# 7:00's Report

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

**December 12th, 2014**


***Brent Crude: Are We Almost There? The Saudi's have said prices will stabilize "around" $60/bbl, so while we aren't at a bottom, we're getting closer (a temporary $5 dollar overshoot wouldn't be shocking).***

## Pre 7:00 Look

- Futures are sharply lower this morning after Chinese data underwhelmed and oil hit new lows.
- The oil decline continued, with WTI and Brent both down more than 1% and hitting new multi-year lows.
- In China, data was mixed as Nov. Industrial Production missed estimates while Retail Sales were in-line, but nothing was good enough to assuage concerns about growth.
- In Europe EMU IP and Italian CPI both met expectations.
- Econ Today: PPI (E: -0.1%), Consumer Sentiment (E: 89.5).

| Market | Level | Change | % Change |
|---|---|---|---|
| S&P 500 Futures | 2012.50 | -11.50 | -0.57% |
| U.S. Dollar (DXY) | 88.515 | -.422 | -0.47% |
| Gold | 1224.90 | -.70 | -0.06% |
| WTI | 59.42 | -.53 | -0.88% |
| 10 Year | 2.178 | .009 | 0.41% |

## Equities

*Market Recap*

Stocks rebounded Thursday thanks to rising QE expectations in Europe and stronger than expected U.S. retail sales. The S&P 500 rose 0.45%.

Despite the rally, though, it was a pretty tepid bounce yesterday. The "reasons" for the rally were the in-line ECB TLTRO offering and the negative core French CPI. Both were a "bad is good" event, as both were seen as increasing the chances of ECB QE in January. (JPM was the latest to join that growing consensus call.)

Also cited as a reason for the rally: was the stronger than expected retail sales report, which helped reinforce the positive of plunging oil prices.

But, an oversold bounce was as responsible for yesterday's move as those other two events. Disconcertingly for the bulls, the highs in stocks were put in well before lunchtime. And, as expected, we are seeing markets give back pretty much all of yesterday's gains this morning.

Short-covering and some fast-money bottom-fishing sent stocks higher out of the gate. But for all intents and purposes the highs were in by 10:30 AM, and stocks began to roll over immediately after the European close.

Word that the House of Representatives wouldn't vote on a spending bill yesterday as expected weighed on markets in the early afternoon, but other than that, activity slowed materially. There was a mild bounce during the final hour of trading, but that didn't last and stocks closed a few points off the lows of the day.

*Trading Color*

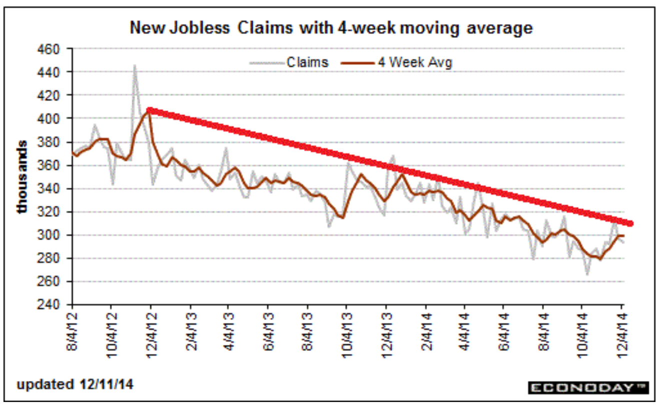
| Market | Level | Change | % Change |
|---|---|---|---|
| Dow | 17,596.34 | 63.19 | 0.36% |
| TSX | 13,905.12 | 52.17 | 0.38% |
| Brazil | 49,861.81 | 313.73 | 0.63% |
| FTSE | 6,360.08 | -101.62 | -1.57% |
| Nikkei | 17,371.58 | 114.18 | 0.66% |
| Hang Seng | 23,249.20 | -63.34 | -0.27% |
| ASX | 5,219.57 | -11.40 | -0.22% |

Prices taken at previous day market close.

