# 7:00's Report

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

**September 5th, 2014**


***Junk Bond ETF (JNK): JNK looks like it's rolling over—and keep in mind this was a leading indicator of the last sell off in stocks.***

## Pre 7:00 Look

- Futures are moderately lower as the selling into Thursday's close continues, while international markets were also modestly weaker as the global rally pauses.
- Economically things were better in Europe, where July German Industrial Production beat expectations, while EMU GDP met expectations.
- Geo-politically a cease-fire is expected to be announced in Russia/Ukraine today, but it's not a done deal yet.
- Econ Today: Employment Situation Report (E: 225k).
- Fed Speak: Plosser (10:15 AM), Rosengren (3:45 PM).

| Market | Level | Change | % Change |
|---|---|---|---|
| S&P 500 Futures | 1990.75 | -7.00 | -0.35% |
| U.S. Dollar (DXY) | 83.795 | -.039 | -0.05% |
| Gold | 1266.70 | 0.20 | 0.01% |
| WTI | 94.74 | .29 | 0.31% |
| 10 Year | 2.448 | .038 | 1.58% |

# Equities

*Market Recap*

The S&P 500 declined yesterday despite several pieces of "good" news, but did manage to finish off the worst levels of the day. The S&P 500 closed down -0.15%.

Stocks were higher out of the gate Thursday, helped obviously by the ECB, and also by the better than expected ISM non-manufacturing PMI, which rose to a new multi-year high.

But, the real strength yesterday was in Europe. When that market closed at 11:30, the U.S. started to lose some steam and, by the early afternoon, the selling started to gain momentum.

The selling accelerated around 2:30, and although there was no real catalyst for it, some mildly hawkish comments by new Cleveland Fed President Mester weighed a bit on sentiment. So did a "hawkish" Fed paper on the labor market, which was released yesterday morning but really began to circulate during the afternoon.

Stocks hit their lows about 45 minutes before the close yesterday before bouncing a bit on some dip-buying. The S&P 500 finished the day below 2,000 for the first time this week.

*Trading Color*

There was mild cyclical underperformance yesterday but it's hard to say that it was a "weak" day internally, as the Russell 2000 and Nasdaq lagged, but only mildly so.

Instead, and as has been the case all week, sector trading was driven mostly by other markets (namely the

| Market | Level | Change | % Change |
|---|---|---|---|
| Dow | 17069.58 | -8.70 | -0.05% |
| TSX | 15576.79 | -80.84 | -0.52% |
| Brazil | 60800.02 | -1037.02 | -1.68% |
| FTSE | 6840.99 | -36.98 | -.54% |
| Nikkei | 15668.68 | -7.50 | -.0.05% |
| Hang Seng | 25240.15 | -57.77 | -0.23% |
| ASX | 5598.69 | -32.57 | -0.58% |
| Prices taken at previous day market close. | | | |

bond market), as there was a bit of a "higher rate" trade in stocks until the declines accelerated during the afternoon.

| Market | Level | Change | % Change |
|---|---|---|---|
| DBC | 24.66 | -.11 | -0.42% |
| Gold | 1263.80 | -6.50 | -0.51% |
| Silver | 19.09 | -.099 | -0.52% |
| Copper | 3.1525 | .0255 | 0.82% |
| WTI | 94.53 | -1.01 | -1.06% |
| Brent | 101.96 | -.81 | -0.79% |
| Nat Gas | 3.833 | -.014 | -0.36% |
| RBOB | 2.6050 | -.015 | -0.57% |
| DBA (Grains) | 26.34 | -.09 | -0.34% |
| Prices taken at previous day market close. | | | |

Banks spent most of the day solidly positive until the market rolled over in the late afternoon, while utilities and other rate-sensitive stocks underperformed until the last 90 minutes of the day. The only rate-sensitive stocks to buck the trend were homebuilders, which bounced thanks to more earnings (HOV in particular). Consumer stocks (staples and discretionary) were the outperformers thanks in part to PVH rallying 9.5%, while energy got crushed again—this time on the news that BP was found "grossly negligent" in the Gulf oil spill (it opens them up to 4X damages).

On the charts the S&P 500 is now back into mild support but there really isn't much until 1,985 (the old, old highs) and 1,975, the 20-day MA.

*Bottom Line*

Stocks have been consolidating this week but yesterday wasn't a very good day, even through the declines were small. Buyers appear uninterested in adding exposure at these levels, and there are now a lot of "late longs" in the market thanks to the 100-point 4-week ramp that induced a lot of chasing.

