# 7:00's Report

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

***July 11, 2013***

## Pre 7:00 Look

- Futures are sharply higher and global equities rally thanks to "dovish" comments from Bernanke after the close yesterday.
- There was broad strength in Asia as more "chatter" of Chinese accommodation helped Shanghai rally more than 3%, although nothing occurred that makes easing from the PBOC more likely.
- Economically it was very quiet o/n. The BOJ meeting was in-line with expectations, as they upgraded the growth outlook for the country but kept policy stable. So, status quo in Japan at least until after the elections on the 21st.
- Econ Today: Jobless Claims (E: 337K), Retail Same Store Sales.

| Market | Level | Change | % Change |
|---|---|---|---|
| S&P 500 Futures | 1652.62 | .30 | .02% |
| U.S. Dollar (DXY) | 83.245 | -.989 | -1.17% |
| Gold | 1281.30 | 33.90 | 2.72% |
| WTI | 106.08 | -.44 | -.41% |
| 10 Year | 2.68 | .05 | 1.90% |

## Equities

*Market Recap*

Stocks closed yesterday virtually flat after some afternoon volatility thanks to the FOMC minutes. But, futures moved sharply higher (about 1%) after the close thanks to some "dovish" Bernanke comments during the Q&A of his speech yesterday afternoon.

Trading yesterday was quiet until the FOMC minutes, which upon release led to some decent market volatility. Stocks traded higher initially off a "dovish" interpretation of the minutes, but then reversed and were lower heading into the close as more careful reading revealed a bit of a "hawkish" surprise (more on that below). For all the late afternoon gyrations, though, stocks finished Wednesday basically where they started, and also where they were just before the minutes were released.

But, during the Q&A after his speech, starting around 4:45 PM EST, Chairman Bernanke made comments that the current 7.6% unemployment rate probably "overstates" the actual health of the labor market (which was taken as dovish, seeing as employment is the key metric that will decide the pace of "tapering'). He also said that "highly accommodative monetary policy for the foreseeable future is what's needed," for the US economy, and that only added to the dovish interpretation, although those particular comments aren't surprising (it's just part of the "tapering isn't tightening" rhetoric campaign).

*Bottom Line*

For all the excitement yesterday and this morning, not much has changed from earlier this week. The FOMC minutes were slightly hawkish (opinions vary, but that's my take) and Bernanke was dovish, just as we all expected each would be.

But, the key here remains that the equity market continues to get more comfortable with the reality of "tapering." Keep in mind that the market broke from its highs almost two months ago on the Hilsenrath WSJ article that said the Fed was game planning its exit, so markets have been adjusting to this new Fed reality, sometimes violently, for 2 plus months.

So, as long as current expectations are generally met: "Tapering" starting in September, QE ending in mid/early '14, then what will decide if this market moves to new highs or not is boring old economic data and earn-

| Market | Level | Change | % Change |
|---|---|---|---|
| Dow | 15291.66 | -8.68 | -.06% |
| TSX | 12306.93 | 9.84 | .08% |
| Brazil | 45483.43 | 407.93 | .90% |
| FTSE | 6560.86 | 55.90 | .86% |
| Nikkei | 14472.58 | 55.98 | .39% |
| Hang Seng | 21437.49 | 532.93 | 2.55% |
| ASX | 4965.70 | 64.34 | 1.31% |
| Prices taken at previous day market close. | | | |

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ings. As long as rallies in bond yields and stocks are no longer mutually exclusive, as they have been since May, and emerging market bonds continue to stabilize (they don't have to rally, they just have to not implode) then the path of least resistance for the market is higher, as long as the data is "ok".

| Market | Level | Change | % Change |
|---|---|---|---|
| Gold | 1250.50 | 4.60 | .37% |
| Silver | 19.14 | 0.00 | -.02% |
| Copper | 3.08 | .01 | .54% |
| WTI | 105.90 | 2.37 | 2.29% |
| Brent | 107.89 | .08 | .07% |
| Nat Gas | 3.67 | .01 | .22% |
| Corn | 5.21 | -.00 | -.05% |
| Wheat | 6.79 | .01 | .22% |
| Soybean | 12.84 | .08 | .67% |
| Prices taken at previous day market close. | | | |

1650 is a key level in the S&P 500 and we're going to open well above it this morning. A strong close today and tomorrow could bring in momentum buyers off the sidelines and accelerate the rally into the end of the week, so that's an important level to watch.

