7:00's Report

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

October 2nd, 2014

S&P 500: The index traded materially through the 100 day moving average for the 5th time in a year. Now, it needs to trade back above it in the next 2-3 days, otherwise this will be something different than previous dips.

Pre 7:00 Look

- Futures are flat ahead of the ECB meeting after Asian shares fell sharply in sympathy with the US declines, and Europe is trading slightly lower (again ahead of the ECB).
- Japan was the global laggard, as the Dollar/Yen fell to the mid 108 level and the Nikkei dropped 2.6% on a "risk off" move. There was no new news from Japan o/n.
- Economically, EMU PPI missed expectations (down 1.4% vs. (E) 1.2% yoy), adding even more pressure to the ECB.
- Econ Today: ECB Decision (7:45 AM), Draghi Press Conference (8:30 AM). Weekly Jobless Claims (E: 297K). Fed Speak: Dudley (12:00 PM), Lockhart (1:00 PM), Bullard (8:00 PM)

Market	Level	Change	% Change
S&P 500 Futures	1940.00	-0.75	-.04%
U.S. Dollar (DXY)	85.81	-.266	-.31%
Gold	1214.50	-1.00	-0.08%
WTI	88.72	-2.01	-2.22%
10 Year	2.403	-.105	-4.19%

Equities

Market Recap

The S&P 500 suffered its second 20+ point decline in as many weeks yesterday as general global economic growth concerns continued to mount. The S&P 500 declined -1.32%.

Stocks actually opened flat Wednesday as U.S. markets largely ignored the soft German PMIs after ADP came in a touch better than expected. But, a very familiar pattern emerged after the open as the SPX saw heavy selling from the moment the bell rang, and the shorts were quick enough to get the market through 1,963 (Monday's low) and initially through 1,958 (the 100-day moving average).

Buyers stepped in at the 100-day moving average and the market managed to bounce a bit heading into the European close (Europe outperformed relatively yesterday).

But, there wasn't any real follow-through to the bounce and by 11:30 AM, the 100-day MA (1,958) has been decisively broken. Markets traded methodically lower for the next three hours, dropping to a low of 1,941 before bouncing a bit on short-covering into the close.

Trading Color

It was a pretty widespread sell-off yesterday, as all the major indices declined between -1.3% and -1.6% (the Nasdaq and Russell 2000 lagged but not majorly).

While most of the indices traded in line with one another, cyclical sectors badly underperformed. SPHB dropped -2.15% while SPLV was down just -0.71%, and basic ma-

Market	Level	Change	% Change
Dow	16,804.71	-238.19	-1.40%
TSX	14,805.44	-155.07	-1.04%
Brazil	52,585.43	-1257.55	-2.32%
FTSE	6,534.88	-22.64	-0.35%
Nikkei	15,661.99	-420.26	-2.61%
Hang Seng	22,932.98	-296.23	-1.28%
ASX	5,297.71	-36.43	-0.68%
Prices taken at previous day market close.			

terials, energy, tech, industrials and consumer discretionary all underperformed. Utilities were the only S&P 500 sub-sector to trade in positive territory yesterday, as XLU rallied +0.57% on purely a risk-off/lower interest rate move.

Market	Level	Change	% Change
DBC	23.14	-.07	-0.30%
Gold	1214.70	-.80	-0.07%
Silver	17.14	-.119	-0.69%
Copper	3.018	-.018	-0.59%
WTI	88.80	-1.93	-2.13%
Brent	92.18	-1.98	-2.10%
Nat Gas	4.051	.028	0.70%
RBOB	2.4050	-.0447	-1.82%
DBA (Grains)	25.63	-0.11	-.043%
Prices taken at previous day market close.			

Looking at some specific trading, the airlines stocks got killed yesterday on Ebola fears, and most major airline stocks were down around -3%. (If they fall further, they are probably a buy because the knee-jerk Ebola fears are likely overdone.)

Banks also relatively outperformed, which is surprising given the size of the declines in the broader market and in interest rates. KBE was down -1.1% (outperforming the SPX) and KRE dropped -1.19% (also mildly outperforming the SPX). The banks have gotten beat up as rates have fallen over the past two weeks, but the fundamental story remains attractive. Getting long the banks with a SPY hedge remains an attractive trade, in my opinion.

