7:00's Report

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

January 12, 2015

Pre 7:00 Look

- Futures are higher this morning as healthcare M&A and expectations for QE in Europe trump falling oil prices.
- Europe is outperforming this morning on more articles confirming the ECB will indeed introduce QE next week.
- Healthcare M&A is also helping stocks rally as Shire agreed to buy NPSP in a 5.2 billion dollar deal (this is the first "big" deal of 2015).
- Crude oil is down 2% as Brent dropped below $50 and hit a new low, while WTI is just off the lows ($46.83).
- Econ Today: No reports today, Lockhart (12:40 PM EST).

Market	Level	Change	% Change
S&P 500 Futures	2046.00	10.75	0.53%
U.S. Dollar (DXY)	92.435	.288	0.31%
Gold	1219.60	3.50	0.29%
WTI	47.17	-1.19	-2.42%
10 Year	1.966	-.050	-2.48%

Equities

Market Recap

Stocks were very volatile last week as new lows in oil and shifting concerns about the EU weighed on risk assets. The S&P 500 finished the week down 0.6% and is down 0.68% year to date.

Last week started with a "thud" as the S&P fell 1.85% Monday, as oil prices hit fresh six year lows and anxiety surrounding the potential "Grexit" weighed on the major indexes. The weakness carried over into Tuesday's session as the S&P finished down another 0.89% despite "ok" global composite PMIs. The early week losses were all about the new lows in oil prices and subsequent declines in oil stocks.

The tables turned on Wednesday as stabilization in oil prices saw stocks rebound sharply on short covering as the S&P bounced 1.16%. An article from Bloomberg that "dialed back" the idea that Germany is ok with a "Grexit" resulted in a squeeze higher in both European and US shares.

The rebound continued Thursday with stocks surging out of the gate thanks to ongoing "calm" in the oil market, "Goldilocks" EU economic data, and more dovish central bank chatter from both the ECB's Mario Draghi and Chicago Fed President Charles Evans. More short covering ahead of the jobs report also contributed to the gains.

I'll be appearing on CNCB's Closing Bell this afternoon at 3:00 PM EST to discuss European QE and the outlook for oil.

But, completing a very volatile week, declines resumed on Friday as articles that implied ECB QE would "underwhelm" were released by Reuters and Bloomberg, while the lackluster wage data from the jobs report also weighed on stocks to end the week on a sour note with the S&P 500 down nearly 1% in Friday trade.

Trading Color

Last week was characterized more by a return of volatility than any broad trend in the markets as every trading day saw a double-digit point swing in the S&P 500.

From a sector standpoint performance diverged significantly. Healthcare and consumer staples surged more than 2% each thanks to increased chatter regarding specialty drug pricing in the former, and general "defensive" inflows in the latter. Conversely, energy, financials and banks all significantly underperformed on plunging crude

Market	Level	Change	% Change
Dow	17,737.37	-170.50	-0.95%
TSX	14,384.92	-72.80	-0.50%
Brazil	48,840.25	-1,103.05	-2.21%
FTSE	6,532.43	31.29	0.48%
Nikkei	17,197.73	30.63	0.18%
Hang Seng	24,026.46	106.51	0.45%
ASX	5,422.70	-42.87	-0.78%
Prices taken at previous day market close.			

and interest rates, respectively. Meanwhile tech, utilities and basic materials all traded close to flat on the week.

Broadly, last week had the look of a massive "defensive" rotation as SPHB dropped more than 2% while SPLV rose 0.4%, but again trading was more nuanced as we didn't see that massive rotation.

Market	Level	Change	% Change
DBC	17.72	-.04	-0.21%
Gold	1218.60	10.10	0.84%
Silver	16.41	.025	0.15%
Copper	2.76	-.0095	-0.34%
WTI	48.33	-.46	-0.94%
Brent	50.09	-.87	-1.71%
Nat Gas	2.945	.018	0.61%
RBOB	1.3231	-.0178	1.33%
DBA (Grains)	24.87	-.03	-0.12%
Prices taken at previous day market close.			

Bottom Line—5 Macro Risks Should Cap Gains Near Term

Markets are currently facing five macro headwinds that will likely limit any upside in the near term. In order of near-term importance, they are: 1) What will ECB QE look like? 2) Can oil stabilize? 3) Will we have another "Grexit" scare? 4) Is there really a global deflation threat or is it just oil? and 5) When will the Fed start to tighten and how will markets react?

Of the five, the first four are almost equal in importance with regards to what stocks do over the coming weeks. And, it's important to note that European QE concerns now have trumped (or equaled) oil contagion worries as the near-term leading indicator for stocks. So, HEDJ should now be just under XLE on your radar screen. That was made evident Friday when articles in Bloomberg (link here) and Reuters (link here) were largely responsible for the drop in stocks (it wasn't the jobs report).

It's key to realize, though, that beyond the very short term, none of the above should be materially negative influences on stocks.

