7:00's Report

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

December 16th, 2014

Pre 7:00 Look

- Futures are flat, Asia traded sharply lower while Europe is stronger this morning as a collapse in the Russian Ruble is offsetting decent European economic data.
- The Ruble is in focus this morning as it failed to rally despite a 6.5% interest rate hike by the Russian central bank. The Ruble is down 2% vs. the dollar following the hike.
- Economic data o/n was mixed. China's flash PMI dropped to 49.5, raising further concerns about that economy. But, EU flash PMIs beat estimates and stayed above 50, while the German ZEW index surged, implying we may be seeing more 'green chutes" in Europe
- Econ Today: Housing Starts (E: 1.038M), Flash PMI (E: 55.5)

Market	Level	Change	% Change
S&P 500 Futures	1979.50	-3.75	-0.19%
U.S. Dollar (DXY)	88.035	-.647	-0.73%
Gold	1206.20	-1.50	-0.12%
WTI	54.20	-1.71	-3.06%
10 Year	2.116	.013	0.62%

Equities

Market Recap

Stocks tried to bounce Monday but lower energy prices again weighed on risk assets, as stocks gave up early gains and closed lower on the day. The S&P 500 fell 0.64%.

Once again it was a day dominated by energy, junk debt and oil and technical trading; there were no market-moving fundamentals yesterday. Stocks initially tried to bounce Monday and markets were higher pre-open and through the first hour of trading. But, as was the case

The Russian Ruble is in free fall this morning despite a 6.5% rate hike by the Russian central bank. The Ruble is now down more than 50% vs. the dollar this year.

last week, once energy stocks and oil started to roll over, so too did the broader market. Despite a very strong November Industrial Production report, the market simply couldn't hold up. By 10:30 not only were stocks negative, but the declines were accelerating.

Stocks fell all the way through the European close (Europe got hammered again yesterday) but support held at the 100-day moving average (1,988). Keep in mind that moving average has acted as stout support for over a year, so it's not surprising that level held on the first test.

We saw a very short-term bounce once that 100-day MA held, as stocks fought to get close to flat. But there was no real buying at these levels and, by 2:30, the market had rolled over again (along with oil, which got hit again after hours). Stocks closed decidedly lower but off the worst levels of the day.

Selling was broad again Monday, as all 10 S&P 500 sub-sectors were lower. However, the declines weren't that bad and the sector trading was better than you would

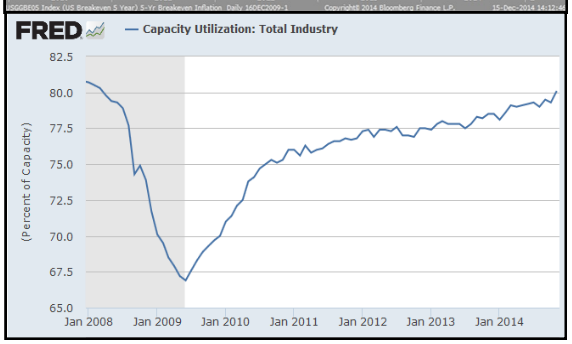
Market	Level	Change	% Change
Dow	17,180.84	-99.99	-0.58%
TSX	13,705.14	-25.91	-0.19%
Brazil	47,018.68	-983.30	-2.05%
FTSE	6,242.85	60.13	0.97%
Nikkei	16,755.32	-344.08	-2.01%
Hang Seng	22,670.50	-357.35	-1.55%
ASX	5,152.34	-33.73	-0.65%
Prices taken at previous day market close.			

have expected. Energy, not surprisingly, was the laggard (down 0.9%) while industrials actually managed to finish basically unchanged. Like the broad averages, there was no definitive cyclical underperformance as utilities were down 0.7%, but so were banks and financials.

Market	Level	Change	% Change
DBC	19.07	-.24	-1.24%
Gold	1197.80	-24.70	-2.02%
Silver	16.35	-.707	-4.14%
Copper	2.87	-.064	-2.18%
WTI	55.62	-2.19	-3.79%
Brent	60.53	-1.32	-2.13%
Nat Gas	3.731	-.064	-1.69%
RBOB	1.5718	-.0255	-1.60%
DBA (Grains)	25.27	.07	0.28%
Prices taken at previous day market close.			

Industrials were helped by the HON 2015 outlook, which was generally in line, and keep in mind GE offers their 2015 outlook this afternoon.