# Economics

FOMC Minutes

The analysis of the Fed minutes yesterday caused a bit of whiplash. Initially, the takeaway from the minutes was that they were "dovish," and we saw stocks move higher and Treasuries rally/yields fall.

But, that interpretation was incorrect (as is often the case with initial interpretations of anything Fed-related). That's why there is a popular trading axiom that states "the first move of the market after a Fed event is usually the wrong one."

What the speed-reading programs and analysts didn't see—in their "dovish" interpretation—was that, buried in the appendix, was this passage:

> *"Given their respective economic outlooks, all participants but one judged that it would be appropriate to continue purchasing both agency mortgage-backed securities and longer-term Treasury securities.*
>
> ***"About half of these participants indicated that it likely would be appropriate to end asset purchases late this year. Many other participants anticipated that it likely would be appropriate to continue purchases into 2014." (Emphasis added).***

Remember back to Ben Bernanke's press conference after the Federal Open Market Committee statement. What surprised the market was that Bernanke said the broad consensus of the Fed was that QE should end in mid-2014, which was earlier than the consensus thinking at that time. (Consensus was for QE to end in late '14.)

Well, the "end date" of QE may be closer than "mid" 2014, depending on data, which is trending better since the last Fed meeting.

Of the 19 participants at the meeting, at least one leans toward QE ending immediately. Of the remaining 18, "about half" thought QE should end later this year, presumably at the December meeting.

That's another "hawkish" surprise, and we did see the effects of it when Treasuries sold off into the close and the Dollar Index pared some losses.

Now, does that mean QE will end in December? Probably not, as Bernanke/Yellen and Dudley still dominate the Fed and they are doves.

But, for all the gaming of the Fed, the takeaway here is that "tapering" remains very much on schedule, and it would appear that the risk is for QE ending sooner than current expectations, rather than later. So, with regard to the market, the minutes only further reinforced the fact that interest rates are going higher, which strengthens the bullish case for "short bond" plays like TBF, TBT, SJB, banks, etc.

# Commodities

WTI crude surged higher yesterday as the weekly inventories saw a big second-straight weekly draw on supplies of about 10 million barrels (making it a 20-million-barrel draw over the past two weeks, which is a large number).

Part of the big draw this week had to do with the re-start of BP's Indiana-based Whiting Refinery. But to further understand and put into context this two-week surge in demand, it's important to look at what's happened with the WTI/Brent spread.

The recent surge higher in WTI prices has closed the spread between Brent and WTI to $2.00, which is a 2 1/2

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year low. That has had a significant implication on one of the best "arbs" in the energy business over the past few years, which has been to send mid-continent Bakken and North Dakota crude (which was trading closest to WTI prices) east via rail and pipeline, and refine it and sell based on Brent prices (which for the last year or so were around a $20 premium to WTI).

But as that spread has narrowed, the profit margins on that arbitrage have gone away. I'm not a physical oil trader, but I would venture to guess that part of the reason we've seen such a big draw in supply over the past few weeks is because—as that Brent/WTI spread narrows and eventually closes—anyone with Bakken crude is going to ship it east right now to capture what's left of the profit margin, thereby artificially depressing inventories.

I point this out because I want to make a few things clear. First, these big demand spikes are not indicative of a surge in domestic energy demand. Yes, energy demand is up year-over-year as the economy recovers, but it's not up big enough to warrant the recent spike. So, if you're buying WTI up here, buy it as a momentum trade and understand the risks—$107/barrel WTI doesn't reflect an economy that is accelerating that much.

*I think ultimately the euro goes lower based on the difference of monetary policy between the Fed and ECB. But, for now it looks like support at 1.28 in the euro has held. Any rally from here is a good shorting opportunity, though.*

Second, as the Brent/WTI spread narrows and the "arb" I mentioned closes, we'll see a reduction in refinery margins. So, we can expect less refinery demand for crude oil.

