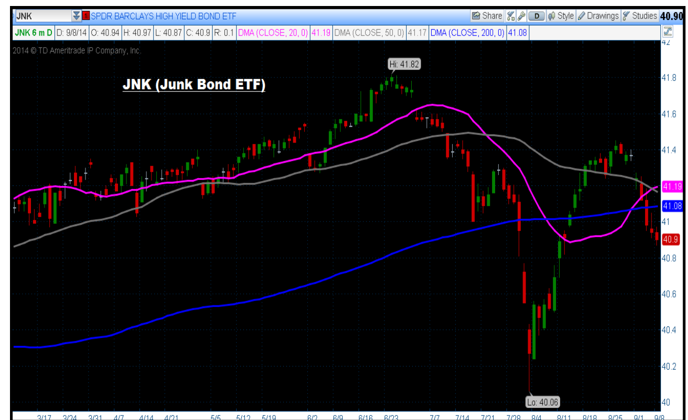
7:00's Report

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

September 9th, 2014



JNK: I put this chart up last week and am doing so again because it's important. If JNK continues to decline from here, stocks likely won't be far behind.

Pre 7:00 Look

- Futures are flat and most international markets are little changed after a very quiet night.
- Economically the only notable report was UK Industrial Production, which beat estimates.
- Geo-politically there were some positives, as the Russia/ Ukraine cease fire continues to hold, while the new Iraqi PM surprisingly was able to form a working government.
- Econ Today: No economic reports today.
- Fed Speak: Tarullo (10:00 AM)

Market	Level	Change	% Change
S&P 500 Futures	2000.75	0.25	0.01%
U.S. Dollar (DXY)	84.45	.079	0.09%
Gold	1257.10	2.80	0.22%
WTI	93.47	.82	0.88%
10 Year	2.469	.008	0.33%

Equities

Market Recap

Stocks again traded a bit heavy to start the week Monday. Global investors further digested the moves by the ECB and the outlook for Fed policy following Friday's jobs report, although stocks managed to close well off their lows of the day. The S&P 500 closed down -0.31%.

The morning session yesterday was mostly quiet, as stocks spent the entire morning drifting in marginally negative territory. Other than the Chinese and German trade balance data, there wasn't much to move markets, and the outlook for the Fed meeting next Wednesday was the focus of most investors.

Specifically, there were articles out over the weekend by the WSJ's Jon Hilsenrath and the FT's Robin Harding about whether the jobs report would result in a change in the Fed's expected statement next week – and basically both concluded they weren't sure. But, both articles dismissed (accurately) the possibility that the jobs report would make the Fed more "dovish." As I said yesterday, if anything it may just delay them getting more "hawkish."

The big catalyst on the day was another Fed paper, as this time a release from the San Francisco Fed implied markets may be underestimating the pace at which interest rates will rise once the increases commence (and the pace is much more important than the time). The Dollar Index broke through 84 on the news, and clearly stops were elected and the dollar began to accelerate materially higher – and that spooked stocks. As the Dollar Index rallied, stocks went in the opposite direction. The S&P 500 hit its lows of the day just before 2 p.m.,

Market	Level	Change	% Change
Dow	17111.42	-25.94	-0.15%
TSX	15509.39	-60.53	-0.39%
Brazil	59192.75	-1489.23	-2.45%
FTSE	6824.89	-9.88	-0.14%
Nikkei	15749.15	44.04	0.28%
Hang Seng	25190.45	-49.70	-0.20%
ASX	5607.90	30.93	0.55%
Prices taken at previous day market close.			

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before both the dollar and stocks steadied and basically drifted into the close.

Trading Color

Market	Level	Change	% Change
DBC	24.505	-.125	-0.51%
Gold	1254.90	-12.40	-0.98%
Silver	19.005	-.151	-0.79%
Copper	3.1795	.01	0.32%
WTI	92.92	-.37	-0.40%
Brent	100.28	-.54	-0.54%
Nat Gas	3.882	.089	2.35%
RBOB	2.5607	-.0227	-0.88%
DBA (Grains)	26.179	-.251	-0.95%
Prices taken at previous day market close.			

