# 7:00's Report

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

***December 17th, 2014***

## Pre 7:00 Look

- Futures are bouncing this morning and international markets are mixed but steady as the ruble and Brent crude were relatively stable o/n.
- Economically, final EU HICP met estimates while the Great Britain Labour Market Report was mixed as unemployment rose 0.1% to 6.0% but the number of unemployed dropped more than expected. Neither report is eliciting much of a market response.
- Econ Today: CPI (E: -0.1%), FOMC Meeting & Forecasts (2:00 PM), Fed Chair Press Conference (E: 2:30 PM).

| Market | Level | Change | % Change |
|---|---|---|---|
| S&P 500 Futures | 1975.75 | 10.75 | 0.55% |
| U.S. Dollar (DXY) | 88.49 | .193 | 0.22% |
| Gold | 1199.90 | 5.60 | 0.47% |
| WTI | 55.39 | -.87 | -1.55% |
| 10 Year | 2.071 | -.045 | -2.13% |

## Equities

*Market Recap*

Yesterday was volatile as a collapse in the Russian ruble, mixed economic data and an attempted bounce in oil led to a nearly 40-point daily trading range in the S&P 500. At the end of the day, despite an attempt to rally, stocks finished decidedly lower, down 0.85%.

Fundamentals were trumped by currency volatility yesterday, as a 20% drop in the ruble overshadowed mixed flash manufacturing PMIs. Stocks were stronger very early Tuesday, but when the ruble collapse accelerated, it brought futures to fresh lows. Stocks opened solidly lower and below support at the 100-day MA.

But, the dip brought in buyers who ignored a disappointing U.S. flash December manufacturing PMI and a housing starts miss. Stocks turned materially positive following some positive comments from Secretary Kerry regarding Russia (which helped the ruble to lift).

But, shortly after the European close, oil began to roll over. Then news broke that Obama would sign a bill from Congress imposing more sanctions on Russia. Stocks followed oil lower and declined sharply into the close to finish at the low ticks of the day.

It was a confusing day of multiple influences, but bottom line the failed rally was disconcerting and the close downright ugly.

*The 4 Major Market Influences Right Now*

Temporarily the ruble has trumped energy/junk bonds as the primary driver of markets. But at this point things are so fluid and there are so many moving pieces, it's hard to keep track of what's really driving markets at any minute. But, as for where things stand right now, and acknowledging things may change this afternoon depending on the Fed, here are the major influences on stocks right now:

**First, Russia:** The currency needs to stabilize and while we cover it more in the Currencies section, that will happen if either oil can stabilize or we can see some sort of a retracement in Russia's meddling in Ukraine. Since most of us don't have ruble quotes, CEW needs to be on your screen so see if the ruble and emerging market currencies are stabilizing.

**Second, continued energy & junk bond declines.** Oil and energy stocks were "ok" yesterday but JNK made frac-

| Market | Level | Change | % Change |
|---|---|---|---|
| Dow | 17,068.87 | -111.97 | -0.65% |
| TSX | 13,861.52 | 156.38 | 1.14% |
| Brazil | 47,007.51 | -11.17 | -0.02% |
| FTSE | 6,296.34 | -35.49 | -0.56% |
| Nikkei | 16,819.73 | 64.41 | 0.38% |
| Hang Seng | 22,585.84 | -84.66 | -0.37% |
| ASX | 5,161.86 | 9.52 | 0.18% |
| Prices taken at previous day market close. | | | |

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tional new lows. There are signs those markets are trying to stabilize, but we're not there yet. XLE and JNK remain leading indicators of the market behind the ruble.

