7:00's Report

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

January 7th, 2015

XLE: This ETF continues to be the leading indicator of markets. Clearly it's rolled over but if it can hold last month's lows, that may be a sign we have a bottom.

Pre 7:00 Look

- Futures are solidly higher this morning as the global markets bounce from the two day sell off.
- Europe is outperforming (up more than 1%) after a "good" night of data. December flash HICP missed expectations (increasing the chances of QE) while a German retail sales report handily beat expectations (1.0% vs. (E) 0.2%), and unemployment moved down one tick to 6.5%.
- Econ Today: ADP Employment Report (E: 235K), FOMC Minutes (2:00 PM).
- Fed Speak: Evans (6:30 PM).

Market	Level	Change	% Change
S&P 500 Futures	2006.75	12.25	0.61%
U.S. Dollar (DXY)	92.205	.467	0.51%
Gold	1213.30	-6.10	-0.50%
WTI	48.08	.15	0.31%
10 Year	1.963	-.076	-3.73%

Equities

Market Recap

Stocks continued to drop Tuesday as two intra-day rallies failed, pushing the market below key technical support by the closing bell. The S&P 500 declined .89%.

There was an early attempt to rally the market Tuesday as stocks opened decently following "ok" global composite PMIs. But, oil continued to get hammered and once XLE started to roll over around mid-morning the S&P 500 followed it lower, as has been the case for the last month and a half.

The only real economic report of the day was the December Flash Services PMI, which missed expectations and added some momentum to the downside, but it remains at a strong absolute level isn't a report that will get people worried about US growth.

News wise there were no real developments to speak of that caused the weakness in stocks. Instead the failure of the early rally just brought out more sellers, and things accelerated a bit once the 100-day MA was "given."

But, the bulls had another try at it mid-afternoon as stocks started to make a comeback despite oil continuing its decent. The declines in stocks were almost entirely erased by the last hour of trading, but a large sell imbalance in the MOC spooked markets during the last half hour (this is the second time in a week a large sell imbalance has appeared) and the S&P 500 gave back a quick 10 points into the close to finish fractionally below the 100-day MA (2003).

Trading Color

Market	Level	Change	% Change
Dow	17,371.64	-130.01	-0.74%
TSX	14,246.77	-145.93	-1.01%
Brazil	48,000.92	484.10	1.02%
FTSE	6,431.23	64.72	1.02%
Nikkei	16,885.33	2.14	0.01%
Hang Seng	23,681.26	195.85	0.83%
ASX	5,353.61	-11.19	-0.21%
Prices taken at previous day market close.			

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The was a big defensive rotation yesterday as the relative outperformance by cyclicals Monday gave way Tuesday as the Russell lagged the major indices and SPHB fell 1.66% compared to just a .34% decline for SPLV.

Market	Level	Change	% Change
DBC	17.80	-.17	-0.95%
Gold	1218.00	14.00	1.16%
Silver	16.55	.337	1.08%
Copper	2.7635	-.0025	-0.09%
WTI	47.85	-2.19	-4.38%
Brent	50.95	-2.16	-4.07%
Nat Gas	2.947	.065	2.26%
RBOB	1.3526	-.0288	-2.08%
DBA (Grains)	25.11	.17	0.68%
Prices taken at previous day market close.			

Sector wise there was significant defensive outperformance as XLU actually finished the day fractionally higher (not surprising given yields are collapsing) while REITs rose 1%. Even consumer staples were little changed, down just .34%).

Tech, energy, industrials and financials (the poster child cyclical sectors) all lagged badly yesterday, and it was those sectors that really dragged down the broad market. Financials were the worst-performing sector, falling 1.53%, while energy dropped another 1.4% and tech dropped 1.2%. It's fair to say there was a pretty big defensive rotation in the markets yesterday, which makes sense given the calendar (no one is getting out of the market on Jan. 6, they are just getting more defensive).

On the charts the S&P 500 is sitting right on the 100-day moving average (which has been a major support level going back to 2013). But, it would likely take a break of yesterday's lows (1993) to elicit more knee-jerk selling.

Bottom Line

Oil isn't stabilizing so neither are stocks. For the entire month of December the SPX followed oil. Oil started to consolidate on 12/16, so did stocks. And, while oil didn't enjoy the rally stocks did at year's end, that move higher in SPX was on low volumes, and mostly year-end positioning. Now that it's a new year and oil is gapping down $2.00/day again, stocks just can't rally.

