7:00's Report

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

December 19th, 2014

Pre 7:00 Look

- Futures are drifting slightly higher this morning as US market take a breath following the huge 2 day rally.
- Internationally, Japan was up 2% on momentum from the US and an in-line BOJ announcement, while European shares are digesting recent gains, like US futures.
- Economically, German PPI came in better than expected 0.0% vs. (E) -0.2%, while Great Britain Distributive Trades (retail sales) surged higher in December 61 vs. (E) 31.0.
- Fed Speak: Evans (10:00 AM), Lacker (12:30 PM)
- Today is Quadruple-Witching Options Expiration.

Market	Level	Change	% Change
S&P 500 Futures	3064.50	4.50	0.22%
U.S. Dollar (DXY)	89.605	.128	0.14%
Gold	1197.30	2.50	0.21%
WTI	55.28	.93	1.71%
10 Year	2.204	.056	2.61%

Equities

Market Recap

Stocks surged for a second straight day as a continued rebound in energy stocks and junk bonds fueled more short-covering and chasing to the upside. The S&P 500 closed up 2.40%.

The momentum from Wednesday's post-FOMC rally continued globally Thursday morning, and futures were solidly higher pre-open despite the lack of any real, positive news.

The S&P 500 has rallied 89 points, or 4.5%, since Tuesday. Perhaps this keeps going into year-end just on momentum, but these types of snap back rallies usually aren't sustainable.

Stocks opened higher and from there saw a strong bout of short-covering for the first 90 minutes of trading, ignoring a disappointing Philly Fed PMI and a flash service sector PMI.

As we approached the European close, the rally stalled a bit as crude oil and energy stocks tried to roll over midday, and the S&P 500 at one point was more than 10 points off the morning highs (although still up solidly).

But, when oil and energy stocks stabilized around lunchtime and reversed the declines, it caused another wave of short-covering and buyers chasing to add long exposure. Stocks experienced a "melt up" rally into the close, finishing the day basically at the highs.

Trading Color

Yesterday had much more of a "buyers' chase" feel to it than just short-covering, and I say that because the most beat-up sectors (XLE, JNK, RSX) didn't outperform (although with the exception of RSX they were higher).

Instead, yesterday reeked of buyers chasing to add long exposure because there was almost indiscriminate cyclical outperformance from a cyclical sector standpoint.

Market	Level	Change	% Change
Dow	17,778.15	421.28	2.43%
TSX	14,346.75	132.87	0.93%
Brazil	48,495.70	-217.94	-0.45%
FTSE	6,499.08	33.08	0.51%
Nikkei	17,621.40	411.35	2.39%
Hang Seng	23,116.63	284.42	1.25%
ASX	5,337.65	127.87	2.45%
Prices taken at previous day market close.			

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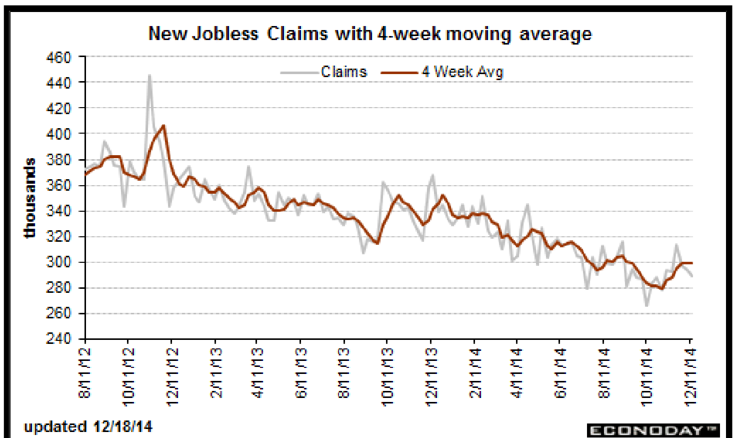
SPHB (S&P 500 high beta) was up 2.5% vs. 1.8% in SPLV. Meanwhile industrials, tech, financials and basic materials all were up more than 2%, while defensive sectors were up barely more than 1.5%.

Market	Level	Change	% Change
DBC	18..94	-.06	-0.32%
Gold	1198.30	3.80	0.32%
Silver	15.94	.012	0.08%
Copper	2.8495	.021	0.73%
WTI	54.97	-1.82	-3.20%
Brent	59.54	-1.64	-2.68%
Nat Gas	3.653	-.049	-1.32%
RBOB	1.5314	-.0348	-2.22%
DBA (Grains)	25.48	.42	1.67%
Prices taken at previous day market close.			

Additionally, while all of tech was higher, mega-cap tech stocks—which have been investors' proxy for adding or taking down long exposure—all headily outperformed. AAPL, MSFT, CSCO, ORCL, MSFT and INTC all finished up a minimum of 2%, with ORCL surging nearly 9% following a good earnings report.

