7:00's Report

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

August 22, 2013

Pre 7:00 Look

- Futures higher after Chinese and European flash manufacturing PMIs beat expectations, trumping continued weakness in the emerging markets.
- The global economy showed more signs it's turning for the better. Chinese manufacturing PMI rose above 50 for the first time in months, & EU PMIs rose more than expected.
- Emerging markets remain a concern, however, as the Rupee hit another record low vs. the dollar o/n.
- Econ Today: Jobless Claims (E: 329K), PMI Manufacturing Index Flash (E: 53.5) .

Market	Level	Change	% Change
S&P 500 Futures	1643.50	7.25	.44%
U.S. Dollar (DXY)	81.69	.467	.59%
Gold	1365.90	-4.20	-.31%
WTI	104.34	.49	.47%
10 Year	2.855	.041	1.46%

Equities

Market Recap

Stocks closed lower again Wednesday in a pretty ugly session, as a late-afternoon FOMC-minutes bounce ran out of steam and markets dropped into the close, going out at their lows. The S&P 500 fell 0.53%.

Stocks spent most of the morning and early afternoon down very slightly, as everyone looked ahead to the release of the meeting minutes. From a news standpoint, continued weakness in India and emerging markets weighed on the averages, but decent earnings results from Toll Brothers (TOL), Lowe's (LOW) and Target (TGT) were welcomed. (TGT's headline was a miss and guidance a bit soft, but that was mostly due to weak Canadian sales, while the U.S. net and same-store sales were actually OK.)

Upon the release of the FOMC minutes, the algorithms drove markets lower. But, as usual, the initial move by markets on anything Fed-related was the wrong one (at least for a time).

Markets rallied hard as we started the last hour of trading, taking the S&P and Nasdaq positive for a very brief time. But, as bond yields moved higher and emerging-market currencies saw their declines accelerate—which was exacerbated by Brazilian central bank President Alexandre Tombini canceling his trip to Jackson Hole, Wyo., to "monitor market activity"—stocks were pulled back in and sold off into the close, going out at their lows.

Trading Color

Bulls will find some solace in the fact that the Russell 2000 and the Nasdaq relatively outperformed yesterday, and while the S&P 500 and the Dow traded to new six-week lows, both the Russell and Nasdaq closed above Monday's lows. Seeing as the Russell has been the leader of markets for months, that's a silver lining to an otherwise-ugly day.

From a sector standpoint, all 10 S&P 500 sectors closed lower, but the dominant theme remains the killing of "bond proxy" sectors, with one exception (mentioned below). Utilities fell 1% and were the worst-performing S&P 500 sub-sector, while telecom and healthcare also underperformed.

Tech, industrials and financials (more cyclical sectors) were the relative outperformers yesterday, so to a point

Market	Level	Change	% Change
Dow	14897.55	-105.44	-.70%
TSX	12573.08	-97.03	-.77%
Brazil	50405.20	-101.82	-.20%
FTSE	6445.03	54.08	.85%
Nikkei	13365.17	-59.16	-.44%
Hang Seng	21895.40	77.67	.36%
ASX	5075.75	-24.24	-.48%
Prices taken at previous day market close.			

we are still seeing relative outperformance of cyclicals vs. income sectors—a trend that's likely to continue for some time unless the economic data turns south.

Market	Level	Change	% Change
Gold	1366.40	-6.20	-.45%
Silver	23.03	-.09	-.40%
Copper	3.31	-.03	-.85%
WTI	103.99	-1.12	-1.07%
Brent	109.96	-.19	-0.17%
Nat Gas	3.47	.03	.78%
Corn	4.83	.08	1.63%
Wheat	6.49	.03	.50%
Soybean	13.04	.14	1.05%
Prices taken at previous day market close.			

The exception I mentioned above pertained to the recent resiliency of the housing-sector stocks. They traded well again yesterday (relatively speaking), thanks to several peripherally positive catalysts. TOL earnings were better than feared, LOW beat, and existing home sales were better than expected. As mentioned yesterday, bulls are hoping that homebuilders and the housing-related sector can put in a bottom here—and, in doing so, this would imply that the uptick in rates has been digested by the housing industry and that the recovery in housing is continuing apace.

Whether or not that is the reality remains to be seen, but I have a hard time seeing how the homebuilders can rally in a falling market if it's higher interest rates that are the cause of the declines. So, I'm inclined to think that if homebuilders can bottom, and that's a big "if," that is a positive sign for stocks.

