# 7:00's Report

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

***November 3rd, 2014***

## Pre 7:00 Look

- Futures are fractionally lower after global manufacturing PMI underwhelmed. Asia and Europe both traded lower off the data, although the declines are moderate.
- Chinese, German and EMU manufacturing PMIs all slightly missed expectations but stayed (barely) above 50, reflecting the still fragile global growth picture.
- Econ Today: ISM Manufacturing Index (E: 56.0).
- Fed Speak: Evans (9:30 AM), Fisher (12:40 PM).

| Market | Level | Change | % Change |
|---|---|---|---|
| S&P 500 Futures | 2009.25 | -2.25 | -0.11% |
| U.S. Dollar (DXY) | 87.29 | .274 | 0.31% |
| Gold | 1171.60 | .00 | 0.00% |
| WTI | 80.77 | .23 | 0.29% |
| 10 Year | 2.335 | .030 | 1.30% |

# Equities

*Market Recap*

Markets surged to new all-time highs last week thanks to continued central bank stimulus, decent earnings and "better than feared" economic data. The S&P 500 rose +2.75% last week and is up +9.18% year-to-date.

Markets traded strong every day last week. Monday started with some consolidation as the S&P 500 closed slightly lower, weighed down by declines in Europe (which traded lower on Italian bank concerns following stress test results) and Brazil, which declined following the re-election of President Dilma Rousseff.

But, the declines were small in the U.S. and the S&P 500 bounced back Tuesday on short-covering ahead of the FOMC meeting, rallying more than +1% off news of potential reforms in China and a break of key technical resistance levels (the 50-day MA specifically).

Wednesday stocks finished lower but again exhibited strength despite the declines. The "hawkish" FOMC statement sent the S&P 500 decidedly negative late in trading Wednesday, but there were buyers of the dip and the markets finished well off the lows of the day.

And, that strength continued Thursday as the S&P 500 rallied more than +0.5% to finish just under the 2,000 level, thanks to strong earnings from V and MA, a strong headline Q3 GDP report, and more digestion of the Fed.

Friday the move higher continued as the Dow Industrials hit a new all-time high and the S&P 500 closed at a new all-time high following the Japanese stimulus announcement. The S&P 500 has now totally completed the "V" recovery, and is sitting just off the highs for the year.

*Trading Color*

With the S&P 500 up +2.75% last week, the sector trading went about as expected. Cyclicals handily outperformed, as the Russell 2000 rose +4.9%, nearly doubling that of the S&P 500, while the Nasdaq also outperformed, up +3.3%.

Sector-wise cyclicals outperformed but not by as much as you'd think, as SPHB rallied +3.7% but SPLV was up +2.63%. But, defensives didn't lag all that much as utilities and consumer staples both hit new 52-week highs, and this V-shaped rebound in the markets has come with strong performance by defensive sectors (thanks mainly to rates staying low).

| Market | Level | Change | % Change |
|---|---|---|---|
| Dow | 17,390.52 | 195.10 | 1.13% |
| TSX | 14,613.32 | 154.63 | 1.07% |
| Brazil | 54,628.60 | 2,291.77 | 4.38% |
| FTSE | 6,527.31 | -19.18 | -0.29% |
| Nikkei | 16,413.76 | 755.56 | 4.83% |
| Hang Seng | 23,915.97 | -82.09 | -0.34% |
| ASX | 5,506.89 | -19.72 | -0.36% |
| Prices taken at previous day market close. | | | |

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Banks traded very well last week, as KRE (regional bank ETF) rallied +6.31% and broke above key technical resistance at $39.75. Banks and consumer discretionary/retail remain my two favorite domestic sectors. Conversely, energy continued to lag, weighed down by lower oil prices. Good earnings by XOM helped XLE recover, but it still underperformed the market, rallying just +2% last week. Despite the "value" argument, I think there are better destinations for capital.

| Market | Level | Change | % Change |
|---|---|---|---|
| DBC | 22.32 | -.03 | -0.13% |
| Gold | 1173.50 | -25.10 | -2.09% |
| Silver | 16.17 | -.25 | -1.52% |
| Copper | 3.0525 | -.01 | -0.33% |
| WTI | 80.70 | -.42 | -0.52% |
| Brent | 84.30 | -.24 | -0.28% |
| Nat Gas | 3.867 | .04 | 1.05% |
| RBOB | 2.1487 | -.0123 | -0.57% |
| DBA (Grains) | 25.66 | -.06 | -0.23% |
| Prices taken at previous day market close. | | | |

*Bottom Line*

The S&P 500 has now rallied almost +11% in a near-straight line in just over 2.5 weeks. Despite the pain of early October, the S&P 500 finished the month *up* +2.5%.

