7:00's Report

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

October 8th, 2014

Pre 7:00 Look

- Markets were mostly stable overnight following the big US sell off and futures are flat as everyone takes a collective breath. News was quiet o/n.
- Economically the only number of note was Chinese Composite PMIs, which slightly missed estimates (52.3 vs. (E) 52.8). But, Chinese markets actually rallied on hopes of more stimulus.
- Econ Today: FOMC Minutes (2:00 PM). Fed Speak: Evans (8:30 AM).
- Earnings Today: AA (E: $0.21).

Market	Level	Change	% Change
S&P 500 Futures	1930.00	2.00	0.10%
U.S. Dollar (DXY)	85.795	.017	0.02%
Gold	1218.60	6.20	0.51%
WTI	88.01	-.84	-0.95%
10 Year	2.35	-.075	-3.09%

Equities

Market Recap

Stocks dropped sharply again Tuesday on more global growth concerns. The S&P 500 smashed through key support at the 100-day MA and fell -1.51%.

There were multiple negative influences on equities yesterday. Stocks opened lower in sympathy with European shares, which were lower on a poor German Industrial Production report.

Stocks then continued lower after the IMF released a

The S&P 500 crashed through support at the 100 day moving average yesterday, and if we don't recover in the next day or two, the technical outlook gets much worse.

statement saying they were going to lower 2015 growth forecasts.

Also weighing on the averages was some bad earnings results from SODA (down -22%), CREE (down -5%) and AGCO (down -11%).

But as has been the case recently, stocks steadied and tried to rally after the European close at 11:30.

But, despite multiple attempts, the market couldn't lift throughout the early afternoon. By the time 3 o'clock rolled around, it was clear we weren't going to get back above that 100-day MA. Bids disappeared and sellers got aggressive as the market took a nosedive into the close, finishing the day basically on the lows.

Trading Color

Yesterday was a pretty classic "risk off" day, as cyclicals led to the downside and selling was broad. Despite holding up (relatively) for most of the day, the Russell 2000 finished down -1.7%, again lagging the S&P 500.

Sector-wise, things went about as you'd expect: Alt-

Market	Level	Change	% Change
Dow	16,719.39	-272.59	-1.60%
TSX	14,576.45	-166.67	-1.13%
Brazil	57,436.33	320.43	0.56%
FTSE	6,456.27	-39.31	-0.61%
Nikkei	15,595.98	-187.85	-1.19%
Hang Seng	23,263.33	-159.19	-0.68%
ASX	5,241.27	-42.93	-0.81%
Prices taken at previous day market close.			

hough there was clearly a bit of a "global growth concern" evident in the sector trading, industrials led to the downside (XLI fell -2.4%) while basic materials declined -1.7% (both sectors are leveraged to global growth).

From there we saw general cyclical underperformance, as financials, consumer discretionary, and tech all declined around -1.5%.

Also as expected, utilities and consumer staples relatively outperformed (the declines were minimal) based on a safety bid as yields collapsed.

Market	Level	Change	% Change
DBC	23.04	-.08	-0.35%
Gold	1211.30	4.00	0.33%
Silver	17.15	-.075	-0.44%
Copper	3.0365	.001	0.03%
WTI	88.80	-1.54	-1.70%
Brent	92.04	-.75	-0.81%
Nat Gas	3.941	.043	1.10%
RBOB	2.366	-.0472	-1.96%
DBA (Grains)	26.415	-.025	-0.09%

Prices taken at previous day market close.

On the charts, it was obviously a bad day: The S&P 500 smashed through the 100-day MA for a second time, making it the first "double break" of that average since it started acting as key support over a year ago. 1,926 (the Thursday spike low) and then 1,903 (the 200-day MA) are now key support levels.

Bottom Line

Stocks are dropping for two reasons: First, sentiment toward Europe is awful as there is a two-headed monster of collapsing economic data and a perceived lack of will by the ECB. (This was exacerbated yesterday by German ECB member Jens Weidmann's interview with the WSJ, which seemed to downplay risks.) The two negative catalysts people are keying on recently there are the soft TLTROs and the three dissents from the last ECB meeting.

