7:00's Report

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

August 3rd, 2014

Pre 7:00 Look

- Futures are higher on rumors of a Russia/Ukraine cease fire, which is helping to overshadow more lackluster data from Europe.
- Reports broke o/n that a cease fire has been reached in Ukraine, but Russia has denied it. Regardless, it's being viewed as positive progress.
- Economically global composite PMIs were mixed. China was surprisingly strong (services up 4 points to 54.0) but Europe again underwhelmed. Bottom line, though, is the numbers aren't changing the outlook for global growth.
- Econ Today: ADP Employment Report (E: 223K), Beige Book (2:00 PM) .

Market	Level	Change	% Change
S&P 500 Futures	2007.50	7.75	0.39%
U.S. Dollar (DXY)	82.89	-.12	-0.14%
Gold	1267.90	2.90	0.23%
WTI	93.71	.83	0.89%
10 Year	2.419	.076	3.24%

Equities

Market Recap

Stocks traded flat Tuesday to start the holiday-shortened week as a slightly "too hot" ISM manufacturing PMI resulted in stocks spending most of the day in mildly negative territory. The S&P 500 fell -0.05%.

Stocks started the day tentatively higher, as strength overseas resulted in a positive open here in the U.S., but there was never much conviction to the move.

Stocks were virtually flat heading into the one important economic release of the day, the ISM manufacturing PMI. The release was good (much better than expectations), but reflected the fact that levels of "Fed angst" are a major influence on equity markets in the short term.

ISM was a touch *too* good, and stocks traded lower on the release and actually hit their lows of the day shortly after lunch, dipping into the mid-1,990s.

But, Fed angst didn't rise *that* much and the selling had little conviction to it, so stocks bottomed mid-afternoon and closely rallied back toward flat before ramping up into the close to finish just below unchanged.

Overall it was a day of digestion.

Trading Color

Cyclicals handily outperformed yesterday, further confirming that the declines midday yesterday were about positioning and day-trading rather than any new, negative influence on stocks. (So, basically, the sell-off was noise.)

The Russell 2000 rose +0.44% and the Nasdaq rose +0.39%, while SPHB was up +0.35% compared to a -0.25% decline by SPLV.

Looking at sector performance, energy and utilities were the two big underperformers, falling about -1% each. The former fell because crude collapsed again, while the second declined as bond yields spiked higher, and there was a definite "higher-rate trade" in the market yesterday as banks were the decided outperformers. (KRE was up more than +1% and looks to be trying to break out.)

Outside of those moves, it was quiet from a "micro" standpoint as there was little single-stock news.

Bottom line yesterday: The market consolidated ahead of some key events Thursday (ECB) and Friday (jobs re-

Market	Level	Change	% Change
Dow	17.067.56	-30.89	-0.18%
TSX	15,619.08	-6.65	-0.04%
Brazil	61,895.98	754.71	1.23%
FTSE	6,880.93	51.76	0.76%
Nikkei	15,728.35	59.75	0.38%
Hang Seng	25,317.95	568.93	2.30%
ASX	5,656.10	-2.42	-0.04%
Prices taken at previous day market close.			

port) and we'll likely see more of the same today.

Need to Know on the Ukraine "Cease Fire"

Market	Level	Change	% Change
DBC	24.67	-.36	-1.44%
Gold	1266.30	-21.10	-1.64%
Silver	19.195	-.297	-1.52%
Copper	3.1585	-.002	-0.06%
WTI	93.25	-2.71	-2.82%
Brent	100.44	-2.75	-2.66%
Nat Gas	3.901	-.164	-4.03%
RBOB	2.5501	-.0728	-2.78%
DBA (Grains)	26.66	.20	0.76%
Prices taken at previous day market close.			

There are a reports of a cease fire in Ukraine this morning, although details and confirmation are vague. But, clearly this is a sign of progress.

If there is a cease fire, look for Europe to be the main beneficiary, and if you want to play a "Ukraine cease fire" trade, buying Europe (VGK) vs. the US is the way to go as there's more snap back potential in Europe. Also, European bonds will likely sell off, as will Treasuries, so inverse bonds funds should also benefit if there is indeed a cease fire reached. The ECB decision tomorrow clouds things a bit, but beyond the next 24-48 hours that's the way to play it, if the cease fire happens.

