7:00's Report

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

October 13th, 2014

Pre 7:00 Look

- Futures are starting the week modestly higher following a busy weekend. Global markets were mixed with Asia lower and Europe higher. Today is Columbus Day, so bond markets are closed.
- The weekend saw a lot of headlines (IMF, Ebola) but nothing materially changed. Global economic leaders pledged to support the global economy, but there were no new policies announced.
- Chinese trade data was better than expected o/n, as both imports and exports beat estimates, helping to (temporarily) alleviate growth concerns.
- Econ Today: No economic reports today. Fed Speak: Evans (12:30 PM).

Market	Level	Change	% Change
S&P 500 Futures	1901.00	6.50	0.34%
U.S. Dollar (DXY)	85.63	-.401	-0.47%
Gold	1226.00	4.30	0.35%
WTI	84.62	-1.20	-1.40%
10 Year	2.305	-.022	-0.95%

Equities

Market Recap

Stocks slumped last week and broke through multi-year support levels on rising concerns about global economic growth. The S&P 500 fell -3.1% and is up +3.13% year-to-date.

Last week saw some of the most-volatile trading in years. Stocks were flat last Monday, but then the last four days of the week saw wild, 1%+ swings each day.

Tuesday the S&P 500 broke below the 100-day moving average for a second time (which differentiated this pull-back from others) on the IMF global growth downgrade and disappointing Germany economic data. But, stocks staged a huge rebound Wednesday following dovish Fed minutes, and the S&P 500 rallied nearly +2% and closed back above support at the 100-day MA. But, that was the last bit of strength this market showed last week.

Thursday stocks broke back through support at the 100-day on general global growth concerns (a disappointing speech by Mario Draghi was one of the catalysts behind the selling). Meanwhile on Friday stocks tried to hold up, but afternoon selling was heavy ahead of the weekend and the S&P 500 collapsed during the final hours of trading— smashing through all near-term support levels and basically closing on the 200-day moving average (1,904). Simply put, the way stocks traded to end the week was downright ugly.

Trading Color

Whenever the market is down -3%, you're going to see significant underperformance from cyclicals, and that's exactly what happened last week. Small caps, Nasdaq and SPHB all badly underperformed while defensive sectors (staples, utilities) all relatively underperformed, and that will continue until the market stabilizes.

But, I do want to point out the utter collapse in the semiconductors. On Friday, MCHP issued a profit warning, and this company is viewed as being a bit of a bellwether of the semiconductor space.

The Nasdaq was down -2.33% on the news Friday and the SOX (semiconductor index) dropped -6.9%!. Semis have been one of the leading sectors of the market for 2+ years, so this was a massive breakdown. And, although anecdotal, I don't view that breakdown as a good signal for the broader market, as now the market lead-

Market	Level	Change	% Change
Dow	16,544.10	-115.15	-0.69%
TSX	14,227.36	-233.24	-1.61%
Brazil	55,311.59	-1,955.94	-3.42%
FTSE	6.337.07	-2.90	-0.05%
Nikkei	15,300.55	-178.38	-1.15%
Hang Seng	23,143.389	54.84	0.24%
ASX	5,155.50	-32.75	-0.63%

Prices taken at previous day market close.

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ers are coming under attack (a hallmark of a bear market). The SOX is something I'm going to be watching closely to see if it can rebound this week.

Market	Level	Change	% Change
DBC	22.62	-.05	-0.21%
Gold	1222.10	-3.20	-0.26%
Silver	17.33	-.088	-0.51%
Copper	3.0395	.0095	0.31%
WTI	85.80	.03	0.03%
Brent	90.12	.07	0.08%
Nat Gas	3.858	.013	0.34%
RBOB	2.2548	-.0201	-0.88%
DBA (Grains)	26.43	-.04	-0.15%
Prices taken at previous day market close.			