Second, the U.S. is showing signs of dis-inflation while at the same time the Fed appears more and more committed to tightening policy. Specifically, the drop in the 5- and 10-year inflation breakevens, which we covered in this Report last week, continue to decline. And, yesterday, former Fed Vice Chair Dudley implied that he now views the low labor participation rate as a structural problem, not a cyclical one. (That matters because the Fed can't fix structural problems, and as such is inclined to not keep rates low to help inflation if the problem is viewed as structural.)

So, brining it back to our "4 Pillars of the Rally," they remain intact. But as we've been saying, these two are under pressure. Pillar 1: Globally accommodative central banks are obviously in flux with regard to when the Fed and BOE will raise rates. Pillar 2: The global economic recovery is obviously being undermined by consistently weak data from Europe, China and Japan.

So, the keys to see when this ends now are 1) Europe (and European data) and 2) Inflationary pressures in the U.S./commodity prices, which if both lift will alleviate dis-inflation concerns.

The FOMC minutes being mildly dovish will be a good step forward today, but after that things get pretty quiet until earnings ramp up early next week (which isn't what we need right now)

From a risk/allocation standpoint, obviously there is a heightened sense of concern given that the technical outlook for this market is bad and getting worse. But, I still want to see JNK break down further to confirm we do need to materially de-risk, as even now we can't discount the previous resiliency of this market. Europe can (and likely will) fix itself as stimulus starts to work through the system and the weaker euro benefits companies. And, most of the "dis-inflation" in the U.S. is commodity-based, not structurally economically based.

If commodity prices stabilize, we'll see dis-inflation pressure alleviate. Point being—nothing has materially changed for the worse during the last two weeks, but the potential is there. For now, though, I am holding firm, nervously.

Economics

No reports yesterday.

Commodities

Commodities were mixed yesterday as the IMF lowered their expectations for global growth in 2015, which obviously weighed on 2015 commodity demand estimates. Energy was the hardest-hit, with crude oil falling as much as -1.5% while gold caught a "fear bid." The benchmark commodity ETF, DBC, fell -0.3%.

Gold rallied +0.41% yesterday thanks to "economic fear bids" introduced by the "IMF growth concerns" headlines that hit in the morning. The slightly weaker dollar (-0.17%) also contributed to precious metals gains.

Gold futures continue to move with sensitivity to the dollar; however, concerns over the global economy are starting to have a larger influence on precious metals trading as investors seek safe-haven assets (note the surge in bonds yesterday).

Oil: Yes, higher supply is a factor, but this decline is more about growth. Oil forecasted this slowdown in global growth, so we are again viewing oil as a leading indicator for global growth, and we'll feel a lot better when it bottoms. Watch oil.

On the charts, gold broke out above some low time frame resistance, which could spur some short-covering in the very near term, especially with the way other asset classes are trading (surging bond prices and broadly weaker stocks) with a "risk-off attitude." Weak support has formed just above the $1,200 level again while initial resistance is above at $1,220.

The IMF growth forecast had an opposite effect on the industrial metals (for obvious reasons), which spent most of the day in the red yesterday. Copper futures however, bounced back on technical buying. Support at the $3 level remains key in the copper market in the near term.

Moving over to energy, the weaker dollar was no match for the global growth concerns as crude oil and the refined products all closed deep in the red. WTI crude oil futures closed down -1.7%. But, WTI traded down even lower in after-market trade as stocks hit their lows, confirming that growth concerns and the subsequent speculation of weaker demand in coming months was the primary driver of trade yesterday. Today, focus will be on the weekly EIA inventory report.