Japan on the Verge of a Breakout? (Again)

Japanese shares and the yen were the big movers yesterday, as the yen dropped nearly -1% vs. the dollar, hitting new lows for the year, while the Nikkei traded up over +1.2%. The moves came thanks to economic data that implied inflation was taking hold in Japan, and a political move that *could* be positive for Japanese stocks.

The first positive catalyst was a report that wage inflation picked up in Japan recently, as wages rose +2.6% over a year ago (the fastest pace since January 1997) and labor income rose +4.2% over a year ago, (again the fastest pace since 1997). And, the big, positive reaction from Japanese stocks/negative reaction from the yen reinforces a theme we've been discussing here for a few weeks – that wage inflation is the #1 economic indicator to watch globally. Wage inflation begets broad price inflation, so that is a positive for Japanese stocks/negative for the yen.

The second positive catalyst was news that PM Abe was going to make cabinet changes (announced today). In particular, Abe is expected to appoint lawmaker Yasuhisa Shiozaki, who is a staunch supporter of shifting the Japanese General Pension Investment Fund from bonds to riskier assets like stocks, to health minister.

Japan: Japanese stocks are quietly at a 7 month high while the yen is at the 2014 lows.

Longtime readers know we have been early and enthusiastic Japan bulls, since late 2012. That's been a good trade, but admittedly it has been stalled for most of 2014. Nonetheless, we have remained bullish despite the recent underperformance. During that period, we've kept focused on the next major catalyst for a sustained rally in DXJ/fall in the yen – namely the "3rd Arrow" of Abenomics – structural economic reforms and a reallocation of the Japanese pension fund system out of Japanese government bonds (JGBs) and into international bonds and Japanese stocks (a move that will depress the yen and boost the Japanese stock market).

We have been looking to the fall as a time for potential movement on those two fronts, and the events of the last 24 hours seem to imply we're getting close (specifically the Cabinet changes). Indeed one of the reasons we've stayed bullish on Japan is because Abe is smart enough to know he'll be punted from office if he doesn't get the economy turned around, so he's not going to stop halfway (meaning, more stimulus was eventually coming). The headlines of yesterday seem to imply that is indeed the case.

Yesterday the yen, which has quietly crept lower all summer vs. the dollar, broke down to new lows for the year, while DXJ gapped higher and equaled its 52-week high.

We've said consistently that we believe Abe's ultimate target for dollar/yen to be 110 (it's currently 105). It appears after a lengthy consolidation we may be seeing a material breakout in the "long DXJ/short yen" trade. Going forward, I advise taking a look if you're looking for a place for some fresh capital, as the risk/reward vs. the S&P 500 appears attractive between now and the end of the year.

Economics

ISM Manufacturing Index

- ISM Manufacturing Index rose to 59.0 vs. (E) 56.8

Takeaway

The manufacturing sector remains very strong according to yesterday's report with the headline reading hitting a 3 year high. Looking to the details of the report, the leading indicator, New Orders, encouragingly increased to 66.7 (the highest reading since April 2004) from an already strong 63.4 in July. This was a very strong report.

But, the market reaction implied that the manufacturing data was "too hot" (meaning it may help contribute to a pulling forward or acceleration of "policy normalization" (interest rate hikes) as stocks and bonds declined while the dollar extended its gains.

By itself, this ISM Manufacturing Report won't be enough to raise Fed angst, but if the jobs report is a big beat, look for markets to get more nervous about the Fed (which could be a mild headwind on stocks as it was in July/early August).

Market	Level	Change	% Change
Dollar Index	82.99	.207	0.25%
EUR/USD	1.3133	.0006	0.05%
GBP/USD	1.6468	-.0139	-0.84%
USD/JPY	105.07	.72	0.69%
USD/CAD	1.0925	.0055	0.51%
AUD/USD	.9274	-.0057	-0.61%
USD/BRL	2.2408	-.0042	-0.19%
10 Year Yield	2.419	.076	3.24%
30 Year Yield	3.174	.094	3.05%
Prices taken at previous day market close.			

