7:00's Report

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

October 23rd, 2014

Pre 7:00 Look

- Futures are only slightly higher this morning despite October flash PMIs being universally better than expected.
- Chinese manufacturing PMIs beat estimates, staying just fractionally above 50 at 50.4. In Europe the EMU number was a slight beat but the highlight was Germany, as manufacturing PMIs bounced back, rising to 51.8 vs. (E) 49.5.
- Econ Today: Weekly Jobless Claims (E: 285k), October Flash PMI (E: 57.0).
- Earnings: MMM (E: 1.96), CAT (E: 1.33), CMCSA (E: 0.70), LLY (E: 0.66), AMZN (E: -0.73), MSFT (E: 0.48).

Market	Level	Change	% Change
S&P 500 Futures	1931.50	6.50	0.34%
U.S. Dollar (DXY)	85.79	-.064	-0.07%
Gold	1239.10	-6.40	-0.51%
WTI	80.76	.24	0.30%
10 Year	22.29	.021	0.95%

Equities

Market Recap

The rally paused Wednesday as stocks digested recent gains ahead of key economic data out overnight and yesterday morning. The S&P 500 declined -0.73%.

Stocks started out Wednesday with tentative gains as good earnings (YHOO) from Tuesday night, good Japanese export numbers, more chatter regarding ECB corporate bond purchases, and an "in-line" CPI reading helped push futures higher.

The S&P 500 failed to break though the downtrend in place since late September yesterday, so the 1935-1940 resistance region become important now.

The buying continued after the opening bell as the S&P 500 resumed the Tuesday grind higher, moving to within one point of resistance at 1,950 before the bulls lost momentum.

There was no real negative catalyst yesterday morning (the Canadian shootings were obviously a horrible tragedy but it didn't really effect US markets that much). But between that, European markets closing and oil rolling over, buying — which was very tentative anyway — stopped almost immediately after 11:30. And as oil sold off, so did the market.

Unlike the recent sell-off, though, this was much more measured and calm, as stocks drifted gradually lower throughout the lunch hour and early afternoon. Again news was quiet and declines were orderly.

The bulls tried to mount a bit of a rally heading into the final hour of trading but it wasn't meant to be. Once that failed, the selling accelerated during the last 30 minutes of trading and the S&P 500 went out at the lows of the day.

Trading Color

Market	Level	Change	% Change
Dow	16,461.32	-153.49	-0.92%
TSX	14,312.07	-235.64	-1.62%
Brazil	52,411.03	-21.40	-0.04%
FTSE	6,379.57	-20.16	-0.32%
Nikkei	15,138.96	-56.81	-0.37%
Hang Seng	23,333.18	-70.79	-0.30%
ASX	5,383.14	-2.73	-0.05%
Prices taken at previous day market close.			

It was quiet trading yesterday. With the flash PMIs looming, and in the context of the big snapback rally we just had, I'm inclined to take yesterday's trading with a grain of salt.

Market	Level	Change	% Change
DBC	22.06	-.23	-1.03%
Gold	1242.00	-9.70	-0.77%
Silver	17.14	-.409	-2.33%
Copper	3.012	-.016	-0.53%
WTI	80.42	-2.07	-2.51%
Brent	84.76	-1.46	-1.69%
Nat Gas	3.666	-.045	-1.21%
RBOB	2.1508	-.0626	-2.83%
DBA (Grains)	25.80	-.18	-0.69%
Prices taken at previous day market close.			

That said, though, the price action wasn't very encouraging. The Russell 2000 badly underperformed, dropping -1.4%. Disconcertingly, it may be rolling over right on the downtrend from the mid-September highs (chart on pg. 1).

Sector-wise it was a pretty textbook "defensive" day. The only two S&P 500 sub-sectors that traded higher were utilities and consumer staples (up +0.62% and +0.22% respectively) while energy led to the downside (down -1.9% on weaker oil prices) and industrials also traded sharply lower (they were weighed down by BA's earnings miss). But financials, consumer discretionary, and basic materials also all sold off about -0.8% each, so clearly there was broad selling in cyclical and "growth" type sectors.

Double Trouble? The Russell 2K also failed at the downtrend yesterday and traced out a negative outside reversal. If I were strictly trading off technicals, this would be a short.

