7:00's Report

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

August 19, 2013

Pre 7:00 Look

- Futures and most international markets flat after a very quiet weekend and night.
- The only economic news o/n was Japanese monthly trade balance, which saw imports rise more than exports. The higher trade deficit is weighing on the yen modestly.
- Focus of the weekend press was on Bernanke's replacement as it looks like Larry Summers is now the mild favorite (CNBC's Harwood tweeted Friday Summer's odds were 2/3). If its Summers that would be mildly "hawkish."
- Econ Today: No reports today.

Market	Level	Change	% Change
S&P 500 Futures	1652.00	0.75	.05%
U.S. Dollar (DXY)	81.195	-.098	-.12%
Gold	1375.20	3.70	.27%
WTI	107.14	-.32	-.30%
10 Year	2.829	.074	2.69%

Equities

Market Recap

Stocks fell more than 2% last week as cautious outlooks from Cisco Systems (CSCO) and Wal-Mart (WMT), combined with just "OK" economic data, led to an already-fatigued market giving way and breaking through support. The S&P 500 is now up 16.10% year-to-date.

Stocks began last week exhibiting more signs of the fatigue we've seen pretty much throughout August. But, last week's declines weren't just a drift lower in a quiet market. They were event-driven: CSCO's cautious outlook, WMT's cautious outlook, and economic data that implied a slowing in the pace of manufacturing growth all combined to send the market down sharply Thursday.

Also weighing on stocks Thursday was the strength in bond yields, which have moved to new multi-year highs as prospects increase for a Fed "tapering" in September. Ten-year bond yields moved sharply higher Thursday and Friday, closing above 2.80% for the first time since August 2011.

Stocks tried to bounce back on Friday, but there weren't really any positive catalysts to help the buyers. With low volumes and desk attendance, markets closed marginally lower.

From a trading-color perspective, amid the broader-market weakness we saw last week, sector trading largely saw a continuation of themes we've been watching over the past several weeks.

First, though, the major averages all traded broadly lower, and the previous leaders of the rally (Nasdaq and Russell 2000) showed little ability to outperform—a disconcerting point for the short-term bulls.

Looking at specific sectors, "bond-proxy" sectors all underperformed in reaction to the move higher in yields: Utilities, REITs and telecom all fell sharply last week, with most of the declines coming Thursday and Friday. Retail stocks were also big underperformers last week (a continuation of a recent, troubling trend) as Macy's (M), WMT and Nordstrom (JWN) all either missed earnings or lowered guidance. The consistently weak results from the retailers has helped reinforce concerns about the health of the consumer, despite a retail sales number last week that was "OK."

On the flipside, we saw continued outperformance from basic materials (which has been a big winner this quar-

Market	Level	Change	% Change
Dow	15081.47	-30.72	-.20%
TSX	12736.92	32.40	.26%
Brazil	51538.78	630.44	1.24%
FTSE	6492.66	-7.33	-.11%
Nikkei	13758.13	108.02	.79%
Hang Seng	22463.70	-54.11	-.24%
ASX	5112.53	-1.33	-.03%
Prices taken at previous day market close.			

ter) as sentiment continues to improve regarding global growth. Banks also outperformed (the positive side of the "higher rates" trade), and international markets continue to outperform ("Europe" was up 1% last week).

Finally, homebuilders rallied to end the week, helped partially by the new home sales Friday, but they were also up Thursday in a down market. Homebuilders have been falling since mid-May, when the "tapering" debate started, so the fact that they were higher despite the uptick in interest rates is raising some eyebrows. I'm not saying they are a "buy" right now (although it sure is a contrarian's play). But if homebuilders can continue to bottom, I'll take that as a positive sign that the market may be properly digesting these higher rates.

Market	Level	Change	% Change
Gold	1375.00	14.10	1.04%
Silver	23.19	.25	1.09%
Copper	3.36	.02	.69%
WTI	107.68	.35	.33%
Brent	111.17	.06	.05%
Nat Gas	3.37	-.05	-1.37%
Corn	4.63	-.09	-1.85%
Wheat	6.34	-.06	-1.02%
Soybean	12.83	-.05	-.39%

Prices taken at previous day market close.

Although volumes were higher Thursday (not surprising given the Dow was off 200+), it is still the middle of August and trading remains very thin and conviction-less. Last week the S&P 500 broke through support at 1,680 and closed fractionally below support at the 50-day MA (1,657), which is near-term support. A break below that and there's not much support until 1,600.

