7:00's Report

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

September 29th, 2014

Pre 7:00 Look

- Futures are lower on general digestion of last week's declines while Asian markets were hit following protests in Hong Kong.
- Economically it was a quite night, but focus this morning will be on inflation. First, we get German CPI as a precursor to the flash HICP coming tomorrow. And, at 8:30 we get the Core PCE Price Index which is the Fed preferred measure of inflation.
- Econ Today: German CPI (E: 0.8%). Personal Income and Outlays (E: 0.03%).

Market	Level	Change	% Change
S&P 500 Futures	1964.00	-12.00	-0.61%
U.S. Dollar (DXY)	85.755	-.012	-0.01%
Gold	1221.60	6.20	0.51%
WTI	93.06	-.48	-0.51%
10 Year	2.535	.024	0.96%

Equities

Market Recap

The S&P 500 dropped sharply last week on general global growth concerns and technical trading. Even with a decent Friday rally, the S&P 500 closed down -1.4% on the week. The S&P 500 is up +7.28% year-to-date.

Stocks were heavy from the start last week as the S&P 500 dropped the most in six weeks (at that point) Monday following cautious comments from the Chinese finance minister regarding the pace of economic growth in China. The selling continued Tuesday, although it did moderate a bit from Monday's pace, following disappointing European flash manufacturing PMIs.

Wednesday we saw a bounce (not unlike Friday) after news broke early that Chinese officials may be replacing the current PBOC chairman (a move seen as potentially "pro-growth"), and Mario Draghi made comments again affirming the ECB's willingness to do QE if necessary. Also helping the rally Wednesday was trader positioning, as the S&P 500 held another test of 1,980 and that led to short-covering by day traders and fast-money funds. The S&P 500 closed just under 2,000.

Than came Thursday. The S&P 500 suffered its worst daily decline in months despite the absence of any really "negative" catalyst—and regardless of media reports, there was no fundamental real "reason" for Thursday's declines. Instead, the S&P 500 opened lower and heavy selling finally pushed it below support at 1,980. From there we just saw piling on that brought the S&P 500 all the way down to 1,965.

Friday brought more "dovish" comments from Draghi and markets bounced, with the S&P 500 again retaking support at 1,980 aided by a strong final Q2 GDP report (4.6%). However, the move (like Thursday's sell-off given Rosh Hashanah) came on low volume and with little conviction.

Trading Color

Anytime the S&P 500 is down -1.4% on the week, there isn't much insight to glean from market internals. That's because everything gets sold regardless of fundamentals. The highest-beta sectors get hit the worst, while lower-beta sectors get hit less hard, but also decline.

And, so it was last week: Tech, financials, consumer discretionary and industrials all lagged, while healthcare was the relative outperformer (XLV down -0.6%). Utili-

Market	Level	Change	% Change
Dow	17,113.15	167.35	0.99%
TSX	15,026.77	133.20	0.89%
Brazil	57,212.38	1250.30	2.23%
FTSE	6.637.54	-11.85	-0.18%
Nikkei	16,310.64	80.78	0.50%
Hang Seng	23,229.21	-449.20	-1.90%
ASX	5,264.22	-49.20	-0.93%
Prices taken at previous day market close.			

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ties also relatively outperformed, but not by much. I continue to think that sector should not be viewed as a place to "hide" given the apparent trend shift in interest rates.

Market	Level	Change	% Change
DBC	23.49	-.04	-0.17%
Gold	1217.50	-4.40	-0.36%
Silver	17.57	.132	0.76%
Copper	3.0365	.0065	0.21%
WTI	93.40	.87	0.94%
Brent	96.94	-.06	-0.06%
Nat Gas	3.984	.013	0.33%
RBOB	2.6596	-.0584	-2.15%
DBA (Grains)	25.3117	.1717	0.68%
Prices taken at previous day market close.			

