7:00's Report

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

August 16, 2013

Pre 7:00 Look

- Futures fractionally higher amidst a quiet night, as international markets didn't continue the selling overnight that we saw in the U.S. Thursday.
- European markets flattish after EU trade balance beat expectations.
- Asian markets were modestly lower, but the focus was on the Shanghai Composite which showed extreme volatility, starting the day down 1% and rallying as high as 5.6% before finishing flat. Authorities are investigating, seriously.
- Econ Today: Housing Starts (E: 900k).

Market	Level	Change	% Change
S&P 500 Futures	1660.00	4.25	.26%
U.S. Dollar (DXY)	81.25	.043	.05%
Gold	1361.70	0.90	.07%
WTI	107.29	-.04	-.04%
10 Year	2.755	.043	1.59%

Equities

Market Recap

Stocks declined sharply Thursday as a combination of weak earnings, anti-Goldilocks economic data, and continued unrest weighed on stocks in another thinly traded tape. The S&P 500 fell 1.4%.

Stocks started the day lower initially off of Cisco (CSCO) and Wal-Mart's (WMT) cautious/negative outlooks, but then took a big leg lower after the jobless claims data was much better than expected and manufacturing data missed estimates. Stocks opened lower and continued to fall throughout the morning session, before stabilizing and basically treading water near the lows of the day for the remainder of the afternoon. There were a few feeble attempts to rally but, given the calendar and sentiment, there weren't a whole lot of reasons to step in and buy stocks yesterday (or people at work to do the buying). So, the rallies never really gained momentum. Stocks went out close to their lows for the second-straight day.

Trading Color

Cyclical sectors led the way down yesterday, although it wasn't a typical "risk off" trading day. If anything, yesterday's declines further imply that where you are positioned in this market, from a sector standpoint, is becoming more and more important. The Russell 2000 badly underperformed (down 2%) and broke near-term support, while tech and consumer discretionary (because of CSCO & WMT) were the worst-performing sectors, along with industrials.

But, not all cyclical sectors traded poorly. Homebuilders traded higher yesterday, helped by the positive homebuilder sentiment index. Basic materials and energy outperformed the market, although only relatively, as both were down on the day.

Interestingly, with bond yields moving higher, "safety" sectors like utilities, healthcare, telecom and REITs all traded basically in line with the market, providing no defensive help for portfolios. Finally, although Europe was lower, European indices relatively outperformed, and actually finished well off the lows.

Volumes were heavier than they have been in a while, which isn't surprising given the declines. On the charts, support at 1,380 has obviously been broken, and now support sits at 1,656 (the 50-day moving average).

Market	Level	Change	% Change
Dow	15112.19	-1.47%	-225.47
TSX	12704.52	65.22	.52%
Brazil	50908.34	12.12	.02%
FTSE	6479.89	-3.45	-.05%
Nikkei	13650.11	-102.83	-.75%
Hang Seng	22517.81	-21.44	-.10%
ASX	5113.86	-38.51	-.75%
Prices taken at previous day market close.			

Bottom Line

Yesterday was an ugly day, but keep in mind that this is August and the tape was thinly traded. People I talked to remarked that yesterday's declines were more the result of a "buyers' strike" than overly aggressive selling, so the declines should be taken in context.

Market	Level	Change	% Change
Gold	1364.80	31.40	2.35%
Silver	23.07	1.28	5.87%
Copper	3.36	.02	.64%
WTI	107.30	.45	.42%
Brent	111.11	.91	.83%
Nat Gas	3.42	.07	2.18%
Corn	4.72	.17	3.73%
Wheat	6.49	.07	1.05%
Soybean	12.65	.27	2.14%

Prices taken at previous day market close.

But, we've been saying for a while that the S&P feels fatigued, and yesterday that fatigue gave way thanks to concerns about the outlook for the economy (CSCO and WMT on a micro level, and the manufacturing data miss on a macro level).

The equity market is stretched and, for the first time all year, there are some attractive alternatives for capital (Europe, perhaps China, and basic materials and commodities). I think we are seeing some air come out of the equity balloon. But, unless the economic data turns bad or the rise in rates becomes disorderly, as of right now I don't think there's anything that says we're not looking at a normal correction, vs. something more onerous.

Bottom line is it looks like things aren't going to be as easy for the back half of the year as they were the first half. We can't simply buy domestic equities and head to the beach—what sectors and regions of the world you're exposed to now very well might make the difference between underperformance and outperformance.

