7:00's Report

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

July 16, 2013

Pre 7:00 Look

- Futures flat after a relatively quiet night of news as focus turns to several important earnings results today.
- European shares slightly lower after economic data disappointed: EU trade balance underscored the sluggishness of the EU economy, and the German ZEW Survey showed future business expectations were weaker than expected.
- Econ Today: CPI (E: 0.4%), Industrial Production (E: 0.2%).
- Earnings Today: GS (E: $2.92), JNJ (E: $1.39), KO (E: $0.64), YHOO (E: $0.30).

Market	Level	Change	% Change
S&P 500 Futures	1677.50	0.00	0.0%
U.S. Dollar (DXY)	83.07	-.131	-.16%
Gold	1286.10	2.60	.20%
WTI	106.56	.22	.21%
10 Year	2.556	-.045	-1.73%

Equities

Market Recap & Trading Color

Stocks saw small gains to start the week as good earnings by Citigroup (C) and "better-than-feared" Chinese economic data helped offset a soft retail-sales report. Overall the day was extremely quiet (trading volumes were well-below recent averages) and, after the economic data ended (about 10 a.m.), the market simply drifted in very boring trading.

From a sector standpoint, though, the "right" sectors continued to lead and the Russell 2000 solidly outperformed. In fact, it made a new all-time high. (Small caps have been crushing large caps since the markets turned in late June, typically a good sign.)

The Russell 2000 has massively outperformed large caps since the lows in late June, rallying to new all time highs. Out performance by small caps is usually a signal the market is in a sustainable rally.

Sector trading largely reflected the news of the day: consumer discretionary and telecom lagged thanks to the soft May retail sales print and merger-and-acquisition activity in telecom. AT&T (T) bought LEAP Wireless (LEAP), which was up 110% yesterday. (Congrats to you if you owned that one.) Homebuilders also lagged on profit-taking after last week's big rally.

Basic materials (thanks to "OK" Chinese data), financials (C earnings) and utilities (falling bond yields leading to short-covering) all led the tape higher.

Volumes, as you already know, were low. So was conviction. On the charts not a lot changed, as the all-time intraday high remains resistance.

Bottom Line

Yesterday was a boring day that didn't change the market narrative. With the "macro-economic" relatively

Market	Level	Change	% Change
Dow	15484.26	19.96	.13%
TSX	12528.35	66.17	.53%
Brazil	46738.90	1205.66	2.65%
FTSE	6595.93	9.84	.15%
Nikkei	14599.12	92.87	.64%
Hang Seng	21312.38	9.07	.04%
ASX	4986.02	4.91	.10%

Prices taken at previous day market close.

calm (there are storm clouds in China/Portugal, but nothing imminent) the focus is on earnings and the economic data. How that goes will dictate whether stocks rally or sell off.

Market	Level	Change	% Change
Gold	1282.80	5.20	.41%
Silver	19.83	.04	.19%
Copper	3.14	-.01	-.25%
WTI	106.06	.11	.10%
Brent	108.95	.14	.13%
Nat Gas	3.61	-.03	-.88%
Corn	5.03	-.06	-1.13%
Wheat	6.69	-.11	-1.65%
Soybean	12.62	.05	.40%
Prices taken at previous day market close.			

For what it's worth, and this is entirely unscientific, it seems that earnings seasons are always "good" lately—in that the vast majority of companies always seem to beat estimates. In fact, I can't remember the last time an earnings season led to a market sell-off.

So, given that recent history, I'm going to go out on a limb and say that if the market is going to decline, it'll be something other than earnings to cause it. Whether it's the companies sand-bagging estimates or the analysts low-balling, earnings season seems to have turned into "heads I win/tails you lose" from a company perspective.

A tale of two managers: Equity focused asset managers like AMG have soundly out performed bond focused managers like BEN since the June lows.

Riding The "Great Rotation"

The "Great Rotation" is a clever name given to the expected move by investors out of fixed-income investments and into equity investments over the next few years as the bond market continues to decline.

But, like most major trends in the markets, this rotation has been slow to materialize (people have been looking for it since January/February). But, after bond yields spiked higher in June, talk of the "Great Rotation" is back on—especially following the highly publicized $9.6 billion outflow from the PIMCO Total Return Bond Fund in June. But, while that grabbed all the headlines, PIMCO wasn't the only company seeing investors move out of flagship bond funds.

