7:00's Report

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

November 18th, 2014

DXJ: Despite the very negative headlines, the Japanese GDP report didn't result in a material decline in DXJ, and any further substantial dip is a buying opportunity.

Pre 7:00 Look

- Futures are lower despite a general rally in foreign markets following positive news from Japan and Germany.
- As expected, Japanese PM Abe announced the delay of the sales tax increase in '15 and called snap elections. The Nikkei rallied 2% and the yen traded to a new 7 year low.
- In the first signs of "green shoots" for Europe, the German ZEW Business Expectations Index turned positive for the first time this year, rising more than 15 points to 11.5.
- Econ Today: PPI (E: -0.1%, Core 0.1%), Housing Market Index (E: 55.0). Fed Speak: Kocherlakota (1:30 PM ET).

Market	Level	Change	% Change
S&P 500 Futures	2037.50	-2.25	-0.11%
U.S. Dollar (DXY)	87.65	-0.36	-0.41%
Gold	1201.80	18.30	-1.55%
WTI	75.92	0.25	0.36%
10 Year	2.34	.02	0.86%

Equities

Market Recap

It was another slow day in markets as several conflicting catalysts offset and stocks finished flat for the 5th straight day. The S&P 500 rose 0.07%.

It looked to be a down start to the week early Monday as futures were decidedly negative following the disappointing Japanese GDP print. Besides being bad for Japan, it reminded everyone that global growth remains very, very fragile. (Remember, concerns about global economic growth were the main catalyst for the late-September/early October action).

But, yesterday was a definite "merger Monday" with two large deals announced (HAL/BHI and ACT/AGN), and optimism over continued M&A helped offset the negative influence from Japan. Economic data pre-open were also mostly in line with estimates (Empire State manufacturing and Industrial Production). Those two factors helped offset the disappointment from Japan and within a few minutes of the open stocks were back to flat.

The real "catalyst" yesterday came mid-morning, and it was Mario Draghi's testimony at European Parliament. Draghi again reiterated the ECB will do "more" if necessary and importantly, he specifically named buying government bonds as a potential tactic it could employ (up till now, he has largely just alluded to QE). Those comments pushed European stocks and ETFs higher. Between that and dip-buyers stepping in once the S&P 500 was down 5 points, a rally was on at 11:30 that pushed stocks to the highs of the day by 1:30.

From there on out trading got very quiet, and the S&P

Market	Level	Change	% Change
Dow	17,647.75	13.01	0.07%
TSX	14,874.59	31.49	0.21%
Brazil	51,256.99	-515.49	-1.00%
FTSE	6,704.75	32.78	0.49%
Nikkei	17,344.06	370.26	2.18%
Hang Seng	23,529.17	-267.91	-1.13%
ASX	5,399.69	-12.88	-0.24%
Prices taken at previous day market close.			

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500 traded in basically a 2-point range for the remaining three hours of the day.

Trading Color

It was a deceptively positive day as the Russell 2000 continued its recent underperformance, declining 0.66% while the Nasdaq also declined 0.35%, weighed down by semiconductors and Internet stocks.

Market	Level	Change	% Change
DBC	21.55	-0.09	-0.42%
Gold	1186.00	0.40	0.03%
Silver	16.14	-.17	-1.07%
Copper	3.04	-.01	-0.18%
WTI	75.48	-.34	-0.44%
Brent	79.11	-.30	-0.38%
Nat Gas	4.30	.28	6.99%
RBOB	2.03	-.02	-0.83%
DBA (Grains)	25.78	-.09	-0.35%
Prices taken at previous day market close.			

Sector-wise, that cyclical underperformance we saw in the averages was confirmed. QNET (the Internet stock index) was down more than 1% as it was weighed down by a 4% drop in LNKD after the announcement of a "for business" Facebook site. Meanwhile, semiconductors dropped 0.5%, and industrials, energy and consumer discretionary all finished flat or slightly negative.

Two big outperformers were healthcare (on the back of the ACT/AGN merger) and utilities, which bounced back in a big way from last week's underperformance—rallying 1.42% and for one day making me look smart to those who saw me on CNBC Friday (obviously kidding).

But, with utilities, healthcare and consumer staples the only 3 S&P 500 sub-sectors to close higher yesterday, it's safe to say there was defensive outperformance.

Energy in particular remains under pressure and the space couldn't get much of a bid following the official announcement of the HAL/BHI merger, and that space remains under pressure.

