7:00's Report

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

October 15th, 2014

Oil collapsed again yesterday in afternoon trading and the selling continues this morning, as a price war within OPEC is exacerbating the effect of slowing demand.

Pre 7:00 Look

- Futures are lower this morning after giving up early gains following a mixed night of gains in Asia and more weakness in Europe.
- Chinese CPI was lower than expected (1.6% yoy vs. (E) 1.7%), and that's adding to global disinflation concerns. In Europe data was in-line but shares are lower on general sentiment.
- Focus remains on earnings as afterhours INTC and CSX beat while LLTC missed. On balance results yesterday are helping markets.
- Econ Today: PPI (E: 0.1%), Retail Sales (E: -0.1%), Empire State Manufacturing Survey (E: 20.50), Beige Book: 2 PM. Earnings: PNC (E: 1.71), BAC (E: -0.09), AXP (E: 1.38), EBay (E: 0.67), NFLX (E: 0.91),.

Market	Level	Change	% Change
S&P 500 Futures	1869.70	-4.75	-0.25%
U.S. Dollar (DXY)	80.06	.12	0.14%
Gold	1224.40	-9.90	-0.80%
WTI	80.70	-1.14	-1.39%
10 Year	2.206	-.080	-3.50%

Equities

Market Recap

Stocks rebounded Tuesday although they finished well off their best levels of the day as decent earnings and some short-covering pushed prices higher. The S&P 500 rose +0.16%.

Stocks were higher from the outset yesterday as markets ignored (or at least became temporarily immune to) more bad European economic data. The S&P 500 opened moderately higher and began to rally mostly on short-covering and some dip-buying.

News-wise, focus was on earnings early Tuesday, and generally they were "ok." Of the big banks, C was the standout (up +3.15%) while JPM slightly missed (stock was flat on the day) and WFC reported in line but still got hit (down -2.7%). Importantly, though, their commentary on the mortgage market was decent. (WFC, because of its massive mortgage book, has its finger on the pulse of the housing market and the comments were fine. Not great, but fine.) Disconcertingly, though, JNJ beat and raised guidance but the stock got punished and closed down just over -2%.

Again, bottom line yesterday with earnings was they were mildly supportive in that they temporarily broke the negative news feedback loop. But it's obviously very, very early to draw any conclusions.

Stocks continued to rise throughout the morning session as a mild short-squeeze ensured, helped by comments by San Francisco Fed President John Williams. He said that, while a lot would have to change, he could see re-starting QE (!) again if the global downturn weighed on the U.S. economy.

Market	Level	Change	% Change
Dow	16315.19	-5.88	-0.04%
TSX	14036.88	-190.68	-1.34%
Brazil	58015.46	58.93	0.10%
FTSE	6333.24	-59.44	-0.93%
Nikkei	15073.52	137.01	0.92%
Hang Seng	23140.05	92.08	0.40%
ASX	5245.61	38.18	0.73%

Prices taken at previous day market close.

The dovish comments sent shares higher still and, at the peak yesterday, the S&P 500 nearly broke back through 1,900. News quieted during the afternoon session, and stocks drifted until just before 2:30. That's when oil went into absolute freefall into its close, and dragged down most risk assets with it. There wasn't any specific catalyst for the decline, although we cover oil more later in the Report.

Market	Level	Change	% Change
DBC	22.27	-.32	-1.42%
Gold	1234.00	4.00	0.33%
Silver	17.405	.06	0.35%
Copper	3.0795	.039	1.28%
WTI	81.92	-3.82	-4.46%
Brent	85.50	-3.91	-4.37%
Nat Gas	3.827	-.089	-2.27%
RBOB	2.18	-.0753	-3.34%
DBA (Grains)	26.72	.28	1.06%
Prices taken at previous day market close.			

It looked like it was going to get ugly again there for a second as the S&P 500 turned negative entering the final hour of trading, but stocks steadied and we saw a mild bounce into the close. Give the past week in this market, yesterday must be considered a (small) victory for the bulls.

Trading Color

Market internals were positive yesterday, as cyclicals and growth sectors rebounded, although a lot of that was on short-covering and dip-buying by day-trading types. The Russell outperformed, up +1.1%, while semiconductors also bounced back (this important leadership group has been crippled since the MCHP profit warning). LLTC earnings yesterday appeared underwhelming and the stock was lower after hours, so it'll be interesting to see how the SOX can hold up today (a further rebound would be a good thing).

Industrials, basic materials and consumer discretionary also traded better yesterday (again "growth" sectors outperformed). But there was absolutely no rotation out of safety sectors to complement the growth outperformance, and disconcertingly, utilities were one of the best-performing S&P 500 sub-sectors.

Bottom line with internals and sector trading yesterday was growth rebounded and there were some signs of life, but nothing that would make you feel we're seeing the formation of a bottom, yet.

