7:00's Report

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

September 30th, 2014

JNK broke through the late July/early August lows yesterday, and unless it can rebound today or tomorrow, I believe this is a potential warning sign for stocks.

Pre 7:00 Look

- Futures are tentatively higher to start the day thanks to strength in Europe, where stocks rallied following disappointing inflation data (which increase chances of QE).
- Inflation stats from Europe today weren't good: Core EMU HICP (their CPI) rose just 0.7% yoy, down .1% from last month, while Italian CPI dropped -0.3% vs. (E) -0.2%.
- In Asia markets were lower, but not majorly so, on continued angst regarding the Hong Kong protests and after economic data (both Japanese and Chinese) was basically in-line with low expectations.
- Econ Today: Case-Shiller (E: 0.1%). Fed Speak: Powell (10:45 AM).

Market	Level	Change	% Change
S&P 500 Futures	1975.25	5.75	0.30%
U.S. Dollar (DXY)	86.195	.479	0.56%
Gold	1210.00	-8.80	-0.73%
WTI	94.73	.16	0.17%
10 Year	2.491	-.044	-1.74%

Equities

Market Recap

Stocks staged a decent rebound Monday and closed marginally weaker after opening sharply lower. As markets continued to digest last week's declines, the S&P 500 fell -0.25%.

Stocks opened deep in the hole Monday, with S&P futures hitting their lows right before the open, down nearly 20 points. The S&P 500 opened through last Thursday's low of 1,965, but shortly after the open it launched a methodical rebound that saw stocks get back to flat by the late afternoon.

As far as reasons for the steep drop at the open Monday, the protests in Hong Kong were cited (China concerns have been the go-to excuse for stock declines since last Monday). The collapse of Brazilian stocks (down just over -4% on political risk ahead of the presidential election) was also in play. Also cited for the early morning weakness were the ever-popular "worries about the ECB underwhelming," "the Fed getting more hawkish" and Catalan independence.

News-wise, markets ignored an in-line personal income number and a disappointing Pending Home Sales report. The only real notable intraday headline was from Chicago Fed President Charles Evans, who made predictably "dovish" comments that didn't move the market much.

As you can tell from my tone, none of these "reasons" actually caused stocks to decline, and again this market remains much more dominated by short-term trading and positioning than anything else. Friday's rally was a mirage, and the fact that we saw the market leap higher

Market	Level	Change	% Change
Dow	17,071.22	-41.93	-0.25%
TSX	14,976.92	-49.85	-0.33%
Brazil	54,625.35	-2587.03	-4.52%
FTSE	6,640.82	-5.78	-0.09%
Nikkei	16,173.52	-137.12	-0.84%
Hang Seng	22,932.98	-296.23	-1.28%
ASX	5,292.81	28.60	0.54%
Prices taken at previous day market close.			

into the close only provided an opportunity for shorts to lay out exposure and smack it down on the open.

But, as has been the case for 2+ weeks, there was no real conviction to the selling. That's why we saw the market start to lift almost immediately after the open, and that lift continued all day on low volume amidst slow trading.

Stocks tried to close in the green, which would have been impressive, but gave back a little bit of ground over the last 30 minutes of trading to end the day with mild losses.

Market	Level	Change	% Change
DBC	23.65	.16	0.68%
Gold	1218.30	2.90	0.24%
Silver	17.535	-.002	-0.01%
Copper	3.0485	.013	0.43%
WTI	94.51	.97	1.04%
Brent	97.22	.22	0.23%
Nat Gas	4.121	.092	2.28%
RBOB	2.5159	.0278	1.12%
DBA (Grains)	25.68	.36	1.42%
Prices taken at previous day market close.			

Trading Color

It was a bland day from a market internals standpoint as all the major averages traded together: The S&P 500, Dow Industrials, Nasdaq and Russell 2000 all basically traded within 20 basis points of one another, although the Nasdaq was the relative outperformer.

Sector-wise it was a mixed bag. Only three out of the 10 sectors were higher yesterday, but nothing strayed too far from unchanged (basic materials were the laggard, down -0.3% on general China worries and after steel prices hit a new low). Utilities were the best-performing S&P 500 sub-sector, rising +0.6% as rates declined. But other "heavy yield" sectors didn't follow, as REITs lagged, as did healthcare, so we didn't see a definitive "lower rate" rotation (and banks generally saw declines in line with the S&P 500).

On the charts the S&P 500 basically closed at the key 1,980 level, while yesterday's low of 1,963 is important, as is Friday's high of 1,986. But, 1,955 (the 100-day moving average) remains very, very important support.

Bottom Line

This remains a market of shadow moves. Yesterday's rebound wasn't really that impressive given the declines at the open were artificial, and the last move we had in this market with any conviction was Thursday's decline.

I still think we need to take a look at 1,955 in the S&P 500 before we know whether this is a typical 3%-5% dip or something more.

