7:00's Report

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

July 30, 2013

The Russell 2000 has led this rally, so the fact that it made a new two-week low yesterday implies this recent consolidation in the broad markets may last a bit longer.

Pre 7:00 Look

- Futures drifting slightly positive after a somewhat busy night of earnings, data, and central bank news. European shares are modestly positive after some good earnings and an uptick in consumer confidence.
- Japanese shares rebounded 1.5%, after industrial output missed expectations (but the details of the number were good, and unemployment fell to its lowest level since '08).
- Chinas central bank injected funds into money markets last night for the first time since February, implying the PBOC is focused on keeping near term interest rates low (which is somewhat positive).
- Econ Today: No economic reports today.

Market	Level	Change	% Change
S&P 500 Futures	1684.50	2.00	.12%
U.S. Dollar (DXY)	81.86	.092	.11%
Gold	1321.60	-6.80	-.51%
WTI	103.83	-.70	-.66%
10 Year	2.585	.024	.94%

Equities

Market Recap

Stocks continued to exhibit signs of fatigue in the near term as major averages logged small declines to start the week in quiet trading. The S&P 500 was down 0.37%.

Equities spent the entire day in negative territory, ignoring the positives from a busy Merger Monday. The $35 billion merger between French ad agency Publicis and Omnicom Group was the headline-grabber, although there were other big deals yesterday (Hudson's Bay/ Saks, and Perrigo/Elan) amidst a trading session devoid of any major headlines.

Continued weakness in Japanese shares and more confusion about Fed Chairman Ben Bernanke's replacement weighed on markets from the outset Monday, although—like several days last week—there was never any strength or conviction. Markets finished well off their intraday lows, as the consolidation of recent gains continues ahead of potentially major catalysts later this week.

Trading Color

With the peak of earnings season in large-cap stocks behind us, sector trading will once again have some relevance in trying to gauge the strength (or lack thereof) of the market. To that end the Russell 2000, which has led this rally since mid-June, again badly underperformed.

It fell 0.75%, trading to basically a two-week low. That's something to watch, and I imagine it implies that there may be some more weakness for the major averages in the days ahead.

Market	Level	Change	% Change
Dow	15521.97	36.84	-.24%
TSX	12669.04	21.14	.17%
Brazil	49212.33	-209.72	-.42%
FTSE	6569.79	9.54	.15%
Nikkei	13869.82	208.69	1.53%
Hang Seng	21953.96	103.81	.48%
ASX	5047.24	.92	.02%
Prices taken at previous day market close.			

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Sector trading echoed the caution from small caps: Cyclical sectors like financials, energy and industrials all led markets lower, while utilities and telecom (defensive sectors) were two of the three S&P 500 subsectors to finish the day positive.

Market	Level	Change	% Change
Gold	1329.80	7.90	.60%
Silver	19.88	.10	.53%
Copper	3.10	.00	.08%
WTI	104.58	-.12	-.11%
Brent	107.43	.26	.24%
Nat Gas	3.46	-.10	-2.73%
Corn	4.73	-.02	-.58%
Wheat	6.51	.01	.19%
Soybean	12.20	-.08	-.69%
Prices taken at previous day market close.			

Interestingly, the third S&P 500 subsector to finish positive was basic materials, and that continues a trend started during earnings season of outperformance by basic materials—and it's even more impressive given the news out of China was a bit depressing. But, despite that outperformance, yesterday was a bit of a "risk-off" day from a sector standpoint.

Bulls will be comforted by the fact that trading volumes yesterday were anemic, as was participation. Expect more of the same today. On the charts, 1,680 remains support (it held again yesterday on a closing basis) while resistance lies at 1,700.

Bottom Line

Nothing really changed yesterday. The market continues to feel fatigued, but that can be rectified by a period of drifting and consolidation. The market doesn't need a big correction to return to short-term health. That said, the Russell trading to two-week lows is a sign that this period of "consolidation" may not be over just yet.

I would be a bit surprised if support at S&P 1,680 held over the next few days. Beyond the immediate term, though, the market remains data-dependent. Unless that economic data turns decidedly bad, the path of least resistance remains higher, although the decline in bonds remains the clearest trend in the markets. Allocating to the ProShares Short 20+ Year Treasury ETF (TBF), ProShares UltraShort 20+ Year Treasury ETF (TBT), ProShares Short High Yield ETF (SJB), etc. remains one of the better uses of capital in the current environment.

Is The "Long Japan" Trade Ending?