That's important because if you own refining stocks, you've probable done very well over the past few years. If so, I'd consider re-allocating that money into other areas of the energy space, because the "golden age of refining" appears to be coming to an end.

Energy and WTI crude could very well spike to $110/bbl. from these levels, but we're ahead of fundamentals. Personally, I'd continue to lighten up some energy exposure into this melt-up and look to re-allocate on a dip back towards $100/bbl.

Precious metals mostly traded off the perceived "dovish" FOMC minutes; gold, silver and copper all rallied basically to the highs of the day in after-hours trading (each up about 1%). Gold is surging this morning, up nearly 3%, however, on a steep drop in the dollar thanks to the Bernanke comments post yesterday's close.

Copper was the only metal with a fundamental bid to it yesterday, as the monthly Chinese trade data showed copper imports jumped 13.1% month-over-month. But, while providing a one-day respite, copper's near-term direction remains tied to the outlook for the Chinese economy. (The supply/demand situation in copper is not fundamentally bullish.)

DBC, my preferred commodity ETF, broke through $26.00 yesterday, which is the 50-day EMA and the last level of resistance. But, in a market that has had so many head-fakes, I want to see a few closes (three or so) above that resistance before declaring that downtrend finally over.

| Market | Level | Change | % Change |
|---|---|---|---|
| Dollar Index | 84.05 | -.53 | -.63% |
| Euro | 1.2885 | .0104 | .81% |
| Pound | 1.4928 | .0062 | .41% |
| Yen | 100.15 | -1.00 | -.99% |
| CAD $ | .9516 | .0016 | .17% |
| AUD $ | .9117 | -.0059 | -.64% |
| Brazilian Real | .4409 | -.0021 | -.47% |
| 10 Year Yield | 2.684 | .043 | 1.60% |
| 30 Year Yield | 3.689 | .038 | 1.03% |
| Prices taken at previous day market close. | | | |

The reason I'm extra-skeptical is because these commodity ETFs have surged almost solely because of the rally in energy, which as you can guess I'm skeptical of in the short term. So, if WTI crude corrects, these ETFs will correct also.

My opinions aside, though, price is price, and if DBC can trade for a few days above $26/share, I think we've seen

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the end of this downtrend, regardless of how or why it happens.

## Currencies & Bonds

The euro rallied 0.75% yesterday vs. the dollar. Although the dip in the dollar post-FOMC minutes helped add to the euro's gains, it's worth noting that the euro was stronger vs. the dollar prior to the minutes for several reasons yesterday.

The biggest factor for the euro rally prior to the FOMC minutes was that the euro once again held critical support at 1.28.

For those chartists out there, it looks as though the euro put in a "double-bottom" (which is a bullish chart pattern) around the 1.28 level. So, any weak hands on the short side covered yesterday.

The fact that the euro held 1.28 was based on some peripherally bullish news: Yesterday industrial production data from France and Italy was better than expected, again implying that the EU economy is finally stabilizing. Plus, Spanish Prime Minister Mariano Rajoy made some positive comments, saying the rescue program remained on track.

So, support in the euro has held once again although, given the relative course of monetary policy, I am still in the camp that believes 1.28 will be broken eventually. But, a bounce of some sort appears to be under way.

Thanks in part to the much-stronger euro, the Dollar Index traded down somewhat sharply after the FOMC minutes, falling nearly 1% before recovering a bit into the close. But, the sharp decline in the dollar was due largely to the strong euro and yen (which rallied into the Bank of Japan announcement on position-squaring and short-covering), not that the Fed minutes were quite as "dovish" as the media let on.

The reason I can say the minutes weren't that dovish, other than reading them and drawing that conclusion, is that Treasuries sold off to their lows of the day after the minutes were released. If the minutes were dovish, Treasuries would have rallied—instead they sold off, so that tells you all you need to know about the minutes.