As far as "why," the reasons remain the same from last week: First, and most importantly, global growth doesn't appear as bad as feared. The outlook for global growth got very negative, very quickly, and recent economic data refuted that point of view (although by no means is this concern totally resolved).

Second, global central banks remain accommodative. If the initial start of the "V" recovery in stocks was thanks to the October flash PMIs being slightly better than expected, then the 2nd half of the "V" recovery was due to central banks. Remember, the single most important positive catalyst of the last few weeks was the ECB article about buying corporate bonds. And, last week, the S&P 500 surged to new highs thanks to the BOJ. It is very important to realize that, while QE is over in the U.S., globally central banks are still becoming more accommodative, led by the BOJ and ECB.

Finally, earnings results were "fine" and specifically major multi-nationals didn't exhibit a lot of caution when talking about the macro environment.

I've been saying for the past two weeks that I didn't see any catalyst that would materially send stocks to new highs (obviously I wasn't thinking the BOJ would take steps to eviscerate their currency in the hopes of higher stock prices and more economic activity). But despite that, I still remain unconvinced that we're about the see a material "melt-up" higher in stock prices into year-end.

And, that's because I'm again not sure of the major positive catalyst that send the S&P 500 through 2,050 or 2,100 (I don't think the BOJ announcement is that powerful). A Republican win in the mid-term elections is at least partially priced in and earnings are basically over. If economic readings continue to accelerate, they will be met with a potentially more "hawkish" Fed. With the S&P 500 at 15.5X next year's earnings, it's tough to make a value argument.

So, the major catalyst I see is if global growth continues to rebound, lifting all equity markets. If that's the case, then I would again prefer to have incremental capital long Europe via HEDJ or EUFN or Japan via DXJ, simply because I think there is more "bang" for the buck vs. the SPY if we are in a rising-tide environment.

# Economics

*Last Week*

The actual economic data released last week were at best just "ok," but that was overshadowed by the various statements, actions and expectations of the major global central banks. Markets were reminded that global central bank policy remains very easy (and will likely in aggregate get more accommodative in the future).

The biggest economic event last week was supposed to be a non-event, and that was the BOJ meeting. By now you know that the BOJ announced plans to increase its QE program by 30 trillion yen (to 80 trillion per year), triple the purchases of J-REITs and ETFs, and double its stock holdings. Additionally, the Japanese Government Pension Investment Fund made official expected major allocation changes, which will see domestic bond holding cut dramatically in favor of increased allocations to domestic and foreign equities and foreign bonds. This news, as you know, was the reason for the big rally Friday.

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In an impressive feat, the BOJ shocker almost made markets forget that the Fed ended QE here in the U.S. (as expected). But, the Fed also provided some surprise through the statement, which reflected a slightly "hawkish" tone. The FOMC significantly upgraded their commentary toward the labor market and downplayed the recent drop in CPI as mostly a temporary, commodity-led phenomenon.

But, while the statement was more "hawkish" than expected, it's important not to get lost in the details. Bottom line, on the margin we need to look at the FOMC as more committed to rate increases at some point in the future (which is good), but they remain very, very accommodative.

Finally, the ECB was quiet last week, but they did announce they will start buying Asset-Backed Securities in November. Meanwhile, the economic data in Europe added more pressure for the ECB to do "more" via buying corporate bonds or outright QE.

Specifically, the October "flash" HICP (the EU CPI) was again subdued, rising 0.4% month-over-month but more importantly the "core" reading declined to a 0.7% increase year-over-year from 0.8% in September. Bottom line, deflation remains a major threat in the EU, and data are continuing to increase the chances of the ECB doing "more" to achieve its balance sheet expansion targets.