Despite there being a lot of potentially negative "signs" out there (collapsing oil, collapsing global bond yields, collapsing European inflation metrics) beyond the short term the set up for stocks remains generally attractive, and for those with some longer-term time horizons, I think if XLE can form some sort of a bottom over the next several days, then I would be prepared to allocate to banks (KRE), retailers (RTH) and tech (XLK) (although again we have to wait for XLE to bottom—but the point is I'm putting together a shopping list now). More broadly, would be surprised if we see the S&P 500 move to the mid-1900s near term barring some major negative surprise (like a "Grexit" or some such event).

It's not that I've gone "perma-bull" or anything—I think this market will see some difficulty in Q1 '15 or early Q2 '15, but I think it may be Fed or economy related—not because of oil prices portending some sort of massive global economic slowdown.

Four Hedges for A "Systemic Oil" Problem

In early December we provided a four position "Oil hedge" portfolio. If oil continues to collapse from here and does cause systemic stress in the market, these positions will protect portfolios. During the December 3rd—December 16th drop in oil (and stocks) these four positions (equally weighted) produced a 6.9% return vs. a -4.9% drop in stocks. Again, I don't think we are about to see an oil inspired collapse in stocks, but if you are concerned about that, then here are some hedges that will work.

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 com-

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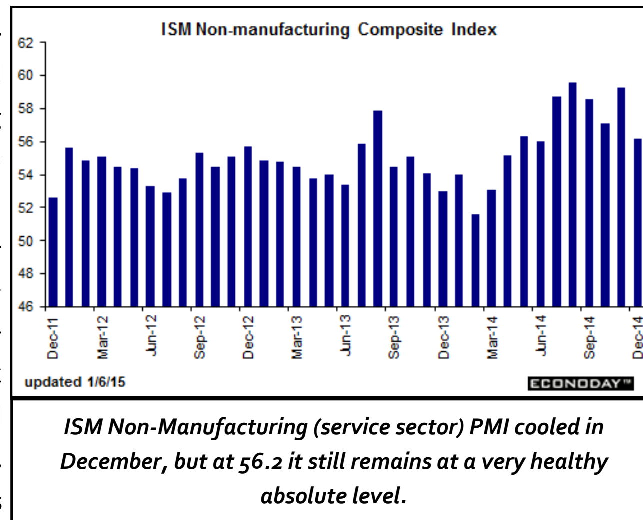
panies will get hammered (E&Ps more than integrateds, but they will all head lower). It's a 2X inverse so it's obviously a trading vehicle, but something to consider for short-term opportunities.

Hedge #4: HEDJ (Hedged Europe ETF). I originally suggested this hedge as part of a "Long HEDJ/short SPX" pair trade based on the idea that HEDJ doesn't have any energy exposure and XLE would weigh primarily on US equities. That obviously was before all the Greek turmoil, so this hasn't worked well as an outright hedge. But, the logic behind this hedge is still sound, beyond the near term geo-political influence.



ISM Non-Manufacturing (service sector) PMI cooled in December, but at 56.2 it still remains at a very healthy absolute level.

Economics

There were no notable economic reports yesterday.

Commodities

Commodity markets remained mixed yesterday, extending Monday's move as oil dropped to yet another fresh multi-year low while the precious metals continued to rally as demand for safe haven assets remains high. The broad-based commodity tracking index ETF, DBC, fell 1.15% thanks to the heavy weighting of energy in the index.

All eyes were on the energy space yesterday as the bleeding continued with WTI crude oil futures falling 4.02% to yet another new five-plus-year low. Yesterday marked the eighth consecutive decline to new lows, which is a very, very bearish technical pattern.

There were no new, overly bearish headlines out regarding the sector yesterday; however, Bloomberg did release analyst estimates for this morning's EIA Report that suggested domestic crude oil stockpiles likely rose 700K barrels last week. Globally, daily surplus estimates now are hovering at ~2M barrels per day.

Market	Level	Change	% Change
Dollar Index	91.875	.253	0.28%
EUR/USD	1.1895	-.0036	-0.30%
GBP/USD	1.5153	-.0095	-0.62%
USD/JPY	118.47	-1.16	-0.97%
USD/CAD	1.1829	.0067	0.57%
AUD/USD	.8093	.0011	0.14%
USD/BRL	2.6996	-.0063	-0.23%
10 Year Yield	1.963	-.076	-3.73%
30 Year Yield	2.523	-.082	-3.15%
Prices taken at previous day market close.			

