7:00's Report

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

October 22nd, 2014

Pre 7:00 Look

- Futures are drifting very slightly lower this morning as markets digest the recent rally following a quiet night.
- Japan was the best performing major index o/n following a stronger than expected export report, while Europe is slightly lower following yesterday's strong rally.
- Earnings after the bell were mixed but modestly positive, as YHOO and BRCM beat, while VMW missed.
- Econ Today: CPI (E: 0.0%).
- Earnings: ABT (E: 0.60), BA (E: 1.96), DOW (E: 0.67), GD (E: 1.91), USB (E: 0.78), XRX (E: 0.26), T (E: 0.64), RJF (0.87).

Market	Level	Change	% Change
S&P 500 Futures	1934.75	-3.25	-0.17%
U.S. Dollar (DXY)	85.625	.231	0.27%
Gold	1246.50	-5.20	-0.42%
WTI	82.70	.21	.25%
10 Year	2.208	.027	1.24%

Equities

Market Recap

The surge continued yesterday as good earnings, potentially more stimulus from the ECB and good Chinese economic data sent shares sharply higher. The S&P 500 closed up +1.96%.

There were multiple reasons why stocks were so strong yesterday (including more short-covering). But the two main reasons were the Reuters article about the ECB potentially buying corporate bonds in early 2015, and the better than expected Chinese GDP data. As a result, futures were higher from the outset Tuesday, and it didn't hurt that AAPL posted good numbers as well. Once stocks opened, the good news kept rolling as September Existing Home Sales beat expectations.

The move higher through the morning (and really the entire day) can best be described as a slow, steady grind higher, as the markets moved methodically upward all morning before seeing a slight pause as traders grabbed lunch. But, by 1:30 the rally was back on. Although the afternoon was very quiet from both a news and volume standpoint, the steady move higher lasted basically into the end of trading, although we saw some slight profit-taking into the close and ahead of the key economic releases coming later this week. Stocks finished very slightly off the highs.

Trading Color

It was a very broad and strong rally yesterday. Unlike Monday, the "right" groups outperformed yesterday and it was a much higher-quality move, although volumes remain muted (that's about the only thing negative you could find yesterday).

The Nasdaq was the best-performing major index, thanks mainly to AAPL (up +2.72%) and TXN (up +5.31%), which helped to further allay microchip and semiconductor concerns. To that point, the SOX was up +3.55% and has now filled the gap left from the MCHP earnings disaster back on October 9th.

Sector-wise, the bulls saw what they wanted: Cyclicals handily outperformed as energy was the best-performing S&P 500 sub-sector, up +3%, followed by industrials (XLI), basic materials (XLB) and consumer discretionary and tech (XLY and XLK). Utilities, consumer staples and REITs all rallied, but just barely (all up less

Market	Level	Change	% Change
Dow	16,614.81	215.14	1.31%
TSX	14,547.71	209.94	1.46%
Brazil	52,432.43	-1,870.14	-3.44%
FTSE	6,363.80	-8.53	-0.13%
Nikkei	15,195.77	391.49	2.64%
Hang Seng	23,403.97	315.39	1.37%
ASX	5,385.87	60.84	1.14%
Prices taken at previous day market close.			

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than +0.4%). So, there was a definitive rotation into cyclical names yesterday.

On the charts the situation continues to improve, as the S&P 500 easily regained the 200-day moving average (1,906) and is now within striking distance of resistance at the 1,950 level.

Market	Level	Change	% Change
DBC	22.29	.18	0.81%
Gold	1248.70	4.00	0.32%
Silver	17.51	.156	0.90%
Copper	3.0295	.0415	1.39%
WTI	82.64	.73	0.89%
Brent	82.26	.86	1.01%
Nat Gas	3.713	.043	1.17%
RBOB	2.2172	.017	.077%
DBA (Grains)	25.97	.10	0.39%

Prices taken at previous day market close.

Bottom Line

What a difference a week makes. Last Wednesday morning, sentiment couldn't have been any gloomier, while this morning it seems the broad consensus is that the correction is over, and grind higher into the high 1900's is coming.

And, yesterday's rally was fundamentally valid, as the news of the day (Chinese GDP and the ECB potentially buying corporate bonds) directly addresses the two main concerns of the market—namely, slowing global growth and European deflation/dis-inflation.

The ECB has pledged to expand its balance sheet by 1 trillion euros over the coming 2 years, which will bring it back to Eurozone crisis highs, and provide a tailwind on risk assets.

Now to be clear, neither of those headlines totally removes those concerns. But, the net effect was to further help the market realize things weren't quite as bad as they seemed last Wednesday.

