7:00's Report

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

November 19th, 2014

Europe has quietly outperformed this week, and I believe that can continue potentially into year-end as long as the flash PMIs are "ok."

Pre 7:00 Look

- Futures are flat this morning and international markets are mixed but the moves overnight were small. Focus today will be on central bank communications.
- The Bank of England minutes were taken as slightly more "hawkish" than expected. But, that's mainly effecting the Pound (which rallied) as UK stocks are little changed.
- The Bank of Japan meeting and press conference contained no new stimulus measures (as expected).
- Econ Today: Housing Starts (E: 1.028M), FOMC Minutes (2:00 PM EST).

Market	Level	Change	% Change
S&P 500 Futures	2047.50	-1.25	-0.05%
U.S. Dollar (DXY)	87.73	.085	0.10%
Gold	1198.20	1.50	0.13%
WTI	74.88	0.25	0.33%
10 Year	2.322	-.018	-0.77%

Equities

Market Recap

The rally resumed Tuesday as stocks drifted steadily higher throughout the entire trading session, despite the lack of any real positive catalysts, to finish solidly above 2,050 and at new all-time highs. The S&P 500 closed up 0.51%.

Futures were flat Tuesday morning despite good news from both Asia and Europe. In Japan, PM Abe made official what everyone already knew—that he would delay the tax hike and call snap elections. In Europe, we actually got a positive piece of economic data for once. The German ZEW Index moved into positive territory for the first time this year, hopefully representing a trough in negative sentiment on the Continent.

As we neared the open yesterday, futures were pulled higher by gains in foreign markets. Additionally, the two economic data points domestically, PPI and the Housing Market Index, largely met expectations.

Stocks opened slightly positive and began a slow, methodical grind higher that lasted the entire day. This was fueled by underinvested managers chasing stocks higher and adding long exposure for fear of underperformance.

Despite the gains and new highs, it was a very quiet day and there were no real news items or catalysts after the morning session. Stocks drifted higher into the close to finish just off the best levels of the day.

Trading Color

It was a broad, boring, methodical rally yesterday. The S&P 500, Russell 2000 and Nasdaq all rallied about 0.5% with the S&P 500 and Nasdaq hitting new all-time and multi-year highs, respectively. The Dow Industrials

Market	Level	Change	% Change
Dow	17,687.82	40.07	0.23%
TSX	14,972.97	90.47	0.61%
Brazil	52,061.86	804.87	1.57%
FTSE	6,697.64	-11.49	-0.17%
Nikkei	17,288.75	-55.31	-0.32%
Hang Seng	23,373.31	-155.86	-0.66%
ASX	5,368.84	-30.85	-0.57%

Prices taken at previous day market close.

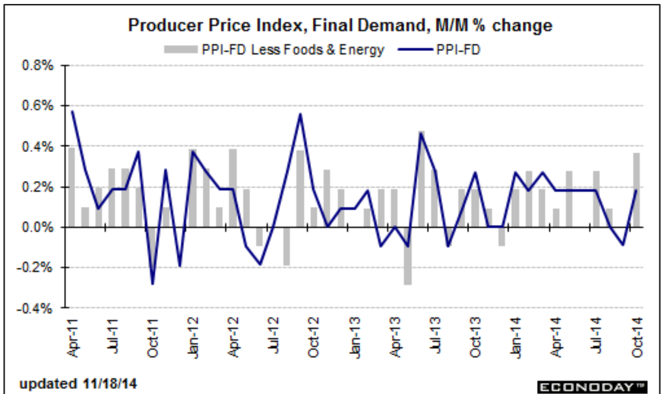
lagged, but only barely (up 0.23%).

All 10 S&P 500 sub-sectors were higher. Healthcare surged, rallying 1.6% on further strength in ACT (up 8.7%) on continued momentum from the merger with AGN.

Market	Level	Change	% Change
DBC	21.43	-.12	-0.55-%
Gold	1194.20	10.70	0.90%
Silver	16.135	.078	0.49%
Copper	3.0005	-.039	-1.28%
WTI	74.42	-1.24	-1.64%
Brent	78.41	-.90	-1.13%
Nat Gas	4.252	-.089	-2.05%
RBOB	2.0408	.0145	0.72%
DBA (Grains)	25.67	-.11	-0.43%
Prices taken at previous day market close.			

Basic materials (XLB) was the other big outperformer, rallying 1.2% mainly on strength in the gold miners. GDX closed up 4.7% on massive short-covering as gold breached $1,200 intraday yesterday.

Retailers were also in focus as we got HD and TJX earnings. Both reports were generally "ok" although HD traded down 2% while TJX was flat on the day. Neither release contained any real macro insight. More broadly, RTH (retailer ETF) continues to trade well, as it was up another 0.22%.



