7:00's Report

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

August 12, 2013

Pre 7:00 Look

- Futures modestly lower after a quiet weekend. A miss on Japanese GDP and earnings news and downgrades from Europe are weighing on futures and European markets.
- Japanese GDP missed expectations, showing 2.6% annual GDP growth vs. expectations of 3.6%. The miss resulted in a marginally weaker yen and Nikkei and is weighing on European markets, which are moderately lower.
- Emerging markets continued their recent rally, led by the Shanghai Composite, which rose 2.4%.
- Econ Today: No Reports Today.

Market	Level	Change	% Change
S&P 500 Futures	1677.50	-8.75	-.52%
U.S. Dollar (DXY)	81.48	.31	.38%
Gold	1325.90	13.70	1.01%
WTI	105.91	-.08	-.08%
10 Year	2.58	-.007	-.27%

Equities

Market Recap

Stocks were marginally lower last week in very quiet trading, as they failed to key off better-than-expected international economic data and continue to exhibit signs of short-term fatigue. The S&P fell approximately 1% last week and is up 18.6% year-to-date.

From a "what happened" standpoint, better-than-expected international economic data (especially from China) was the big "event" of last week. Unfortunately, that uptick in data failed to translate into a rally in U.S. equities. (Part of the reason is that the better data is potentially causing a re-allocation out of the U.S. and into Europe/China/emerging markets, contributing to the underperformance.)

Other "market-moving" events from last week included a bunch of second-tier Fed presidents implying QE tapering in September (which the market already assumes and is comfortable with) and the proposed Fannie Mae/ Freddie Mac reform announced by President Obama.

But, to say any of these events, other than the international economic data, were "market-moving" would an over-exaggeration. Last week was close to, if not *the*, slowest of the year from a volume and activity standpoint. Overall, all the U.S. markets did was drift around amid low-volume trading action.

The sector trading last week mirrored the "events." Although the broader averages were marginally lower, anything "China related"—including basic materials, industrials, and international and emerging markets—all significantly outperformed. Conversely, anything "housing" related lagged thanks to the proposed FNM/FRE reform. So, homebuilders, REITs and banks all traded worse than the averages last week.

Volumes, as stated, were borderline anemic last week, and on the charts the S&P is sitting between near-term support around the 1,680 level, and resistance at the old all-time highs of 1,709.

This Week

Things should stay pretty quiet this week, although there is a small uptick in activity from last week. Empire State Manufacturing and Philly Fed (Thursday) will give us the first look at August data, while EU GDP (Wednesday) is the highlight internationally.

Market	Level	Change	% Change
Dow	15425.51	-72.81	-.47%
TSX	12542.13	-10.79	-.09%
Brazil	49874.90	946.08	1.93%
FTSE	6558.19	-25.20	-.38%
Nikkei	13519.43	-95.76	-.70%
Hang Seng	22271.28	463.72	2.13%
ASX	5108.65	53.44	1.06%
Prices taken at previous day market close.			

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There are also several important August earnings reports coming this week. Cisco Systems (CSCO) reports Wednesday night, and that's always watched closely because of CEO John Chambers' general commentary on the economy (which is almost always spot-on). Wal-Mart (WMT) reports Thursday morning, as does Kohl's (KSS). Given some concern about the consumer, those reports will be watched as well.

Market	Level	Change	% Change
Gold	1313.50	3.60	.27%
Silver	20.51	.32	1.57%
Copper	3.31	.04	1.18%
WTI	106.03	2.63	2.54%
Brent	108.26	1.58	1.48%
Nat Gas	3.22	-.08	-2.43%
Corn	4.53	-.07	-1.41%
Wheat	-6.33	-.08	-1.21%
Soybean	12.18	-.09	-.75%
Prices taken at previous day market close.			

Fed-wise, there are only two speakers this week (Dennis Lockhart and James Bullard) and they shouldn't be market-moving. Finally, expect more speculation on Bernanke's replacement, although at this point there is no decision expected until mid-September, at the earliest.

This week will be busier than last, but expect another several days of quiet trading as we're really in the dog days of summer.

Bottom Line

Given several factors—the improving domestic economic data, general macro-economic calm, continued high levels of skepticism toward this market and rally by investors (this is receding a bit, but anecdotally Marc Faber called for an '87-style crash last week), and the resulting levels of underinvestment—the path of least resistance for domestic equities remains higher.

But, that said, perhaps we are seeing a shifting dynamic. So far this year, it has paid to be broadly long the U.S. equity market and just ride the wave. Trying to outperform by overweighting certain sectors or countries has generally led to underperformance. But, with the S&P up 18% year-to-date, and valuations no longer cheap (they aren't expensive either, although some would argue that), I get the feeling the "smart money" is asking the question of "How much more is left in the S&P this year?"

