7:00's Report

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

August 26, 2013

Pre 7:00 Look

- Futures slightly lower and global markets calm after a quiet night that saw stability in the emerging markets.
- Emerging markets are stable on a combination of Brazil's efforts to defend the real last Friday, central banker lip service over the weekend, and lower U.S. bond yields. But, whether that calm lasts remains to be seen.
- Over the weekend central bankers at Jackson Hole addressed the EM situation at length, which is positive. But, no coordinated actions were taken to ensure EM stability.
- Econ Today: Durable Goods (E: -4.0% m/m).

Market	Level	Change	% Change
S&P 500 Futures	1659.25	-2.25	-.14%
U.S. Dollar (DXY)	81.46	.063	.08%
Gold	1394.10	-1.60	-.11%
WTI	106.49	.07	.07%
10 Year	2.818	-.083	-2.86%

Equities

Market Recap

Markets saw a small rally last week in very illiquid trading, as strong economic data (global Purchasing Managers' Indexes, jobless claims) offset renewed turmoil in the emerging markets and more weak retail company earnings. The S&P 500 is up 16.64% year-to-date.

Stocks spent the early part of last week treading water, but after the FOMC minutes failed to provide any more clarity on the logistics of QE tapering, the big rally we saw in bond yields weighed hard on emerging markets, which saw their currencies and bonds plunge. U.S. equity markets put in a very ugly close Wednesday, selling off hard and going out at their lows.

But, just when it looked like this correction might really accelerate, global economic data last Thursday morning was almost universally positive. This helped to steady the markets, which eventually led to a big rally Thursday (the day Nasdaq went down).

Emerging markets were the key driver of the stock markets last week, and the strong global economic data Thursday helped emerging markets halt their declines, and it was that temporary EM stabilization that allowed markets to lift into the end of the week. For all the focus on the FOMC minutes, Jackson Hole and housing data last week, it was the emerging-market currency and debt sell-off, led by India, that was by far the most important "event" of last week. It's clear that unless emerging markets can stabilize, it'll be very difficult for equity markets to rally.

Trading Color

Looking at some market internals, perhaps the most encouraging thing that happened last week from a trading perspective was the Russell 2000 closed moderately higher on the week and, unlike the S&P 500 and the Dow, didn't violate Monday's low when markets sold off Wednesday. I mention that because the Russell has bottomed first during the last several corrections.

Sector trading largely reflected specific news last week, but generally you can say that cyclicals continue to outperform "income" or "defensive" sectors, a trend we've been seeing for several months now, and one that is usually bullish.

Basic materials and industrials outperformed last week, thanks the strong global flash PMIs Thursday. Mean-

Market	Level	Change	% Change
Dow	15010.51	46.77	.31%
TSX	12762.30	87.95	.69%
Brazil	52197.06	799.40	1.56%
FTSE	694.10	45.23	.70%
Nikkei	13636.28	-24.27	-.18%
Hang Seng	22005.32	141.81	.65%
ASX	5135.40	12.04	.24%

Prices taken at previous day market close.

while, retail continued to struggle as earnings continue to miss expectations and outlooks are downright gloomy. Some notable "misses" this week were Gap Inc. (GPS), Abercrombie & Fitch (ANF), Staples (SPLS) and Dick's Sporting Goods (DKS).

Market	Level	Change	% Change
Gold	1396.30	25.50	1.86%
Silver	24.045	1.01	4.38%
Copper	3.35	.03	.69%
WTI	106.32	1.29	1.23%
Brent	110.95	1.05	.96%
Nat Gas	3.48	-.065	-1.83%
Corn	4.70	.05	1.20%
Wheat	6.34	.04	.63%
Soybean	13.65	.43	3.27%
Prices taken at previous day market close.			

The other big theme in sector trading last week was the continued weakness in the "bond proxy" sectors. This was obviously in reaction to interest rates hitting a multi-year high. Utilities, telecom and REITs were big underperformers all week, until Friday, when they rallied on short-covering. But, even with Friday's big sell-off in yields, "bond-proxy sectors" remained one of the worst performers in the market last week.

Volumes and attendance were very, very low last week, so trading was extremely thin. On the charts, the S&P 500 hit a multi-week low Wednesday, but managed to rebound into the end of the week and actually closed back above its 50-day moving average (1,659) for the first time in a week, which is now support.

