7:00's Report

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

September 23rd, 2014

Pre 7:00 Look

- Futures are lower this morning, as global manufacturing PMIs were mixed (but on balance a slight negative).
- China's Sept PMI was surprisingly better (50.5 vs. (E) 50.2), helping to alleviate some growth concerns. Asia saw a mild relief rally.
- Europe is being weighed down by a soft German PMI, which dropped to 50.3 vs. (E) 51.2 (the rest of Europe was "ok" and it's again reinforcing European growth worries.
- Econ Today: Flash Manufacturing PMI (E: 58.1). Fed: Powell (8:20 AM), George (8:30 AM), Bullard (E: 9:00 AM).

Market	Level	Change	% Change
S&P 500 Futures	1980.75	-5.50	-0.28%
U.S. Dollar (DXY)	84.54	-323	-0.38%
Gold	1226.70	8.70	0.71%
WTI	91.32	.45	0.50%
10 Year	2.566	-.021	-0.81%

A "Death Cross" in the Russell 2000: The 50 day MA broke below the 200 day MA yesterday.

Equities

Market Recap

Stocks dropped sharply Monday. The S&P 500 had its worst day in six weeks, as worries about Chinese and global growth weighed on markets. The S&P 500 closed down -0.80%.

Stocks were lower from the outset yesterday on concerns about China, ahead of the flash PMIs and after cautious comments from the Chinese finance minister. Also, we saw a continuation of Friday's declines as weak-handed longs, who were pulled into the market, sold today.

Turing to Monday's events, the highlights were comments by two important central bank officials: Draghi and Dudley. (Draghi is important for obvious reasons, Dudley is considered a bellwether for the "consensus" of the Fed.) Neither said anything particularly new, although both were "dovish" on the margin.

Draghi directly addressed the poor TLTRO of last week, stating initially that both the September and December TLTROs should be viewed in tandem, and then went on to reiterate that the ECB will do whatever is necessary to prevent deflation (again, a veiled reference to QE). Though his comments contained nothing new, they did help to send the euro negative on the day and Treasuries off the highs.

Dudley was also slightly "dovish" as he cautioned not to focus too much on the "dots" (he cited the obvious—there's a lot that can happen in 3 years). But, he hedged that a bit by saying that "considerable time" isn't a guarantee (implying it still will be removed in the near fu-

Market	Level	Change	% Change
Dow	17,172.68	-107.06	-0.62%
TSX	15,129.00	136.35	0.89%
Brazil	56,826.93	-961.77	-1.66%
FTSE	6,685.07	-88.56	-1.31%
Nikkei	16,205.90	-115.27	-0.71%
Hang Seng	23,837.07	-118.42	-0.49%
ASX	5,415.73	52.77	0.98%
Prices taken at previous day market close.			

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ture).

Finally, news also broke that Charles Plosser, the Philly Fed president, would retire in March 2015. Although Plosser is an ardent "hawk," his retirement won't have any effect on the FOMC — Philadelphia doesn't have a vote on next year's FOMC.

Market	Level	Change	% Change
DBC	23.47	-.20	-0.84%
Gold	1216.20	-.40	-0.03%
Silver	17.770	-.074	-0.41%
Copper	3.044	-.0475	-1.54%
WTI	90.86	-.79	-0.86%
Brent	96.96	-1.43	-1.45%
Nat Gas	3.85	.013	0.34%
RBOB	2.5837	-.0277	-1.06%
DBA (Grains)	25.165	.005	0.02%
Prices taken at previous day market close.			

Stocks basically hit their lows for the day when Dudley finished speaking, and spent the remainder of the session basically treading water down just under -1% as trading got quiet before bouncing slightly into the close.

Trading Color

Despite the stock market rallying last week, we made a point to alert clients that cyclical and growth sectors weren't confirming the move higher. Well, cyclicals didn't just "not confirm" the rallies; they badly underperformed yesterday and "confirmed" the declines..

"Growth" got hit hard yesterday, as the Russell 2000 continues to trade very heavy. The Russell was down another -1.53% and traced out a "death cross" on the charts (the 50-day MA crossed the 200-day MA to the downside).

"Growth sectors" also underperformed as Internet and biotech (like last Monday) got hammered with both QNET and NBI falling -2% and -1.01%, respectively. Other cyclicals like industrials, energy and consumer discretionary all fell well over -1%.

Selling was broad yesterday as all 10 S&P 500 sub-sectors were weaker. There was little relative outperformance to be found, with the exception of consumer staples, which declined only slightly.

On the charts support at 1,990 held, but really the key levels to watch (if they are tested) are 1,985 and 1,980.

