7:00's Report

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

August 14, 2013

Broad-based European indices are hitting new 52-week highs. But, for some context, while the S&P 500 is at all-time highs, "Europe" remains well-below pre-crisis levels.

Pre 7:00 Look

- Futures slightly lower this morning despite EU GDP beating estimates.
- 2nd quarter GDPs from Europe were all better than expected. EU GDP rose 0.3% in 2Q vs. consensus of 0.2%, while French and German GDP posted strong growth in 2Q and year over year GDP growth turned positive in both countries.
- Asia was quiet as Typhoon Utor closed markets early in Honk Kong.
- Econ Today: PPI (E: 0.3%, Core 0.2%).

Market	Level	Change	% Change
S&P 500 Futures	1687.75	-3.00	-.18%
U.S. Dollar (DXY)	81.875	.06	.07%
Gold	1324.00	3.30	.25%
WTI	106.03	-.79	-.74%
10 Year	2.715	.11	4.22%

Equities

Market Recap

Stocks posted a small rally during another relatively boring trading session Tuesday. Equities continue to do little more than tread water. The S&P 500 rose 0.28%.

Markets started Tuesday flat, as just-"OK" July retail sales data offset strength in the futures, thanks to another round of better-than-expected economic data and a big rally in the Nikkei. But, shortly after the open, stocks went on sale and traded to their lows of the session mid-morning, before stabilizing and slowly grinding their way back to positive territory by early afternoon.

As far as "why" stocks rallied, there really wasn't any big catalyst. However, some people pointed to the quasi-dovish comments by Atlanta Fed President Dennis Lockhart (he reiterated that the Fed is "data-dependent" with regard to tapering, although the comments weren't really dovish), and Carl Icahn disclosing a large Apple (AAPL) stake via Twitter and simultaneously making himself a whole bunch of money as the stock immediately rallied. (The AAPL rally lifted the S&P 500; AAPL gained 4.75% yesterday.)

Trading Color

Higher bond yields and the Justice Department were the main drivers of sector performance yesterday in the markets. "Bond-proxy" sectors were all lower Tuesday, led by REITs, homebuilders, utilities and telecom, in reaction to higher bond yields. Transports, however, were the big laggards, as the airlines got killed over the Justice Department suing to block the merger of AMR Corp. (AAMRQ) and US Airways (LCC). Delta (DAL) and United

Market	Level	Change	% Change
Dow	15451.01	31.33	.20%
TSX	12642.19	47.92	.38%
Brazil	50600.55	301.06	.60%
FTSE	6610.27	-1.67	-.03%
Nikkei	14050.16	183.16	1.32%
Hang Seng	22541.13	269.85	1.21%
ASX	5157.42	-0.28	-.01%

Prices taken at previous day market close.

Continental (UAL) were both down 7%, while LLC fell 13% and AAMRQ plunged 45%! The discount airlines fared better, with Southwest (LUV) and JetBlue (JBLU) trading down a bit more than 1% each.

Looking at some of the bigger trends we've been monitoring, basic materials and industrials continued to rally. Sentiment toward China and the global economy is getting better, some European indices hit new 52-week highs, and AAPL helped tech to continue its recent outperformance. The stock rallied back above its 200-day moving average for the first time in months ahead of the fall iPhone refresh and with the help of the Icahn tweet.

Market	Level	Change	% Change
Gold	1321.10	-13.10	-.98%
Silver	21.44	.10	.45%
Copper	3.31	.01	.35%
WTI	106.75	.64	.60%
Brent	109.80	.83	.76%
Nat Gas	3.28	-.03	-.79%
Corn	4.48	-.16	-3.45%
Wheat	6.40	-.08	-1.31%
Soybean	12.27	.02	.18%

Prices taken at previous day market close.

On the flipside, retail and consumer discretionary continued the recent trend of underperformance on a combination of stock-specific weakness (JCP) and the just-"OK" retail sales data.

Volumes and attendance were again below recent averages, while on the charts the S&P 500 continues to consolidate between 1,680 and 1,709.

Bottom Line

Not a lot has changed so far this week, as all we've seen is a continuation of last week's themes:

- U.S. equities continue to feel fatigued, but there's no conviction to the selling.
- Europe, basic materials, China and emerging markets (the year-to-date laggards) are all outperforming.
- Bond yields, on balance, want to move higher. Yet, the pace of the rally is orderly, so it's not a negative influence on equities.

Although they are now getting a touch overbought in the very short term, I think Europe, basic materials, inverse bond ETFs and, depending on your stomach, China and emerging markets remain the regions and trends to look to with regard to incremental capital allocations. As long as there is macroeconomic calm, we can look forward to outperformance over the coming months.

Economics

Retail Sales

- July retail sales rose 0.2% vs. (E) 0.3%.

Takeaway

The important thing about the retail sales report was that it wasn't bad (like June's report).

The headline was a slight miss vs. expectations, but the most-insightful part of the release is actually retail sales excluding automobiles, gasoline and building materials. That number, "core" retail sales, was up slightly month-over-month. So, the headline was a touch misleading. Also, data from June was revised slightly higher (an incremental positive).

Bottom line is the data implies that consumer spending is basically steady at current levels, but the positive takeaway is that retail spending isn't declining—which has been a concern for investors given higher taxes, the sequester, healthcare, etc. With regard to the Fed, the release yesterday shouldn't have any effect on expected tapering because it wasn't bad enough to delay tapering and not good enough to move the date of tapering forward or increase the amount.

Commodities

Commodities were flat Tuesday in relatively quiet trading as a stronger dollar weighed on gold, while industrial commodities rallied thanks to the better international economic data out Tuesday morning.

