7:00's Report

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

January 5th, 2015

Pre 7:00 Look

- Futures are slightly lower but are off the worst levels of the morning as new lows in oil and European concerns weigh on markets.
- The euro is the big mover this morning as it's below 1.20 following comments by Angela Merkel over the weekend implying a Greek exit of the euro is manageable.
- Economically, German CPI mostly met expectations, printing yoy CPI growth of just 0.3%.
- Econ Today: There are no economic reports today.
- Fed Speak: Williams (8:00 AM).

Market	Level	Change	% Change
S&P 500 Futures	2041.25	-5.00	-0.24%
U.S. Dollar (DXY)	91.97	.587	0.64%
Gold	1188.10	1.90	0.16%
WTI	51.59	-1.10	-2.09%
10 Year	2.123	-.047	-2.17%

Equities

Stocks sold off last week as end-of-the-year positioning dominated the markets. The S&P 500 fell 1.5% last week and is down fractionally year-to-date.

Stocks started the shortened trading week in a quiet manner despite the failed Greek elections last Monday, as the major indices drifted sideways in low volume.

Stocks declined Tuesday and Wednesday as new lows in oil, some cautious housing comments by Robert Shiller, bellicose rhetoric by Russia regarding U.S. sanctions, and disappointing economic reports (notably the Chicago PMI and Pending Home Sales reports) saw the S&P 500 fall more than 1% on the week by the close on Wednesday.

Friday the volatility continued in very low-volume, thin trading as stocks initially opened higher but turned lower after the disappointing U.S. December manufacturing PMI. At one point Friday the S&P 500 was down almost 1%, but during the last hour of trading there was a nice recovery in the averages. Stocks finished virtually flat on the day to start the new year.

Bottom Line: A "Mostly" Clear Macro Start to 2015. But There Are Two Risks to Watch

The last two weeks of 2014 (and the first trading day of 2015) can largely be dismissed as we look forward. Stabilization in energy (and, as a result, junk debt and the ruble) led to a relatively quiet drift higher into the end of 2014. Year-end positioning dominated trading last week (including the declines Tuesday/Wednesday and the volatility Friday).

As we start the new year, the general backdrop for U.S. equities remains (at the moment) supportive: The economy is as strong as it's been in years, importantly led by a resurgence of the U.S. consumer ... the labor market is continuing to tighten ... the Fed (ostensibly) isn't in a hurry to raise rates … and valuations for the S&P 500, at 16X approximate $128/share EPS, remain reasonable (but not cheap).

That said, the coast is not entirely clear here as there are two risks we need to be closely monitoring: Oil contagion and central bank disappointment.

In the very short term, energy remains a leading indicator for this market. Again, the absolute level of oil doesn't really matter; it's the pace of declines that got everyone spooked about junk debt and the ruble back in

Market	Level	Change	% Change
Dow	17,832.99	9.92	0.06%
TSX	14,753.65	121.21	0.83%
Brazil	48,512.22	-1,495.19	-2.99%
FTSE	6,497.37	-50.43	-0.77%
Nikkei	17,408.71	-42.06	-0.24%
Hang Seng	23,721.32	-136.50	-0.57%
ASX	5,450.3	14.40	0.26%
Prices taken at previous day market close.			

December. And, although it was largely ignored during the holiday trading, oil prices have not put in a bottom yet (they made lower lows last week). On top of that, energy (XLE), junk debt (JNK) and the ruble are at key inflection points as to whether the bottom is "in" or this was just a low-volume bounce in a still-downtrending market. If XLE and JNK begin to decline again, the broader stock market will follow.

Market	Level	Change	% Change
DBC	18.23	-.22	-1.19%
Gold	1189.80	5.70	0.48%
Silver	15.785	.186	1.19%
Copper	2.814	-.0115	-0.41%
WTI	52.81	-.46	-0.86%
Brent	56.49	-.84	-1.47%
Nat Gas	2.958	.069	2.39%
RBOB	1.443	-.0291	-1.98%
DBA (Grains)	24.64	-.25	-1.00%

Prices taken at previous day market close.

Beyond the very short term, the biggest potential risk I see for markets in Q1 2015 is disappointment by central banks. The Fed, despite statements to the contrary, is seen as remaining uber-dovish with regard to rate increases. While June 2015 is the consensus for the first hike, it is not overwhelming and there are many who think September or no hikes at all in 2015 are just as likely. So, one major risk for markets in Q1 2015 is the Fed "disappoints" on the current expectation and either shows it is committed to rate hikes, or implies it may raise rates faster than the current consensus.

Likewise, the ECB is widely expected to unveil a QE program in January. If the ECB 1) doesn't do QE in January or 2) Announces a program that is a) vague b) not specific with regard to the size and c) employs measures to counter its effectiveness to satisfy the Germans, than we could see European markets fall sharply (and that will weigh on U.S. stocks).

