7:00's Report

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

August 1, 2013

Yesterday was a hugely bullish "Outside Reversal" day for commodities, and rightly so. If the Fed delays "tapering," then commodities are the primary beneficiary.

Pre 7:00 Look

- Futures and international markets moderately higher after economic data o/n largely beat expectations.
- European shares rally as the official manufacturing PMIs from Europe & UK beat expectations, further implying the economy is stabilizing.
- Asian shares were also stronger (Nikkei up 2.5%) as the official Chinese government manufacturing PMI rose to 50.3 in July, contradicting the "flash" Markit PMI, which stayed soft at 47.7.
- Econ Today: Bank of England Announcement (7:00 AM), ECB Announcement (7:45 AM, Q&A 8:30 AM), Jobless Claims (E: 345K), ISM Manufacturing PMI (E: 53.1).

Market	Level	Change	% Change
S&P 500 Futures	1692.25	11.75	.70%
U.S. Dollar (DXY)	82.085	.546	.67%
Gold	1324.80	11.80	.90%
WTI	106.90	1.87	1.78%
10 Year	2.593	-.01	-.38%

Equities

Market Recap

Stocks finished a volatile session Wednesday almost dead-flat, as the S&P 500 declined -0.01%. That flat finish underscored a huge trading range, though (1,684-1,698), as markets were whipsawed by good economic data early, and a "dovish" Fed late.

Stocks started Wednesday strong thanks to the better-than-expected ADP jobs report and second-quarter GDP, along with some decent earnings (SYMC, CMCSA, BUD). Markets traded to their highest levels of the morning around 11 a.m., before some profit-taking ahead of the Federal Open Market Committee statement brought most averages back to flat ahead of its 2 p.m. announcement.

The FOMC statement, which was taken as dovish, acted as an initial positive catalyst and the S&P traded up to 1,698 in the hours following the release. But, 1,700 was strong resistance once again. As the S&P 500 again failed to break through, buyers lost their nerve and markets gradually fell back to flat during the last hour of trading, in what was no doubt a disappointing finish for the bulls.

Trading Color

Despite the flat finish for the broader markets and late rally in bonds, yesterday's sector trading was decidedly bullish. The Nasdaq and the Russell 2000 outperformed the major averages, while cyclical sectors like consumer discretionary (good earnings), energy (crude rally), industrials, and homebuilders (FOMC focus on higher mortgage rates) all outperformed. Conversely, if you just looked at how "bond-proxy" sectors traded yesterday,

Market	Level	Change	% Change
Dow	15499.54	-21.05	-.14%
TSX	12486.64	-95.11	-.76%
Brazil	48234.49	-327.29	-.67%
FTSE	6639.41	18.51	.28%
Nikkei	14005.77	337.45	2.47%
Hang Seng	22088.79	205.13	.94%
ASX	5061.49	9.51	.19%

Prices taken at previous day market close.

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you would have expected that bonds declined: Utilities, telecom, consumer staples and REITs all finished the day decidedly negative. So, equity-market bulls should find some relief in the fact that, from a sector standpoint, yesterday was pro-cyclical and bullish.

Market	Level	Change	% Change
Gold	1321.50	-2.50	-.19%
Silver	19.76	.08	.41%
Copper	3.12	.08	2.63%
WTI	105.16	.79	.74%
Brent	107.70	.79	.74%
Nat Gas	3.44	.01	.29%
Corn	4.79	.01	.31%
Wheat	6.64	.09	1.37%
Soybean	12.49	.01	.01%
Prices taken at previous day market close.			

Volumes, given the large amount of headlines out yesterday, were well-above average, as you'd expect. Yet on the charts, despite the big trading range, nothing really changed. 1,680 is near-term support in the S&P 500, and 1,700 again proved formidable resistance.

Bottom Line

I was taught when I started on the floor of the NYSE (and prior to that by my father) that markets value clarity above all else. From a "clarity" standpoint, yesterday was not a good day for the Fed.

First, the statement was "dovish" enough for some to wonder if tapering will occur in September after all (and this wavering comes after the market had finally become "OK" with that idea). What's more, there was yet another name thrown into the "Who Will Replace Bernanke" derby. News broke—coincidentally at the exact same time as the Fed statement—that the president mentioned Don Kohn as a potential Fed chair, so the pool now consists of Janet Yellen, Larry Summers, Kohn and Roger Ferguson.

Fed continuity, in this age of historic and unprecedented Fed influence on the markets and economy, is the single most important factor for the markets, by a mile. Having the "who will replace Bernanke" situation devolving into open-mic night, with no resolution expected for months, isn't particularly positive.