Gold backed away from resistance at $1,340, and it remains firmly entrenched in the $1,300-$1,340 trading range. The much-stronger dollar, coupled with news that India has again raised important taxes on gold from 8% to 10%, pushed the metals lower throughout the day, although gold finished off its worst levels. For all the commentary surrounding gold, the bottom line is that it remains range-bound. Until $1,300 or $1,340 is broken decisively, expect more of a chop.

Industrial commodities were almost universally higher

Tuesday, reflecting strength in the global economic data. WTI and Brent crude, copper, RBOB gasoline and heating oil were all close to 1% higher in quiet trading. Even silver, which is considered a “hybrid” precious and industrial metal, continued its short-squeeze. It rallied 0.5% to another multi-week high.

WTI in particular traded back above $107/bbl, as some shorts covered ahead of the weekly inventory data. But like gold, WTI crude remains range-bound between the recent closing low of $103.08 and the recent high of $108.82.

The yen sold off hard yesterday on news of a potential corporate tax cut, but I would wait until the uptrend is broken before adding additional shorts.

I’m generally a oil bull because we are seeing mildly accelerating GDP growth domestically. And positive GDP growth, regardless of how tepid, is almost always accompanied by higher oil prices. So, I’d expect that resistance to be taken out eventually, although I’d continue to allocate to the energy sector via the U.S. Oil Fund (USO) or the Energy Select Sector SPDR (XLE) on dips back toward the bottom of the range, as we’ve done successfully over the past two weeks.

Currencies & Bonds

The Dollar Index registered its biggest rally in two weeks Tuesday, and the 30-year Treasury note was sharply lower (down more than 1%) yesterday in surprisingly volatile trading, especially given the relative calm in equities. While retail sales were basically in-line, it didn’t really cause that much movement in the dollar or Treasuries on the release.

Market	Level	Change	% Change
Dollar Index	81.804	.471	.58%
Euro	1.3257	-.0043	-.32%
Pound	1.5443	-.0018	-.12%
Yen	98.24	1.34	1.38%
CAD $	.9665	-.0038	-.39%
AUD $	.9098	-.0050	-.55%
Brazilian Real	.4327	-.0044	-1.01%
10 Year Yield	2.72	.099	3.64%
30 Year Yield	3.757	.071	1.89%
Prices taken at previous day market close.			

Instead, the catalyst for the rally in the dollar and drop in Treasuries was a paper from the San Francisco Fed that was released Monday. It implied that “forward guidance” was, to a point, a more-effective tool for stimulating the economy and inflation than quantitative easing. It also suggested that focusing on forward guidance is the best way to stimulate the economy going forward. (For those interested, [here’s the link](#).)

That paper caught people’s attention because it subtly argues for the greater use of forward guidance over clearly communicating the “tapering” schedule of QE, and sort of implies that QE really isn’t that effective. If you extrapolate it out, it means the Fed can taper at a quicker pace as long as forward guidance is in place. And, coming from the Federal Reserve Bank of San Francisco—where favored Ben Bernanke replacement Janet Yellen was president until 2010—makes this a bit more interesting (although obviously she didn’t write the paper).

Regardless, the news caused a short-covering rally in the dollar, despite another round of better-than-expected data from Europe, and the euro sold off 0.3% while the pound was marginally weaker.

One currency that was not marginally weaker, however, was the Japanese yen, which plunged 1.5% vs. the dollar. The catalyst for the drop was a report that Prime Minster Shinzo Abe was considering cutting the corporate tax rate to potentially offset the drag on the economy that would result from the sales tax hike due early next year.

While at this stage the Abe government is only considering the corporate tax cut, it does reflect the fact that Abe is going to defend “Abenomics” with policies that will help it succeed. As I’ve said before, the government and the Japanese central bank both want a weaker yen. The odds say they will achieve that goal, although I would wait for a break of 100 yen/dollar before adding to or initiating any incremental short positions.

The Dollar Index looks as though it has held support at that 81 level, and I again think this is a good risk/reward setup for those looking to get long dollars (UUP) or short euro or yen (EUO or YCS).

Is "Forward Guidance" Overvalued?

Whether the paper from the San Francisco Fed has any effect on Fed policy remains to be seen. But I think the conclusion that "forward guidance" is a more-effective policy tool than QE is incorrect, and I'm starting to get the impression that the academics at the Fed, and other central banks, are overvaluing "forward guidance."

Last week, the Bank of England released "forward guidance" that said they would keep rates at or near 0% for the next several years. The British pound reacted by doing exactly the opposite of what should happen—it rallied more than 1%. The reason it rallied was because most investors think the BOE is too pessimistic on their economic projections, and that the economy will be doing much better over the coming years. At that point, the BOE would then have to abandon its "0% until 2016" policy stance or risk big inflation.

I think it's the same thing with the Fed. All of us have watched the Fed for a long time—and I can tell you their long-term forecasting abilities leave a lot to be desired. So, beyond about 6 months or a year, I'm not sure how many people actually believe the Fed's forecasts. Does anyone think that, if the economy starts to accelerate and the 10-year yield moves through 3% and GDP growth accelerates, the Fed reiterating its promise to keep rates low until 2016 will have any legitimacy behind it?

I bring this up because if the Fed "tapers" QE and expects "forward guidance" to keep rates anchored, I think they risk letting the rise in interest rates accelerate, potentially significantly. So, if this shift in policy focus does occur, I think it only strengthens the case for the inverse bond plays: the ProShares Short 20+ Year Treasury ETF (TBF), ProShares UltraShort 20+ Year Treasury ETF (TBT), iPath U.S. Treasury Steepener ETN (STPP) and ProShares Short High Yield ETF (SJB).

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	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.

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.

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 as the longer term direction remains lower, although I'd wait for a break of the current uptrend at around 100 yen/dollar to initiate or add to positions. Short the euro (EUO) 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	*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.**