Looking forward, the rallies this week definitely had a painful feel to them, either via short covering or as though investors weren't long enough and (again) the rally caught them off-guard, which has led to chasing. Sentiment has shifted rapidly during the last 48 hours and while the "pain trade" is still higher, I'm not sure how much is left (maybe a retake of the 100 day moving average at 1961 but that's probably about it without good fundamental data).

Bottom line is markets are recovering, but the key will be the data coming out over next 24 hours. If the data can further allay concerns about the global economy and deflation, then stocks can continue to rally. Although I am more reserved than most of the Street given the change in sentiment, I still remain cautious on the broader market and want some more evidence of actual improvement before re-allocating money materially to the long side.

The Case for Europe

A Reuters article that hit early yesterday morning, which suggested the ECB is now strongly considering buying non-financial corporate bonds starting in 2015, was in large part responsible for the rally in stocks. It reminded the market that the ECB is determined to expand its balance sheet and buy assets, and this will be a positive for European stocks and the economy.

So, while fears about another European recession are as high as they've been in 2+ years, you can't look at Europe correctly without also acknowledging the desire of the ECB to expand its balance sheet (which is good for stocks) and the large amount of stimulus currently in the pipeline.

First, the ABS/covered-bond purchase program started earlier this week. While initial buying has been slow, the bigger picture is it will include "retained" bonds—bonds from bailed-out countries like Greece—and allow for the ECB to purchase portfolios of lower-rated debt than was the consensus. Point being, the ECB wants this to be a big purchase program, and the criteria they have established prove that.

Second, the TLTRO in December should see much larger demand than the disappointing first offering in September. First, the bank stress tests will finally be out of the way (they come October 26th) and second, learning from its mistakes, the ECB will almost certainly announce some structural tweaks to the program to make it more attractive (reduce the interest rate by 10 basis points, potentially make it 4 years instead of 3, etc.).

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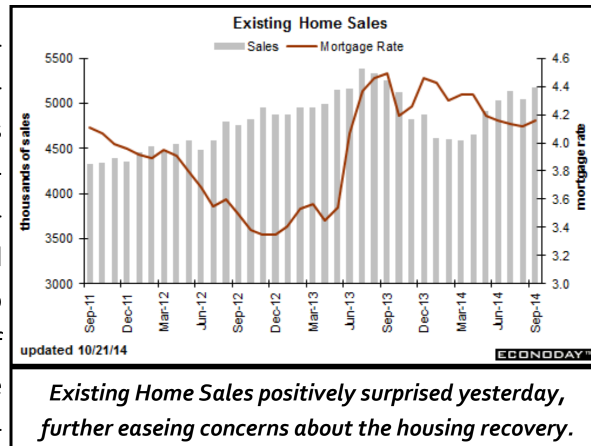
Third, the euro is down nearly 10% from the May highs vs. the dollar. That is a huge decline for a major currency like the euro, and the benefits of that depressed euro will start to appear in exporting countries like Germany and tourism-based countries in Southern Europe. (Germany's finance minister, Wolfgang Schauble, made comments yesterday that the weaker euro is already helping German exports.)

Bottom line, despite the poor August data in Europe, it is important to realize that the ECB has committed to expanding its balance sheet by nearly 1 trillion euros over the next 2 years. This will expand the ECB balance sheet to just below all-time highs. In fact, if this were any other country, these programs likely would have already spurred a big rally in stocks.



Existing Home Sales positively surprised yesterday, further easeing concerns about the housing recovery.

But, this is Europe, and as was the case in the euro-zone crisis, politics and public bickering have led to a confidence problem.

Once again we have a situation where it's the Germans vs. everyone else in Europe (financially speaking, obviously). And, just like during the depths of the EU sovereign-debt crisis, the market is asking (again) the question of whether Europe has the political will to fix itself.

The market remains skeptical the ECB stimulus programs will actually be implemented forcefully—fearing that political divisions and German blocking will make the programs ineffective.

But, as with the EU sovereign-debt crisis, nothing motivates like the prospect of complete financial ruin. Undoubtedly, the collapse in stock prices over the past two weeks spurred some action. In addition to the news the ECB is considering buying corporate bonds, there are also multiple reports the Germans and French are having "secret" meetings to resolve their fiscal differences.

Ultimately, I believe Europe will save itself. There's too much money at stake not to. And, because of that, Europe offers significantly more upside than the U.S. After all, Europe is starting from a much lower base (think fall 2012 in the SPX) and has a central bank that's expanding its balance sheet, not contracting it (like the Fed will over the coming year).

But, the danger is due to politics, so HEDJ or EUFN could easily fall another 10%-20% before Europe gets its act together.

So, the trick now is to be patient. And, for clients where it's appropriate, I would rather keep some portion of discretionary capital in cash and wait to buy a clear bottom in Europe rather than allocate to the S&P 500 here. The upside once the market does bottom in Europe should be substantially higher than anything here in the U.S. – as long as Europe proves it has the will to do what is necessary. Contrarian food for thought.