India Is Now the Center of the EM Crisis—Watch EPI & ICN as They'll Bottom First.

The turmoil in India seems to be asserting itself as the tail wagging the emerging-market dog. The relentless declines in the rupee have been a problem for months, but the acceleration recently has stoked concerns that we may see a full-blown capital flight out of India. That's a pretty big concern, because while it is an emerging market, India is also one of the 10 largest economies in the world. A current-account or balance-of-payments crisis in India would have significant ripples across the globe.

Already a problem, the situation in India has been made worse by recent "flip-flopping" by the Reserve Bank of India. Several weeks ago, the RBI took measures to tighten liquidity and push up interest rates in an effort to stem the slide in the rupee. Well, it didn't work, and yesterday the RBI reversed course and provided liquidity to the market (effectively pushing borrowing costs lower) after they realized that the higher rates they manufactured several weeks ago were putting stress on Indian banks and risking a further economic slowdown.

Basically, the market is losing confidence in the RBI. It is becoming clear that they don't know what they want to do: hold up the rupee or help support economic growth in the short term.

Bottom line is the rupee is making new lows vs. the dollar almost every day, and it's becoming more volatile (it moved more than 3% from peak to trough yesterday) as the RBI flails about.

This sounds a bit odd, but I don't think markets can rally until we get calm in the emerging currency and bond markets, and I don't think we can get calm in the emerging currency and bond markets until India stabilizes. So, that puts the WisdomTree India Earnings Fund (EPI) and the WisdomTree Indian Rupee Fund (ICN) at the top of our watch list, just above the PowerShares Emerging Markets Sovereign Debt Portfolio (PCY) and the iShares JPMorgan USD Emerging Markets Bond Fund (EMB).

Bottom Line

We're all looking for signs of a bottom here, so I point out what's happening with the Russell and homebuilders because they *should* bottom before the S&P 500. But, this emerging-market turmoil trumps all else. So, while homebuilders and small caps may be acting better based on what's happening in the U.S. economy, I don't think there's any way we can see a rally until emerging markets stabilize. Once that happens, then we can look at how small caps and homebuilders are trading to see if it's time to add exposure. But, we need macroeconomic stabilization in the emerging markets first.

Economics

Existing Home Sales

- 5.39M vs. (E) 5.15M SAAR

Takeaway

Existing home sales saw a big increase in July, as higher

interest rates pulled buyers into the market. The July number easily beat estimates and, excluding the period of time where there was the first-time homebuyer tax credit, hit a new high for the recovery. Inventory remains low and prices steady in July, so overall this is a good report.

But, as strong as this report is, it's important to note existing home sales represent *closings* of sales. The July data reflects deals that were agreed to back in May/June (30-60 days prior), so the full effect of higher mortgage rates isn't really factored into this report, nor does it give a great look at the state of the housing market in July. Nonetheless, it's a good report that helps quell fears about a significant loss of momentum occurring in the housing market.

FOMC Minutes

Synopsis/translation of yesterday's minutes:

> ***Fed***: *"We are pretty sure we're going to taper QE at some point and in some size, and remain comfortable with the course of action we decided upon back in June."*
>
> ***Markets***: *"OK, what did you decide back in June?"*
>
> ***Fed***: *"Well, nothing really, but we remain data-dependent, which at the moment shows both strength and weakness in the economy."*

Takeaway

My poor attempt at humor aside, the FOMC minutes didn't really further resolve anything regarding upcoming QE tapering. Bottom line is there isn't any clear consensus on the course of action with regard to tapering. A "few" Fed governors urged patience and supported seeing more data before "tapering" QE, while a "few" urged sticking to the plan articulated back in June to taper later this year, and that it will "soon be time to somewhat slow" the pace of purchases.

Market	Level	Change	% Change
Dollar Index	81.304	.398	.49%
Euro	1.3370	-.0044	-.35%
Pound	1.5696	.0028	.18%
Yen	97.79	.52	.53%
CAD $	.9571	-.0052	-.54%
AUD $	.9032	-.0035	-.43%
Brazilian Real	.4095	-.0079	-1.92%
10 Year Yield	2.869	.052	1.81%
30 Year Yield	3.891	.036	.93%
Prices taken at previous day market close.			

