7:00's Report

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

October 30th, 2014

Pre 7:00 Look

- Futures are lower and European shares have turned negative as peripheral concerns about a slightly more "hawkish" Fed outweigh good economic data.
- Despite European stocks trading lower, economic data from the EU o/n was good: Spanish GDP was in line with estimates, German unemployment saw the first drop since July, and EU Economic Sentiment beat expectations at 100.7 vs. (E) 99.5.
- Econ Today: Jobless Claims (E: 280K), Advanced Q3 GDP (E: 3.0%). Fed Speak: Yellen (9:00 AM).

Market	Level	Change	% Change
S&P 500 Futures	1962.25	-10.00	-0.53%
U.S. Dollar (DXY)	86.30	.264	0.31%
Gold	1205.70	-19.20	-1.57%
WTI	81.35	-.85	-1.03%
10 Year	2.323	.039	1.71%

Equities

Market Recap

Stocks declined Wednesday thanks to a slightly more "hawkish" Fed statement than expected, but the selling pressure wasn't significant and stocks bounced hard from intraday lows. The S&P 500 declined -0.14%.

Yesterday was totally Fed-dominated, as stocks largely ignored earnings early (in particular the disappointing FB expense guidance) and drifted near the flat line right through lunchtime. There were no economic reports or other news to move markets pre-Fed.

Regional Banks (KRE) were one of the few "winners" from yesterday's hawkish FOMC meeting, although KRE will need to trade through 39.75 to break a 6 month downtrend.

Despite the expectation that the Fed statement would be "dovish," stocks declined in the hour preceding the release, most likely on some late longs booking profits ahead of the statement.

That proved prudent as the statement was taken as more "hawkish" than expected. Stocks immediately sold off after 2 o'clock, hitting their lows about 15 minutes after the release. But, as usual, the algos and momentum funds overreacted, and stocks bounced back almost immediately to trade "flat" post-FOMC. This trading "noise" continued until about 3:15 when it seemed like actual people traders woke up and realized the statement wasn't *that* hawkish. Stocks rallied nearly 10 points in the final 45 minutes of trading to finish very slightly lower on the day, but again well off the lows.

Trading Color

Most of the major indices traded more or less in line with one another, although technically the Russell underperformed but just barely (down -0.27% vs. -0.14%). This reflects the quiet nature of trading yesterday despite the headline gyrations post-FOMC (there was never any conviction to the declines after the statement).

Market	Level	Change	% Change
Dow	16,974.31	-31.44	-0.18%
TSX	14,527.57	-96.68	-0.66%
Brazil	51,049.32	-1,280.71	-2.45%
FTSE	6,411.58	-42.29	-0.66%
Nikkei	15,658.20	104.29	0.67%
Hang Seng	23,702.04	-117.83	-0.49%
ASX	5,476.20	28.52	0.52%
Prices taken at previous day market close.			

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Broadly, seven out of the 10 S&P 500 sub-sectors declined. But outside of basic materials, which got hit on more bad earnings, most of the declines were mild and there was no real underperformance of cyclicals vs. defensives.

Market	Level	Change	% Change
DBC	22.53	.25	1.12%
Gold	1211.50	-17.90	-1.46%
Silver	17.075	-.151	-0.88%
Copper	3.0810	-.012	-0.39%
WTI	82.18	.76	0.93%
Brent	87.05	1.02	1.19%
Nat Gas	3.79	.059	1.58%
RBOB	2.1837	.0285	1.32%
DBA (Grains)	25.88	.14	0.54%
Prices taken at previous day market close.			

More specifically, though, there were two themes to note: First, until the FOMC meeting, energy (XLE) was by far the outperformer. XLE was up more than +1% on a continued rebound following the quasi-positive comments about oil by OPEC Secretary General Abdullah el-Badri. (He said he didn't see much change in production in 2015 and that both supply and demand are still growing. And, he downplayed the recent drop in prices, although that's what expected of an OPEC Secretary General.) Post-FOMC, the energy complex came in as oil declined on dollar strength, although XLE is continuing to try and stabilize at these levels. If crude continues to rally, we'll see a lot more upside in XLE over the short term.

The other theme in sector trading yesterday was the outperformance of higher interest rate sensitive names. Banks were the best performing sector yesterday as KRE and KBE both rallied more than +1% and now they have totally retraced the late September declines. Conversely, utilities and REITs underperformed. I'll cover the FOMC more later, but there was a subtly hawkish shift yesterday. And as long as the market grinds sideways or higher, banks (specifically regionals) remain one of the more attractive sectors out there if you are looking for higher-beta long exposure.

