

7:00's Report

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

October 28th, 2014

Pre 7:00 Look

- Futures are higher this morning as Europe rebounds from Monday's declines and China surged higher on hopes of more free market reforms.
- China was the outperformer o/n, rallying more than 2% after President Jinping said other regions should copy the Shanghai free trade zone and the government announced the merger of two large railroads.
- Economically it was quiet but Japanese retail sales did beat expectations (2.3% vs. 0.6%) sending the yen lower.
- Econ Today: Durable Goods Orders (E: 0.09%).

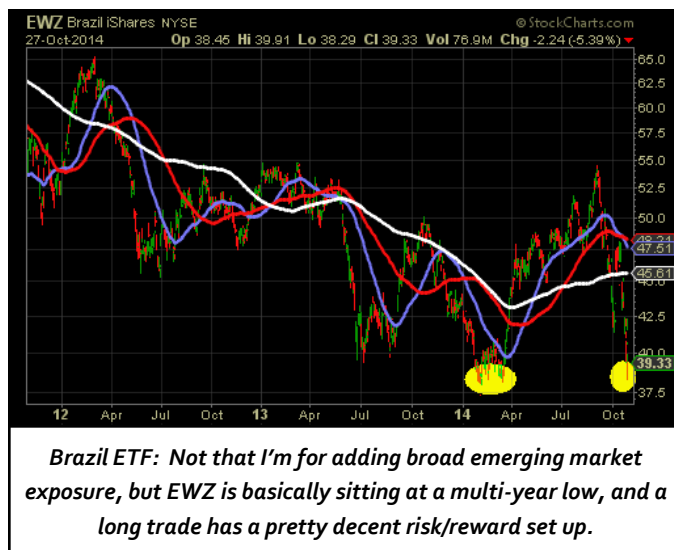
Market	Level	Change	% Change
S&P 500 Futures	1967.00	10.00	0.51%
U.S. Dollar (DXY)	85.715	.139	0.16%
Gold	1228.20	-1.10	-0.09%
WTI	81.13	.13	0.16%
10 Year	2.257	-.016	-0.70%

Equities

Market Recap

Stocks declined modestly to start the week as weakness in Europe and some uninspiring economic data weighed on the broad indices. The S&P 500 closed down -0.15%.

Stocks started out lower yesterday as European shares declined despite overall "good" European bank stress test results. But, weakness in Italy (that market was down more than -2% on poor bank test results), a big drop in the Brazilian market following a disappointing



presidential election outcome, and another Ebola headline all weighed on markets pre-open.

And, immediately following the open, the markets were greeted with two lackluster economic reports. The October flash services PMI slightly missed expectations, while Pending Home Sales was basically in-line. Stocks declined modestly throughout the morning session but the selling was very orderly and markets never felt "panicked" despite being down -0.6% at the lows.

The S&P 500 steadied within the first hour of trading, though, and a short-covering rally ensued and the index hit the highs of the day (just under unchanged) right before the European close. From there news items quieted considerably and stocks spent much of the rest of the session trading in a tight 8-point range (although after lunchtime, that range compressed even further as things got very quiet). The S&P 500 spent most of the afternoon down marginally (-0.25%) before catching a small rally into the close. Overall it was a quiet day (In stark departure from the previous two Mondays).

Trading Color

Market	Level	Change	% Change
Dow	16,817.94	12.53	0.07%
TSX	14,469.00	-74.82	-0.51%
Brazil	50,503.86	-1,437.07	-2.77%
FTSE	6,379.43	15.97	0.25%
Nikkei	15,329.91	-58.81	-0.38%
Hang Seng	23,520.36	377.13	1.63%
ASX	5,452.60	-6.36	-0.12%
Prices taken at previous day market close.			

Most indices were little-changed yesterday, as were most of the major sub-sectors, so there's not a lot to read into, frankly.

But, I do want to point out the extreme weakness in energy (XLE down -2%) and basic materials stocks (XLB down -2%). The major catalyst for the call was the GS cut in its target oil price to \$75 from the mid-\$90s and their downgrade of most of the energy sectors (services in particular).

Also contributing to the weakness in materials stocks was an earnings miss from HUN.

With regard to energy, oil held on at \$80 yesterday (a silver lining on the day), but I imagine GS won't be the last to downgrade the sector. So, while I do think there is some value in the energy names, I'd prefer to wait a bit before allocating capital to them.

Finally, on the charts I'll point out that the S&P 500 failed for a second straight day at the 100-day moving average (1,965). That's been an important technical level for well over a year, so the bulls' case will be strengthened if/when the S&P 500 gets above that level.

Europe Update

The two most important events of the day yesterday came from Europe, as that region's influence over everything continues to grow.