This Week

This will be a busier week than last as we get several important economic data points (i.e., global flash Purchasing Managers' Indexes, FOMC minutes). The annual Jackson Hole, Wyo., central banker meeting is Thursday and Friday, although this will likely wind up being a non-event because none of the world's most-important central bankers are attending. (No Ben Bernanke, Mark Carney, Mario Draghi or Haruhiko Kuroda.)

On a more micro level, there are a lot of retailers reporting earnings Tuesday through Thursday, and they will be in focus given the recent weakness in that sector. Target (TGT) and Gap Inc. (GPS) are the highlights (Wed/Thurs) but there are many others reporting. Finally, housing will also be watched as we get economic data and earnings reports from Home Depot (HD) and Lowe's (LOW) (Tues/Wed).

Bottom Line

Last week was ugly, but it's worth noting that with the S&P 500 just 3% from its all-time highs, sentiment has become very, very negative. (Not that this means it's necessarily wrong.) Some of the most-cited reasons for the negativity that I heard last week/this weekend are: Fed removing the punch bowl (tapering), higher interest rates, doubts about stabilization of global growth, concerns about economic growth domestically, Washington's debt-ceiling debate looming this fall and, finally, multiples.

While these are al legitimate concerns, the biggest takeaway from August so far is that these risks, unlike "macro" risks over the past several years, aren't causing a total "risk-off" trade. While the S&P 500 is correcting, Europe and China have outperformed, bonds continue to be driven lower, and specific sectors are outperforming (basic materials, commodities).

So, as I said last week, the "easy money" may have already been made riding the S&P 500 relentlessly higher this year, but I don't think that means we can't make money being long other things (Europe, basic materials/commodities, and inverse bond funds). And, as long as the macro horizon remains relatively clear, then the concerns listed above don't require a exodus from risk assets. After years of "passive" management outperforming "active," we may be seeing a reversal.

Economics

Last Week

If economic data had been "Goldilocks" (meaning good, but not so good that the Fed would "taper" QE early) domestically during the past two months, then last week's data was decidedly "anti-Goldilocks." (It wasn't bad enough to remove the prospects of tapering, but it wasn't good enough to give people confidence the economy can keep growing if the Fed pulls back.)

Retail sales were basically flat last week, meeting low estimates. The first look at August manufacturing data via the Empire State and Philly Fed reports showed continued expansion but at a slower pace than July. Jobless claims fell to the lowest levels since October '07, implying we're seeing incremental improvement in the labor market, and the Consumer Price Index rose slightly. But it has been increasing for three consecutive months, which is helping to ease some fears about dis-inflation.

So, the latter two reports helped solidify the expectation of "tapering" being announced at the September Fed meeting. Meanwhile retail sales, Empire State manufacturing, Philly Fed, Industrial Production and Friday's new home sales (which met expectations) basically showed an economy that's still expanding, but at a slower pace than the previous few months.

Bottom line: The data rekindled the market's primary fear that the Fed has to taper QE because of the potential negative side effects they risk by keeping it going, but that the economy isn't strong enough to handle the rise in interest rates that will accompany the tapering of QE. The economic data last week didn't directly imply that's what's happening, but it certainly made people think about it. With the S&P 500 up 18% year-to-date, that's a reason to de-risk a bit, which is what happened.

The opposite was true in Europe, as the data there almost universally showed the EU economy is indeed starting to turn, although many investors remain skeptical. EU GDP turned positive thanks to strength in Germany and France, while the ZEW index, German industrial production, UK retail sales and labor market report were all better-than-expected.

So, from a rate-of-change perspective, last week implied that the EU economy is actually outperforming the U.S. economy. The data there implies an acceleration while the data here implies continued recovery, but at a stagnant pace—meaning, we may see continued outperformance from EU markets over the near term.

Market	Level	Change	% Change
Dollar Index	81.35	.143	.18%
Euro	1.3337	-.0012	-.09%
Pound	1.5638	0.00	0.0%
Yen	1.0250	-.002	-.19%
CAD $	.9680	-.0021	-.22%
AUD $	.9182	.006	.65%
Brazilian Real	.41785	-.00785	-1.84%
10 Year Yield	2.829	.074	2.69%
30 Year Yield	3.857	.065	1.71%
Prices taken at previous day market close.			

This Week

There isn't a lot of data this week but what's reported is important, and this is by far the most important week of the month from an economic and a WWFD (What Will the Fed Do) perspective.

