7:00's Report

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

December 8th, 2014

Pre 7:00 Look

- Futures are weaker this morning after Chinese trade data badly missed expectations and S&P downgraded Italian debt to one notch above junk.
- Chinese trade balance was a big disappointment, as imports dropped a shocking –6.7% vs. (E) 3.4%, although Chinese shares rallied on hopes of more stimulus (so bad news is good).
- In Europe, the downgrade of Italy by S&P initially are resulting in mild losses, but the cut isn't a total surprise.
- Econ Today: No reports. Fed Speak: Lockhart (12:30 PM).

Market	Level	Change	% Change
S&P 500 Futures	2069.75	-6.25	-0.30%
U.S. Dollar (DXY)	89.37	.01	0.01%
Gold	1195.10	4.70	0.39%
WTI	64.57	-1.27	-1.93%
10 Year	2.314	.057	2.53%

Equities

Market Recap

Stocks rallied to fresh all-time highs last week thanks to good economic data and increased expectations of QE in the EU. The S&P 500 added 0.39% and is now up 12.28% this year.

Credit markets and energy were in focus, as concerns over the sell-off in corporate debt (specifically junk bonds) weighed on stocks early last week, and last Monday ended up being the worst day of the week as stocks dipped modestly.

But, the weakness didn't last long as stocks were surprisingly strong Tuesday thanks to decent economic data (auto sales and construction spending) and stabilizing credit markets. The rally continued into Wednesday's session again on stabilizing credit and energy markets paired with good economic data (ADP largely met expectations while ISM non-manufacturing beat).

Thursday was the most volatile session of the week. Stocks initially sold off on Draghi's disappointing press conference but then whipsawed into the green, reaching new highs on the "leaked reports" from two ECB members that a QE package was being prepared for January. The snapback rally stalled midday though and stocks drifted down to close slightly lower.

The volatility continued into Friday's session as the jobs report was initially taken as "hawkish" for being "too hot." The unexpectedly strong print caused stock futures to sell off pre-market. But after the open, the indexes stabilized and began a steady march upward to yet another set of new all-time highs. However, the gains were relatively muted in absolute terms and stocks closed with small gains on the week.

Trading Color

For all the volatility last week, the major indices finished with modest moves. The S&P 500 was up small, the Russell rose a slightly more impressive 0.77% and the Nasdaq actually declined following some profit-taking from some large-caps (AAPL and GOOG in particular).

Despite the lack of absolute moves, though, there were several worthwhile observations:

First, international equities continues to handily outperform. HEDJ rallied 1.07% while DXJ surged another 3.7% following an explosion higher Friday on yen weakness. The fundamentals behind both regions continue to

Market	Level	Change	% Change
Dow	17,958.79	58.69	0.33%
TSX	14,473.70	3.75	0.03%
Brazil	51,992.89	566.02	1.10%
FTSE	6,693.16	-49.68	-0.74%
Nikkei	17,935.64	15.19	0.08%
Hang Seng	24,047.67	45.03	0.19%
ASX	5,372.71	37.38	0.70%

Prices taken at previous day market close.

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turn more attractive (taken in context of central bank actions), and we think this trend will continue.

Second, Friday saw a "higher rate" rotation. Financials and banks surged higher Friday while telecom and utilities lagged, and there was definitely a "higher rate" rotation in the market.

Market	Level	Change	% Change
DBC	20.24	.02	0.10%
Gold	1191.10	-16.60	-1.37%
Silver	16.30	-.275	-1.66%
Copper	2.904	-.0105	-0.36%
WTI	66.10	-.71	-1.06%
Brent	69.53	-.11	-0.16%
Nat Gas	3.797	.148	4.06%
RBOB	1.7853	-.0095	-0.53%
DBA (Grains)	25.40	.05	0.20%
Prices taken at previous day market close.			

I am pointing this out because fundamentally the data and Fed-speak imply a more "hawkish" Fed coming (finally). If that's the case, then we could be on the cusp of higher-rate-sensitive sector outperformance (banks, financials, general cyclicals) and "income-oriented" sector underperformance (utilities, telecoms, consumer staples, REITs). It's obviously too early to tell, but this is something we are watching to see if this "higher rate" rotation has any staying power.

Finally, retail and consumer names got hit late last week on profit-taking following some initial disappointing holiday sales reports. But, given the macro backdrop, it's extremely unlikely that this holiday shopping season will be disappointing, so I would view any material dip as a buying opportunity.

Bottom Line

The market remains strong and the rally must be respected, but we continue to see signs of fatigue setting in at these levels. Taken in the context of the seemingly endless string of good economic reports that were released last week, the rally was somewhat underwhelming.

Broadly, there remain plenty of buyers on dips. As a result, the market is having a hard time generating any downside momentum (as we saw last Monday/Tuesday). But that said, last week's gains were tentative and there's not a lot of desire to push stocks higher from here. That likely results in a continued sideways chop with, perhaps, fractional new highs.

