7:00's Report

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

October 31st, 2014

Pre 7:00 Look

- Futures are surging and global markets are universally higher after the Bank of Japan surprisingly unleashed another massive round of economic stimulus.
- The BOJ announced it will nearly double their current QE program and double and triple ETF and stock holdings, sending the Nikkei to a 7 year high and the yen to a 7 year low.
- Everything took a back seat this morning but importantly EU flash HICP was again underwhelming (up 0.7% yoy) and that's adding more pressure on the ECB to do "more."
- Econ Today: Personal Income and Outlays (E: 0.3%), Employment Cost Index (E: 0.5%).

Market	Level	Change	% Change
S&P 500 Futures	2011.25	22.75	1.14%
U.S. Dollar (DXY)	86.69	.458	0.53%
Gold	1172.80	-25.80	-2.15%
WTI	80.55	-.57	-0.70%
10 Year	2.305	-.018	-0.77%

Equities

What you need to know about Japanese Stimulus

The entire focus of the market this morning (and the reason futures are up so much) is the surprise stimulus from Japan, so I'm leading with that analysis this morning:

Bank of Japan/Japanese Stimulus Measures

- The BOJ voted 5-4 to significant increase stimulus.
- The QQE program will now buy 80 trillion yen worth of government bonds per year, up 30 trillion from the previous 50 trillion.
- The BOJ will triple its purchases of domestic ETFs/REITs.
- The BOJ will double its holdings of domestic stocks.
- Japan's General Pension Investment Fund (GPIF) will reduce its portfolio holdings of domestic bonds from 60% to 35%, and increase it's holding of domestic stocks from 25% from current 12%, and increase its holdings of foreign stocks to 25% from current 12%.

Takeaway

This was a shocking, massive expansion to the current stimulus packages in Japan, and frankly is very negative for the yen and very, very bullish for Japanese stocks. There was essentially **zero** expectation coming into this meeting that 1) the BOJ would announce more stimulus, and 2) That even if they did it would be *this* big. Markets are seldom caught totally by surprise—this is one of those times.

The Nikkei jumped over 5% on the news while the dollar/yen soared through 111 (declining in value by more than 2%), and while we may see some consolidation today or Monday, both trends (DXJ up, yen down) are clearly in motion again. Not only is the BOJ stimulus a positive for Japanese stocks/negative for the yen, but almost more importantly the GPIF allocation changes will put a big under stocks/selling pressure on the yen over the coming months and quarters.

Bottom line, the economic impact of this is unclear, but these moves will make Japanese stocks rise and the yen decline vs. the dollar. DXJ remains, by far, the best way to buy Japanese stocks as it hedges out the yen declines (it is the better option compared to EWJ) while YCS remains the easiest way for most investors to short yen.

Market	Level	Change	% Change
Dow	17,195.42	221.11	1.30%
TSX	14,458.69	-68.88	-0.47%
Brazil	52,336.83	1,287.51	2.52%
FTSE	6,537.68	74.13	1.15%
Nikkei	16,413.73	755.56	4.83%
Hang Seng	23,998.06	296.02	1.25%
ASX	5,526.60	50.40	0.92%
Prices taken at previous day market close.			

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As I've said in the past, if a central bank wants to destroy their currency and makes stocks go up in nominal terms, they can do it. The moves may not make the economy better, but from an investment standpoint the "Japan longs" have a big partner in the BOJ once again.

We already owned DXJ/YCS in longer term portfolios, and we will be adding to those positions over the next few days (we'll divide the buying over the next 2-3 days given the big jump we will see this morning in DXJ/YCS).

Market	Level	Change	% Change
DBC	22.37	-.17	-0.75%
Gold	1198.80	-26.10	-2.13%
Silver	16.41	-.854	-4.95%
Copper	3.06	-.0445	-1.43%
WTI	81.07	-1.13	-1.37%
Brent	86.12	-1.00	-1.15%
Nat Gas	3.833	.045	1.19%
RBOB	2.1588	-.0228	-1.05%
DBA (Grains)	25.74	-.14	-0.54%
Prices taken at previous day market close.			

Market Recap

Stocks rebounded Thursday thanks to good earnings and a better than expected headline Q3 GDP report. The S&P 500 closed up +0.62%.

Stocks were flat for most of the morning session despite a series of positive catalysts. Headline Q3 GDP was better than expected, earnings were good (highlighted by V and MA), and the ECB announced that it will begin purchasing Asset-Backed Securities (ABS) in November.

Despite the positive catalysts, though, stocks spent most of the morning near flat (the exception was the Dow, which was up on V earnings), as concerns about the "hawkish" Fed weighed a bit on sentiment.