Market	Level	Change	% Change
Dollar Index	85.725	-.319	-0.37%
EUR/USD	1.2672	.002	0.16%
GBP/USD	1.6102	.002	0.12%
USD/JPY	107.88	-.91	-0.84%
USD/CAD	1.1159	.0029	0.26%
AUD/USD	.8818	.0057	0.65%
USD/BRL	2.404	-.0196	-0.81%
10 Year Yield	2.35	-.075	-3.09%
30 Year Yield	3.056	-.072	-2.30%
Prices taken at previous day market close.			

Once again, natural gas was the outlier in the energy sector as futures rallied +1.10% mostly in technical trading as the bulls defended a two-month-old trendline at $3.90. For now, natural gas futures remain in a consolidation pattern, stuck between the aforementioned trend support at $3.90 and the 100-day moving average at $4.13.

Currencies & Bonds

The bond surge continued yesterday as multiple factors pushed the 30-year back over 140 for the first time since late August. Once again it's clear (primarily) European money flows are trumping negative bond fundamentals.

Weak European data, concerns about global economic growth and a strong 3-year Treasury auction all contributed to a broad rally in bonds yesterday, as the 30-year rose +0.90% while the yield on the 10-year fell to 2.35%.

Bonds hit new multi-week highs, and if the old highs of 141'21 are taken out following today's FOMC minutes release, that will complete the biggest head-fake I think I have ever seen in the markets.

In currency markets, the dollar correction that started Monday continued Tuesday. The Dollar Index fell -0.41% on more long liquidation, and it likely would have been worse had the German IP report not been so bad (it weighed a bit on the euro).

The euro and pound traded higher by +0.40% each (the euro rose on mild deflation fears while the pound rallied small on a better than expected Industrial Production report). Both currencies will likely churn vs. the dollar for a little while unless we get a surprise in the FOMC minutes today.

The real currency movement came from Asia. Starting with the yen, it rallied +1.03% vs. the dollar yesterday after the BOJ concluded its meeting with no changes to policy as expected. But, the yen caught a bid yesterday after Japanese PM Abe voiced some caution on the quickly depreciating yen at a meeting at the Diet. Abe highlighted the fact that a weaker yen hurts household purchasing power (which we all know), and that was taken as an inference that the yen declines were occurring too quickly (which, frankly, they have been).

As we've been saying, this "short yen" hit our initial target of 110 and now needs to consolidate for a while to restore health. A move back into the mid-100s in the dollar/yen would not at all surprise us.

The Aussie was the other best performer vs. the dollar, rallying +0.84% after the RBA made no changes to policy (as expected) but didn't say anything overtly dovish. Given how one-sided that trade has been to the sell side, we're seeing shorts cover and a bounce occur. As I said yesterday, if we are lucky enough to get Aussie back to the $0.90 level vs. the dollar, that seems like a pretty solid short up there.

Three Reasons the Bond Rally Came Back "On."

It's a very disconcerting notion to see bonds surging and yields plunging when economic indicator after economic indicator has been hitting multi-year highs (PMIs, job additions, GDP, etc.) and the Fed is outright signaling rates will begin to rise mid next year, if not sooner.

And, there are three main reasons we've seen bonds surge higher over the past two weeks.

The #1 reason is Europe. European data has taken a decided turn for the worse. Between that occurrence and the disappointing demand for the initial TLTROs, the outlook for the European economy has worsened while the view of the ECB as being ineffective has grown stronger. That is once again sending European money into Treasuries on deflation fears.

Frankly, I think both of those premises will be proven out to be false (the European economy will recover and the ECB's measures will work). But that will take time to occur, and for now money pouring into Treasuries trumps all else.

The #2 reason is a surprising bout of dis-inflation caused by a stronger U.S. dollar. Markets seem to be extrapolating falling inflation expectations to worries about deflation, and normally that's correct. But, falling inflation expectations are mostly tied to the surging dollar, which has crushed commodity prices. So, it's not like we are seeing consumer-led deflation (which is really bad). Instead, it's commodity-price-led, which can actually have positive effects on consumer spending.

Again, I think that will be proven out over time, but for right now, "dis-inflation" is becoming a very popular word.