On the charts the S&P 500 failed to hold 1,900, and the 200-day moving average (1,906-ish) remains resistance. Yesterday's intraday lows of 1,871 are support, but most people are viewing 1,850 as the next major level.

Bottom Line

I think most of Wall Street's eyes got really big when the S&P 500 turned negative yesterday around 3 o'clock, fearing a fourth-straight washout into the close, and a very large collective sigh of relief was heard when the S&P 500 finished in the green.

Helping things is the fact that the market is very short-term oversold, but the best thing for this market right now with regards to forming a trade-able bottom would be to "chop" sideways for a few days. (A sharp reflex rally here wouldn't be positive, because it'd just set up another beat-down – we need to build a bit of a base to put in a sustainable bottom.)

Bottom line is this market remains all about Europe and oil, so EWG (German ETF) and oil need to stabilize if this market is to bottom. Clearly, oil did not yesterday (more on that later). EWG acted better and Europe acted "ok" for the first time in over a week. Sentiment remains horrible in Europe and they are also short-term oversold, but we need to see some sort of progress (economic or political) before we can sound an all-clear in that region.

Yesterday was "one of the good guys," as an old-timer on the NYSE floor used to say. But fundamentally this remains a challenged market, and even with an oversold bounce, I don't think we're out of the woods yet.

What Is Happening With Oil?

Oil collapsed further yesterday, dropping all the way to the low-$81 level. We and others have been pointing to the decline in oil as a potentially worrisome sign about the state of global growth, but you don't have to work on a physical oil desk to figure out that, with oil falling through the floor, something else is going on here.

Both supply and demand influences are pushing oil prices lower.

On the demand side, foreign oil demand is falling. Yesterday, the International Energy Administration (IEA) significantly reduced expected oil demand growth for

2014—down to 700K barrels per day, from the previous 900K boe/d. Although they kept 2015 demand growth estimates unchanged, it's still a large reduction.

The main reason behind that demand-growth reduction is a drop in economic activity in Asia (mostly China) and Europe. Both economies are losing positive momentum (one slowly, one quickly), but these aren't exactly new facts, and this demand reduction by itself isn't responsible for the sharp drop in WTI crude prices.

There is also a significant supply aspect to this drop, but likely not the one you think. Simply put, OPEC is starting to fracture, and it is sending Brent crude, which is what's traded globally, falling sharply. Last month, despite falling prices, OPEC increased production to a 13-month high, led by Saudi Arabia. In addition, Saudi Arabia is now cutting prices to multi-year lows for Asian and European buyers to maintain market share. And, it's sparked a bit of a price war. Over the last week, Saudi Arabia, Iraq and Iran have all cut prices to buyers to try and compete on market share, and that is driving the price of Brent crude sharply lower (from $113 to $84.50 over the last 3 ½ months, or a -25% drop).

So, this recent plunge in oil prices has largely been a Brent crude-led phenomenon.

That's important, because our firm and others are trying to figure out if the plunge in WTI crude prices (which is produced here in the U.S.) is reflecting a slowing of our economy, and basically the answer is "no." WTI has fallen *in sympathy with* Brent crude, not because U.S. demand for oil is falling. U.S. demand isn't falling – it's still sitting basically near all-time highs.

Now, the direction of oil prices is very important to the stock market on a sentiment basis, so I'm not saying we can discount this plunge. And, I do not believe stocks will bottom until oil can stabilize.

But – in addressing the important fundamental question of whether or not the plunge in oil is a warning sign on the U.S. economy, the answer is "no." It's more a sign of dysfunction at OPEC, which could be a virtuous thing down the road.

Finally, the logical question then is, "Are oil stocks a buy here?" No, I don't think yet, as the chances of a further decline in oil prices are high. But, certain sectors of that market (low-cost, lower-leveraged domestic oil and natural gas producers, and select oil service stocks) will be fantastic buys. But we've got to be patient and let this OPEC spat settle itself out – because if they want to drive oil lower, they will continue to succeed.

Economics

No important reports yesterday.

Commodities

Commodities were mixed yesterday as energy got obliterated again, closing at multi-year lows, while the metals and grains traded higher. DBC was weighed down by the relentless selling pressure in the energy markets to close down by -1.42% on the day

We covered most of the "need to know" about the energy markets earlier, but here are a few of the specifics and technical notes regarding the crude oil market.

WTI crude oil fell -4.4% yesterday to close down at the lowest level since June 2012. WTI futures crashed through the only hopeful support level that was on the chart at $84/bbl. Moving forward, both Brent and WTI futures remain in very sharp downtrends and are now in oversold territory, according to several technical indicators (including the popular Relative Strength Index). We are now looking for support at the psychological $80 level; however this sell-off has a lot of momentum behind it, so the path of least resistance remains lower.