__This Sell off is a lot like Jan/Feb—But There Are Key Differences to Consider__

On the surface this sell-off seems a lot like the late January/February declines, where the market dropped on emerging market (and global) growth concerns. Looking at market technicals: Other risk metrics are declining sharply, as JNK and emerging market bonds have broken down to new lows (which happened in January). The S&P 500 has violated the 100-day moving average, which has been key support for this 2+ year rally (this happened in January, although not to this extent). The VIX traded back above 20 (the last time that happened was in late January /early February).

But, there are some key differences that I think should be considered (that make this potentially more serious/concerning) ...

First, the Fed is ending QE. And, while not by itself a reason for the selling, the simple fact is that the last two times the Fed ended QE (in March 2010 and June 2011), the stock market fell 16% and 20%, respectively. Yes, there are a lot of differences between the economic backdrop then and now, but I'm just saying people are thinking about that.

Second, oil has collapsed, potentially making the case that the fears of a global slowdown are actually materializing (the growth fears that caused the January/February sell-off never materialized).

This 2+ year rally must be respected and the markets resiliency considered, but given these differences and the new lows in JNK and the clear break of the 100-day moving average, we are moving to reduce equity exposure in our tactical accounts.

Yes, I realize we could be selling the lows, but we operate on a risk/reward basis here. And from a risk/reward perspective, I simply don't view the chances of missing an extended rally from here as greater than avoiding a deeper pullback.

If earnings are good this week and global growth metrics stabilize, the market likely will too. But with QE ending and Europe still a few months away from stimulus starting to work through, I would rather buy back into a market that's showing strength than stay materially long amidst all the uncertainty.

Long-term fundamentals remain broadly supportive of stock prices, and governments are committed to stimulating global growth. (Europe will get it in gear; it's just a question of when.) So, we're keeping allocations in our retirement accounts and will grin and bear it. But, for more tactical accounts, we're following the facts—and the facts are starting to imply this could be a different correction that we're used to.

Bottom line is this remains all about global growth and Europe, so the two key indicators to watch are Oil and Europe. When oil and EWG (the Germany ETF) bottom, so will the market (Germany is really ground zero for this decline, so watching it vs. a broad Europe ETF will be more effective).

Economics

__Last Week__

The focus of the global economy shifted entirely to Europe last week, and the continued lackluster economic numbers were among the main reasons we saw such massive volatility and selling in risk assets. At the moment, U.S. and Chinese data are firmly in the backseat (barring any major disappointments).

Specifically within Europe, focus was on Germany last week and the data simply weren't good: Monday it was August manufacturers' orders, which slumped — declining -5.7% vs. (E) -2.5%. Tuesday it was August industrial production, which fell -4% vs. (E) -1.1%). And then Thursday exports dropped -5.8% in August—completing a trifecta of negative data from Germany.

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Now, to be fair, August is typically a bad data month in Europe, and especially the export numbers were hurt by the timing of a holiday. But at this point the No. 1 concern for the market is global growth and, specifically, whether Europe is backsliding into a recession. And as Germany goes, so goes Europe. So, the bad data elevated fears about global economy growth.

While the European data were the most important last week, the most followed/anticipated release was the FOMC minutes, which surprised markets by being exceptionally dovish. The main takeaway was the "core" of the Committee appears much more concerned about growth in Europe, global growth and the stronger dollar than most people thought. As a result, they seem to be putting a lot of weight behind these risks, implying they may be more dovish than the market thinks.

Oddly, these "dovish" minutes were somewhat contradicted by FOMC officials' comments later in the week, as multiple Fed presidents—including former Vice Chair Dudley and current Vice Chair Fischer—implied "lift off" for interest rates remains mid-2015. That muddled message added to the volatility in stocks last week.

Muddled message aside, the market took the Fed is dovish last week, and Fed Fund futures are now pricing in a rate hike sometime in Q4 2015.

Turning to actual data in the U.S., it was sparse but what we got was good: the 4-week moving average for jobless claims fell to an 8-year low, while both the Kansas City Fed Labor Market Index and the new "Labor Market Conditions Index" both showed further improvement in the jobs market (some tried to spin the LMCI as dovish, but it wasn't).