And, JNK looks like it's starting to roll over again—and as we know from the July/August sell-off, JNK is a pretty good leading indicator of the stock market.

Consolidation remains the most likely outcome, but that could mean some additional downside in the very near term (say, near aforementioned support at 1,985/1,975) before any real buying emerges.

*Jobs Report Preview*

This is already a full Report so I'm going keep this short and sweet; honestly, unless this is a shocking (good or bad) number, the market will move beyond it quickly.

The risk here is of a "too hot" number—especially out of the wage data. The two components to watch are the headline job adds and the year-over-year wage data.

| Jobs Report Expectations | Too Cold | Just Right | Too Hot |
|---|---|---|---|
| Job: (E) 225k | < 150k | 200k – 250k | >275k |
| Wage Inflation: (Y/Y) (E) 2.1% | | | >2.25% |

# Economics

There were multiple economic reports yesterday, the most important of which was the ISM non-manufacturing PMI. It continued the streak of very good economic numbers, and the levels of "Fed angst" are definitely starting to rise a bit into this morning's jobs report. But, overshadowing that was the ECB decision, so we're focusing on that today.

ECB Decision

The ECB shocked/surprised markets this morning by announcing a targeted, private-market QE program that will begin in October. This decision, combined with the start of the TLTRO, represents a significant bullish tailwind on the euro zone that should not be ignored.

*What Happened:*

The important event you need to be aware of from the ECB today was the announcement that it would begin purchasing "Asset-Backed Securities" and "Covered Bonds" starting in October. This amounts to a "private-market QE" program, which was not expected by the market (and is very dovish).

*Why It Is Important:*

The ECB can't do the type of QE we have here in the U.S. because there is no European equivalent to Treasuries. Instead, there are individual countries' bonds. So, if the ECB were to try and do traditional QE on the scale of the Fed or Bank of England, it could very well end up owning all of smaller European countries' debt (like Portugal, Ireland, etc.). So, public QE isn't an option.

Instead, the ECB needs to do a more-targeted, private QE program, and that was what today's announcement was about.

By buying ABSes and covered bonds (which are basically higher-rate ABSes), the ECB is directly funneling money into the real EU economy, which should help spur economic growth and, eventually, inflation.

This is how it works: A European bank will now be able to bundle and sell performing loans on its books to the ECB. It would get cash in return, which it can then turn around and lend to businesses, thereby creating inflation (eventually) and economic growth.

*How We Make Money Off It*

There are two major investment implications here:

First, it's very bullish for European equities. I have often used the analogy that Europe is 2-3 years behind the U.S. and the UK from a monetary-policy and economic-growth standpoint. Two years ago, the U.S. and UK were fighting a deflation threat. Now, it's Europe.

We know what's happened to U.S. and UK stock markets over the past two years, largely as a result of QE. We have been tactically bullish on Europe for the last two months, and today's announcement makes us even more so.

Second, I believe this move by the ECB will signal a top in the U.S. Treasury market. We all know what an influence the rally in German bunds has been on Treasuries. But, these moves by the ECB should eventually lead to inflation and growth. As such, the "mania" in German bonds should end and we should see German bonds begin to sell off, and with them longer-dated U.S. Treasuries. Bottom line, I believe this is bullish for TBT and other inverse bond plays.

*Bottom Line*

There are a few ways we are playing this: We bought HEDJ (Europe hedged equity ETF) for about 50% of the total "Long Europe" portfolio. It hedges against a decline in the euro the same way DXJ hedges against a decline in the yen. That's the best way to play Europe given what's happening with the euro currency. Second, we also bought smaller allocations of EUFN, EWI and EWP (European financials, Italy ETF and Spain ETF). Third, we bought TBT.

The last time the ECB did something like this, European stocks and the euro gave a huge head-fake. And with the jobs report looming this morning, there are risks. So, we only bought half of the total allocation yesterday, and will look to add later on—because we believe the time horizon on this trade is weeks and months, not days.

| Market | Level | Change | % Change |
|---|---|---|---|
| Dollar Index | 83.785 | .897 | 1.08% |
| EUR/USD | 1.2946 | -.0204 | -1.55% |
| GBP/USD | 1.6341 | -.012 | -0.73% |
| USD/JPY | 105.11 | .32 | 0.31% |
| USD/CAD | 1.0873 | -.0013 | -0.12% |
| AUD/USD | .9349 | .0007 | 0.07% |
| USD/BRL | 2..2418 | .0051 | 0.23% |
| 10 Year Yield | 2.448 | .038 | 1.58% |
| 30 Year Yield | 3.205 | .049 | 1.55% |
| Prices taken at previous day market close. | | | |

## Commodities

Commodities were mostly lower yesterday, with energy underperforming amid some slightly bearish inventory data while industrial metals rallied on ECB stimulus speculation. The broad-based commodity tracking index ETF, DBC, fell back -0.44%.

