7:00's Report

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

December 1st, 2014

Pre 7:00 Look

- Futures and most global markets are decidedly lower this morning after a further decline in oil prices and worse than expected final November manufacturing PMIs.
- Oil continues to collapse in the wake of the last week's OPEC decision, dropping to a spike low of $63.72 o/n.
- Economically, the final readings on global manufacturing were a universal disappointment. German manufacturing PMI dropped to 49.5, a 17 month low, while EU and Chinese PMIs declined from earlier "flash" readings.
- ISM Manufacturing PMI (E: 57.8). Fed Speak: Dudley (12:15 PM), Fischer (1:00 PM) .

Market	Level	Change	% Change
S&P 500 Futures	2057.00	-9.25	-0.45%
U.S. Dollar (DXY)	88.125	-.288	-0.33%
Gold	1173.40	-2.10	-0.18%
WTI	66.43	-.72	-1.09%
10 Year	2.194	-.040	-1.79%

Equities

The S&P 500 hit another new all-time high last week but finished the week modestly lower, as the plunge in oil prices weighed on the index Friday. The S&P 500 fell 0.24% last week and is up 11.86% year-to-date.

Last Monday was the best day of the week for the markets, as stocks drifted higher thanks to a Reuters article implying more Chinese stimulus and a stronger than expected German IFO Business Expectations survey.

On Tuesday, pre-holiday trading was very much in effect as stocks drifted the entire day, largely ignoring a better than expected revised Q3 GDP report and a sharp drop in oil prices as news leaked that OPEC would not cut production.

Wednesday saw the largest amount of data released last week, but it failed to have much of an impact. Focus was more on traveling to holiday destinations than it was on markets, and stock drifted slightly higher throughout a quiet session.

Friday was by far the most interesting day last week, as the plunge in oil prices following the OPEC meeting was initially viewed as a positive, and the S&P 500 hit a new all-time high. But as the drop in energy stocks got worse, it began to weigh on the indices. The S&P 500 ended the half-day just off the lows, down 0.25%.

That subtle change in how the market reacted to oil prices Friday is notable, as I read several things over the weekend that implied the steep drop is now starting to shift from a blessing to a bit of a worry (more on that later).

Trading Color

With markets basically flat last week, there wasn't a lot to read into. But there are a few trends I want to point out.

Trend No. 1: Some reports over the weekend implied Black Friday sales were down year-over-year. That may be true, but the buying season is shifting and all macro signs point to an acceleration in consumer spending. Any weakness in RTH, SYF or LEAF on soft holiday sales articles would be a buying opportunity, in my opinion.

Trend No. 2: Europe continues to outperform. HEDJ rallied 2% last week on more "green shoots" of slightly improving economic sentiment and (mainly) increasing expectations of QE by the ECB sometime in the first half

Market	Level	Change	% Change
Dow	17,828.24	0.49	0.01%
TSX	14,744.70	-177.74	-1.19%
Brazil	54,664.36	-56.96	-0.10%
FTSE	6,674.49	-48.13	-0.72%
Nikkei	17,590.10	130.25	0.75%
Hang Seng	23,367.45	-620.00	-2.58%
ASX	5,207.72	-105.28	-1.98%
Prices taken at previous day market close.			

of 2015.

With stimulus beginning to take effect and more ECB members apparently warming to the idea of QE, I continue to like Europe as a destination for incremental capital. The ECB meeting this week should be a non-event other than Draghi's press conference (no changes to policies), and the next TLTRO auction in two weeks will be the next major data point in this "long Europe" trade.

Market	Level	Change	% Change
DBC	20.42	-0.98	-4.58%
Gold	1165.80	-31.70	-2.65%
Silver	15.455	-1.151	-6.93%
Copper	2.8445	-.112	-3.79%
WTI	66.15	-7.54	-10.23%
Brent	70.15	-2.43	-3.35%
Nat Gas	4.09	-.27	-6.13%
RBOB	1.8273	-.1843	-9.16%
DBA (Grains)	25.54	-0.22	-0.85%
Prices taken at previous day market close.			