First, the ECB bank stress tests were the big release Sunday/Monday, and on the whole they were a positive. First, no Spanish banks failed, which was a concern. Second, 9 of the 25 failures came in Italy, which was somewhat expected. So, overall the stress tests are an aggregate positive for the region—not just because they are out of the way (they were acting as a headwind on investments, it is assumed), but also because they didn't contain any sizeable surprises.

Despite that reality, European stocks declined yesterday thanks mainly to weakness in Italy. The Italian stock

Market	Level	Change	% Change
DBC	22.10	-.06	-0.27%
Gold	1228.80	-3.00	-0.24%
Silver	17.135	-.047	-0.27%
Copper	3.064	.023	0.76%
WTI	80.71	-.30	-0.37%
Brent	85.41	-.72	-0.84%
Nat Gas	3.563	-.06	-1.66%
RBOB	2.1585	-.0232	-1.06%
DBA (Grains)	25.70	-.01	-0.04%
Prices taken at previous day market close.			

market was down more than -2% yesterday as several Italian banks got hit hard. (Monte Paschi, which you will remember from the euro-zone crisis as being one of the most troubled banks in the region, dropped more than -15%.) But, the weakness in Italy, which did weigh on Europe, was more stock-specific than it was systemic, and by itself isn't going to be a major

headwind on European markets. (Instead, there are negatives on those specific Italian banks, which make up a large portion of the FTSE MIB, or the Italian stock index.)

Second, the ECB announced it bought 1.7 billion euros worth of covered bonds last week, kick starting its "private market" QE program. The number isn't incon-siderable, but it certainly wasn't a "shock and awe" campaign. The release coincided with a Reuters article imply-ing that, internally, the ECB doesn't think it can hit its 1

trillion euro-expansion goal with-out increasing the type of assets it can buy. (This further validates the idea that the ECB will have to buy corporate bonds and eventually embark on sovereign QE like here in the U.S.)

The article didn't reveal anything new per se, but it just reinforced the fact that despite the beginning of stimulus programs, doubts remain about how committed the

ECB is to stimulating the EU economy.

Bottom line with both events yesterday was that fundamen-tally they were good (good stress test result, and the start of bond-buying by the ECB). But sentiment re-mains very negative toward the EU, and the market still needs a confidence boost either via ECB communication or an uptick in data (I think the latter is likelier over the next 2 months). Regardless, though, the news yesterday shouldn't make anyone less bullish on Europe if you



think like I do (that it's an opportunity over the medium/long term).

Economics

No material reports yesterday, as the October services PMI slightly missed (57.3 vs. (E) 58.0) but still remains at a very high absolute level. Meanwhile Pending Home Sales was in-line, further signaling the housing recovery remains solidly in motion. Neither report will change anyone's economic or Fed outlook.

Commodities

Commodities started the week mixed yesterday as energy and precious metals fell while industrial metals and the grains saw modest gains. Crude oil remains in the commodity spotlight as traders continue to speculate about global growth expectations. DBC, the benchmark commodity ETF, fell -0.27%.

Beginning with the energy markets, WTI crude oil opened the primary session just above \$80/barrel before dropping sharply to a new 2014 low of \$79.44 in the first 15 minutes of trading thanks to Goldman Sachs slashing its Q1 2015 price target from \$100/barrel to \$85/barrel. But, as we have seen multiple times over the past few weeks, the bulls circled the wagons to defend support at \$80/barrel and futures rallied over the course of the day to close little-changed near \$81. But, although support at \$80 held (which seems promising), futures printed the fifth "lower high" in a row. This is obviously a bearish signal on the charts and the near-term path of least resistance remains lower.

Bottom line, WTI is at a tipping point here just above \$80/ barrel and the threat of another leg lower (and the fact that crude has not been able to "bounce back" at all) is continuing to weigh on equity markets. And, support is beginning to get exhausted, so if we don't see a near-term reversal from \$80 in the next couple sessions, we can expect a steep decline in futures prices down into the \$70s.

Natural gas also traded down to a new low yesterday, as weather forecasts remain mild. But unlike crude oil, natural gas closed down -1.6% near the lows of the day. Nat gas is into some support in the mid-\$3.50s; however the technicals remain bearish. On the charts we continue to look up at \$3.65 as initial resistance while the next support level is below between \$3.47 and \$3.49.

Moving to the metals, gold continued to slide yesterday, falling -0.32% despite a weaker dollar (-0.26%). Gold traders are continuing to digest the flat CPI report from last week and are beginning to position ahead of tomorrow's FOMC announcement. As I mentioned in yesterday's Report, the path of least resistance for gold is toward some old support at \$1,220.

Bottom line in the gold market is that trading is largely being driven by Fed policy speculation now that the stock market and the dollar have both steadied and "fear bids" and equity hedges are being unwound. Having said that, any dovish surprise out of the FOMC tomorrow could send futures right back up toward resistance at \$1,250.

