7:00's Report

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

August 20, 2013

PCY: Emerging market bonds are breaking down, and if they make new lows, they'll likely take the equity markets down with them.

Pre 7:00 Look

- Futures holding close to flat but most markets lower o/n as concern about higher rates led to a continued sell off in emerging markets.
- Indonesian & Indian markets fell sharply again, down 4% and 1% respectively, leading to a sharp drop in Asia as the Nikkei and Hang Seng declined more than 2% each.
- European markets modestly lower on peripheral concern about emerging markets and after BHP missed earnings.
- Econ Today: No Reports Today.
- Earnings Today: HD (E: $1.20), TJX (E: $0.63) BBY (E: 0.12).

Market	Level	Change	% Change
S&P 500 Futures	1745.50	0.50	.03%
U.S. Dollar (DXY)	81.00	-.26	-.32%
Gold	1364.90	-0.80	-.06%
WTI	106.56	0.54	0.50%
10 Year	2.884	.055	1.94%

Equities

Market Recap

Stocks started the week lower as concern about higher interest rates and weakness in the emerging markets again weighed on markets. The S&P 500 fell 0.59%.

Monday was a quiet day from a news standpoint, and stocks spent most of the day hovering around flat until the last hour of trading, when markets could no longer hold up in the face of growing concern about the rise in interest rates. Stocks went out basically at their lows.

There was no real reason why stocks sold off during the last hour of trading (there wasn't a specific catalyst), and instead it just seems like the concern regarding higher rates is simply becoming more and more of a headwind for stocks.

If I had to point to one reason why rates were higher yesterday, then it would be that Larry Summers appears to be pulling ahead in the "who will replace Ben Bernanke" race, and that is seen by the market as hawkish. Not helping things is the fact that there is virtually no other news at the moment, volumes remain very low, and trading is thin.

Trading Color

The Russell 2000 again underperformed yesterday, falling more than 1% and making a multi-week low, implying this sell-off isn't done yet.

From a sector standpoint, rising rates were the big story in markets yesterday and this was the defining factor in sector trading. Bond-proxy sectors like utilities, REITs, and telecom all were down more than 1% while home-builders, which looked to be trying to bottom last week,

Market	Level	Change	% Change
Dow	15010.74	-70.73	-.47%
TSX	12588.02	-148.09	-1.17%
Brazil	51574.09	35.31	.07%
FTSE	6420.52	-45.21	-.70%
Nikkei	13396.38	-361.75	-2.63%
Hang Seng	21970.29	-493.41	-2.20%
ASX	5078.18	-34.35	-.67%

Prices taken at previous day market close.

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got hit hard and fell more than 2%. Financials also underperformed on some micro news (negative JPM headlines) and on peripheral concerns regarding the sell-off in emerging-market debt.

Market	Level	Change	% Change
Gold	1365.30	-5.70	-.42%
Silver	23.20	-.17	-.74%
Copper	3.33	-.03	-.92%
WTI	107.13	-.33	-.31%
Brent	110.08	-.32	-.29%
Nat Gas	3.46	.09	2.70%
Corn	4.85	.22	4.75%
Wheat	6.53	.10	1.55%
Soybean	13.03	.44	3.49%
Prices taken at previous day market close.			

Healthcare was the only S&P 500 sector to trade higher, although consumer staples and consumer discretionary were relative outperformers.

Volumes remain very, very low and trading thin. The S&P 500 has now broken through support at the 50-day moving average. There isn't a lot of support between current levels and 1,600, although there is some mild support in the 1,624-ish area.

Emerging-Market Debt Sell-Off—This is a Potential Problem (again).

In May and June, when markets initially declined on the prospects of Fed tapering, I pointed out two very important things we all needed to keep in mind as the market started to adjust to the reality of higher interest rates in the future.

First, it's the pace of the rise in interest rates that's important, not the absolute level. So, the stock market can rally along with interest rates, as long as the pace of the rise in interest rates isn't too fast.

Second, emerging-market debt is now the "leading edge" of any potential market turmoil, as that sector has replaced Europe as the "weakest link" in the global financial system. Stable emerging debt markets are a prerequisite for any sustainable rally in stocks.

With that in mind, after we saw an initial shock in May/early June, the pace of the increase in interest rates leveled off, and emerging-market debt stabilized—which allowed the stock market rally to new all-time highs.