Yesterday was inventory day for the entire energy space and the results were mixed. Crude supplies fell -900K barrels, slightly less than the expected -1.1M barrel draw (mildly bearish). Meanwhile RBOB gasoline and distillate supplies both fell more than expected (bullish), down -2.3M vs (E) -1.4M and -600K vs. (E) -200K, respectively. But, as crude generally reigns supreme, WTI, RBOB and heating oil futures all suffered losses on the day.

WTI fell -1.15% yesterday on the slightly bearish inventory report, but price action was rather neutral as futures chopped sideways in trendless trading. On the charts, WTI held onto enough of Wednesday's gains to close back above recently formed trend support at $94.45 and so far, Tuesday's bloodbath (-3% drop) is appearing to be a head-fake.

Bottom line, crude prices are continuing to consolidate the sharp two-month sell-off seen between mid-June and mid-August. Although we remain fundamental bulls, we still need to see a further shift in technicals before putting outright positions on. Having said that, the line in the sand remains the August low of $92.50 while resistance hovers above toward $97.50.

Natural gas futures slipped back -0.36% yesterday and tested support below $3.80 thanks to a slightly larger than expected build in supplies reported by the EIA (+79 Bcf vs. E: +74 Bcf). But the build was still well below the required weekly average needed to see supplies fully restored to "normal" levels for entering the draw season. Bottom line, natural gas has sold off the past three days because of easing geopolitics in eastern Europe, more moderate weather forecasts here in the U.S., and most recently this slightly bearish EIA report. However, the fundamental story remains the same in that supply levels remain well below the 5-year average, and weekly injections are not near the size needed to see supplies adequately restored to normal levels for entering the draw season. On the charts, there is initial support at $3.80 while the bulls' target is back toward $4.00.

Moving to the metals, gold was getting hit earlier in the week because economic data were coming in a bit "*too* hot," upping the chances that the Fed would have to raise rates sooner/faster than initially thought (hawkish). But, yesterday's jobs data were more in line and actually slightly worse than expected, namely the ADP Employment Report (204K vs. E: 223K), which caused some of those speculative shorts betting on hawkish policy decisions to unwind. Gold fell -0.45% to close at $1,264. Bottom line, gold is trading almost exclusively on Fed speculation and this will continue. So, if this morning's BLS report is "too hot," then expect another leg lower. The next level of support is at $1,250.

## Currencies & Bonds

The currency and bond markets remained the most volatile of major assets Thursday, with major moves in the 30-year Treasury and euro following the ECB meeting.

It'd be impossible not to start with the euro, as it absolutely imploded, dropping -1.5% yesterday and crashing through 1.30 to trade to a 14-month low. Obviously by now you know why the euro declined, but the reason it fell so sharply was because most currency traders expected the euro to catch a "buy the news" bid after the ECB meeting. So, when they shocked the markets, a lot of late longs when running for the door.

There's support for the euro around 1.28 (lows of summer 2013) and we'll likely see some sort of bounce over the coming days given how oversold the euro is. But it's clear that the ECB *wants* a weaker euro going forward, so obviously any bounce should be viewed as a shorting opportunity.

Thanks to the collapse in the euro, the Dollar Index rose +1.14% also to a 14-month high. Although almost all of the move was due to the euro sell-off, there was more "dollar-bullish" news in the markets yesterday, as economic data were good (ISM non-manufacturing PMI) and the Fed working paper that attributed the decline in labor force participation to structural (demographic) factors rather than cyclical factors also helped push the dollar higher (more on that later). The dollar is now absurdly overbought, and with the jobs report looming there is room for a pullback. But, clearly, the trend remains higher.

Turning to the bond market, Treasuries continued to trade lower, as they have all week, as the long bond declined -0.5% and is once again below the 2014 uptrend as we await the jobs report. You know already that one reason for the drop in the long bond was the fact that German bonds declined (and yields rose) following the ECB decision. But, there was also the aforementioned Fed working paper on the labor force participation rate. Bottom line, Fed researchers found the declines to be structural in nature – and as we've covered here that's important, because Fed policy can't solve structural problems (they solve cyclical problems). Stepping that out, it means the Fed may not see low rates as a "cure" for the labor market anymore, and may be more prone to raising rates despite a low participation rate. So, the paper was mildly hawkish.