This Week

This should be a very quiet week. There are some economic releases, but none should be important enough to materially change expectations for the Fed or any other central banks. Speaking of which, there are a few Fed governors speaking this week (John Williams on Tuesday is probably the highlight, as he's pretty reflective of the "consensus" Fed view), but none should shed any further light on specifics surrounding when and how the Fed will taper QE. Finally, from a micro standpoint, it's also pretty quiet. On the earnings front, Tiffany & Co. (TIF) (Tuesday), mining equipment-maker Joy Global (JOY) (Wednesday), and Salesforce.com (CRM) (Thursday) are the highlights, although I wouldn't expect results from any of them to materially move markets.

Bottom Line

Since the market began to adjust back in May to the eventual tapering of QE and the prospect of higher interest rates, we've been focusing on the fact that as long as the rise in interest rates wasn't too fast, both equities and interest rates could rise together. Well, in May and June the 10-year went from 1.60% to 2.50% in about six weeks. That pace was too fast, and it caused capital to stampede out of the emerging markets, which caused a correction in global equities.

But, rates stabilized after that and global markets were able to resume a rally that is based on an improving global economy coupled with extremely accommodative central banks.

Two weeks ago the yield on the 10-year Treasury went from 2.55% to 2.90% in just over one week, a pace of increase that was again too fast. Not surprisingly, that caused another stampede of capital out of emerging markets (in particular India and Brazil), which led to this latest round of equity market turmoil.

Point being, if rates can stabilize and emerging markets can behave, then stocks can rally because the fundamentals are supportive of equities.

Last Friday's new home sales number was a big miss, and helped cause a big short-covering rally in the bond market. If 2.90% on the 10-year proves to be the top for several weeks (that's the key level to watch this week) and the rupee can stabilize, then this market can resume the rally. So, in addition to watching the 10-year yield, this week we need to watch the WisdomTree India Earnings Fund (EPI) and the WisdomTree Indian Rupee Fund (ICN), as well as the PowerShares Emerging Markets Sovereign Debt Portfolio (PCY) and the iShares JPMorgan USD Emerging Markets Bond Fund (EMB). If they can stabilize and hold last week's lows, that's bullish for stocks globally.

And, I continue to think that any incremental capital will be best served in Europe (the U.K., via EWU, and Ireland, via EIRL) or the basic materials sector, as both are the laggards this year and will benefit most from the positive turn in global economic growth we are experiencing. But, again, adding anything incremental to the long side has to be done in the context of emerging market calm, because if we get an emerging-market debt crisis, everything is headed lower.

Economics

Last Week

Economic data last week was largely supportive of the current market trends (improvement in global economic growth & tapering of QE in the U.S. to begin this fall). But the one glaring exception was Friday's new home sales report, which implies higher mortgage rates are indeed acting as a headwind on the housing recovery.

FOMC minutes from the August meeting was the most-watched item last week, although they failed to provide any insight into when the Fed might taper QE or how they might do it (size of the taper and split between Treasuries or mortgage-backed securities). The minutes showed a divided Fed that lacks consensus on every aspect of tapering QE … other than the fact that they all agree QE does need to be tapered starting this fall.

The bottom line from the Fed minutes (and the outlook for Fed policy) is that the market "consensus" (and I use that term lightly because it's not a big majority that see tapering in September) is that the Fed will announce a small tapering ($10 billion-$15 billion) to start in October and it will occur entirely in Treasury purchases. That represents a slightly more "dovish" outlook than we had going into the meeting (the expectation for a September taper was a bit higher, and the amount of tapering was expected to be around $20 billion). But, the key is that tapering is still on schedule for later this year.

The second big release last week was the flash global PMIs, and they were universally better than expected. Importantly, China's flash manufacturing PMI got back above 50 for the first time since April, and Germany and the EU's flash PMIs beat estimates. This data further implies we're seeing a stabilization of global economic growth, which should continue to benefit European and Chinese markets.

Market	Level	Change	% Change
Dollar Index	81.41	-.121	-.15%
Euro	1.3384	.003	.22%
Pound	1.5572	-.0009	-.06%
Yen	1.0137	-.0008	-.08%
CAD $	.9508	.0013	.14%
AUD $	.9019	.0033	.37%
Brazilian Real	.42290	.01495	3.66%
10 Year Yield	2.818	-.083	-2.86%
30 Year Yield	3.798	-.087	-2.24%
Prices taken at previous day market close.			

Finally, housing was in focus last week, and here's where an otherwise good week of data hit a speed bump.

Existing home sales for July largely met expectations, but the new home sales data released Friday was a big miss. Not only did the headline badly miss, but we also saw a revision of negative 64K to the prior three months' sales data.

While this report doesn't show the housing recovery has stalled, this report has to make investors and the Fed nervous that higher mortgage rates are indeed acting as a headwind on the recovery. And if the housing data continues to appear to be getting soft, we could see an even smaller "taper" in September than currently expected.