Finally, the Russell 2000 continues to badly lag the S&P 500, as it dropped -2.4% (!) last week, and also traced out a "Death Cross" on the charts as the 50-day MA crossed down through the 200.

The Russell underperformance so far this year hasn't been the harbinger of doom many thought it would be. Yet, the performance gap between the Russell and the S&P 500 is getting pretty extreme. (Russell 2000 is down -3.1% year-to-date.)

Bottom Line

Last week's sell-off was painful, but at this point doesn't appear to be anything materially worse than what we've seen three other times this year (late January, early April, late July).

The general backdrop for stocks remains positive, but stocks have felt heavy for the past two weeks due to:

1) Markets accepting the Fed is ending QE in October, which will begin to be less of a tailwind on stocks,
2) Recent lackluster Chinese economic data renewing concerns about global growth, and
3) Continued worries the ECB will fail to beat deflation (prompted in part by the soft TLTRO demand).

None of these "reasons" are new nor are they more dire than a month ago. But for now they are weighing slightly on sentiment.

1,955 in the S&P 500 (the 100-day moving average) now becomes important, because that MA has been **where every dip this year has stopped**. So, unless we get a material break of that level, this remains a typical 3%-5% pullback we've seen so many other times over the past two years.

But, I'm not being dismissive here—the weakness in junk bonds and emerging markets are important indicators to watch. While neither has signaled decisively that this equity move may be something more than we've seen, they are not trading well at all. I would be very surprised if we don't test 1955 this week, as Friday's bounce was mostly "noise."

From a "what to do" standpoint, I don't think we have any reason to materially de-risk at this point—but obviously I remain cautious.

If I had new capital to allocate this week, I'd do three things:

1) Buy HEDJ (Europe ETF) with an SPX hedge,
2) Buy EUM as an outright hedge against stock exposure, and then ...
3) Buy KRE (regional banks) with an SPX hedge.

Economics

Last Week

The calendar was busy, but the only number of any real importance last week were the flash global manufacturing PMIs. There were gives and takes, as always, but the bottom line was that they met current market expectations (and as such aren't rocking the global macro boat).

Growth remained strong in the U.S. While it was a "technical miss" vs. expectations (57.9 vs. (E) 58.1), the September flash PMI was the second-highest ever. So on an absolute basis, it's still strong.

In Europe, official EMU PMI stayed above 50 (so technically in expansion territory). But, the German number was a big miss (50.3 vs. (E) 51.2), and that number was definitely the biggest disappointment last week.

But, if Germany was the disappointment, then China was the positive surprise. Despite loud "whispers" that PMI would drop below 50, it actually rose slightly. It confirmed what we know about China: Growth isn't particularly strong, but it's not about to implode either.

The takeaway from last week was: The U.S. is still strong, China is "OK" and Europe remains in the economic ICU.

This Week

It's a busy week of data with a large number of reports.

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While we get insight into virtually every corner of the domestic and global economy this week, the most important numbers to watch will be from Europe.

In order of importance: EMU flash HICP (their CPI) (Tuesday), U.S. jobs report (Friday), ECB decision and press conference (Thursday), global official PMIs (Tuesday night/Wednesday morning), global composite PMIs (Thursday night/Friday morning).

The EMU HICP is the most important number of the week because it'll offer us the latest insight into whether we are seeing a continued slight moderation of deflation fears in the EU. Because a "triple-dip" recession in the EU remains the #1 global macro risk to watch, it's obvious why this inflation reading is so important.

The jobs report here in the U.S. is always important, although honestly it's not quite as monumental as it has been in the past. Unless it's another "dud" like August, or a very hot number (say north of 300K) it's not going to shift expectations for the Fed. But, it will be important to see a bounce-back and a revision higher to August's disappointing 142K. Also keep in mind it's "jobs week," so we get ADP Wednesday and claims Thursday.