Reasons For the Sell-Off & What Makes It Stop

News-wise, there wasn't any single catalyst for the decline (and there hasn't been for this entire pullback). Yesterday the usual suspects of "Chinese growth," "Unwilling ECB" and "Hawkish Fed" were all cited, although there were some new additions I heard kicked around, including "Ebola," "Strong U.S. Dollar" and "Disinflation in the U.S."

In truth, all those are potential negatives, but with the exception of Ebola, none of them were any worse yesterday than they were at the beginning of the week. (German PMIs were a disappointment, but everyone already knows the EU economy is teetering, and really there it's all about what the ECB is willing to do.)

Bottom line is this market is still much more dominated by traders and fast money than any shifting fundamentals, which still remain broadly positive.

On the charts, the S&P 500 smashed through its 100-day moving average, and while disconcerting, that by itself is not a definitive "sell signal," yet.

We have been keying on JNK and the 100-day moving average to give us a clear "de-risk" signal, and despite the S&P's collapse through the 100-day yesterday, we still don't have it.

First, JNK actually rallied yesterday and we're seeing some firming in that ETF (it remains above the spike lows from earlier this week, and keep in mind it's been a leading indicator for stocks).

Second, we need a "definitive" break of the 100-day MA, and we don't have it yet—at least not according to the last year. The S&P 500 has violated the 100-day MA four times over the past year, but it's never closed below it more than four times. So, if the SPX firms up here and can hold this break, it's not a sell signal at this point.

Now, for that to happen, I think we need to see:

1) Draghi be "dovish," specific and forceful about the ABS program in his press conference this morning (see my "ECB Preview" in yesterday's Report for what the market is specifically looking for).
2) The jobs number needs to print in the "just right" range between 175K—250K and wages need to increase over 2% year-over-year (to help invalidate inflation fears).
3) Finally, Asian stocks need to rebound when they reopen and general political unrest needs to subside.

For the last year, buying a break of the 100-day has been the right thing to do, and while the backdrop is marginally more negative this time, that strategy continues to deserve the benefit of the doubt—for now.

Economics

Global September Manufacturing PMIs

- U.S. ISM PMI was 56.6 vs. (E) 58.0.
- China Manufacturing PMI 51.1 vs. (E) 51.3.
- German Manufacturing PMI 49.9 vs. (E) 50.3.
- EMU Manufacturing PMI 50.3 vs. (E) 50.5.

Takeaway

Yesterday wasn't a particularly good day for global growth as universally the final September manufacturing PMIs were a disappointment, the biggest of which was the German number.

The headline German PMI dropped below 50 for the first time in years, while the broader EMU PMI is now just above 50. So, obviously concerns about the EU economy will grow—and there is now more pressure on the ECB to be "dovish" at today's meeting.

But, today's meeting aside, clearly the EU economy needs help, and if it does not get it soon, then a triple-dip recession will clearly be on the table.

The Chinese number was more or less in-line with expectations, and importantly did stay above the 50 level. But on an absolute level, it wasn't particularly strong. As a result, it did not at all alleviate general concern about the pace of growth for the Chinese economy.

Finally, turning to the U.S., the PMI was a disappointment vs. the expectation. But, in contrast to China, on an absolute basis the number remains strong and manufacturing continued to expand at a solid pace in September. Bottom line: Manufacturing remains strong, and while we will likely see a bit of a further decline as the stronger dollar takes a bite out of exports, the manufacturing sector remains solid.

The outlook for global growth got very slightly worse yesterday, and the German PMI is concerning, because pressure is mounting for the ECB to do "more" now. The global recovery is technically still ongoing, but we're losing steam.

<u>ADP Employment Report</u>

- September Private Payrolls increased by 213K vs. (E) 200K.

<u>Takeaway</u>

Yesterday's ADP employment report came in slightly better than expected at 213K vs. (E) 200K, while the August report was revised down very slightly to 202K from 204K. It's another strong report that shows solid private payroll growth, but it's not materially changing the expectations for Friday's official jobs report. The market largely shrugged at the release (E: 215K).

Market	Level	Change	% Change
Dollar Index	85.89	-.186	-0.22%
EUR/USD	1.2631	.0006	0.05%
GBP/USD	1.6143	-.0041	-0.38%
USD/JPY	108.61	-0.26	-0.24%
USD/CAD	1.1121	-.0041	-0.37%
AUD/USD	.8773	.0036	0.41%
USD/BRL	2.485	.0045	0.18%
10 Year Yield	2.403	-.105	-4.19%
30 Year Yield	3.113	-.099	-3.08%
Prices taken at previous day market close.			