So, as yesterday demonstrated, there remains value in adding incremental capital or increasing allocation to things like Europe, inverse bond funds, commodities and basic materials. It would appear that the days of just passively riding the SPOOs to never-ending outperformance are over. And thinking longer term about the global economy—that's a good thing (although it wasn't fun yesterday).

Economics

There was a lot of market-moving data released yesterday, and stocks sold off on the various releases. The reason stocks traded lower off the data was that it was viewed as 1) increasing the likelihood of QE tapering in September and 2) simultaneously implying that the manufacturing sector is losing a bit of momentum. Although I think this analysis is nitpicky, it does underscore the central fear of the market: that we get a tapering of QE and higher interest rates without further strengthening in the economy. Yesterday's data didn't really state that's what's happening, but it served as a reminder that if this does happen, stocks are going lower.

Jobless Claims

- Weekly claims fell to 320K vs. (E) 330K.
- The 4 Week Moving Average made another multi-year low, declining 4K to 332K.

Takeaway

Weekly jobless claims fell to the lowest level since October 2007, clearly a positive sign. Although it's summer and the data is still volatile, the four-week moving average continues to hit new lows, so a reasonable takeaway is that we're seeing incremental improvement in the labor market from the levels of June and July.

Given that the labor market is the key metric the Fed is watching with regard to when they will taper QE, this number was viewed yesterday as solidifying the chances of tapering being announced at the September meeting. Stocks and Treasuries traded lower on the release and the dollar initially rallied. If this number stays relatively unrevised over the next two weeks, then that should be reflected in a stronger August jobs report—making the announcement of tapering in September more certain.

Empire State Manufacturing, Philly Fed & Industrial Production

- Both Empire and Philly missed expectations (8.24 vs. (E) 10.0 & 9.3 vs. (E) 15.0).
- The details of both reports were a bit discouraging as new orders declined.
- Industrial production was flat, but the manufacturing component declined by 0.1% in July vs. (E) 0.3% increase.

Takeaway

Both the Empire State and Philly Fed reports were mild disappointments vs. expectations, although both indices continue to show expansion in the manufacturing sectors in the New York and mid-Atlantic regions—just at a slower pace than in July. Industrial production was a surprise miss, although excluding automobile production, manufacturing was flat in July.

Dollar Index: For no apparent reason, at 1:14 PM yesterday the Dollar Index went into freefall, but I suspect that's the unwind of a massive leveraged trade.

The headline numbers for Empire and Philly weren't really that bad—instead it was the details that were weak. As mentioned, new orders—the leading indicator for both indices—declined to 0.27 in Empire from July's 3.77 and to 5.3 in Philly from July's 10.2. Shipments and inventories also implied a slowdown in business, and there was mixed news on employment, as it rose in Empire and fell in Philly.

Bottom line is, against the backdrop of the strong economic data we've seen, all three releases were a disappointment, although none of them imply we're seeing a stalling of recent positive momentum in the manufacturing sector regionally or nationally. Instead it's just a cooling in the pace of acceleration. Now, if that cooling continues next month, then that's something to get concerned about.

CPI

- July CPI increased 0.2%, meeting expectations.
- "Core" CPI also rose 0.2%, meeting expectations.

Takeaway

CPI ticked up modestly in July, marking three-consecutive months of gains. The year-over-year increase in core CPI, which the Fed watches, moved from 1.6% to 1.7%, and while that is still below the Fed's preferred 2%, it's moving in the right direction. Although the CPI print won't be a direct influence on Fed policy, peripherally it does imply a greater likelihood of tapering, as the threat of dis-inflation appears to be subsiding a bit.

Market	Level	Change	% Change
Dollar Index	81.134	-.577	-.71%
Euro	1.3357	.0102	.77%
Pound	1.5646	.0146	.94%
Yen	97.33	-.81	-.83%
CAD $	.9706	.0037	.38%
AUD $	.9137	.0016	.16%
Brazilian Real	.4269	-.0036	-.84%
10 Year Yield	2.761	.043	1.56%
30 Year Yield	3.796	.043	1.13%
Prices taken at previous day market close.			

Commodities

Commodities surged yesterday as an early afternoon breakdown in the dollar led the broad-based commodity ETF DBC to rally nearly 1% and break through overhead resistance at $26.30. Gains in the commodity complex were led by the precious metals, which were up big yesterday, but strength in the complex was broad thanks to the afternoon decline in the dollar.

