7:00's Report

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

September 22nd, 2014

Pre 7:00 Look

- Futures and global markets are lower this morning on renewed concerns about Chinese economic growth.
- Chinese shares led markets lower, down more than 1%, ahead of Sept. flash PMIs released later tonight. The negative catalyst was cautious comments on the economy by Chinese finance minster Lou Jiwei.
- There were no economic reports o/n.
- Econ Today: Existing Home Sales (E: 5.18M saar). Central Bank Speak: Draghi (9:00 AM EST), Dudley (10:05 AM EST), Kocherlakota (7:30 PM EST).

Market	Level	Change	% Change
S&P 500 Futures	1997.00	-6.75	-0.34%
U.S. Dollar (DXY)	84.85	-.015	-0.02%
Gold	1214.50	-2.10	-1.17%
WTI	91.62	-.03	-0.03%
10 Year	2.587	-.042	-1.60%

Equities

The S&P 500 surged to another new all-time high following a "less hawkish than feared" FOMC Wednesday and a rejection of Scottish independence Thursday. The S&P 500 rose +1.2% last week and is up +8.77% year-to-date.

Stocks started last week in a cautious mode. The S&P 500 closed flat Monday, and all eyes and focus were on the Fed. But, stocks caught a nice bid and had their best day of the week Tuesday after the WSJ's resident Fed "spy" said in a webinar that he thought "considerable time" would stay in the statement. That caught traders off-guard, and a short-covering rally took the S&P 500 to just below 2,000 by the close.

Hilsenrath was right, of course. Stocks rallied again Wednesday to close back above 2,000 after the Fed statement was taken as "dovish" (or, really, less hawkish than feared). The rally continued Thursday on follow-through buying and on relief that Scotland voted to stay in the United Kingdom. The S&P 500 traded up to both a new intraday and closing all-time high.

The rally extended further on Friday morning, and honestly it seemed like all the BABA hype was the main positive catalyst. But once BABA opened, stocks turned around and despite making another new intraday high, the S&P 500 closed very slightly negative. However, Friday was a "quad-witch" so some of the afternoon action was certainty options-related.

Trading Color

Despite the S&P 500 making new all-time highs, we again didn't see a lot of conviction in the move higher. The S&P 500 was by far the best-performing major average, as the Nasdaq was up just +0.42% and the Russell 2000 actually closed down more than -1%.

Sector-wise it was the same, as SPLV handily outperformed SPHB thanks to a sell-off in the latter Friday and a move higher by utilities on Friday following the drop in interest rates. SPHB was up just +0.21% while SPLV rallied +0.97%.

There was a definitive and aggressive "higher rate" rotation through Friday, when that trade unwound a bit as bonds rallied. Banks and financials rallied more than +1% despite a decent drop on Friday, and importantly both KBE and KRE broke out on the charts last week.

Basic materials surged midweek on news of China's

Market	Level	Change	% Change
Dow	17,279.74	13.75	0.08%
TSX	15,266.35	-200.19	-1.29%
Brazil	57,788.70	-585.78	-1.00%
FTSE	6,786.85	-51.07	-0.75%
Nikkei	16,205.90	-115.27	-0.71%
Hang Seng	23,955.349	-350.67	-1.44%
ASX	5,362.96	-70.10	-1.29%

Prices taken at previous day market close.

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"targeted stimulus" package, and XLB hit a new 52-week high Thursday, although the stimulus wasn't a bullish game-changer for China.

Finally, international markets continued to outperform. DXJ rallied +1.6% to a new 16-month high, while "Europe" rallied over +1% last week as well.

The "higher rate" rotation and international outperformance are trends I think can continue, although they are short-term overbought and need a bit of consolidation, which we may see this week.

Market	Level	Change	% Change
DBC	23.68	-.07	-0.29%
Gold	1215.30	-1.30	-0.11%
Silver	17.70	-.144	-0.81%
Copper	3.046	-.0455	-1.47%
WTI	91.95	-.46	-0.50%
Brent	97.65	-.74	-0.75%
Nat Gas	3.832	-.005	-0.13%
RBOB	2.5981	-.0133	-0.51%
DBA (Grains)	25.16	-.13	-0.51%
Prices taken at previous day market close.			