JNK broke down badly yesterday; if it doesn't recover today, that will make me more nervous about support at 1,955 being "given." A decisive break of 1,955 would confirm the break in JNK and would make me get significantly more defensive from an allocation standpoint. But again for now, the benefit of the doubt has to remain with the bulls.

Economics

Is Dis-Inflation a Worry?

Since the surprisingly weak CPI report earlier in September, there's been a subtle but growing concern about the return of dis-inflation—not in the EU, but in the U.S. And, recently we've seen a fair bit of financial media coverage detailing the fall in market inflation expectations—so I wanted to cover the topic and explain why we're seeing that dip (it's not entirely because the market is expecting dis-inflation).

Renewed worries about dis-inflation have come from three places:

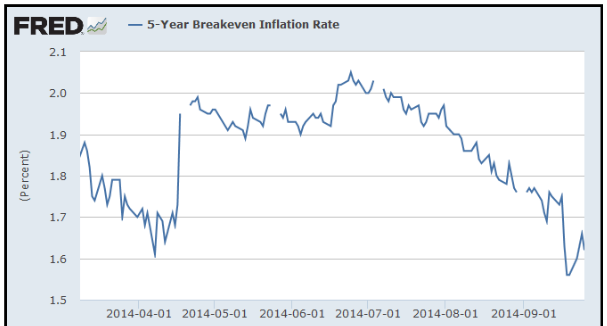
First, commodity prices have utterly collapsed since earlier this summer, which obviously weighs on inflation statistics.

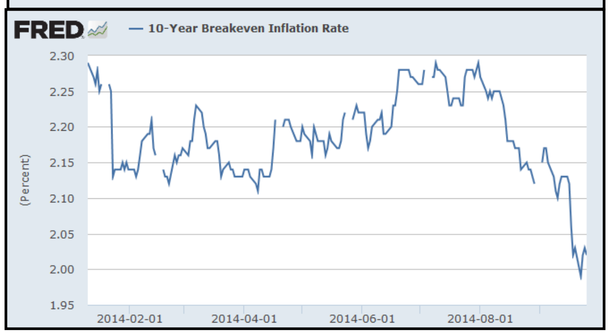
Second, despite the stock market reacting "dovishly" to the last Fed meeting, bonds and the dollar are beginning to price in the reality of a rising Fed Funds rate in mid-2015. Given the apparent lack of statistical inflation, the reality of a higher Fed Funds rate will dampen expectations for inflation 5 years out.

Third, and most-cited, both the 5- and 10-year Breakeven Inflation Rate have dropped precipitously over the past three months. (The breakeven inflation rate is the difference between the yield on a Treasury bill vs. the yield on the same-duration TIP. So, the 5 year-inflation break-even is the yield on the 5-year Treasury minus the yield on the 5-year TIP.)

These events have led some to become worried that the U.S. is about to go through another period of "dis-inflation." If that does indeed happen, then stock prices will get hit—potentially hard (because the Fed is basically out of monetary bullets). It's also led some to believe the Fed may end up being slightly more "dovish" than is currently expected.

But, yesterday we got some encouraging news on inflation. The August "Core PCE Price Index," which is the Fed's preferred measure of inflation, was unchanged from July, at a +1.5% increase year-over-year. Importantly, it didn't confirm the drop we saw in CPI in August, and should help to alleviate some concerns about dis-inflation (this was underappreciated by the market yesterday).





Turning then to the "inflation breakeven," with regard to the drop in the 5-year inflation breakeven, that number is very highly correlated to commodity prices. If you'll look at a chart of the 5-year breakeven yield (link here), it started to decline very shortly after commodity prices began to collapse in late June. So, it would appear most of that has to do with commodity price declines (so it's mostly a commodity phenomenon, not something more structural and worrisome).

The 10-year breakeven *is* a bit more worrisome, but if you look at that chart, what you'll see is it really came for sale hard following the lackluster jobs report of August. What I think the 10-year is reflecting is the lack of wage inflation, as represented by the poor August jobs report. Remember, wage inflation begets real inflation, so until we start to see material wage inflation (which will come from further labor market improvement), expect the 10-year inflation expectations to remain relatively subdued.

Market	Level	Change	% Change
Dollar Index	85.72	-.047	-0.05%
EUR/USD	1.2689	.0006	0.05%
GBP/USD	1.6248	.0003	0.02%
USD/JPY	109.43	.16	0.15%
USD/CAD	1.1144	-.0006	-0.05%
AUD/USD	.8723	-.004	-0.46%
USD/BRL	2.452	.0322	1.33%
10 Year Yield	2.491	-.044	-1.74%
30 Year Yield	3.18	-.036	-1.12%

Prices taken at previous day market close.

Bottom line, dis-inflation is a background risk we need to monitor here in the U.S.—but at this point the low inflation readings seem to be more a product of commodity price declines and sluggish wage inflation ... not an indicator that the market's fundamental outlook on inflation going forward has materially changed.

