7:00's Report

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

October 1st, 2014

Pre 7:00 Look

- Futures are flat while most of Europe is modestly weaker following some lack luster final September manufacturing PMIs. Japan also fell modestly and Chinese market were closed for holiday. It wasn't a good night for global growth.
- The negative surprise of the night was German PMI which slipped below 50, dropping to 49.9 from the 50.3 flash estimate. The rest of the European data was lackluster but generally in line.
- In Japan, the yen hit 110 briefly after mixed data: The Tankan Survey was better (13 vs. 10) but the Sept PMIs missed.
- Econ Today: ADP Employment Report (E: 200K), ISM Manufacturing Index (E: 58.0)

Market	Level	Change	% Change
S&P 500 Futures	1964.50	-1.00	-0.05%
U.S. Dollar (DXY)	86.195	.148	0.17%
Gold	1209.40	-2.20	-0.18%
WTI	91.62	.46	0.50%
10 Year	2.508	.017	0.68%

Equities

Market Recap

Stocks ended trading yesterday with marginal declines following a volatile session that was more about digestion than anything in the news. The S&P 500 closed down -0.27%.

Stocks opened higher Tuesday thanks to strength in Europe (European shares handily outperformed yesterday on more ECB stimulus expectations) and China (authorities announced measures to help mortgage availability). But as has been the case for 10 days now, the market got hit on the open by sharp selling as the S&P 500 again dropped below the 1,980 support level. News-wise, the early part of the session had a lot of headlines: Case-Shiller declined unexpectedly, Chicago PMI missed and consumer confidence dropped. But none of those releases elicited much of a market reaction.

30 Year Treasury: We're at a bit of a cross roads here in the near term "short bond" trade. A material break of the downtrend would be an unwelcomed short term bullish sign.

Also in a familiar pattern, the declines stopped less than 30 minutes after trading and stocks rallied sharply on fast money and day trader covering. But, then we did get some actual news that caused a market move.

Stocks declined sharply before lunchtime on a Bloomberg report that Russia was considering capital controls (never a good thing, especially for an emerging market). Stocks dropped on the news, falling for two hours with the S&P 500 hitting the lows of the day shortly before 2 o'clock.

But, during the late afternoon the Russians refuted the Bloomberg article. Stocks again bounced off of 1,970 and drifted higher before selling off a bit into the close.

Market	Level	Change	% Change
Dow	17,042.90	-28.32	-0.17%
TSX	14,960.51	-16.41	-0.11%
Brazil	54,115.98	-509.37	-0.93%
FTSE	6,596.27	-26.45	-0.40%
Nikkei	16,082.25	-91.27	-0.56%
Hang Seng	22,932.98	-296.23	-1.28%
ASX	5,334.13	41.32	0.78%

Prices taken at previous day market close.

Overall it was another volatile day dominated by fast money and positioning, and the Russia headlines just exacerbated the swings. Bigger picture, the market is still digesting and churning sideways.

Market	Level	Change	% Change
DBC	23.19	-.44	-1.86%
Gold	1208.20	-10.60	-0.87%
Silver	16.975	-.592	-3.37%
Copper	3.008	-.0485	-1.59%
WTI	91.24	-3.33	-3.52%
Brent	94.68	-2.52	-2.59%
Nat Gas	4.125	-.029	-0.70%
RBOB	2.439	-.0752	-2.99%
DBA (Grains)	25.54	-.16	-0.62%
Prices taken at previous day market close.			

Trading Color

It was both month- and quarter-end yesterday, so price action has to be taken with a healthy grain of salt. But that said, small caps got killed again yesterday, as the Russell dropped -1.45% while every other major average was down marginally (-0.25%-ish for the Nasdaq, S&P 500 and Dow, as they all traded basically in line with one another). Even the higher-beta sectors didn't badly underperform, as SPHB was down just -0.4% vs. a flat SPLV.

Russell 2000: The index made a "lower low" yesterday and while significant small cap underperformance hasn't been a weight on large caps yet, this chart is not looking good, and at some point that has to mean something.

Given yesterday was the last day of the month and quarter, I imagine a lot of the small-cap selling was portfolio managers dumping stocks they don't want to show up on the quarterly holding list. But even so, the continued decline in small caps remains a major theme in this market that I believe is being too easily dismissed. Of note, the Russell dropped below the late July/early August lows.