Bottom line is there is simply no bullish influence that will stop oil futures from sliding right now, leaving the path of least resistance decidedly lower. The risk for a short squeeze "pop" does increase as futures become more and more oversold (futures were down nearly 10% for the week at one point yesterday), but such a bounce back towards the resistance band between $50 and $52 should be seen as an opportunity to sell short or add to existing shorts.

Natural gas bounced yesterday largely thanks to the cold weather that is blanketing much of the northern half of the country. Futures rallied 1.77% on the session, however the move doesn't appear to be a change of trend (from bearish to bullish) as prices remain near the lower portion of the roughly 40 cent range the futures are currently trading in ($2.80-$3.20). Bottom line, both fundamentals and technicals remain bearish for nat gas but a retest of the upper end of the trading range in the next week as a result of "cold weather bids" is possible, but like a "pop" in crude oil, such a move would be a selling opportunity.

Looking to the metals market, Monday's moves continued there as well, with copper slipping 0.05% thanks to the broad "risk off" moves in the market while gold and silver remained well bid for the same reason.

Gold futures finished the day right up against the upper edge of the formerly mentioned resistance band (between $1210 and $1220) after adding 1.25% on the day. According to the most recent Commitment of Traders Report released by the CFTC, the "rips" in gold are largely a function of short covering. In the most recent report, net longs held by money managers increased 4,854 to 87,050 but 3,012 of that increase

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was due to short covering.

So, bottom line, the gold market remains volatile as weak-handed traders continue to get knocked out of short positions thanks to stops and margin calls. When the dust settles (when oil bottoms) we should see gold reverse and continue the more prominent trend in the market which is lower. Until then though, it will likely remain painful for existing shorts.

Currencies & Bonds

Bonds were the story yesterday, as Treasuries surged in sympathy with German bonds while a declining stock market added a "risk off" bid to the market. The 30-year Treasury rose .74% while the 10-year yield broke below 2% for the first time since the spike lows in early October.

Despite the big moves in bonds, there simply isn't a lot to say from an analysis standpoint. Bonds have been surging since the first of the year for several reasons: Collapsing oil is increasing global deflation worries; European inflation numbers are horrid; the media is fanning the flames of a potential "Grexit," and the ECB has all but guaranteed QE on January 22. That, combined with a declining stock market, sent Treasuries soaring yesterday, although it's worth noting that Treasuries finished the day well off their best levels of the day.

Beyond the short term the pace of the gains in Treasuries simply isn't sustainable (or justified), but again, until we get some real signs of economic progress in Europe (inflation and economic growth) the trend in bonds remains higher.

Turing to Greece for a moment, there was another article out yesterday that further discussed a "Grexit." Again, to be clear, it's important to look past the articles and to the market.

Spanish, Portuguese and Italian 10-year bond yields were up only slightly, and unless we start to see a decided move higher in those bonds, then the chances of a "Grexit" simply are not increasing, regardless of rhetoric or headlines.

Case in point, Spanish 10-year yields are 1.65%-ish, Portuguese 10-year yields are 2.50%-ish, and Italian 10-year yields are 1.86%-ish. If there are real concerns about a "Grexit" then we will see all of those yields start to move materially higher from here (up towards 4% - 5%).

In the currency markets the recent trend of euro weakness accelerated overnight as the euro is now decidedly through 1.19 while the Dollar Index surged through 92 (both at multi-year lows and highs, respectively).

The catalyst was the EU HICP, which missed expectations (but there's more to it than that).

On the headline, EU HCIP dropped .2% year over year, more than the –.1% expectation. But, while that's the headline everyone focused on, the truth is the number wasn't that bad.

The yoy change in core HICP was unchanged in December at 0.7% (and this is the more important number). Additionally, the service component of HICP actually moved higher, to 1.2% yoy increase. That's notable because the data clearly points to the soft inflation readings being largely a factor of falling commodity prices, just like in the US inflation readings.

Bottom line, this report likely does solidify QE at the ECB meeting on the 22nd due to the horrid headline and overall price pressure. But, it's not as bad of a report as some media reports suggest, and importantly does not imply that the ECB's policies are futile (which would be a bearish games changer for our "Long Europe" thesis).

Elsewhere in the currency space we are seeing broad dollar strength this morning as the yen is down .4% while the commodity currencies drift lower, but most of those moves are just "give back" from yesterday's rally (especially in the yen).

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 fundamen-			

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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)

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