Internals yesterday were positive, and while the market continues to feel “heavy” to me, even at midday the selling didn’t have a lot of conviction to it and was mostly driven by algos and day traders. The Russell 2000 and Nasdaq both ended the day positive, while SPHB was up one penny, but solidly outperformed SPLV (down -0.35%).

Sector-wise, there was no real theme in the markets to speak of (trading was really pretty quiet yesterday despite the midday decline). However we did see a bit of a “higher rate” trade as traders booked profits in utilities (they were up +1.5% on Friday) and banks were able to buck the tape to finish positive (GS upgraded BAC). KRE closed up +0.46%, basically at the highs of the day. And, this “higher rate” rotation is something I believe will continue, assuming I’m right about bonds finally rolling over from here.

On the downside, energy continues to get hammered, as the XLE was down another -1.5% and is now sitting at early August lows. It’s getting dangerously close to support at $95, between BP weighing on the ETF and the inability of oil to stage any sort of bounce-back rally.

On the charts the S&P 500 managed to close back above 2,000 and seems stuck around that level, at least until we get more information on what to expect from the Fed next week. Near-term support sits at 1,982.

2 Reasons We May Be In For Another Sell-Off

Even though the fundamental backdrop is favorable for stocks, the inevitability of a continued market rise is palpable. The “Pain Trade” is now clearly lower for both stocks and bonds.

There were three pieces of anecdotal evidence yesterday to support my opinion (although, obviously, anecdotal evidence has to be taken with a grain of trading salt). First, I read that the Investors Intelligence sentiment survey, released last week, showed just 13.3% of those surveyed were bearish—which is the lowest since 1987.

Second, the cover of Barron’s was bullish. The cover story—which was about a survey Barron’s conducted involving the Chief Investment Strategists from 10 large investment managers—found that *not one of them was bearish*. Now to be fair, Barron’s isn’t a mainstream publication and obviously has a more sophisticated readership than the average investor. Nonetheless, it again speaks to the inevitability of higher stock prices.

This weeks Barron’s cover—I wouldn’t say it’s irrational exuberance, but the feeling of inevitability of higher stock prices is becoming much more prevalent.

Finally, Deutsche Bank Strategist David Bianco, an ardent bear for all of 2014, has now switched and introduced a 2,050 target for the S&P 500 (previously 1,850), along with 2,150 for 2015 (previously 2,000) and 2,300 for 2016.

Again, none of these things mean equities are about to roll over, and I’m certainly not becoming bearish on stocks. And, yes there remains healthy skepticism for the reasons stocks are rallying (the most common is a Fed-induced bubble). But for the first time in a long time, people seem very comfortable with stocks inevitably grinding higher. Yesterday’s midday sell off came with little to no fanfare – and even if there is a small dip, everyone has plans to buy it.

Again, anecdotal evidence needs to be taken with a grain of salt—but I’m just saying there has been a shift in sentiment, and the pain trade is definitely to the downside.

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JNK Is Rolling Over—That is A Warning Sign

JNK, the junk bond ETF, accurately forecast the July/early August decline in the stock market. Now, it's rolling over again—providing a potential warning sign that we may be in for another dip.

In the July 22 issue of the Report, we included a chart that showed how junk bonds had broken a 2014 up-trend, and warned it could be a negative sign for stocks.

Likewise, we kept watching JNK as *the* leading indicator for the stock market during the late-July/early August sell-off. We pointed out on Aug. 13 that JNK was close to breaking back above resistance at $41 and, if successful, could signal an end to the stock sell-off. JNK did break resistance, and over the next week the S&P 500 rallied 50 points in a straight line …

So, to recap:

- JNK topped on 6/23/14.
- SPY basically topped on 7/3, 11 days after JNK. (The SPX did make a nominal new high on 7/24 but really the market was chopping for those three weeks.)
- JNK declined -4.21% peak to trough, bottoming on Aug. 1.
- SPX declined -4.25% peak to trough and bottomed on 8/7, one week after JNK.