**Third, Greece/ECB QE disappointment worries.** This has been put on the back burner but the first round of presidential voting in Greece happens tonight at 7 p.m., so it'll be back in the news.

| Market | Level | Change | % Change |
|---|---|---|---|
| DBC | 18.88 | -.12 | -0.63% |
| Gold | 1194.00 | -13.70 | -1.13% |
| Silver | 15.75 | -.813 | -4.91% |
| Copper | 2.8615 | -.017 | -0.59% |
| WTI | 55.93 | .02 | 0.04% |
| Brent | 59.87 | -1.19 | -1.95% |
| Nat Gas | 3.631 | -.088 | -2.37% |
| RBOB | 1.5375 | -.0389 | -2.47% |
| DBA (Grains) | 25.07 | -.20 | -0.79% |
| Prices taken at previous day market close. | | | |

**Fourth, concerns about global growth.** The flash manufacturing PMIs from China were bad. The global economy is sputtering and the only reason that's not a greater negative on the market is because of expected QE or stimulus from the ECB and the People's Bank of China. If either of those assumptions is challenged, look out.

*Bottom Line*

The S&P 500 has given back about half of the year-to-date gains over the past two weeks. But despite ominous headlines, none of the abovementioned events are really significant negatives at this point (although they could become significant negatives).

People trying to lock in gains for the year, low liquidity, and an unwind of weak longs from that ephemeral 2,000 to 2,080 straight line rally are all contributing to the pullback. Russia and energy remain a concern, but I maintain this is a dip we need to view as a buying opportunity. Just like we overshot to the upside in November on fundamentals that weren't that good, so too are we now overshooting to the downside on fundamentals that aren't that bad. But, until XLE and JNK bottom, we need to remain patient.

## Economics

FOMC Preview

There are three general themes we'll be watching for in this afternoon's report: First, is "Considerable Time" removed from the statement? Second, does the Fed explicitly mention a risk of lower inflation expectations due to falling oil prices? Third, do Fed officials' expectations of future interest rate levels (aka, the "dots) get any closer to market-based expectations? Finally, remember this is the last of the four 2014 meetings with a press conference, so that will be watched closely.

*"Considerable Time"*

Although not a sure thing, it is the consensus expectation that the phrase "considerable time" will be removed from this sentence in the 4th paragraph of the statement: "The Committee anticipates, based on its current assessment, that it likely will be appropriate to maintain the 0 to 1/4 percent target range for the Federal Funds rate for a **considerable time** following the end of its asset purchase program this month, especially if projected inflation continues to run below the Committee's 2 percent longer-run goal, and provided that longer-term inflation expectations remain well-anchored."

As a reminder, considerable time equals 6 months, from a market standpoint. So when "considerable time" is removed, markets anticipate rates will rise six months hence. Removal of that phrase means the first rate hike comes in June 2015, which is the general consensus.

The removal of this sentence is largely priced into stocks, the dollar and bonds, so if it is removed we may see a knee-jerk "hawkish" response and see stock and bond weakness/dollar strength, but that shouldn't be long-lasting. The bigger surprise would come if "Considerable Time" stays in the statement; that will be taken as "dovish" and we will likely see stocks, bonds and commodities rally, while the dollar sells off.

*Oil And Inflation*

As we touched on in yesterday's Report with our "A Tale of Two Inflations" section, much has been made of the negative effect falling oil prices have had on inflation expectations. Some think this will elicit dovish commentary surrounding inflation in the statement, but that is not the market consensus.

If the FOMC cites falling oil as a threat to meeting its 2% inflation target, that will be taken as "dovish," although as we contended yesterday, we do not think the Fed will

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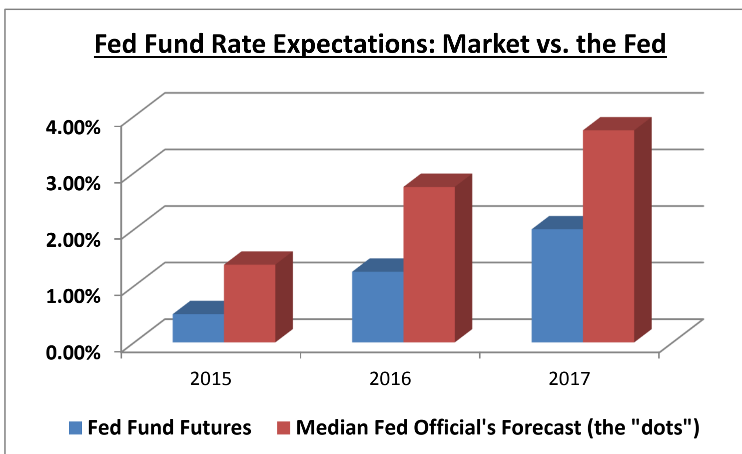
mention oil with regard to posing a legitimate threat to inflation. But, this is a second area for a potential "dovish" surprise.