The ECB meeting Wednesday won't bring any new policies or interest rate cuts, but the market will be looking for more reassurance from Draghi & Co. about both their willingness to do QE if needed (and it almost certainly will be), and their reaction to the soft TLTRO demand. (If he can make a credible case why he thinks the December offering will be good, that will help market sentiment and be EU-stock-positive, bond-negative.)

The official PMIs are released Tuesday night/Wednesday night, and China's official government manufacturing PMI will be the most important number to watch. It's holding on above 50 and if it can confirm the surprise uptick we saw in the Markit flash PMI last week, it'll help alleviate some nerves about the pace of China's economic growth. The European and U.S. numbers will obviously be closely watched, but they shouldn't differ too far from the "flash" readings we got last week. (If there's a surprise negative revision to the European data, it may weigh on markets a bit, but there are too many other catalysts this week for it to do any major damage.)

Market	Level	Change	% Change
Dollar Index	85.77	.003	0.01%
EUR/USD	1.2679	-.007	-0.55%
GBP/USD	1.6243	-.0072	-0.44%
USD/JPY	109.28	.54	0.50%
USD/CAD	1.1152	.0044	0.40%
AUD/USD	.8761	-.0025	-0.28%
USD/BRL	2.4198	.00	0.00%
10 Year Yield	2.535	.024	0.96%
30 Year Yield	3.216	-.004	-0.12%
Prices taken at previous day market close.			

Finally, we get the composite global PMIs (so, manufacturing and service sector) Thursday and Friday, and again the market will be looking for confirmation of current expectations: Chinese economy losing some momentum but still seeing incremental growth, Europe "hanging on," and the U.S. recovery progressing. As long as the numbers generally confirm those expectations, don't expect too much of a market reaction.

But, proving my point it's a busy week, we also get several other numbers: Personal Income and Outlays will be watched this morning to see if there is a drop in the "core PCE price index" (the Fed's preferred inflation gauge). Remember, CPI two weeks ago surprisingly dropped. If core PCE confirms this, it may give the Fed some room to stay "dovish" a bit longer than the market may expect. So, there is risk from a Fed expectation standpoint into the number. We also get more housing data, via Pending Home Sales Tuesday, auto sales Wednesday, and non-manufacturing PMIs Friday.

Japan also has a slew of data out overnight tonight, but the biggest number this week will be the Tankan survey, released tomorrow night. Worries about a slowing Japanese economy and eventual incremental stimulus have pushed the yen to multi-year lows and the DXJ to near-all-time highs. So, the data need to confirm that we are indeed seeing a slowdown; otherwise we could see a violent (albeit temporary) snapback move in both the yen and DXJ.

Bottom line is this week is busy, but really the key is Europe. If investors can come away from this week more confident about Europe and the ECB, it'll become a welcomed tailwind on risk assets (and likely a headwind on Treasuries).

Commodities

Most major commodities finished higher on the week

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but the notable outlier was copper, which struggled due to bearish news out of China.

WTI crude oil traded well last week as futures rallied +1.72% on the week. A large portion of those gains came on Wednesday as a result of an EIA inventory report that showed an unexpected drop in supplies (-4.3M bbl vs. (E) +500K bbl). Crude has been trading in a tight range in the low-$90s for over a month now—down nearly $20 from the June highs as traders continue to focus on abundant global supply and wavering economic data in both Europe and China. On the charts, futures are trading “better”; however, we still need to see the multi-month downtrend broken with a close above $95 before we get outright bullish on crude.

Natural gas was the best-performing commodity last week, with futures adding +4.94% and re-taking the $4 level late in the week. The gains came in spite of a bearish EIA report (+97 Bcf vs. (E) 89 Bcf). But cooler weather and the fact that Russia has been cutting natural gas exports to Europe is continuing to support the market. Bottom line, the primary focus of the natural gas market is supply, and with total inventories still 12.5% below the 5-year range, futures are being looked at as a value. On the charts, natural gas is finally breaking out of the multi-month range between $3.80 and $4, but we have seen a head-fake once before so we will need to see a few more closes above $4 before the move is confirmed.