Turning to the actual data, in the U.S. it was lackluster, as mentioned. September Durable Goods was a bad number, as was New Orders of Non-Defense Capital Goods Excluding Aircraft (NDCGXA), which is the sub-index to watch in this release, fell 1.7%. This suggests some softening of the manufacturing sector in September, likely due to reduced exports courtesy of the stronger dollar.

Finally, the first look at Q3 GDP was better than expected at 3.5% vs. (E) 3.0%. It was a good number but the headline was deceiving. A big uptick in government spending (thanks to the ISIS campaign) and a reduction in imports (which normally subtract from GDP) were responsible for much of the "beat."

| Market | Level | Change | % Change |
|---|---|---|---|
| Dollar Index | 87.055 | .823 | 0.95% |
| EUR/USD | 1.2508 | -.0016 | -0.13% |
| GBP/USD | 1.5972 | -.0023 | -0.14% |
| USD/JPY | 112.81 | .51 | 0.45% |
| USD/CAD | 1.1284 | .0019 | 0.17% |
| AUD/USD | .8734 | -.006 | -0.68% |
| USD/BRL | 2.4779 | .00 | 0.00% |
| 10 Year Yield | 2.335 | .030 | 1.30% |
| 30 Year Yield | 3.060 | .024 | 0.79% |
| Prices taken at previous day market close. | | | |

*This Week*

Global growth and inflation remain the two areas to watch from a macro standpoint. Last week we got a lot of data on inflation (which seems ok everywhere except Europe) while this week we get a lot of data on growth.

The most important number this week, as usual, is the October jobs report. And, it's also "jobs week" so we should expect ADP Wednesday, claims Thursday and the government number Friday. Again, unless this is a materially bad number, don't expect it change anyone's outlook on stocks or the economy.

We already got the official global manufacturing PMIs (the Chinese data slightly missed at 50.8 vs. 51.2 and will keep alive concerns about the pace of growth), while German and EMU PMIs also slightly missed, but stayed above 50 (reflecting a still fragile economy). U.S. manufacturing PMIs come later this morning.

Later this week we get the global composite PMIs (both manufacturing and services), with China releasing data Tuesday night, Europe Wednesday morning and the U.S. "Non-Manufacturing" or services PMI later Wednesday morning.

Domestically other than the aforementioned numbers it's pretty quiet. The came can't be said for Europe, though, as there is an ECB meeting Thursday. Although no changes to policy are expected, as the BOJ showed last week, anything is possible.

Bottom line this week is It's important to keep the data in the context of the last three weeks. Remember concerns about global growth were at the heart of the recent sell-off, but that stopped two weeks ago when flash PMIs were better than expected. At this point, global growth being "better than feared" is priced into stocks, so the risk this week is for a negative disappointment from the data.

## Commodities

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Commodities were mixed last week as gold plummeted on dollar strength while natural gas prices popped on cold weather. Meanwhile crude oil futures traded in a tight range to finish the week little-changed but importantly held support at $80/barrel. The benchmark commodity ETF, DBC, rallied +0.72% last week.

Gold was the big story in the commodity space last week as the most recent rally fizzled out and futures accelerated to the downside. Gold futures ended the week lower by -4.69%. On the charts, gold crashed through multi-year support at $1,180, falling as low as $1,160/oz on Friday. The sharp sell-off was the result of the rallying dollar which was fueled by the surprise, additional stimulus announcement by the BOJ. Going forward the path of least resistance is lower with the next level of support at $1,150. After such a breakdown, it is common to see a "throwback" to former support, and such a move in gold (to anywhere between $1,180 and $1,220) should be seen as an opportunity to sell gold.

In energy, WTI crude oil futures fell modestly last week, closing down -0.74%. The stronger dollar continued to put pressure on the energy sector; however the additional stimulus in Japan caused a general "risk on" move across asset classes and that helped WTI futures hold support at $80. Oil was little-changed last week on the charts, and support at $80 remains in critical focus here. Futures are in a compressed, trendless trading range between $80-$83.

