# 7:00's Report

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

**October 20th, 2014**

## Pre 7:00 Look

- Futures are marginally lower following a quiet weekend and uneventful night. The weekend was calm from a macro standpoint, and with key economic releases looming Wednesday/Thursday, focus early in the week will be on earnings.
- Japan was the big outperformer o/n, surging nearly 4% on the Friday's strong US market and on news PM Abe may delay a planned tax increase next spring.
- Econ Today: No reports today. Fedspeak: Powell (10:00 AM), Tarullo (12:00 PM).
- Earnings Today: HAL ($1.10), VFC (E: 1.09), AAPL (E: 1.30), TXN (E: 0.71).

| Market | Level | Change | % Change |
|---|---|---|---|
| S&P 500 Futures | 1881.00 | 0.25 | 0.01% |
| U.S. Dollar (DXY) | 85.225 | 0.12 | 0.01% |
| Gold | 1242.50 | 3.50 | 0.28% |
| WTI | 82.01 | -.05 | -1.33% |
| 10 Year | 2.199 | .046 | 2.14% |

## Equities

*Market Recap*

Stocks were lower again last week on general European growth and political concerns. But thanks to decent economic data in the U.S. .and some dovish "Fedspeak," stocks closed well off their worst levels. The S&P 500 declined -1% last week and is up +2.08% year-to-date.

Last week was volatile from start to finish. Reflecting just how jittery this market was, Monday saw stocks drop the most of any day last week, thanks to a late-day dive following an erroneous headline about Ebola on a plane at Logan Airport. Tuesday stocks steadied thanks to "not as bad as feared" earnings from large banks and consumer companies (C, WFC, JNJ) and some dovish comments by San Francisco President John Williams, who implied failing international growth could delay rate hikes here.

But, that was the calm before the storm, as stocks plunged Wednesday morning following news of a second Ebola case and universally bad U.S. economic data, which raised concerns about the pace of growth domestically. Early in trading Wednesday, the Dow Industrials were down more than 400 points while the S&P 500 hit a low of 1,820. But, looking past the carnage, there were signs that the selling was (short term) at an apex as small caps and energy outperformed.

Thursday saw more consolidation, although importantly stocks were able to rebound from another round of heavy early morning selling, as a spike in Greek bond yields had investors nervous about European sovereign debt, again. Despite the S&P 500 being down another 20 points early in the day, the index managed to recover thanks to more "dovish" comments by Fed President Bullard, who suggested the Fed "taper" the tapering of QE at the meeting in 10 days.

The stabilization Wednesday afternoon and Thursday led to a big short-covering rally Friday, with most major indices rising between +1.2% and +1.7%, although of note the Russell 2000 closed down .3% Friday, sending a potential non-confirmation signal. As far as catalysts for the Friday move, there weren't any, really, other than typical short-covering.

*Trading Color*

The most interesting observation from last week was that the most beat-up indices and sectors handily out-

| Market | Level | Change | % Change |
|---|---|---|---|
| Dow | 16,380.41 | 263.17 | 1.63% |
| TSX | 14,227.68 | 174.71 | 1.24% |
| Brazil | 55,723.79 | 1,425.46 | 2.63% |
| FTSE | 6,251.69 | -58.60 | -0.93% |
| Nikkei | 15,111.23 | 578.72 | 3.98% |
| Hang Seng | 23,070.26 | 47.05 | 0.20% |
| ASX | 5,319.44 | 47.72 | 0.91% |
| Prices taken at previous day market close. | | | |

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performed thanks to huge Thursday/Friday rallies, despite the overall market weakness.