Commodities

Commodities began the week trading mostly higher yesterday, led by the energy space, while the metals underperformed. The benchmark commodity tracking index ETF, DBC, rallied +0.64%.

Natural gas was the best performer yesterday, rallying +2.2% largely as a result of technical trading. The move higher began with a bullish technical breakout on Friday, with futures closing at the highest level in nearly a month and comfortably above resistance at the $4 mark. Then yesterday, the market got squeezed higher as shorts hustled to close positions and futures moved up as much as +3% before finishing the day up +2.2%.

Looking to the fundamentals, the situation remains favorable for the bulls with inventories still sitting 12.5% below the 5-year average and time running out for the build season. Also, temperatures are dropping in many areas of the country sooner than expected, upping demand for nat-gas-fueled heat. Bottom line, being long natural gas continues to be one of the best trades in the space right now, and opportunity remains in buying any material dips back toward support at $4. Meanwhile the 100-day moving average is the primary resistance level in focus at $4.16.

WTI crude oil futures closed the gap on the global Brent contract as futures rallied +1.04% and +0.23% respectively yesterday. This week global manufacturing data will be in focus as traders speculate demand metrics for the medium term.

Friday's jobs report will also be watched by energy traders to see if last month's report was just a "one-off" or if weakness in the August data is actually a concern.

On the charts, WTI futures are certainly trading better and have established multiple layers of support in recent weeks with the first now at $93. But, we are into resistance here between $94.50 and $95.50 as the downtrend line dating back to June is hovering just below $95, the last "top" on the daily chart is sitting at $94.70, and the 50-day moving average is above at $95.48. So, bottom line, we are in a consolidation pattern at best until those levels are broken and we see a couple closes above them on the daily chart.

Moving to the metals, gold was little-changed yesterday as the Core PCE Index within the Personal Income and Outlays report was in line with expectations and eased concerns that we could possibly see dis-inflation in the U.S. over the medium term (disinflation is obviously bearish gold). Also, the fact that stocks were able to close well off of last week's lows caused some spec traders to unwind "fear" longs. Going forward, the technicals still favor the bears, but it will be interesting to see if there will be enough "value hunters" to defend the $1,200 level. It may be worth taking a shot at the long side on dips toward $1,200, but we will have to see how things develop in the coming weeks.

Currencies & Bonds

All major currencies were flat Monday with the exception of the Aussie, which declined -0.36% to new 8-month lows on peripheral selling given the unrest in Hong Kong (remember, anything China-related is always an influence on the Aussie). The Dollar Index fell -0.06% after hitting a new high early Monday, then gradually selling off throughout the morning, and trading flat from 11 AM out. Fundamentals were mixed in the U.S., as Core PCE was a bit better than feared, while Pending Home Sales missed.

The euro managed to stabilize yesterday, trading opposite to the dollar (lower initially, then rallying throughout the morning) after Spanish and German CPI both met expectations (raising some hope the HICP this morning wouldn't be so bad).

But, they were bad. Both EMU and Italian HICP missed estimates, further increasing the expectation that the ECB will eventually do QE, and as a result the euro is trading at new lows this morning (closing in on 1.26) while the Dollar Index surged above 86, hitting a new 4 year high.

The pound and yen were also flat ahead of data overnight, but the releases for both economies mostly were in-line, and we're seeing the yen and pound down marginally on peripheral dollar strength.

The Treasury market continued to rally yesterday, with the 30-year rising +0.54% while the 10-year yield fell back below 2.5%. Much of that move was a continuation of the rally late last week and an unwind of the temporary bond selling we saw after the Bill Gross/Janus headlines. Apparently some people were worried that massive redemptions from PIMCO funds would pressure Treasuries and the bond market, but that's honestly a bit absurd (that would likely be a retail move, and retail isn't big enough to move the Treasury market that much). So, the market partially corrected the error yesterday.

Bottom line is once again the Treasury market is trading better than I would like it to, but unless we get a close back above that 2014 uptrend (around 139'15ish), I continue to view this as a counter-trend rally that should be shorted, especially considering the price action in junk and emerging market debt.

JNK and Emerging Market Bonds to New Lows

While the long end continues to enjoy a counter-trend rally, riskier parts of the bond market continue to trade poorly. Junk bonds hit a new low for the year yesterday while emerging market debt is also now trading at multi-month lows (based on the ETFs JNK and EMB).The stresses we're seeing in the riskiest corners of the bond market remain a warning sign we shouldn't ignore. They obviously don't guarantee this decline in the stock market will be something more, but logically I have a hard time reconciling aggressive selling in the junk and EM bonds that doesn't eventually weigh on stocks and, later, Treasuries. JNK and EM bonds need to stabilize; otherwise the warning signs get more compelling.

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 9.27.14)

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)			