# 7:00's Report

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

**July 17, 2013**

## Pre 7:00 Look

- Futures drifting slightly lower after a pretty uneventful night, ahead of the Bernanke testimony. Expect Bernanke's comments to again stress the difference between "tapering" and "tightening"
- Most of Asia rallied after Chinese Premier Li Keqiang said the government would prevent "wide fluctuations" in economic growth, implying action if growth slows materially.
- European shares modestly lower after the BOE minutes showed all 9 members voted against QE (which is taken as hawkish). That overshadowed a strong labor market report.
- Econ Today: Housing Starts (E: 951K), Ben Bernanke (10AM). Earnings Today: BAC (E: $.25), EBAY (E: $.63), IBM (E: $2.78).

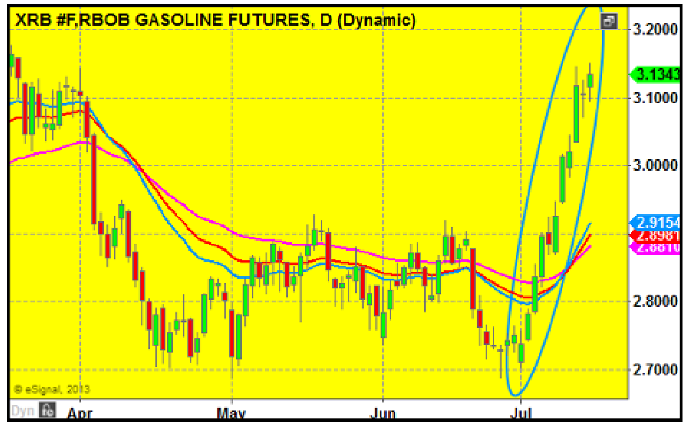
| Market | Level | Change | % Change |
|---|---|---|---|
| S&P 500 Futures | 1667.75 | -3.50 | -.21% |
| U.S. Dollar (DXY) | 82.725 | .088 | .11% |
| Gold | 1285.70 | -4.70 | -.36% |
| WTI | 105.54 | -.45 | -.42% |
| 10 Year | 2.532 | -.024 | -.94% |

## Equities

Lackluster earnings weighed on the averages Tuesday in quiet trading ahead of the key event this week: today's Ben Bernanke testimony. The S&P 500 fell 0.30%.

In another of a long line of humbling experiences at the hands of the market, just one day after I commented that lately it seems earnings season always ends up "good," we saw a rash of earnings misses from major companies.

Coca-Cola (KO) was the big disappointment, after volume metrics fell short. (I guess we're drinking less Coke these days.) But, KO wasn't the only miss: Marathon Petroleum (MPC) cut guidance and Schwab (SCHW) missed estimates.




***Gasoline futures have seen a big rally since early July, and we'll start to see this increase appear at the pump over the coming weeks.***

Yet, even the "beats" weren't that great. Goldman Sachs (GS) and Comerica (CMA) traded more than 1% lower after both beat estimates, but the "beats" weren't exactly great quality because revenues weren't as strong as the earnings prints. Even some of the "best" results of the day, like Johnson & Johnson (JNJ), finished basically unchanged.

Outside of earnings, Fed President Esther George made some "hawkish" comments during a speech, which were credited with pushing stocks lower as well. (I don't think that's necessarily true. First, George has been a consistent hawk, so her comments were expected. Secondly, the dollar fell and Treasuries rallied—not what we would see if the market was trading off "hawkish" expectations.) Overall, most of the day's news hit before lunchtime, and it was another sleepy afternoon ahead of Bernanke's testimony this morning.

| Market | Level | Change | % Change |
|---|---|---|---|
| Dow | 15451.85 | -32.41 | -.21% |
| TSX | 12516.89 | -11.46 | -.09% |
| Brazil | 46869.29 | 130.39 | .28% |
| FTSE | 6519.37 | -36.98 | -.56% |
| Nikkei | 14615.04 | 15.92 | .11% |
| Hang Seng | 21371.87 | 59.49 | .28% |
| ASX | 4981.68 | -4.33 | -.09% |
| Prices taken at previous day market close. | | | |

*Trading Color*

With earnings kicking into high gear now, results of the bellwethers dictated the sector trading more than anything else. Basic materials were the worst performers on the day, weighed down by the MPC and Mosaic (MOS) news (negative pre-announcement and earnings miss). Financials, energy, and consumer discretionary (a hangover from Monday's weak retail sales report) also lagged.

| Market | Level | Change | % Change |
|---|---|---|---|
| Gold | 1290.60 | 7.10 | .55% |
| Silver | 19.96 | .12 | .58% |
| Copper | 3.18 | .03 | 1.14% |
| WTI | 105.94 | -.38 | -.36% |
| Brent | 109.45 | .36 | .33% |
| Nat Gas | 3.67 | -.00 | -.08% |
| Corn | 5.11 | .08 | 1.59% |
| Wheat | 6.69 | -.00 | -.04% |
| Soybean | 12.86 | .22 | 1.78% |
| Prices taken at previous day market close. | | | |

Telecom was the only S&P 500 sub-sector to finish positive, as small companies continue to benefit from a bounce related to the LEAP Wireless (LEAP) buyout announced Monday. Finally, homebuilders fell yesterday, despite the very strong homebuilder sentiment index. I'm sure it's because of more profit-taking ahead of Bernanke, but I thought this was worth noting.