PPI rose month/month for the first time since in nearly 6 months, but the gain was mostly due to increased service costs and it won't change anyone's view on stubbornly low inflation. The market didn't react to the data.

Outside of those moves sector trading was quiet, with the remaining S&P 500 sectors enjoying relatively modest rallies.

On the charts the uptrend remains very much intact, as the S&P 500 hit new all-time highs.

Europe on the Verge of a Breakout?

If there was one "reason" the rally resumed this week, it's Europe—specifically the dovish comments from ECB President Mario Draghi on Monday, where he specifically cited the potential to buy government bonds.

So, while the rally has resumed here in the U.S., Europe has quietly outperformed so far this week. HEDJ—our preferred Europe play because it hedges out a euro decline vs. the dollar—is up 2% through yesterday and has broken above a key downtrend line extending back to early September (chart on page 1).

Obviously the ZEW survey was a big catalyst. But slowly the outlook for Europe is improving as the ECB begins to ramp up its balance sheet expansion and Draghi continues to hint at QE.

The flash PMIs loom large tomorrow morning. But if they are generally in line I believe this rally in Europe, and outperformance into year-end, can continue.

Economics

PPI and the Housing Market Index were the only releases yesterday, with both slightly beating expectations. Neither moved markets, however.

FOMC Minutes Preview: Sentiment vs. Market Based Inflation Expectations.

Today the minutes from the October FOMC meeting will be released, and there is one specific topic we will be looking for additional discussion on: Inflation Expectations.

Keep in mind that the October FOMC statement was more "hawkish" than markets expected. Specifically, the fact that the Fed was pretty dismissive of falling inflation expectations surprised a lot of people, so we and others will be looking for how that came to be.

To that point, there is an important distinction the FOMC has made in inflation expectations: market-based vs. sentiment-based.

Market-based inflation expectations have to do with the spread between same-period Treasuries and TIPS. Basically, the market forecasts the expected CPI out several years by subtracting the difference in yield between the two bonds. Because market based inflation expectations are basically a prediction of future CPI, we have to realize that falling commodity prices will weigh on CPI, regardless of whether it's a deflationary phenomenon.

As a result, when commodities decline, market-based measures of inflation expectations decline, whether or not there is a fear of wide spread deflation. The Fed basically said because of that, they aren't really paying too much attention to falling market based inflation expectations.

Sentiment-based inflation expectations are different, though. Sentiment-based inflation expectations reflect the consumer or business outlook on inflation, and if they begin to decline materially, that is a problem for the Fed. It's a problem because the expectations can feed on each other and create deflation.

For example, if I think car prices are going to decline over the next 6 months, I'll delay getting a new car and keep the clunker. If a lot of people think like me, then demand evaporates near term, forcing dealers to cut prices. As a consumer, once my opinion about lower prices is confirmed, it only encourages me to wait longer for lower prices—further eroding demand and causing dealers to cut prices … and then the cycle starts all over.

So, the point here is basically what we want to see is whether or not the FOMC discussed a decline in sentiment-based inflation expectations as well as market-based. If they did, then the minutes will be more "dovish" than the actual statement, and that could help gold to rally further and the dollar to correct.

Commodities

Commodities were mixed yesterday with a bias to the downside due to the continued weakness in the energy sector. The precious metals, however, saw gains on dollar weakness while RBOB gasoline rallied on some technical short-covering.

Market	Level	Change	% Change
Dollar Index	87.65	-.36	-0.41%
EUR/USD	1.2535	.0086	0.69%
GBP/USD	1.5634	-.0006	-0.04%
USD/JPY	116.96	.32	0.27%
USD/CAD	1.1291	-.0012	-0.11%
AUD/USD	.8727	.0019	0.22%
USD/BRL	2.582	-.0257	-0.99%
10 Year Yield	2.322	-.018	-0.77%
30 Year Yield	3.043	-.016	-0.52%
Prices taken at previous day market close.			

Precious metals were among the few commodities that saw gains yesterday as gold and silver rallied 0.9% and 0.64%, respectively. The move higher was mostly the result of the weaker dollar, which was down against the euro as the German ZEW survey handily beat expectations. Gold remains inversely pegged to the dollar, which is why any material surprises in global economic data are continuing to affect gold prices (the last two weeks it was Japan; this week it appears to be Europe).

On the charts, gold futures rallied back above $1,200 yesterday morning for the first time since Halloween, but the gains proved unsustainable and gold fell back to the mid-$1,190s by the close. Looking ahead, the next release(s) to watch will be the global flash PMIs due out tonight/tomorrow morning.