Bottom Line—Shorter Term Still Cautious

Last week's rally to new highs was impressive and obviously a positive. (Technical trading rule #1 is "Buy what's making new highs.")

But, the #1 reason for the broad S&P 500 rally continues to be short-term positioning by traders and money managers, as once again the short-term guys were simply too negative heading into the Fed (expecting them to be "hawkish").

We saw it start last Tuesday with the Hilsenrath comments. The "dovish" prediction caused a short-covering rally, which extended through Wednesday on the actual release and into Thursday when stocks grinded to new all-time highs, pulling reluctant buyers in on the long side.

We know this by how the market traded. First, Tuesday, Wednesday and Thursday saw short, sharp spikes higher in futures and broad indices. And after that spike, markets basically traded sideways (the hallmark of short-covering).

Second, the S&P 500 continues to outperform not just cyclical indices, but also cyclical sectors. When that happens, it usually reflects a "renting" of long exposure. (Money managers and traders need to get more "long" so they buy S&P futures or SPX, not specific sectors they are bullish on. It's usually a sign of a low-conviction buying.)

Now, does any of this negate the new highs? Of course not, but I'm pointing it out because I feel like the market is now full of very "weak hands" on the long side. If we get some sort of a surprise negative event, we could see an ugly day over the coming weeks. Point being, this isn't the type of high-conviction, high-quality rally that makes you comfortable about your longs.

As a result, I continue to be worried we're at the "as good as it gets" stage in the short term, because anything else really "good" happening economically will be met by a more "hawkish" Fed. So, I continue to prefer international exposure and "short bond" plays as destinations for new capital. We may see a bit of a dip in both those trends this week (they are both a touch overbought) but I view that as a decent entry point for anything other than shorter-term accounts.

Bigger Picture: 4 Pillars of the Rally Remain Intact—But there are Cracks Appearing.

The 4 pillars of the rally remained intact this week: 1: Global central banks remain very accommodative (the Fed confirmed, at least in the near term, it isn't becoming more "hawkish" and rate "lift-off" expectations remain in mid-2015. 2. Global macro horizon remains clear (Russia/Ukraine continues to fade and ISIS is no longer advancing in Iraq). 3. The global recovery remains intact, although Chinese data has faded a bit on the margin and Europe is still teetering. But for now, it's still a recovery. 4. Valuations are still reasonable, but we won't be able to say that for much longer if the melt-up rally continues. The S&P 500 is now at 16.75X 2014 EPS, and 15.25X 2015 EPS (2015 EPS nudged up a bit to $131-$132).

So, bottom line is that while in the near term I remain cautious on stocks and think there is a chance for a sharp, painful move into the mid-1,900s, the fundamentals remain in place to keep less tactical and longer term "long equity" allocations in place and not materially de-risk, yet.

Economics

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Last Week

There were plenty of economic reports last week (and they were in aggregate slightly weaker than expected) but the real focus was on the FOMC. While the Fed's "hawks" seem to be gaining strength, the takeaway is that the expectations for policy remain unchanged.

Starting with the Fed, you know by now that they kept the "considerable time" phrase in the statement. Generally speaking the statement was considered slightly "dovish" when compared to expectations (which got a touch too "hawkish" going into the meeting).

But, the "dots" were increased, implying Fed officials now expect interest rates to rise faster than they envisioned back in June, and that was taken as "hawkish" by both the bond and currency markets. So, depending on which camp you're in (equities vs. all other assets), the Fed was both "hawkish" and "dovish."

Stocks rallied after the meeting because, while the Fed was on balance slightly more "hawkish" in an absolute sense, they certainly aren't going to pull forward tightening at this point. So, the Fed will remain a tailwind on stocks.

But, from a risk standpoint, I took this Fed meeting to show that it's just a question of "when" the Fed gets more hawkish. The risk of a "hawkish" surprise in the coming months is rising, while the risk of a "dovish" one has diminished almost to zero. So, incrementally the risk of a "hawkish" surprise is rising, and that makes me less bullish on U.S. stocks generally. The risk of a "hawkish" Fed surprise that rattles markets is rising, while the risk of a "dovish" surprise is virtually nil at this point.

