7:00's Report

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

August 27, 2013

Silver has rallied more than 20% in August alone, as a weaker dollar and improved global economic outlook caught record shorts by surprise.

Pre 7:00 Look

- Futures and foreign markets moderately lower as emerging market currencies, bonds and stocks resume their declines. The rising expectation of military action in Syria isn't helping either, but the weakness in EM is the primary reason for the declines this AM.
- The Indian Rupee hit another record low vs. the dollar o/n while the SENSEX fell more than 3%. Other emerging markets were lower as well, as the Turkish Lira hit an all-time low vs. the dollar.
- Despite the EM turmoil, economic data continues to impress as the German IFO business expectations survey slightly beat expectations.
- Econ Today: Case-Shiller HPI (E: 1.0%) m/m.

Market	Level	Change	% Change
S&P 500 Futures	1645.25	-9.00	-.56%
U.S. Dollar (DXY)	81.50	.059	.07%
Gold	1411.40	18.30	1.31%
WTI	106.90	.98	.93%
10 Year	2.805	-.013	-.46%

Equities

Market Recap

Stocks declined modestly to start the week as a late-day press conference by Secretary Kerry that implied an impending escalation of U.S. involvement in Syria sent market lower during the last hour of trading. The S&P 500 declined 0.4%.

Monday started on a sour note as the durable goods report badly missed estimates, but the market was resilient and largely shrugged it off. Until 3 p.m., it looked as though we were going to have small gains on the day.

But, the press conference from Secretary Kerry, while it didn't actually announce anything new, was more bellicose than expected. Shortly after it concluded, stocks began to decline and sold off right into the close, although the pace of selling was pretty calm and markets declined as much because of a lack of bids as opposed to aggressive selling. Yesterday's close wasn't nearly as ugly as last Wednesday's.

Trading Color

The Russell again outperformed, making the bulls happy. It finished fractionally positive while the Dow and S&P 500 were both down modestly, continuing the theme of small-cap outperformance that's been in place since last Tuesday.

From a sector standpoint, anything China-related (basic materials), industrials and biotech were the leaders Monday. The former rallied because of positive comments regarding the Chinese economy from the National Bureau of Statistics (official Chinese stats office), while the latter two were higher thanks mainly to M&A. In the

Market	Level	Change	% Change
Dow	14946.46	-64.05	-.43%
TSX	12760.30	-2.00	-.02%
Brazil	51429.48	-767.58	-1.47%
FTSE	6443.92	48.18	-.74%
Nikkei	13542.37	-93.91	-.69%
Hang Seng	21874.77	-130.55	-.59%
ASX	5141.22	5.81	.11%
Prices taken at previous day market close.			

industrial sector, TMS rallied 12% after it was announced the company was being acquired and taken private (TMS is in the steel industry). Meanwhile the healthcare sector rallied thank to a big biotech rally, as Amgen (AMGN) announced a takeover of Onyx Pharmaceuticals (ONXX).

Market	Level	Change	% Change
Gold	1393.20	-2.60	-.19%
Silver	24.07	.28	1.19%
Copper	3.33	-.03	-.77%
WTI	105.95	-.47	-.44%
Brent	110.99	-.05	-.05%
Nat Gas	3.51	.02	.60%
Corn	5.01	.31	6.65%
Wheat	6.67	.21	3.29%
Soybean	13.89	.62	4.63%
Prices taken at previous day market close.			

Conversely, "bond proxy" sectors again were lower despite interest rates falling, as utilities, telecom and REITs continued to underperform. Financials also lagged thanks so some political concerns in Italy. (Silvio Berlusconi is threatening to collapse the government if they expel him from the Senate because of his fraud conviction, but at this point it looks like some sort of shady deal will be reached to avoid that outcome.)

Volumes were very light yesterday, and the normal dip in volumes given it's the last week of summer was compounded by the fact that the UK was closed yesterday, so trading was very, very thin. On the charts the late-day sell-off resulted in the S&P 500 closing below its 50-day moving average, but real support is now the intraday lows of last week (1,639).

Bottom Line

Yesterday was a slow day and markets did little other than drift around. The fact that the Kerry presser caused a mild sell-off speaks more to the lack of activity in the market than the threat of Syrian intervention. If anything actually happens, I'm reading it'll be a Kosovo-type intervention with cruise missiles—definitely not troops on the ground.

Bottom line is emerging markets are still driving the bus. They weren't a disaster yesterday but there weren't any real signs of stabilization, either, as the real and peso both sold off throughout the day despite the rally in Treasuries. Until emerging markets stabilize, it'll be very hard for stocks to make material gains, plain and simple.