So, bottom line, the prospects of a September announcement of tapering were probably reduced somewhat yesterday, but it's still the most-likely case compared to October or December. Also, the minutes provided no clarity on the details of "tapering" with regard to how much, or which assets (Treasuries or mortgage-backed securities). So, in a market craving clarity, the FOMC minutes provided none.

Commodities

Commodities ended the day little-changed with the exception of WTI crude, which fell more than 1%. Commodities spent much of the day in negative territory, but they ended up getting a lift from the FOMC minutes after an initial sell-off, to close not far off the best levels of the day.

The precious metals were the biggest beneficiaries of the FOMC minutes, as both gold and silver rallied off their lows to finish flat for gold and modestly higher for silver. Interestingly, the strength in gold and silver came despite the fact that the dollar didn't really decline on the minutes. So, gold and silver's price action yesterday again showed some relative strength, and although I remain skeptically bullish of the precious metals, they continue to "act" well.

Industrial commodities also caught a big tailwind off the FOMC minutes, as WTI crude and copper rallied off their lows to finish down 1% and 0.5%, respectively. WTI was once again the worst-performing commodity yesterday (like Tuesday) as WTI continues to drift toward the bottom of its recent trading range around the $102-$103 level.

There was no specific catalyst for the declines, as the weekly inventory data met expectations with a 1.4 million barrel draw vs. (E) 1.3 million barrels. Bottom line is WTI remains range-bound. As it's done twice before since late July, it hit the top of the range near $108, and now wants to test the bottom

of the range around $103. The 50-day exponential moving average has been support. As before, I'd look to be a buyer of "energy" either via the U.S. Oil Fund (USO) or the Energy Select Sector SPDR (XLE) on any dip toward $103/bbl, with a stop shortly below $102/bbl. (So, a little more than a dollar of risk for 4+ dollars in potential reward if WTI moves back to the top of the range.) Unless economic data turns for the worse and GDP growth slows further, I have a hard time seeing how WTI crude is going to decline materially.

Staying in the industrial metals, copper fell modestly yesterday in relatively quiet trading ahead of the global flash PMIs released this morning. (It makes sense that people would book some profits given copper's run over the past few weeks ahead of that important number.)

Industrial commodities are higher this morning after the universally better economic data overnight from China, Germany and the EU. Despite emerging market turmoil, the data continues to show evidence the global economy is improving.

Currencies & Bonds

Emerging markets are the key right now so we're going to start with them, and yesterday was not a good day. The Indian rupee, Mexican peso, and Brazilian real all fell more than 2% vs. the dollar, while the Aussie fell nearly 1.5% as U.S. Treasuries traded back down to recent lows and actually made a fractionally lower closing low. So, clearly the EM currencies have not stabilized, and until they do, risk assets will not be able to rally.

The dollar bounced back above support yesterday on short-covering and some bargain-buying as the FOMC minutes weren't dovish enough to exert further pressure on the dollar.

The Dollar Index rose 0.5% to close back above the 81.00 level, as the euro and yen fell vs. the dollar (-0.5% and -0.6%, respectively). While there wasn't any fundamental news, there were some statements that, supposedly, helped to pressure the euro and yen. But, yesterday was about a dollar rally, not weakness in other currencies.

But, to those comments: First, German Finance Minister Wolfgang Schauble admitted that Greece will likely need a third bailout. In other news, water is still wet. Seriously, though, everyone knows Greece needs some more money at some point, and the whole affair was brought on by German Chancellor Angela Merkel's political opponent in the upcoming elections. I only point it out because the financial press intimated this was some new revelation—but it's not, and it's not euro-bearish (at least not in the short term).

In Japan, BOJ Governor Haruhiko Kuroda made comments that he's not against more monetary easing if the sales tax increase next week were to negatively affect the economy. But again, while that seems dovish, it simply isn't anything new.

As mentioned, Treasuries sold off hard. As of this writing, they are basically sitting on their lows from Monday. The bond market had the clearest read on the minutes, and sold off immediately following their release and didn't bounce for more than a minute all afternoon. The trend in bonds obviously remains lower, and the declines are accelerating, which we all know is a problem.

Bottom line, yesterday was a good day for the bond shorts, and a bad day for everyone else, because the problems that caused the market to sell off aren't fixed.

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**	*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 1620 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.

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, but if the uptrend at 81.00 is decisively broken, I'll have to admit I'm wrong.*

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.**