Outflows from fixed-income firms in June were widespread: $14.2 billion from PIMCO, $9.8 billion from Vanguard, $6.4 billion from BlackRock and $5.3 billion from Fidelity (data according to Morningstar).

I have no idea whether this rotation out of bonds and into equities is going to be "Great." (I don't presume to be that smart—there are many nuances to consider in people's asset allocations, not the least of which is a retiring baby boomer generation). But, whether the rotation is "Great" or not, I do think we will see *some* rotation, and there may be an opportunity to make money off of that over the coming quarters in the asset-management space.

Keep this in mind: Since 2009, fixed-income fund flows have been approximately $1.25 trillion, or five times the amount of the preceding five-year period (2004—'09). Conversely, equity fund inflows since '09 were just $250 billion, which is one-third the amount of money taken in by equity funds during the '04-'09 period. So, if we just assume a simple reversion to the mean, you can make the case for equity asset-management shops to outperform over the coming months and quarters.

As a result of this, we should then expect potential underperformance of "bond-heavy" asset managers, and outperformance of "equity-heavy" asset managers, as over time money continues to move out of bond funds and into equity funds.

We've already started to see this divergence occur. Equity-heavy managers like Affiliated Managers Group (AMG), T. Rowe Price (TROW) and Waddell & Reed (WDR)—which have the heaviest mix of equity Assets Under Management compared to debt—are at or near 52-week highs. Meanwhile bond-heavy managers like Franklin Resources (BEN), Legg Mason (LM) and, to a lesser extent, BlackRock (BLK) have underperformed.

But—I am not really a single-stock guy and it's somewhat simplistic analysis, so I would strongly suggest doing some more homework on these names before doing anything. But, I do think these names are at least a starting point to craft a strategy (either getting long the "equity-exposed" AMs, short the "debt-exposed" AMs, or a pair trade of both).

Finally, the "equity"-focused names are all at or near 52-week highs, so in the short term they are overbought. You may want to wait for a correction (which we might get on a bounce in yields). But, I don't think we've missed the boat on this trade, seeing as the actual "rotation" hasn't even really started yet.

Economics

Retail sales and the Empire State Manufacturing Survey were released yesterday, and the results were mixed: Retail sales missed while Empire beat estimates. Neither result had much of an effect on equities, but the "weak" retail sales number did lead to a rally in gold and Treasuries, on hopes it would make the Fed more "dovish."

Empire Manufacturing

- July Empire Manufacturing Index rose to 9.46 vs. (E) 5.00.
- New Orders rose into positive territory for the first time since April.

Takeaway

Last month a better-than-expected Empire Manufacturing survey kicked off a trend of improved manufacturing data, and the trend appears to have continued in July. The headline index rose to a three-month high, but more importantly the New Orders index (which is the leading indicator in the report) moved up 10 points and into positive territory, suggesting more business strength lies ahead.

Market	Level	Change	% Change
Dollar Index	83.080	.092	.11%
Euro	1.3064	-.0003	.02%
Pound	1.5091	-.0016	-.11%
Yen	99.90	.69	.69%
CAD $	.9593	-.0026	-.27%
AUD $	.9095	.0047	.51%
Brazilian Real	.4483	.0071	1.61%
10 Year Yield	2.568	-.02	-.78%
30 Year Yield	3.622	-.009	-.25%
Prices taken at previous day market close.			

While just a regional indicator, June's manufacturing data implied that the to-date sluggish manufacturing sector was seeing an uptick in activity, and yesterday's report echoes that sentiment. If manufacturing is turning for the better, that will be an added tailwind of the economy. The Philly Fed index later in the week will now be closely watched to see if it confirms the continued uptick in business in the New York region.

Retail Sales

- May retail sales rose 0.4% vs. (E) 0.8%.
- "Core" retail sales, excluding autos and gasoline, fell 0.1% vs. (E) 0.3%.

Takeaway

The retail sales number was a bit of a disappointment, although not quite as bad as the press reaction. One of the main causes of the weak "core" number was a steep drop in sales of building materials and garden supply stores, which likely was in part attributable to some wet June weather across the country.

