7:00's Report

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

December 15th, 2014

Pre 7:00 Look

- Futures are higher this morning as markets try to bounce from last week's declines following some stabilization in oil o/n.
- In Japan, PM Abe won a landslide victory in Sunday's election. And, while that is "dovish" the markets were unimpressed, as the Nikkei dropped 1% and the yen is flat.
- Outside of Japan it was a quiet weekend with most of the focus on oil and speculation about the FOMC Wednesday.
- Econ Today: Empire Manufacturing Survey (E: 12.0), Industrial Production (E: 0.7%), Housing Market Index (E: 59.0).

Market	Level	Change	% Change
S&P 500 Futures	2004.50	14.00	0.70%
U.S. Dollar (DXY)	88.77	.175	0.20%
Gold	1211.80	-10.70	-0.88%
WTI	58.22	.41	0.71%
10 Year	2.103	-.075	-3.44%

Equities

Market Recap

Stocks declined materially last week as a continuing collapse in energy stocks, oil and junk bonds combined with fresh Greek political worries to create a "risk off" market environment. The S&P 500 declined 3.5% last week and is now up 8.33% year-to-date. It was the worst weekly decline in nearly 3 years.

Last week started off on a bad note. Disappointing Chinese import data (raising more concerns about the Chinese economy) and the decision by Greek PM Samaras to hold a surprise early presidential election weighed on markets, and the S&P 500 declined 0.73%.

Tuesday and Wednesday got interesting. Stocks were sharply lower early Tuesday but staged a big rebound to finish flat. Given Tuesday's trading, it looked like a typical "buy the dip" response from the market we've seen frequently over the past eight weeks. But on Wednesday, new lows in oil and junk debt rattled markets. Once the Tuesday lows were broken, thereby invalidating the rebound, stocks came for sale hard into the close. The S&P 500 dropped 1.6% and suffered its worst declines since early October.

Thursday we again saw markets attempt to rebound as increased expectations of QE in the EU (thanks to the "Goldilocks" TLTRO auction and negative core French CPI) and a strong U.S. retail sales report prompted heavy short-covering. But, stocks hit their highs early and drifted lower all day, closing up 0.5% but at the day's lows.

That weak trading spilled over into the Friday session as stocks collapsed again, with the S&P 500 falling more than 1% mostly on de-risking going into the weekend and lower oil. The index closed just above the 2,000 level.

Trading Color

Despite the magnitude of the declines last week, internals of the market weren't actually that bad. First, the Russell 2000 and Nasdaq relatively outperformed the S&P 500 by 1%, dropping 2.5% vs the S&P 500's 3.5%. So, at the index level, we did not see the cyclical outperformance you would expect given the declines (so this is a slight positive).

Sector-wise there were a few observations worth noting:

First, international badly underperformed the U.S.

Market	Level	Change	% Change
Dow	17,280.83	-3154.51	-1.79%
TSX	13,731.05	-174.07	-1.25%
Brazil	48,001.98	-1859.83	-3.73%
FTSE	6,346.64	46.01	0.73%
Nikkei	17,099.40	-272.18	-1.57%
Hang Seng	23,027.85	-221.35	-0.95%
ASX	5,186.08	-33.49	-0.64%
Prices taken at previous day market close.			

HEDJ dropped 6% thanks to a nosedive late last week, which was led by a 20% drop in Greek shares. But, it wasn't just Europe that traded poorly. Japan declined by more than 3%, as did the Hang Seng. So, we saw a reversal in the "international outperformance" trend lately, and that may continue a bit in the short term.

Second, energy is in freefall. Oil dropped 13% last week and XLE dropped 7%, as we saw year-end tax-selling take hold. At this point, energy is seeing indiscriminate panic-selling. And while I have no interest in catching a falling knife, we will investigate selling a put spread on XLE this morning, as these declines are simply getting a bit absurd here and we want to potentially take advantage of some premium in the puts.