Energy started the day stronger but then rolled over as crude went into freefall. But considering WTI was down another 4%(!), the less than 1% decline in XLE really isn't that bad (and again, the stock market traded more with XLE than it did oil). We continue to like selling an XLE put spread here as a controlled-risk way of profiting from premium. The basic logic is that selling in the energy space got panicked and indiscriminate last week, and that generally speaking is a good time to sell puts (because there's likely a bounce-back rally coming at least short term).



Finally, retail continued to trade very well. RTH was up 0.3% on the day as the market continues to view the retail space as the natural beneficiary of the continued collapse in WTI crude.

So, yesterday was very much a mixed bag from an internals standpoint. But like last week, the sector trading didn't reflect a market that is seeing deteriorating internals. Point being, the last few days haven't been as bad as the indices would imply, at least from an internals standpoint.

Bottom Line

Despite the continuation of the sell-off yesterday, not much new happened. This market remains driven by energy stocks, junk debt and oil—and two out of the three hit new lows yesterday and pulled stocks lower. As we've been saying, until XLE and JNK bottom, this market slide isn't over.

A Tale of Two Inflations

The two charts on this page reflect a divergence in the statistical path of inflation. The first is a chart of the 5-year TIPS/Treasuries' break-even inflation expectation, which hit a new 4-year low and, frankly, is screaming "dis-inflation."

The second is capacity utilization, which measures how much of the manufacturing sector resources are being utilized. The higher the number, the more resources are being used—and that drives up prices for those resources. This leads to inflation.

The difference between the two, we think, is oil. Oil is distorting the 5 year inflation break-evens because they are based in CPI, which is sensitive to oil, while capacity utilization implies more-powerful inflation forces are starting to build.

Point being, we think the Fed is focused on the second chart, not the first. As a result, we think the belief the Fed may get dovish in 2015 and delay rate hikes because of a perceived dis-inflation risk is incorrect. We think if anything the risk is of the FOMC getting more hawkish, not less.

Economics

Industrial Production

- Production rose 1.3% vs. (E) 0.7% in Nov.

Takeaway

The manufacturing sector bounced back substantially in November, according to yesterday's Industrial Production Report. Not only did the headline beat, but the revisions to the October data were favorable with the headline edging up from -0.1% to +0.1%.

Importantly, we saw the headline strength confirmed by a strong gain in the manufacturing sub-index, up 1.1% vs. (E) 0.6%.

But, perhaps the biggest takeaway from yesterday's report was the Capacity Utilization figure, which hit a fresh multi-year high, rising to 80.1%.

The reason that is such a big deal is because rising Capacity Utilization is a precursor to inflation. I know everyone is focused on the drop in 5-year inflation expectations (they hit 4-year lows yesterday), but we maintain that this is an oil phenomenon—rising capacity utilization is much more indicative of rising structural inflation, which is potentially hawkish for the Fed.

Bottom line, yesterday's Industrial Production report was very strong, suggesting the manufacturing sector of the economy is beginning to accelerate again after taking a breather in September and October. This is a general positive for risk assets going forward.

Empire State Manufacturing Survey

- The General Business Conditions Index fell to -3.58 vs. (E) 12.0 in December.

Takeaway

In total contradiction to the November IP report, yesterday's December Empire State Manufacturing Survey was very disappointing as it turned negative for the first time since January. New Orders, the leading indicator within the report, also fell into negative territory—dropping to -1.97 from November's reading of +9.14. This marks the second time in three months new orders have been in negative territory.

Market	Level	Change	% Change
Dollar Index	88.655	.06	0.07%
EUR/USD	1.24381	-.0022	-0.18%
GBP/USD	1.5645	-.0073	-0.46%
USD/JPY	117.63	-1.14	-0.96%
USD/CAD	1.1644	.0063	0.54%
AUD/USD	.8221	-.0019	-0.23%
USD/BRL	2.6952	.0411	1.55%
10 Year Yield	2.116	.013	0.62%
30 Year Yield	2.745	-.011	-0.40%
Prices taken at previous day market close.			

Bottom line, though, is the market largely ignored this report because of two factors: First, the national flash manufacturing PMIs come out at 10 this morning and will make this Empire report stale very quickly. Second, Empire manufacturing is notoriously volatile, and the only reason anyone pays attention to it is because it's the first data point from the current month (December). Unless the flash PMI this morning confirms this sharp drop, this number will quickly be forgotten.