That said, the market continues to simply digest recent gains, but it's worth noting that stocks *should* have rallied yesterday. (After all, economic data was good, and the Fed was dovish—it doesn't get much better than that for equities.) I get that yesterday was month-end and there was positioning, etc., but the flat outcome and inability to break 1,700 in the S&P isn't a positive.

For now, though, the benefit of the doubt remains with the bulls, as the market seems more-inclined to chop sideways than materially correct. But, I'm wary of rising uncertainty at and toward the Fed, and I don't think stocks can mount a material rally if bonds and currencies are gyrating around like penny stocks. So, the path of least resistance is still higher due to the high levels of skepticism and positioning, but I'm not as convinced about that opinion as I was Tuesday.

Economics

Economic data yesterday was roundly equity-market-positive. First, the ADP jobs report beat expectations, showing 200K jobs were added in July vs. (E) 179K. The June report was also revised higher by 10K, to 198K. This further cements the expectation for a good jobs report Friday, and implies that the current improvement in the labor market is sticking. This favors "tapering" QE in September, as long as the government report confirms ADP.

Second-quarter GDP was a big positive surprise, coming in at 1.7% vs. (E) 1.1%. But, first-quarter GDP was revised sharply lower to 1.1% from the previous 1.8%. Bottom line with Q2 GDP: The economy continues to plod along, but really the takeaway is that GDP is a number we can, to a point, ignore. The original print on Q1 GDP was in the mid- to high-2% range, and it's been systematically revised lower to finally, we think, finish at 1.1%. So, my confidence in this most-recent number is understandably low.

Regardless, the key now is what the expectations are for the economy going forward. Clearly, by the FOMC statement, the expectations are for a strong economy in the second half of the year.

FOMC Meeting

The FOMC meeting and statement generally met expectations, although on balance the statement was taken as slightly dovish (which shouldn't surprise anyone). There were four wording changes in the statement from June:

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First, *"Information received since the Federal Open Market Committee met in May suggests that economic activity has been expanding at a moderate pace"* was changed to *"Information received since the Federal Open Market Committee met in June suggests that economic activity expanded at a* ***modest*** *pace during the first half of the year."*

This represents a bit of a economic downgrade, likely reflecting the low GDP numbers for both Q1 and Q2 that were released yesterday morning.

Second, "*and the housing sector has strengthened further, but fiscal policy is restraining economic growth"* was changed to "*the housing sector has been strengthening,* ***but mortgage rates have risen somewhat and fiscal policy is restraining economic growth."***

This language change obviously points out the Fed is not oblivious to the uptick in mortgage rates, and shows the Fed understands just how important a continued housing recovery is for the economy.

Third, *"The Committee also anticipates that inflation over the medium term likely will run at or below its 2 percent objective"* was changed to "***The Committee recognizes that inflation persistently below its 2 percent objective could pose risks to economic performance, but it anticipates that inflation will move back toward its objective over the medium term."*** This was no doubt added at the urging of Fed President Bullard, who dissented in the June meeting because the committee didn't explicitly acknowledge the risks of currently low inflation. Apparently his arguments carried more weight this month, which means that at least some on the Fed are getting a bit worried about stubbornly low inflation.

Finally, the committee "reaffirmed" that monetary policy will remain highly accommodative until long after QE ends. ("Reaffirmed" was likely added to pave the way for extension of the forward guidance at the September meeting when tapering will likely begin.)

Market	Level	Change	% Change
Dollar Index	81.73	-.184	-.22%
Euro	1.3297	.0031	.23%
Pound	1.5198	-.004	-.26%
Yen	1.0213	.0003	.03%
CAD $	.9720	.0032	.33%
AUD $	.8960	-.0073	-.81%
Brazilian Real	.4357	.00005	.01%
10 Year Yield	2.593	-.01	-.38%
30 Year Yield	3.646	-.026	-.71%

Prices taken at previous day market close.

<u>*Bottom Line*</u>

The statement was taken as dovish, but the Fed has been trying to "talk down" rates for nearly a month now, so I don't know why this was so surprising. With regard to WWFD (What Will the Fed Do) this statement has created some uncertainty. While the expectation is still for a September "taper," yesterday's statement was dovish enough to have some people expecting "tapering" to occur in December, especially if mortgage rates continue higher. So, the odds still say September "taper" but, they're not as high as they were this time yesterday.

Commodities

Commodities were the clear winner yesterday, as the complex finished a volatile day higher, thanks to the "dovish" FOMC statement and a big rally in WTI crude. The commodity ETF DBC staged a big, bullish "outside reversal"—trading well below Tuesday's low, and then rallying to nearly a one-week high.

