7:00's Report

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

September 4th, 2014

The Long Bond: The 2014 uptrend was tested again yesterday, but for the 7th time this year, support held. Until that line is decisively broken, the trend in bonds remains higher.

Pre 7:00 Look

- Futures are flat this morning as the whole world is more or less on hold ahead of the ECB decision (7:45 AM).
- Asia was the weak spot as major indices declined small, but that was after a big run so far this week (especially in Japan).
- Economically it was quiet. The Bank of Japan announcement was as expected, while the only material economic release was German Manufacturer's Orders, which handily beat expectations (4.6% in July vs (E) 1.6%).
- Econ Today: BOE Decision 7:00 AM (E: No Change), ECB Decision 7:45 AM (E: No Change), ADP (E: 223k), Jobless Claims (E: 300k), Trade Balance (E: -42.3 B), US ISM Non-Manufacturing (E: 57.5).

Market	Level	Change	% Change
S&P 500 Futures	2002.50	3.75	0.19%
U.S. Dollar (DXY)	82.945	.082	0.12%
Gold	1272.50	2.30	0.18%
WTI	95.13	-.42	-.44%
10 Year	2.410	-.009	-0.37%

Equities

Market Recap

Stocks ended trading flat Tuesday after reaching a new intraday high, as markets further consolidated ahead of the week's key events (ECB today, jobs report tomorrow). The S&P 500 declined -0.08%.

The S&P 500 started higher Tuesday, dragged up by international markets given the positive headlines out of Ukraine (i.e., news of a potential cease-fire, although details yesterday morning were hazy and contradictory). But, the general feeling with regard to the situation was one of progress, and stocks hit their high ticks of the day just under 2,010 immediately following the open.

From there, stocks began a methodical decline all the way back to 2,000 by lunchtime despite strong auto sales (17.5 MM SAAR) and a basically in-line factory orders report (it was a slight miss but up +10.5% vs. (E) 11%). The market simply sold off from the highs because it's consolidating the recent gains, as there wasn't any real negative catalyst.

Instead, it was a lack of follow-through buying at 2,010 that caused the drop, not aggressive selling. (I wouldn't be aggressively buying this market at 2,010!) During the afternoon session, stocks rebounded after a headline hit that quoted Putin as saying an "outline" for a cease-fire in Ukraine was agreed upon, and that peace talks would begin Friday in Minsk.

Markets declined again right before the release of the Beige Book (released at 2 PM), which was almost identical to last month, and the start of an interview with Fed President Richard Fisher that provided nothing new.

Market	Level	Change	% Change
Dow	17,078.28	10.72	0.06%
TSX	15,657.63	38.55	0.25%
Brazil	61,837.04	-58.94	-0.10%
FTSE	6,883.06	9.48	0.14%
Nikkei	15,676.18	-52.17	-0.33%
Hang Seng	25,297.92	-20.03	-0.08%
ASX	5,631.26	-24.83	-0.44%

Prices taken at previous day market close.

But, again the late-afternoon declines weren't "caused" by those events, and instead we just saw buy demand dry up again. Stocks bounced a bit during the last hour of trading to close basically flat.

Market	Level	Change	% Change
DBC	24.77	.10	0.41%
Gold	1270.30	5.30	0.42%
Silver	19.215	.063	0.33%
Copper	3.132	-.023	-0.73%
WTI	95.36	2.48	2.67%
Brent	102.41	2.07	2.06%
Nat Gas	3.85	-.04	-1.04%
RBOB	2.6176	.0746	2.93%
DBA (Grains)	26.43	-.23	-0.86%
Prices taken at previous day market close.			

Trading Color

Trading yesterday was the opposite of Tuesday, as cyclicals underperformed with the Russell 2000 and Nasdaq both giving up Tuesday's gains.

Tech was in focus yesterday as AAPL got hit by a surprise "bear raid" ahead of its product release next week (the 9th), and closed down more than -4%. That drop alone weighed on the Nasdaq and made the S&P 500 close in the red.

Homebuilders lagged as TOL and LEN earnings missed, with cautious comments on new home construction from both firms.

More broadly we saw some dip-buying in sectors that were beaten up Tuesday, as utilities and energy outperformed, while tech was again weighed down by AAPL. None of the SPDRs (the S&P 500 sub-sectors) traded more than 0.5% one way or the other, though, except tech—so overall it was a pretty quiet/non-convicted day.

Turning to the banks, the Fed and FDIC released their liquidity rules, and generally they are being taken as "not as bad as feared." KRE and KBE both were down modestly, but considering the gains from Tuesday the performance was pretty good.

