7:00's Report

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

October 27th, 2014

Pre 7:00 Look

- Futures are very slightly negative but are being weighed down by European shares, which are declining following the bank stress test results and some more lack luster German data.
- Despite the stock reaction (which seems more like digestion of last week's rally) the ECB stress tests weren't bad. In total less than 1/4 of the 130 banks "failed' and 9 were in Italy, which was expected. Capital shortfalls were also lower than expected.
- In Brazil, incumbent Dilma Rousseff won a close election and Brazilian futures are sharply lower in reaction.
- Econ Today: October Flash Services PMI (E: 58.0), Pending Home Sales (E: 0.8%).

Market	Level	Change	% Change
S&P 500 Futures	1955.50	-4.25	-0.22%
U.S. Dollar (DXY)	85.725	-.093	-0.11%
Gold	1230.60	-1.20	-0.10%
WTI	80.55	-.46	-0.57%
10 Year	2.273	-.002	-0.09

Equities

Market Recap

Stocks staged a big rally last week, reclaiming key technical levels on the back of good earnings, better than expected global economic data, and hopes of more stimulus from the ECB. The S&P 500 rose +4% and is up 6.29% year-to-date.

Things were better from the outset last week as stocks rallied last Monday on continued short-covering. Importantly, there were hints the market dynamic had changed for the better Monday when stocks were able to rally despite an awful earnings report from IBM.

Tuesday was the best day last week as the S&P 500 surged almost +2% following a Reuters article that stated the ECB was considering buying corporate bonds (this was the major positive catalyst last week). Chinese GDP beating expectations also helped.

Wednesday stocks digested the recent gains (it was the only negative day on the week, and only marginally so), but the rally was back "on" Thursday after global PMIs universally beat expectations. The S&P 500 finished the day up more than +1% but gave back some of the gains following an erroneous headline that a plane landing in Boston carried multiple potential Ebola patients.

Speaking of Ebola, the news of the New York doctor contracting the disease hit futures hard overnight Thursday/Friday. But again the market showed strength and stocks shrugged off the news Friday. More strong earnings and short-covering pushed stocks higher going into a busy weekend of news (Brazilian elections, ECB bank stress tests). Stocks went out basically on the highs of the day.

Trading Color

Obviously with the S&P 500 up +4% it was a broad rally, although there wasn't the cyclical dominance that you would have expected. The Nasdaq outperformed the S&P 500 last week but the Russell 2000 did not, rising +3.3% (so it's not like it lagged *that* much).

Sector results were shockingly similar. Financials, energy, utilities, tech and consumer discretionary all rallied about +3.5% each (again showing it was a broad rally).

Industrials and healthcare were the outperformers (up +4% and +6.6%, respectively) helped by strong earnings. Meanwhile consumer staples lagged (up +2.8%), as that sector was weighed down by some lackluster results.

Market	Level	Change	% Change
Dow	16,805.41	127.51	0.76%
TSX	14,543.82	56.99	0.39%
Brazil	51,940.73	1,227.47	2.42%
FTSE	6,367.05	-21.68	-0.34%
Nikkei	15,388.72	97.08	0.63%
Hang Seng	23,143.23	-158.97	-0.68%
ASX	5,458.95	46.71	0.86%

Prices taken at previous day market close.

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Bottom line: It remains a cautious, mostly short-covering driven rally, although that's been similar to previous recoveries this year, so it doesn't necessarily mean the rally is weak. I would like to see small caps trading better, though.

Earnings Season Update

It's still not quite half over but earnings season has been decent. With just over 200 S&P 500 companies reporting, over 80% have beaten estimates with (importantly) 60% beating on revenues. (Those numbers look great but keep in mind generally 75% of companies beat the estimate, so we're just a little better than normal.)

Market	Level	Change	% Change
DBC	22.16	-.14	-0.63
Gold	1231.20	2.10	0.17
Silver	17.195	.037	0.22
Copper	3.04	0.00	0.00
WTI	81.30	-.79	-0.96
Brent	84.30	-.24	-0.28
Nat Gas	3.631	.009	0.25
RBOB	2.1858	-.0211	-0.96
DBA (Grains)	25.71	-.21	-0.81
Prices taken at previous day market close.			

The "winners" this season have been the industrials (CAT/MMM/GE) and larger-cap tech (TXN/INTC/AAPL) while the one sector that has seen pretty sloppy results has been Internet stocks (NFLX, AMZN and P all missed while YHOO has been one of the few bright spots).

Overall results have been fine, and not one is materially altering its FY 2015 earnings outlook (still around $132-ish per share for the S&P 500).

Bottom Line

There are four main reasons as to "why" stocks have recovered so swiftly (since the 10/15 low, the S&P 500 is up +8% and just over 3% away from all-time highs).

Reason #1 is the ECB "Covered Bond" article. The broader point is that the market remains concerned over the ECB commitment to stimulus and the EU economy. The ECB threatening to do "more" helps confidence in the region and increases the chances of a recovery in the EU.

Reason #2 is global growth data were better than expected. I'll cover it more in the Econ section, but sentiment toward global economic growth has become very negative, and last week's solid data helped dispel the idea that the global economy was falling off a cliff.