So, JNK peaked and bottomed one week before SPY, and the declines were almost identical.

And, while nothing in the market is 100% guaranteed, it sure seems like JNK acted as a leading indicator for stocks.

And, that makes sense fundamentally. If we are going to see a decline in stocks, it's going to be due to fears about the Fed getting too hawkish, which will come with higher rates. And, when rates do start to rise, junk bonds will get hit the hardest because they are the sector of the bond market that is the most overbought, thanks to years of QE and the subsequent reach for yield.

Turning to the present, JNK is rolling over, as the chart on pg. 1 shows. JNK peaked on 8/26 and is now down 4 days in a row, again below support at the $41 level.

Point being—JNK acted as a leading indicator for stocks 2 months ago, and I believe it's continuing to do so now. Does that make me outright bearish on stocks? No, you can't fight this tape and have to respect the rally. But, it is a warning sign we need to monitor, and it may be an indication that we're in for another sell-off in the coming weeks.

Economics

There were no economic reports yesterday.

Commodities

Commodities began the week trading mostly lower as the stronger dollar (+0.64%) continues to weigh on the space. Crude oil and gold were among the worst performers yesterday, while natural gas and copper were the only two commodities to finish higher. The benchmark commodity ETF, DBC, fell -0.51% on the day.

Gold was the worst performer yesterday, falling -0.92% to 3-month lows thanks primarily to the strengthening dollar. The fundamentals of the precious metals market are largely the same in that gold and silver are going to have a hard time rallying while the Dollar Index continues to go straight up.

Also, a calmer geopolitical backdrop, paired with decent-to-strong economic data, isn't exactly inviting bids to the market. So, sellers maintain control for the time being.

But, looking more at the long-term picture, gold will eventually bottom and rally (likely hard) as the threat of inflation becomes a reality. On the charts, support at $1,240 is key, and if we see that broken, it is a pretty straight shot toward the $1,200 level.

Market	Level	Change	% Change
Dollar Index	84.275	.518	0.62%
EUR/USD	1.2902	-.0048	-0.37%
GBP/USD	1.6116	-.0209	-1.28%
USD/JPY	105.99	.91	0.87%
USD/CAD	1.097	.0092	0.85%
AUD/USD	.9286	-.009	-0.96%
USD/BRL	2.265	.0247	1.10%
10 Year Yield	2.469	.008	0.33%
30 Year Yield	3.223	-.014	-0.43%

Prices taken at previous day market close.

Copper futures rallied nicely yesterday, adding +0.39% on better than expected Chinese export data that fueled speculation that industrial metals demand remains strong. The

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stronger dollar, however, remains a headwind for copper—which is now approaching a breaking point on the charts, with futures trading in a narrowing "wedge" on the daily chart. A close above $3.20 would be a bullish breakout while a close below $3.11 would violate trend support. We are becoming more neutral on copper as the fundamentals are less clear and the technicals are actually shifting to favor the bears. Having said that, booking some profits here and waiting for the aforementioned "wedge" is not a terrible idea at this time.

Crude oil finally broke out of its recent "range-bound" trade, falling -0.40% yesterday to hit fresh 8-month lows. Brent crude, the global benchmark, fell below $100/barrel for the first time since June 2013, partly due to the weak Chinese *import* data (not to be confused with the strong *export* data that helped copper to rally), as well as Friday's miss in the U.S. jobs report. Also, traders are hesitant to buy ahead of what is expected to be an extended maintenance period for refiners, which will weigh on WTI demand. And, with geopolitics the calmest they have been in months, there are very few fear bids in the market currently.