As a result, I think we are potentially seeing a shift where some active management—e.g. over-allocating to certain sectors or regions of the world—will potentially result in outperformance over the next several months. Like I said in Friday's issue, with the S&P 500 up 18%, Europe up 6%-ish and China and emerging markets down 10%, if the path of least resistance for markets is higher (which you may not agree with) then which markets will likely outperform—ones that have been up, or ones that have been beaten up—especially as the global economy appears to be stabilizing?

As a result, I think incremental allocations to Europe (and, depending on your risk tolerance, China and emerging markets) makes some sense at these levels. If the market continues to rally (or doesn't fall apart) then those regions should outperform, even if the S&P continues to consolidate around 1,700 or corrects several percentage points. Perhaps we are entering a reality where the U.S. can consolidate and correct naturally, and/or because of some potentially cataclysmic macro event, like we've seen the last few years. If the "macro" horizon stays calm, then perhaps the laggards so far this year offer an opportunity.

Economics

Last Week

Domestically, last week was quiet from a data standpoint, but there was still an important takeaway: Chinese economic data was largely better than estimates. If that continues it implies the pace of economic growth is stabilizing, and the 7.5% annual GDP number won't be revised lower. This would be a positive for the global economy and the basic materials sector specifically.

June exports, imports and industrial production all beat expectations. Retail sales were basically in-line with estimates while the Consumer Price Index stayed flat from May at 2.7% year-over-year, providing some scope for Chinese authorities to further stimulate the economy if they want to.

Turning to Europe, the economic data last week, while not as impactful as the Chinese data, continues to show the EU economy is also stabilizing. Composite PMIs (both manufacturing and service sector) and German

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and UK industrial production all beat estimates, further confirming the uptick in the economic data we've been seeing in Europe, and especially the UK, for the last two months.

Domestically, things were quiet. Jobless claims, the only really watched economic report last week, ticked a bit higher from the multi-year lows of two weeks ago, but only very slightly. Importantly, the four-week moving average, which is the better indicator to watch, hit a new, multi-year low. July is a statistically noisy month for claims, so take the good news with a grain of salt. But the takeaway is that at a minimum the labor market is holding recent gains, and likely seeing some incremental improvement.

One number that wasn't very well-covered last week was weekly mortgage applications, which rose for the first time since June. That's important because there is some anecdotal evidence that higher mortgage rates are a headwind on the housing recovery. The uptick in mortgage applications last week may signal buyers have gotten comfortable with higher rates (which in reality are still absurdly low), and the recovery is again picking up steam. If the housing data this week further confirms that, then it's a big positive for the domestic economy.

That said, last week was about the international markets. Concerns about further slowing of Chinese economic growth, and the possibility of an economic "hard landing" in China, are one of the bigger "storms" on the macro horizon.

So if economic growth there can stabilize, that will signal a further "clearing" of the macro horizon. This would be good for equities generally, but especially international equities, emerging markets and the basic materials sectors (all big underperformers year-to-date).

Watching the "turn" we are seeing economically in Europe and China has been one of the themes we've been focusing on here for several weeks now. Last week's data further implied that international markets may present an opportunity to outperform for the rest of the year.

Market	Level	Change	% Change
Dollar Index	81.16	.13	.16%
Euro	1.3342	-.0049	-.37%
Pound	1.5509	-.0035	-.23%
Yen	1.0384	.0022	.21%
CAD $	.9723	.0039	.40%
AUD $	.9193	.0095	1.04%
Brazilian Real	.4387	.0026	.60%
10 Year Yield	2.58	-.007	-.27%
30 Year Yield	3.639	-.033	-.90%
Prices taken at previous day market close.			

This Week

This week is a reverse of last week: Not a lot of international data, but an increase in domestic reports, although most of the releases are "second-tier" and are unlikely to have an effect on Fed policy going forward.

The highlight of the week is probably the Empire State Manufacturing and Philly Fed surveys Thursday. They are the first look at August economic data, and both surveys were leading indicators to the uptick in manufacturing activity nationally that we've seen over the past month. If they can keep positive momentum going, it'll speak well for August economic data.

Retail sales are released Tuesday, and June's sales numbers were one of the few disappointing economic reports we've had recently. That was furthered last week by some soft same-store sales reports and reduced earnings guidance from retailers. So, it'll be important to see if the consumer bounced back in July. The consumer remains one of the areas of concern in the domestic economy, so the market will watch closely for any signs of a further pullback.

The latest round of housing data also kicks off Friday with housing starts, and as I said when recapping mortgage applications, it'll be important for the market to see the housing data at least stay level from June or even tick a bit higher in July. Don't underestimate how important housing is to the economy. If the housing data is disappointing over the next few weeks and shows the recovery may be slowing, that's a reason to rethink levels of risk.

Internationally, China is quiet, and Europe is pretty slow too. EU industrial production (Tuesday) and flash GDP (Wednesday) are the highlights. But, barring some horrid number, neither should alter current sentiment toward the EU economy (which is that it's stabilizing).

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Commodities

Commodities were down modestly last week (a bit more than .5%) as weakness in energy (especially WTI Crude) weighed on most commodity indices. That weakness was offset, however, by strength in both industrial and precious metals, which rallied on a combination of better than expected Chinese economic data and a weak dollar.