Bottom line, stocks remain buoyant and clearly there remain buyers on dips (every time the S&P 500 went down 5% the last two weeks, there were buyers there). So, the benefit of the doubt very near term remains with the bulls. But, I'm still cautious and the Japanese data reminded us global growth remains fragile and the flash PMIs Thursday are now very important. A print below 50 by China or Europe would not be received well by global markets.

In Good Company

Finally, I'm in good company with my "Long Europe" call, as yesterday JPM echoed my sentiment and moved Europe to an "Overweight" from an "Underweight."

Their reasoning is similar to ours: Better valuation, currency tailwinds via a falling euro, extremely depressed sentiment toward it, and ability to relatively outperform in a global rising tide (if we get one). These make the risk/reward profile appealing vs. incremental money into the U.S.

HEDJ remains our favorite way to play "Europe" broadly as it hedges out further declines in the euro.

What Japanese GDP Means for YCS/DXJ

The huge miss in Japanese GDP yesterday roiled Asian markets and sent futures lower initially on Monday, but that number and subsequent drop in Japanese shares should be viewed as a buying opportunity, not a material blow to the uptrend.

As you know by now, Q3 GDP printed a -1.6% contraction vs. expectations of a 2.2% **gain.** But, before everyone gets bearish on Japan, the first thing to note is that the number wasn't as bad as it seemed. A huge drop in inventories was responsible for much of the miss, as the decline in inventories was a -2.6% influence on GDP.

Much of the drop was due to a depletion or write-down of inventories—which generally corrects itself over the coming quarters as manufacturers re-stock. So, the bad number exaggerated how weak the Japanese economy was in Q3.

But, it was still a weak number. First, the huge decline in GDP from Q2 was revised even lower, to -7.3% from the previous -7.1%. Also, private consumption (think consumer spending) barely rebounded from the second quarter, up just 1.5% after falling more than 18% in 2Q.

So, while not as bad as the headline number implied, clearly the Japanese economy is still suffering from the increase in the national sales tax back in April.

As expected given this data, overnight PM Abe announced the delay of the second half of the sales tax increase and called for snap elections, making official

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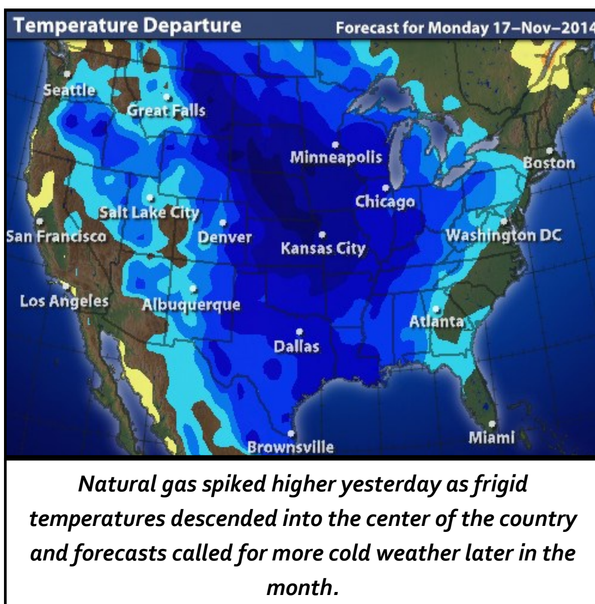
two moves everyone has expected since last week.

So, the bottom line here is this bad GDP report is actually a relative positive for the "long Japan" trade beyond the short term.

First, as we have shown, the data overstated how weak the Japanese economy actually was in Q3.

Second, the after effects of this weak GDP report (no tax increase/new elections) are negative for the yen/ positive for DXJ because no tax is short term positive for the economy and a stronger "pro Abe" Deit improves the changes of more stimulus.

Bottom line, we may see some profit-taking in YCS/DXJ over the next several days, but I view yesterday's news as an odd positive for the "long Japan" strategy, and will view any material dip in YCS/ DXJ as buying opportunities.



Natural gas spiked higher yesterday as frigid temperatures descended into the center of the country and forecasts called for more cold weather later in the month.