Despite the declines yesterday, selling was both orderly and on low volume, and most of the immediate declines were driven by day traders and fast money, so don't read too much into the moves.

On the charts things remain constructive with resistance at 1,991 and then 2,000, while support lies lower at the 50-day MA (1,967).

Bottom Line

I had said last week that I saw two potential positive catalysts on the horizon that could push the S&P 500 higher towards 2000: A "dovish" FOMC meeting and a Republican win in the mid-terms.

Clearly, the first of those did not materialize as the FOMC was not "dovish" as everyone expected. So, I view yesterday's marginally "hawkish" statement not so much as a new headwind on stocks, but instead as the removal of a potential positive short term catalyst. Importantly, though, the FOMC didn't make any radical changes and it's not like yesterday's statement is going to cause stocks to decline materially from here.

My thesis for the past two weeks has been that stocks grind into the upper 1900's and then chop sideways, and the "hawkish" FOMC furthers that opinion.

Focus domestically now turns to the mid-terms, which are another potential positive short term catalyst, although I still do not see what's going to push the S&P 500 materially though 2000 in the coming weeks (a Republican victory likely won't be that much of a positive). As a result, while using hindsight I would have loved to have bought the market at 1850 two weeks ago, I continue to be hesitant to add new capital at these levels, simply because I don't like the risk/reward set up.

If there was one "winner" from yesterday's FOMC, though, I believe it's the regional banks (KRE) and to a slightly lessor extend the larger banks (KBE). Rates, especially shorter term, should be stable now, and that will help remove a headwind from the banks—and with an economy that's still growing, there's the potential there to outperform.

Economics

FOMC Meeting and Statement

- No change to rates, as expected.
- The Fed ended the current QE program, as expected.

Takeaway

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The FOMC statement was marginally "hawkish" for two main reasons:

First, the Fed somewhat significantly upgraded its outlook on the jobs market, and it altered "significant underutilization of labor resources" and replaced it with "underutilization of labor resources is gradually diminishing."

Second, the Fed did not downgrade the outlook for inflation at all, and somewhat dismissed the recent drop in CPI. This is important because it implies the FOMC views this dip in CPI (and the threat of "dis-inflation") as something commodity-driven and temporary. And, at this point the statement implies the CPI decline isn't going to make the FOMC more "dovish" nor delay the expected "lift off" date for interest rates, which is still mid-2015 (according to the Fed).

Finally, this isn't as clear-cut, but the fact that there was only one dissent by uber-dove Kocherlakota—and no dissents by "hawks" Plosser and Fisher (who both dissented at the September meeting)—implies a slight "hawkish" shift by the core of the committee, specifically that the bar for getting the FOMC to turn dovish may be higher than the market currently expects.

Market reaction, at least initially, was textbook "hawkish." Stocks sold off moderately, gold collapsed and bonds declined. But the big move was in the dollar, which surged to a six-week high. Other than the dollar and gold, though, most of the moves were largely retraced by the end of trading yesterday, which is the appropriate reaction.

The bottom line, is that the FOMC appears slightly more committed to policy normalization than the market may have previously thought. The drop in CPI, risks to global growth, and declining stock market volatility didn't cause the FOMC to waver, and to a point that is a surprise to the market (remember one of the contributors to this "V-Shaped" bounce was the thought of a still very dovish Fed.

Market	Level	Change	% Change
Dollar Index	86.085	.612	0.72%
EUR/USD	1.2635	-.0099	-0.78%
GBP/USD	1.6012	-.0118	-0.73%
USD/JPY	108.87	.73	0.68%
USD/CAD	1.1189	.0025	0.22%
AUD/USD	.8793	-.0061	-0.69%
USD/BRL	2.4609	.0003	0.01%
10 Year Yield	2.323	.039	1.71%
30 Year Yield	3.048	-.009	-0.29%
Prices taken at previous day market close.			

I believe the market will look to the Fed a bit more "hawkishly" going forward, but nothing yesterday would change any expectation of policy—nor does it present a material, new headwind toward equities. But, generally speaking, the Fed is no longer as strong an ally to stocks as it has been in a literal sense (no more QE) and a figurative sense (via dovish language). And, that's another reason I think the likeliest move for stocks over the coming weeks is a "chop" sideways rather than a sprint to new highs.

Commodities

Like all other asset classes, the FOMC was in focus for commodity traders yesterday. The hawkish announcement, which sent the dollar soaring, pushed gold down to fresh multi-week lows and caused oil futures to fall back from session highs (although they did close higher on the day). The broad-based commodity tracking index ETF, DBC, rallied +1.12%.

