7:00's Report

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

December 22nd, 2014

Pre 7:00 Look

- Futures are higher again this morning as the positive momentum from last week continues. Asia and Europe were broadly higher o/n, rising slightly less than 1%.
- News wise it was a very quiet night, and generally the strength this morning is a continuation of last week's rally.
- Geo-politically, there is some hope Greek PM Samaras will form a broader coalition to get the 180 votes needed to elect a President on 12/29 (tomorrow's election has no chance).
- Econ Today: Existing Home Sales (E: 5.2M).

Market	Level	Change	% Change
S&P 500 Futures	2072.00	5.00	0.24%
U.S. Dollar (DXY)	89.72	-.121	-0.14%
Gold	1196.60	.60	0.05%
WTI	57.11	-.02	-0.04%
10 Year	2.176	-.028	-1.27%

Equities

Market Recap

Stocks enjoyed a big rebound last week. More Russian turmoil, coupled with continued weakness in energy and junk bonds, weighed on markets early. However, a "dovish" FOMC and stabilization in Russia/energy led to a massive midweek short-covering rally. The S&P 500 added 3.4% and is now up 12.03% this year.

Stocks started the week lower as selling momentum from the week prior carried over into Monday and Tuesday's sessions. Weak energy prices and a continued decline in junk debt combined with angst surrounding the Russian economy weighed on risk assets early last week. That angst reached a crescendo Tuesday thanks to the 20% collapse in the Russian ruble and mixed economic data.

But energy and the ruble stabilized on Wednesday, and stock futures began to quietly rally early in the morning before surging after the more "dovish" than expected FOMC meeting. The S&P 500 rose into the end of the day to finish up well over 1%.

Stocks continued to broadly rally on Thursday as a continued rebound in energy stocks and junk bonds spurred further short-covering and "chasing" to the upside, as the S&P 500 closed up approximately 2%. Friday saw a general digestion of the two-day, 89-point rally, although there was some light covering into the weekend, and the S&P 500 finished its best single week in years.

Trading Color

Generally cyclicals outperformed last week, but with that said it wasn't the highest quality rally from an internals standpoint. Wednesday and Thursday reeked of short-covering and "long rentals" by whipsawed portfolio mangers. I say that because on Wednesday, the most beat-up sectors of the market (energy, basic materials, junk debt, emerging markets) all handily outperformed, which implies short-covering. Then on Thursday, it was large-cap tech, which has been a proxy for "long exposure" for underinvested money managers.

Generally, the Russell slightly outperformed the S&P 500, but not by much, while the Nasdaq actually lagged. SPHB (S&P 500 High Beta) did handily outperform its defensive counterpart, though, rallying 4.12% thanks to a big surge Thursday/Friday as portfolio managers "slapped on" exposure.

Market	Level	Change	% Change
Dow	17,804.80	26.65	0.15%
TSX	14,468.26	121.51	0.85%
Brazil	49,650.98	1,155.28	2.38%
FTSE	6,596.89	51.62	0.79%
Nikkei	17,635.14	13.74	0.08%
Hang Seng	23,408.57	291.94	1.26%
ASX	5,441.96	103.31	1.94%
Prices taken at previous day market close.			

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Sector-wise there were a few observations worth noting: Retail hit a new 52-week high but actually underperformed, rallying just 2.3%. Likewise with the banks, as we saw KRE rise 2.7%. I would have liked to see both outperform to imply this rally is of "higher quality," as both had fundamental tailwinds last week (banks especially with the increase in interest rates).

Bottom line, I would have liked to see a more high-quality rally from a sector standpoint, and it only reinforces my skepticism that the move of late last week is sustainable over the coming months.

Market	Level	Change	% Change
DBC	19.22	.28	1.48%
Gold	1194.50	-.30	-0.03%
Silver	16.065	.131	0.82%
Copper	2.8975	.044	1.54%
WTI	57.77	3.41	6.27%
Brent	62.08	2.81	4.74%
Nat Gas	3.446	-.196	-5.38%
RBOB	1.577	.0498	3.26%
DBA (Grains)	25.44	-.04	-0.16%
Prices taken at previous day market close.			