Of note, while financials were very strong yesterday, banks lagged a bit (KRE up 1.5% despite higher rates), and the strength in financials was due mainly to brokers and insurers.



Weekly jobless claims fell for the third week in a row last week, pushing the 4-week moving average lower for the first time in 6 weeks. The general downtrend in claims data continues to suggest the labor market is healthy and steadily improving.

Also, retail stocks also relatively underperformed (RTH up 1.5%), and while that could just be some buyer exhaustion, it again backs up my point that money yesterday wasn't flowing into fundamentally stronger sectors, but instead just to higher-beta large-cap names as a way to "slap on" more long exposure..

Finally, as we would have hoped, "Europe" handily outperformed as nerves have calmed, for now, ahead of the Greek vote next week.

On the charts the S&P 500 is now back above all major moving averages, so the technical picture has obviously improved considerably and it now mostly neutral.

Bottom Line

The S&P 500 is up 89 points from the Tuesday lows, and basically the reason is because the Fed was perceived as "dovish" (more on that later), and energy stocks and oil have stopped collapsing every day.

Despite the nice move, though, rallies like the past two days aren't what typically proceed a sustainable move higher in stocks, as clearly there are short-term investors simply stampeding out of stocks (Friday – Tuesday) and then back into stocks (Wednesday & Thursday) on various whims.

Going forward, both XLE and JNK are trying to bottom but it's too early if its been successful. As a result our opinion is right back where it was 14 days ago—the market has risen a lot in a very short time on little more than weak-handed longs chasing performance and shorts booking trades. I would not be adding to equities here (including energy stocks).

Oil Stocks vs. Oil

Over the past 2+ weeks we've been stressing that the performance of oil stocks is more important to the overall stock market than performance of oil itself.

Case in point, yesterday oil sold off hard (nearly to the recent lows) in after hours trading from 2:30—4:00 PM. But, stocks ignored the drop because XLE remained buoyant. **So, continue to watch XLE and JNK not oil itself, as leading indicators of stocks.**

Economics

Philly Fed Survey

- The General Business Conditions Index was 24.5 vs. (E) 25.0 for Dec.

Takeaway

According to the Philadelphia Fed Survey, manufacturing growth remains quite strong in the area for the month of December. But, the headline General Business Condi-

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tions Index did fall nearly 15 points to 24.5 from November's sky-high reading of 40.8, but aside from the November data, it was the best headline since March 2011. Looking to the details of the report, however, the report was not as optimistic.

New Orders slowed to 15.7 vs. 35.7 in November and Unfilled Orders (a measure of demand) fell to 1.5 vs. 7.1 in November, while Shipments (which greatly contributed to the strong November Industrial Production report) were cut in half from 31.9 to 16.1.

Bottom line, although the headline remained near a multiyear high, the components of yesterday's Philly Fed survey are more consistent with the disappointing Empire State Mfg. Survey and Flash Manufacturing PMI reports from earlier this week, suggesting manufacturing output is at the very least taking a breather here as we approach the end of the year.

Commodities

Commodities were mixed yesterday as the bounce in crude oil futures fizzled out and WTI and Brent both led the space lower. Meanwhile, the metals were little-changed but the grains outperformed, managing to notch modest gains on the day. The benchmark commodity ETF, DBC, fell 0.26% due to the heavier weight of the poorly performing energy sector.

The brief, short-squeeze rally in crude oil futures came to an abrupt end yesterday morning when futures failed to make a new high, rolled over, and tumbled lower for the remainder of the session. WTI closed down 3.70%, with a staggering 8.06% drop from the high print to low tick. Needless to say, volatility in the space remains very high, and now that we have seen the brief hiatus in the sell-off come to an end, its seems like the bears are ready to push down to new lows.

Market	Level	Change	% Change
Dollar Index	89.45	.124	0.14%
EUR/USD	1.2282	-.0059	-0.48%
GBP/USD	1.5671	.0097	0.62%
USD/JPY	118.73	.09	0.08%
USD/CAD	1.159	-.0039	-0.34%
AUD/USD	.8159	.0039	0.48%
USD/BRL	2.6623	-.0522	-1.92%
10 Year Yield	2.204	.056	2.61%
30 Year Yield	2.812	.060	2.18%
Prices taken at previous day market close.			

The only fundamental news was out of Russia where Putin said that the Russian economy needed to brace for $40/barrel oil, which is just another bearish comment from one of the global big shots in the oil game. On the charts we remain bearish, with eyes on Tuesday's low of $53.60 while initial resistance is above at $55.50.

