7:00's Report

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

October 21th, 2014

A Good Sign: Junk bonds (JNK) have surged higher since late last week, and yesterday traded through a steep downtrend. It's not a definitive sign this correction is over, but it is encouraging.

Pre 7:00 Look

- Futures are sharply higher this morning following better than expected Chinese economic data and good earnings.
- Chinese GDP (7.3% vs. (E) 7.2%) and Industrial Production (E: 8.0% vs. (E) 7.5%) beat expectations and retail sales were inline, somewhat alleviating global growth concerns.
- Earnings were good after the bell, as AAPL and TXN beat estimates, helping broad sentiment but especially in tech.
- Econ Today: Existing Home Sales (E: 5.10M saar).
- Earnings Today: KO (E: 0.52), MCD (E: 1.37), VZ (E: 0.92), VMW (E: 0.83), YHOO (E: 0.31).

Market	Level	Change	% Change
S&P 500 Futures	1913.50	13.50	0.72%
U.S. Dollar (DXY)	82.245	.207	0.24%
Gold	1248.70	4.00	0.32%
WTI	82.32	0.41	0.50%
10 Year	2.181	-.018	-0.82%

Equities

Market Recap

The bounce continued Monday as stocks grinded steadily higher mostly on short-covering ahead of key economic reports during the next few days. The S&P 500 closed up +0.91%.

It looked like Monday was going to be another potentially ugly day. Futures rolled over early and turned negative around 7 a.m. following more weakness in Europe and the earnings miss and guidance cut from IBM. Stocks opened moderately in the red, but within a half-hour of the open, the selling subsided and stocks were back in positive territory by 10 a.m.

There wasn't any real reason for the rally, as nothing fundamentally improved yesterday. But, the fact that stocks were able to stabilize early and not sell off hard on the very poor IBM results caused short-covering. From there, the higher the S&P 500 went, the more the shorts got squeezed.

The afternoon session was very quiet from a news standpoint and the drift higher continued. When the S&P 500 crossed the 1,900 level, the covering accelerated during the last hour of trading. Stocks grinded higher right into the 200-day moving average, closing fractionally below that level and just off the highs of the day.

Trading Color

It was a broad rally as most major indices finished up more than +1%, although the Dow Industrials obviously lagged thanks to IBM, which fell -7% yesterday.

All 10 S&P 500 sub-sectors traded higher, but it was the defensive sectors that outperformed—utilities, consumer staples and REITs were the best performers on the

Market	Level	Change	% Change
Dow	16,399.67	19.26	0.12%
TSX	14,337.77	110.09	0.77%
Brazil	54,302.57	-1,421.22	-2.55%
FTSE	6,317.66	50.59	0.81%
Nikkei	14,804.28	-306.95	-2.03%
Hang Seng	23,088.58	18.32	0.08%
ASX	5,325.03	5.59	0.11%
Prices taken at previous day market close.			

day (all up about +1.5% each).

So, from a leadership standpoint, it wasn't the highest quality rally, although cyclicals did trade higher. But, the bulls would have liked to see cyclicals leading.

Market	Level	Change	% Change
DBC	22.10	-.17	-0.75%
Gold	1246.10	7.10	0.57%
Silver	17.385	.054	0.31%
Copper	2.986	-.0175	-0.58%
WTI	81.98	-.08	-0.10%
Brent	85.38	-.78	-0.91%
Nat Gas	3.666	-.10	-2.66%
RBOB	2.2026	-.0301	-1.35%
DBA (Grains)	25.88	-.26	-0.99%
Prices taken at previous day market close.			

Earnings didn't have a big influence on trading yesterday, although the Mattel earnings did help push consumer discretionary higher. Tech was still able to rally despite weakness in IBM and some other "old guard" tech companies like CSCO—but strength in semiconductors and Internet stocks offset the weakness. (I read yesterday that Facebook now has a larger market cap than JPMorgan.)

On the charts things improved, as the S&P 500 closed above 1,900 and just below the 200-day moving average at 1,906.

Bottom Line

Sentiment has improved substantially from last week, and yesterday was the most-encouraging day we've seen in a few weeks. The market was able to shrug off the soft IBM earnings report and grind steadily higher—albeit in very low-volume, quiet trading, and with poor internal leadership. That aside, though, yesterday was a good day for the bulls.