You don't have to be a 20+ year market veteran to know yesterday's rally wasn't very strong. First, small caps and tech did not outperform (but they did badly underperform during Wednesday's dip), and generally the price action (spike higher in the morning, fade throughout the day) isn't what you want to see from a trading standpoint.

| Market | Level | Change | % Change |
|---|---|---|---|
| DBC | 19.50 | -.15 | -0.76% |
| Gold | 1225.80 | -3.60 | -0.29% |
| Silver | 17.08 | -.107 | -0.62% |
| Copper | 2.916 | .023 | 0.80% |
| WTI | 59.85 | -1.09 | -1.79% |
| Brent | 63.69 | -.55 | -0.86% |
| Nat Gas | 3.645 | -.061 | -1.65% |
| RBOB | 1.6256 | -.0162 | -0.99% |
| DBA (Grains) | 25.19 | -.04 | -0.16% |
| Prices taken at previous day market close. | | | |

Sector-wise, gains were broad. Nine out of 10 S&P 500 sub-sectors were higher, with XLE being the lone exception (it closed fractionally lower during the last hour of trading). But, the leadership was poor, as utilities rallied 1% (best performer on the day) and consumer staples rallied 0.83%.




With the exception of consumer discretionary (which was up off the Retail Sales report), all other S&P 500 sub-sectors finished with less than a 0.5% gain following big losses Wednesday. So, bottom line, it was not much of a bounce.

Looking at stock-/sector-specific news, retail was obviously in focus as RTH hit a new 52-week high off the economic data (RTH was up 1.47%) while other consumer-related stocks also did well, as you'd expect. We said over the past two weeks that any weakness following Black Friday should be bought, as all signs point to a very strong holiday spending season, and we continue to espouse that belief. Our "Return of the U.S. Consumer" thesis still has legs. Meshing that with our caution on the market, getting long RTH/short SPX is one of the hedged trades out there right now.

*Bottom Line*

This remains all about energy stocks and credit. Despite the negative headlines of oil dipping below $60/bbl the market continues to key off energy stocks, and despite the weakness in oil, energy stocks were higher for most of Thursday, supporting the broad market.

But, if you were to overlay a chart of energy and the SPX, you'd see XLE began to sell off about 30 minutes before the S&P 500, and once that ETF rolled over, the market went with it. Point being, keep watching XLE more than the price of oil for a leading indicator of stocks.

Fundamentally the outlook remains the same: The U.S. economy is doing well, the European economy is not and the risk of deflation is growing. This is prompting rising expectations for QE (which is now almost a forgone conclusion, at least from a market expectation standpoint).

But, troublingly, junk bonds (and corporates) continue to trade heavy. JNK was down another 0.7% yesterday. That makes more than a 2% decline in less than 2 days, which is a lot for a junk bond index. Investment-grade traded "ok" yesterday but, as we pointed out in the chart in yesterday's Report, that sector is also looking like it's rolling over.

Bottom line: There are headwinds forming via Greek politics, collapsing oil prices, junk bond/stock divergence, and soaring expectations for QE in Europe (and the chance of a letdown). As a result, the market has hit a bit of a wall. These events aren't outright negatives yet, but they do warrant caution. We remain cautious on stocks here until there is some stabilization in energy/credit. When XLE stops going down, that'll be a sign to start thinking about buying the dip.

# Economics

Retail Sales

- Retail Sales rose 0.7% vs. (E) 0.4% in Nov.
- The Control Group rose 0.6%, better than expected.

*Takeaway*

The Retail Sales report for November came in better than expected yesterday. But, more importantly, the key sub-index to watch—the "control" index, which is Retail Sales Ex-Autos, Building Materials, and Gasoline Stations—also rose for the 9th straight month, increasing 0.57%. That gain was on top of a 0.5% increase in October, so it's fair to say that consumer spending is gaining some decent momentum, as we have expected. This "control group" is the best measure of true consumer discretionary spending, which is why we and others back it out from the larger retail sales report.

Obviously the uptick in the control is related to the decline in gasoline purchases. Given that prices have continued to drop in December, that's a trend we expect to continue. The October/November retail sales report will push up expectations for PCE in the Q4 GDP report (out in late January).

Finally, this report further validates our "Return of the U.S. Consumer" thesis that is a few months old at this point (and we think still has legs). As mentioned, retail stocks surged on the news and the report helped lift futures broadly. (Of course, the weakness in oil/energy undid much of those gains later in the day.) Regardless, this retail sales report confirms the U.S. consumer has a tailwind, and is increasing spending.

## Commodities

Commodities were mixed yesterday as oil traded down to fresh 5-year lows in the high $50s, copper rallied on supply concerns and speculation of Chinese stimulus, while precious metals finished the day little-changed.