Finally, a lot of the commentary I heard yesterday on this subject focused on the Japanese economy. It is very important to keep the outlook for the economy separate from the outlook for Japanese stocks for foreign investors. What the Japanese economy does isn't really *that* important to this trade, as long as Abe continues to destroy the yen. Point being, I have no idea whether Abe "doubling down" on QE/stimulus will actually help the Japanese economy, but as long as he is in power he'll continue to push and that is positive for Japanese stocks and negative for the yen. 120 remains a reasonable medium target for dollar/yen.

Market	Level	Change	% Change
Dollar Index	88.00	.407	0.46%
EUR/USD	1.2453	-.0075	-0.60%
GBP/USD	1.5637	-.004	-0.26%
USD/JPY	116.34	.01	.01%
USD/CAD	1.1285	-.0018	-0.15%
AUD/USD	.8696	-.0043	-0.49%
USD/BRL	2.5892	-.0185	-0.71%
10 Year Yield	2.34	.02	0.86%
30 Year Yield	3.06	.02	0.56%
Prices taken at previous day market close.			

Economics

Industrial Production

- October Industrial Production rose 0.1% vs. (E) 0.2%.

Takeaway

This number was a bit of a disappointment, but it's not going to be enough to change anyone's outlook on the U.S. economy.

The manufacturing sub-component, which is really what you want to watch, rose 0.02% vs. (E) 0.3%, but the disappointment came from the September data, which were revised lower from 0.05% to 0.2%.

Finally, capacity utilization, which is a measure of inflationary pressures, surprisingly dipped to 78.9 vs. (E) 79.3%. Readings above 80 are generally considered inflationary, so this implies inflation pressures (at least statistically) remain well-contained, which makes sense given the declines in commodity prices in October.

Bottom line, it wasn't a good number but won't significantly shift anyone's outlook on the U.S. economy, either.

Empire Manufacturing Survey

- November Empire Manufacturing rose to 10.16 vs. (E) 10.13.

Takeaway

Manufacturing activity in the New York region bounced back to positive in November after turning negative in the October reading, underlying the volatility of this indicator (and that's why it's not followed all that much).

And, while this isn't a widely followed report, it is the first reading of November and it's encouraging the see the bounce back, which implies the October negative reading was an anomaly.

Of note, while most of the details in the report were good, the 6 month outlook for employment doubled to 24.47, which is anecdotally supportive of our belief that the labor market is starting to tighten materially, and we will continue to closely watch that trend, because if it continues to gain momentum, it will have inflationary implica-

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tions in the coming months.

Commodities

Commodities were mixed but in aggregate the complex traded lower on general global growth concerns following Japan's bad GDP print. The commodity ETF DBC declined 0.42%.

Starting with energy, Natural Gas surged yesterday, rallying more than 7% after bitter, bitter cold descended on the interior of the country yesterday and today, and weather models forecast a return of frigid weather toward the end of the month.

The temperatures were so cold this week that it's now expected we will see the first decline in storage in nearly 4 months, which is a bit earlier than normal.

Keep in mind the storage situation in natural gas is just "OK' and while we are sitting just 6% below recent averages, a surprisingly early and cold winter will rekindle memories of massive storage drops last year.

Staying in energy, Brent and WTI crude oil both declined 0.5% but both finished well off the lows (both were down more than 1% early Monday). There weren't any specific negative catalysts Monday, and instead it was just general selling following the Japanese GDP number as that was extrapolated out to mean less demand for oil (although that's a pretty big leap).

The current setup in oil is all about the Saudis and OPEC supply. As long as OPEC is relatively silent and global economic data remain lackluster, it will be very hard to get any sort of a material bid in either Brent or WTI crude.

Metals markets were mostly quiet yesterday, as gold closed fractionally higher while silver saw some profit-taking following Friday's big rally (silver declined 1.2%).

Looking at some fundamentals, the weekly Commitments of Traders report for last week showed another drop in gold net longs, down to 30,615. That's close to the lows for the year (28,630) but still not low enough that you would say the market has become too bearish. And, keep in mind these COT's don't count last Friday's short-covering rally. Bottom line on gold is that while longer term there is certainly an inflation case to be made, near term with the dollar stronger and statistical inflation low, I continue to remain generally cautious here.

Commodities remain broadly linked to global growth prospects, and while the Japan GDP number didn't help, it's not a material negative for the commodity space. The next major catalyst comes Wednesday/Thursday with the global flash PMIs.

Currencies & Bonds

Dovish commentary from ECB President Draghi was the main catalyst in the currency markets yesterday, followed by the soft Japanese GDP. The Dollar Index closed up 0.42% at 88.01, as yesterday we saw the USD catch the other side of the euro decline off the aforementioned Draghi comments. The euro declined 0.6% and is now drifting back toward lows below 1.24.