Trend No. 3: Market leadership is becoming narrower. I've been touching on this for the last few weeks, but a small number of large-cap tech stocks have been driving markets higher. Case in point, for the November rally, more than 1/4 of the point gains in the SPX came from just six stocks, and more than 10% of the point gains came just from AAPL. Narrow leadership doesn't mean a rally isn't sustainable, but it is something to consider.

Oil: The Next "Systemic" Risk?

If there is one clear takeaway from OPEC's decision not to cut production at last week's meeting, it is this: Gulf states (Saudi Arabia mainly) are intent on targeting and shutting down U.S. shale production.

Reports suggest that almost all non-Gulf OPEC members demanded a production cut last week, but Saudi Arabia (mainly) blocked it, and the reason is U.S. shale. Correctly, the Saudis view U.S. shale as a long-term threat and clearly want to squeeze those producers.

For now, this drop in oil prices remains a virtue, but as I have said from the beginning (back in the mid-/late summer), if the pace of the declines accelerated substantially, it could become a headwind. And, I am reiterating that point today.

One growing concern, given falling oil prices, is the junk debt market. According to JPMorgan, shale companies have been heavy issuers of junk debt, apparently between 15% and 20% of all recent issuance.

Energy-related junk bonds have been falling sharply over the past few months, and those declines obviously accelerated over the past week. And, while not a direct threat, there is growing concern that if we begin to see a wave of shale company defaults, it could begin to affect banks, ETFs and mutual funds, etc.

Disconcertingly, the "systemic" word is once again being thrown around. The fear is growing that a collapse in energy-related junk debt could reverberate into other corners of the junk market and up into the investment-grade space.

Bottom Line

The decline in oil and energy company junk debt isn't a reason to sell stocks now. But should this pace of decline continue in oil, it will no longer be a tailwind on stocks and could represent a potential headwind going forward. This is a theme I will be watching closely.

More broadly, my view on stocks remains the same: Markets are overbought and we continue to lack clarity on a major upside catalyst. Fundamentals are fully valued with stocks at these levels, and while we are not bears, we are also not fans of placing incremental capital broadly in U.S. stocks at these levels and believe the possibility of a pullback in increasing. Tactically we prefer Europe (HEDJ) as a destination for incremental capital, and continue to like our "Return of the U.S. Consumer" theme via SYF, LEAF and RTH for domestic outperformance.

Economics

Last Week

Global economic growth and the risk of dis-inflation/deflation remain the two major macro trends to monitor, and last week global inflation data was in focus.

The most important number last week was the EU HICP, which came Friday morning and was a bit misleading. The month-over-month change missed estimates, rising at just 0.3%, which is a multi-year low for monthly price increases. But, the much more important "Core HICP" year-over-year change was unchanged from October, with HICP rising 0.7% yoy.

While not as bad as the headlines implied, this is still a weak number, and certainly doesn't counter any of the "QE in the EU" momentum we've seen gathering steam lately.

The only place where inflation metrics surprised to the upside was in the U.S. The Core PCE Price Index, which was contained in Wednesday's Personal Income and Outlays report, showed a slight uptick in prices as the yoy increase rose to 1.6% from 1.5% in September. But, before we all get too bullish on inflation here in the U.S., keep in mind that's still well below the FOMC's stated 2.0% floor.

But, between the uptick in the PCE Price Index and the more-firm CPI from two weeks ago, it is safe to say that the risk of dis-inflation here in the U.S. has been materially reduced, and low inflation likely won't make the Fed more dovish over the coming months.

Turning to economic growth, the highlight last week was the 2nd look at US Q3 GDP, which beat expectations at 3.9% vs. expectations of 3.3%. The details of the number confirmed the strong headline as PCE and Non-Residential Fixed Investment (think business investment and spending) were both revised higher.