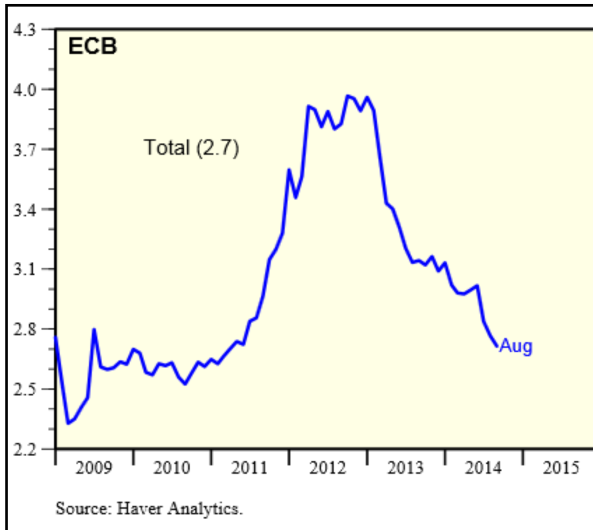
Bottom Line

Yesterday's declines, like last week's rally, were again mostly about short-term positioning. While painful, this isn't a material negative, yet.

The market got "squeezed" higher starting Tuesday of last week on a "not as hawkish as expected" FOMC, and in large part Friday's and Monday's declines were just an undoing of that squeeze higher.

I continue to remain cautious on this market and am looking at JNK still as the leading indicator. (Support sits at $40.46 and $40.24; if either of those levels break I think it's a bad sign for stocks.) In the S&P 500, 1,980 is now a key area to watch, as that was support that held two weeks ago. Really, until we break that level, this is nothing more than a continuation of the consolidation.

The Key to Europe—the ECB Balance Sheet (What It Means for Stocks and Bonds)



Contrary to all other major central banks, the ECB balance sheet has been falling for nearly 2 years, and that must change, and soon.

What Happened: Part of the reason we've seen a rally over the past two days in the Treasury market is because of Europe—specifically the "dud" of the first TLTROs late last week.

Not only was demand for the initial offering poor (86.4 billion vs. (E) 150 billion euros), but on Friday European banks actually repaid nearly 19 billion euros worth of the previous LTRO, making the total addition to the ECB balance sheet only about 67 billion (86.4B - 19B)—less than half of the 150 billion the market expected.

Why It's Important: The size of the ECB balance sheet is very critical to the economic recovery in Europe. QE, TLTROs, ABS purchases and all the other acronyms are simply tools being deployed to accomplish the same

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goal—to get the ECB balance sheet to rise.

The logic goes that if the ECB can expand its balance sheet and pump money into the system, then they should create economic growth. That would in turn create inflation, which would then solve the deflation problem they are currently experiencing. (That script has "worked" in the US, UK and lately, Japan).

So, to keep things simple, an expanding balance sheet is inflationary and positive for growth, while a contracting balance sheet is deflationary. And as you can see from the chart, the ECB is the only major central bank whose balance sheet has been contracting.

How We Make Money Off It: If the ECB fails to materially expand its balance sheet, then deflation will get a tighter grip on the economy. European bonds will rally like they did for most of this year, and that will put upward pressure on Treasuries—just like it did from March to September.

As the ECB implements these measures (TLTRO, ABS), you will see the market waver in the short term between thinking the measures are working (and the balance sheet expanding, which is Treasury-bearish) and the measures failing (as in the case of last week, which is Treasury-bullish).

Treasuries will be much more sensitive to the short-term data from Europe than stocks. But importantly, as long as the ECB remains committed to expanding the balance sheet, any short-term rally is "noise" compared to the overall negative trend in bonds.

European stocks should be much less sensitive to short-term fluctuations than bonds. That's because, as was the case last week, the failure of the initial TLTRO was just seen as further increasing the odds of QE. The ECB simply cannot fail to increase its balance sheet and spur a recovery—because if they do, it's very likely the EU would split apart. (Southern European countries are not going to stay in the EU if deflation takes hold—they will break away and devalue their own currencies.)

Market	Level	Change	% Change
Dollar Index	84.795	-.07	-0.08%
EUR/USD	1.2848	.002	0.16%
GBP/USD	1.6366	.008	0.49%
USD/JPY	108.74	-.27	-0.25%
USD/CAD	1.1026	.0065	0.59%
AUD/USD	.8876	-.0045	-0.50%
USD/BRL	2.3909	.023	0.97%
10 Year Yield	2.566	-.021	-0.81%
30 Year Yield	3.289	-.010	-0.30%
Prices taken at previous day market close.			

