number as a lot of spec longs unwound, but the selling pressure faded out at $3.90 and futures drifted sideways into the close.

The bullish supply-side fundamentals remain very much intact as inventories are still well below the 5-year average. And, although they are making up a lot supply thanks to the nation's ever-increasing production capacity, all it will take is one or two early-season cold blasts to really interrupt supply injections that are already not on pace to replenish stockpiles to the levels normally seen as we enter the draw season.

On the charts, the recently reclaimed $4.00 mark was disappointedly forfeited yesterday, but support at $3.90 (50-day MA) held. Going forward, we continue to like the idea of opening positions or adding to existing positions as futures dip toward the aforementioned $3.90 level—or, even better, toward solid range support at $3.80.

WTI crude oil continued its recent trend of range-bound trade, selling off -1.25% yesterday to give back all of the week's gains. But, part of the drop back toward $92 was a result of the active contract shifting ahead to November from October. Going forward, the technicals are still favoring the bears, but are leveling out on the lower time frame. Support has been established at $92, but it barely held yesterday, and the dominant downtrend dating back to June is still intact. Until we see that broken, we are expecting more sideways trade despite the fundamental demand argument being bullish.

Moving to the metals, copper fell -1.5% yesterday and gave back more of Tuesday's gains that were driven by the Chinese stimulus chatter. As we said in yesterday's Report, copper is trading heavy as fears over both Chinese growth and the stronger dollar continue to weigh on the industrial metals. Copper futures have room to trade lower going forward, with the next level of solid support being down between $3.01 and $3.02.

Gold dipped to $1,216 in early trade yesterday, which was the lowest level since early January, as longs continued to unwind positions thanks to the hawkish Fed. Gold futures did however bounce back $10 to close at $1,226 for just a -0.75% loss on the day. And although the risk for a short-covering bounce remains, the path of least resistance remains lower as the dollar continues to hold recent gains. On the charts, the $1,200 mark is in focus while there is resistance at former support of $1,240.

Currencies & Bonds

Thursday was a day of digestion in the currency and bond markets, as we finally saw a reduction in volatility. The yen was the exception, which continued its implosion vs. the dollar, falling another -0.67%. U.S. economic data, which were somewhat mixed, weren't really an influence on the currency or bond markets yesterday.

The Dollar Index, following Wednesday's surge higher, traded slightly lower (down -0.07%) almost entirely on digestion. The euro also was flat on the day, although again it initially spiked following the low demand for the TLTRO, and briefly broke back above 1.30 vs. the dollar. It turned around once the market interpreted the results as increasing the chance for QE.

Both currencies have had tremendous moves during the last few weeks with major events (ECB meeting) and potentially major events (FOMC meeting) now behind us – and I think we'll see a bit of a consolidation in both currencies going forward.

We now know the money was right on Scottish independence (as usual) and we're seeing the Pound rally in sympathy, although the moves aren't as big as you would expect (keep in mind the pound rallied over the past few days in anticipation of a "no" vote). Going forward I think we could see some further incremental upside in the pound, but nothing that I think is worth risk capital at this point.

Looking at the yen, a lot of the "dovish" comments by BOJ Governor Kuroda over the past 48 hours were drowned out by the Fed, Scottish and TLTRO hysteria. But the simple fact is that Kuroda again reminded everyone that the BOJ will act again to ensure their 2% inflation target is met (if he deems it's necessary to act). The selling momentum continued overnight as the yen went briefly into free fall, rising above 109 yen/dollar, but has now settled down. This move is getting a little too ahead of itself, so I'd expect some consolidation over the coming week.

Turing to Treasuries, the 30-year was down small yesterday (declining -0.18%) as it also was in digestion mode. But, Treasuries continue to trade heavy (they tried to rally yesterday but couldn't). Unless we get another buying spree from Europe (which would only happen if the ECB starts to hedge their commitment to further accommodation), the trend downward in bonds should continue over the coming weeks. Regardless of how you read the Fed earlier this week, there wasn't anything in there that was bullish Treasuries, as its clearly now a question of "when", not "if", they get more hawkish.

Have a good weekend,

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)			