Finally, Chinese composite PMI slightly missed expectations but remained solidly above 50, and the market largely ignored the release.

Bottom line is the main concern of the market is the health of the global economy, and last week's data were not reassuring.

This Week

It's going to be a busy week, as there are multiple reports from all regions of the globe (U.S., Europe and Asia), although as mentioned, the European data will be the most important.

Starting with that, then, we get multiple readings on inflation and growth from Europe.

First, the growth numbers to watch (in order of importance): EMU industrial production comes Thursday (it's going to be bad—just a question of how bad). The German ZEW Business Survey is released Tuesday night (look at the expectations component), while Italian GDP is released Wednesday (there are fears that Italy is already in a recession).

Turning to inflation, we get final inflation readings for September (we got the "flash" readings two weeks ago). There shouldn't be any major surprises, but given the concern about deflation, if the flashes are revised down even by just -0.1%, look for that to pressure the market.

Italian CPI comes Tuesday, Germany CPI is released Wednesday, EMU HICP comes Thursday, and French CPI comes Friday.

Again, this is all about Europe at the moment, so any good news on the growth or inflation front will be welcomed by risk assets.

Turning to the U.S., it's also a busy week. By all accounts, U.S. growth remains "fine," but this market is unsettled and it needs a confidence boost. Good data this week, especially from Empire State manufacturing and the Philly Fed (Wed/Thurs), could help sentiment. That's because they are the first look at October data and will remind everyone growth here is still good.

Also on the calendar are retail sales (Wednesday) and industrial production (Thursday), as well as weekly claims and housing starts (Friday). Again, while none of these numbers will change anyone's outlook on growth for the U.S., they will affect confidence, so good numbers are needed.

Market	Level	Change	% Change
Dollar Index	86.03	.375	0.44%
EUR/USD	1.2615	-.0075	-0.59%
GBP/USD	1.6055	-.0063	-0.39%
USD/JPY	107.81	-.02	-0.02%
USD/CAD	1.1212	.0029	0.26%
AUD/USD	.8708	-.007	-0.80%
USD/BRL	2.4076	.0096	0.40%
10 Year Yield	2.305	-.022	-0.95%
30 Year Yield	3.035	-.027	-0.88%
Prices taken at previous day market close.			

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Finally turning to China, its trade balance was better than expected, while CPI and PPI are tomorrow. Again, not to be repetitive, but the No. 1 concern is about global growth—if the trade numbers are a disappointment, that's going to be a headwind.

Commodities

Global growth and movement in the dollar remain the two largest influences in the commodities market right now, with the former weighing heavily on the energy space while the latter helped the metals rally last week (the dollar fell -0.99% on the week). General commodity prices remain in a steep downtrend as the benchmark commodity tracking index ETF, DBC, fell for a 6th straight week, finishing down -1.05% at a fresh 4-year low.

WTI crude oil was one of the worst performers in the space last week as futures fell -4.67% to close at a near 2 year low on Friday. Crude oil weakness is largely being driven by global growth concerns as Europe is teetering on the edge of falling back into recession, and Chinese data continue to disappoint rekindling fears of a potential "hard landing" there. Going forward, the price action of crude oil bears watching, because it has been a leading indicator of sorts for the stock market. Until we see oil prices bottom, the selling pressure on equities will likely continue. On the charts we are having to go way back to find support, but there is some support in the $84-$85 band while there is resistance above at $88.

Moving to natural gas, futures traded heavy last week, falling an even -4% despite a slightly bullish EIA inventory report on Thursday (+105 Bcf vs. E: +108 Bcf). As we mentioned in the middle of last week, natural gas futures have been forming a similar consolidation pattern on the daily and weekly charts to the one seen between March and July of this year that ended with a 60-cent (13%) sell-off. We are keeping a close eye on support here at $3.80 because if it decidedly violated, we could see futures make a sharp move lower toward $3.50.

