7:00's Report

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

August 15, 2013

The S&P 500 has traded heavy for nearly two weeks now, and a close below 1680 implies a correction may be starting.

Pre 7:00 Look

- Futures modestly lower as negative headlines from Egypt and CSCO's cautious outlook weigh on sentiment, ahead of a busy day of economic data.
- CSCO shares fell nearly 10% as the quarterly results were ok, but the outlook was cautious (especially in Asia) and the company announced layoffs.
- The only economic data o/n was July UK retail sales which rose more than expected, but the effect on shares is pretty muted.
- Econ Today: CPI (E: 0.2%, Core 0.2%), Jobless Claims (E: 330k), Empire Manufacturing (E: 10.0), Industrial Production (E: 0.3%), Philly Fed (E: 15.0).

Market	Level	Change	% Change
S&P 500 Futures	1676.00	-5.75	-.36%
U.S. Dollar (DXY)	81.575	-.183	-.22%
Gold	1337.70	4.30	.34%
WTI	107.67	.80	.75%
10 Year	2.714	-.001	-.04%

Equities

Market Recap

Stocks declined moderately Wednesday, and although the declines were bigger than recent days, activity and volumes remain at very low levels. The S&P 500 fell 0.52%.

As has been the case for nearly two weeks now, there wasn't any real "reason" for the weakness in the markets yesterday other than the fact that stocks continue to feel fatigued, as they have for a while now . (The market has only closed positive five days in August.)

With regard to "why" stocks fell, people seem to want to de facto point to Fed speakers. (Yesterday it was St. Louis Fed President James Bullard making comments on tapering, although he revealed nothing new.)

The declines yesterday looked a lot worse than they seemed, as markets spent the entire day lower. This was despite "good" news internationally Wednesday morning. Although stocks went out not far from their lows of the day, really it was little more than a drift lower amidst quiet trading.

Trading Color

From a market internals standpoint, many of the themes we've been watching lately were again present on Wednesday. The Russell 2000 and Nasdaq, which have been outperformers recently, finished lower yet they relatively outperformed the Dow and S&P.

From a sector standpoint, basic materials stocks continue to trade well. (Basic materials was the only S&P 500 sub-sector higher yesterday.) Meanwhile, anything housing-related or a "bond proxy" continues to underper-

Market	Level	Change	% Change
Dow	15337.66	-113.35	-.73%
TSX	12639.30	-2.89	-.02%
Brazil	50895.92	295.37	.58%
FTSE	6540.09	-47.32	-.72%
Nikkei	13752.94	-297.22	-2.12%
Hang Seng	22539.25	-1.88	-.01%
ASX	5152.37	-5.05	-.10%
Prices taken at previous day market close.			

form: homebuilders, utilities and REITs were again laggards yesterday. Finally, retail continues to trade poorly, and I am surprised there isn't more coverage of the lackluster retail reports, in the face of the "ho-hum" retail sales report on Tuesday. Yesterday it was Macy's (M) that provided the negative spark, missing earnings and guiding lower for the year.

Market	Level	Change	% Change
Gold	1333.40	12.90	.98%
Silver	21.73	.39	1.81%
Copper	3.33	.01	.39%
WTI	106.75	-.08	-.07%
Brent	110.18	.36	.33%
Nat Gas	3.37	.08	2.44%
Corn	4.54	.07	1.51%
Wheat	6.40	-.01	-.12%
Soybean	12.37	.10	.81%
Prices taken at previous day market close.			

Bottom Line

U.S. equities have acted fatigued for nearly two weeks and did so again yesterday. And, while the market appears to be deteriorating a bit, it's important to note that stocks have been in a range of 1,680-1,709 (and really 1,700) for a few weeks now. Until that range is broken, this should be considered more of a consolidation than the start of a material correction.

But, while I think from a directional standpoint the S&P still deserves the benefit of the doubt, I do think we need to continue to think about the relative performance of U.S. equities vs. international going forward.