Economic data points in U.S. were "ok" but didn't really move the needle much, and the dollar traded mostly off Draghi's comments.

The yen bounced hard off GDP news as recession/deflation were yen-positive, but as the shock from the weak GDP wore off, the yen drifted lower vs. the dollar throughout the day to finish down 0.2% after spending most of yesterday morning flat.

In the bigger picture, yesterday was a good example of just how different the U.S. economic outlook is from every other major economy. The ECB is looking to ease, Japan is back in recession, and the UK is worried about dis-inflation. That chasm between the U.S. and everyone else contributed to the dollar's universal strength yesterday despite lackluster domestic data, and it will continue to boost the dollar going forward.

Bonds rolled over midday on Draghi's comments, led by a decline in German bunds. Yesterday was a textbook day to show how pegged U.S. Treasuries are to Europe. Treasuries ignored slightly soft U.S. data, which should have been dovish, and instead declined along with bunds once Draghi mentioned QE. Bottom line: Europe is still driving the Treasury bus.

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*
12/13/13	FCG XOP	18.97 65.62	None	*Natural gas supplies low, increasing 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
September 2014	**Long Europe**	**HEDJ**	*On a longer time frame, Europe is poised to outperform other major developed economies as the ECB is proving their unanimous commitment to increasing the Balance Sheet. HEDJ is the equivalent of Japan's DXJ ETF and is the best way to gain exposure to Europe while hedging against currency depreciation.*

Strategy Update (11/6/14): The ECB continues to slouch towards more stimulus and QE, and at the October ECB meeting Mario Draghi did as good of a job as possible to "speak" dovish and reiterate that the ECB remains unanimously for more stimulus if needed. Additionally, the ECB staff has begun work on modeling more stimulus, which is the most concrete sign yet the ECB is planning to do "more" in early 2015. We continue to view dips as buying opportunities.

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 (11/3/14): The Bank of Japan shocked markets last week by announcing massive new monetary stimulus. I have been a Japan bull since late 2012, and I never thought the BOJ would go this far. The trend lower in the yen/higher in DXJ has clearly resumed, with a reasonable target for the dollar/yen now 115-120. This is a trend that will outperform over the coming months/quarters as the yen devalues and the BOJ/GPIF buys Japanese stocks.

Date Initiated	Strategy	Position (s)	Investment Thesis
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 (11/6/14): Treasuries are finally beginning to roll over here on the charts. The fundamentals for this trade remain decidedly negative, but once again money flows (specifically European) have recently been trumping the fundamentals.

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Asset Class Dashboard

(Updated 11.17.14)

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**	*Stocks chopped sideways last week during quiet trading, and while the market remains buoyant, I continue to be skeptical about how much more is left in this "V" bottom. Most of the recent buying has been underinvested longs chasing stocks higher, and while that could continue for another 10-30 points in the SPX, the risk/reward for new capital at these levels isn't attractive.*
Best Idea: Buy Regional Banks (KRE). **Best Contrarian Idea:** Buy Energy (XLE)			
Commodities	**Bearish**	**Bullish**	*Commodities continued to decline last week, led lower by crude oil, which simply can't seem to find a bottom. Metals were flat all week before catching a big short covering bid on Friday following "Dovish" comments by Fed President Bullard, and the grains (DBA) remain the best performers in the commodity space recently.*
Best Idea: Buy Natural Gas (UNG) **Best Contrarian Idea:** Buy Grains (DBA)			
U.S. Dollar	**Bullish**	**Bullish**	*The Dollar Index traded mostly flat last week as strength in the euro was offset by weakness in the yen and Pound. The dollar remains short term overbought and is in need of some consolidation, but the trend remains decidedly higher, and any dip is a buying opportunity.*
Best Idea: Sell the Yen (YCS) **Best Contrarian Idea:** Long British Pound (FXB)			
Treasuries	**Neutral**	**Bearish**	*Treasuries saw very mild declines last week in quiet trading. Economic data in the US was anecdotally "hawkish" but Europe remains firmly under a deflationary threat, so Treasuries remain well supported and any material decline is unlikely.*
Best Idea: Short "long" bonds (TBT) **Best Contrarian Idea:** Short High Yield Bonds (SJB)			

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