Market	Level	Change	% Change
Dollar Index	84.80	-.065	-0.08%
EUR/USD	1.2847	.0019	0.15%
GBP/USD	1.634	.0054	0.33%
USD/JPY	109.05	.04	0.04%
USD/CAD	1.0978	.0017	0.16%
AUD/USD	.8876	-.0045	-0.50%
USD/BRL	2.3677	-.0002	-0.01%
10 Year Yield	2.587	-.042	-1.60%
30 Year Yield	3.299	-.060	-1.79%

Prices taken at previous day market close.

Turing to the actual data, it was a bit soft last week. August industrial production missed and, even stripping out a big negative for a drop in auto production, the number was still underwhelming.

Housing starts also missed estimates, while the first look at September regional manufacturing activity was mixed, with Empire State manufacturing beating while Philly slightly missing. (But both remain strong on an absolute sense.)

The biggest surprise of the week came from CPI, which dropped -0.2% in August, while "core" CPI was flat month-over-month for the first time since January. It was a surprise, and I saw some analysts try and spin it as a "dovish" influence on the Fed. But I don't think any moderation in inflation would make the FOMC more dovish at this point, as deflation simply isn't a threat. The FOMC knows they have to start removing liquidity before something bad (like a bubble) starts to form (or pop) depending on your opinion of the Fed.

This Week

The biggest release to watch this week is the global flash manufacturing PMI. The most important number is China's, which comes tonight. Recent data show the Chinese economy is losing some steam, but we're still a long way from any renewed fears of a "hard landing." So, even if this number is a miss, it likely won't be too much of a negative influence. But, that said, if it drops below the 50 level, that could weigh on markets tomorrow morning (so, more of a short-term thing than a negative macro event).

Europe comes Tuesday morning and markets will want to see some incremental improvement over August (the absolute level will be very low, but at this point it'll be encouraging if Europe is at least seeing some incremental acceleration of activity). And, here in the U.S., everyone expects the number to be strong. But if it's very hot, that may push levels of Fed angst a touch higher, so the stocks bulls need a "Goldilocks" to slightly weaker number. Outside of the global PMIs, it's quiet internationally.

Domestically, we get more housing data (Existing Home Sales today, New Home Sales Wednesday). Again, the market is looking for constant reinforcement that the housing recovery remains in gear and is gaining momentum.

Bottom line is the global flash PMIs are the most important release this week, and as long as they meet general market expectations (slow but positive growth in China and

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Europe; strong growth in the U.S.), they shouldn't elicit too much of a response).

Commodities

Despite some inter-week, news driven volatility (largely the FOMC announcement and the Chinese stimulus headlines) most commodities finished the week little changed last week as they continue to consolidate recent losses. The benchmark commodity tracking index ETF fell 0.63% on the week.

The rallying dollar has been the overarching theme in the commodity markets recently causing steady declines across the space since the greenback really began to rally back in July. Metals have been effected the most directly by the dollar's gains, however energy has also suffered. And, although most commodities appear to be taking a "breather" and consolidating, the strengthening dollar will continue to be a headwind going forward.

Crude oil futures slipped .41% last week but did make a promising run at the September highs mid-week thanks to the Chinese stimulus chatter improving the global demand outlook. But, futures failed to hold the gains and prices fall back towards $92 to finish the week. Fundamentally, we continue to believe that WTI will eventually begin to rally as demand rises with the improving global economy however the near term trend still favors the bears. The 2014 low of $90.43 that was established earlier this month will be in focus going forward and will be seen as a "line in the sand" of sorts for the bulls.

Natural gas finished the week essentially unchanged as the EIA inventory report match analyst estimates on Thursday that triggered a selloff in which most of the week's gains were forfeited. The supply situation continues to favor the bulls as inventories remain well below the 5 year range and the technicals are continuing to favor the bulls as well. Pretty solid support has formed at the $3.80 level but futures will need to close above $4.00 several days in a row before the bulls will really take control of the market.