On the charts things are getting interesting. Both the Russell 2000 and S&P 500 hit and failed at the downtrend lines in place since mid-September. So, the 1,115-1,120 range in the Russell 2000 is now key, as is the 1,935-1,940 range in the S&P 500. Finally, the Russell 2000 traced out a large and negative "outside reversal" yesterday. So, while it's not accurate to say the technical picture deteriorated significantly yesterday, we are at an important inflection point.

Bottom Line

I think we're at a bit of a near term tipping point this morning. Nothing fundamentally changed yesterday (the Canadian shootings were not a market mover in the US despite headlines), but beneath the surface price action yesterday was weaker than the averages implied.

Oil plunged (down over 2%), as did the Russell 2000. And, as the charts show, we're basically at the September downtrend in both the S&P 500 and Russell 2000.

This morning the data is good, as global flash PMIs were universally better than expected, so there is fundamental justification for stocks to break through, and I think they need to if we are going to continue higher in the near term.

A failure to rally on today's news and a moderate decline would be a negative signal for the market, in my opinion.

Bottom line, fundamentals have improved this week but the market is also 5+ percent off the lows, so this incremental improvement is priced in. I'm still watching EWG and oil, and neither one tell me we're in an "all clear" situation yet, so I remain cautious.

Finally, although it may be premature, if anyone bought XLE or sold that put spread we suggested last Thursday morning, I would exit both positions on a higher open this morning.

Economics

CPI

- September CPI rose 0.1% vs. (E) 0.0%.

Takeaway

CPI showed a slight uptick in inflation in September, which was a market positive as it helped marginally dispel dis-inflation worries. Keep in mind that "bad" economic data aren't good—as the market would much rather see stable inflation and Fed hikes compared to whiffs of dis-inflation. The key component in CPI, the change in year-over-year core CPI, was unchanged from August at 1.7%, and that helped calm fears that we were seeing dis-inflation trends gaining momentum.

Bottom line is this report won't have any material affect on Fed policy (especially with regard to the FOMC meeting next week), but it does show that price levels are holding steady and not continuing to lose significant momentum, which is a positive for the economy/ market.

Commodities

Commodities reversed Tuesday's broad gains yesterday as the stronger dollar weighed on the entire space and bearish inventory data caused the energy sector to test recent support. DBC fell -1.03%.

Crude oil and the refined products were the worst performers in the commodity space yesterday as WTI fell 2.55%, RBOB closed down 2.80%, and heating oil futures dropped 1.70%. The weakness was largely driven by the bearish government inventory report released mid-morning. The EIA reported a +7.1M barrel build in crude oil stockpiles (vs. E: +3M bbls), a -1.3M barrel draw in gasoline supplies (vs. E: -1.45M bbls), and a +1.0M barrel build in distillate inventories (vs. E: -1.3M bbls).

Futures sold off, briefly recovered and then began a sharp decline that lasted into the Nymex close. Crude oil remains in the market spotlight as the weakness in energy futures was cited as one of the reasons the stock market sold off yesterday (in addition to the Canadian shootings). Going forward, the trend remains decidedly lower with last week's low tick of $79.78 being the "line in the sand" for many speculative longs in the market.

Natural gas futures have been range-bound this week between $3.65 and $3.72. Yesterday, prices fell back from resistance at the upper level of that range and closed down -1.3%. The market fundamentals are favoring the bears as temperatures are largely "comfortable" across the country (low heating demand) and supply levels are steadily rising. Also, the "build season" is expected to last a few extra weeks into November now, which will allow stockpiles to get pretty close to levels seen as normal for entering the "draw season." And, the technicals match as prices are trending lower, with the next substantial support level down toward $3.50 while trend resistance is above at $3.725.

Market	Level	Change	% Change
Dollar Index	85.85	.446	0.52%
EUR/USD	1.2643	-.0071	-0.56%
GBP/USD	1.6052	-.0057	-0.35%
USD/JPY	107.16	.19	0.18%
USD/CAD	1.124	.0022	0.20%
AUD/USD	.8775	-.0003	-0.03%
USD/BRL	2.4841	.0039	0.16%
10 Year Yield	22.29	.021	0.95%
30 Year Yield	3.00	.016	0.54%
Prices taken at previous day market close.			

Moving to the precious metals market, the in-line CPI report caused gold futures to fall -0.65% (while the dollar rallied +0.60%). Futures sold off sharply on release of the report because, basically, there was a large unwind of dovish positions from the market (bonds and gold fell while the dollar spiked higher). Those positions were in place on speculation that the Fed would be forced to be more accommodative because of the threat of disinflation after the last CPI report.