Intraday positioning continued to dominate the daily direction of this market Thursday. After the initial 30 minutes of selling, and despite any actual news, Fed concerns evaporated and buyers stepped in to buy the dip. Stocks began a methodical march higher, which accelerated during the 1 o'clock hour (the S&P 500 sprinted higher by 10 points once it broke through 1,990 to hit a high of the day just under 2,000).

But, the buyers ran out of gas at 2,000 as there was solid resistance at that level, and stocks fell back to retrace the afternoon move higher into the close.

Trading Color

The Dow Industrials were the big outperformer yesterday, as that index doubled the performance of the S&P 500, rallying +1.3% vs. the SPX +0.62% gain. But, that strength was due in large part to the V rally, as it's a higher-dollar stock and the Dow is a price-weighted index, so the effect was outsized.

The Nasdaq also underperformed (up just +0.36%) thanks mostly to weakness in semiconductors (the SOX was down -1.3%) on some weak earnings. Broadly, though, the index moves were governed much more by earnings than any sort of macro trade.

Looking at the sectors, utilities and healthcare were the outperformers yesterday (both up +2%) as the two sectors surged thanks to earnings. Healthcare also rallied thanks to good earnings yesterday (specifically BMY and ABC) while the move seems to be a "catch-up" to good earnings Wednesday from EXC. (Remember, utilities got hit on the "hawkish" FOMC statement, but as the reality that the Fed wasn't that "hawkish" set in, investors moved to buy the dip in the utilities.)

Outside of those two sectors, gains were broad and moderate. Consumer discretionary, staples, basic materials and financials all rallied about +0.55% each.

Energy reversed the recent trend and lagged yesterday on renewed WTI crude weakness. Despite there being "value" in a lot of those names, it seems the rallies in XLE are eliciting more selling pressure than anything else. I'm not sure energy is out of the woods yet and would remain on the sidelines there.

Is the Oil/S&P 500 Link Broken?

Interestingly, the S&P 500 was able to rally this week despite any material move higher in oil (and yesterday the S&P 500 was up despite a -1% loss in oil). We (and many others) have been watching WTI crude as a leading indicator for stocks for the last month, and that has been a pretty reliable indicator.

But, it would appear now that unless WTI materially break down below $80 (which is possible but unlikely unless something out of left field occurs), the "link" between stocks and the price of oil appears to be broken,

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and as such oil isn't the "leading indicator" of stocks that it has been. Obviously that can change if oil breaks down, but for now it appears stocks and oil are taking a break from each other, which leaves Europe as the main leading indicator for global markets.

Economics

Advanced Q3 GDP

- Q3 GDP rose at 3.5% saar vs. (E) 3.0%.

Takeaway

Third-quarter GDP was decidedly stronger than expected on the headline, but the reasons for the beat aren't the highest quality and, in all likelihood, "pulled forward" growth from Q4. Bottom line, this was a good report, but not quite as good as it seemed.

Starting with the positives, though, final sales of domestic product—which is GDP excluding inventories (and a better measure of actual economic production)—rose +4.2%, up from +3.2% in Q2.

But, other than that, the details of the report weren't that great, and it's caused a few asterisks to be placed next to the stronger than expected 3.5% headline number.

Asterisk #1: Potentially soft consumer demand. First, PCE, consumer spending, rose at 1.8% vs. (E) 1.9%, and declined from 2.5% in Q2. Second, despite a stronger dollar, imports declined 1.7%, potentially reflecting softer than expected consumer demand.

Keep in mind that imports subtract from GDP, so negative imports actually artificially boost GDP (a negative is a positive) as was the case this quarter (but again, it doesn't reflect economic strength).

Asterisk #2: Government spending rose at a 4.6% annual rate in Q3, with most of the increase coming from defense spending, which rose 16% annualized (ISIS campaign).

Market	Level	Change	% Change
Dollar Index	86.225	.189	0.22%
EUR/USD	1.2609	-.0022	-0.17%
GBP/USD	1.6001	-.0008	-0.05%
USD/JPY	109.23	.35	0.32%
USD/CAD	1.1191	.0013	0.12%
AUD/USD	.8832	.0035	0.40%
USD/BRL	2.4039	-.057	-2.32%
10 Year Yield	2.305	-.018	-0.77%
30 Year Yield	3.036	-.012	-0.39%
Prices taken at previous day market close.			

Bottom line, it's unlikely that the decline in imports (due to the ever-strengthening dollar) and the pace of government spending will continue in Q4. As a result, this stronger than expected report likely "pulled forward" growth.