But, over the last week, emerging debt markets have quietly begun to break down again as the pace of the rise in interest rates here in the U.S. has quickened substantially. (The 10-year yield went from a low of 2.55% last Monday to a high of 2.899% yesterday.)

In reaction to that acceleration, emerging-market bonds—as measured by the PowerShares Emerging Markets Sovereign Debt ETF (PCY) and the iShares JPMorgan USD Emerging Bond Fund (EMB)—have declined sharply, and are now dangerously close to breaking down.

As a refresher, I've included an excerpt from the June 12 Report that explains why emerging-market debt poses a potentially significant risk to the market (below):

Why The Plunge In the South African Rand Matters to You.

"Away from the yen, the other focus in the currency markets was on the implosion we're seeing in emerging-market currencies. The Indian rupee hit another all-time low vs. the dollar. The Brazilian real and South African rand hit four-year lows vs. the dollar, and even strong currencies like the Mexican peso got hit yesterday.

"The reason for the weakness is this: Since the Fed went to 0% interest rates and round after round of QE, investors have moved into higher-yielding emerging-market currencies over the past few years.

"Now with the Fed potentially 'tapering' and interest rates in the U.S. rising, investors are reversing the trade. They no longer need to take the risk of being in emerging markets, as rates are rising here at home.

"That's causing the currencies of those emerging-market countries to drop as investors sell their bonds and reconvert those investments back into dollars. Basically, 'doomsayers' are saying the world's major central banks, led by the Fed, have created a bubble in emerging-market credit, and now it's popping.

"The question I'm sure you're asking right now is 'Why the hell do I care about emerging-market credit?' Well, you care because, as these currencies and bonds plunge, it's causing losses in the leveraged hedge funds that have put the trade on. That's causing them to liquidate other holdings to cover the losses (like stocks and gold, for instance).

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"Point being, you should care for the same reason everyone should have cared when the mortgage-backed security markets started blowing up in '07, '08 and eventually led to the takedown of Bear, Lehman, etc. I'm not saying it's the same thing here at all—but it's the leverage and the huge declines that are making people nervous.

"So, while it's not a disaster yet, this unwind out of emerging-market debt and currencies is having an effect on all asset classes. It's not anywhere near 1998-style proportions yet (the emerging-market debt crisis), but it is unnerving investors, and weighing on other risk assets. Bottom line is watch PCY and EMB, the two emerging-market bond ETFs. Emerging-market bonds need to stabilize in order for equity markets to calm down a bit."

<u>Bottom Line</u>

The market dynamic may have changed a bit yesterday, and for the worse. The acceleration in the rise in interest rates is causing another round of turmoil in the emerging markets. And, as stated, a stable EM debt market is a requirement for any rally in the global equity markets. If emerging-market bonds can't stabilize at these levels and they take another leg lower, then stocks are going to follow them down, regardless of the positive economic momentum in Europe China, etc.

My optimism on equities has been consistently hedged with the statement "if the macro environment stays relatively clear." Well, an emerging-market currency/debt crisis doesn't constitute a "relatively clear" macro horizon, so emerging markets need to stabilize before equities can resume their rally.

Keep an eye on PCY and EMB—if they break down to new lows, that's a sign to get defensive with regard to domestic and international equity exposure.

I wouldn't sell this morning as EM bonds haven't made new lows, and keep in mind the EM inspired dip in June turned out to be a buying opportunity. But, this is a potential game changer if we get a sustained move lower in the emerging markets, so I'd certainly get a plan together about just how I want to de-risk if EM bonds break down further.

Market	Level	Change	% Change
Dollar Index	81.231	-.026	-.03%
Euro	1.3345	.0016	.12%
Pound	1.5655	.0026	.17%
Yen	97.65	.11	.12%
CAD $	.9667	-.0008	-.08%
AUD $	.9122	-.0063	-.69%
Brazilian Real	.4139	-.0046	-1.10%
10 Year Yield	2.894	.066	2.28%
30 Year Yield	3.903	.052	1.33%
Prices taken at previous day market close.			

Economics

No reports yesterday.

Commodities

It was a pretty quiet day in the commodity markets yesterday, with hotter weather being the only market-moving event. The broad-based commodity ETF DBC was virtually unchanged in trading yesterday.