*The "Dots" and Interest Rate Expectations*

The third area of focus today will be on the Fed official's projections for future interest rates. Simply, there is a huge gap between where the market believes interest rates will be over the next three years (via Fed Funds futures), and where Fed officials say interest rates will be. This gap is a potential risk to markets, because if it closes quickly (like what happened in 1994) then we could see a snap higher in interest rates in the coming couple of months.

The median forecast from Fed officials for interest rates in the September meeting was: 1.375% for 2015, 2.75% for 2016, and 3.75% for 2017. That is 0.8%, 1.5% and 1.75% higher than what the market thinks. If the median rate forecasts come down a bit (which they might) or at least stay the same, then that will be taken as slightly dovish, although don't expect too much of a market reaction. Conversely, the risk is that they move higher and the gap widens—if that occurs it'll be taken as "hawkish" and stocks, bonds and commodities will come under pressure.




Global December Flash Manufacturing PMIs

- **US: December Manufacturing PMI was 53.7 vs. (E) 55.5.**

*Takeaway*

It was a bit of an opposite day in the global flash PMIs, as Europe was surprisingly stronger than expectations, while the U.S. was decidedly weaker than estimates. China, however, was the real disappointment on the day, and the drop below 50 wasn't taken well, especially since it was not accompanied by a Pavlovian response by Chinese authorities to tease more stimulus at the sight of a disappointing economic indicator.

In Europe, the data were very much "just right" from a Goldilocks standpoint, as while they barely beat expectations and remain precariously above 50, it's a step in the right direction. Staying in Europe, it was a good day for Germany. Not only did manufacturing PMIs beat, but the important ZEW Business Expectations Index shot higher, rising to 34.9 vs. (E) 18.

In the U.S. the flash manufacturing PMI dropped to an 11-month low (lowest since January), although before any of us get worried about the economy, keep in mind that 1) the PMI is still well-above 50, so there's still decent growth and 2) We all expected the stronger dollar would begin to weigh on exports/manufacturing, but the benefit the stronger dollar gives the consumer will more than outweigh any dip in manufacturing activity, given 70% of the economy is consumer-based.

Bottom line, nothing yesterday should materially change anyone's outlook on the global economy with the exception of China, where yesterday's soft PMI will definitely stoke worries that the economy is losing more momentum. Remember 7% GDP growth remains the "Maginot Line" for markets in China, so if growth expectations drop below that level, it'll start to be a headwind.

| Market | Level | Change | % Change |
|---|---|---|---|
| Dollar Index | 88.25 | -.432 | -0.49% |
| EUR/USD | 1.2497 | .0061 | 0.49% |
| GBP/USD | 1.5726 | .0089 | 0.57% |
| USD/JPY | 117.18 | -.62 | -0.53% |
| USD/CAD | 1.1632 | -.0038 | -0.33% |
| AUD/USD | .8209 | .0001 | 0.01% |
| USD/BRL | 2.7382 | .043 | 1.60% |
| 10 Year Yield | 2.071 | -.045 | -2.13% |
| 30 Year Yield | 2.702 | -.043 | -1.57% |
| Prices taken at previous day market close. | | | |

## Commodities

Commodities continued to trade heavy yesterday but the metals were the worst performers for a change. WTI crude oil bounced on positioning while Brent futures continued to slide lower. The broad-based commodity ETF, DBC, fell to yet another 5+ year low, down 0.53% yesterday.