Third, retail remains one of the best-performing S&P 500 sub-sectors. RTH nearly hit a new 52-week high last week and finished **positive** despite carnage in the broader market, and that's a trend we think can continue.

Bottom Line

We've been saying this for nearly two weeks, but when XLE and JNK bottom, so will stocks. So, I think we wait to see signs of that before trying to buy this dip (which could go a bit further depending on oil or if the Fed "hawkishly" surprises this Wednesday).

More broadly, over the past two-plus weeks, we've seen the emergence of two potentially negative macro events: contagion from the decline in oil and prolonged political instability in Greece And, while neither are definitively negative at present, they both pose threats to stocks and we've seen the markets price in that increased potential risk.

But, the declines of last week have to be taken in context of the "straight line" rally since mid-October. Remember, the S&P 500 basically rallied 260 points from the low of 1,820 to the high of 2,080 in a seven-week period. So, the magnitude of the declines the last week is partially because of that rally and the weak longs that were pulled into the market.

Market	Level	Change	% Change
DBC	19.31	-.16	-0.82%
Gold	1222.50	-3.10	-0.25%
Silver	17.06	-.06	-0.32%
Copper	2.934	.013	0.45%
WTI	57.81	-2.14	-3.57%
Brent	61.85	-2.87	-1.83%
Nat Gas	3.80	.16	4.43%
RBOB	1.5973	-.0271	-1.67%
DBA (Grains)	25.20	.03	0.12%

Prices taken at previous day market close.

The same goes for Europe, which got hit very, very hard late last week on general "risk off" sentiment and Greek worries. Medium term, we continue to like Europe to outperform, so we will take the pain near term and look to add more on a dip. We still believe Europe (HEDJ) remains one of the best places to be for 2015.

Bottom line, despite the market selling off hard, we don't view the events of the past week as a reason to de-risk materially at this point. While we need to have XLE bottom to declare the sell-off over (and that hasn't happened yet), we are viewing this dip as a buying opportunity.

Economics

Last Week

There was not much economic data last week but the reports that were released further confirmed what we all already know: First, The U.S. economy is by far the "best house on a bad block." Second, Europe is still facing a major deflation fear. Third, the pace of Chinese growth appears to be slowing, again.

If there was a key takeaway from last week, it's that the economic data from Europe further solidified the market expectation of the ECB announcing QE in January.

The most "important" release last week wasn't even on anyone's radar, and that was French CPI.

French core CPI, which again no one ever really pays attention to except outfits like ours, turned negative year-over-year for the first time since the stat has been kept (so back to the early 1990s).

That's important because it further confirms that deflation risks are growing in the EU. The net of this release is that it solidified the expectation of the market that we will see QE in the EU in January (so, next month).

Staying in Europe, the ECB's second TLTRO offering met low expectations, coming in at 129.84 billion euros vs. expectations of 130 billion euros. As we explained in last week's Report, that number was pretty "Goldilocks." It wasn't good enough (say, greater than 150 billion) to make the ECB think about delaying QE, nor was it "bad enough" (say less than 100 billion) to make the market think that ECB policies aren't going to work and they've already lost the deflation battle.

Staying on the international front, the bulk of the rest of the data came from China, and the results were lackluster. Chinese November CPI missed expectations, furthering the fear of a global deflation risk, while November Industrial Production also missed estimates.

Recent Chinese data imply a slowdown in the pace of growth. But similar to Europe, the soft data are seen as only prompting more stimulus from Chinese authorities and the PBOC. For now, bad news is good and 7% remains the number to watch in China. If expectations of Chinese GDP growth drop below 7%, bad news will become "bad" almost regardless of what Chinese authorities do, and that will be a headwind on global stocks.

Finally, looking at the U.S., the only notable report was retail sales, which beat estimates on the headline and the important "control group"—which is the best gauge of true consumer discretional spending—rose 0.6% after a 0.5% gain in October. This number is important because it reminded the market of the virtues of lower oil prices on the economy, and helped counter all the negativity surrounding the decline in oil.