Natural gas futures were higher yesterday morning but sold off sharply to close down 1.22% following a largely in-line EIA report. The EIA reported a -64 Bcf draw in supplies last week vs. analyst expectations calling for -60 Bcf. Futures closed down toward $3.65, about $0.10 above the 2014 lows, which traders continue to focus on. We remain cautiously bearish on natural gas because of the often unforeseeable volatility; however, if futures can violate the late October lows at $3.54, we have an initial target of $3.40. Bottom line, natural gas trade is primarily weather-driven this time of the year, And with forecasts suggesting average-milder temperatures for much of the country through the new year, markets are beginning to trade a bit heavy.

Moving to the metals, gold futures bounced yesterday, rising 0.30% as support at the $1,190 level continues to hold on by a thread. In addition to the former lows, there is also countertrend support at $1,190, but once that is broken, it should signal the resumption of the sell-off in gold.

Fundamentally, there was a lot of chatter surrounding heightened physical demand for gold between China and the Swiss, while there was opposing news that Russia may be forced to sell reserves due to their plummeting ruble. However we do not believe the current global economic and geopolitical situations will have enough of an effect on gold to push it up through the December highs near $1,240.

So, right now, there is a decent risk/reward setup for shorting gold anywhere above $1,200, with a stop at $1,240. If you are looking for a swing trade and a chance to see futures make new multi-year lows below $1,130, now would be the time to sell. And, a close below aforementioned support at $1,190 would help confirm that position.

Currencies & Bonds

Bonds were the story yesterday as Treasuries are clearly

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taking the Wednesday FOMC statement as "hawkish." The 30-year closed down 0.8% yesterday, making the two-day drop in the 30-year nearly 2% (which is a lot for the 30-year).

But, in testament to how powerful the rally has been in the long bond this year, the 2% dip still registers pretty small on a year-to-date chart. This serves as reminder that, while the bond market may be acknowledging the Fed is slouching toward rate hikes, Europe remains a driving supportive force in the Treasury market for now.

I don't want to jump to conclusions, but the price action feels a bit heavier than earlier this year, as perhaps the bond market is starting to realize that the Fed actually intends to raise rates in the first half of 2015. With the Greek presidential election still looming, I don't expect any material sell-off, but *if* they elect a president and the ECB actually does QE in January, then perhaps we may finally see bonds start to reflect domestic fundamentals sometime in early '15.

It was mostly a day of digestion in the currency space following the very strong dollar rally on Wednesday. The Dollar Index closed fractionally higher, thanks to gains against the euro and yen.

Importantly, though, while the Dollar Index was only up small yesterday, it did make a new multi-year high, and clearly the trend of dollar strength is still very much intact.

The euro and yen were actually the only major currencies to decline against the dollar yesterday, but given their heavy weighting in the Dollar Index, it caused the dollar to finish positive on the day.

The euro was the worst performer vs. the dollar, down 0.36% as the currency ignored the strong German IFO Index. Instead the market focused on the expectation of QE in the EU at the January 22nd ECB meeting (there was a article out yesterday describing how Draghi has launched a "charm offensive" in Germany to minimize the fallout from a QE announcement).

The yen was down a much more modest 0.15% as that market continued to digest recent volatility, but the general outlook for the yen remains static (it's heading lower).

The British pound was the best performer vs. the dollar, rallying 0.75% following the much stronger than anticipated November retail sales data, and that's the second piece of "hawkish" news regarding the pound this week.

Earlier this week, like in the U.S., CPI in Great Britain missed estimates, prompting some to think it would elicit a "dovish" response from the Bank of England. But, like his counterpart here in the U.S., BOE Governor Carney largely dismissed the oil-backed CPI decline as transitory, and it won't make the BOE more dovish. As a result, I continue to think there is a growing risk of a "hawkish" surprise from the BOE looming in 2015, and if I were to get long one currency vs. the dollar, it would be the pound.

<u>The Currency and Bond Market Is Telling You the Fed was Hawkish.</u>

Despite most media reports and the stock market rally, the Fed wasn't dovish Wednesday, and you know that because of the dollar and bond market. The dollar recouped all of this week's losses and hit a new multi-year high overnight Thursday, while bonds have seen their steepest two day declines in weeks.

So, we have a growing divergence occurring in markets here between what the stock market thinks of the Fed going forward, and what the currency and bond markets think about the Fed going forward.

We are going to talk more about this next week, as we think this growing divergence surrounding Fed expectations is one of the themes we need to be watching in early '15. We are growing concerned the stock market isn't quite "getting it" with regard to Fed intentions for rates in early to mid 2015, as this divergence will reconcile itself one way or the other. It's one of the things we're watching that may cause some volatility in early 2015. More on that next week, though.

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 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)

	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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