As I mentioned earlier this week, for the 4th jobs report in a row Treasuries are teetering on the 2014 uptrend line. But, unless the report is a big miss, given what's happening in Europe, I think we may finally be seeing the end of this 2014 bond rally – but I'm definitely "once bitten, twice shy" on this thing.

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 |
|---|---|---|---|---|
| **9/4/14** | HEDJ<br>EUFN<br>EWI<br>EWP<br>TBT | 59.35<br>24.67<br>16.44<br>41.34<br>56.59 | 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. Given the sour sentiment towards the region and relative attractive valuation we are committing capital to the trade. 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.* |
| **7/28/14** | DBC | 25.65 | None | *We have initiated long positions in DBC here as we believe many components of the benchmark index have become oversold, namely in the energy space. The potential target to the upside is close to the $27 mark. Original Issue* |
| **7/21/14** | UNG | 20.98 | None | *We are replacing the "long copper" trade on the tactical sheet with our "long natural gas" call because of the time frames of the two trades. Copper is a long term fundamental play dependent on continued global economic growth (namely in China) while buying nat gas is a medium term trade based on smaller supply injections and warming weather patterns. "Long Copper" has been moved to the ACD. Original Issue.* |
| **6/11/14** | SPHB | 32.73 | 30.32 | *Long domestic cyclicals. Part of the "Post ECB Decision" portfolio of what should outperform if bond rally is done. Original Issue* |
| **6/11/14** | UUP | 21.55 | 21.13 | *Long Dollar. Part of the "Post ECB Decision" portfolio of what should outperform if bond rally is done. Original Issue* |
| **4/30/14** | IYZ | 28.99 | 28.32 | *Original Issue* ***Selling Positions at Open*** |
| **3/3/14** | XLI<br>IYM<br>PICK<br>DIA | 52.19<br>83.06<br>19.48<br>164.28 | None | *Original Issue* ***Selling Positions 9.5.14.*** |
| **12/13/13** | FCG<br>XOP | 18.97<br>65.62 | None | *Natural gas supplies low, increased 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 |
|---|---|---|---|
| **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 (6/4/14): Focus on this trade has shifted to Abe's "3rd Arrow" of fiscal reforms, and if enacted, it could lead to a material decline in the yen/rally in DXJ.* | | | |
| **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.* |

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|---|---|

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** | **Bullish** | **Bullish** | *The S&P 500 traded to new highs last week as economic data was strong and the outlook for Fed policy remained stagnant. Positioning was the main reason stocks were higher last week, as investors chased and added long exposure. A period of consolidation is necessary (again) but the trend remains higher.* |
| **Best Idea:** Buy Regional Banks (KRE).<br>**Best Contrarian Idea:** Buy Small Caps (IWM). | | | |
| **Commodities** | **Bullish** | **Bullish** | *Commodities rose for the second week in a row last week, led by outperformance in the energy space. Both crude oil and natural gas have established near term support and the technicals are shifting more bullish. Fundamentally, the broad outlook for commodities remains bullish primarily based on the idea that as the economy continues to improve, we will see demand for commodities rise accordingly.* |
| **Best Idea:** Long Oil (USO), Long Copper (JJC)<br>**Best Contrarian Idea:** Buy Grains (DBA) | | | |
| **U.S. Dollar** | **Bullish** | **Bullish** | *The Dollar Index surged to new highs for the year last week on good data and increasing speculation the ECB will do "more" from a policy standpoint, perhaps as early as this week. The Dollar Index is now close to 83, and while we need to see some sort of consolidation in the Dollar, with the path of policy between the US and Europe diverging materially, the trend in the Dollar should stay higher.* |
| **Best Idea:** Sell the Yen (YCS)<br>**Best Contrarian Idea:** Long Canadian Dollar (FXC) | | | |
| **Treasuries** | **Bullish** | **Bearish** | *Treasuries were flat again last week and exhibited some signs of fatigue, and although fundamentally the outlook is negative (better US economy, potentially more "hawkish" Fed) this trade remains dominated by European money flows, so until German Bunds Break down, the trend in bonds is higher short term.* |
| **Best Idea:** Short "long" bonds (TBT)<br>**Best Contrarian Idea:** Short High Yield Bonds (SJB) | | | |