The headline this week is the global flash PMIs from China (Wed night) and the EU and U.S. (Thursday morning). International markets and basic materials have outperformed thanks to better economic data internationally, and this trend needs to continue for those markets to rally further.

The next most-watched event this week will be the FOMC minutes, as investors will parse the release for insight into whether tapering will be announced in September, October or December. Right now the consensus remains on a September announcement, but that's no sure thing. Anything beyond September will probably be taken as peripherally "dovish" by the market. The important thing to keep in perspective here is that the Fed is tapering, whether it's in September, October or December.

We get more housing data also this week in the form of existing and new home sales (Wednesday and Friday respectively). The new home sales figure was "OK" and the market will welcome more signs that the housing recovery isn't losing too much positive momentum in the face of higher mortgage rates. It is very important for the market that housing doesn't show signs of backtracking.

Finally, weekly jobless claims will be watched to see if the six-year low set last week sticks, or if there are some big revisions. Regardless, the anecdotal evidence implies the job market is incrementally improving, and that supports the September taper argument.

Internationally, it's quiet outside of the flash PMIs, as most of Europe will be on "holiday."

This could be an important week with regard to resolving what's expected of the Fed and specifically answering the question of whether or not we will see tapering announced in September.

One important thing to remember, though, as the week unfolds: Good economic news is still good for the market, regardless of the very short-term reaction. Better economic data is the only way this rally has legs over the medium and longer term—if the market sells off on good data, then that's probably a place to nibble on the long side.

Commodities

Commodities surged last week as a weaker dollar and better global economic growth prospects led to multiple commodities breaking months-long downtrends and trading to multi-month highs.

Precious metals were the big outperformers last week, as gold and silver both broke through downtrends in place since February. Silver was easily the best-performing commodity last week, rallying 14% after breaking through resistance on Monday, while gold rallied hard into the end of last week as it broke its downtrend on Thursday thanks to dollar weakness. Although both markets remain volatile, given the number of shorts in both silver and gold, the potential for a sharp rally is relatively big. While it's a high-risk/high-potential-reward move, if you want to own or add to gold then I would do it now instead of waiting for a correction.

Industrial commodities were also higher, thanks to better-than-expected economic data from Europe and improving sentiment toward China/Asia. The energy complex was modestly higher last week, although WTI crude still has yet to break through resistance at $108/bbl and appears range-bound for now (unless we get some surprisingly good economic data).

Commodities this week will be focused on the global PMIs and the Fed minutes, as expectations for global growth and the U.S. dollar remain the two major influences. For the first time in six-plus months, though, commodities are no longer in a downtrend and could substantially outperform going forward if global growth accelerates and the dollar remains relatively contained near current levels.

Currencies & Bonds

Last week the 30-year Treasury note hit a new low for the year, while 10-year yields settled above 2.80% for the first time in two years. A six-year low in weekly jobless claims and a third consecutive monthly increase in the CPI helped increase to expectations for a September announcement regarding Fed "tapering." Short of the economic data collapsing, shorting the bond market via TBT, TBF, STPP and SJB remains, in my opinion, one of the best trades in the market—and there remains a long, long way to go. Whether tapering comes in Sept/Oct/Dec as long as the economic data doesn't reverse, tapering is coming, so continue to short rallies in the bond market.

The Dollar Index rallied last week, but not nearly as much as you would expect given the decline in bonds, mostly because the Dollar Index fell hard on Thursday. But as I explained in Friday's issue, I think that was more a "one-off" than anything else and would look to "buy" dollars at these levels via UUP.

The pound was the big gainer vs. the dollar last week as the Monetary Policy Committee's meeting minutes were perceived as a touch "hawkish" by the market and as economic data (retail sales) continue to beat expectations. The euro was flat vs. the dollar despite EU GDP turning positive (it was largely expected).

In Asia, the yen was volatile but traded slightly lower vs. the dollar as there were mixed messages on whether the Shinzo Abe administration would use a corporate tax cut to offset the increase in the national sales tax coming next spring. While the corporate tax appears to be off the table, the point from last week was the administration is looking for ways to offset the tax increase. Whether it's a corporate tax cut or more stimulus for the Bank of Japan, ultimately that is yen-negative. But, I would wait until the yen breaks 100/dollar before adding to any shorts or initiating new positions.

Have a good week,

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	Neutral	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 of a months long downtrend last week .*

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.**