I said earlier last week that energy and credit are the two leading indicators to watch in this market, and we maintain that stance. Energy stocks appear to be trying to stabilize and the market ignored the sell-off in credit markets (JNK/LQD) late last week thanks to the good jobs report. But, I continue to think ***there are risks in the energy patch and corporate bond market that can't be ignored.***

Admittedly, the market at the moment appears to be rationalizing the weakness in corporate credit as an "energy"-specific issue, and they may well be right. But I continue to think we can't have junk debt dropping to new multi-month lows while stocks march merrily to new highs.

Adding to this risk is the fact that we may finally be seeing *some upward pressure on interest rates*. This could exacerbate the stress in the junk bond market.

Bottom line: We continue to much prefer "Europe" over the U.S. from a broad exposure standpoint. That's because of valuations, where each respective central bank is in the easing cycle, and the large and growing discrepancy between U.S. corporate credit markets and stocks. We do not think the "Europe" trade is over (by a long shot) and do continue to like HEDJ as it is hitting new highs.

Economics

Last Week

Last week didn't reveal anything new from a fundamental economic standpoint, as the data confirmed the divergent growth trends in the US (better growth) and the rest of the world (weaker growth).

But, the data last week did result in new dovish market expectations for the ECB (now QE in Q1 '15) and hawkish market expectations for the Fed (no more "considerable time" in December). From an investment standpoint, last week was very positive for our "long Europe" portfolio.

Starting with the ECB, as it was the most important event last week, it provided a one-two punch that has led the market to fully expect QE from the ECB in Q1 2015.

First, the economic data in Europe continue to slip, as

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evidenced by both manufacturing and composite PMIs that missed expectations (and continue to lose momentum). The "lowlight" of the data last week was the German November manufacturing PMI, which fell into contraction territory at 49.5.

While there have been some "green shoots" from a sentiment indicator standpoint in Europe, the hard data continue to be lackluster. Plus, the current dis-inflation problem/future deflation threat is growing, and data last week further imply that point.

Validating the risk the poor data implied, ECB President Mario Draghi continued to add fuel to the QE expectation fire when he stated unanimous support wasn't necessary for further unconventional measures. And, obviously, the Bloomberg article out Thursday furthers the idea that QE in the EU is coming.

Turning to the U.S., it was almost the exact opposite. Strong data and "hawkish" comments by influential Fed speakers led to a slight "pull forward" of the date of the first rate hike.

Starting with the jobs report, it was obviously a blowout number at 321K, nearly 100K over the expectation. And, details of the report were also good, as average earnings rose 0.4% and the year-over-year metric ticked up slightly to 2.1%. Unemployment held firm at 5.8% but U-6 dipped another 0.1%, down to 11.4%, implying further reduction in the "underemployed" or people who can't find as much work as they want.

I know some analysts had some issues with the quality of the job adds, and the household survey didn't confirm the business (or establishment) survey, but the bottom line is this was a good jobs report. And, combined with the strong manufacturing and non-manufacturing PMIs that were released earlier last week, it's clear the U.S. recovery is continuing to gain momentum.

Market	Level	Change	% Change
Dollar Index	89.375	.64	0.72%
EUR/USD	1.2285	-.0092	-0.74%
GBP/USD	1.5587	-.0085	-0.54%
USD/JPY	121.43	1.65	1.38%
USD/CAD	1.1435	.0051	0.45%
AUD/USD	.8320	-.0061	-0.73%
USD/BRL	2.593	.0023	0.09%
10 Year Yield	2.314	.057	2.53%
30 Year Yield	2.973	.015	0.51%
Prices taken at previous day market close.			

Turing to Fed-speak from last week, it was "hawkish." Vice Chairmen William Dudley and Stanley Fischer made comments last week basically downplaying the negative inflation implications of lower oil prices (remember, two Sundays ago there was a Reuters article that implied lower oil's negative effect on inflation indicators would delay rate hikes). Messrs. Dudley and Fischer both basically refuted that argument (and rightly so) and, as such, implied the FOMC is more committed to policy normalization than perhaps the market thought.

Given the data and those comments, there were *two Fed-related takeaways from last week*: First, the phrase "considerable time" is almost certainly going to be removed from the FOMC meeting later this month. Second, June is now the consensus expectation for the first interest rate increase (it was slipping to July/September following that Reuters article).

<u>This Week</u>

This week will be quiet, but there is some China data we need to pay attention to. China's market has ripped lately on expectations of more stimulus, but fundamentally the economic data there have been quietly deteriorating. If it gets much worse, that may start to be a bit of a headwind on stocks.

We already got the trade balance, but CPI/PPI come Tuesday night, while the most important numbers of the week—Industrial Production and Retail Sales—are released Friday morning. Again, those numbers largely meeting expectations will help ease some concern about just how much momentum the Chinese economy has lost.