Volumes remain below recent averages, and nothing's really changed on the charts, as resistance remains the all-time high of 1,687 on the S&P 500.

*Bottom Line*

The earnings results yesterday weren't great, but they weren't horrid either. More than anything else, yesterday felt like a day of digestion. That's not surprising considering Bernanke's testimony and what happened last week.

At the risk of sounding like a broken record, for all the guessing about earnings season and the near-term direction of equities, I continue to point to the clearest trend in markets: higher rates due to the Fed "tapering" QE in September.

Whether stocks make new highs this week or correct again, or whether gathering turmoil in Europe pushes markets temporarily lower, interest rates are going higher because the Fed is going to taper. I firmly believe we are being given another chance to get "in" on this trend, as bonds rally ahead of Bernanke and the dollar falls.

Unless economic data turns decidedly negative or inflation falls further, rates are headed higher. I'll continue to focus on that, as it's the most-consistent and -apparent trend across asset classes.

# Economics

There were three economic reports yesterday, and while none of them were particularly market-moving, they did offer additional insight into some bigger trends in the economy. From a "What Would the Fed Do" (WWFD) standpoint, though, nothing yesterday will alter the expected path of policy (QE tapering to begin in September).

First, inflation—for the first time in a while—ran a touch hotter than expected, thanks to higher energy prices. Headline inflation rose 0.5% vs. (E) 0.4% but, more importantly, year-over-year headline inflation rose from 1.4% in May to 1.8% in June. Again, that's thanks to higher energy prices.

"Core" Consumer Price Index data, which excludes food and energy, was predictably tame—rising 0.2%, as expected. Meanwhile, the year-over-year increase actually declined 0.1% to 1.6% in June.

But, while "core" CPI remains tame, the takeaway here is we've seen the slightest hint of inflation in June (between the Producer Price Index and CPI). Now, this small uptick is energy-related, but inflation almost always starts in commodities (especially energy).

Point is, inflation is now something to keep an eye on—not because it's high, but instead because it looks to have bottomed. If it has, then rising inflation will be a tailwind for 1) higher rates 2) gold and 3) non-"bond-proxy" equities in the late third and fourth quarter.

June Industrial Production also was higher than estimates yesterday, rising 0.3% last month vs. (E) 0.2%. More importantly, though, the manufacturing component also rose 0.3% vs. (E) 0.2% and May's data was revised higher from 0.1% to 0.2%.

While not "blowout" numbers, this improvement in IP does further confirm recent data that implies the manufacturing sector has stabilized and is starting to grow again. That's a peripheral positive for the economy.

Finally, the first look at homebuilder sentiment shows that, at least as of July, higher interest rates haven't darkened the outlook for homebuilders. Homebuilder sentiment jumped 6 points to 57 in July, the highest reading since January 2006! So, the first piece of data for housing was a good one, although the remaining data will be watched closely to see if higher rates will slow the recovery in housing.

# Commodities

Commodities were little-changed again Tuesday, despite decent economic data (higher headline inflation/decent Industrial Production) and a sharply lower dollar. But, with the Bernanke testimony looming, commodities simply weren't going to move much yesterday unless something fundamental happened, and it didn't.

Metals led commodity markets higher as gold was the biggest beneficiary of the falling dollar, rallying 0.5%. There were some other factors at work also helping gold. Copper was the best-performing commodity yesterday, rallying 1% on short-covering and somewhat-encouraging Chinese machinery data. Heavy-duty truck sales (a proxy for construction and industrial production) surged 51% year-over-year. And, each of the last few months have seen greater sales growth. So, combined with Monday's "less than feared" Chinese economic data, it was a reason for shorts to cover.

Energy was mixed yesterday, as WTI crude sold off a bit despite violence escalating in Egypt. But, while the headlines seem to be getting worse, the situation is largely stable. The military is in control and will remain so, and that means the Suez Canal is safe, which is the entire focus of geo-political concern in the region.

| Market | Level | Change | % Change |
|---|---|---|---|
| Dollar Index | 82.580 | -.463 | -.56% |
| Euro | 1.3147 | .0085 | .65% |
| Pound | 1.5130 | .0030 | .20% |
| Yen | 99.21 | -.65 | -.65% |
| CAD $ | .9642 | .0052 | .54% |
| AUD $ | .9246 | .0148 | 1.63% |
| Brazilian Real | .4442 | -.0061 | -1.35% |
| 10 Year Yield | 2.544 | .001 | 0.00% |
| 30 Year Yield | 3.593 | -.001 | 0.00% |

Prices taken at previous day market close.