Given this general backdrop, we are entering the year still expecting U.S. stocks to generally have a tailwind, as neither of these risks are reasons (yet) to materially de-risk. But, given these are legitimate (and potentially material) risks, we have our long exposure broadly balanced between cyclicals (SPHB) and more defensive sectors (SPLV).

For a preferred destination of incremental tactical capital, we still like "Europe" and HEDJ despite the risks mentioned above. First, the ECB is committed to expanding its balance sheet in 2015, regardless of the details of QE. And, if the last five years have taught us anything, it's that a central bank expanding its balance sheet will result in higher nominal stock prices (see the ECB bailout programs in 2011-2013, QE 2 and QE Infinity in the U.S. in 2011 & 2012, and "Abenomics" in Japan since May 2013).

Second, on a valuation basis "Europe" is much cheaper than the U.S. But if the ECB and a weaker euro can create a bottom in the EU economy, then there is a significant amount of multiple expansion that needs to occur (remember the entire 30% 2013 rally in the S&P 500 came on multiple expansion from around 13X earnings to around 15X earnings). Given these factors, we view the potential reward in Europe to be worth the risk for incremental tactical capital.

Economics

Last Week

The global December manufacturing PMIs were the only notable economic report last week, and outside of China (where growth metrics remain disappointing) the PMIs largely reflected the growing influence of the major currency moves of 2014, as European manufacturing is showing signs of stabilization thanks to a weak euro, while the stronger U.S. dollar is starting to become a headwind on manufacturing growth.

For the first time in nearly a year, the U.S. December manufacturing PMI was the biggest economic disappointment last week. The PMI fell to 55.5 vs. expectations of 57.1, the lowest reading in months.

But, the soft number needs to be taken in the context that 1) it was largely expected, as other manufacturing indicators including Industrial Production and Durable Goods have been losing momentum lately, and 2) at 55.5 the absolute level of manufacturing in the U.S. is still very healthy.

Bottom line, as we've been saying, the stronger U.S. dollar was bound to weigh on manufacturing indices at some point. But from a broader economic standpoint, as long as the consumer segment of the U.S. economy continues to gain momentum, the trade-off of a slowing manufacturing recovery for a strengthening consumer recovery is a new positive for the U.S. economy.

Europe was the positive surprise last week, as the much better than expected German December flash PMI was confirmed in the final reading at 51.2. While the broader EMU final PMI dipped a bit from the flash reading (50.6 vs. flash 50.8) it still importantly held above 50. Bottom line, the weaker euro, which is at multi-year lows, is starting to become a tailwind on the European economy. In the very near term, EU non-inflation economic data are being overshadowed by QE expectations. But beyond January, it's important to note that we are seeing more "green shoots" from European economic data.

Finally, Chinese data remained lackluster, although the official December PMI remained fractionally above the key 50 level (50.1). But, as we start 2015, doubts about China being able to maintain 7% growth abound. If I had to pick one potential headwind on global stocks people aren't accounting for, it's a steeper than expected slowdown in China. Remember, 7% GDP growth remain the key—below that and markets will react negatively.

This Week

Macro-economically, the outlook for ECB policy (whether they will do QE in January) and Fed policy (when will they first raise rates) are the major influences on markets right now. As such, the three most important events this week will offer greater insight into those two topics.

First it's jobs week in the U.S., with the December Labor Market Report coming Friday, ADP Wednesday, and jobless claims Thursday. As has been the case with the last several jobs reports, the market focus will be on whether the jobs report is good enough to make the Fed consider "pulling forward" the first rate hike.

As such, the U-6 unemployment rate and average hourly earnings (wages) will be almost as important as the headline jobs number and traditional unemployment rate. It'll have to be a very strong number to get the market worried about an earlier than June rate hike, but the difference between market expectations and Fed expectations for rates in 2015 is large. This is the first potential data point that could start to shrink that gap.

Additionally, the minutes from the December FOMC meeting will be released Wednesday, and obviously they will be pored over to try and see if there are "clues" as to when the majority of the FOMC wants to raise rates. Remember the December meeting had the "considerable time" removal/non-removal, so more clarity around that decision will be welcomed by the market.

In Europe, the January flash EU HICP (their CPI), is released Wednesday. This is the key inflation report in the EU, and a soft HICP reading would likely fully solidify expectations of QE by the ECB at the January 22nd meeting. From an investment standpoint, that is important because European markets have rallied over the past 2 months in anticipation of QE being announced in January. Anything that reduces that possibility will be a negative for European (and global) stocks.

The rest of the releases this week are mostly "second tier" as composite December PMIs in China (tonight), Europe and the U.S. (tomorrow morning) shouldn't really shift anyone's expectations for global growth. Although, of the three regions, China remains the most important to watch.

Finally, there are several data points from Europe this week including German manufacturers' orders and EMU retail sales on Thursday. While I don't want to be dismissive of those reports, because they are important, the market is totally focused on QE in the EU right now, and none of those reports are expected to sway the ECB. Bottom line, they are important from a "long Europe" portfolio standpoint so we will watch them closely, but don't expect them to be major market movers.

