7:00's Report

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

December 3rd, 2014

Pre 7:00 Look

- Futures and most international markets are flat this morning after economic data o/n largely met expectations. Oil and gold are bouncing slightly despite the US dollar rising to a new 5 year high, just under 89.00.
- Global composite PMIs were released o/n and they were generally speaking slightly underwhelming in China and the EU, but they aren't shifting anyone's economic outlook.
- Econ Today: ADP Employment Report (E: 225K), ISM Non-Manufacturing Index (E: 57.3).
- Fed Speak: Plosser (12:30 PM), Brainard (2:00 PM), Fisher (7:30 PM).

Market	Level	Change	% Change
S&P 500 Futures	2065.50	-0.50	-0.02%
U.S. Dollar (DXY)	88.94	.237	0.27%
Gold	1200.90	1.50	0.13%
WTI	67.00	.12	0.16%
10 Year	2.285	.067	3.02%

Equities

Market Recap

It was a surprisingly strong day in the markets Tuesday as decent economic data and stable corporate credit markets helped stocks rally. The S&P 500 gained 0.56%.

Stocks started the day slightly higher as there was some dip-buying following Monday's drop and the auto sales looked good early.

News-wise, two positive catalysts yesterday were those good auto sales (17.2M vs. (E) 16.5M) and positive con-

Investment grade bonds (LQD) have sold off this week, so the declines in the bond market aren't exclusive to the junk sector.

struction spending (up 1.1% in October vs. (E) 0.5%).

The early strength caught most short-term traders off-guard, and as a result we saw dip-buyers return (remember they were on the sidelines Monday) and new shorts cover, and stocks moved steadily higher throughout the morning session.

Once again we had a few Fed speakers on the docket yesterday, but comments didn't move markets materially.

Stocks drifted steadily higher on light volume throughout the afternoon and hit their highs just before 3 o'clock, when the buying interest exhausted itself. Stocks came in a few points during the last hour of trading to close quietly.

Some Caution is Warranted on Regional Banks

We have been bullish on regional banks for several months now (since early August). It's been a trade that, notwithstanding Sept/Oct volatility, has done well.

But, while we are still broadly bullish on the space given stable housing prices, a tightening labor market and the strengthening U.S. economy, it is important to note that

Market	Level	Change	% Change
Dow	17,879.55	102.75	0.58%
TSX	14,620.07	-5.25	-0.04%
Brazil	51,612.47	-664.11	-1.27%
FTSE	6,731.51	-10.59	-0.16%
Nikkei	17,720.43	57.21	0.32%
Hang Seng	23,428.62	-225.68	-0.95%
ASX	5,321.82	40.57	0.77%

Prices taken at previous day market close.

certain regional banks have more exposure to energy-related loans (as a percentage of total book) than money center banks.

And, if we see more weakness in oil and some shale energy company defaults, then regional banks will get hit.

We would remain cautiously long the space, but certainly don't see anything wrong with booking some profits here given the run since mid October and new potential risk to the thesis.

Market	Level	Change	% Change
DBC	20.39	-.45	-2.16%
Gold	1199.50	-18.60	-1.53%
Silver	16.47	-.222	-1.33%
Copper	2.889	-.009	-0.31%
WTI	67.19	-1.81	-2.62%
Brent	70.76	-1.78	-2.45%
Nat Gas	3.883	-.124	-3.09%
RBOB	1.8122	-.0688	-3.66%
DBA (Grains)	25.50	-.35	-1.35%
Prices taken at previous day market close.			

Bottom line, regional banks are still probably "ok" but if this oil concern grows, they will get hit the hardest among the financials, so that needs to be taken into account. Finally, if we see JNK, XLE and KRE all breaking down over the next few weeks, that will be a sign concern is growing about energy-related credit. It likely won't happen, but those three are now grouped together on our screens here at the office.

Bottom Line

The two areas we are watching in the markets are energy and credit. Both were lower Monday, and so were stocks. Both were higher yesterday (mostly) and so were stocks.

And, as the fear of some sort of credit stress from energy seeps through the market over the next few days, I expect those two areas to remain the key catalysts to stocks.

Looking at energy, oil had another bad day but energy stocks were up 1% on some value-hunting and short-covering (so focus on XLE, not oil).

In credit markets, junk debt rallied yesterday (JNK up 0.31%), but interestingly investment grade (and I'm using LQD as a proxy) continued to sell off and the declines so far this week are pretty impressive. For now the market is ignoring that (I know there is a lot of corporate issuance this week, so perhaps we are seeing money rotate within the space and that's affecting the ETF), but if we see renewed declines in JNK and further declines in LQD, that is a potential headwind on stocks.

More broadly it seems like the market is in a bit of a "wait and see" mode. The inevitability of a melt-up into year-end, which was very pervasive pre-Thanksgiving, is gone. But, at the same time, there are not very many people who are cautious on the market right here (other than us and a few others). So, with regards to the next 5% in the market, the "pain trade" is lower.