Finally, general concerns about global growth (exacerbated by the IMF downgrades yesterday, which in reality were big headlines but didn't reveal anything new) are also pushing money into Treasuries for both safety and to hedge against potential deflation in foreign economies.

All the while, the Fed is marching steadily toward raising interest rates while economic growth continues to move along at highs for the recovery, implying the Fed is indeed too "easy."

Money flows always trump fundamentals in the short term, and we're seeing it again now. But, be wary of any bond bulls doing a "victory dance" unless they are also huge equity bears—because what is happening in the bond market right now is **not** good for the stock market, and if it continues, the outlook for stocks is downright ugly. If bonds are signaling real dis-inflation, the S&P 500 is heading much, much lower.

At the end of the day, this is all about Europe. The past 5 years have taught me that when central banks want to inflate stock prices and prop up their economy, they will do so. So, I maintain the ECB will indeed do that, although I fully admit it's off to a slow start. But, like Churchill once said about the Americans, you can count on the ECB to do the right thing, after they've tried everything else. If I'm right, this entire move reverses itself over the coming months. If I'm wrong, and we are facing deflation in Europe and dis-inflation here in the U.S., then batten down the hatches, because we are all in for a very bumpy ride.

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 TBT	59.35 24.67 16.44 41.34 56.59	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.*
6/11/14	SPHB	32.73	30.32	*Long domestic cyclicals. Part of the "Post ECB Decision" portfolio of what should outperform if bond rally is done. Original Issue*
6/11/14	UUP	21.55	21.13	*Long Dollar. Part of the "Post ECB Decision" portfolio of what should outperform if bond rally is done. 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 (9/8/14): After spending most of 2014 in trading range, the yen have broken down to new lows as expectations for pension reforms (allocation more Japanese pension funds away from Japanese bonds and into stocks) as well as the rising potential for more stimulus have weighed on the yen. It appears after nearly a year of consolidation, this trade is back "on."			
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 (9/8/14): One of the biggest positive influences on bods in 2014 has been buying from Europe, as German bunds and peripheral European debt saw mania buying on rising fears of deflation. Those money flows overwhelmed negative bond fundamentals in the US and sent Treasuries soaring. But, with the ECB engaging in QE, the European bond mania should break, and Treasuries should now resume their declines.			

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Asset Class Dashboard

(Updated 10.6.14)

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 looks to have completed another typical 4%-5% pull back last week, as stocks temporarily violated the 100-day moving average before recovering late in the week. Going forward global economic growth is becoming a greater risk to equity prices, but as of now the benefit of the doubt remains with the bulls.*
Best Idea: Buy Regional Banks (KRE). **Best Contrarian Idea:** Buy Consumers Stocks (XLY)			
Commodities	**Bearish**	**Bullish**	*Commodities again tried to stabilize last week, but the surge in the dollar Friday weighed on the space as both gold and oil traded to new lows last week. The outlook remains dim near term: Slowing global growth and a surging US Dollar is not a good recipe for commodities.*
Best Idea: Buy Natural Gas (UNG) **Best Contrarian Idea:** Buy Grains (DBA)			
U.S. Dollar	**Bullish**	**Bullish**	*The Dollar Index surged to another 4 year high last week thanks to a massive Friday rally off the strong jobs report. The divergence in economic growth and policy between the US and Europe/Japan/China continues to grow, and that will continue to support the dollar.*
Best Idea: Sell the Yen (YCS) **Best Contrarian Idea:** Long Canadian Dollar (FXC)			
Treasuries	**Neutral**	**Bearish**	*The Treasury bounce accelerated last week, as a "risk off" move Wednesday caused a big short covering rally, a "disappointing ECB" sent European money back into Treasuries, while the sluggish wage number in the jobs report kept Fed policy expectations anchored. The bond market is threatening a new uptrend, but for now remains neutral.*
Best Idea: Short "long" bonds (TBT) **Best Contrarian Idea:** Short High Yield Bonds (SJB)			