This "fatigued" trading we're seeing in the S&P could actually be a rotation out of U.S. and into international assets, and the return data supports that. Europe was higher yesterday and this week. Meanwhile, quarter-to-date the S&P is up about 5% and "Europe" is up nearly 10%. So, while Europe is a bit overbought in the very short term, I'd be a buyer of any correction because I think this "rotation" has some more room to run.

The commodity ETF DBC made a "higher low" and if it can trade above $26.30, that will be a "higher high" and the charts will turn bullish.

Bottom line, this two-week period has been devoid of any major catalysts, and trading volumes are very, very low. Although the market feels heavy, I'd be hesitant to read too much into it until 1,680 is decisively broken. But, I think the potential for continued international (especially European) outperformance is something that will continue regardless of the overall direction of the S&P 500, and thus I would use any weakness in Europe to add incremental exposure.

Economics

Economic data wasn't really market-moving yesterday, but I do want to mention two anecdotal negatives we saw from an economic standpoint.

First, the Producer Price Index showed a smaller uptick in input prices than expected, with headline PPI flat in July vs. (E) 0.3%, while "Core" PPI rose 0.1% vs. (E) 0.2%. More importantly, "Core" PPI rose just 1.2% year-over-year vs. 1.6% in May.

This matters (and makes this morning's Consumer Price Index numbers a bit more important) because the Fed mentioned during its August meeting that if inflation doesn't start moving toward its 2% target, it may consider delaying tapering QE.

Yesterday's PPI (and today's CPI, if it's light) won't be enough to delay tapering on their own. But the longer low inflation persists, the more it raises the risks of disinflation or outright deflation, which is not good for the economy. All of us, including those at the Fed, will feel a lot more confident about the economic recovery when these inflation numbers start to tick higher.

Second, mortgage applications fell rather sharply last week, declining 4.7% in aggregate while purchase applications fell 5% and refinance applications fell 4%. I don't know if there were some seasonal factors in the data (the second week of August doesn't seem like a great time to buy a home, as families wouldn't be able to close by the start of the school year, but maybe I'm wrong about that). But with the latest round of monthly housing numbers kicking off tomorrow, the mortgage application data isn't pointing toward especially good sales numbers.

Again, this is important because as housing goes, so goes the economy. And if the economy is going to continue to accelerate, the housing recovery cannot stall—it's that simple.

Commodities

Commodities were universally higher yesterday as precious metals once again led markets higher despite a flat dollar, while energy surprisingly lagged. DBC, the broad-based commodity ETF, rallied 0.62%.

Silver was the best-performing commodity yesterday, rallying more than 2% to trade to a two-month high on continued short-covering. Generally, the good GDP data from Europe was supportive of industrial metals, but silver's gains were more about the record shorts still having to cover than it was anything fundamental. Silver's recent rally should serve as a warning to the near-record shorts in gold, which rallied 1% yesterday but remains range-bound between $1,300-$1,340/oz.

Natural gas rallied almost 2%, also on short-covering, as forecasts call for hotter weather over the coming 10 days. Plus, part of the boost came from buying ahead of the weekly inventory data this morning (expectations are for a 74 Bcf injection).

Natural gas has bounced from the lows near $3.20 and could rally all the way back to the $3.50-ish level on a bounce. But unless you've got a weather forecast model telling you we're going to see a late-summer blast of heat, it'll be very tough for natural gas to mount any sort of a sustainable rally. I'd look for more choppy trading with a slight downward bias, until we get into early winter.

Staying in the energy complex, WTI crude was basically flat yesterday despite a bullish weekly inventory number and renewed violence in Egypt. First, crude inventories declined by 2.8 million barrels vs. (E) 1.5 million barrels. Oil inventories domestically are now 1.5% lower than levels last year, and have successfully worked off the large year-over-year surplus that existed back in the late spring and early summer.