The big movers yesterday were natural gas (up 3%), corn (up 5%) and soybeans (up 3%). As a general rule, when you see natural gas and the grains rally, you can almost always assume it's weather-related.

True to form, temperatures are expected to move above 90 degrees tomorrow in the Corn Belt and Midwest (pushing grain prices higher) and then move east over the rest of the week (which is what pushed natural gas higher).

The grains and natural gas are some of the more heavily shorted markets in the commodity space, so yesterday's surprise was enough to cause a strong short-covering rally. Unless the hot weather hangs around for several weeks, though, it won't be enough to change the fundamental outlook for either of those commodities. We can still expect near-record crops in the grain markets, while natural gas continues to see inventories rise as this summer hasn't materially increased cooling demand.

As mentioned, elsewhere things were quiet. Oil was flat despite more unrest in Egypt (it's still not a major influence in energy prices) and WTI specifically remains capped at the $108/bbl level.

Metals were slightly lower on some light profit-taking, but given the big run they had last week, it's encouraging that the profit-taking didn't result in a greater decline.

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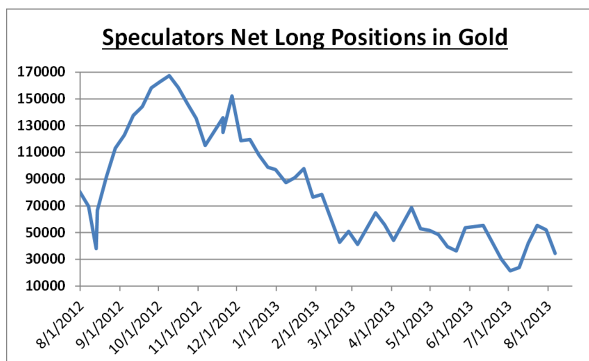
With regard to gold and silver, it was also encouraging to see that the Commitment of Traders reports from last week didn't really show a huge uptick in "net longs," although it's worth pointing out that the COTs are reported as of Tuesday's close. So with gold, it doesn't reflect the breakout we saw on Thursday.



Regardless, though, with net longs of 38K and 11K in gold and silver respectively, the positioning in both markets implies there's more room on the upside. (When you see net longs get above 130K in gold and 30K in silver, that's a time to get cautious—so we're a long way from there.)

Bottom line is commodities have had a good run over the past week to 10 days, so some consolidation/profit-taking ahead of the FOMC minutes and PMIs is to be expected—but whether this rally stalls or "gets legs" will be dependent on the data later on this week.

Currencies & Bonds

As already mentioned, the important action in the currency markets yesterday occurred in the emerging-market currencies, while developed-market currencies were relatively unchanged.

Emerging-market currencies had a very bad day yesterday, led lower by the Indian rupee, which hit another record low vs. the U.S. dollar. But, the South African rand, Brazilian real, Mexican peso and even the Australian dollar fell sharply vs. the dollar and other developed currencies.

Away from the emerging markets, the Dollar Index was little-changed yesterday in very quiet trading, while the euro, pound and yen were all flat. There was little in the way of news or catalysts for developed countries' currencies yesterday, as all eyes are focused on the FOMC minutes and PMIs later this week.

The big story in the bond markets, unsurprisingly, is the continued move higher in rates. Treasury yields hit another multi-year high yesterday, despite the Fed buying $1.6 billion worth of long bonds yesterday at 11 a.m.

And, although I've already covered it, obviously emerging-market debt also declined sharply as both PCY and EMB were off by almost 1% each. Both are very close to breaking through the July lows and, potentially, revisiting levels last seen during the panic lows in June.

Looking ahead at the rest of the week, if I were at the FOMC, I'd buy some Wite-Out today and start editing the Fed minutes if they are "hawkish," because if they are, emerging-markets bonds could test those June lows. If they do, stocks will follow them down.

Bottom line, though, is that the most-consistent trend in this market is that of lower bond prices/higher rates, and even if you're not in TBF, TBT, STPP or SJB, it's still not too late, as this trend has a lot further to run.

Have a good day,

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**	*US equities have been consolidating recent gains and going through a typical correction. But, turmoil in emerging markets is threatening to be a potentially bearish game-changer. EM bonds haven't moved to new lows (which would be a signal to de-risk) but stocks will have a hard time rallying until the emerging markets stabilize.* *The S&P has broken through its 50 day MA and support now lies in the mid 1630 area.*

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. 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.

	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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