Commodities

Commodities began the shortened trading week with a substantial thud yesterday. The energy space led the way lower after seeing broad strength last week. Precious metals also saw steep declines as the Dollar Index hit fresh 14-month highs yesterday morning, amid a multi-asset-class, hawkish tone in the markets. The benchmark commodity tracking index ETF, DBC, fell -1.49% to within a few ticks of the 2014 lows.

WTI crude oil fell a sharp -2.82% yesterday (but was down well over -3% intraday), giving back all of last week's gains and then some. There was no specific reason for the weakness; however there were a few things to consider. First, there were a lot of shorts squeezed out of the market last week as technical resistance was broken and the situation between Ukraine and Russia escalated ahead of a holiday weekend. But, it appears a lot of those shorts came back to the table while weak-handed spec longs were forced out in yesterday's landslide. The only encouraging thing with regard to yesterday's sell-off was the technical picture remains "OK."

On the charts, the downtrend that was broken last week (that is not acting as support), was not violated, which would have suggested that last week's rally was a "head-fake." Also, the low of the outside reversal on 8/21 held as well. Going forward, that multi-month low from 8/21 ($92.50) will continue to act as the *line in the sand.*

Like crude, natural gas also fell out of bed yesterday, and largely for the same reasons. Nat gas futures dropped -4% on the day to close below $4.00 for the first time in a week. Short-covering into the long weekend with the Ukraine-Russia debacle heating up was partially responsible for the gains seen late last week. And, much of that trade was reversed yesterday after there was no material change in the situation in Eastern Ukraine over the weekend.

Also, near-term weather forecasts were adjusted to reflect more mild temperatures as opposed to initial reports that were calling for hotter weather across the U.S. that would theoretically spur higher demand for power generation to satisfy heightened cooling demand.

Bottom line, once futures started to sell off, momentum took over and the selling accelerated through several support levels, seeing natural gas closing just below the $3.90 level. Looking ahead, there is room to pull back further, but trader focus will change as the short week progresses and supply (a bullish influence) comes back into the spotlight with the EIA report tomorrow.

In the metals, gold fell -1.64% and broke through longstanding support at the 2014 uptrend line largely thanks to the stronger than expected ISM manufacturing report. Some geopolitical fear bids unwinding, plus positioning ahead of the report, undoubtedly contributed as well.

But the selling really accelerated following the economic release because the print was a touch "too hot" and spurred a multi-asset-class, hawkish reaction. As we have been saying for months now, hawkish Fed spec is gold-negative in the near term, hence yesterday's drop. However, on a longer time frame, the reason for the hawkish reaction (rising inflation) will eventually lead prices to rally. On the charts, next solid support lies at $1,240-$1,245.

Currencies & Bonds

Treasuries sold off hard yesterday, with selling in European bonds causing the initial declines early Tuesday morning. But Treasuries took another leg lower following the very strong ISM manufacturing PMI, which was a bit "too good" and caused a very slight uptick in "Fed angst."

Interestingly, the selling was much more extreme in the long end of the curve, as the 10-year Treasury only declined -0.46%, roughly half of the drop in the long bond. And, most of that is because there was heavier selling in longer-dated European bonds, as expectations shift around what, if anything, Mario Draghi and the ECB will do Thursday. (There is more and more "chatter" of them easing further; no QE remains a remote possibility, at least at this meeting.) The takeaway though is that ECB expectations, more so than Fed expectations, continue to dominate the trading in the long end of the curve.

For the 4th month in a row, it appears the 30-year will test the 2014 uptrend line heading into a monthly jobs report (it's happened in May, June, July and August – all of which were successful tests). And, until that uptrend is broken, the trend in bonds remains higher (in the short term).

On any other day, the currency market would have been the lead-off in this section, as it was a volatile day. The dollar again reigned supreme, again rallying versus all its major trading partners, finishing the day just off the highs—up +0.26%. And, beyond the dollar strength, the two big stories in the currency markets yesterday were the yen and the euro.

And, except for the euro, most currencies traded sharply lower vs. the dollar, led downward by the yen, which collapsed to just off 2014 lows, falling -1%. The dollar/yen closed comfortably above 105 thanks to stops being hit following the Abe Cabinet shakeup news and the higher than expected wage inflation.