Bottom line, I'd expect more of a chop sideways over the next few days while we see what energy and credit will do, as they appear to be the leading indicators of the market right now.

How to Hedge a "Systemic" Problem in Oil

In Monday's Report, we touched on the idea that this sharp decline in oil prices could have ramifications in the junk bond market as shale companies potentially default. And, there is the worry that if we see defaults and dropping junk prices, that could lead to forced sales in investment-grade bonds. Throw in reduced dealer inventory (courtesy of Dodd-Frank), and the proliferation of bond-backed ETFs and mutual funds, and we've got a recipe for another systemic scare—not on the order of '08/'09, but certainly enough to cause stocks to decline.

That general thesis is the latest representation of the idea that many investors (including me) share that this perma-0%-interest rate backdrop has created a fundamental mispricing of risk across assets, and this mispricing of risk will metastasize into another crisis—likely in the bond market.

I obviously don't know if that will come to fruition, but we are watching JNK, LQD and other bond market indicators for sources of stress.

But, knowing that it's happening is one thing … hedging for it is another. So, I wanted to identify 4 ETFs that will hedge portfolios against a drop in oil/junk-bond-inspired sell-off.

Hedge #1: EUM (Inverse Emerging Market ETF). We have held EUM for a few months now, because we continue to believe that if we see systemic stresses begin to appear, they will hit emerging markets hard and early. That's because emerging markets have been some of the biggest beneficiaries of this multi-year stretch for yield, and have some of the most mispriced bonds on the planet.

A drop in EM currencies and bonds will result in a drop in EM stocks, and EUM will rise if that occurs.

Hedge #2: SJB (Inverse Junk Bond ETF). It's obvious what this is. The only problem is that, from a volume standpoint, it's trade-by-appointment (around 30K shares per day). You can also short JNK or HYG, but this is the only "pure play" inverse junk bond ETF out there.

Hedge #3: DUG (UltraShort Oil & Gas). This one doesn't need much explanation, but the simple fact is that if oil continues lower and causes junk market stress, oil companies will get hammered (E&Ps more than integrateds, but they will all head lower). It's a 2X inverse so it's obviously a trading vehicle, but something to consider for short-term opportunities.

Hedge #4: HEDJ (Hedge Europe ETF). Shale is a uniquely U.S. phenomenon (at least at this point), and as a result, if we see bond market stress it'll hit the U.S. the hardest. HEDJ has virtually no energy sector exposure, and it should relatively outperform in a junk-bond-inspired decline. Also, consider a "Long HEDJ/short SPX" pair trade, as then you will actually profit from relative outperformance.

Economics

There were no notable economic reports yesterday.

Commodities

Commodities were universally lower in volatile trading yesterday, giving back a lot of Monday's gains as the Dollar Index strengthened against all of its major pairs. The market was led down by losses in energy, but metals were not far behind as Monday's short squeeze was reversed. The benchmark commodity tracking index ETF, DBC, fell 2.23%.

Market	Level	Change	% Change
Dollar Index	88.70	.718	0.82%
EUR/USD	1.2379	-.009	-0.72%
GBP/USD	1.5637	-.0091	-0.58%
USD/JPY	119.23	.84	0.71%
USD/CAD	1.1402	.0074	0.65%
AUD/USD	.8445	-.0044	-0.52%
USD/BRL	2.5684	.0095	0.37%
10 Year Yield	2.285	.067	3.02%
30 Year Yield	3.004	.053	1.97%
Prices taken at previous day market close.			

Both Brent and WTI crude rolled over yesterday, pulling the refined products down with them after the sector saw strong gains to start the week Monday. WTI finished the session down 2.81%.

There was one piece of bearish news out yesterday regarding an agreement between the Kurds and Iraqis, which will put an additional 300K barrels of oil on the world market. Needless to say, volatility remains very high as traders continue to look for direction. Near term, the technicals are pointing at further losses as production levels have not yet been noticeably affected by the low prices. On the charts we are looking at resistance above between \$69 and \$70 while the level to watch on the downside is Monday's spike low of \$63.72.

Natural gas broke through support at the \$3.90 level yesterday as futures fell 3.17% on continued speculation of a warmer December than meteorologists originally forecasted, which will curb demand for natural gas as a heating element.

But, there is increasing chatter that a potential cut in oil production could be bullish for natural gas prices because, in a lot of cases, natural gas is produced as a by-product of oil drilling/fracking. And so, if oil production is reined in as prices remain low or fall further, natural gas production will fall in lockstep, which is a potential positive catalyst for prices down the road.