Bottom Line

We've been focusing on the pace of the oil decline as the key weight on stocks over the past 2+ weeks. Last week that pace of decline slowed materially, and it ignited a massive short-covering rally as portfolio managers and investors covered shorts and then chased stocks higher to add long exposure in anticipation of a "melt-up" into year-end. Astonishingly, the S&P 500 is just 10 points off the all-time highs, despite the lack of any real, fundamental change to the investment outlook.

The "risks" that caused this decline in stocks still remain: First, "systemic" effects from the oil decline (especially in Russia), the junk bond market and emerging markets still remain (although obviously, concerns about those risks have receded over the past few days). Second, the Greek political situation, which was thrown decidedly on the back burner last week, remains unsettled. The first presidential vote failed, and now there are just two rounds remaining (tomorrow and the 29th).

Finally, the FOMC, despite being taken "dovishly" by stocks last week, really wasn't. Although the gap between Fed expectations for interest rates and the market's expectations for interest rates narrowed slightly last week, the gap remains large.

Bottom line, last week's rally was impressive but we feel it remains a lot of "weak hands" pushing the S&P 500 materially above the 2,000 mark. As a result, we aren't interested in adding broad, long exposure up here. Obviously we wished we bought the market broadly on Tuesday's lows, but so does everyone else.

We continue to like "Europe," which rallied hard last week as the destination for incremental capital, and buying last week's dip appears to have been a good move.

Domestically, RTH and consumer-related names (the two we've been highlighting are SFY and LEAF) remain our preferred destination for new capital if it must go domestic.

Again, we're not bears on U.S. stocks, but we want to see a real improvement to fundamentals materializing—and some sort of further digestion of the fundamentals—before confidently adding more money to the broad U.S. markets at these levels, as we think there are better risk/reward setups elsewhere.

Going forward, keep watching XLE, JNK and RSX (in that order). If they continue to stabilize, so will stocks. If they start to roll over again … then look out. They remain leading indicators of the market.

Economics

Last Week

There were three practical takeaways from last week's economic data (which happened to be the last important week of the year): First, there are clear signs that the U.S. manufacturing sector is losing some momentum, mainly because of a stronger U.S. dollar. Second, we continue to see some "green shoots" in EU economic data. Third, the confusion over "Considerable Time" aside, the FOMC is clearly focused on raising rates sometime in the middle of 2015 (consensus is June, but the range is anywhere from April to September).

U.S. manufacturing related data disappointed last week, although that statement must be taken in context that the overall level of activity is still strong. December flash PMIs dipped to 53.7, the second-lowest reading of the year. Meanwhile, Empire State manufacturing PMI fell into negative territory and the Philly Fed generally met

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expectations (but the details of the report were a touch worse than expectations).

Most of these declines can be attributed to the stronger dollar pressuring exports (as we all expected it would), and also some general moderation as manufacturing activity in Q3 and early Q4 was unsustainably high. Importantly, though, retail, employment and confidence metrics on the economy are accelerating higher. So, this dollar-related dip in manufacturing is being offset by an uptick in consumer spending, continued improvement in the labor market, etc. The takeaway is we can expect more moderation in manufacturing activity in the coming months, but the U.S. economy remains on very solid footing as consumer spending and the jobs market are finally starting to "break out" from multi-year doldrums.

Internationally Europe continues to show some small signs of life. German flash manufacturing PMIs were stronger than anticipated at 51.2 vs. (E) 50.3, while the broader EU PMI also slightly beat expectations at 50.8 vs. (E) 50.5.

Most importantly, though, the economic data remains "Goldilocks" in that it's not too good as to deter the ECB from QE in January, nor bad enough to make investors think the ECB will fail.

The recent data continues to imply that the EU economy is trying to stabilize, and in the context of forthcoming QE, we continue to like the economic/macro backdrop for European stocks in 2015.