So, bottom line is this:

"Short bond positions" will see volatility depending on what's happening with the ECB balance sheet, because it will directly affect Treasuries. But, the trend should remain lower in bonds as long as the ECB remains committed to balance sheet expansion. So, don't get spooked by counter-trend rallies.

For "long Europe" equity positions, the trend upward should be more smooth, as stocks are clearly viewing "bad as good" in Europe—as long as the expectation remains that the ECB will eventually do QE. Point being, the trends (Treasuries down, European stocks up) remains in place despite the fact we're likely to see some short term counter trend moves.

Economics

Existing Home Sales

- Existing Home Sales fell 1.8% m/m to 5.05M SAAR vs. (E) 5.18M.

Takeaway

Existing home sales were disappointing, falling in August compared to expectations of a slight gain, while July data were revised very slightly lower (from 5.15 million to 5.14 million, saar).

Yesterday's existing home sales report, although soft, was by no means a "game-changer" in the housing market. Overall the housing trends remain decent, and although a slight miss, housing has definitely seen some improvement from earlier this year. The slightly soft housing numbers in August aren't going to make people significantly more worried the housing recovery is losing steam, unless we see an acceleration next month. Bottom line is the data had little effect on the markets.

Commodities

Commodities continued to slide yesterday, led lower by crude oil and copper, as traders showed concern for the Chinese economy and the dollar

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edged up to another fresh high. The benchmark commodity tracking index ETF, DBC, fell -0.84%.

Copper fell -1.6% to a more than a 3-month low over concerns surrounding the Chinese economy, specifically a statement in which China Finance Minister Lou Jiwei. He said the government would take additional steps to stimulate the economy despite the recent dip in economic data caused yesterday's weakness. Bottom line, the price action of copper remains largely dependent on China going forward, and additional "soft" economic data will lead to further weakness in the industrial metal. On the charts, the path of least resistance is down toward the even $3.00 mark.

Elsewhere in metals, gold futures were little-changed yesterday after dipping to $1,208 overnight. The trend in gold remains lower; however, futures are approaching support here toward $1,200. The major theme in precious metals is the stronger dollar, and until that rally loses some steam or we see an uptick in inflation metrics, the dollar will continue to weigh on gold.

Moving over to crude oil, WTI futures fell to a new 2014 low of $90.41 and finished the day down -0.77% thanks to both the bearish Chinese news as well as more chatter that OPEC will not adjust production levels in spite of very high global inventories. WTI made a fresh 17-month low yesterday and the trend remains lower for the near term.

Natural gas wavered yesterday but the bulls defended support at $3.80 and futures finished the day higher by +0.50%. We continue to like the bullish fundamentals in natural gas, but we need to see futures break out of the technical range that has formed on the charts. The two key levels to watch are support at $3.80 and resistance above at $4.00.

Currencies & Bonds

Bonds rallied for a second straight day Monday mostly on European buying and in reaction to a weaker stock market—but the gains weren't nearly as big as I would have expected. The 30-year finished up just +0.18% and well off the best levels of the day, despite several bond-positive influences, including a weaker stock market (S&P 500 down -1% and bonds not moving is something to note), a "not hawkish" Dudley, and an existing home sales miss.

But, as we've said for a while now, Europe is a major (and perhaps predominant) influence on Treasury prices in the short term, and the dovish comments by Draghi helped cap any material Treasury rally.

So, although the last two days have been losses for short bond positions, there was a bit of a moral victory (and that's continuing this morning as Treasuries are only up small on soft European data, although we'll see how the day goes).

Turning to currencies, it was again mostly quiet except for the commodity currencies, which continue to exhibit unbelievable volatility.

Starting first with the majors, though, the Dollar Index was unchanged after starting the day weaker. But the greenback caught a bounce on the Draghi comments, while the euro did the opposite. It started slightly higher and then came off in the morning, finishing flat on the day. The pound rallied +0.25% as it continued to recoup some of a "Scotland independence" sell-off, but that's not going to be a major positive influence going forward.

Again we're seeing a reversal of the recent trend thanks to the soft EU flash PMIs: The euro is up on weak growth and deflation concerns, while the dollar is down moderately—but again given the enormity of the recent moves, I'm frankly surprised it's not more this morning.

As mentioned, the real action yesterday was in the commodity currencies, which makes sense given Chinese growth worries were the major influence on trading yesterday. Both the Aussie and Loonie fell -0.66% on general commodity weakness, as the Aussie broke below $0.89 to a new 6-month low and the Loonie moved closer to support at $0.90. The trend in both (fundamentally and technically) remains decidedly lower.

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 9.22.14)

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).			
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)			
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)			
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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