Copper futures fell 1.3% yesterday to settle essentially right on the $3 mark thanks to a mildly disappointing Chinese home prices report. But, a lot of yesterday's price action was driven by trader positioning ahead of the global flash PMIs. The charts are continuing to show some promise here as $3 is stubbornly holding as support. If futures rally on strong flash PMI data to close above trend resistance between $3.04 and $3.05, there will be an opportunity in buying copper on any pullbacks with an initial target of $3.10, the next level of downtrend resistance.

Shifting over to the energy sector, natural gas futures were down as much as 4% in yesterday's session as volatile market conditions continue. Cold weather and prospects of the first inventory draw of the season being reported by the EIA tomorrow are the major themes.

Bottom line, demand for natural gas has surged once again due to very cold temperatures across the country and traders will be focused on the EIA report due out tomorrow at 10:30 AM. For now, the bulls are in charge with the support of cold weather influencing heightened demand. Technically, there is support between $4.14 and $4.15 while initial resistance is above at the 200-day moving average ($4.295).

Oil Update: OPEC vs. the U.S.

WTI crude oil fell 1.74% yesterday thanks to bearish technicals and a headline regarding the reopening of Iraq's largest oil field, potentially further increasing supply.

But, the *real* focus of the market continues to be on the Nov. 27 OPEC meeting and whether or not the cartel will decide to cut production materially. The consensus right now is that they will *not* do enough and that is certainly contributing to the price weakness in oil.

There are currently a lot of conflicting articles and misinformation circulating with regard to OPEC production, U.S. production, operating margins and breakeven price levels, so I wanted to take a moment to break down the relationship between U.S. producers and *everyone else.*

There have been several stories about a decline in the number of active rigs in the United States (Baker Hughes has reported a drop of 31 rigs in the U.S. to 1,578), and although that is true, it does not necessarily mean companies are cutting overall production levels because of lower global crude prices.

Domestic oil companies are simply cutting back on high-cost/high-risk/high-reward exploration projects and speculative well drilling and focusing more on their productive, low cost wells and actually **increasing production** in order to capitalize on current crude prices in the event they continue to fall. So, they are pumping more from the wells that are still profitable, increasing overall production as those increase offset the shut ins from unprofitable wells.

Case in point, three of the larger American oil companies, Pioneer Natural Resources Co., Devon Energy and Continental Resources, are forecasting production increases of 21%, 25% and 29% respectively for next year. And, in their recent Q3 earnings calls, they all said it would take a substantial move lower to curb the output of the aforementioned productive wells.

So, if OPEC is trying to put shale producers out of business, it still has more work to do. And, really the sell off in oil at this point continues to be as much about the turmoil within OPEC as anything else production related. The OPEC meeting in Vienna on the 27th is now very, very important for the near term price of oil.

Currencies & Bonds

The Dollar Index declined the most in 10 days (down 0.45%) on the back of a stronger euro Tuesday. Much like Monday, the Dollar Index traded off the euro, not on its own fundamentals.

The euro, which rallied 0.7%, recouped all of Monday's losses following the stronger than expected ZEW Business Expectations Index (11.5 in Nov vs. -3.6 in Oct).

And, although clearly still in a downtrend, the euro is acting like it wants to mount some sort of a counter-trend rally and may extend higher if the flash PMIs are "ok" tomorrow. If we see a move through 1.2581 it could elicit more short-covering, and if that resistance is broken the euro could easily rally all the way to the 1.27 level and still be in a very defined downtrend.

The Aussie was the other decent gainer vs. the dollar as it bounced 0.25% after the RBA minutes from the meeting two weeks ago were in line with expectations. But, given how oversold the Aussie is, it was a slight "cover on the news" reaction. But, this morning Aussie is plunging , down 1% following a sharp decline in iron ore prices, and Aussie remains under significant pressure.

Staying in Asia, the yen was down again, but only modestly (-0.33%) as dollar/yen briefly crossed above 117 Tuesday morning. The BOJ announcement overnight was in-line with expectations (it didn't contain anything new), but momentum remains to the downside and dollar/yen is now solidly through 117 as of this writing. The rout continues.

Ultimately we remain very comfortable with our 120 dollar/yen target over the medium term. But at the same time the yen is oversold short term, a lot of "negative yen" news is priced in at these levels, and a correction back into the mid-110-115 range would not shock me short term (this would obviously be an opportunity to get more short yen).

Finally, bonds drifted slightly higher (30-year up 0.18%) in very quiet trading. German bunds didn't really react much to the ZEW data, which is a bit surprising, and as such Treasuries drifted slightly higher in quiet trading as there were no auctions and the economic data (PPI/Housing Market Index) didn't really move markets.

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.			
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.			
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)**

	Near Term Trend	Long Term Trend	Market Intelligence
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)**

	Near Term Trend	Long Term Trend	Market Intelligence
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)**

	Near Term Trend	Long Term Trend	Market Intelligence
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)**