Moving to the metals, the stronger dollar continues to be a major headwind on both the industrial and precious metals markets. Gold, however, finished the week higher by +0.25% thanks to a “flight to safety” move during Thursday’s sharp sell-off in the stock market. But, gold futures will continue to trade heavy thanks to the surging dollar, and a test of $1,200 is likely in the near term.

Copper was the worst performer in the space last week, falling -1.65% thanks to more concerns over the Chinese economy. And, that will likely continue until we see the world’s largest copper consumer show an uptick in economic activity or implement some sort of stimulus. For now, prices seem content in the low-$3s.

Currencies & Bonds

It was more of the same in the currency space last week, as the Dollar Index surged to a new 4-year highs, rising sharply on Friday following the strong GDP report. The Dollar Index rose +1.2%.

As you’d expect, the euro dropped sharply, hitting a two-year low and breaking through 1.27. And, the reasons are obvious: Draghi was on the tape seemingly every morning last week “threatening” to start QE, while U.S. economic growth continues to power higher. The perceived paths of the two central banks couldn’t be further apart, and the currencies are reflecting that.

Elsewhere, the dollar/yen once again rose through 109 on more concern regarding the Japanese economy. As stated, this will be a pivotal week for the yen and Japanese stocks. Whether we see this move accelerate or a correction will depend on the data.

Finally, turning to the commodity currencies, we saw continued selling in both last week. The Loonie broke below $0.90 vs. the dollar Friday on the strong U.S. GDP report while the Aussie traded below $0.87 to hit an 8-month low. The trend in both remains lower, and neither are at levels I’d consider a “value.”

More broadly, the dollar rally is stretched, and I would not be getting long dollars here as there is a big snap-back coming. But the trend of a high dollar is very much in place. The only risk to it is soft inflation here in the U.S., but that remains a low probability.

Turning to Treasuries, the 30-year traded higher last week, rising +0.71% and moving to a 2-week high. The bulk of the move came Thursday on a “risk off” trade as stocks were selling off. More broadly, Treasuries are also benefiting from European money again as doubts linger about whether the ECB will “win” its fight with deflation.

The trend in bonds remains lower, though, and I view this as a counter-trend rally—and will continue to do so unless we get 1) a further moderation of inflation here in the U.S. or 2) the 30-year trading back above the 2014 trendline, currently at 139’17.

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."			
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 9.29.14)

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 faltered last week, dropping nearly 1.5% on general global growth concerns and after key support at 1980 was broken. Stocks bounced Friday but I remain cautious and would be surprised if we don't see a test of the 100 day MA at 1955 before this pullback is over.*
Best Idea: Buy Regional Banks (KRE). **Best Contrarian Idea:** Buy Small Caps (IWM).			
Commodities	**Bearish**	**Bullish**	*Commodities tried to stabilize last week despite a continued dollar rally, as better than expected Chinese data helped industrials and Thursdays sharp sell off put a bid into gold. Beyond the short term, though, with concerns about global growth and a stronger dollar, the outlook for commodities near term isn't good.*
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) on strong Q2 GDP and more dovish comments from ECB President Mario Draghi. But, the dollar continues to power higher against virtually all currencies as it hit new recent highs against the Aussie and Loonie.*
Best Idea: Sell the Yen (YCS) **Best Contrarian Idea:** Long Canadian Dollar (FXC)			
Treasuries	**Neutral**	**Bearish**	*The Treasury bounce continued last week thanks to a big Thursday rally (a "risk off" move to plunging stock prices. We're also seeing renewed buying from Europe given doubts about ECB policies, but the near term trend remains down.*
Best Idea: Short "long" bonds (TBT) **Best Contrarian Idea:** Short High Yield Bonds (SJB)			

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