Copper was actually the standout performer Wednesday, rallying more than 2.5% on a combination of factors. First, the Chinese "politburo," which is basically an advisory council to the government, again re-iterated that the Chinese government would defend economic growth if it slowed meaningfully. This echoed more than a week of commentary by officials aimed at calming concerns about a significant deceleration in Chinese economic growth.

Also helping copper were the positive economic data out of the U.S. earlier in the trading day, and finally the weaker U.S. dollar post-FOMC. Combine those three factors with an oversold market like we had in copper, and it's a recipe for a violent rally. But, despite the nice rally, the downtrend featured in yesterday's report will remain intact, and until copper can break through it (currently at $3.18-ish, or about 2% from here) the trend remains lower.

WTI crude rallied more than 2% yesterday thanks to the better domestic economic data (GDP and ADP jobs) and then obviously got an addi-

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tional leg up thanks to the dollar decline post-FOMC.

The rally came despite bearish weekly inventory data. Weekly inventories rose 400K barrels vs. an (E) 2.3M barrel decline, so that was a pretty big divergence. But, given the enormity of the recent declines (remember, we had over 27 million barrels of draws in July) the market appeared to shrug off the inventory increase and the fact of expected increases in demand (due to better data). WTI crude corrected right into the $102-$103 range I was looking for, but it now appears to be back in rally mode. I remain bullish and would expect WTI to move to new highs (and to a premium vs. Brent) over the coming weeks, as long as the economic data continues to improve.

Gold finished the day flat, which would be a disappointing result unless you factor in that, at one point midday, Wednesday gold was down more than 1% and threatened to test support at $1,300/oz. Gold is continuing to trade “contra-dollar” more than anything else. When the dollar was strong yesterday, gold was weak, and when the dollar reversed post-FOMC, gold shorts rushed for cover. But, for all the volatility, $1,300-$1,340 remains the range. Until one of those bounds is broken, then gold will continue to simply chop sideways.

Again, it was a “Goldilocks” day for commodities yesterday, as good economic data propelled the industrials, while a weaker dollar post-FOMC helped precious metals. And, if indeed the FOMC yesterday signaled they aren’t going to “taper” in September, as some are saying they did, then expect commodities to significantly outperform in an environment of a weaker dollar and an improving economy. If tapering is “off” (which I don’t think it is, but that’s one opinion) then the commodity rally is “on” and DBC should outperform.

Currencies & Bonds

There was simply massive volatility in the currency markets yesterday, as the dollar initially rallied above 82 off the better domestic economic data, before reversing and selling off post-FOMC. Like commodities, the dollar traced out a huge “outside” reversal, but unlike commodities it was to the downside, so the message from the charts yesterday was to be “bullish commodities, bearish the dollar.” Clearly the FOMC was the reason for the reversal, as the minutes were taken as “dovish.”

Most foreign currencies, with the exception of the pound and Aussie dollar, traded in reaction to the greenback. So, the euro, yen and Loonie were all lower vs. the dollar for much of Wednesday, but rallied as the dollar sold off to finish trading higher.

Aussie and the pound both didn’t really rally that much despite the U.S. dollar sell-off. The pound stayed weak ahead of the Bank of England meeting this morning (the thought is the BOE might be “dovish”), while the Aussie saw follow-through selling from the big declines Tuesday, as the market now fully expects the RBA to cut rates next week. The Aussie dollar closed below 0.90/U.S. dollar for the first time since September 2010 and yet, as it made a new low, the bottom doesn’t appear to be in. (Most have circled the mid- to low-0.80s as an ultimate bottom, which I agree with.)

Turning to bonds, as you’d expect, Treasuries also had a huge reversal Wednesday afternoon. The 30-year note traded down more than 1% post-ADP and GDP, but rallied hard after the FOMC to close up 0.23%, which is a huge swing for bonds.

Yesterday was a strange and confusing day in the currency markets. On one hand, the hard economic data was dollar-bullish/bond-bearish. On the other, the FOMC statement had a dovish tone to it. So, what we get is a volatile, headline-driven currency and bond market, which isn’t particularly good for equities.

But, the bottom line remains it’s not a question of “if” the Fed will taper; it’s a question of “when” (September or December). Either way, tapering is going to occur this year, and the marginal direction of policy for the Fed is toward less accommodation, which is ultimately dollar-bullish/bond-bearish. The Friday jobs report (and data this morning) just got even more important, too—if the jobs number is particularly weak or strong, look for violent reactions in bonds and currencies.

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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