Natural gas was the best performer last week with futures jumping +6.5% as a blast of winter weather moved across much of the country and the EIA reported a smaller weekly build in stockpiles than analysts expected. Traders will be looking ahead to the EIA's weekly inventory report due out Thursday morning to see how the first cold front affected supply metrics as the "build season" comes to an end and the winter "draw season" begins. Currently, the market is rather volatile and there is not a clear trend in place, so we remain in "wait and see" mode with natural gas.

## Currencies & Bonds

The Dollar Index surged to a new multi-year high last week, rising more than +1% on a combination of a "hawkish" FOMC statement, a weaker euro (due to rising expectations of the ECB to do "more") and Friday's collapse of the yen, which traded to a decade low (the yen is the second-heaviest weighting behind the euro in the Dollar Index).

The yen was the worst performer vs. the dollar last week for obvious reasons, as Friday it smashed through all support as the dollar/yen closed above 112. Obviously the BOJ stimulus was the reason, and even though the yen is short-term oversold, the direction is lower. Given the BOJ's moves, 115 dollar/yen is probably a forgone conclusion over the coming months, while 120 within a year isn't out of the question. If a central bank wishes to destroy the value of their currency, they will succeed.

The euro was overshadowed at the end of the week but it was also sharply lower, breaking below 1.25 vs. the dollar for the first time in years on Friday, again courtesy of the soft HICP reading (which will encourage the ECB to do "more.") The euro was down -1.1% on the week.

From a "long dollar" standpoint, clearly the trend is higher. The euro and yen make up over 65% of the Dollar Index weighting, and both currencies are being discretely actively devalued by their respective central banks. So the Dollar Index is headed higher and 90, at this point, isn't an unreasonable target over the coming months.

Turning to the bond market, the 30-year Treasury declined but only modestly so, down -0.19%, as foreign demand continues to trump domestic fundamentals. The FOMC statement was "hawkish" and GDP was good, but European inflation remains subdued and deflation a real risk, while the BOJ moves will undoubtedly make Treasuries more popular in Japan. (Not only will Japanese government bonds decline in value, but the GPIF will surely add to Treasury holdings as part of its new asset allocation.)

So, the theme of foreign money flows trumping fundamentals continues (and gets more intense). And, until we get some evidence of inflation/growth in Europe, that will continue.

Have a good week,

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<br>EUFN<br>EWI<br>EWP | 59.35<br>24.67<br>16.44<br>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<br>XOP | 18.97<br>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 (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 (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 11.3.14)**

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 completed a "V" shaped rebound last week as good earnings and a surprise announcement of massive new stimulus by the Bank of Japan propelled the S&P 500 to new all time highs. Despite the strength, though, I remain cautious on how much more upside there is, as valuations are now elevated, and any acceleration in the economy will be met with a more "hawkish" Fed.* |
| **Best Idea:** Buy Regional Banks (KRE).<br>**Best Contrarian Idea:** Buy Energy (XLE) | | | |
| **Commodities** | **Bearish** | **Bullish** | *Commodities were mixed last week as gold plummeted on dollar strength while natural gas prices popped on cold weather. Crude oil futures traded in a tight range to finish the week little changed but importantly held support at $80/barrel. The rallying dollar is continuing to weigh on the entire space, in some cases overpowering the fundamentals.* |
| **Best Idea:** Buy Oil (USO)<br>**Best Contrarian Idea:** Buy Grains (DBA) | | | |
| **U.S. Dollar** | **Bullish** | **Bullish** | *The Dollar moved to new multi-year highs last week thanks to a "hawkish" FOMC statement, a weaker euro (courtesy of soft HICP data) and a plunging yen (following the BOJ announcement. Bottom line is the Dollar Index is headed higher, as the euro and yen are being actively de-valued by their respective central banks.* |
| **Best Idea:** Sell the Yen (YCS)<br>**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 rally in the Dollar. Fundamentals were Treasury negative as the FOMC statement was hawkish and economic data good, but European and now Japanese money flows continue to trump fundamentals.* |
| **Best Idea:** Short "long" bonds (TBT)<br>**Best Contrarian Idea:** Short High Yield Bonds (SJB) | | | |

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