The Russell 2000 finished the week *up* +2.7%, compared to the -1% drop in the S&P 500, as did many beat-up "growth"-oriented sectors: Semiconductors rallied 2.7%, Industrials were up 2%, Transports (despite the Ebola dears) rallied over 2%, and Energy (XLE) finished flat despite basically "crashing" early last week.

| Market | Level | Change | % Change |
|---|---|---|---|
| DBC | 22.27 | .08 | 0.36% |
| Gold | 1238.30 | -2.90 | -0.23% |
| Silver | 17.27 | -.167 | -0.96% |
| Copper | 3.0035 | .022 | 0.74% |
| WTI | 83.10 | .40 | 0.48% |
| Brent | 86.29 | .47 | 0.55% |
| Nat Gas | 3.773 | -.023 | -0.61% |
| RBOB | 2.2381 | .0272 | 1.23% |
| DBA (Grains) | 26.14 | -.26 | -0.98% |
| Prices taken at previous day market close. | | | |

Conversely, defensive sectors such as utilities and consumer staples lagged, with both XLU and XLP finishing the week flattish.

Earnings season picked up last week, although the results were largely overshadowed by macro volatility. We got a lot of bank reports, and they were generally "ok." But, the collapse in interest rates weighed on the space, and KRE and KBE were both flattish on the week, underperforming other cyclicals.

At this point, earnings season has taken a backseat to macro news, as no real trends have emerged in the results that give the market any great added insight on the state of the U.S. or global economy. That may change this week, but so far earnings are on the back burner.

Finally, on the charts, the S&P 500 obviously exhibited substantial volatility last week, as the peak-to-trough move was 1,898-1,820, or just under 4%. Going forward, last week's lows (1,820) are new critical support, while the first level of major resistance is the 200-day MA (1,906).

*Bottom Line*

As I said last week, it seems like in the short term, the selling has reached a crescendo. I expect the 1,820 lows to hold for some time, but I still do not think we should expect a typical "bounce back" rally to new highs like we've seen several times over the past two years.

Fundamentally, despite last week's volatility, not a lot changed, and there are still two main concerns driving this market: 1. Is global growth slowing materially (led by Europe)? 2. Are we seeing global dis-inflation/deflation?

Those two concerns are at the heart of this correction. Although stocks almost certainly overreacted to the downside (last week the S&P 500 at one point was off -10% from the recent all time highs), those two questions remain largely unanswered.

And, although I hope I am wrong, the big rally and outperformance of cyclicals late last week looks to me like a textbook short-covering rally in an otherwise-downtrending market. As such, I remain extremely cautious on stocks at these levels and would not be buying here for anything other than a very, very, very short term trade.

We will continue to watch EWG (German ETF) and oil, which both bounced late last week. If they can stabilize further this week, combined with the S&P 500 getting back above the 200-day moving average, that may be something positive to consider. But, until that happens, I remain cautious and would not be allocating to equity markets at this point.

Finally, with regard to Greek politics (it weighed on stocks Thursday morning). that situation bears watching. But it's just another symptom of the real disease: no European economic growth. If Europe can jumpstart growth, then Greece will calm down again—as the economy will get better and the anti-European, nationalistic candidates won't have misery and frustration to leverage. Point being, this is still all about Europe, and growth cures all.

## Economics

Last Week

We got a lot of data and central bank speak last week, but not a lot changed from a macro standpoint—except we were reminded that the U.S. economic rebound remains very much intact, despite mixed data. And, that was an incremental positive late in the week.

Despite that strong finish, things were ugly to start last

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week. Retail sales slightly missed expectations, falling -0.3% vs. (E) -0.1%. The “control” group, which is retail sales less autos, gasoline and building materials, met expectations, declining -0.2%. But the previous month was revised lower, from a +0.4% gain to just a +0.2% gain.

Also early last week Empire State manufacturing, which is the first data point from October, plunged, dropping 6.17 vs. (E) 20.50. New orders, the leading indicator in the report, went negative for the first time in months.

And, despite retail sales being just a small miss and Empire State being historically volatile and not very correlated to national manufacturing activity—in a market that was nervous about growth everywhere—these disappointing reports definitely contributed to the stock market declines, as people (inappropriately) began to get nervous about U.S. growth.

But, the data late in the week helped calm some nerves. Industrial production beat expectations (up +1% vs. (E) +0.4%), the manufacturing subcomponent (which is the important part of the release) was a slight beat, and Philly Fed stayed strong (20.7 vs. (E) 20.0) and importantly contradicted and potentially invalidated the bad Empire State report. Finally, weekly jobless claims plunged to a 14-year low, which helped sentiment.