Most importantly, though, emerging-market bonds took a big hit yesterday. It's important to remember that equities can only rally as long as emerging-market debt and currencies "behave" themselves by having an orderly decline. PCY and EMB fell 1.4% and 0.9% post-Fed minutes, respectively, and that is not "behaving."

The key now is whether there are follow-through declines in those markets. If they are down big again today, that's not going to be good for stocks. If they can stabilize (yesterday saw the "fast money" pushing the ETFs around), then the recent rally still has momentum. Emerging markets are still the key.

Have a good day,

Tom

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# The 7:00's Report Asset Class Dashboard

(Outlook on the primary trend for major asset classes over the next month)

| | Fundamental Outlook | Technical Outlook | Overall | Comments |
|---|---|---|---|---|
| Stocks | **Neutral** | **Neutral** | **Neutral** | *Stocks continue to act better than they have in two months as the market appears to be much more comfortable with Fed "tapering." As long as "cross assets" like emerging market debt can remain orderly, the path of least resistance for stocks appears higher.* *The S&P 500 broke through it's 50 day moving average on Friday for the first time in weeks, and now the S&P is sitting on resistance at 1652. If 1652 can be decisively broken to the upside, then the technical picture will turn bullish.* |

**Trade Ideas**

***Long/Overweight:*** **The biggest trend in the equity markets currently is the rotation out of "bond proxy" sectors and into sectors positively correlated to higher rates and more economic growth. So, banks are the most favored sector in that environment, followed by other typical cyclicals like tech, consumer discretionary, and energy. For those looking for a contrarian play, basic materials remains on of the biggest underperformers in the market, but offers value if the economic recovery turns global in the coming months. Also, after a correction, the "Long Japan" DXJ trade appears to be back "on" and I'd use any decent dip to initiate or add to positions.**

***Short/Underweight:*** **Anything that is a "bond proxy" - Utilities & REITS especially, Telecom, healthcare & consumer staples (to a lessor extent).**

| | Fundamental Outlook | Technical Outlook | Overall | Comments |
|---|---|---|---|---|
| Commodities | **Bearish** | **Bearish** | **Bearish** | *Commodities continue to try and put in a bottom, but are facing stiff headwinds from a "hawkish" FOMC and a slowing growth in China. The recent rally in oil has helped push commodity indices into month's long resistance, although once again commodities are "knocking on the door" of breaking it's downtrend.* |

**Trade Ideas**

***Long:*** **I have no great conviction as the environment is simply too unpredictable. For those looking to take some risk, and who think the global economy will see an acceleration of growth over the coming quarters, then industrial commodities offer some value, and a ETF like DBB will offer substantial upside. More broad based commodity ETF's (like DBC) are also a potential value at these levels, if growth stabilizes. Commodities and raw materials are the ultimate "contrarian" investment in the current market environment.**

| | Fundamental Outlook | Technical Outlook | Overall | Comments |
|---|---|---|---|---|
| U.S. Dollar | **Bullish** | **Bullish** | **Bullish** | *The dollar is in full rally mode, and should be given the marginal direction of change for short term interest rates in the U.S. is higher, and everywhere else in the world it is lower, regardless of short term volatility.* |

**Trade Ideas**

***Short*:** **Japanese Yen on any decent bounce (YCS being the ETF to use). Short the Aussie Dollar, given a weakening economy and dovish central bank (short FXA). Short the euro on any further bounce due to the fact the ECB is squarely focused on economic growth, and won't let the currency appreciate too much as that would cause a stagnation in exports.**

| | Fundamental Outlook | Technical Outlook | Overall | Comments |
|---|---|---|---|---|
| Treasuries | **Bearish** | **Bearish** | **Bearish** | *Treasurys traded to new lows for the year last week on good economic data. The decline in bonds is accelerating, and every oversold bounce should be used to initiate or add to short or inverse positions.* |

**Trade Ideas**

***Buy:*** **TBF (unleveraged short 20+ year Treasurys) and TBT (2X leveraged short 20+ year Treasury). SJB (inverse junk bond ETF) is also rallying during this period of global uncertainty, and basically has acted as a hedge against falling equity prices. It doesn't trade with a lot of volume, however, so buyer beware.**

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