The one major disappointment last week was the Chinese flash PMI, which dipped below 50 to 49.5. But, the Russian ruble and oil volatility somewhat overshadowed the soft Chinese data. Remember, 7% annual GDP growth is the "Maginot Line." If estimates drop below it, expect markets to react negatively.

Finally, turning to the FOMC, we covered the meeting pretty in-depth last week, but the takeaway is we believe the FOMC was more "hawkish" than the stock market interpreted it to be.

Market	Level	Change	% Change
Dollar Index	89.82	.343	0.38%
EUR/USD	1.2222	-.0007	-0.06%
GBP/USD	1.5621	-.0005	-0.03%
USD/JPY	119.41	-.09	-0.08%
USD/CAD	1.1598	-.0002	-0.02%
AUD/USD	.8163	.0033	0.41%
USD/BRL	2.6595	-.0033	-0.12%
10 Year Yield	2.176	-.028	-1.27%
30 Year Yield	2.774	-.038	-1.35%
Prices taken at previous day market close.			

Part of that conclusion comes from the currency and bond markets: Bonds sold off and the dollar hit new highs following the meeting. The other is from our own analysis/conclusions. We believe the proper interpretation of the "Considerable Time" maneuvering is that the Fed is signaling rate hikes at the June meeting, which is not dovish. The gap between market expectations of rates and Fed expectations of rates remains too wide and it will have to reconcile at some point over the coming months. We believe this is another risk to monitor closely as we start 2015.

Finally, the soft CPI report last week (the headline fell) was a bit misleading. As mentioned, the stronger dollar and falling oil is pressuring core and headline CPI. But core "service" CPI rose 0.24% in November, faster than the current pace, and November Capacity Utilization rose above 80 for the first time since 2008. Point being, we believe structural inflation pressures are building, and that will put "hawkish" pressure on the Fed in the first few months of 2015.

This Week

This week is very similar to Thanksgiving week as the economic data is pulled forward to Tuesday and Wednesday. There are several reports out this week but don't expect any of them to change anyone's outlook on the U.S. or global economy.

Home sales data continues with Existing Home Sales this morning, while there are several reports out tomorrow: Durable Goods, final look at Q3 GDP, Personal Income and Outlays, and New Home Sales. Of those, Durable Goods and Personal Income and Outlays are the two most important.

In durables it'll be interesting to see if we get a moderation in the data thanks to the stronger dollar. And in Income and Outlays, the Core PCE Price Index (the Fed's preferred measure of inflation) will be released.

Internationally it's even quieter than in the U.S., as there is really no materially important data being released.

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Commodities

Commodities were mixed last week as crude oil traded better—with prices at least temporarily stabilizing in the mid-$50 range—while the metals and natural gas all finished lower on the week. The broad-based commodity tracking ETF, DBC, finished slightly lower, down 0.47%, but notably well off the week's worst levels.

Crude oil prices took a breather from selling off last week as futures finished higher by 0.48%. It was only the second weekly gain since September. There was no material, fundamental reason for the bounce other than apparent "seller exhaustion." The late-week gains (WTI rallied nearly 7% on Friday) were largely driven by short-covering and end-of-the-year positioning.

The only fundamental news last week was a bearish comment out of Russia where Putin said that the Russian economy needs to be prepared for $40 oil prices. (He basically reiterated what several Gulf producers have said recently; oil prices are poised to continue selling off.) The headlines put futures under pressure midweek, but the downside momentum was curbed thanks to the short-covering.

Bottom line, after such a violent breakdown—about 50% in 6 months—it seems money flows (short-covering) are temporarily trumping the market fundamentals, which remain bearish. And, the counter-trend rally could continue into the end of the year as money managers and physical producers alike square their books. But, the prominent trend in oil prices remains decidedly lower, so any material bounce-back into the low- to mid-$60s should be seen as a selling opportunity.

