# 7:00's Report

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

***December 29th, 2014***

## Pre 7:00 Look

- Futures are mildly weaker this morning after the Greek Parliament failed to elect a President, negatively surprising markets (the expectation had been for a successful vote).
- It's still early, but the fall out from the election isn't too bad. Greek shares fell 10% on the news and short term Greek bond yields are higher, but pan-European indices are down less than 1% and the euro is flat.
- Outside of Greek politics it was a quiet night economically and geo-politically.
- Econ Today: There are no economic reports today.

| Market | Level | Change | % Change |
|---|---|---|---|
| S&P 500 Futures | 2080.75 | -3.50 | -0.17% |
| U.S. Dollar (DXY) | 90.30 | -.01 | -0.01% |
| Gold | 1193.10 | -2.20 | -0.18% |
| WTI | 55.39 | .66 | 1.21% |
| 10 Year | 2.25 | -.014 | -0.62% |

## Equities

*Greek Election Update*

The biggest event of this holiday week has already come and gone, as the Greek Parliament failed to elect a President and there will not be general elections in early February. PM Samara's gamble has failed, and as of this writing the Athens stock market is down 11% and European markets are off about 1%.

From an investment standpoint, despite the drop in Greek shares, we do not see this as a negative game changer. To be clear, the reason stocks are down is because the market is afraid the looming election will delay QE by the ECB at the Jan 22nd meeting, **not** because of a fear Greece will leave the EU or default if Syriza gains a majority. It is important to realize the true "negative" outcome the market is worrying about.

Bottom line, even if Syriza wins the general election, the party has moderated materially and no one is afraid of another default/Greek exit showdown. This is all about QE and frankly we don't think this results in a delay of QE be the ECB in January, assuming the governing council is planning on doing it already.

**So, we do not see this as a negative game changer in our "Europe outperforms" thesis, and we would be patient buyers of this dip.**

*Market Recap*

The rally rolled on last week as stocks moved to new all-time highs in quiet holiday trading thanks to continued stabilization in the ruble and better than expected economic data. The S&P 500 ended the week up 0.9% and is now up 13.01% year-to-date.

Monday turned out to be the best day of last week as the S&P 500 rose 0.38% mostly on continued momentum from the previous week's big rally. Other than some more hints at QE in the EU from ECB members last weekend, there weren't any positive catalysts last Monday and stocks were mostly higher on buyers chasing to add exposure.

Tuesday brought the best news of the week as the GDP report and Personal Income and Outlays were both better than expected (GDP was a blowout number). But stocks managed only a marginal gain, with the S&P 500 rallying 0.17% in quiet trading.

Wednesday was predictably slow as stocks were flat for

| Market | Level | Change | % Change |
|---|---|---|---|
| Dow | 18,053.71 | 23.50 | 0.13% |
| TSX | 14,609.25 | 15.22 | 0.10% |
| Brazil | 50,144.63 | -745.18 | -1.46% |
| FTSE | 6621.61 | 11.68 | 0.18% |
| Nikkei | 17,729.84 | -89.12 | -0.50% |
| Hang Seng | 23,773.18 | 423.84 | 1.82% |
| ASX | 5,473.78 | 79.28 | 1.47% |

Prices taken at previous day market close.

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the abbreviated session. But the buying resumed Friday in very quiet trading. Stocks continued to drift higher on low volumes, as money managers continued to add long exposure as stocks are poised to enter the year basically on the highs.

On Friday, there was an announcement by Chinese officials that they would allow banks to include more money in their deposit bases (which will increase the amount they can lend, providing some additional stimulus to the Chinese economy). Other than the U.S. economic data, that headline was probably the most significant development, although it's not a definitive positive game-changer on China).

| Market | Level | Change | % Change |
|---|---|---|---|
| DBC | 18.79 | -.02 | -0.11% |
| Gold | 1196.10 | 22.60 | 1.93% |
| Silver | 16.085 | .375 | 2.39% |
| Copper | 2.814 | -.0395 | -1.38% |
| WTI | 55.14 | -.70 | -1.25% |
| Brent | 59.57 | -.67 | -1.11% |
| Nat Gas | 3.063 | -.009 | -0.29% |
| RBOB | 1.5145 | .0018 | 0.12% |
| DBA (Grains) | 25.21 | .08 | 0.32% |
| Prices taken at previous day market close. | | | |

*Trading Color*

Last week's rally was really due to year-end positioning and was driven by managers and day-traders chasing the averages into year-end (although "why" stocks rallied doesn't make a difference for performance, given it's December 29th). So, that said, there's simply not a lot to read into from an internals standpoint.

Sector-wise, one of the notable occurrences was massive outperformance by the utilities as XLU hit new, multi-year highs. That was especially curious given the decline in bond yields over the past two weeks, but the reason for the outperformance was natural gas, which dropped below $3.00/MMcf for the first time since 2012. Natural gas is a major input cost for many utilities, so the drop implies better margins going forward (although it's obviously more complicated than that). Although at new highs, utilities are pretty highly valued at this point, and if we see interest rates begin to move higher next year, booking some profits in XLU around these levels may not be a bad idea.