The yen has risen to a one-month high over the past week, and the Nikkei has fallen to a one-month low. That's a pretty odd occurrence given Prime Minster Shinzo Abe's recent election victory, which should pave the way for more economically reflationary structural changes and a lower yen.

So, whenever a currency or stock doesn't do something the fundamentals say it should do, I get a bit nervous.

Monday's 2% drop in the Nikkei and rally in the yen were the result of growing concern that PM Abe may be considering delaying a planned sales tax hike that's scheduled to hit next year and again in 2015, designed to bring the national sales tax from the current 5% level to 10%.

Abe, being a politician, doesn't want to hike the sales tax because it will hit everyone (as opposed to just the rich). Over the weekend he made comments that he was considering delaying the proposed two-step hike, which was authorized by the previous administration.

Normally, the market is welcoming of delays in tax hikes, but not in Japan. Japan's fiscal situation is the worst among developed economies, with a very high deficit-to-GDP ratio and debt-to-GDP ratio. The only reason Japan is still afloat is because the government can borrow almost unlimited money from international investors and the populace at low rates.

But, sooner or later, even Japan will begin to see its borrowing costs rise if its fiscal situation doesn't improve over the coming years. The increase in the sales tax is an important part of keeping the international markets confident that, while currently very poor, the fiscal situation in Japan will improve.

If Abe delayed the sales tax increase, the market may lose confidence in Japan's ability to fix its fiscal issues. When the market loses confidence in the government to fix its fiscal imbalances, bad things happen (see Greece, Ireland, Portugal).

So, the Nikkei was down more than 2% on concerns that Abe may sacrifice long-term fiscal health for short-term political gain.

But, while that explains yesterday's declines, the Nikkei

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fell 3% on Friday, with the stronger yen being blamed for that decline. So, to a point I feel like the headlines are being used to explain these drops, and are not necessarily *causing* the drops.

The biggest risk to the Japan reflation trade/devaluation of the yen was always policy—that the populace or elected officials would alter course and not see the program through. I'm not convinced that's what we are seeing right now, but it's certainly a prelude to what might happen if Abe delays the sales tax increase.

Bottom line: I still believe the long Japanese stocks/short yen trade is "on" and that, ultimately, Abe goes forward with the tax hike and the yen continues to fall toward the ultimate goal of 115 yen/dollar to 120 yen/dollar. But there's reason to be a bit uncomfortable with that opinion based on how Japan and the yen are trading.

$44.15 is key support in the WisdomTree Japan Hedged Equity Fund (DXJ) and $42.00 the line in the sand—if the latter is violated, I would be inclined to think something indeed has changed, and the trade may be over. For now, though, if you can stand the risk, I'd buy the dip.

Economics

Pending Home Sales

- June sales fell 0.4% vs. (E) -1.4%

Takeaway

The final housing sales report for June echoed the mixed reports from earlier this month. Pending sales fell less than expected, after jumping more than 5.8% in May, although that number was revised down from the previous 6.7%.

Market	Level	Change	% Change
Dollar Index	81.666	.009	.01%
Euro	1.3267	-.0012	-.09%
Pound	1.5359	-.0023	-.15%
Yen	97.87	-.34	-.35%
CAD $	.9749	.0019	.20%
AUD $	.9206	-.0053	-.57%
Brazilian Real	.4413	-.0023	-.52%
10 Year Yield	2.594	.027	1.04%
30 Year Yield	3.657	.034	.93%
Prices taken at previous day market close.			

The pending home sales report implies higher mortgage rates are having at least some negative effect on the pace of sales, although so far the effect seems relatively minor. Bottom line is the housing data for June turned a bit mixed as higher mortgage rates are at a minimum causing some pause amongst buyers. The recovery remains firmly in gear, although the effect of higher mortgage rates is something to closely monitor going forward.

Commodities

Commodities were broadly flat Monday in quiet trading. In fact, trading was so quiet that natural gas was the only commodity to move more than 1% yesterday. It fell nearly 3% on longer-range weather forecasts again calling for balmy temperatures and less cooling demand.

Natural gas remains a weather-dominated market, and the prospects for cooler temperatures saw natural gas break down to a more than four-month low, trading through the June low of $3.562. I had said earlier that this level was critical support that needed to hold and also a clear stop. So, unless it trades back through it today, I'd be inclined to leave natural gas alone.

We're once again looking at a potential large inventory build unless we get some late-summer heat, and if that's not the case, then the next major potentially bullish catalyst for natural gas comes in late November/December with the first cold fronts of winter.