Elsewhere in energy, RBOB gasoline continues to rally, up another 1% yesterday on a combination of increased domestic demand and some refinery outages that, while not huge, underscore the fragility of the refinery system in the U.S.

Higher demand (because of a recovering economy and fewer imports) and tight supply are a good cocktail for higher prices, and that's what we've seen over the past few weeks (and what you're starting to see at the pump). If gas prices keep rising, then I want to be the first on record as saying it'll be a few weeks before we start to hear rumors about the Strategic Petroleum Reserve being tapped to bring down gas prices (which it won't do for more than a few days).

Commodities in aggregate continue to tread water at a critical level—and depending on Bernanke today, we very well could see a strong break out of a reversal lower. We are at a tipping point (again) for the sector.

*Incremental Positives for Gold*

While a weaker Dollar Index and slightly higher headline inflation helped gold to rally yesterday, there was something more important that happened in the gold market, and it continues on a trend I first started talking about last week.

Overnight, the Reserve Bank of India took several steps to help arrest the decline in the rupee, which again recently hit a record low vs. the dollar. The step included raising short-term interest rates, as well as restricting funds to banks and selling bonds to soak up excess liquidity in the system. These measures come on the heels of the steps taken last week to prevent speculative trading in the rupee by increasing margins and restricting some proprietary trading in the rupee by banks.

Finally, the Indian government has relaxed foreign direct investment limits on companies in the telecom, single-brand retail, and oil and gas sectors. It hopes to encourage more foreign investment in India, which will also help the rupee.

Whether these tactics work is uncertain—the Indian economy is quickly losing steam. Tightening policy to help the rupee could cause a further deceleration of growth. But, from a gold investor's perspective, this is encouraging because the Indian government and the RBI seem to be finally working in concert to stabilize the rupee, and a stable rupee will help gold to rally.

I'm not saying this means we're at a bottom in gold and it's time to buy. But if you're looking for some light at the end of the tunnel or some straws to grasp onto, we have seen a bit of a turn in the tone of news toward gold lately. But, the trend remains lower until we get a couple closes above $1,300/oz.

## Currencies & Bonds

The dollar continued its correction Tuesday, despite the absence of any fundamental reason for the Dollar Index to decline 0.6% (and, in fact, the economic data was mildly dollar-bullish). Instead, money flows and positioning ahead of Bernanke were responsible for most of the major currency moves yesterday.

With Bernanke looming, and recent history from last week pointing to Bernanke being "dovish" at his "Humphrey-Hawkins" testimony, traders took advantage Tuesday to press shorts in the dollar or book long profits on longer-held positions.

The dollar weakness resulted in strong rallies from most major foreign currencies, as the euro rallied 0.7% vs. the dollar despite the bubbling of potential political problems in Portugal and Spain, while the pound rallied 0.26% and the yen rallied 0.7%. But, it was the falling dollar that drove those gains, not anything in those respective countries.

The one currency that did trade off some fundamentals was the Aussie dollar, which finally saw a big rally vs. the U.S. dollar (up 1.7%) because the minutes of the last Reserve Bank of Australia meeting weren't as "dovish" as the market was expecting. That surprise has now led to a lot of short-covering, as traders look to lock in what are likely very profitable positions.

But, despite the RBA minutes, the trend in Aussie remains lower, and will be that way until 1) the RBA is satisfied with the "value" of the Aussie (the Aussie is still considered a bit higher than they would like), or 2) China and global economic growth stabilizes. Given the enormity of the decline in Aussie, a rally back to the 0.94 to 0.96 level is entirely possible. So, if you've got a good profit in the position you may want to consider booking some of it and looking to re-short at higher prices. But, as I said yesterday, I don't think we've seen the lows in Aussie yet.

Turning to bonds, the counter-trend rally in Treasuries continued yesterday despite the 1) "hawkish" comments by the Fed's Esther George, and 2) the decent economic data. But, like currencies, money flows and positioning ahead of Bernanke dominated trading yesterday in Treasuries. So did buying bonds for a trade (or covering some shorts) in the very, very short term, as the likelihood is that he'll either be "dovish" or the market will interpret him as "dovish." But, regardless of the short-term interpretation, unless something monumental happens today, "tapering" is still on track for September.

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.*<br>*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).**

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|---|---|---|---|---|
| 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.**