Oil prices dropped 1.85% to fresh 5-year lows yet again yesterday as there was follow-through selling after the bearish comments from the Saudi Oil Minister on Wednesday. Early on, it looked as though the speculative buyers were going to be able to defend the $60/barrel level in WTI, which has not been violated since July 2009. But, futures rolled over into the close yesterday afternoon, falling to an intraday low of $59.56. Bottom line, the sharp downtrend in prices remains very much intact. Although we could see some short-covering into the weekend today, we believe oil prices have further to fall in the near term.

| Market | Level | Change | % Change |
|---|---|---|---|
| Dollar Index | 88.96 | .423 | 0.48% |
| EUR/USD | 1.238 | -.0067 | -0.54% |
| GBP/USD | 1.5708 | -.0005 | -0.03% |
| USD/JPY | 119.25 | 1.44 | 1.22% |
| USD/CAD | 1.1529 | .0048 | 0.42% |
| AUD/USD | .8256 | -.0061 | -0.73% |
| USD/BRL | 2.6494 | .0344 | 1.32% |
| 10 Year Yield | 2.178 | .009 | 0.41% |
| 30 Year Yield | 2.825 | -.010 | -0.35% |
| Prices taken at previous day market close. | | | |

Natural gas futures rallied sharply following the EIA report that showed a 51 Bcf draw in supplies last week, 1 Bcf more than the average of analyst estimates. But, the rally, which seemed to be driven by algorithms the way it surged so quickly on the news release, was short-lived and futures rolled over and fell to close down 1.48%. On the charts, the recent volatility appears to be subsiding as prices continue to consolidate the recent slide. The trend in natural gas remains a bearish one and, if recent lows in the mid-$3.50s are violated, we could see a swift move lower toward an initial target of $3.40 with a secondary target of $3.20.

Moving to the metals, copper was among the best performers in the space yesterday, rallying 0.80% as traders closely watched a mine strike currently taking place at Peru's largest copper mine. This mine is responsible for 1/3 of the country's copper production. In addition to that bullish supply news, investors are also speculating the potential for further economic stimulus measures from the Chinese government, which should support demand for the industrial metal. Despite the bounce we have seen from the recently established 5-year lows, copper futures do remain in a clearly defined downtrend for now. So, the path of least resistance will likely be lower, with selling opportunities arising as futures trade up toward resistance in the mid-$2.90s.

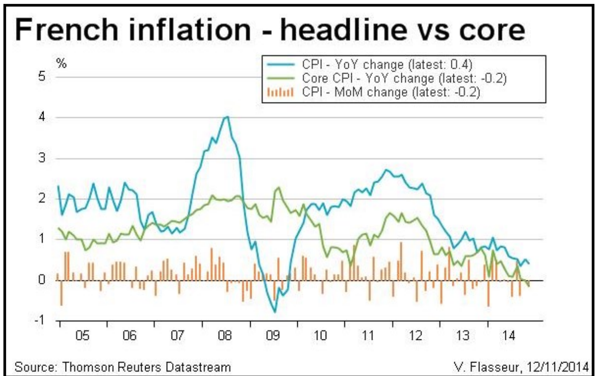
Shifting gears to the precious metals, gold futures fell further away from the resistance band between $1,240 and $1,250 that we pointed out earlier in the week. Gold traders are still trying to catch their breath after the recent whipsaw moves, the first of which was lower on dollar strength then the second was higher as the short side got overcrowded and spec sellers were squeezed out of their positions.

Bottom line, the froth appears to be coming out of the gold market and the trend lower looks to be resuming here. Any move toward the aforementioned resistance band should continue to be seen as an opportunity to add to or open short positions in gold.

## Currencies & Bonds

The world returned to some degree of normalcy yesterday as the primary trend of dollar strength and foreign currency weakness resumed yesterday, thanks to disappointing EU data and strong U.S. retail sales.

But, yesterday's moves have quickly been reversed this morning as we are definitely "Risk off" in the currency markets right now, courtesy of lower oil prices, with the Dollar Index falling and the euro and yen rising.