Market	Level	Change	% Change
Dollar Index	81.695	-.073	-.09%
Euro	1.3258	-.0005	-.04%
Pound	1.5510	.0061	.39%
Yen	98.11	-.09	-.09%
CAD $	.9679	.0011	.11%
AUD $	.9138	.0024	.26%
Brazilian Real	.4311	-.0012	-.28%
10 Year Yield	2.705	-.022	-.81%
30 Year Yield	3.75	-.013	-.35%
Prices taken at previous day market close.			

On the geopolitical front, Egypt appears to be backsliding as the "Presidency" has declared a month-long state of emergency and is cracking down on supporters of ousted President Mohamed Morsi, which is causing widespread violence. Vice President Mohamed ElBaradei resigned yesterday after more than 270 deaths in Egypt resulted from police and military actions.

Egypt matters in the oil world not because of production, but because of the Suez Canal, although no one at this point thinks the military is about to lose control of the country's infrastructure. But, clearly the escalation of violence isn't a positive and will probably result in some sort of an increased geopolitical risk premium should the violence continue.

Despite these generally bullish factors, WTI traded flat and I think that's reflective of:

1) Refinery utilization falling this week as we move past peak summer driving season (so, less demand for WTI crude in the short term).

2) WTI being range-bound at these elevated levels, and likely remaining that way until there is another positive catalyst.

Beyond the very short term, though, as long as GDP growth is moving higher, I'd continue to be a buyer of oil/energy on dips toward the lows of the last two weeks.

More broadly, commodities have continued their upward momentum from last week despite the lack of anything really "new" in the markets. DBC is now less than 1% from breaking the recent high of $26.30, and a close or two above that level would imply the trend in commodities has finally turned higher.

From a global perspective, commodities continue to confirm that the global economy has stabilized and that the rate of change of economic growth now favors international markets over the U.S. (implied by copper turning bullish while WTI remain range-bound).

Currencies & Bonds

It was a pretty quiet day in the currency and bond markets Wednesday as the Dollar Index, euro and yen all traded basically unchanged. Treasuries were also flat after rallying out of negative territory following the soft PPI report.

The two movers in the currency markets were the British pound and Aussie dollar, both of which rallied vs. the dollar yesterday.

The pound was higher because the minutes of the August Monetary Policy Committee meeting at the Bank of England revealed that one BOE member, Martin Weale, dissented against providing forward guidance. The market took this as "hawkish" and the pound rallied as a result.

But, the dissent wasn't really hawkish. Weale dissented not because he wasn't in favor of "forward guidance" but instead because he didn't like the 18-24 month timeframe for the inflation "thresholds" that, if breached, would necessitate an increase in interest rates.

Weale felt that 18-24 months is too far out and might lead to entrenched inflation expectations. (So, in plain English, he thinks the BOE is risking a potential inflation problem down the road by having too long of a time frame.) The important point here is that he dissented over the details, not the "forward guidance" itself.

Bottom line is while the market may have interpreted the minutes as "hawkish," they weren't. With regard to being long the UK via EWU, the takeaway is the UK economy is accelerating. Whether or not one MPC member dissents, it doesn't alter the fact that the economy is getting better. The BOE is going to be very, very accommodative for a long time (months and quarters at a minimum), which gives us plenty of time to make money in EWU.

Turing to the Aussie, it rallied because New Zealand retail sales beat expectations (the kiwi and Aussie and their respective markets often trade together). But, I mainly point it out to again reiterate that I think the "easy money" has been made in the short Aussie trade.

As I said last week, if I'm no longer negative on Chinese growth, and cautiously optimistic on basic materials and commodities, then I can't really be that negative on the Aussie—although I don't think there's risk of a material rally, either. Aussie has likely found new range in the low-0.90s to upper-0.80s vs. the dollar, which is probably about right if Chinese and global growth is stabilizing.

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.**