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Like DBC, WTI crude oil futures fell to a fresh 5-year low overnight last night before catching a bid to finish the day essentially unchanged. Volatility remains high as futures were down as much as 4% Monday night, and up as much as 2% during yesterday's session. Brent prices continued to tumble yesterday as global oil traders are now eyeing $40/barrel thanks to the UAE Oil Minister's comments that $40 would be the level Brent crude would need to reach before OPEC even "considered" holding an emergency meeting.

WTI crude oil recovered from morning losses largely as a result of options expiration yesterday as day traders and corporate prop traders alike bought up futures against short options positions. Near term, the bounce could spur some additional short-covering, which we are seeing this morning, but any material rally would be an opportunity to sell into as the trend remains decidedly lower from here.

Moving to the metals market, industrials have gotten hit hard this week as last week's copper mine strike in Peru was resolved on Sunday, which spurred a "sell the news" reaction. That paired with the disappointing flash PMI out of China yesterday pushed copper futures down 0.61%, back toward a multi-year "closing low" just below $2.85. As we mentioned last week, the "mine-strike rally" was a great short-selling opportunity with a favorable 3.1% move in this week alone. Bottom line, copper remains in a well-defined downtrend with resistance above in the low $2.90s while the early December "spike low" of $2.7775 is in focus to the downside.

After rallying over $20 on a fear bid early yesterday morning, gold futures finished the day down 0.94%. We remain bearish on gold largely based on the stronger dollar argument, Obviously the FOMC decision will result in volatility this afternoon, but on the charts, we are eyeing initial support at $1,190 while there is a band of resistance above between $1,205 and $1,210.

## Currencies & Bonds

It was a downright historic day in the currency markets yesterday, mainly thanks to simply unbelievable movements in the Russian ruble. Given we are short on space in today's Report, I'm going to focus on it. For formality's sake, the dollar declined 0.6% yesterday while the yen, euro and pound all rallied the same amount.

Bottom line, the ruble is collapsing because of 1) plunging oil (that systemic risk we've been discussing) and 2) continued pain from sanctions relating to Russian interference in Ukraine (yesterday President Obama said he will sign a law that imposes new sanctions on Russia).

So, for now the fate of the ruble is tied to 1) oil prices and 2) Russian policy in Ukraine. As long as the recent trend in those two things remains the same (oil trending lower, Russian meddling in Ukraine trending higher) then expect the ruble to be under further pressure.

But, a dial back in either (meaning stabilization in crude or a softening of Russian stance vs. Ukraine) will see the ruble stabilize. We saw that yesterday as positive comments by Secretary of State Kerry and Russian Foreign Minister Lavrov helped lead to the bounce in the ruble. Bottom line, watch oil and Russia/Ukraine geopolitical headlines for clues as to when the ruble will stabilize.

Obviously, the reason we all care about the ruble is contagion, and while we are seeing some, this is not a full-blown currency crisis, yet. CEW, as I mentioned yesterday, remains an important ETF to watch, since most of us don't get ruble, lira, peso or other quotes. Of note, CEW bounced a bit yesterday and closed well off the intraday lows, but that ETF is a good proxy for the level of emerging market contagion.

Bottom line, unless things get materially worse (and by that I mean the Russian central bank flails about or institutes capital controls, both of which seem remote) then this should not be a major macro headwind nor a reason to materially de-risk, although obviously it bears close watching (and you can count on us to do so).

Bonds caught a bid early yesterday as part of a larger "risk-off" move in the markets thanks to the plummeting Russian ruble, mixed economic data globally, and further sell-off in crude oil. The 10-year note added 0.39% while the long bond gained 0.67%.

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<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 12.15.14)**

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)**

| | Near Term Trend | Long Term Trend | Market Intelligence |
|---|---|---|---|
| **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)**

| | Near Term Trend | Long Term Trend | Market Intelligence |
|---|---|---|---|
| **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)**

| | Near Term Trend | Long Term Trend | Market Intelligence |
|---|---|---|---|
| **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)**

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