Global growth and dis-inflation remain the primary headwinds on the market. But between the Chinese data out o/n, CPI tomorrow and the flash PMIs Thursday, we're going to get a definitive answer as to whether those headwinds are getting stronger or weaker. And, frankly we're off to a good start with the Chinese data out overnight, as it was better than expected and much better than feared, and is helping to calm nerves about global growth.

Importantly, the remaining numbers don't have to beat expectations to inspire a rally. As long as they are generally in line with expectations and the markets don't sell off of the news, that will inspire more short covering and adding of long exposure, just like we saw yesterday with the bad IBM results.

Oil and EWG are showing signs of life, but it's too early to tell whether they have bottomed. I remain broadly cautious on the market despite the good day yesterday – but if we get good data later this week and stocks can close above that 200-day MA, the outlook will improve significantly. For now, though, I remain skeptical and prefer to continue to wait on the sidelines.

Economics

What You Need to Know About the "Deflation" Threat

We are on the eve of another CPI report. As we look back over the last month, the surprise steep decline in the September CPI release was one of the catalysts that turned this market lower, as focus shifted squarely to dis-inflation and the stronger dollar.

But, it's important to point out that what we have seen over the past two months in the U.S. was a commodity-led decline in inflation statistics … not full-scale deflation. For those of us who were in the business in 2008, we've seen what real deflation looks like (at least as close we ever want to get to it). Major indicators of monetary conditions, credit, economic activity, consumer spending, etc. are NOT showing dis-inflation. CPI is showing dis-inflation, mainly because of commodity prices.

Much has been made of the decline in the 5-year inflation break-evens (the difference in 5-year TIPS yields and 5-year Treasuries). Yes, it is true they have declined sharply. But, keep in mind TIPS are priced off of headline CPI – so as headline CPI drops (with oil and other commodity prices), then the attractiveness of TIPS also drops. Again, that's because it is directly tied to headline CPI. Case in point, if you look at a chart of DBC (the commodity ETF), you'll see it closely mirrors the drop in 5-year inflation expectations, and that's not just a coincidence.

Two very reliable indicators of deflation (which I learned to follow during the '08 crisis) are the adjusted monetary base and revolving consumer credit.

Adjusted monetary base is one of the most useful barometers of the stock of available money in the U.S. It's accelerated to a new all-time high and is considerably higher than it was just a year ago, thanks to QE.

Revolving consumer credit (think credit card debt and other consumer-based lending) has exploded so far this year.

So, while things may change in the future, obviously, neither of these indicators are signaling we are seeing any sort of a deeper deflation threat.

The commodity collapse started right before the plunge in 5 year inflation break evens.

PMIs are at multi-year highs. The six-month rolling average of payrolls is at multi-year highs. Durable goods, retail sales, housing prices, etc. are all fine. Weekly jobless claims hit an 14-year low last week.

Nothing in the economy that I can see is screaming dis-inflation, other than CPI and (potentially) the yield curve, which has flattened. But, I believe what's going on in the bond market is a confluence of the short end selling off in anticipation of the Fed Funds hike next year (so short term rates go up), and the long end rallying as European money flows into Treasuries given their relative value (so long rates decline, flattening the yield curve). If we see a global deflation/depression, then obviously the U.S. won't be immune, but my point here is to show the difference between real deflation, and commodity price-led dis-inflation.

Market	Level	Change	% Change
Dollar Index	85.015	-.198	-0.23%
EUR/USD	1.2811	.005	0.39%
GBP/USD	1.6175	.0083	0.52%
USD/JPY	106.85	-.02	-0.02%
USD/CAD	1.1277	.0002	0.02%
AUD/USD	.8795	.0052	0.59%
USD/BRL	2.4634	.0286	1.17%
10 Year Yield	2.181	-.018	-0.82%
30 Year Yield	2.959	-.009	-0.30%
Prices taken at previous day market close.			

Bottom line, there is a silver lining to this commodity-led dis-inflation, as it's a positive for the U.S. consumer. And, over the next few days, we're going to be laying out a case as to why we think a theme for the remainder of the year is the "return of the U.S. consumer" and why consumer-related stocks (finance companies and select retailers) can outperform if the broader market stabilizes.