The big story in commodity markets last week was copper, which saw a big rally Thursday after the June Chinese trade numbers reported a large increase in commodity imports. Importantly, copper has so far held those gains and appears to have broken a downtrend that dates back to February. Copper is a proxy for China and global economic growth, so its encouraging that copper appears to have finally ended its downtrend.

Gold finished last week flat, after declining sharply early in the week and falling through $1300. But, the Chinese trade numbers caused a rally and gold once again traded back into the $1300—$1340 range that it's been in for weeks. Gold is rallying again this morning in reaction to the weak Japanese GDP reports (logic goes they will do more stimulus), but until support at $1300 or resistance at $1340 is decisively broken, gold remains range bound.

WTI Crude, and energy generally, finished marginally weaker last week, but that was only after a big Friday rally keyed by better than expected Chinese industrial production. From a macro standpoint it was quiet last week in the energy space, and most of the declines in crude were "micro economic," as issues like a reduction in the renewable fuels standard and rumors of impending Keystone pipeline approval weighed on WTI. Although the growing US economy is a tailwind, WTI crude appears to have traced out a "double top" on the charts at the $108 level. But, support at $103 (on a closing basis) also held last week, so for now WTI looks range bound.

I think the big takeaway from the commodities markets last week is this: Commodities are signaling an uptick in global economic growth (copper breaking out) which is good for international markets (China), while WTI Crude, a leading indicator for US economic growth and, to a point, the stock market, now appears range bound at current elevated levels. So, commodities appear to be confirming the potential for "international/basic materials" outperformance going forward, as international growth (copper) is breaking out, while domestic growth (WTI Crude) appears range bound.

Currencies & Bonds

The dollar fell 1% last week, right into major support at the 81.00 level, which appears, for now, to have held. The declines in the dollar were more driven by positive things occurring in other currencies as opposed to anything "dollar negative" last week (and you could make the case that the Fed speakers and jobless claims were dollar bullish).

Good economic data helped the euro trade to a six week high vs. the dollar last week, while the Bank of England's much anticipated "Inflation Report" provided dovish forward guidance, but only met expectations and the pound also rallied to a multi-week high as the "forward guidance" was already priced in. In Asia, the Aussie dollar staged a huge rally as 1) the Reserve Bank of Australia cut interest rates 25 bps as expected, but didn't imply further cuts were coming, and 2) better than expected Chinese data caused "Aussie shorts' to cover.

This correction in the dollar has been bigger than I thought it would be, but the contrast in the marginal direction of policy for the Fed vs. other major central banks remains stark: The Fed is moving towards less accommodation, while other banks are committed to the same levels if not more. Fundamentally I believe that is dollar bullish, and would be a "buyer" of the dollar index here (UUP) or short the euro or yen (EUO/YCS), with a stop at the lows/highs of last week.

Treasurys rallied small last week despite "hawkish" rhetoric from Fed officials but fundamentally speaking the news was quiet in bonds. There were three Treasury auctions that saw "ok" demand for the debt (the 30 year auction was the weakest on Thursday), but it was generally a quiet week in bonds. Beyond the very short term, the trend remains lower.

Have a good week—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	Bullish	*Markets are consolidating recent gains, but the path of least resistance is higher for stocks as the market is comfortable with Fed "tapering" of QE, investor sentiment remains less than enthusiastic, and cross assets like emerging market are stable.* *The S&P 500 broke through resistance at 1700, while support is lower around 1680.*

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.

	Fundamental Outlook	Technical Outlook	Overall	Comments
Commodities	Neutral	Neutral	Neutral	*Commodities continue to try and "bottom," as recent global economic data appears to be showing signs of stabilization in Europe and China. But, at this point, commodities, as measured by broad based commodity ETFs like DBC remain range bound.*

Trade Ideas

Long: **WTI crude remains one of the more bullish commodities, as increasing domestic demand should help push oil higher over the coming months. A double top appears to have been traced out at $108, but I would look to be a buyer of oil on any material decline down to support at $103/bbl (using the ETFs USO or XLE).**

Copper has broken its months long downtrend as global growth appears to be stabilizing, and if that continues, industrial commodities offer some value, and an 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 continues to stabilize. 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 index has traded to support at the 81.00 level, which should hold if the trend is still higher in the dollar. I remain dollar bullish based on the marginal direction of monetary policy: less accommodative for the Fed, equally or more accommodative for everyone else.*

Trade Ideas

***Short*:** **Japanese Yen on any decent bounce (YCS being the ETF to use), like we've seen now, especially in the face of weak GDP reports. Short the euro (EUO) 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	*The outlook for FOMC tapering is more cloudy after the recent FOMC meeting, but the bottom line is whether tapering occurs in Sept or Oct, as long as economic data stays good, tapering will occur, which is bearish 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. Finally, with the Fed committed to holding down near term rates, the yield curve will steepen dramatically, so STPP should continue to do well.**

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