Gold spent much of the morning trading close to flat, as an early strong U.S. dollar weighed on the metal. But, after starting Thursday basically at the lows of the day, gold moved steadily higher until 12:45, when some sort of massive buy order was entered and drove gold through resistance at $1,349. This then resulted in a big short-squeeze that saw gold rally another $25 over the remaining 30 minutes of trading, Gold finished yesterday up 2.5%. Interestingly, I think the breakout in gold actually *led* to the decline in the dollar, which is the opposite of what usually happens, and that decline in the dollar in turn helped lift the entire commodity complex. I'll explain more in the currency section.

I heard a lot of people point to the situation in Egypt as a reason for the strength in gold, but that really hasn't been much of a factor. Gold didn't rally when the situation deteriorated on Wednesday, nor was it higher yesterday morning despite worrisome headlines. Truth is, there really wasn't much of a fundamental reason behind "why" gold rallied so hard yesterday other than the fact that someone, likely a large fund, drove the price higher and caused a short-squeeze.

Regardless, gold has broken through resistance so the question now, obviously, is "Do We Buy Gold Here?"

This is a tough one because I'm not a dollar bear, so I don't subscribe to the idea that gold will go up just because the dollar is going down. But, I have learned over the years that the way you trade gold is you buy big breakouts regardless of the "Why." You don't wait for a pullback because it usually doesn't come, and given the numbers of shorts in the market, that seems true now more than ever.

So, my head has me cautious about getting long here, but my experience says you can get long gold at these levels, although it's a high-risk, high-potential-return trade. And, that goes the same for the gold miners (GDX). The miners, while awful businesses, trade as a leveraged proxy for the metal—so if the metal is now in a new uptrend, then GDX is going higher.

Energy was marginally higher yesterday as the benefit of the weaker dollar overcame the disappointing manufacturing data. WTI crude was little changed, and that leads me back to the situation in Egypt.

Bottom line with Egypt is this: As I said Monday, Egypt is only important from the oil market perspective because of the Suez Canal. So, as long as the military is in control, violence can continue and a big geopolitical premium *won't* go into oil.

That said, the upside risk is this: If some other country in the Gulf starts supporting the Muslim Brotherhood, then you'll see the oil market start to get a little nervous. So, the key to watch for is the spread of involvement—does this internal conflict become a rallying cry for Islamists in the Middle Eastern countries? Right now the chances appear pretty slim, but that's the risk to monitor.

Currencies & Bonds

The economic data yesterday was fundamentally dollar-bullish, as it implies "tapering" is more likely. But, the Dollar Index finished the day down 2/3 of a percent—and the weakness in the dollar was universal, as the euro rallied 0.75%, the pound 1%, and the yen 0.9%. I read several places that this reversal in the dollar led some to think that the dollar was actually forecasting a delay in tapering. However, I disagree with that and think the dollar's decline was more trading-related than anything.

The Dollar Index spent most of yesterday flat, until 1:14 p.m., when all of a sudden it plunged. That decline came about 30 minutes after gold broke through months-long resistance. This is just a theory, but I think the gold breakout likely resulted in the "unwind" of a massive "Short Gold/Long Dollar" trade, likely from foreign investors.

I say foreign investors because if you were a European, and wanted to short gold in dollar terms and not in euros, you would sell gold and then use the proceeds to buy dollars, making you short gold and long U.S. dollars. That trade makes sense if you're a European because, given that the Fed is looking to taper while the European Central Bank is still being accommodative, logic says gold will decline more in dollar terms than in euro terms. So, to unwind the trade, you do the opposite: Buy gold and sell dollars.

The reason I bring this up, other than to dispel the myth that the dollar was forecasting a "no taper" move by the Fed, is because this dollar weakness may be artificial. I'd view any further weakness as a buying opportunity—or shorting opportunity in the euro or yen (EUO/YCS).

Turning to Treasuries, the 30-year Treasury note made a new low for the year yesterday and the 10-year yield traded above 2.80% for the first time in two years on the economic data. The sell-off in the dollar during the afternoon led to a temporary bounce in bonds, but bottom line is that the Fed tapering is coming. Unless the economic data turns for the worse (which it hasn't), then the trend of higher rates remains the strongest fundamental trend in the markets, and any rally in bonds should continue to be shorted.

Have a good weekend,

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	*US equities are consolidating recent gains and appear to be entering a bit of a correction. While I think the path of least resistance still lies higher, the rally in stocks appears more nuanced than before, with certain sectors and region handily outperforming.* *Support in the S&P lies at the 50 day MA, about 1653ish, while resistance is 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.

Commodities	Neutral	Bullish	Neutral	*Commodities continue to try and "bottom," as recent global economic data appears to be showing signs of stabilization in Europe and China. Commodities, as measured by broad based commodity ETFs like DBC finally broke out this week of a months long downtrend. .*

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 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.**

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.**