Is QE Now In a Downtrend?

One of the more talked-about papers to come out of the Jackson Hole central bankers' meeting was one presented by professors Arvind Krishnamurthy and Annette Vissing-Jorgensen from Northwestern and U.C. Berkeley, respectively, that stated QE has been much less potent than the Fed believed it would be.

That paper adds to a string of academic arguments lately that question the effectiveness of the QE program. (Earlier this month a paper from the San Francisco Fed implied "forward guidance" is more-powerful than QE.)

Being that I watch these kinds of things from the perspective of someone who has spent his entire career in markets, I get the sense that QE's popularity as a monetary policy tool has peaked, and is now in a clear downtrend. Now "forward guidance" seems to be entering a bull market, as the world's central banks use guidance to try to keep interest rates down.

I'm certainly not qualified to be a central banker, but I get nervous that the Fed is finally about to make a mistake they have avoided for 5+ years—namely erring on the side of some academic theory that, in real life, simply won't work.

The idea that "forward guidance" will be as effective at putting downward pressure on interest rates may make perfect sense in a classroom or a textbook, but as we've seen recently in the UK and are seeing here in the U.S., "forward guidance" doesn't seem to work as well as academics think.

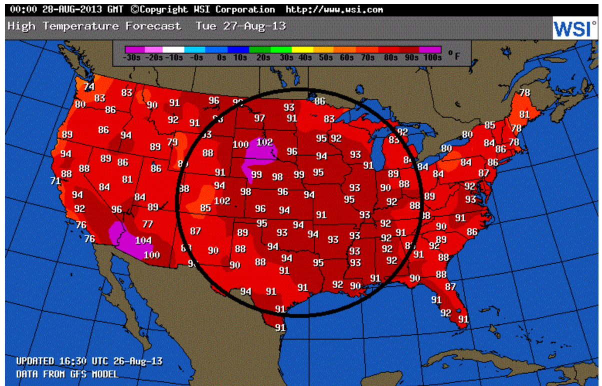
The failure, I believe, comes from two sources: First, markets are always anticipating the *next* move, so they are already trying to discount when rates will increase, and basically are ignoring the Fed's promise to keep them low until 2016. Second, markets simply don't believe central banks' long-term forecasts, and for good reason. The Fed, and pretty much everyone else, is horrible at forecasting where the economy will be in 3+ years.

So, given the market doesn't believe the forecasts, a promise to keep rates low until 2016 is about as credible as a promise to keep rates low until 2066. I say that because the market knows if the economy picks up between now and then, rates will rise, regardless of what the Fed promises today.

I don't like to talk about abstract economics unless it has practical implications, so here's why I'm bringing this up: You are going to read in the mainstream financial media over the coming months that forward guidance will keep interest rates low. I do not believe that to be true.

If the Fed does indeed embrace forward guidance as their primary policy tool over the coming quarters, in place of QE, then I believe the bearish argument for bonds gets much, much stronger.

Watching this market for years I can tell you, academic papers aside, that QE has put massive downward pressure on rates, and QE has acted as a "governor" of sorts on this recent rise in rates. If the Fed takes that "governor" off sooner than they otherwise would because they think "forward guidance" will replace it, I think its fair to say I'll go from a bear on bonds, to a super bear.



Scorching heat across the Plains and Mid-West has caused huge short covering in the grain markets.

Economics

Durable Goods

- July Durable Goods were -7.3% vs. -4.0%.
- NDCGXA fell 3.3% in July.

Takeaway

It's two in a row for bad economic releases, as the big miss in new home sales Friday was followed by a big drop in durable goods orders in July. The 7% decline was much-worse than the expectations although, as normal, you can largely ignore the headline in durable goods because it is so heavily affected by airplane orders.

Market	Level	Change	% Change
Dollar Index	81.446	.085	.10%
Euro	1.3368	-.0015	-.11%
Pound	1.5571	.0002	.01%
Yen	98.66	-.06	-.06%
CAD $	.9520	-.0008	-.08%
AUD $	.9027	-.0003	-.03%
Brazilian Real	.4196	-.0060	-1.41%
10 Year Yield	2.807	-.008	-.29
30 Year Yield	3.789	-.006	-.16
Prices taken at previous day market close.			

The key number to watch in durable goods is new orders for "Non-defense capital goods excluding aircraft" (NDCGXA). It gives the best picture of the state of capital expenditures from businesses as well as consumers' demand for big-ticket items. Unfortunately, NDCGXA fell 3.3% in July, its largest drop since February, confirming that July was soft for capital expenditures.