Natural gas prices broke down late in the week as investors focus on surging U.S. production while demand remains subdued thanks to the mild weather across the nation. Natural gas futures are now officially in a bear market after futures fell 8.62% last week, increasing the fall from the November peak to -23%. We remain bearish on nat gas for the near term, and futures have already broken through our first downside target of $3.40 in over night trade. The next support is below at $3.20.

Moving to the metals, gold fell 2.26% last week with most of that move being a result of positioning ahead of the FOMC events. As we explained last week, the Fed was marginally hawkish which is bearish for gold. We remain bearish gold as the dollar continues to trade up to new highs and expect futures to resume selling off as soon as support at $1,190 is broken.

Currencies & Bonds

The dollar rally resumed in earnest last week following the FOMC meeting, despite the equity market interpreting it as "dovish." The Dollar Index rose 1.41% to hit a new multi-year high following the FOMC (it really was the major catalyst last week).

As to be expected, most other major currencies were lower. The euro fell nearly 2% and on Friday hit a new multi-year low, mainly on U.S. dollar strength but also as expectations for ECB QE in January continue to grow (ECB member Benoit Coeure made "dovish" comments last week that pressured the euro). Turning to Japan, the yen gave back almost all of the previous week's gains and dollar/yen is once again sitting just below 120. There was a BOJ meeting last week, and while there were no changes to policy (as expected), positive commentary on the economy further pressured the yen.

Bottom line, the FOMC last week highlighted the large and growing gap between FOMC policy (getting tighter) and everyone else (getting more accommodative). That divergence is a massive foundational force in the currency markets, and dollar strength will continue as a result.

Turning to bonds, the 30-year declined modestly following the FOMC meeting, as the bond market is simply not priced for rate hikes in June '15 (partly because the market doesn't believe the Fed, and partly because of European buying of Treasuries). That gap remains a potential risk to monitor in 2015, but until we see more signs of economic progress in Europe, Treasuries will ignore domestic fundamentals and remain well-bid.

This week there will be several auctions, starting with a 2-year note auction today, following by a 5-year and 7-year Tuesday and Wednesday, respectively. It will be interesting to see if last week's bond weakness carried over into the auctions, so we will be watching closely.

Have a good holiday shortened 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 fundamentals.

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Asset Class Dashboard

(Updated 12.22.14)

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**	*After suffering its worst decline in 3+ year two weeks ago, the S&P 500 enjoyed a huge "snap back" rally last week as stabilization in energy stocks, junk debt and the Russian ruble led to a massive short covering rally. Fundamentally, though, nothing material changed, so the 90+ point, 3 day rally in the SPX last week seems a bit artificial. We*
Best Idea: Buy Retail (RTH). **Best Contrarian Idea:** Buy Energy (XLE)			
Commodities	**Bearish**	**Bullish**	*Commodities stabilized last week as oil finally tried to put in some sort of bottom. But, it's important to differentiate the stabilization of oil as mostly just an oversold bounce, not the result of some positive change in supply/demand fundamentals. With the Dollar Index hitting new highs, though, we expect commodities to at best be range bound.*
Best Idea: Buy Natural Gas (UNG) **Best Contrarian Idea:** Buy Grains (DBA)			
U.S. Dollar	**Bullish**	**Bullish**	*The Dollar Index hit new multi-year highs last week, resuming its months long uptrend as the FOMC focused on rate hikes in mid 2015, highlighting the growing divergence between US monetary policy (tighter) and everyone else (more accommodative). Because of that, we expect the dollar rally to continue.*
Best Idea: Sell the Yen (YCS) **Best Contrarian Idea:** Long British Pound (FXB)			
Treasuries	**Neutral**	**Bearish**	*Treasuries declined modestly last week following the "hawkish" FOMC meeting, as domestic economic and policy fundamentals (better economy, forthcoming interest rate increases) continue to be ignored by bond investors. Until Europe shows signs of economic progress, Treasuries will remain well supported, even as fundamentals deterio-*
Best Idea: Short "long" bonds (TBT) **Best Contrarian Idea:** Short High Yield Bonds (SJB)			

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