So, yesterday's September CPI report being in line suggested that the "whiff of dis-inflation" in the August report was commodity-driven and/or only temporary. Bottom line: We saw a lot of repositioning yesterday, and the dollar being back in "rally mode" will likely bring an end to the recent strength in gold. The path of least resistance is now lower toward the $1,200 level.

Currencies & Bonds

Volatility returned to the currency markets Wednesday, as the Dollar Index rallied +0.5% on more euro weakness and the aforementioned firm CPI report. On the charts, the Dollar Index retook the 20-day moving average, a positive technical development.

The euro was the worst performer vs. the dollar yesterday, falling a significant +0.62% and frankly trading very poorly, as it went out basically on the lows.

News-wise, nothing really changed in the EU yesterday. Instead, the move was more a trading response than anything. The euro has enjoyed a nice bounce over the past 2+ weeks, and between the swirling rumors of the ECB potentially readying to buy corporate bonds, and the looming October flash manufacturing PMIs that came overnight, there were more than enough reasons for unconvinced longs to sell and shorts to lay out exposure. And then when the short-term uptrend in place since mid-September broke, it accelerated the selling.

This morning the euro is bouncing modestly following the better than expected flash PMIs (especially in Germany), but the move is pretty subdued (which is a negative for the euro).

Turning to the yen, it continued to bleed lower vs. the dollar and retrace much of the "risk off" rally of the past 2+ weeks. Earlier this week, it was the shift in pension fund allocations to more domestic stocks (and less foreign stock and Japanese government bond investment), along with PM Abe wavering on the second half of the sales tax increase slated for the spring.

And then yesterday, it was a stronger than expected export number (up +6.9%) which is not only a positive data point for the Japanese economy, but it was also taken as more anecdotal evidence that the global economy isn't in as terrible shape as was feared last week.

The dollar/yen pair now appears to have bounced on the 50-day moving average at 106.50 and looks to be heading higher again. But, while I remain a decided yen bear, I still think there's more consolidation left in this trade, and would not be adding to short yen positions just yet.

The commodity currencies were little-changed yesterday despite catalysts for both the Aussie and the Loonie. First, Aussie CPI was broadly in line, and seeing as the Aussie had already rallied into the release, it was little-changed on the day (up +0.05%).

The Loonie was also virtually unchanged (down -0.05%) despite both disappointing September retail sales and a dovish tone by the Bank of Canada at their policy meeting yesterday.

Interestingly, yesterday's reaction to the BOC meeting was a classic case of the market trading off expectations, not absolutes. While citing the challenges posed by slowing global growth, the BOC Monetary Policy Report (which was the first one since July) wasn't quite as "dovish" as the market priced in, considering the plunge we've seen in the Loonie since July, when the Loonie was trading around $0.93, or nearly +6% higher from current levels.

The release of the policy statement caused a knee-jerk rally in the Loonie back into the high $0.88 range, where it stayed for the remainder of the trading day.

The tragedy in Ottawa, while gripping the headlines, didn't really cause much of a reaction in the currency yesterday.

<u>A Foreshadowing of the Fed Next Week</u>

This is anecdotal but I found it interesting that both the Bank of England, via their minutes, and the Bank of Canada, via their meeting, basically replaced domestic economic data as their main catalyst for policy with global economic weakness, making themselves more "dovish" in the process.

Given that, I wonder if there's a chance we could see a more "dovish" than expected FOMC statement next week that goes along the same lines, namely: "Domestic economic data continue to get gradually better, but we're now very focused on global weakness. So, even though things here warrant a slightly more hawkish stance, we're staying dovish because of foreign threats."

Obviously I'm paraphrasing, but it's something to consider as we approach the statement next Wednesday.

<u>A Materially Dovish BOE</u>

The pound also traded moderately lower vs. the dollar yesterday, dropping -0.47% on actual news (unlike the euro). The negative catalyst was the minutes from the October Bank of England meeting, which despite seeing yet another dissent from Messrs. Weale and McCafferty (they again dissented in favor of a 25-basis-point increase), the meeting minutes were decidedly "dovish."

Keeping in mind the minutes from this meeting were taken before the recent market turmoil, we can only assume it's made the BOE more dovish, and as a result expectations for a BOE rate hike are now being pushed out to the March-July time frame.

That shift aside, I would still prefer to be a buyer of the pound rather than a seller, especially if we see the European economy firm up over the coming months thanks to ECB measures. In fact, if I had to buy one foreign currency right now, it would be the pound.

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)			