A lot of the price action yesterday can be chalked up to end-of-quarter/-month window-dressing. In an interesting turn of events, we again saw 3 out of 10 S&P 500 sub-sectors positive, and they were the exact same ones as Monday: utilities, tech and consumer staples. Utilities caught a bid despite higher interest rates on some stock-specific news, D got FERC approval for a new project in Maryland and tech got a boost from the EBAY/PayPal split, with AAPL bouncing on news of the iPhone approval in China.

Energy was again the big laggard as XLE collapsed -1.25% as oil prices fell more than -3% yesterday. XLE traded to a new 4-month low and while some are starting to make a bit of a "value" argument for the energy names, I still think it's too early, as I'm not convinced this puking of the entire commodity space is over yet.

On the charts, the S&P 500 closed below the 50-day, which was at 1,976 (some were pointing to that as support), and now the Monday lows (1,963) and 100-day MA (1,957) remain key support levels.

Bottom Line

The market continues to digest the recent declines and remains dominated by short-term trading and sentiment. JNK bounced back above $40 yesterday and emerging market steadied a bit, but I still expect the S&P 500 will need to at least test the 100-day MA (1,957) and hold it before we can declare this most recent pullback "over."

If that test fails and JNK rolls over from here, though, I think that will be cause to get much more defensive than we've been in years, frankly. For now, though, the benefit of the doubt remains with the bulls.

Economics

There were multiple economic reports yesterday, but all of them were "second tier." And although they all missed estimates (Chicago PMI, Consumer Confidence and Case-Shiller CPI) none are altering anyone's outlook for the economy, as the focus remains on the jobs data starting this morning with ADP.

Commodities

Commodities gave back all of Monday's gains and then some yesterday. The weakness was universal but crude oil and gasoline were notable underperformers while the grains, gold and natural gas relatively outperformed, managing to limit losses to less than -1% each. The benchmark commodity tracking index ETF, DBC, turned negative on the week, falling -1.76% to a fresh multi-year low.

As we said in yesterday's Report, although trading in WTI crude has been encouraging in recent weeks, the greater trend remains lower. That was confirmed yesterday when futures had their worst day in 2 years, falling -3.5% after failing to break above the longstanding downtrend resistance in early trade.

Then, a sell-off in gasoline futures, which expired yesterday, added pressure to crude oil and weak-handed speculative longs rushed for the door. WTI prices dropped back to a 1-week low before finding support at $91/bbl. Despite yesterday's big moves in crude—and energy in general—the situation is largely unchanged, with prices range-bound between $91 and $95. The downtrend that has been in place since June remains intact.

Elsewhere in energy, natural gas fell -0.72%. It outperformed most other commodities and importantly stayed positive on the week. Buyers became exhausted in the opening minutes of the primary session, and it looks like short-term traders simply took some profits. On the charts, the 100-day moving average at $4.16 is the key resistance level, as futures have failed there two days in a row now while weak support has formed at $4.10. We remain fundamentally bullish on natural gas, and any material sell-offs should be seen as opportunities to get long, or add to existing positions.

Moving to the metals, copper futures fell -1.5% toward support at $3 yesterday, closing at the lowest level since mid-April amid lingering concerns over Chinese economic growth thanks to the HSBC China Manufacturing PMI that came in below the preliminary reading.

Also, the surging dollar put additional pressure on copper. Base metals are priced in dollars, making them more expensive to international buyers such as China (note the Chinese account for 40% of global copper demand). Copper futures are continuing to make new lows, which is obviously bearish. However, many traders are looking to the $3 mark for support.

Testing support seemed to be a theme yesterday as gold futures drifted down to within $5 of the psychological $1,200 level yesterday. The stronger dollar certainly weighed on the precious metals. However, some geopolitical and cross-asset "angst" along with value bidders supported the market just above the $1,200 mark.

Fundamentally, the Commitments of Traders report that was released on Friday showed that net long positions held by money managers for both gold and silver have fallen to the lowest levels since early January, which suggests the risk for a short-squeeze is still something to be wary of. So, bottom line, further tests of $1,200 are all but inevitable, but there is a risk that shorts could start to cover and lead futures back up as high as the mid-$1,200s.

Currencies & Bonds

The dollar rally resumed in earnest Tuesday as the Dollar Index crossed through the 86 level for the first time since July 2010, thanks mainly to low inflation in Europe and lackluster economic data everywhere else (Japan, Great Britain and Canada). The data were so underwhelming everywhere else that not even a "miss" in Chicago PMI, Consumer Confidence and Case-Shiller could stop the dollar rally, although it did end off its best levels of the day, up +0.38.