Natural gas also traded lower yesterday with futures declining -2.27%. However, unlike crude oil (which is making new multi-year lows), natural gas remains largely range-bound between $3.80 and $4.10. But, futures have been favoring the lower end of that range and support has been getting repeatedly test-

Market	Level	Change	% Change
Dollar Index	85.915	.188	0.22%
EUR/USD	1.2652	-.01	-0.78%
GBP/USD	1.5905	-.0178	-1.11%
USD/JPY	106.92	.09	0.08%
USD/CAD	1.1302	.0106	0.95%
AUD/USD	.8702	-.0066	-0.75%
USD/BRL	2.4015	.0075	0.31%
10 Year Yield	2.206	-.080	-3.50%
30 Year Yield	2.957	-.057	-1.89%

Prices taken at previous day market close.

ed. Nat gas traders will remain focused on the weekly EIA supply data (released on Thursdays at 10:30 AM), as well as new weather forecasts and revisions to previous longer-term forecasts. And, you know the drill—any significant changes in forecast for the colder (which would increase demand speculation) or warmer/milder (which would lower demand speculation) will have the potential to materially move them market.

Moving to the metals, gold held onto morning gains yesterday despite the dollar rallying back to positive territory over the course of the day. Gold finished up +0.26%. The reversal in the stock market off the session highs midday was largely the reason for the sustained gains in gold as investors continued to look to gold as a "fear hedge." Near term, $1,240 remains resistance. However, on the low time frame charts, an uptrend is forming that could potentially push prices through that level—which could in turn spark a short-covering rally back toward the upper-$1,200s.

Copper was among the best performers yesterday, gaining +1.28% to close at the highest level in nearly a month. Copper began to trade higher overnight on news that China's central bank cut short-term borrowing costs for banks, which eased some concerns surrounding recent economic weakness in the world's largest consumer of the industrial metal. That, in turn, caused some speculative short-covering as well. On the charts, copper futures stopped just shy of the 50-day moving average at $3.10, which we will consider initial resistance. Longer term however, copper futures remain in a steady downtrend, and until we see global economic data turn around for the better, that trend will likely continue.

Currencies & Bonds

The Dollar Index bounced back yesterday mostly thanks to a big drop in the pound (there wasn't anything materially dollar-bullish yesterday), as the DXY rallied +0.2% and continued to hold support at the 20-day moving average (85.50).

The big mover yesterday was the pound, which collapsed -0.96% following much lower than expected CPI and PPI reports, which only added to the "Deflation" phobia streaking across Europe.

September core CPI rose just +1.5% year-over-year, down from a 1.9% reading in August, which simply spooked markets. With that type of a drop in core inflation, the market's expectation of a Q1 2015 rate hike by the BOE will be called into question (if the data are validated in October).

Astonishingly, the pound is now lower than it was during the "Scottish Independence" spike low, and if it trades through 1.5850 (currently 158.96) then there's little resistance until the low 1.57 level. So, despite an almost universal expectation that the BOE will be the first major central bank to raise rates next year, the pound is under severe pressure vs. the dollar, and that trend likely will continue for the near future. At some point, assuming we don't go into global deflation, the pound is a buy, but patience is needed now.

Elsewhere in the currency markets the "commodity" currencies, the Aussie and Loonie, were also down sharply vs. the dollar, although that was more oil-related than anything else (the commodity currencies will trade with oil and commodities in the short term). The Loonie in particular got hit very hard, down -0.8%, again on concerns about oil.

Given what OPEC is doing to prices, Canada is seen as the biggest loser, because its crude is some of the most expensive to extract. So, as prices fall, it will see production curtailed, which is not a good thing for the Canadian economy. The Loonie traded to a new 5-year low vs. the dollar, and a move into the mid to low $0.80s is likely.

Turning to bonds, they predictably soared higher, as they seemingly do every day. Simply put, the global bond market is sending a very, very worrisome signal to markets. The world bond markets are screaming "global deflation" at the moment, and it is my hope/belief that these are simply knee-jerk overreactions due to an apex of European worries and a volatile stock market. But, if yields go much lower than current levels, I believe that will be a very, very bad signal for the stock market. This is not a "virtuous" QE-inspired bond yield decline—this is a economic slowdown-/deflation-led yield decline. If bond yields keep falling, then we are just at the beginning of the market correction.

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	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.*
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, dis-inflation and the end of QE pushed stocks below key support levels. The markets re-siliency 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 dichoto-my: 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 believe we're seeing the start of a needed correction in the US Dollar.*
Best Idea: Sell the Yen (YCS) **Best Contrarian Idea:** Long Canadian Dollar (FXC)			
Treasuries	**Neutral**	**Bearish**	*The Treasury bounce 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)			