Finally, I mentioned yesterday that Europe would be a beneficiary if there is a cease-fire in Russia/Ukraine, and if there are no further sanctions or if the current ones are rolled back, expect European financials to benefit especially. EUFN is close to breaking out on the chart, and while today's ECB meeting will be important, keep an eye on that sector as a potential contrarian play.

Bottom Line

More consolidation. Yesterday was driven by positioning and short-term traders, and the market needs some more clarity on the ECB and the Fed (via the jobs report) before knowing which way to head next. (I believe it'll be more consolidation, especially if the jobs number is good.)

Why You Need to Care More About the ECB Than You Probably Do.

KRE: The regional bank ETF broke through resistance this week, and a quick run to major resistance in the mid $40's could be in order, if the broad market holds up.

I realize not everyone will have read this by the time the ECB makes its policy announcement (in 45 minutes) or when Draghi holds his press conference (in 90 minutes), but I want to include this analysis because simply put, Europe is really important right now.

Europe is by far the weakest major developed economy in the world, and it's teetering on the brink of a triple-dip recession, if not worse. And, seeing as a "global recovery" is one of my 4 pillars of the stock market rally, if the EU slips back into recession, that will be a headwind globally.

So, understanding what's happening with the EU economy and what the ECB is doing is very important. It is equally important as understanding what Fed policy was during the past three years here in the U.S. – because like the US economy with the Fed back then, the EU economy is now totally dependent on the ECB to provide stimulus. This is all about the ECB.

Before going into what's expected from the ECB today and the implications on policy, it's important to make sure we correctly understand the setup ...

First, the major threat to the EU is deflation. That threat has resulted in European bonds surging to record levels, and a rise in the expectation that the ECB will eventually do QE—just as the BOE and Fed did when faced with a deflation threat in '11/'12.

Second, think of EU (especially German) interest rates as an inverse indicator of deflation. So, the lower the yields go, the higher the market expectation the EU will actually find itself in deflation (and German yields are just off record lows).

Third, unlike the Fed when it did QE, the ECB's goal isn't to lower interest rates. Interest rates in the EU are already too low. For the ECB to start winning this economic fight, interest rates need to start rising. That will reflect increasing inflation expectations and an uptick in the demand for money (which means increased economic activity).

Fourth, if the ECB does not ease policy materially this morning (i.e. is hawkish), you will see EU interest rates go down, as the expectation of a deflationary crisis in the EU grows and investors rush for cover. Conversely, if the EU shocks the world and actually announces QE, rates likely won't decline by all that much in Europe, as that will ultimately be inflationary. Those two reactions are the opposite of what *should* happen normally, but again this is about deflation expectations, not about the level of interest rates.

With that in mind, let's turn to ECB expectations:

Consensus: No changes to policy. Draghi talks "dovish," threatens QE, but basically plans to wait and see if the plans announced in June (TLTROs/ABS purchases) can help jumpstart the economy. **Market Reaction:** European bonds and the euro will rally (which is bad) and European stocks will likely fall.

"Slightly Dovish": Draghi announces some tweaks to the existing TLTRO program by reducing the fee to use it, increasing the size, releases more specific plans on the Asset Backed Lending program or makes further small cuts to interest rates. **Market Reaction:** The market wants QE; this won't satisfy it. Look for a mild decline in European bond yields and EU stocks.

"The Total Surprise": ECB announces QE. **Market Reaction:** This would be a total shock – but if so, European (and U.S.) stocks would scream higher. EU bond yields would decline but only modestly – and may even rally. Treasury reaction would be tough to gauge, but I think we'd see a Treasury sell-off after an initial spike higher.

I know we don't normally think of Europe as a key influence on stock prices – but it's a different world nowadays. The bottom line is what's happening with the EU economy (and specifically its influence on Treasuries) is critical to monitor – and we'll continue to stay on top of it.

Economics

There were no major economic reports yesterday, but what was released was supportive of a growing economic recovery (auto sales were better than expectations, July factory orders were mostly in line, and the Beige Book offered nothing new by way of Fed commentary).

Commodities

Commodities traded much better yesterday, specifically the energy sector, after beginning the shortened week with steep declines. However copper, natural gas and the grains all saw modest selling yesterday. The benchmark commodity tracking index ETF, DBC, gained +0.52% on the day.