Market	Level	Change	% Change
Dollar Index	91.455	.808	0.89%
EUR/USD	1.2002	-.0102	-0.84%
GBP/USD	1.5328	-.0258	-1.66%
USD/JPY	120.50	.76	0.63%
USD/CAD	1.1785	.0174	1.50%
AUD/USD	.8089	-.0094	-1.15%
USD/BRL	2.6942	.0366	1.38%
10 Year Yield	2.123	-.047	-2.17%
30 Year Yield	2.697	-.052	-1.89%
Prices taken at previous day market close.			

Commodities

Commodities were mostly lower last week as the declines in oil prices continued, weighing on the rest of the space. The benchmark commodity tracking index ETF, DBC, ended the week on the lows, down 2.98%.

Energy was the big mover in commodity markets once again last week despite some seemingly bullish headlines.

News-wise, focus last week in the energy markets focused on 1) a Libyan supply disruption, 2) a dropping rig count, and 3) a potential policy shift that may allow for more exports of oil from the U.S.

But, the headlines were misleading. The Libyan supply disruptions are mostly temporary and of modest size (500K barrels per day) and won't be near enough to counter the rising supply glut, despite the headlines. With regard to the rig count, the number of active oil-specific rigs fell by 37 last week to 1,499, an 8-month low. But it's more important "which" rigs are being shut down (they are mostly speculative, low-producing, high-cost rigs), and the declining rig count at this point isn't a bullish influence for WTI crude.

Finally, headlines hit the wires mid-session Tuesday that the Obama administration had released a statement explaining which petroleum products are allowed to be "shipped" under the crude oil export ban that has been in effect for the past 40 years. But, the news didn't contain any actual policy changes that will result in a material uptick in oil exports. And, while oil exports are a major theme we will cover a lot more throughout this year, it's not a bullish influence in the near term.

Bottom line, despite the multiple (seemingly) bullish developments in the energy sector over the last week, the momentum in the market continues to strongly favor the bears for the near term as supply continues to rise and soft global economic growth has kept investors concerned about demand. Last week, WTI futures fell another 4.23% and the charts suggest prices will continue to fall into the high-/mid-$40s as we begin the first quarter of 2015.

Precious metals finished the week lower with silver falling 1.87% and gold declining 0.53%. Gold has been hovering around the $1,200 mark for over a month now but finally seems to be breaking down as the dollar reaches new highs. An uptick in geopolitical angst and global market volatility in recent weeks has been the primary influence preventing gold futures from materially breaking down, as there is a "fear bid" lingering in the market. But bottom line, the path of least resistance for gold remains lower with resistance up toward $1,200 while initial support lies below at $1,180.

Currencies & Bonds

The dollar rally accelerated last week as the Dollar Index surged 1.25% higher last week thanks almost entirely to weakness in the euro, as Mario Draghi's interview last Friday and forceful foreshadowing of QE by the ECB sent the euro down 1.4% last week and to new, multi-year lows. That weakness is continuing this morning as the euro is below 1.20 on more Greek concerns (more on that below).

The euro really was the story in the currency and bond markets last week, as the increased expectations for low inflation/QE in Europe sent Treasuries sharply higher. The 30-year rose 1.4% and the 10-year yield fell back below 2.22% almost entirely because of rising deflation worries in the EU (German bonds surged Friday, which was the catalyst for the stronger U.S. dollar and stronger Treasury prices).

Things got a bit more complicated in the euro zone over the weekend as Der Spiegel released an article (link here) that stated Germany views a "Grexit" as "manageable"—as Ireland, Portugal and Spain are in much better fiscal health than before and the risks of contagion are much lower than in 2012. In all likelihood, this article is meant to help frame the Greek elections as a referendum on EU membership for the Greek people, and the article should be viewed as more of a political tool than official policy. Regardless, it obviously puts more focus on Greek elections, and we can expect more volatility leading up to that event on January 25th.

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 1.5.15)

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 over 1% last week mostly on year-end positioning. Most of the declines last week were due to year end positioning, but it is notable that oil made new lows. Very short term, this market is still being led by energy, and XLE and JNK appear to be rolling over. If they resume their decline, stocks will too.*

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 making new, multi-year lows. With both Brent and WTI making new lows this morning, clearly the bottom in oil isn't "in" yet, and until oil stabilizes, commodities in general will have a hard time sustaining any real gains.*

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 exploded higher on Friday thanks almost entirely to a declining euro, which fell as ECB President Mario Draghi strongly implied coming QE. And, that drop in the euro to new multi-year lows is continuing this morning as concern rise about Greece remaining in the Eurozone.*

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 enjoyed a strong rally to start the year as growing EU deflation worries, more concern about Greece political stability, and the foreshadowing of QE in the EU send German bunds and US Treasuries soaring. Until there are signs of economic progress in the EU, Treasuries will remain well bid in spite of an improving US economy and looming rate hikes.*

Best Idea: Short "long" bonds (TBT)

Best Contrarian Idea: Short High Yield Bonds (SJB)