The ECB may disappoint with initial QE, but the bottom line is the ECB knows it has to expand its balance sheet and provide more stimulus, which is bullish for European stocks over the coming months and quarters. While we haven't likely seen the low tick yet, oil appears to be trying to stabilize, as prices at these low levels will likely start to have an impact on marginal producers (so the pace of declines should slow), which is what is important from a "oil contagion" standpoint. The global "deflation" scare is mostly linked to oil prices so when they stabilize, so will inflation statistics.

Third, the "Grexit" story is likely overdone (the chances of Greece leaving the EU remain very slim, and we know that from the bond markets), and finally the concern about the FOMC raising rates is a problem for the April time frame (as we approach the potential June "Lift off").

Point being, we are likely to see more near-term volatility until the events above get resolved, but I would view any material dip below 2000 in the S&P 500 as a buying opportunity in domestic cyclicals (banks, retailers and tech specifically) and continue to view European market weakness as offering fantastic longer term entry points. Hey, the near term may be bumpy, but we see no reason to materially alter equity allocations.

Economics

Last Week

Last week's economic data was important from a "What will the Fed and ECB do next" standpoint as the data shed more light on expected central bank policy (especially in Europe).

Starting with the most important release for the market near term, the EU Flash December HICP missed but wasn't as bad as the headline. While the headline HCIP fell –.2% yoy (worse than the –0.1% expectation), the "Core HICP" (which excludes oil prices) was flat from November at a 0.7% yoy increase, and much like the US CPI report, the "service sector" portion of HICP posted a much more healthy 1.2% yoy gain.

There are two takeaways from this: First, while deflation still is a very legitimate risk in the EU, most of the negative price drop year over year is oil and commodity related, and not some broader deflationary force like we saw in 2008. Second, the 0.2% yoy drop in prices almost guarantees the ECB will do QE next Thursday, because while the internals point to a slightly better inflation picture than the headline HICP, in absolute terms the number is still very ugly and the EU economy needs the ECB to try to further stoke inflation.

Importantly, from a European stock standpoint, the data was slightly positive longer term, as the details of the HICP report imply the risk of deflation isn't as bad as the market may think. And, if that's the case, then ECB QE may be more effective than estimated. Simply put, the "bearish game-changer" I'm watching out for with regards to my Long Europe thesis is that the ECB's policies become viewed as ineffective, and that the ECB is "out of bullets". The details of the HICP report imply that inflation is a bit healthier than the market realizes, and as such any QE program and balance sheet expansion should be a greater positive on EU stocks, beyond the very near term.

Turning to the US, obviously the jobs report was in focus last week, and it was a mixed bag. As we pointed out in our "Jobs Report Preview" the most important number in this report was the yoy wage gains, and it disappointed. Wages dropped 0.2% yoy and the December number was also revised 0.2% lower. That disappointing number largely offset all the other positive indicators in the jobs report, i.e. strong headline job adds (252k vs. (E) 245k), strong revisions to the previous two reports (greater than 50k jobs added to Oct/Nov), and further signs of labor market tightening (unemployment rate down to 5.6% and U-6 down 0.2% to 11.2%).

From a Fed policy standpoint the disappointing wage data is slightly "dovish." I don't think it's enough to push expected rate hikes out from June of this year because the labor market is tightening (which should result in wage pressures soon), but that can be debated after this report.

Bottom line, the takeaway from last week was that EU economic data was actually slightly better than feared, but weak inflation data solidified QE on January 22. Meanwhile the US jobs data further implied a sound recovery but still sluggish wage growth, which was taken as incrementally "dovish" by the market (but policy outlook remains the same for a mid 2015 rate hike).

This Week

There are some important reports this week but really this is the "calm before the storm" as next week is the first big macro week of 2015 (flash PMIs, earnings, ECB meeting, Greek elections).

In the US we get the first look at January data via Empire Manufacturing and Philly Fed Manufacturing Index (both Thursday). Remember manufacturing indices have been losing some momentum lately mostly thanks to a stronger US dollar, but if the declines accelerate this may get the market's attention and weigh a bit on stocks.

More broadly, the moderation in some manufacturing indices has been considered "ok" as it's been offset by increased consumer spending (numerous retailers said last week that holiday spending was strong) so the most important number this week is Retail Sales Wednesday. The loss of manufacturing activity is "ok" as long as it's replaced by increased consumer spending. But, if we see both start to lose momentum, then that may be a surprise headwind on stocks.

In Europe, the only really notable number is IP on Wednesday, but in truth everyone is focused on the ECB meeting next Thursday, and articles about what ECB QE will look like will be more important this week than any economic indicators.

Commodities

Commodities were mixed last week as the energy space continued to decline while shorts got squeezed out the precious metals thanks again to an inflow of "fear bids" early in the week. The general trend in the commodities space remains a bearish one as the surging dollar is keeping broad pressure on the various products. The benchmark commodity tracking index ETF, DBC, fell 2.74% notching its seventh weekly decline.

Market	Level	Change	% Change
Dollar Index	92.185	-.417	-0.45%
EUR/USD	1.1835	.0043	0.36%
GBP/USD	1.5161	.0074	0.49%
USD/JPY	118.52	-1.13	-0.94%
USD/CAD	1.1854	.0025	0.21%
AUD/USD	.8203	.0081	1.00%
USD/BRL	2.631	-.031	-1.16%
10 Year Yield	1.966	-.050	-2.48%
30 Year Yield	2.547	-.046	-1.77%
Prices taken at previous day market close.			