Bottom line, the data further confirm our "return of the U.S. consumer" thesis that we've been pushing for more than 2 months now, and we continue to think the strategy has legs. We continue to like RTH, LEAF and SYF, and a "long RTH/short SPX" spread trade is something we think can outperform over the coming weeks and still hedge out the risk of a general market decline.

Market	Level	Change	% Change
Dollar Index	88.575	-.362	-0.41%
EUR/USD	1.2468	.0008	0.06%
GBP/USD	1.5727	.0009	0.06%
USD/JPY	118.73	-.04	-0.03%
USD/CAD	1.1594	.0013	0.11%
AUD/USD	.8231	-.0009	-0.11%
USD/BRL	2.6612	.0071	0.27%
10 Year Yield	2.103	-.075	-3.44%
30 Year Yield	2.756	-.069	-2.44%
Prices taken at previous day market close.			

This Week

This will be the last busy week of 2014, and it's going out with a bang. We have a Fed meeting, the latest global flash PMIs, U.S. CPI, several European economic reports, and the start of the November U.S. housing data.

Despite the volume of reports this week, the clear highlight is the FOMC meeting Wednesday. This is a meeting with the Fed officials' forecasts (the "dots") as well as the Fed Chair Press Conference.

As usual I'll preview it when we get closer, but the main focus on this meeting is whether the phrase "considerable time" remains in the statement. The market consensus right now is that the phrase will be removed from the statement, signaling interest rates will begin to rise sometime in the next 6 months.

After the FOMC meeting, the next most important event this week is the global flash PMIs. Without repeating myself from the earlier section, the main areas of concern will be the Chinese flash PMI (out tonight) and the European flash PMIs (out tomorrow morning).

Much like with the ECB TLTRO of last week, the market is looking for a "Goldilocks" number that isn't below 50, but isn't too good as to delay expected stimulus. A material drop in Chinese and EU flash PMIs below 50 will be taken as "too cold" by the market and will be a negative, but anything marginally above 50 should be received as "just right" and stocks shouldn't react that much. The U.S. flash PMI comes tomorrow morning, but everyone expects that to be good and it's not much of a focus.

There are also several other economic releases that will give us anecdotal insight into the U.S. and EU economy. U.S. CPI comes Wednesday morning, right before the FOMC, and remember there are some analysts out there who are worried that falling oil may create a dis-inflation problem in the U.S. That isn't positive for the market, even if it makes the Fed more dovish, so a firm CPI report is what we are looking for Wednesday morning. Other data to watch include U.S. Industrial Production, which comes later this morning, and two important German sentiment indicators: The ZEW Survey is released tomorrow morning and IFO comes Thursday morning.

Bottom line, unless the Chinese and EMU PMIS are a big disappointment, most of the focus will be on the Fed early this week. But, there are important insights into the global economy and outlook for Fed policy to be gleaned from the data/meetings this week that is important as we craft strategy for early 2015.

Commodities

Commodities were split last week as crude oil prices crashed through the $60 level on Thursday while the metals outperformed with gold up on further short-covering and copper rose on supply concerns and Chinese stimulus speculation. The broad based commodity ETF, DBC, fell 4.3% last week.

Oil is clearly still the primary focus of the commodity space (and the entire investment community for that matter) as prices slumped to yet another 5-year low last week. WTI futures fell 13% on the week. There were several bearish headlines last week, but the most important one was regarding comments from the Saudi oil minister in which he essentially said he was "selling at market" and "why should I cut production?" Those words were largely responsible for futures punching through the round $60 figure late in the week. Looking ahead, we are approaching the Saudis' "estimated target" for Brent prices at $60. But as trading continues, volatility will remain high as traders are trying to feel out the market for where a bottom might develop.