Copper rallied yesterday breaking through some near term trend resistance, and is up 0.4% this morning on supply concerns as employees are preparing to strike at the Freeport-McMoRan's Indonesia mine, the 3rd largest in the world. The strength in copper is entirely a result of this potential supply disruption and if employees follow through with the strike futures have room to run up towards multi-month resistance at the \$3.15 level. But, given that the strike is resolved in a timely manner, the "pop" would be seen as an opportunity to get short as global growth concerns remain a primary theme in the markets.

Currencies & Bonds

We saw the USD finally take a break ahead of the FOMC meeting this week. Monday's move down in the U.S. Dollar Index left it down -0.263% at 0.8555. The dollar declined courtesy

of a weaker Pending Home Sales report (coming in only +0.3% month-over-month, while most economists

Market	Level	Change	% Change
Dollar Index	85.575	-.243	-0.28%
EUR/USD	1.2707	.0037	0.29%
GBP/USD	1.6126	.0038	0.24%
USD/JPY	107.71	-.43	-0.40%
USD/CAD	1.1237	.0008	0.07%
AUD/USD	.8799	.0005	0.06%
USD/BRL	2.5213	.048	1.94%
10 Year Yield	2.257	-.016	-0.70%
30 Year Yield	3.034	-.016	-0.52%
Prices taken at previous day market close.			

were looking for a +0.1 number) and euro strength.

The euro was the best performer vs. the U.S. dollar and this was a continuation from the overnight news of the EU banks' stress test. Despite ominous headlines about the state of banks in Europe, it was a big relief that no Spanish banks failed. Plus, the banks that did fail look to be small enough that, while the recovery may be hitting a bump in the road ahead, nothing will block the road.

Turning to the ECB, we did see the central bank announce that it purchased \$1.7B in covered bonds last week, and this is a start in what it is trying to do with its own version of QE. But, that number won't be enough to quiet the ECB doubters, and what remains in question is how much more they will remain committed to these purchases.

So, between short-covering off "not as bad as feared" bank stress test results and some euro buying on uninspiring ECB bond purchases, the euro had a good bid yesterday (although it's not materially bullish).

As one might expect, the one big mover on the currency board today was the Brazilian real. The largest traded currency in the world took a hit after the pro-business candidate came up short in the presidential election. Lame duck president Dilma Rousseff secured a second term and the hopes for a more proactive business government is fading here in the near term. The only thing I'm thinking is that Brazil has managed to stay on the path of growth in the past few years, and it should at least be able to continue with the status quo (which probably means the real, and perhaps EWZ, is a buy here, although I'd like to see some stabilization before taking a risk).

The Japanese yen didn't see much action Monday and we may not see anything too exciting from the Asian currencies until we get a clearer picture from the FOMC meeting on Wednesday. Right now we're seeing a balancing of books and some risk reduction.

U.S. Treasuries rallied yesterday (30-year at 3.03%, 10-year 2.26%), but closed off their highs of the day. We're also seeing some quiet times here as rate traders are sitting patiently on the sidelines until after the FOMC meeting.

There are also a few auctions (2-year Tuesday, 5-year Wednesday and the 7-year on Thursday) this week to keep everyone guessing on the demand side.

At this point it's almost a widely accepted idea that the Fed will end QE at this meeting, but it's the timeline for the eventual rate hike that has kept investors on their toes. We are expecting one in 2015, but whether that comes in Q2 or as late as Q4 is going to depend on the pace of growth in the U.S. economy.

Bottom line, there's not a whole lot of fear the FOMC will be "hawkish" at this meeting, so we may see a rally in Treasuries going into the new statement. Keep in mind, though, that while the FOMC may "talk" dovish, they continue to reference mid-2015 as the time of rate "liftoff."

Have a good day,

Tom

Tactical Trading/Investment Account (Time frame of a few weeks to months).

<u>Date</u>	<u>Position</u>	<u>Open Price</u>	<u>Stop</u>	<u>Strategy</u>
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).

<u>Date Initiated</u>	<u>Strategy</u>	<u>Position (s)</u>	<u>Investment Thesis</u>
November 2012	Long Japan	DXJ/YCS	The election of Prime Minister 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.
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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.

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.

	<u>Near Term Trend</u>	<u>Long Term Trend</u>	<u>Market Intelligence</u>
Stocks	Neutral	Bullish	<i>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.</i>
Best Idea: Buy Regional Banks (KRE). Best Contrarian Idea: Buy Energy (XLE)			
Commodities	Bearish	Bullish	<i>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.</i>
Best Idea: Buy Oil (USO) Best Contrarian Idea: Buy Grains (DBA)			
U.S. Dollar	Bullish	Bullish	<i>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.</i>
Best Idea: Sell the Yen (YCS) Best Contrarian Idea: Long British Pound (FXB)			
Treasuries	Neutral	Bearish	<i>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.</i>
Best Idea: Short "long" bonds (TBT) Best Contrarian Idea: Short High Yield Bonds (SJB)			

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