Economics

No material reports yesterday.

Commodities

Commodities were broadly higher yesterday as global economic data were largely in line or better than expectations. On top of that, the ECB announced additional easing measures that helped stocks rally worldwide. The broad-based commodity tracking index ETF, DBC, added +0.81% on the session.

Market	Level	Change	% Change
Dollar Index	85.395	.357	0.42%
EUR/USD	1.2726	-.0072	-0.56%
GBP/USD	1.6121	-.0041	-0.25%
USD/JPY	106.85	-.09	-0.08%
USD/CAD	1.1223	-.006	-0.53%
AUD/USD	.8778	-.0002	-0.02%
USD/BRL	2.4819	.0173	0.70%
10 Year Yield	2.208	.027	1.24%
30 Year Yield	2.984	.025	.084%
Prices taken at previous day market close.			

Trading in gold caught our attention yesterday because, with both stocks and the dollar higher, most would have expected gold to fall back from resistance at $1,250. But, gold futures rallied +0.32% yesterday and there were a couple reasons.

First, economic data simply *met* expectations and did

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not *beat,* so many investors remain concerned over the health of the global economy and are continuing to allocate some funds to gold as an equity hedge/speculative bet.

Second, yesterday's dovish news out of the ECB gave gold a boost, because further weakness in Europe will remain a headwind for the U.S. economy. This is leading traders to expect the Fed to be slightly more dovish (as in, later than initially expected rate hikes).

On the charts, gold traded up to a new one-month high of $1,255. However, futures closed well off those highs, thanks to downward pressure from the stronger dollar and surging stock market. But, it feels as though gold is getting "spring loaded" here. If the important data we are expecting later in the week disappoint, then it could spur a sharp rally up toward the initial resistance levels we mentioned earlier in the week at $1,280.

Copper bounced back above the $3 mark yesterday as futures gained +1.37% on Chinese demand hopes. Several Chinese economic reports were released overnight Monday, and notably, the Industrial Production data beat expectations (8.0% vs. 7.5%)—causing some short-covering and speculative buying. But, bottom line, copper prices are trending with economic data, specifically that out of China. Until we see that data stabilize and begin to rise, copper will remain range-bound around $3.

WTI crude oil futures rallied +0.72% yesterday thanks to the aforementioned Chinese economic data and ECB stimulus chatter. WTI futures did break above 3-week-old trend resistance yesterday, a technical sign that obviously favors the bulls. But, bottom line, WTI remains largely range-bound between $80 and $84 per barrel as the market continues to consolidate recent declines.

Today, traders will be focused on the EIA inventory report. Analysts are expecting +3M barrel build in crude stocks, -1.45M barrel draw in gasoline, and -1.3M barrel draw in distillate fuel according to Bloomberg.

Currencies & Bonds

The Dollar Index enjoyed a strong rally yesterday mainly on a weaker euro, which took a hit on the Reuters corporate bond article, and on the better than expected Existing Home Sales report. The Dollar Index rallied +0.46%.

The euro, conversely, was the worst performer vs. the dollar, dropping +0.67% on the speculation is that Draghi and the ECB are targeting corporate bonds instead of covered bonds, and that's putting an ECB "twist" on the way they are incorporating their "private market" QE.

The Canadian dollar was actually the best performer vs. the dollar with the China data helping from the start yesterday morning. China's GDP coming in at 7.4% ahead of the 7.3% expectation gave Canada, China's second-largest trade partner behind the U.S., a positive spin on the Loonie.

The Aussie, however, didn't rally with the good Chinese data, mainly because the RBA minutes were largely as expected (and the Aussie rallied Monday ahead of the minutes). While mostly meeting expectations, the RBA again referred to the value of the Aussie as "high" and specifically commented on the drop in iron ore prices (and commodities more broadly) as a potential headwind on the Aussie economy. Bottom line—it wasn't dovish, but it wasn't hawkish, either. We can expect status quo from the RBA going forward (which keeps the trend in the Aussie decidedly lower).

Turning to Treasuries, the 10-year yield drifted back above 2.2% while the 30-year Treasury declined modestly (-0.26%), which is less than you would expect given the strong rally, positive European news and euro-positive news. But, bond markets remain buoyant despite the looming threat of the end of QE and 2015 rate hikes. Until we get a decided move lower in the German 10-year, we won't see any sort of material sell-off in Treasuries. (The German 10-year was little-changed on the Reuters article yesterday, as yields moved just 2 basis points higher to 0.87% - so clearly there remains a healthy dose of skepticism of ECB policies in the EU.)

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)

	Near Term Trend	Long Term Trend	Market Intelligence
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)

	Near Term Trend	Long Term Trend	Market Intelligence
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)

	Near Term Trend	Long Term Trend	Market Intelligence
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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