The energy sector fell to yet another five-and-a-half year low last week, led down by crude oil prices. WTI futures fell 8.71% on the week. Traders remain focused on any commentary out of oil producing nations (most notably Gulf states), rig counts (in the US), global supply data, and economic reports (as they attempt to gauge potential demand).

Last week we again saw some "bullish" headlines but they aren't materially affecting supply/demand dynamics, which are at the heart of this decline. First, chatter from non-core OPEC members about production cuts are heading up. Iran's Ayatollah Ali Khamenei said during talks with Venezuelan President Nicholas Maduro, that he supported taking joint action to help reverse the downtrend. But, it's important to remember that Saudi Arabia *is* OPEC, and the world's swing producer, so until they start talking about a cut, OPEC will remain impotent.

Second, US rig counts continue to fall, dropping another 61 last week to 1750. Rigs are now slightly lower than they were this time last year. But, while appearing bullish on the surface, most of the rigs being shut are high cost/low production operations and are not materially affecting the overall levels of production, which are actually still forecasted to grow in 2015 despite the lower number of active rigs.

Lastly, the technicals remain very bearish with both Brent and WTI oil futures currently in sharp downtrends with traders continuing to push prices to new multi year lows. We are nearing, but have not met, our $45 target on WTI, but we are sticking with that view so while we may see some consolidation here, we do not think the absolute bottom is "in" yet.

This morning both WTI and Brent crude are down more than 2%, as WTI challenges the low of $46.83 while Brent made a new low this morning at $48.50. Momentum is the real reason for the drop, but refinery fires in Pennsylvania and Ohio as well as a GS cut of oil price forecasts for WTI and Brent (to $41/bbl from $70 and $42 from $80 respectively) were catalysts overnight.

Precious metals rallied last week with gold gaining 2.83% and silver adding 4.66% by Friday's close. Trading in precious metals, notably gold, has been volatile as general "Risk off" sentiment is causing mini-short squeezes. Bottom line though, the outlook for precious metals remains neutral at best as the surging dollar will continue to suppress prices beyond the very short term. Despite the multi-week highs, we would not be buyers of gold here.

Currencies & Bonds

The Dollar Index rally continued last week despite declines Friday following the jobs report, as weakness in the euro continues to be the driving factor across most currency markets.

The Dollar Index rose another 0.76% last week thanks almost entirely to euro weakness. The euro dropped 1.3% vs. the dollar despite ending the week off the lows. The euro traded through 1.18 vs. the dollar for the first time in nearly 10 years as increased "Grexit" chatter and the soft HICP report Wednesday solidified QE expectations. Going forward, expect more volatility this week in the euro as we can expect many reports regarding what ECB QE will look like, but the euro is now extremely oversold short term, and I would be very surprised if the 1.17 level doesn't provide some sort of temporary bottom for the next few weeks/months.

Turning to the ruble (it's one of the most important currencies at the moment) it declined last week and settled above 60/dollar, but late last week was stable. If we see the ruble move through 65/dollar expect that to weigh on risk assets, but at current levels (62ish) it's not a material bearish headwind.

Shifting to bonds, Treasuries continued to surge last week, as the 30-year bond rose 1.43% to a new multi-year high while the yield on the 10-year Treasury dropped below 2% again. The reasons were obvious: Rising deflation concerns and QE expectations in Europe had Treasuries higher last week, and that rally was compounded by the soft wage data in the Friday jobs report (which was taken as incrementally dovish).

Treasuries remain all about Europe, so we can expect more volatility as we approach European QE—but the bottom line is it's going to take actual signs of economic progress in Europe to reverse this stream of money into Treasuries, and that simply isn't going to happen any time soon regardless of the ECB's QE program. The trend in Treasuries remains higher as the world economy wrestles with deflation threats and the yields on US Treasuries remain relatively very attractive.

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.

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.

Asset Class Dashboard

(Updated 1.12.15)

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 declined .6% last week as dropping oil prices continued to weigh on global stock markets. Broadly there are several macro headwinds facing stocks at the moment (European QE, Grexit, lower oil, potential rate hikes by the Fed) and as a result we view the upside as limited and would prefer to buy dips in the S&P 500 below 2000.*

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 declines accelerated. The commodity complex remains under pressure broadly as a stronger US dollar, flagging global demand and continued exodus of investment dollars weighs on the complex.*

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 rallied to new highs last week despite declining last Friday following the disappointing wage data in the jobs report. Euro weakness remains the #1 driver of the currency markets at the moment, and while we may see some stabilization in the coming weeks, the trend remains firmly euro lower, Dollar higher.*

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 rallied to new highs last week as fears about European deflation sent German bunds and Treasuries higher, while Friday's disappointing wage data in the jobs report added fuel to the fire. Until there are legitimate signs of economic progress in Europe, Treasuries will continue to be extremely well bid, almost regardless of US economic fundamentals.*

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

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