Healthcare was the other sector of note, as we saw steep declines early in the week on the back of pricing worries following the Express Scripts/AbbVie Hepatitis C drug deal. The pricing was lower than expected, and that weighed on biotechs, which pulled down all of healthcare. The space rebounded Friday but still finished down nearly 2%, making it by far the worst performer.

Finally, energy traded flat last week despite more volatility in crude prices, and I think we are at a key crossroads here with XLE. If this is a dead-cat/end-of-year covering bounce, we should see the ETF start to roll over around here. $80.90, the intraday high from last week, is an important level to watch. If we can trade above that level for a day or so this week, that will be an encouraging sign that a medium-term bottom in energy is "in."

*Bottom Line*

The rebound in stocks has certainly been impressive (the S&P has rallied 116 points (or 6%) in less than two weeks), but this market remains all about energy and its potential contagion effects (the weakness in junk debt and turmoil in the ruble). As those three markets have stabilized, so have stocks, but at this point it simply isn't clear whether energy has put in a real bottom, or whether this rebound is simply year-end positioning.

As the inventory data last week reflected, supply is surging. Ex-U.S., the global economy remains fragile and mostly stagnant. Additionally, this wasn't really noticed by markets but the Saudis released their 2015 budget, and they didn't reveal any material cuts in spending. This implies that they either expect a rebound in oil prices, or they simply aren't planning on cutting production regardless of the drop in prices (as they've repeatedly said).

Bottom line: We aren't bears, but much like early December, we remain cautious on the market simply because the 100+ point rally hasn't come with any material uptick in the macro outlook. Yes, the stabilization in oil is a positive, but it's not worth 100+ points in 7 trading days!

Domestically we would hold broad allocation levels, and direct new money to consumer-leveraged names/ sectors including RTH, consumer finance companies like SYF and broader financials (XLF, KRE). Europe remains

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our preferred destination for new capital (HEDJ) and again we would be patient buyers of this Greek election related dip as we think it creates an attractive entry point for 2015.

## Economics

Last Week

There were two key takeaways from last week's economic data: First, the U.S. consumer re-emerged in the 2nd and 3rd quarters of 2014, and was the main driver of growth in the U.S. economy during the second half of 2014. Second, the stronger U.S. dollar is starting to have an impact on the economy and we should expect further moderation in manufacturing metrics going forward. Importantly, this moderation in the manufacturing sector isn't a bad thing as long as the landscape continues to improve for the U.S. consumer. It's much more positive for the U.S. economy to be led by a resurgence of the U.S. consumer than continued manufacturing growth (because consumer spending is nearly 70% of the U.S. economy).

The key number from last week was the final revision of the Q3 2014 GDP report. Final GDP was 5.0% saar (beating the 4.3% expectation), and the gains were driven by consumer spending. PCE (broad consumer spending) was revised higher to 3.2% from 2.2% while Gross Domestic Purchases (the amount of goods purchased by the country regardless of where the goods came from) was revised to 5.0% from 4.1%.

Again, those who are skeptical of the recovery will point out that a lot of the uptick in consumer spending came from increased healthcare expenses, and that is true. But the bottom line is these are healthy numbers for the economy, and they again underscore the shift we are seeing from a manufacturing-led recovery, to a consumer-led recovery (which again is much more healthy and positive for risk assets).

| Market | Level | Change | % Change |
|---|---|---|---|
| Dollar Index | 90.315 | .092 | 0.10% |
| EUR/USD | 1.2183 | -.0042 | -0.34% |
| GBP/USD | 1.5558 | -.0001 | -0.01% |
| USD/JPY | 120.31 | .21 | 0.17% |
| USD/CAD | 1.1627 | .0002 | 0.02% |
| AUD/USD | .8121 | .0002 | 0.02% |
| USD/BRL | 2.6692 | -.0266 | -0.99% |
| 10 Year Yield | 2.25 | -.014 | -0.62% |
| 30 Year Yield | 2.814 | -.020 | -0.71% |

Prices taken at previous day market close.

Case in point, November Durable Goods missed estimates, as the headline was weaker than expected. Meanwhile new orders for Non-Defense Capital Goods Excluding Aircraft were flat month-over-month and the rolling 3-month moving average fell by 1%. The soft Durable Goods report confirmed the lackluster PMIs we saw in November and December. To be clear, it's not like manufacturing activity is falling out of bed, but we are seeing some moderation due to the stronger dollar, which again is "ok" as long as it's accompanied by a surging consumer.

From an investment standpoint, this shift from a manufacturing-led recovery to a consumer-led recovery is important, because we can expect continued outperformance from consumer-leveraged names (RTH, consumer finance companies) and, generally speaking, underperformance from industrials with heavy foreign revenue exposure. That isn't a particularly insightful observation, but it's something to think about as you plan asset allocations for early 2015. (During the last several years, industrials have soundly outperformed consumer names, so double-check to make sure you're not too heavy in stodgy, goods-producing, foreign-leveraged manufacturers and industrials.)