Moving to the metals market, gold steadily sold off overnight Monday and over the course of yesterday's session, closing just off the worst levels of the day for a loss of 1.51%, mere ticks below the \$1,200 mark. The "dust is still settling" in the gold market after the whipsaw moves of the last week (the "Thanksgiving break plunge" and Monday's \$70 rally). But, we continue to believe that continued outperformance in the dollar will trump other influences and keep gold prices subdued over the near term.

Bottom line, commodities are continuing to trend lower as global demand for energy and industrial metals is stagnant with stalling economic growth (and there is obviously an oversupply problem within the energy space). Meanwhile precious metals remain pressured by the rallying dollar. Having said that, we continue to believe the ag space is the best place to be in commodities at the moment based on both the fundamentals of the market and the individual technicals of the primary products (Soybeans, Corn and Wheat). If you are looking for commodity exposure, look to the ags via DBA or futures.

Currencies & Bonds

The dollar resumed its rally yesterday and gained steam throughout the day, as the Dollar Index rocketed to a new multi-year high, finishing the day up 0.83%.

Weakness vs. the dollar was both universal and uniform. All major currencies were down around 0.75% yesterday, as the major catalyst for the dollar was "hawkish" comments by Fed speakers.

As there was one main catalyst for the moves in currencies yesterday, detailing the percentage changes of each one is a waste of your time. Instead, I'm just going to cover the overarching reason we saw universal strength in the dollar yesterday.

Dudley and Fischer Refute Reuters Article

One of the reasons for the Dollar Index weakness on Monday was a Reuters article that strongly implied (citing an unnamed Fed official) that the declining oil price was going to further pressure inflation statistics. And, as a result of that, the FOMC would likely delay the first rate increases into late 2015 or even early 2016.

But, importantly, both Dudley and Fischer (especially Fischer) basically refuted the thesis of the Reuters article. Fischer specifically was somewhat dismissive of lower oil prices' effect on inflation readings, and instead focused on his belief that wage inflation will start to accelerate soon.

Also yesterday, at another speech, Fischer implied that the term "considerable time" will probably be removed at the FOMC meeting later this month.

So, given the comments by the Fed speakers, the dollar rallied hard yesterday as this notion of a potential delay of interest rate hikes (which is dovish) had to be removed form the market. This caused buyers to chase the Dollar Index higher and new shorts to run and cover.

Bottom line, the Mssrs. Dudley and Fischer were more resolute about the Fed moving forward with tightening than the market was expecting, and that's why we saw universal dollar strength yesterday, and why the dollar rally isn't close to being over yet.

Moving to the bond market, Treasuries sold off for a second day in a row yesterday with the long bond falling 0.66% while the 10 year dropped 0.43%.

A lot of the declines were a result of the aforementioned "hawkish Fed speak," but there are a couple of other things to consider as we approach the end of the year.

Some of the selling pressure this week has been a result of corporate debt issuers, who are trying to get deals closed before the end of the year, hedging their bets against movement in the Treasury market. Issuers hedge by selling Treasury futures to lock in the spread rate between corporate and government debt.

Also, it is worth nothing that there was at least some "organic selling" yesterday by tactical longs in the market as they booked profits ahead of the jobs report Friday.

But, bottom line, Treasuries are trading surprisingly heavy this week, and the 30 year actually broke through a 2 month old supporting trendline. It is unclear yet whether this is going to turn out to be another "head-fake," which the bond market is getting well-known for this year, or if Treasuries are actually beginning to roll over as the consensus view is shifting to be more "hawkish" when it comes to Fed speculation and the chances of ECB stimulus.

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 12.1.14)

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 hit new all time highs last week but declined marginally by weeks end thanks to a Friday dip that was due mainly to the collapse in oil prices. The general macro back drop remains positive for stocks, but we continue to be cautious about adding additional capital at current levels, as we think most of the good news out there is already priced in.*

Best Idea: **Buy Regional Banks (KRE).**

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

Commodities	**Bearish**	**Bullish**	*Commodities collapsed, again, late last week as oil went into free fall following a "do nothing" OPEC meeting. There was massive general selling in the commodity space and a surging dollar weighed on precious and industrial metals. The near term outlook for commodities remains very negative.*

Best Idea: **Buy Natural Gas (UNG)**

Best Contrarian Idea: **Buy Grains (DBA)**

U.S. Dollar	**Bullish**	**Bullish**	*The Dollar Index closed flat last week thanks to a big Friday rally. The euro sold off Friday (but finished the week positive) following lack luster HICP data, while the yen weakened Friday after economic data missed estimates. Finally commodity currencies got crushed last week on lower oil and at or near multi-year lows.*

Best Idea: **Sell the Yen (YCS)**

Best Contrarian Idea: **Long British Pound (FXB)**

Treasuries	**Neutral**	**Bearish**	*Treasuries rallied last week thanks to a good 5 year Treasury auction and continued strength in German Bunds. Despite some indications EU economic data is starting to get better, Bunds remain well bid, and as long as they do, Treasuries will stay buoyant.*

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

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