Starting with the euro, EU HICP was a miss, with the core HICP rising just +0.7%, down from +0.8% the previous month (the important number to watch is the core yoy change, not the month-over-month changes). But, seeing as "good news is bad" in Europe, the soft reading led to a stock market rally early Tuesday and a bond market sell-off, as the weak inflation reading will put further pressure on the ECB to ultimately do "QE." I'd expect at least some sort of a pause in the euro declines today as traders cover some shorts into the ECB meeting to-

Market	Level	Change	% Change
Dollar Index	86.04	.324	0.38%
EUR/USD	1.263	-.0054	-0.43%
GBP/USD	1.6208	-.0032	-0.20%
USD/JPY	109.65	.19	0.17%
USD/CAD	1.1201	.004	0.36%
AUD/USD	.8749	.0036	0.41%
USD/BRL	2.445	-.0016	-0.07%
10 Year Yield	2.508	.017	0.68%
30 Year Yield	3.212	.032	1.01%

Prices taken at previous day market close.

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Staying in Europe, UK data were mixed. GDP was revised slightly higher to 0.9% in Q2 vs. (E) 0.8%, but the Seasonally Adjusted Annual Rate (saar) remained at 3.2%, so it wasn't any significant uptick. On the flipside, a measure of home prices actually declined -0.2% vs. (E) 0.5%, sending the year-over-year gains down to 9.4% vs. (E) 10.4%, which is the main reason we saw the pound trade lower vs. the dollar.

Bottom line is the pound has now recouped much of the Scottish independence declines, and at this point it's likely fairly valued vs. the dollar. Until we get more clarity on just when the BOE plans to raise rates, I'd expect the pound to chop mostly sideways from here vs. the dollar.

Turing to Asia, dollar/yen continued to inch closer to 110, after mildly disappointing economic data. The yen rose to 109.84 and briefly broke above 100 in early trading this morning following the Tankan and manufacturing data. But given the frankly dramatic declines in the yen, I would not be surprised if hitting 110 marks a short-term bottom. This pace of decline simply isn't healthy, and if it continues it will elicit some sort of response from the BOJ. The yen is fundamentally still a short, but from a timing perspective, I'd be pulling trailing stops in tight at these levels. That's because a reversal could be dramatic.

Finally, looking at the commodity currencies, the Loonie broke to a new 6-month low and it sitting just above $0.89 vs. the dollar following a weaker than expected monthly GDP report (0.0% vs. (E) 0.3%). The Aussie bounced a touch (+0.22%) following the Chinese housing stimulus report, but the bottom line with both currencies is that the trends remain lower. Any decent bounce is one to be shorted. With regard to both, "value" remains lower, in the lower $0.80s.

Bonds were flat for most of the day yesterday before the 30-year fell out of bed during the last 20 minutes of trading. When asking friends/colleagues, the most-cited reason I got was "quarter-end window-dressing" but that just means no one had a reason. So, for now, it appears it was just a gap in liquidity and someone was a little aggressive in their selling (which is strange for the bond market — you should not see the 30-year "gap" lower on no news. The market is too big and too liquid, or at least it used to be).

Regardless, the 30-year finished down -0.30% and importantly traded back below the downtrend from the August highs. It may be a mistake, but given yesterday's close, I added to my TBT position on the break, and will now stop the entire position out following a few closes above that downtrend line. So, here's hoping Mr. Draghi is "dovish."

ECB Preview

I know the meeting is tomorrow, but not everyone reads the Report first thing in the AM so I'm including the preview here. First, there are no additional monetary policy measures expected at this meeting, and the primary way the ECB will be "dovish" at the meeting is by Draghi further hinting at QE during the press conference.

But, further clarification is expected regarding "just how big" the ABS program (announced last month) will be. In particular, pay attention to "distributed" vs. "retained" ABSes. Without getting too much in the weeds, the bottom line is that if the ECB says it'll also buy "retained" ABSes, then the size of the ABS program will be much bigger. That means the ECB balance sheet would likely grow more, which is a "dovish" positive. So, watch for "retained" ABSes to be mentioned.

Also, with regard to the TLTROs, there were some structural factors that people believed resulted in the low demand for the September offer, and one was that the new TLTROs are priced at a rate 10 basis points higher than the old LTROs. Look for that 10-basis-point spread to be removed tomorrow.

Bottom line is nothing radical will come from the meeting, but between a dovish press conference and the two issues covered above, the meeting does still have the potential to be "dovish" on the margin (and EU-stock-positive).

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 9.29.14)

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).

	Near Term Trend	Long Term Trend	Market Intelligence
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)

	Near Term Trend	Long Term Trend	Market Intelligence
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)

	Near Term Trend	Long Term Trend	Market Intelligence
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)