This Week

Although there are numerous releases this week, the data is largely "second-tier" and unless it's horrid, it shouldn't really change current Fed expectations.

Revised 2Q GDP is released Wednesday, and there aren't expected to be any major positive or negative revisions from the 1.7% annual rate that was announced at the preliminary look back in July.

Personal income and outlays is the second most important report this week, but not because of the headline data. Instead, the core Personal Consumption Expenditure price index, which is the Fed's favorite measure of inflation, is contained in the report. Markets will be looking to see if we get any uptick in that price index, which would imply we are seeing the seeds of inflation.

Given last Friday's report, housing also remains in focus this week as we wrap up the July housing data. Pending home sales is released Wednesday, and this will be a more closely watched report than usual given last Friday's New Home Sales miss.

Commodities

Commodities were higher last week, with the commodity ETF DBC posting small gains, but importantly trading to a new, multi week high, thanks to the Friday rally.

The news in the commodity space was almost universally good last week: better than expected global flash PMIs and stronger than expected Chinese foreign direct investment (released last Friday) helped push copper to new multi-month highs, while Brent crude also hit its highest levels since April, above $110/bbl.

Non-industrial commodities also traded well thanks to the weak news home sales, which caused the US dollar to trade well of its highs Friday. Silver continued its massive rally, as it rose nearly 4% last week, with most of the gains coming Friday. Gold also broke above resistance in the $1380 region Friday, and is now sitting just below $1400/oz.

But, although they rallied last week, commodities aren't immune from the turmoil in the emerging markets, and its fair to say that the news last week should have resulted in a bigger rally in the commodity space. But, like equities, commodities are fighting the EM headwind. Regardless, the outlook for commodities continues to look favorable, with global economic growth turning for the better, and the Fed keeping "tapering" as small as possible. I'd continue to expect commodity related sectors to outperform as long as emerging markets stabilize.

Currencies & Bonds

Emerging market currencies and bond were the most important movers in their respective markets last week, as the extreme weakness in both unnerved all other asset classes.

In particular, weakness in the Indian Rupee, which seemingly hits a new all time low vs. the dollar every day, and the plunging Brazilian Real were the drivers of more broad EM volatility.

Over the weekend, there was actually quiet a bit of focus on the instability in the emerging markets from the Jackson Hole central bankers conference, and the central bank of Brazil took some significant steps to help defend the Real last Friday, helping to at least temporarily boost market confidence.

But, as of this morning the Rupee has resumed its decline, and markets will be watching to see if that results in more EM turmoil this week. The Rupee remains the center of this latest iteration of the emerging market currency and debt crisis, and watching for stabilization in ETFs like ICN (Rupee ETF), EPI (Indian equity ETF) and broad emerging market ETFs (PCY & EMB) remains important.

Elsewhere in currencies, the dollar finished last week fractionally higher, rebounding after hitting a new multi-week low early last week ahead of the FOMC minutes. And, although the FOMC minutes were taken as slightly "dovish," the bigger takeaway from a currency perspective is that the Fed does intend to taper QE this fall. So, tapering is a matter of "when" not "if."

Overall it was a pretty quiet week from EuropeThe euro was flat last week despite the strong PMI data, while the pound was lower vs. the dollar after some dovish comments by Monetary Policy Committee member Weale. Turning to Asia, the Japanese yen was lower versus the dollar last week as expectations rise that BOJ President Kuroda will unleash more stimulus on the Japanese economy ahead of a national sales tax increase next fall. The yen is threathening to break through multi-month support, and I'd look to short the yen (via YCS) the next time it breaks through 100 dollar/yen, as that should be the end of this three months long counter trend rally.

Looking at bonds, Treasuries actually finished the week higher last week, thanks entirely to a huge short covering rally Friday off the new home sales data. But, earlier in the week, Treasuries hit a new low for the year, and yields hit a new high, showing the trend in bonds remains very firmly lower.

The decline in bonds has come in stages, and I think that will continue. We could see a rally in bonds as they are very short term oversold, but the fact that the Fed is tapering (regardless of when) is the important point here, so any material rally should still be used to add short exposure to the bond markets via TBF, TBT, STPP or SJB. Declining bond prices remains the strongest trend in the markets.

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 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 traded back above its 50 day MA last week which is now support.*

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	Bullish	Neutral	Bullish	*The commodity complex continues to see the environment turn more favorable. Global economic growth appears to be turning for the better, especially in China and Europe, while the Fed appears committed to tapering in very, very small increments.*

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, 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.**

	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.**