A miss of this magnitude would normally result in futures falling. But markets, with the exception of Treasuries, largely ignored the release—mainly because I don't think anyone expects one bad durable goods number to materially alter Fed policy with regard to tapering, and I agree with them.

That's because the Fed likes to watch trends in data, not single data points. To that end, the rolling three-month average of NDCGXA is 6% higher than it was at the start of the year. So, the July number was a disappointment, but clearly we've seen improvement in capital expenditures so far this year.

Bottom line is this will keep people on edge about whether the economic recovery is still accelerating, but by itself it shouldn't materially delay any tapering of QE.

Commodities

Commodities were mixed yesterday, but strength in the grains and relatively muted trading everywhere else helped propel DBC to highs not seen since early April. The two main pieces of news in the commodity markets were positive comments regarding Chinese economic growth and the durable goods report. Starting with the former, a spokesman from China's National Bureau of Statistics confirmed the recent uptick in Chinese economic data and stated they were seeing stabilization in the economy. Importantly, they expressed confidence that the country would see 7.5% GDP growth in ’13. Encouragingly, the spokesman cited improved global demand (Europe) as one reason for the stabilization in the Chinese economy.

But, while that pushed commodities higher initially, the soft durable goods report weighed on industrial commodities, and copper finished lower by nearly 1%. WTI crude and energy in general were both broadly flat as both closed before the State Department presser. But, we’re seeing a rally in energy this morning as prospect of military action in Syria is putting a small bid under oil.

As mentioned, grains were the star performers Monday. Corn rallied 7.7% and soybeans 5% as simply oppressive heat has descended upon the Midwest, at a critical stage for the late-planted crop. And, while a few days of heat won’t cause the damage last year’s drought did, an event like that in a market that was very, very short can cause panic-covering, which is what we saw yesterday. But, short-term rallies aside, unless this heat sticks around and does material damage to the crops, then I don’t see any way grains can enter another sustained rally given that we’re looking at simply massive crops this fall.

Precious metals got a boost from the weaker-than-expected durable goods number, and for an instant gold traded above $1,400/oz yesterday selling off on heavy selling. But, gold traded through $1400/oz. after the State Department press conference, and has spent all night holding that level. Gold’s strength aside, though, silver, continues to be the star performer. Silver rallied 1% yesterday and is now up 22% for the month, as the shorts have been absolutely slaughtered. The next level of resistance for silver lies at $24.40-ish, which is a downtrend line extending back to November 2012. If that resistance can be broken, then it’ll be mostly a straight shot to the highs-$20 dollar range.

Looking at the Commitment of Traders reports in both gold and silver, both markets remain healthy, and nothing would imply this recent rally is going to run out of steam. “Net longs” increased, as you’d expect, but at 48K contracts in gold, they are well-below levels you’d consider a warning sign.

Silver, despite the huge rally in August, also has pretty healthy COTs. The number of shorts has been cut in half from the record levels April, but at 13K contracts, they remain well-above the levels which you would consider to reflect too much bullishness. (When short contracts are below 4K, it’s a reason to get a bit nervous about a continued rally.)

Whether gold and silver can break through these next levels of resistance will be decided by the economic data and the dollar, but at this stage the fundamentals in the market don’t imply this rally is running out of gas—far from it.

Currencies & Bonds

Emerging-market currencies, which remain the key currencies to watch, all declined yesterday, as the rupee fell 1%, the real fell 0.8% and the peso fell 1.2%.

That’s not necessarily surprising given the bounce at the end of last week, but the key levels now are last Wednesday’s lows. So, $18.42 in the WisdomTree Indian Rupee Fund (ICN), 0.4066 in the real and 0.0750 in the peso. If those currencies make new lows this week, then this latest round of market turmoil isn’t over.

Looking at the developed-market currencies yesterday, it was very quiet. The Dollar Index, euro, pound, Aussie, Loonie and yen were all flat in lack luster trading.

Treasuries rallied initially following the soft durable goods report (investors thinking it would possibly delay QE), but as the day wore on the reality sunk in that one weak durables number isn’t going to materially affect Fed policy. Treasuries moved back toward flat throughout the session. But, they rallied throughout the last hour of trading as the stock market sold off, at least particularly on the saber-rattling from Secretary Kerry.

More broadly, while Treasuries clearly remain in a downtrend, I’d expect that 2.90% level in the 10-year yield to act as a top until the next major Fed-related catalyst, which is the jobs report next Friday. Until then, I’d expect a chop sideways or small rally in yields, depending what happens with Syria.

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 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.

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.

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.**