The yen is now just off the lows of the year, and it's likely not long before those lows are "given" and we see another bout of selling in the yen. The fundamentals support the move (generally stronger U.S. dollar, rising inflation in Japan, and the Abe administration's desire to see the yen weaker). YCS remains the easiest way to get "short" the yen for a non-futures trader/investor.

Turning to the euro, it was flat yesterday and is now sitting just above lows for the year. The euro is basically at the mercy of ECB expectations for Thursday's meeting –at which it seems the consensus is for no incremental easing, although that consensus isn't particularly strong.

There is the possibility that the ECB increases the size of its upcoming TLTRO or softens the terms to make it more attractive. But the bottom line is the market wants QE – and while the ECB is getting closer to QE, the chances of it being announced tomorrow are very slim.

So, what we're seeing in the euro is a bit of covering/buying into the meeting, as the euro has sold off based on anticipation of more stimulus. But the risk now is of disappointment, as Draghi tries to "verbally ease" while waiting for the TLTRO to take effect. Simply put, they're just not there yet with QE, despite euro bears' hopes.

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
7/28/14	DBC	25.65	None	*We have initiated long positions in DBC here as we believe many components of the benchmark index have become oversold, namely in the energy space. The potential target to the upside is close to the $27 mark. Original Issue*
7/21/14	UNG	20.98	None	*We are replacing the "long copper" trade on the tactical sheet with our "long natural gas" call because of the time frames of the two trades. Copper is a long term fundamental play dependent on continued global economic growth (namely in China) while buying nat gas is a medium term trade based on smaller supply injections and warming weather patterns. "Long Copper" has been moved to the ACD. 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*
4/30/14	IYZ	28.99	28.32	*Telecom trading at a value to the market, has lagged other safety sectors. Original Issue*
3/3/14	XLI IYM PICK DIA	52.19 83.06 19.48 164.28	None	*Long Market "Losers." So far in 2014 the right strategy has been to buy beaten down sectors that offer some value, as opposed to the broad market. 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 (6/4/14): *Focus on this trade has shifted to Abe's "3rd Arrow" of fiscal reforms, and if enacted, it could lead to a material decline in the yen/rally in DXJ.*			
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 (7/21/14): *Geo-political concerns and foreign money flows sent bonds to new highs for the year last week, and the gap between deteriorating fundamentals and price action is widening. For now, though, the trend is higher and more patience is required in this long term trade.*			

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Asset Class Dashboard

(Updated 9.2.14)

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	Bullish	Bullish	*The S&P 500 traded to new highs last week as economic data was strong and the outlook for Fed policy remained stagnant. Positioning was the main reason stocks were higher last week, as investors chased and added long exposure. A period of consolidation is necessary (again) but the trend remains higher.*

Best Idea: Buy Regional Banks (KRE).

Best Contrarian Idea: Buy Small Caps (IWM).

	Near Term Trend	Long Term Trend	Market Intelligence
Commodities	Bullish	Bullish	*Commodities rose for the second week in a row last week, led by outperformance in the energy space. Both crude oil and natural gas have established near term support and the technicals are shifting more bullish. Fundamentally, the broad outlook for commodities remains bullish primarily based on the idea that as the economy continues to improve, we will see demand for commodities rise accordingly.*

Best Idea: Long Oil (USO), Long Copper (JJC)

Best Contrarian Idea: Buy Grains (DBA)

	Near Term Trend	Long Term Trend	Market Intelligence
U.S. Dollar	Bullish	Bullish	*The Dollar Index surged to new highs for the year last week on good data and increasing speculation the ECB will do "more" from a policy standpoint, perhaps as early as this week. The Dollar Index is now close to 83, and while we need to see some sort of consolidation in the Dollar, with the path of policy between the US and Europe diverging materially, the trend in the Dollar should stay higher.*

Best Idea: Sell the Yen (YCS)

Best Contrarian Idea: Long Canadian Dollar (FXC)

	Near Term Trend	Long Term Trend	Market Intelligence
Treasuries	Bullish	Bearish	*Treasuries were flat again last week and exhibited some signs of fatigue, and although fundamentally the outlook is negative (better US economy, potentially more "hawkish" Fed) this trade remains dominated by European money flows, so until German Bunds*

Best Idea: Short "long" bonds (TBT)

Best Contrarian Idea: Short High Yield Bonds (SJB)