Beginning with gold, the most-sensitive commodity to any Fed news, futures fell -1.55% yesterday on the hawkish FOMC announcement. Of the two reasons the announcement was hawkish, it was the fact that the Fed did not even acknowledge the inflation/deflation situation that influenced the sharp sell-off in gold.

As I mentioned last week, gold reversed direction and started to fall back from the mid-$1,200s because the CPI report was in line as opposed to negative, which eased concerns of deflation (remember, although deflation is technically gold-bearish, the potentially dovish reaction from the Fed is what caused gold to rally toward $1,250 in the first place).

Gold fell to a 3-week low yesterday on the hawkish FOMC statement, and the technicals are bearish. On the charts, there is resistance at former support of $1,225 while the even $1,200 level is in focus on the downside.

Copper was continuing higher yesterday, as has been the trend for over a week now, but the hawkish FOMC (and subsequent spike in the dollar) caused copper to give back all

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of the morning gains and then some as futures closed down -0.40%. It appears that yesterday capped the short-term, counter-trend rally in copper and the medium-term multi-month downtrend has resumed.

On the charts, material resistance is higher still, toward \$3.13, while initial support is below between \$3.05 and \$3.06. Looking ahead, and as is the case with gold, traders will be looking to today's GDP report as they speculate the health of the U.S. economy and future demand of industrial metals.

Moving to energy, crude oil continued to trade better yesterday, finishing higher for the second day in a row with WTI futures rallying to a one-week high. Intraday, WTI reversed from the highs after the FOMC announcement, giving back nearly -1% in gains; however, futures still closed up +1.09%. Prices fell back from the highs for two reasons: First, the surging dollar weighed on all commodities including the energy space, and second, because equities pulled back and traded to session lows, crude and stocks are still trading with a high degree of correlation. Bottom line though, crude oil finished the session, right in the middle of the current trading range between \$80 and \$84.

Elsewhere in energy, natural gas futures jumped +1.77% thanks to a roll in futures contracts (the active month shifted forward from November to December) as well as a cold blast moving across the country that is expected to hit the country this weekend. This should spur natural gas demand to satisfy heating needs. On the charts, the near-term technicals are bullish while the medium term is more neutral. There is resistance at \$3.85 and support below between \$3.73-\$3.75. Today, traders will be watching the EIA inventory report closely and analysts are calling for a build of 82 Bcf.

Currencies & Bonds

Yesterday was all about the Fed as most currencies were flat into the statement release. As you'd expect, given the "hawkish" interpretation of the statement, the Dollar Index rallied hard following the Fed and finished .66% and that rally is continuing this morning as the Dollar Index is now at a near 8 week high.

With the dollar so much stronger, we saw universal weakness in other currencies, and the fact that they all basically declined equal amounts tells you this was all in reaction to the dollar. The euro, pound, yen and Aussie were all basically flat heading into the FOMC statement, and all finished the day down about -0.65%. Other than a decent Industrial Production report in Japan, there was little economic news in any of these countries, leaving trading at the mercy of the Fed and dollar.

The one exception was the Loonie, which was actually materially higher vs. the dollar most of the day, but declined sharply with other currencies post-FOMC to close fractionally lower. The "positive" catalyst for the Loonie was a disappointing PPI report yesterday morning, which is stoking some dis-inflation fears in Canada (remember, with the Bank of Canada firmly "on hold" with regard to rates, deflation is currency-*positive* like it is in Europe because it increases the value of cash). It's very unlikely Canada will face dis-inflation, but yesterday that was why the Loonie was well-bid. Going forward, though, I remain a committed Loonie "short" and think this is probably a decent area to lay out some short exposure if you trade currencies.

Bonds ended the day lower but not materially so, as they recovered from an initial spike lower following the FOMC statement, and that makes sense as it wasn't as "hawkish" as the initial -0.7% decline in the 30-year implied.

Contributing to the weakness in bonds was a soft 5-year auction that came out pre-Fed. The bid to cover was 2.39, the lowest since July 2009, and bidding there was soft as the actual yield was more than 1.5 basis points higher than the "when issued." But, it remains essential to look at Treasuries on a relative value basis, and even despite a slightly more "hawkish" Fed and lack of domestic demand for low-yielding debt, Treasuries remain very attractive to international investors. Until we get more signs of progress in Europe, Treasuries will remain well-bid and well-supported.

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 10.27.14)

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)			
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)			
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)			
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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