Reason #3 is dovish mumbling from Fed officials. Starting with Bullard last week suggesting to "halt" the tapering of QE, Fed comments—while not representative of the committee—have been dovish. That's reminded the market that while QE is ending, the Fed remains an ally for the stock market via keeping policy very easy and reacting if data get worse.

The final reason is earnings, which have been good (not great). Importantly, though, large multinational industrials (GE/CAT/MMM/UTX/FDX) haven't materially downgraded their outlooks, which has also helped dispel the "global growth slowing" notion.

Going forward there are catalysts for a further rally (FOMC meeting, midterm elections) and I would not be surprised to see this market "grind" higher into the higher 1,900s (say 1,980-1,990). Additionally, this rally has been mostly short-covering, so under-allocated managers will be "forced" to get more long as stocks rally. So, point being, the "pain trade" may be higher still.

But, I continue to have a hard time seeing the catalyst that takes us meaningfully to new highs beyond 2,000. I remain cautious on a risk/reward basis—and as a result I continue to like HEDJ and EUFN as preferred destinations for incremental capital, simply because Europe offers better upside and is a more compelling value than U.S. stocks.

Economics

Last Week

The market needed economic data last week to show that the global economy wasn't as bad as markets had come to believe over the past month, and the data delivered.

On the growth and inflation fronts (the two main areas of concern for risk assets), data last week were solid if unspectacular (but helped correct sentiment, which had been getting almost exponentially worse each day).

The data started good last week as Chinese Q3 GDP was 7.3%, slightly under the 7.5% "target" but better than expected. And, importantly, it was comfortably above the 7% GDP "Maginot Line" that determines when concerns about Chinese growth become a significant head-

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wind on risk assets.

But, the October flash manufacturing PMIs really helped calm nerves about the global recovery. Again, while not spectacular, they were definitely better than feared. At a 10K-foot level, the data last week showed the global economy is still recovering, and not contracting again, as expectations for German and Chinese PMIs were for both numbers to fall below 50 (signaling contraction) but both surprised to the upside.

The highlight was the German data (remember Germany is now “Ground Zero” for European economic worries. German manufacturing PMI rose 51.8 vs. (E) 49.5, while the Chinese data hung on, rising to 50.2 vs. (E) 49.9.

The broader EMU PMI was also a beat at 50.7 vs. 50.0 (but again showing expansion) while the U.S. number was a slight miss at 56.2 vs (E) 57.0—but the important thing is that, at an absolute level, activity in the manufacturing sector is still brisk.

Turning to inflation (and specifically worries about dis-inflation/deflation), the September CPI was also steady. Month-over-month CPI rose +0.1% vs. (E) 0.0%, and the year-over-year change in “core” CPI (which is the most important metric to watch) was unchanged from August at 1.7%. Again, while unspectacular, the data implied the dis-inflation threat in the U.S. isn’t increasing, which is a positive.

This Week

We get more important data on growth and inflation this week, but the most important event of the week will be the FOMC meeting Wednesday.

I’ll preview it as we get closer, but the almost universal expectation is for the FOMC to end QE (as expected). Where expectations differ, though, is what the statement will look like. Specifically, the big question is whether the Fed will remove the “significant time” statement or the “significant underutilization of resources,” thereby making the statement slightly more “hawkish.”

Market	Level	Change	% Change
Dollar Index	85.80	-.146	-0.17
EUR/USD	1.2671	.0025	0.20
GBP/USD	1.6090	.0060	0.37
USD/JPY	108.16	-.11	-0.10
USD/CAD	1.1231	.0001	0.01
AUD/USD	.8793	.0031	0.35
USD/BRL	2.4739	-.0261	-1.04
10 Year Yield	2.273	-.002	-0.09
30 Year Yield	3.050	.004	0.13
Prices taken at previous day market close.			

Given recent events with inflation and the global economy, the market is very interested to see if this has made the core of the FOMC more “dovish” or if they appear intent to stay the course. Given the rally in stocks, a slightly “dovish” statement has been priced in already.

After the Fed, the focus this week will be on inflation. The second most important event this week will be the October flash EU HICP, which comes Friday. Europe remains the major source of risk to global equities, and we need positive news on that front.

In the U.S. we also get an important inflation indicator Friday, via the “Core PCE Price Index” contained in the Personal Income and Outlays Report. The Core PCE Price Index is the Fed’s preferred measure of inflation, and for dis-inflation worries to recede further, we need to see the year-over-year number hold firm like in CPI.

Also, we get the quarterly Employment Cost Index Friday, which provided a big surprise to markets back in June when wage costs jumped higher. Remember, wage inflation begets broad inflation, so this will be watched to see if wage increases continued in Q3.

If those numbers are good, that will go a long way toward easing deflation worries in the EU and dis-inflation worries in the U.S.

From a growth standpoint, the first look at Q3 GDP comes Thursday, with expectations currently sitting just under 3.0%. Other than that we Durable Goods tomorrow and some more housing data (Pending Home Sales today, Case-Shiller tomorrow) and weekly jobless claims, which continue to hover at a near-15-year low.