Commodities

It was more of the same in the commodities space yesterday as crude oil prices dropped to new multi-year lows, leading the rest of the space lower. Precious metals were also notable underperformers. The benchmark commodity tracking index ETF, DBC, fell another 1.29%

Oil futures opened in the green yesterday morning amid news of potential production interruptions in both Libya and Nigeria. But, traders saw the modest gains as a selling opportunity and futures turned negative in the first hour of trading. WTI futures slumped 3.93% to fresh 5-year lows again yesterday.

The "bearish quote of the day" came from United Arab Emirates Energy Minister Suhail Al-Mazrouei who said "OPEC will refrain from cutting output even if prices slumped to $40/barrel." Remember, the UAE basically does what Saudi Arabia wants them to do, so when they say something with regard to oil prices, it is a reflection of Saudi Arabian policy. So, bottom line, OPEC (really the Saudis via the UAE) is basically lowering their previously mentioned "target" of $60/Brent barrel by a long shot—news the market correctly interpreted as very near-term bearish.

So, with that in mind, oil remains in freefall for now, and the bears have a lot of momentum on their side. On the charts there is a level of support as we approach $53/barrel in WTI, and with all of the recent momentum, the potential for a sharp, snapback short-covering rally exists. But again, such a move would be one to sell into.

Precious metals fell sharply yesterday with gold and silver declining 2.42% and 5.29% respectively. The selling accelerated in the second half of the day as weak-handed longs began to dump their positions ahead of the two-day FOMC meeting that commences today. The Commitments of Traders report released weekly by the CFTC continues to suggest the recent rally was merely a violent short-squeeze. Over the past 4 weeks, 40K short positions have been forced out of the market, cutting the open short interest in half from nearly 80K to below 40K contracts.

On the charts, gold has broken back down through multiple support levels. However $1,190, the early October lows, are going to be an important level for futures to get below for the sell-off to confirm this most recent reversal.

Fundamentally, precious metals traders are primarily focused on tomorrow's FOMC announcement, Yellen's press conference, whether or not "considerable time" is removed/altered and where the "dots" are in the release.

Currencies & Bonds

There was a battle in the currency markets yesterday between strong U.S. economic data, which was dollar-bullish, and continued declines in stocks, which is dollar-bearish, and in the end the two sides fought to a draw. The Dollar Index started the day decently higher but declined as stocks sold off and closed fractionally stronger, up 0.09%.

The euro traded almost perfectly inverse to the dollar yesterday as it opened lower, pressured by comments by ECB member Nowotny that QE was possible in the EU. But at this point that doesn't add much as QE in January is now the consensus market expectation. Instead, the euro is continuing to trade as an inverse proxy for risk: Stocks go up, risk is on, and the euro declines. Conversely, stocks go down, risk is off, and the euro declines. That's been the driving force in the euro (and yen) for the last two weeks, and generally speaking we can expect that to continue.

The yen was by far the biggest mover of the day, as dollar/yen fell 1% and again dropped below support at 118. The decline in stocks was mostly to blame for the declines (again risk-off) but parliamentary elections in Japan were also an influence. As expected, PM Abe's party (and partner parties) won in a landslide and kept their super majority in the Diet. Fundamentally, that is a positive, as it makes it more likely Abe will be able to implement the "third arrow" of Abenomics, which is structural corporate reform (wage increases and a lower corporate tax rate). But, we definitely saw a "buy the rumor, sell the news" reaction in dollar/yen as it was flat following the expectedly dovish announcement. And, given the yen was flat once the declines started in stocks, it didn't take much to get another big short-covering rally rolling in the yen. Last week's low of 117.43, the spike low has been broken, and now dollar yen is sitting on an uptrend in place since early October at 116. If that is broken, a move to 114 isn't out of the question.

Turning to bonds, Treasuries were flat yesterday and corporate markets (junk and investment grade) were steady, despite the drop in stock prices. Treasuries were higher early Monday but sold off following the strong IP and Capacity Utilization report (which is bond-bearish). But, buyers were there on the dip and bonds rallied as stocks sold off, hitting their highs of the day around noon. Yesterday was a textbook example of how fundamentals simply aren't in control in the bond market, as very good data could only get bonds to decline temporarily. And while the gap between Treasury prices and U.S. economic fundamentals continues to widen, it won't be until we get some sort of positive motion in Europe that this gap begins to close (although when it does, I think it'll close rather violently, but for now more patience is required).

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 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 are viewing this dip as a buying opportunity.*
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 German bund yield continue to make Treasuries attractive to international investors.*
Best Idea: Short "long" bonds (TBT) **Best Contrarian Idea:** Short High Yield Bonds (SJB)			