Commodities

Commodities were mixed yesterday as the energy sector failed to hold morning gains while the metals held respective support levels. The commodity ETF, DBC, finished the day down .34%.

Crude oil was up about 2% yesterday morning thanks to a bullish EIA report that stated crude oil stocks bell 1.4M barrels vs. (E) +900K. Additionally, there was a 1.8M barrel draw in gasoline vs. (E) -800 barrel draw and a 2.9M barrel draw in distillate fuels vs (E) -200K, both of which helped support prices.

But, morning gains were reversed in the early afternoon partially weighed down by a "risk off" move in other asset classes, but also because of news of a Saudi "price cut." The price cut basically means that the Saudis are more concerned with keeping their market share than they are with keeping global prices elevated and suggests that they will not reduce production levels.

On the charts, the trend is clearly still lower, and futures have broken down sharply this morning to fresh 17 month lows, trading well below former support between $90 and $91. Looking ahead, ample global supply and elevated production levels paired with easing economic growth metrics worldwide will continue to weigh on the energy space.

Natural gas prices fell back towards the $4 mark yesterday amid analyst estimates that are calling for a larger than initially expected build to be reported by the EIA today. Official estimates are for a +106 Bcf injection to supplies. But, even if the report is in line with estimates, supply levels will remain over 12% below the average for this time of year, and we are quickly approaching the official start to the draw season which comes later this month. So, the fundamentals continue to favor the bears for now and that will continue unless we see a large jump in supply injections over the coming weeks.

The technical story has shifted however. Yesterday, there was a bearish outside reversal on the daily chart as futures failed to break through the 100 day moving average for the third day in a row. And although you always need to "respect the reversal," we believe further weakness will provide a good buying opportunity. Support at $4.00 will continue to be in focus in the immediate term.

Moving to the metals, both the precious and industrial types "bounced" off psychological technical support yesterday with gold holding $1200 and copper holding $3.00. But, the other market influences were quite different.

Gold futures moved higher as part of the general "fear trade" that was apparent across asset classes with stocks plummeting and bonds surging. The bounce however was unimpressive on the charts, and the near term trend continues to favor the bears, but things do get interesting here at the $1200 level as support has held multiple times since gold has fallen back from the frothy 2011 highs. If $1200 is violated we will almost certainly see the multi-year lows of $1180 tested, but a move through $1200 would require a serious move higher in stocks, an incrementally more hawkish fed, and an even stronger dollar.

30 Year Treasury: If the 30 year continues higher, the August/Sept. decline will have been the biggest head fake I've ever seen.

Currencies & Bonds

Bonds exploded yesterday thanks to a combination of start-of-quarter allocations, weak European data (making Treasuries more attractive), a significant violation of the two-month downtrend that caused massive covering, and soft economic data. And, the very painful rally grinded higher throughout the day, with the 30-year closing on the highs of the day.

And, it took my TBT trading position, which had been doing well, and knocked me squarely in the teeth with it. Today, I will wait for Mr. Draghi and then make an assessment on the trade—but if he is not convincingly "dovish," then I fully expect bonds to head higher—perhaps tracing out what will be the greatest head-fakes I have ever seen throughout my career. And, I'll take my lumps in my trading positions and close TBT, while keeping longer-term short-bond holdings, as the fundamentals on the "short bond" trade remain solid. But, clearly the European bond market is once again pouring into Treasuries, as money flows again trump fundamentals.

If TBT trades below the yearly low of 53.91 for more than an hour or so, I'll exit my TBT trading stock.

Looking at the currency markets, in what is a now familiar pattern, the Dollar Index basically hit new intraday highs early Wednesday morning before selling off throughout the day to end the session off the best levels of the day. Yesterday, it was the "miss" from the ISM manufacturing PMIs that brought the dollar in, and it closed the day almost perfectly unchanged ahead of the ECB and jobs report.

The euro did the opposite: It was under significant pressure early, and it basically matched the multi-year lows of Wednesday following the disappointing German PMIs. But then it began a rally in part because the dollar sold off and also following a Bloomberg article that implied, citing two anonymous ECB officials, that the details on the ECB ABS purchases would be underwhelming. (That is "hawkish" and positive for the euro, because it implies deflation.)

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."

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 (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).			
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)			
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)			
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)			