Again, bottom line was the data were mixed and the negative market reaction to the early-week “misses” was more a reflection of overall nervousness—not that the data were that “bad.“

Looking at the Fed, there was a lot made about “dovish” comments by Bullard and Williams (especially the Bullard comments).

But, neither one reflects the “core” of the FOMC. Although Fed Funds futures continue to push out the expected date of the first rate hike (now December 2015), the Fed will almost certainly end QE at the meeting next week.

*This Week*

This week is all about the October global flash PMIs, plain and simple. Chinese numbers come Wednesday night, while European and U.S. numbers come Thursday morning. Given that worry about global growth is the main negative influence on markets right now, these numbers are the next major catalysts for markets.

In China, the main focus is whether the flash PMIs can hold 50 (if they can, it’ll be a mild positive). In Europe, it’s the same question (can they hold 50?). Sentiment is so negative toward Europe right now, it’ll take a pretty bad number to make the outlook there materially worse. Finally in the U.S., the market will be looking for further evidence that, despite global issues and a stronger dollar, the manufacturing sector is continuing to expand at a decent pace.

After the flash PMIs, the next most important number to watch is the September CPI, out Wednesday. As you know, growth and dis-inflation are the two concerns in the market right now. Obviously the PMIs give us a glimpse into growth, and the CPI will give us a glimpse into the dis-inflation. A bounce back toward that 2.0% yoy increase in core CPI will be very welcomed by the market, if it occurs.

Third in importance this week are the Chinese economic data coming tonight: GDP, IP and Retail Sales. China’s been put slightly to the back burner with all this Europe worry, but growth there needs to maintain pace. If concern grows that China may not be able to maintain 7.0% annual GDP growth, this will be an added negative on the market.

| Market | Level | Change | % Change |
|---|---|---|---|
| Dollar Index | 85.30 | .259 | 0.30% |
| EUR/USD | 1.2761 | -.0046 | -0.36% |
| GBP/USD | 1.6088 | .0001 | 0.01% |
| USD/JPY | 106.86 | .54 | 0.51% |
| USD/CAD | 1.1274 | .002 | 0.18% |
| AUD/USD | .8761 | .0005 | 0.06% |
| USD/BRL | 2.4335 | -.038 | -1.54% |
| 10 Year Yield | 2.199 | .046 | 2.14% |
| 30 Year Yield | 2.968 | .032 | 1.09% |

Prices taken at previous day market close.

## Commodities

Commodities continued lower last week, led down by the energy sector again. Crude oil and the refined products all fell to fresh multi-year lows midweek; however, all closed well off their worst levels. Meanwhile the dollar falling for the second consecutive week, paired with stock market volatility, helped the precious metals rally. At the same time, copper was essentially flat as traders

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weighed global growth concerns against Chinese stimulus plans. The benchmark commodity tracking index ETF, DBC, dropped another -1.4% last week.

Despite the declines in the energy sector last week, the space actually traded somewhat better and finished the week well off the lows (something we did not see the previous two weeks). WTI crude oil fell futures fell -3.8%. Trading in the sector continues to be dominated by the gloomy global growth outlook and the ongoing "market share drama" within OPEC, both of which are bearish influences right now. Bottom line though, the sector is continuing to make new lows and the technical path of least resistance remains lower. So, buying into this market would still be an attempt to "catch a falling knife," and we are going to stay sidelined until a clearer opportunity presents itself.

Elsewhere in energy, natural gas futures fell -1.42% last week and the market is continuing to trade "heavy," below recent trend support. Natural gas is down about -3% since we first noticed and mentioned in the Report that futures were trading with a bearish tone. Traders are focused on the summer lows toward $3.70 and if those levels are violated, prices could make a quick run at old support near $3.50.