That said, while not as good as it seems, it's still a decent economic report and it gives us no reason to believe the economic recovery is wavering—nor does it provide any reason to believe it's about to accelerate. So, it's steady as she goes (but don't believe the media outlets that touted this as a "strong" number—it wasn't).

Commodities

Commodities were collectively lower yesterday as the dollar rallied for the second day in a row. The sole exception was natural gas, which rallied on inventory data and weather. The broad-based commodity ETF, DBC, fell -0.78%.

The metals were the hardest-hit in the commodity space yesterday as the stronger dollar weighed on both the precious and industrial varieties.

Beginning with precious metals, gold lost -2.10% and fell back to flat for the year; meanwhile silver futures plummeted nearly -5% yesterday to close at a 55-month low. Since Wednesday's FOMC release, gold has been in a sharp downtrend as the "Fed policy backdrop" has shifted slightly more hawkish. So the stronger dollar paired with rallying equities is putting a fair amount of pressure on precious metals.

And, the surprise news out of the BOJ overnight has sent the dollar soaring back towards 4 year highs and in turn, gold has fallen sharply through multi-year support at $1180 (dropping as low as $1166 as of this writing). Currently, the gold market is dominated by currency trade, and this most recent leg higher in the dollar as a result of the additional QE in Japan is going to keep the selling pressure on gold.

As I pointed out in yesterday's Report, Wednesday did indeed turn out to be a near-term "top" in copper as futures fell -1.35% for the second day in a row yesterday. The stronger dollar is certainly weighing on copper; however, there are

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also a lot of shorts re-initiating positions after being stopped out during the rally earlier in the week on the Freeport-McMoRan strike headlines.

Bottom line, the fundamentals of the copper market are pretty well-balanced with prices around $3.00, and with supply relatively consistent, we will need to see a material shift in economic data/global demand metrics to see the market move materially one way or another. On the charts there is trend resistance at $3.13 while the first line of support is below at $3.04.

Moving to energy, WTI crude oil prices fell -1.50% yesterday, giving back all of Wednesday's gains and returning to flat for the week. As was the case with most other commodities yesterday, the stronger dollar weighed on oil prices, but traders are also continuing to digest ample supplies with lackluster economic data around the globe. Bottom line in oil, the market remains in consolidation after the 25%+ drop that occurred from mid-summer to early October. And, although the technicals continue to favor the bears, $80 is proving to be a stubborn support level and will be in focus in the coming sessions.

Elsewhere in energy, it was inventory day for natural gas, but the EIA report was close enough to in-line with expectations (+87 Bcf vs. E: +82 Bcf) that speculative traders buying up futures because of imminent cold weather pushed prices higher by +1.9%. There is without a doubt some momentum behind the rally in natural gas futures right now; however I believe it's largely weather-driven, which is in turn causing short-covering. Once the rally runs out of steam, an opportunity to get short again may present itself. But until we get a clear signal on the charts, we will be in "wait and see" mode.

Currencies & Bonds

The U.S. Dollar Index is continuing the rally as the tone of the FOMC meeting yesterday is still ringing in traders' ears. We saw it settle yesterday at 86.23 to ease off the three-week high we saw during the day. Once the currency traders digested the GDP number, they drilled down on the fact that the whole number is not as good as advertised.

Yesterday the euro slipped on the U.S. dollar strength and soft numbers on the German CPI (-0.3). The moves in the currency here were relatively muted ahead of the HICP (euro down -0.28%). The euro shrugged off the announcement of ABS purchases in November and the market still remains skeptical. This morning the flash October HICP (the EU CPI) wasn't very good either. The most important part of the release, the core year over year change in HICP, declined to 0.7% from September 0.8% (in line with expectations). While not a truly negative shock, it does reinforce that deflation remains a major threat in the EU and adds to the pressure for the ECB to do "more" which is why the euro is trading .4% lower this morning (this report incrementally increases the chances of the ECB buying corporate bonds and eventually QE).

The bond market bounced back a bit (30-year up +0.15%) despite stronger than expected GDP thanks mainly to soft German CPI (0.8% yoy vs. (E) 0.9% and -0.3% m/m vs. (E) -0.1%.

We also saw a third straight weak auction, this time of 7 year Treasuries: The bid to cover came in at 2.42, the lowest of the year. The actual yield was 1 basis point above the "when issued," suggesting soft bidding again. Even though the Fed's primary dealers rated this auction at a "3," we're still far from an outstanding rating of "5."

Overall, more concerns about deflation in Europe are trumping the lack of demand for Treasuries at auctions. We are getting a slightly more "hawkish" Fed, so money flows are trumping the fundamentals, which has been the theme of the Treasury market all year (and it continues).

Have a good weekend,

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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