On the charts, the downtrend dating back to the frothy June highs remains intact. Until that is decidedly broken, the benefit of the doubt continues to be with the bears who now have their sights set on the 2014 low of $91.24.

Currencies & Bonds

The dollar rally is turning into a runaway train, at least in currency market volatility terms. The Dollar Index again finished higher against all major trading partners thanks to the aforementioned Fed paper, rising +0.61% to trade through 84 and hit another new 14-month high.

All major currencies were down vs. the dollar, and yesterday it was just a question of by how much (and the answer universally was, "a lot"). The British pound, though, certainly takes the cake, as it dropped -1.3% vs. the dollar. This came after a Sunday Times/YouGov poll showed for the first time that a majority of those surveyed in Scotland favored independence before the vote on Sept. 18. This was especially shocking because, over a month ago, the "no's" with regard to independence held a greater-than-22% lead in the polls. The drop sent the pound to levels last seen in November of last year.

Turing briefly to the Scottish independence vote, I'm no scholar on UK politics – but despite the poll results, a breakup seems unlikely. First, all polls naturally tighten going into the election (although not by 22 points). But the simple fact is that a "yes" vote, this poll aside, remains the low-probability event. If the "yes" vote is carried through, though – then expect significantly more downside in the pound, as we may see some minor chaos if that happens. That "black swan" aside, though, I'd imagine we'll see some support start to materialize for the pound around here, with major support around 1.60.

Staying in Europe, the euro fell as the dollar was strong – dropping -0.4% to a new 14-month low. That drop came despite strong German August export data, which is now the third-straight German data point to show some signs of life. August exports rose +4.7% after being basically flat in July. Combined with the good industrial production and manufacturers orders from last week, this implies things might not be as bad in Europe as feared.

Regardless, momentum in the U.S. dollar was simply too much, although I do expect a bounce-back in Europe at least in the very short term. (I would be surprised to see 1.28 violated in the next few weeks. But, to be clear, we need to be selling any material "dead cat" rallies in the euro.)

Although there was more volatility in the currency markets, the more important trading yesterday happened in the long bond. For the second-straight day, the 30-year Treasury opened basically on the highs, but then bled lower throughout the day to again finish negative. That is the hallmark of a market that is trending lower. While again the benefit of the doubt remains with the bond bulls, given the strength of the 2014 rally, the fact that we've got 3 consecutive closes below that 2014 uptrend makes me think this market is legitimately starting to roll over.

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
9/4/14	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. Given the sour sentiment towards the region and relative attractive valuation we are committing capital to the trade. 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.*
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*
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 9.8.14)

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 traded to new highs again last week thanks to a big Friday rally in response to the softer than expected jobs report (it lowered levels of Fed angst). Despite the new highs, though, stocks traded a bit heavy last week and a period of consolidation looks in order, although beyond the very near term the back drop remains favorable.*

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 traded lower last week as a decline in WTI Crude oil and gold weighed on the complex. Both gold and oil are now at critical levels of support, but with the US economy accelerating and the growing potential for inflation, expect buyers to defend current levels.*

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 (again) after the ECB shocked everyone and unveiled private sector QE. Also helping the dollar rally was disappointing economic data out of Japan (the yen hit a new low for the year). While overbought, the path of monetary policy between the US and most of the rest of the world is diverging (US tight, everyone else loose), and that is dollar bullish.*

Best Idea: Sell the Yen (YCS)

Best Contrarian Idea: Long Canadian Dollar (FXC)

	Near Term Trend	Long Term Trend	Market Intelligence
Treasuries	**Neutral**	**Bearish**	*Treasuries declined last week despite the disappointing jobs report, as the positive influence from Europe waned after the ECB announced private market QE. The 30 year Treasury is now below the 2014 uptrend, but before getting outright bearish short term, I'll want to see it close a few more times below that support level—as this 2014 rally deserves the benefit of the doubt.*

Best Idea: Short "long" bonds (TBT)

Best Contrarian Idea: Short High Yield Bonds (SJB)

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