Precious metals failed to break out above important technical resistance levels last week ($1,240-$1,245 in gold and $18 in silver), but gold did rally +1.24% thanks to equity hedging and "fear bids." The weaker dollar certainly contributed to the gold rally as well. Looking ahead, gold traders are focused on stock market volatility and dollar strength, so the direction of gold prices will continue to be a function of those two variables. If everything "calms down" a bit, gold futures are likely to fall back toward the low-$1,200s while if volatility remains elevated and the dollar continues to fall, we would expect futures to rally toward initial resistance between $1,275 and $1,280.

## Currencies & Bonds

Last week was one for the history books in the bond market. As you all know, bonds surged last Wednesday, completing what I believe to be a "blow off" top Wednesday morning as the yield on the 10-year fell to a low of 1.86% and the 30-year bond surged more than 2.5% at one point, before both retraced some of those gains before the close.

The impetus behind the surge in bonds last week was familiar: European growth/sovereign debt concerns, a plunging stock market, concern about domestic growth, and dovish Fedspeak.

But, while all those are legitimate reasons, the real driver of higher bond prices in the U.S. remains Europe, as last week the yield on the 10-year German bund fell below 0.80% as deflation worries continued to surge. And, until we see signs of growth in Europe, Treasuries will have a hard time sustaining any material rally, although I think and hope that the highs of last week/lows in the yields won't be violated again, because if they are then stocks will go much, much lower. The bond market remains a big "caution" signal for risk assets.

In currencies the Dollar Index correction continued last week, as the Dollar Index fell -0.6% and broke below support at the 20-day moving average. The bulk of the declines came Wednesday, as the Dollar Index declined -1% following lackluster economic reports and dovish Fedspeak.

The euro was the best performer vs. the dollar last week, rising +1% on dollar-weakness-inspired short-covering, and buying on general deflation concerns. Although the longer-term trend for the dollar and euro remain higher and lower, respectively, I think this correction in the dollar/rally in the euro will continue in the short term.

Despite the weakness in the dollar, other currencies were mixed. The Aussie and yen were modestly higher vs. the dollar, while the Loonie and pound both declined modestly thanks to lackluster economic data.

Generally speaking, though, with the dollar correction ongoing, the headwind on most other currencies has been alleviated temporarily. I wouldn't be surprised to see broad strength against the dollar over the coming weeks, although that likely will present multiple shorting opportunities, as longer term the dollar is still very much in an uptrend.

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<br>EUFN<br>EWI<br>EWP | 59.35<br>24.67<br>16.44<br>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<br>XOP | 18.97<br>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).* | | | |
| **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 10.20.14)**

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 most volatile week in years last week thanks to more concern about global growth, dis-inflation and the end of QE. Despite hitting a low of 1820, though, there are signs a short term bottom is in at that level, although I remain broadly cautious on the market and expect a volatile chop sideways over the coming days.* |
| **Best Idea:** Buy Regional Banks (KRE). **Best Contrarian Idea:** Buy Energy (XLE) | | | |
| **Commodities** | **Bearish** | **Bullish** | *Commodities were lower but tried to stabilize last week as gold moved higher on a general "risk off" trade, while oil appears to have held support at $80.00 and is trying to put in a bottom. The dollar correction is also helping commodities and short term we could see a further bounce if global growth metrics improve this week.* |
| **Best Idea:** Buy Gold (GLD) **Best Contrarian Idea:** Buy Grains (DBA) | | | |
| **U.S. Dollar** | **Bullish** | **Bullish** | *The Dollar correction continued last week as dovish comments and lack luster economic data resulted in a big decline last Wednesday. Broadly fundamentals remain dollar positive, but it remains short term overbought and more of a correction/digestion is needed, although the trend remains higher.* |
| **Best Idea:** Sell the Yen (YCS) **Best Contrarian Idea:** Long British Pound (FXB) | | | |
| **Treasuries** | **Neutral** | **Bearish** | *Treasuries traded with historic volatility last week as a lower stock market and European angst saw Treasuries put in a "blow off' top Wednesday morning. Europe remains the key to the Treasury rally, and despite the end of QE being less than two weeks away, as long as European growth disappoints, there will be support for Treasuries.* |
| **Best Idea:** Short "long" bonds (TBT) **Best Contrarian Idea:** Short High Yield Bonds (SJB) | | | |

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