Gold was the best performing commodity last week, rallying +2.7%. The gains were largely a result of fear bids and the "risk off" trade in the market as equities plummeted and bonds rallied over the course of the week. Also, the dollar finished the week lower for the first time in 13 last week, which helped all metals trade higher. Looking ahead, the near-term direction of gold prices will depend on the stock market and the dollar. If we see continued weakness in both, expect gold prices to run up, potentially as high as $1,300. However, such a move would be considered a good level to sell longs or initiate shorts as dollar strength is poised to continue over the medium term. This will keep pressure on gold prices.

Currencies & Bonds

For the first time in 13 weeks the Dollar Index declined last week, dropping 1.3% thanks mainly to buyer exhaustion, as the Dollar was absurdly overbought short term, and dovish FOMC Minutes released last Wednesday.

The chart of virtually every currency vs. the dollar last week looks very similar, as the euro, pound, Aussie and Loonie all gained around 1% vs. the dollar with the biggest moves coming Wednesday.

We did see a small bounce in the dollar following Wednesday's decline as there was a definitive "risk off" bid in the markets Thursday/Friday. But, beyond any short term support from a declining stock market, this correction in the dollar (and rally in everything else) should continue over the coming weeks, as the Fed is clearly "spooked" by the fall in global growth, and the Dollar is still very overbought. Beyond that the fundamentals remain very dollar bullish, but for now I think this market had more to go on a correction.

The best performer vs. the dollar last week was the yen, and it's higher again this morning. The yen rallied 2.1% vs. the dollar after some generally upbeat comments on the economy from BOJ Governor Kuroda, and on a general "risk off bid." We got near term cautious on the yen a few weeks ago after it hit our $110 target in early October, and maintain that stance. Longer term fundamentals remain yen negative, but this market needs to correct, and it's doing do. Again I would book any short yen/long DXJ profits that aren't very long term holdings.

Have a good week,

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	59.35 24.67 16.44 41.34	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 (10/13/14): The yen hit our target of 110 vs. the dollar and DXJ traded basically to its all time highs in early October, but now we are seeing a much needed correction. Longer term, I remain a bull on Japan/bear on the yen, but this trend will likely pause for some time, and I'd book any profits in those positions for accounts that don't have a very long time frame (and can stomach a correction).

Date Initiated	Strategy	Position (s)	Investment Thesis
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 (10/13/14): Treasuries are once again at new highs for the year, as a floundering European economy and worries about a stock market correction trump better economics here in the US. The fundamentals for this trade remain decidedly negative, but once again money flows have trumped fundamentals in the near term.

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Asset Class Dashboard

(Updated 10.13.14)

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 had its worst week in years last week as concerns about global growth, disinflation and the end of QE pushed stocks below key support levels. The markets resiliency can't be discounted, but stocks are acting "different" than previous corrections, and we advise caution in shorter term, more tactical accounts.*
Best Idea: Buy Regional Banks (KRE). **Best Contrarian Idea:** Buy Consumers Stocks (XLY)			
Commodities	**Bearish**	**Bullish**	*Oil continued to drag commodities lower last week. Global growth concerns continued to weigh on the space, although with the dollar declining we are seeing some dichotomy: grains and gold are trading better, but energy remains a major concern.*
Best Idea: Buy Natural Gas (UNG) **Best Contrarian Idea:** Buy Grains (DBA)			
U.S. Dollar	**Bullish**	**Bullish**	*The Dollar Index traded lower for the first time in 13 weeks, as a dovish FOMC minutes broke the dollar rally fever. The dollar needs to correct, and although it'll be supported somewhat if the stock sell off continues, I'd expect a further pullback (which is needed to restore some health to this market).*
Best Idea: Sell the Yen (YCS) **Best Contrarian Idea:** Long Canadian Dollar (FXC)			
Treasuries	**Neutral**	**Bearish**	*The Treasury rally accelerated last week and the 30 year traded to a new 52 week high, as worries about global growth (especially in Europe) sent money pouring into Treasuries, as money flows again trump deteriorating economic fundamentals.*
Best Idea: Short "long" bonds (TBT) **Best Contrarian Idea:** Short High Yield Bonds (SJB)			

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