Within the details, the report implied consumer spending was stronger than we thought in Q3, and with a tightening labor market and even lower oil/gas prices, that bodes well for our "Return of the U.S. Consumer" theme we've been playing.

As mentioned, PCE was revised higher, but so was "Final Sales to Domestic Purchasers." This is a better gauge of pure spending, as it accounts for the purchase of goods that were produced domestically and imported. Final Sales to Domestic Purchasers was revised higher from 3.2% to 2.7%.

Market	Level	Change	% Change
Dollar Index	88.40	.751	0.86%
EUR/USD	1.2472	.0020	0.16%
GBP/USD	1.5655	.0010	0.06%
USD/JPY	118.66	.03	0.03%
USD/CAD	1.1420	.0004	0.04%
AUD/USD	.8469	-.0037	-0.43%
USD/BRL	2.5651	.00	0.00%
10 Year Yield	2.194	-.040	-1.79%
30 Year Yield	2.910	-.030	-1.02%
Prices taken at previous day market close.			

But, while revised GDP was the focus of last week, it was also the most dated release, and the more recent numbers weren't all that good. Durable Goods missed expectations, as the key sub-index to watch, Non Defense Capital Goods Ex-Aircraft, dropped for the second month in a row, falling 1.3%. In housing, both October New Home Sales and Pending Home Sales missed expectations. Finally, jobless claims popped back above 300K, although that has to be taken with a grain of salt as this is a very noisy statistical period.

This Week

Focus this week shifts from data to global growth, as we get the final November and composite global PMIs (the final manufacturing PMIs are already out for everywhere except the U.S., which come later this morning). The data was almost universally disappointing as all the initial "flash" estimates from two weeks ago were revised lower. German Nov. Manufacturing PMI dropped below 50 for the first time in 17 months (49.5), EU Nov. PMI fell to 50.1 from 50.4, and the official Chinese manufacturing PMI was 50.3 vs. (E) 50.6, confirming the decline we saw in the flash PMI in mid-November.

Outside of the manufacturing PMIs, it's jobs week in the U.S. So, we will get ADP Wednesday, claims Thursday and the government employment report Friday.

As has been the case for the last several jobs reports, unless the headline is a shocking disappointment, the most important numbers to watch in this release will be the yoy wage increases and the unemployment rate, as a jump in the former or a material drop further in the latter may pull forward some rate hike expectations.

Away from the PMIs and jobs report it's a quiet week. Global composite PMIs (manufacturing and service sector) come Wednesday, as does the U.S. Non-Manufacturing PMI. While not as important as the already-released manufacturing PMIs, these numbers will be important to help provide a clearer picture on the health of the global economy.

Looking at central banks, there are ECB and Bank of England rate announcements Thursday morning, but neither of those events should generate much volatility unless ECB President Mario Draghi says something surprising at the press conference (and given the frequency with which he's spoken lately, that's unlikely). Neither bank is expected to change policy.

Bottom line, the idea of an ongoing global recovery, however slow, is a key to a continued equity market rally, and data this week need to show the global recovery is still inching forward.

Commodities

Commodity markets got crushed late last week, led down by energy as OPEC disappointed by not cutting production or convincing investors that they would be more strict in enforcing individual member quotas. The rest of the space fell in sympathy and felt pressure from the dollar, which traded up to yet another four-year high. The benchmark commodity tracking index ETF, DBC, fell **6.07%.**

Last week's OPEC meeting caused a knee-jerk sell-off in global crude oil prices, as decision-makers chose not to cut their collective production target of 30M barrels/day. But, that was largely expected, as was the announcement of more strict regulations and oversight on adhering to the individual quotas. And, the latter would have been somewhat bullish for crude if OPEC was able to convince the market that it was serious about doing so and the decision was unanimous. However, after the meeting, the commentary out of individuals from various OPEC member nations was conflicting, and this discord caused the sharp sell-off.