Domestically it's a quiet week. Retail sales is the highlight (and only notable report). Obviously people expect a good number (and that's important for our "return of the U.S. consumer" thesis that's been working).

In Europe it's also quiet. The final reading of German CPI comes Thursday, but everyone already expects that to be bad, while EMU IP is reported Friday.

Bottom line, with the exception of surprisingly bad data from China, none of the economic reports this week

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should result in much market volatility or a shifting of current central bank or global growth expectations.

Commodities

Commodities collectively continued to grind lower last week despite good economic data and generally favorable central-bank-speak globally. DBC fell 1.22%.

The dollar traded to fresh multi-year highs as investors digested strong economic data and continued to speculate when the Fed will raise rates. The rallying dollar continues to be a major headwind for the commodities space, specifically metals and energy.

Oil remains in the commodity market spotlight as traders eye last week's spike low of $63.72. Oil fell 0.55% last week as traders continued to digest the sharp sell-off from the week prior. The chatter by many physical producers (most notably the Saudis) that oil prices will stabilize on their own was interpreted by most traders and analysts to be bearish for the near term. And, the technicals agree, as last week's sessions made a series of lower highs and lower lows—a bearish pattern.

Looking ahead we continue to believe the path of least resistance remains lower and anticipate futures breaking through the aforementioned "spike low" of $63.72 before year-end.

Natural gas sold off hard last week, crashing through the $4 mark and then through support at $3.90 to fall all the way to $3.63. Natural gas futures settled down 7.47% for the week. The reason for the slide was a series of revisions to weather forecasts that suggested December would not be as cold as initially thought, which obviously translates to much lower demand estimates.

From a supply standpoint, the EIA reported a much smaller than expected draw in supplies (-22 Bcf vs. E: -41 Bcf), which also contributed to the losses. The level in focus is the September low of $3.54, and if that is broken, futures could continue to slide toward the next level of support at $3.40.

Moving to the metals, there were some violent moves in the gold market last week as futures surged nearly $80 on Monday amid several headlines, most notably the Moody's downgrade of Japan's credit rating. But, the rally stalled at trend resistance and consolidated sideways into Friday's blowout jobs number, and that put the selling pressure back on gold futures as the dollar surged to fresh multi year highs.

Gold finished the week up by 2.3% for the week but failed to hold onto the $1,200 level. Bottom line, the trend in gold remains lower as a function of dollar strength, and we believe that will continue for the near to medium term.

Currencies & Bonds

The Dollar Index rallied again last week as the "perfect storm" of weaker international data and rising ECB QE expectations, coupled with ever stronger US data, rolled on. The Dollar Index rose to a new, multi-year high and is now approaching the 90 level, while the euro broke down through 1.23, falling 1.15% last week.

While most of the focus was on the euro, though, it was the yen that collapsed, again, yesterday. The yen dropped more than 1% Friday, smashed through our 120 dollar/yen target, and kept going through 121 to close down 2.65% last week.

Bottom line, the currency markets continue to reflect the increasing differences between the US economy and direction of monetary policy (stronger and hawkish) and the rest of the world's major economies and direction of monetary policy (weaker and dovish). That will continue for some time, so this dollar run isn't over.

Turning to bonds, good US data and slightly "hawkish" Fed speak appears to finally be having a bit of an impact on bonds. The 30 year declined .8% last week and the ten year yield closed the week above 2.3% for the first time in nearly a month.

The issue in bonds this entire year has been foreign demand for Treasuries counteracting better US data and a potentially more "hawkish" Fed. Last week it appeared that hawkish Fed speak and good data are finally starting to weigh on bonds. We will need a real improvement in EU data to confirm bonds are truly rolling over, but cracks in the unbelievable 2014 bond rally appeared last week. Stay tuned.

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 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 12.8.14)

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 a new all time high last week thanks to strong US data and rising hopes of QE in the EU. But, markets also acted a bit fatigued as Friday's blow out jobs report failed to spur much of a rally, as data that good is seen as potentially creating a slightly more hawkish Fed. Bottom line, it'll be tough for stocks to sell off materially given current sentiment, but we see limited upside over the coming weeks.*

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

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

	Near Term Trend	Long Term Trend	Market Intelligence
Commodities	**Bearish**	**Bullish**	*Commodities declined again last week as oil tried to stabilize (but largely failed) and gold got hit on Friday following the strong jobs report. With concerns about the global economy and a relentlessly stronger dollar, the near term outlook for commodities remains poor.*

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 shot to new multi-year highs last week following the blow out jobs report. The yen was the weakest performer vs. the dollar, dropping more than 2%, but every major currency declined as the difference between US growth/monetary policy and the rest of the world continues to widen.*

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 last week on slightly "hawkish" comments by Fed officials Dudley and Fischer, and the strong jobs report. Importantly, last week the rising prospect of a more "hawkish" Fed weighed on bonds, and there are cracks appearing in the rally.*

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

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

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