Crude oil and the refined products rallied back hard yesterday, making up most of Tuesday's losses. WTI crude added +2.64% on the day. The initial threat of further sanctions between the west and Russia put pressure on Brent because of the potential economic repercussions, but when news broke that the situation may be close to being resolved, buyers came in on the dip.

Market	Level	Change	% Change
Dollar Index	82.86	-.15	-0.18%
EUR/USD	1.315	.0019	0.14%
GBP/USD	1.646	-.0009	-0.05%
USD/JPY	104.72	-.35	-0.33%
USD/CAD	1.0883	-.0043	-0.39%
AUD/USD	.9344	.007	0.76%
USD/BRL	2.2348	-.0082	-0.37%
10 Year Yield	2.410	-.009	-0.37%
30 Year Yield	3.156	-.018	-0.57%

Prices taken at previous day market close.

WTI has been following Brent's lead recently when it comes to geopolitics. Also, as mentioned in yesterday's Report, the Tuesday sell-off failed to reverse any technical progress made in the past 10 sessions (the downtrend remained broken while last week's lows were not violated).

Today is "inventory day" for crude oil and the refined products, delayed a day because of Labor Day, and traders will be looking to the supply numbers for direction. On the WTI charts, support has been re-established at $94 while there is resistance toward $96 per barrel.

Looking to natural gas, prices did not rebound yesterday after seeing sharp losses Tuesday. Futures fell an additional -0.9%, but encouragingly for the bulls closed well off the lows of the day.

The Russia/Ukraine debacle has had a distinctly different effect on natural gas because economic sanctions are not necessarily demand-side bearish, but rather supply-side bullish. The reason is due to speculation that Russia may halt supplies to Europe via Ukraine if things were to deteriorate further.

Bottom line, we saw many of the geopolitical fear bids surrounding Ukraine and Russia continue to be closed as the situation there improves. Also, our domestic weather forecasts continue to moderate, suggesting power demand for cooling needs will continue to dwindle. But, while those factors have suppressed prices over the near term, the historically low supply situation remains the key underlying influence, and we remain medium-term bullish on natural gas. Speaking of supply, analysts are forecasting a build of 74 Bcf to be reported by the EIA this morning. (Note: the release will be delayed 30 minutes to 11 AM this morning because of Labor Day.) Technically speaking, there is support at $3.825 while a close above the $4 mark would be considered bullish.

Moving to the metals, copper continued to fall yesterday, slipping -0.71%. Copper did not materially react to the strong Chinese composite PMI released o/n Tuesday, but that should not be seen as a huge surprise given the report is largely a service indicator. The long-term fundamental argument based on global growth is still largely intact, but the weakness in Europe is beginning to weigh on futures prices. Going forward, there is trend support just above $3.10, and should that be violated, we would need to reconsider our long position in copper.

Currencies & Bonds

The 30-year Treasury rebounded from Tuesday's beating yesterday despite more good economic data (Factory Orders and Auto Sales) as Europe continues to be the major influence on longer-dated Treasuries.

German bunds rallied yesterday despite positive news out of Ukraine/Russia, as investors positioned ahead of the ECB this morning, and Treasuries went with them. Also helping support Treasuries was buying along the 2014 uptrend, which again was violated on an intraday basis but the 30-year managed to close above it again.

For all the noise in this trade, and I'm hearing some pretty smart groups advocating shorting bonds here, the bottom line is we need a decisive break of that trendline before adding more tactical "short bond" positions. That support has held multiple tests this year, and still deserves the benefit of the doubt.

Turing to currencies, Wednesday was a much more quiet day than Tuesday, as most currencies ex-Asia were little-changed. The Dollar Index fell -0.15%, ignoring the economic data as positioning ahead of the ECB dominated the dollar/euro cross yesterday. (The euro was up an equal/opposite +0.15% on short-covering into the meeting).

The only real movement yesterday was in Asia, as both the yen and Loonie bounced back from the Tuesday declines. The Aussie rallied +0.77% to complete reverse the post-RBA drop (helped by improving sentiment from China given the better than expected composite PMIs) while the yen saw a bit of a "dead cat bounce" of +0.36%. Starting with the Aussie, it remains very solidly within the $0.92-$0.94 trading range it's occupied since early April. Given the RBA is very much on "hold," I imagine the Aussie will continue to occupy that range for a while yet. Eventually I do believe the Aussie will break lower, but would want to see a decline through support at $0.92 before shorting it.

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).			
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)			
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)			
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 Break down, the trend in bonds is higher short term.*
Best Idea: Short "long" bonds (TBT) **Best Contrarian Idea:** Short High Yield Bonds (SJB)			