*Sacre bleu! French core inflation turned negative for the first time since the early 1990's (when the stat started being recorded).*

Looking back to yesterday, the Dollar Index rallied 0.47% after retail sales were strong and jobless claims stayed below 300K. But, the dollar was higher even before that data hit the tape, thanks to more economic data that implies a growing deflation threat in Europe (and as a result a greater chance of QE).

All the focus (and rightly so) was on the TLTRO auction yesterday, and as you know by now it was "just right." It wasn't too hot (meaning so much demand it may reduce the potential of QE), and it wasn't too cold (say sub-100 billion euros worth of demand, which may imply the ECB is going to abjectly fail to expand its balance sheet).

Instead, at just under the expectation of 130 billion euros, it was "just right" in that it was strong enough not to be a disaster, but weak enough to make a stronger argument for QE.

But, for all the focus on the TLTRO, the most important data point yesterday was French core inflation. This was largely ignored by most places, but French core CPI dropped below 0 year-over-year for the first time since the stat has been produced—and given the ECB is worried about a growing deflation threat, that should be concerning.

That number, more than anything else yesterday, was the reason the euro declined. This is because that negative core French CPI will increase the likelihood that the ECB does QE in January, and that was the number to focus on yesterday.

While the euro was the most talked about currency yesterday, the yen was the biggest mover—dropping nearly 1% almost entirely in reaction to the rally in stocks. With so much money in the yen trade (mainly short yen) it's trading basically inverse to risk sentiment, so yesterday risk was "on" and the yen declined. Tuesday, it was the opposite. Dollar/yen closed back above 119 yesterday but continue to look for volatility. We are holding our yen shorts through this volatile period, but I would not be adding shorts up here. If we get an extended dip in stocks, the yen will rally vs. the dollar, and I would be much more comfortable selling yen at 115-ish or lower to the dollar than 119-ish right now.

Turning to bonds, they were flat on the day despite the strong retail sales report, as German bunds again rallied following the TLTRO and bad French CPI report. Helping bonds turn higher midday (they were slightly lower in the morning) was another very strong Treasury auction, this time for 30-year bonds. Like the 10-year on Wednesday, we saw the best bid to cover of the year at 2.79, despite the lowest yield of the year. As I said yesterday, the fact that this is the last auction of the year undoubtedly had something to do with the uptick in demand, but it can't explain it all. Treasuries remain very well-bid despite fundamentals that say the opposite, courtesy of Europe, Japan, *et al*.

Have a good weekend,

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* |
| **12/13/13** | FCG<br>XOP | 18.97<br>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 fundamen-* | | | |

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# Asset Class Dashboard

**(Updated 12.8.14)**

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 a new all time high last week thanks to strong US data and rising hopes of QE in the EU. But, markets also acted a bit fatigued as Friday's blow out jobs report failed to spur much of a rally, as data that good is seen as potentially creating a slightly more hawkish Fed. Bottom line, it'll be tough for stocks to sell off materially given current sentiment, but we see limited upside over the coming weeks.* |
| **Best Idea:** Buy Regional Banks (KRE).<br>**Best Contrarian Idea:** Buy Energy (XLE) | | | |
| **Commodities** | **Bearish** | **Bullish** | *Commodities declined again last week as oil tried to stabilize (but largely failed) and gold got hit on Friday following the strong jobs report. With concerns about the global economy and a relentlessly stronger dollar, the near term outlook for commodities remains poor.* |
| **Best Idea:** Buy Natural Gas (UNG)<br>**Best Contrarian Idea:** Buy Grains (DBA) | | | |
| **U.S. Dollar** | **Bullish** | **Bullish** | *The Dollar Index shot to new multi-year highs last week following the blow out jobs report. The yen was the weakest performer vs. the dollar, dropping more than 2%, but every major currency declined as the difference between US growth/monetary policy and the rest of the world continues to widen.* |
| **Best Idea:** Sell the Yen (YCS)<br>**Best Contrarian Idea:** Long British Pound (FXB) | | | |
| **Treasuries** | **Neutral** | **Bearish** | *Treasuries declined last week on slightly "hawkish" comments by Fed officials Dudley and Fischer, and the strong jobs report. Importantly, last week the rising prospect of a more "hawkish" Fed weighed on bonds, and there are cracks appearing in the rally.* |
| **Best Idea:** Short "long" bonds (TBT)<br>**Best Contrarian Idea:** Short High Yield Bonds (SJB) | | | |