*This Week*

It will be another quiet week given the holiday, but the highlight will be the global final manufacturing PMIs on Friday. That said, the most important manufacturing PMI, China's, won't be released until next week. So, focus will be on Europe and the U.S. Specifically, the December "flash" PMIs in Europe showed some small signs of life, especially in Germany, so it will be important not see those flash PMIs revised lower.

Here in the U.S., we can expect some more moderation in the ISM Manufacturing PMIs. But again on an absolute basis, the manufacturing sector is still growing; it's just losing momentum due mainly to the stronger U.S. dollar.

## Commodities

Commodities remained heavy and volatile last week as crude oil oscillated in the mid- to upper-$50s, natural

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gas futures broke down through $3 at one point, and the metals rallied late in the week on further short-covering. The DB commodity ETF, DBC, fell 2.24%

Energy remains the main focus in commodity markets. After bouncing the week prior, crude oil and the refined products all finished the shortened holiday week lower. WTI crude oil futures fell 4.55%.

Fundamentally, OPEC chatter (namely from Saudi Arabia) continues to be very closely watched. The latest comments were seen as moderately bullish as a former economic adviser said Saudi Arabia's 2015 budget is likely assuming $80/barrel. Those comments however were not enough to see crude prices rally into the end of the week. But thus far, crude prices have roughly held the Saudis' initial target of $60 for Brent crude, and that will be a level to watch this week.

Looking at our domestic market, bearish supply data and mild temperatures across the nation are curbing demand for products such as heating oil, which is contributing to the heavy price action in energy.

Bottom line, futures prices have essentially been drifting sideways in a consolidation pattern for the last two weeks as the recent drop continues to be digested. But, a "convincing" bottom has not formed and the path of least resistance remains lower for now.

Natural gas was the big loser in the space last week as futures plummeted 11.11%, briefly dropping below the $3 mark for the first time since September 2012. Booming production and warmer weather are the key drivers of the market, which was essentially in freefall last week. If psychological support at $3 fails to hold, the next solid level of support is below between $2.70 and $2.75.

Gold however was the sole commodity to finish higher last week as futures added a modest 0.13%. But, the price action and move higher on very thin volume suggest last week's gains were the result of more short-covering ahead of the end of the year as PMs lock in gains on longer-term short positions. On the charts, $1,200 is initial resistance while support at $1,190 has been re-established.

## Currencies & Bonds

The Dollar Index hit a new multi-year high and traded through 90 for first time in years following the much stronger than anticipated Q3 GDP data last week. Dollar strength was the primary influence in the currency markets last week and, as a result, the dollar was universally stronger against all major currencies.

Dollar/yen was the laggard last week despite a still-sluggish CPI report. Some in the media tried to spin that as bearish Japan, but the low CPI number was expected (as it is everywhere) following the decline in the price of oil. Case in point, the yen finished lower Friday after the release (if the number really was bearish Japan, the yen would have rallied).

In Europe, the euro fell 0.41% to close below 1.22 for the first time in years. Dollar strength, as opposed to euro weakness, was the reason for the declines. Potentially validating our call that the failed Greek election isn't a bearish game changer, the euro is flat this morning (we would have expected it to be higher if the elections results were a material negative).

Turning to the ruble, it was stable last week thanks to continued efforts by the Russian central bank (hiking interest rates, cutting grain exports, forcing companies to sell foreign reserves). But, to keep the ruble stable longer term, two things need to happen: First, Brent crude needs to remain stable, and second, international sanctions need to be removed. Until both those things happen, the ruble remains a risk to monitor.

In the bond market, the 30-year had its worst day of the year last Tuesday following the strong U.S. GDP report and bad 5-year Treasury auction (all three auctions were disappointing last week).

Continued buying from Europe and Japan supports Treasuries, though, and the 30-year fell 0.75%. It seems during the past two weeks the bond-negative fundamentals here in the U.S. are starting to be priced into the bond market a bit. But again, it's going to take an improved inflation outlook from Europe to really get the Treasury market headed lower, despite deteriorating domestic bond fundamentals.

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<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 fundamentals.* | | | |

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# Asset Class Dashboard

**(Updated 12.29.14)**

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 rallied just under 1% last week mostly on year-end positioning. The move higher extended the rally to over 100 points in less than 8 trading days, as a stabilization in oil prices and the Russian Ruble has led to massive short covering and buyers chasing into year end.* |

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

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

| | Near Term Trend | Long Term Trend | Market Intelligence |
|---|---|---|---|
| **Commodities** | **Bearish** | **Bullish** | *Commodities were lower again last week as oil resumed its declines, although it did not make new lows. Oil continues to try and put in a bottom here, but it's unclear if a bottom is truly "in." Gold was the only commodity to finish higher last week higher, as it rallied in low volume trading Friday on general geo-political concerns.* |

**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 again hit new multi-year highs last week following the very strong GDP report, which further highlighted the growing disparity between the US economy (getting stronger) and everyone else (stagnant). Because of that, we expect the dollar rally to continue.* |

**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 declined again last week following the strong GDP report, although there remains plenty of support for Treasuries and this failed Greek election will further support Treasuries in the near term. But, it does appear that markets are starting to consider negative domestic bond fundamentals, although again we need some progress in Europe before we will see any material downside in Treasuries.* |

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

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

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