What can't be explained away, however, was a reduction in May's retail sales from 0.6% to 0.5%. Part of the reason the market was a bit sensitive to this number was because of the lingering concern regarding the consumer finally succumbing to the headwinds of higher taxes, healthcare costs and the sequester.

This May report doesn't strongly imply that's happening but, along with other data, it certainly doesn't allay that concern either. So, the consumer will be something to continue to keep an eye on going forward. With regard to the Fed, though, nothing in this report will even make them think about delaying "tapering," which in the end is the most important takeaway.

Commodities

Commodities were little changed Monday as the dollar was flat in trading and Chinese economic data was largely in-line with expectations.

The one catalyst in the commodity markets was the weaker-than-forecast retail sales, which caused gold to reverse early losses and finish marginally higher. But, the rally was small and, until gold can get a few closes above $1,300/oz., the trend remains firmly lower.

It was a day of reversals in the energy complex, as both WTI crude and natural gas both spent much of the day more than 2% lower, only to rebound and finish the trading session marginally positive.

WTI crude rallied thanks to dip-buyers stepping in (WTI fell below $105/barrel briefly yesterday), while natural gas caught a bid on the release of some longer-dated weather models that showed higher temperatures looming for much of the country. But, yesterday's trading was slow and thin, and more than anything it just reflects that investors are on the sidelines waiting to buy energy. Expect corrections to be shorter-than-normal, as long as the economic data remains decent.

Overall, though, it was a pretty quiet day in the commodities space, and I expect today will be more of the same ahead of Ben Bernanke's testimony tomorrow.

Bottom line: We didn't get any additional insight into the pivotal question of whether commodities have finally broken their months-long downtrend, and I think we'll have to wait until after Bernanke before we can definitively say "yes" or "no."

Currencies & Bonds

It was a very quiet day in the currency markets. The Dollar Index started Monday higher but sold off on the retail sales report, and spent most of the day basically unchanged. The euro was also unchanged, despite continued political rumblings in Portugal (there was a self-imposed deadline of July 21 for the various parties to hammer out some "Grand Coalition" and continue with the current government). But while bond yields have ticked higher, it's not spooking the equity market the way it used to. Of course, as always, the situation bears watching.

Turning to Asia, the yen was the big mover in the currency space yesterday, falling back below 100/yen on multiple press reports that Prime Minister Shinzo Abe will win big in the upper-house elections on July 21, which will give him even more power to implement "Abenomics." If that expectation holds, I believe it'll usher in the next phase of the devaluation of the yen. For those looking to initiate or top off on the WisdomTree Japan Hedged Equity Fund (DXJ) or the ProShares UltraShort Yen ETF (YCS), now may be a good time (as long as these election results come to fruition.)

Finally, the "Aussie" rallied 0.4% on the "not as bad as feared" Chinese data. But given how beaten-up the currency is, I view this bounce as pretty weak and, although it may continue for a few days, the "Aussie" remains a short.

Bonds of all sorts rallied yesterday as Treasuries and emerging-market bonds saw broad gains. Shorts continue to cover in the Treasury market ahead of Bernanke's testimony, and they got extra reason to after the retail sales data. If you're a short-term trader, covering here and locking in a profit probably does make sense, especially seeing how the market reacted to Bernanke last week. But, for anyone other than a short-term trader, the trend remains firmly lower, as the Fed—despite the rhetoric—is still tapering in September.

The Treasury rally could last a while longer depending on the Bernanke comments and data, but the fundamentals still point to the trend being lower.

Finally, emerging-market bonds rallied and importantly have now recovered the entire decline from the positive July 5 jobs report, further implying that market is stabilizing (which is bullish for stocks).

Have a good day,

Tom

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	Bullish	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 made a new closing high Thursday. The last bit of resistance now lies at the intra-day high of 1687.*

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).**

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, and 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.**

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.**

Treasuries	Bearish	Bearish	Bearish	*Treasurys saw a strong bounce last week on "dovish" comments for Bernanke. That could continue this week with Bernanke testimony Wed/Thurs, but the trend in bonds remains lower, and this bounce should be used to get short.*

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.**