So, bottom line, crude oil prices remain in a sharp multi-month downtrend as the market is continuing to look for equilibrium the old-fashioned way (forcing production cuts) and until we see some action taken by producers (OPEC and non-OPEC), prices will continue to fall.

Elsewhere in the space, gold prices plummeted on Friday, finishing the week down 3.59% as the recent short-covering rally finally seems to have fizzled out. The price action of gold remains largely a function of the dollar and with the dollar set to continue rallying, we remain near-term bearish on gold.

Copper fell sharply last week in sympathy with oil. The industrial metal finished the week down 6.21% with a lot of that move occurring on Friday in very thin volume as absent traders' stops got hit in the mid- to low-$2.90s. Copper bears watching here as we may see a rebound today as traders return to work.

Currencies & Bonds

As with most other markets, the latter half of last week provided the material movements, as the Dollar Index reversed declines from early in the week and rallied hard Thursday/Friday to finish flat.

The Dollar Index traded almost entirely off of other data, mainly the euro and yen. The euro finished last week modestly higher (up 0.4%) but closed well off the highs after declining Thursday/Friday following lackluster inflation data (German CPI last Thursday and HICP last Friday).

The yen closed down nearly 1% thanks to declines Friday following lackluster economic data in Japan (inflation and growth readings were subdued). Dollar/yen rose back through 118 Friday and closed just off the recent multi-year highs of 118.97.

Not surprisingly, commodity currencies were the big losers last week, as the Loonie fell more than 1% Friday in reaction to the collapsing oil prices to close near multi-year lows, while the Aussie got hit early in the week on dovish RBA member comments and declining iron ore prices. Both currencies remain in very clear downtrends.

Treasuries rallied to multi-week highs despite strong U.S. GDP, thanks in part to a strong five-year Treasury auction midweek and further strength in German bunds. The lackluster inflation readings from the EU only put more of a bid into German bunds, which in turn continued to make Treasuries more attractive on a relative basis. ECB members hinting at QE may be enough to push the euro lower, but bond investors need to see actual proof of an acceleration of the EU economy, and despite some "Green Shoots," we're not there yet.

Have a good week,

Tom

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.			

Asset Class Dashboard

(Updated 11.24.14)

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 hit new all time highs last week but declined marginally by weeks end thanks to a Friday dip that was due mainly to the collapse in oil prices. The general macro back drop remains positive for stocks, but we continue to be cautious about adding additional capital at current levels, as we think most of the good news out there is already priced in.*
Best Idea: Buy Regional Banks (KRE). **Best Contrarian Idea:** Buy Energy (XLE)			
Commodities	**Bearish**	**Bullish**	*Commodities collapsed, again, late last week as oil went into free fall following a "do nothing" OPEC meeting. There was massive general selling in the commodity space and a surging dollar weighed on precious and industrial metals. The near term outlook for commodities remains very negative.*
Best Idea: Buy Natural Gas (UNG) **Best Contrarian Idea:** Buy Grains (DBA)			
U.S. Dollar	**Bullish**	**Bullish**	*The Dollar Index closed flat last week thanks to a big Friday rally. The euro sold off Friday (but finished the week positive) following lack luster HICP data, while the yen weakened Friday after economic data missed estimates. Finally commodity currencies got crushed last week on lower oil and at or near multi-year lows.*
Best Idea: Sell the Yen (YCS) **Best Contrarian Idea:** Long British Pound (FXB)			
Treasuries	**Neutral**	**Bearish**	*Treasuries rallied last week thanks to a good 5 year Treasury auction and continued strength in German Bunds. Despite some indications EU economic data is starting to get better, Bunds remain well bid, and as long as they do, Treasuries will stay buoyant.*
Best Idea: Short "long" bonds (TBT) **Best Contrarian Idea:** Short High Yield Bonds (SJB)			