Commodities

Commodities began the week mostly lower in relatively quiet trading yesterday. Precious metals were the sole exception as futures rallied thanks to continued volatility in global equity markets and a weaker dollar. The benchmark commodity tracking index ETF, DBC, fell -0.72%.

Natural gas was the worst performer yesterday as futures fell to fresh 2014 lows thanks to warmer than initially expected weather forecasts through the end of October. This softens demand speculation for the remainder of the month. The revised weather forecasts will likely extend the "build season" by a few weeks, which will in turn allow national inventories to rise closer to levels seen as "normal" for entering the "draw season," which is fundamentally bearish. Bottom line, natural gas prices are in a sharp downtrend with the path of least resistance remaining lower. The next material support level lies below toward $3.50 while resistance is above toward $3.80.

Moving to the crude oil market, our domestic benchmark grade, WTI, handily outperformed the global Brent contract yesterday as international equity markets were mixed on further growth concerns while U.S. stocks rallied. WTI futures finished essentially flat as Brent finished down nearly -1%.

As expected, WTI started the week in consolidation mode as buyers stepped in midday to reverse morning lows and see futures close toward the upper end of the near-term trading range ($80-$83 per barrel). On the charts, WTI futures are in a steep 3-week downtrend with resistance moving down to $82.50.

Moving to the metals market, gold traded higher yesterday, adding +0.59% on the day and ending very close to resistance at last week's high of $1,250. Demand for gold remained high yesterday as global equity markets were mixed and volatile. The underperformance by European markets specifically contributed to gold strength yesterday. Also, the weaker dollar helped futures close near session highs.

The gold market bears watching here as futures are threatening to break out above resistance at $1,250. Going forward, it will all depend on other asset classes, namely equities and the dollar. If both of those markets can stabilize and rally, it will likely pour cold water on the gold rally. However, if the dollar takes another leg down and stocks can't hold the recent bottom, gold has a pretty clear path toward resistance at $1,280.

Copper futures continued to trade heavy, falling -0.63% to close just below the $3 mark yesterday. The ongoing concerns over the future of the global economy have been a major weight on the industrial metals market. As long as that continues, the path of least resistance will remain lower.

Currencies & Bonds

Currencies and bond markets were quiet yesterday for the first time in over a week, as the Dollar Index drifted lower on general long selling ahead of the first wave of catalysts this week (the Chinese economic data). The Dollar Index declined -0.17% in mostly quiet trading, as every currency except the yen was modestly higher vs. the greenback.

The best performer on the day was the British pound, which rallied +0.37% on general short-covering and some value-buying.

Keep in mind that it is still widely expected that the BOE will be the first major central bank to raise rates, likely in January 2015. And, seeing as Fed Funds rate expectations are now signaling a December rate hike for the U.S., that is pound-bullish. It's a bit of a risky trade ahead of all the economic data coming later this week, but for those looking to buy the pound on the cheap, this isn't the worst place.

The euro also continued to drift higher vs. the dollar, rallying +0.20%. That rally occurred despite the formal announcement that the ECB is now buying covered bonds (the first purchases were yesterday), so another piece of stimulus is now actually being implemented. But, the market remains skeptical of the ECB's will, and until the program gains more momentum, it won't be much of an influence on the currency or the economy. There was further confirmation o/n that the initial purchases by the ECB were small—but the euro is down moderately this morning on a reuters article that said the ECB is going to expand the pool of assets it can but early next year to include corporate bonds—and if that happens, it'll expand the score of the ECB's "private" QE program.

The most "news" yesterday came from the yen, where not only were official pension reforms apparently leaked (they were equity market positive and the main reason the Nikkei was up 4% Monday) but PM Abe also implied that he may not be willing to go through with the second sales tax increase in the spring of 2015.

Both ostensibly dovish events had the yen down early, but there's still a decent degree of trepidation in the market. The yen rallied steadily throughout the day to finish well off the lows and down just -0.16% vs. the dollar.

Finally, looking at the commodity currencies, the Loonie drifted slightly lower ahead of a Bank of Canada meeting later this week (no change to rates expected) while the Aussie rallied +0.37% on short-covering ahead of the Chinese economic data and Reserve Bank of Australia meeting minutes out overnight (they were mostly in-line with expectations).

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).

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)**