Moving to gold, the dollar has been the primary influence and that will likely continue in the near term as the dollar is in a solid uptrend against most major currencies. So, the path of least resistance remains lower in gold with the $1200 level now in focus. Looking ahead to the medium and longer term though, the threat of inflation is still looming on the horizon which will eventually ignite a rally in the precious metals. But, according to last week's flat CPI report, that is not happening just yet.

Currencies & Bonds

The currency and bond markets viewed the Fed as "hawkish" as the Dollar Index surged to another 14-month high, rallying +0.75% and rising against the euro, yen and Aussie. (The pound traded higher on Scotland relief and the Loonie bounced because of economic data.)

The yen was the biggest loser vs. the dollar last week, as several "dovish" comments by BOJ Governor Kuroda and PM Abe sent the dollar/yen surging above 109 (nearly a 10-year high). The move was pretty violent and swift, and we'll almost certainly see a bounce in the yen as this pace of decline isn't sustainable (and if you have a profitable trade in YCS or DXJ and it's a short-term play, I'd book profits). But, longer term the trend remains very much intact.

The euro fell to a new 14-month low Friday after disappointing demand for the ECB's TLTRO. Simply, the ECB balance sheet is still falling, and they need to get it to rise to save the EU economy. The market views the bank as doing whatever it takes to achieve that goal, so every failure simply increases the chances of QE. Short term we may see a bit of a bounce in the euro, as it's likely some deflation fears will again creep in following the TLTRO results, but that bounce would be one to sell.

Treasuries actually ended the week positive thanks to a big Friday rally, despite reacting to the Fed "hawkishly" and declining Wednesday. Friday's rally was mostly Europe-inspired, as I'm sure the failed TLTRO (which is being welcomed by stocks) probably spooked some deflation fears in European bond investors. Europe remains a big influence on Treasuries, so we could see a bounce in Treasuries if the EU flash PMIs miss tomorrow. But unless the data are awful and we get another deflation scare, that bounce is imply an opportunity to add shorts, as it appears the trend in bonds in now lower.

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*
7/21/14	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."

Date Initiated	Strategy	Position (s)	Investment Thesis
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 9.22.14)

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 rallied to new highs again last week after the FOMC was less "hawkish" than feared, which caused traders and faster money to chase indices higher. Broadly speaking the "4 pillars" of the rally remain in tact, but we continue to be cautious near term, as things in the US appear to us simply "a good as it gets" economically.*

Best Idea: Buy Regional Banks (KRE).

Best Contrarian Idea: Buy Small Caps (IWM).

	Near Term Trend	Long Term Trend	Market Intelligence
Commodities	**Bearish**	**Bullish**	*Commodities continued to be under pressure, as a very strong dollar and concerns about Chinese economic growth weigh on the complex. Oil continued to slip last week and previous metals sold off hard as gold traded with currencies and bonds, taking the Fed as hawkish. With Chinese growth worries and a strong dollar, the near term out-look for commodities remains unattractive.*

Best Idea: Buy Natural Gas (UNG)

Best Contrarian Idea: Buy Grains (DBA)

	Near Term Trend	Long Term Trend	Market Intelligence
U.S. Dollar	**Bullish**	**Bullish**	*The Dollar Index surged to a new 4 year highs (again) as both bonds are currencies took the FOMC as incrementally more "hawkish" due to the rise in the Fed rate forecasts (the dots). The Dollar Index is now very overbought, and consolidation is needed, but the trend remains clearly higher.*

Best Idea: Sell the Yen (YCS)

Best Contrarian Idea: Long Canadian Dollar (FXC)

	Near Term Trend	Long Term Trend	Market Intelligence
Treasuries	**Neutral**	**Bearish**	*Treasuries actually bounced last week thanks to a big Friday rally, despite trading lower following the Fed (bonds took the meeting as hawkish). The trend in bonds is now downward but we could see a bounce this week on renewed European demand for Treasuries, but any material rally should be sold.*

Best Idea: Short "long" bonds (TBT)

Best Contrarian Idea: Short High Yield Bonds (SJB)

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