Bottom line this week will be important from a Fed expectation and deflation/dis-inflation standpoint. If the Fed is dovish and the inflation numbers are steady, it will support a further rally in equities.

Commodities

Commodities were mostly lower last week as the dollar continued to stabilize. However the losses were limited as global PMI reports were in-

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line to better than expected, easing global growth concerns. The broad based commodity tracking index ETF, DBC, fell -0.50%.

Crude oil held onto support at the $80 level but finished the week in the lower part of the current $80-$84 trading range. WTI futures fell -1.16% on the week. Fundamentally the global glut in supply and unimpressive economic numbers are keeping the bears in control, and the technicals match. Crude futures remain in a sharp downtrend over the medium time frame and support at $80 is shaping up to be a "tipping point." The path of least resistance remains lower but if $80 holds, we could see prices bounce back toward $90 a barrel.

Natural gas fell -3.43% to fresh 2014 lows last week as extended weather forecasts remain moderate and supply continues to build largely on pace for inventories to reach levels seen as "normal" for entering the winter "draw season." Futures did run into some support in the mid-$3.50s, which was our initial target for our short call initiated around $3.85-$3.90. But, it doesn't appear that the selling is over just yet, with the path of least resistance remaining lower. With that said we will watch trend resistance closely in the $3.70 area; a close above that level would be considered bullish.

Moving to the metals, gold fell +0.59% last week largely as a result of traders repositioning following the in line CPI report that was released midweek. The report was interpreted as "hawkish" because it eased fears of disinflation/deflation that were spurred after the report from the month prior and, in turn, saw a dovish reaction as investors anticipated Fed action. Gold had been rallying over the past few weeks on fear bids and hedging against the volatility in equity markets, but the CPI report ended the rally. Looking ahead it seems like a retest of the support band between $1,180 and $1,200 is all but inevitable.

Industrial metals were the sole bright spot in the commodity space last week as futures rallied +1.16% on the decent PMI data. Copper however remains in a well-defined downtrend, but it bears watching here to see if the global economy can pick up and in turn spur some demand for industrial metals.

Currencies & Bonds

The Dollar Index rally resumed last week thanks to the good U.S. economic data and (more importantly) weakness in the euro following the Reuters "ECB buying covered bonds" article. It was the euro news that really drove U.S. dollar trading last week.

Both currencies have seen their respective markets get much more balanced over the past three weeks, and it's fair to say the dollar is no longer overbought nor the euro oversold. This week the FOMC is key, but the longer-term trends remain very much in place: dollar higher, euro lower. Unless the Fed surprises very dovishly, I would expect a "chop sideways" with a bid higher in the dollar over the coming weeks, but nothing like the volatility we saw over the past 2 months.

The worst performer vs. the dollar last week was the yen, which dropped -1% following news of larger than expected pension re-allocations, good economic data, and news PM Abe may delay the second half of the sales tax increase early next year. But, despite yen weakness, I'm not convinced there's a lot more to go in this trade short term, as I expect 110 in dollar/yen to be a top for a while (currently at 108). As a result, I would look to be a buyer of DXJ/seller of yen on dips from current levels, although I'm holding longer-term positions.

Turning to Treasuries, the 30-year declined modestly (down -0.7%) last week on (primarily) ECB covered bond news, good economic data and (lastly) general "risk on" sentiment, and the 10-year yield climbed back above 2.25%. But, given the huge rally we've seen in bonds, the moves were relatively muted.

The FOMC meeting obviously will affect Treasury trading if they aren't as "dovish" as expected. But the main driver of this trade remains Europe—and until the economy shows progress in Europe, Treasuries will continue to be well-supported by foreign money, despite ever-increasing "bond-negative" fundamentals here at home.

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 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 10.27.14)

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 bounced back in a big way last week thanks to the ECB considering buying corporate bonds, good global economic data, and good earnings. Concerns about global growth and EU deflation remain, but data is helping calm those worries. Near term stocks could sprint higher into the FOMC but I still remain unconvinced on new all-time highs in the near future.*

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 bounced late in the week as the stronger dollar didn't weigh on the complex as much as usual. Gold underperformed on dollar strength and general "risk on" while WTI Crude consolidated in the low $80.00's.*

Best Idea: **Buy Oil (USO)**

Best Contrarian Idea: **Buy Grains (DBA)**

	Near Term Trend	Long Term Trend	Market Intelligence
U.S. Dollar	**Bullish**	**Bullish**	*The Dollar bounced last week thanks mainly to weakness in the euro, which fell after the Reuters article regarding the ECB buying corporate bonds. The FOMC is obviously in focus this week, but unless they materially surprise markets by being hawkish I would expect a chop sideways in the dollar over the near term.*

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 declined last week but only marginally so, and definitely less than you would have expected given the huge rally in stocks. Economic fundamentals continue to be bond negative, but European money flows are still supporting Treasuries, and until the EU economy shows some life, Treasuries will be well bid.*

Best Idea: **Short "long" bonds (TBT)**

Best Contrarian Idea: **Short High Yield Bonds (SJB)**

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