Natural gas futures spent most of the week consolidating the recent plunge in prices that was a result of weather forecasts being revised to suggest December would be milder than initially thought, lowering demand expectations. The market remains weather-driven, but the path of least resistance appears lower. As long as there isn't any material cold snap in the coming weeks, prices will likely trade down toward support levels at $3.40 and $3.20.

Moving to the metals, gold spiked on Monday of last week and then largely drifted sideways in quiet trade through the remainder of the week. Gold finished the week up 2.5%. But, gold hit resistance at $1,240, the lower end of the resistance band we mentioned would likely hold early last week (between $1,240 and $1,250).

Bottom line, we remain cautious on gold beyond the very short term mainly because we expect further dollar strength, but gold has benefited from the "risk off" move in markets and the decline in stocks is supporting gold. Unless something fundamentally changes, though, we would rather be sellers of gold here than buyers. Beyond the very short term, the fundamentals remain challenging given expected dollar strength.

Currencies & Bonds

We saw a reversal in the currency markets last week as "risk off" trading in stocks led to a oversold rally in the euro (up 1.5%) and yen (up 2.2%). The Dollar Index dropped 1% last week, despite economic data being fundamentally dollar-bullish (retail sales) and euro-bearish (French CPI).

But, last week the market was trading off negative momentum, not fundamentals, and both the euro and yen continued to trade inversely to their respective stock markets.

Fundamentally the near term trends remain very dollar-bullish/yen- & euro-bearish, but that trend likely won't resume in earnest until we see some stabilization in the stock market. But, any material dip in the dollar should be viewed as a buying opportunity, and likewise a short entry point for the euro and yen.

Over the weekend the Japanese elections led to a landslide victory for PM Abe, and that was taken initially as "yen-negative" because it's seen as increasing the chances of him further implementing structural fiscal reforms like a reduction in corporate taxes. (This should further pressure the yen beyond the very short term).

This week the FOMC meeting looms large. "Considerable time" is the key—if it's removed from the FOMC statement ,this reversal in the dollar rally could be very short-lived, regardless of what the stock market is doing.

Turning briefly to Treasuries, they surged to new closing highs last week on a combination of "Risk off" and European deflation fears. Despite ever improving economics in the US and a slightly more "hawkish" Fed, Treasuries remain very well bid. 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 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 fundamen-

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Asset Class Dashboard

(Updated 12.15.14)

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 suffered it's worst decline in 3+ years last week as concerns about plunging oil and Greek politics weighed on global markets. But, the declines were exacerbated by the straight line rally we've enjoyed since October, and while we remain near term cautious on the market, we don't think fundamentals have deteriorated this badly and*

Best Idea: **Buy Retail (RTH).**

Best Contrarian Idea: **Buy Energy (XLE)**

Commodities	**Bearish**	**Bullish**	*Commodities continued their declines last week as oil fell 13% to fresh multi-year lows, although metals actually rallied on the week. Gold and copper finished higher on a "risk off" trade as stocks fell, while copper rallied on China stimulus hopes. But, a short term bounce aside, the trend remains clearly lower for commodities.*

Best Idea: **Buy Natural Gas (UNG)**

Best Contrarian Idea: **Buy Grains (DBA)**

U.S. Dollar	**Bullish**	**Bullish**	*The Dollar Index fell 1% last week despite fundamentally good economic data, as strength in the euro and yen outweighed those economic reports. The euro and yen both bounced as part of a general "risk off" trade across assets last week, but the primary trend in currencies remains of a higher dollar, and this would be a dip to buy.*

Best Idea: **Sell the Yen (YCS)**

Best Contrarian Idea: **Long British Pound (FXB)**

Treasuries	**Neutral**	**Bearish**	*Treasuries surged last week to new closing highs for the year thanks to general "Risk off" sentiment in markets and growing deflation fears in Europe. Treasuries continue to largely ignore better economic data and a slightly more "hawkish" Fed, as plunging*

Best Idea: **Short "long" bonds (TBT)**

Best Contrarian Idea: **Short High Yield Bonds (SJB)**