It's often said the best cure for high prices is high prices, as they cut off demand. That appears to be the case in natural gas, and a balmy summer is only serving to help inventories recover from the late-winter draws that led to natural gas above $4.00/MMcf. The rest of the energy complex was little changed, with WTI crude trading around flat all day (as did Brent crude).

The best-performing commodity yesterday was gold, which rallied 0.6% despite flat dollar. There wasn't any

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real catalyst for the rally, and gold remains stuck in a $1,300-$1,349 trading range. Until that's resolved (which could be later this week) the near-term trend in gold is unclear.

Fundamentally speaking, the Commitment of Traders report shows the number of "shorts" in the market decreased some from last week, but remains very high historically—so a potentially violent rally, if gold can break above $1,349 this week, is there—although that's a big "if."

Interestingly, China news seems to be having less of an effect on commodity markets, as the Chinese equity market fell 1% Monday and commodities didn't follow. The news events out of China were peripherally negative, and yet commodities didn't react. Specifically, the Chinese government ordered an audit of all national debts, which is leading people to believe the Chinese remain concerned about a potential credit bubble. (Remember, it was this concern that prompted the mini-liquidity crisis in June that weighed on stocks and commodities.) Industrial companies' profits slowed in June, rising 6.3% year-over-year compared to a 15.3% increase in May. But, commodities largely dismissed the information, which may signal that the sluggish state of the Chinese economy is "priced in" to commodities, which is potentially bullish for the asset class. But, we'll learn more about that on Wednesday.

Commodities, like most other assets Monday, were in a "wait and see mode" ahead of the events later this week, and that will probably continue today. Look for industrial commodities (oil, copper) to trade off the global Purchasing Managers' Indexes Wednesday/Thursday, and non-industrial commodities (gold, silver) to trade off the FOMC Wednesday. Until then, I imagine we'll tread water.

Currencies & Bonds

If trading in the commodity markets was quiet, then trading in the currency markets yesterday was downright boring, at least with regard to the Western currencies. The Dollar Index, euro, pound and Loonie were all little changed as investors await the central bank decisions later this week.

The action Monday was in the "Eastern" currencies (as has been the case for weeks) as the Aussie dollar declined 0.65 vs. the dollar on the aforementioned negative China news (and on profit-taking after a nice bounce over the past two weeks). The yen continued to strengthen on continued short-covering from last week and, apparently, in reaction to Abe's hedging on the sales tax issue. (While it would be a short-term negative, it would potentially help the economy in the short term, which to a point is yen-bullish) although I think the rally in yen didn't really trade off that news all that much. The yen has rallied much further than many (including me) thought it would, and that's causing shorts to cover, plain and simple.

Finally, turning to Treasuries, the long bond fell nearly 0.5% yesterday, which made it one of the more volatile securities across the markets yesterday. (This says more about the dull trading everywhere else than the volatility in bonds.)

Treasuries appear to be consolidating ahead of the big catalysts later this week that should decide whether we see more of this counter-trend rally or a resumption of the decline. (And we may see some volatility between the FOMC meeting, which is expected to be dovish, and the jobs data, which is expected to be decent.)

If I had to pick one thing that weighed on Treasuries yesterday, though, it would be that some are now pointing to Roger Ferguson as another potential Bernanke replacement (thanks to this Atlantic article over the weekend, link here). Given he's somewhat out of left field, it's leading some to believe that the Obama administration simply doesn't want Janet Yellen, which would be taken by the market as slightly hawkish, as she's viewed as an "ultra-dove."

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**	**Bullish**	**Neutral**	*After trading to new record highs, markets are now consolidating those gains ahead of several big catalysts later this week. The path of least resistance remains higher for stocks, however, as the market is comfortable with Fed "tapering" of QE, investors sentiment remains less than enthusiastic, and cross assets like emerging market debt have stabilized.* *The S&P 500 has near term support at 1680 and resistance at 1700.*

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.**

Internationally, European economic data shows the EU economic is finally stabilizing, so long EWU (UK ETF) or EIRL (Ireland ETF) are two ways to potentially get exposure to a recovery in Europe. Also, the "Long Japan" DXJ trade appears to be back "on" and I'd use any decent dip to initiate or add to positions (like we are seeing right now).

	Fundamental Outlook	Technical Outlook	Overall	Comments
Commodities	**Neutral**	**Neutral**	**Neutral**	*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 their 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 rally in the dollar index has seen a steep correction over the past two weeks, but 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 saw a strong bounce over the past two weeks on "dovish" comments for Bernanke. But, with the Fed moving to the sidelines until later August, the fundamentals of "tapering" and an improving economy should once again exert downward pressure on bonds.*

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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