7:00's Report

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

August 28, 2013

Russell 2000: So much for bottoming first. The Russell fell more than 2% yesterday and is now sitting on last Monday's lows. A breakdown from here confirms we're looking at something more than a small correction.

Pre 7:00 Look

- Futures bouncing slightly after yesterday's sharp declines, but emerging markets weakness is again weighing on global markets. Asia bore the brunt of the selling as emerging markets in the region were sharply lower.
- India's Rupee collapsed more than 3% to another new all time low vs. the dollar, and India's SENSEX fell more than 2% before both rebounded in late trading.
- Nothing new on Syria as WTI hit $110/bbl. on anticipation of a US missile strike expected in the coming days.
- Econ Today: Pending Home Sales Index (E: -1.0% m/m).

Market	Level	Change	% Change
S&P 500 Futures	1628.75	.50	.03%
U.S. Dollar (DXY)	81.30	.10	.12%
Gold	1424.80	4.60	.32%
WTI	109.97	.96	.88%
10 Year	2.721	-.084	-2.99%

Equities

Stocks had another ugly day Tuesday as continued emerging-market turmoil and expected military action against Syria led markets to steep declines. The S&P 500 declined 1.59%.

While concern about military action in Syria dominated the market narrative yesterday, continued emerging-market turmoil was more responsible for the weakness in equities. Even if Syria wasn't in the news, with the rupee plunging to another new all-time low vs. the dollar, I think the market would have seen similar declines.

But, while emerging markets and Syria were the main negative influences on stocks Tuesday, the day also served as a reminder of the debt-ceiling fight coming. (Treasury Secretary Jack Lew said the administration won't negotiate on the debt ceiling, while House Speaker John Boehner later in the day said he expected a "whale of a fight.") And, not to be outdone in the governmental circus department, concerns still linger over whether Silvio Berlusconi will collapse the Italian government unless they give him his "get out of jail free" card.

Combine all of that with a low-volume, low-attendance summer day, and it's easy to see why markets were under pressure all day and went out basically at their lows. (The Boehner comments came late in the day and were responsible for the last leg lower.)

Trading Color

First off, the Russell 2000 badly underperformed yesterday, and any hope the bulls had about the Russell bottoming first is in serious doubt, as the Russell fell 2.4% yesterday and is sitting on last week's lows.

Market	Level	Change	% Change
Dow	14776.13	-170.33	-1.14%
TSX	12591.21	-169.09	-1.33%
Brazil	50091.55	-1337.93	-2.60%
FTSE	6404.55	-36.42	-.57%
Nikkei	13338.46	-203.91	-1.51%
Hang Seng	21524.65	-350.12	-1.60%
ASX	5087.16	-54.05	-1.05%
Prices taken at previous day market close.			

From a sector standpoint, we saw a pretty typical "risk off" trade yesterday, as utilities bucked the recent trend of underperformance. They were actually the only S&P 500 sub-sector to finish positive, while consumer staples relatively outperformed as well.

Market	Level	Change	% Change
Gold	1418.70	25.60	1.84%
Silver	24.66	.60	2.49%
Copper	3.33	.01	.21%
WTI	109.03	3.11	2.94%
Brent	114.05	3.32	3.00%
Nat Gas	3.52	.00	.06%
Corn	4.86	-.14	-2.90%
Wheat	6.63	-.03	-.45%
Soybean	13.70	-.19	-1.37%
Prices taken at previous day market close.			

Financials were the worst-performing sub-sector yesterday, and that's part of the reason we know it was emerging markets, not Syria, that remain the key negative influence on markets. If we see emerging-market turmoil turn into a full-blown crisis, then financials, and banks in particular, are most-exposed.

Outside of financials, cyclical sectors led to the downside, as you'd expect in a "risk off" trade.

On the charts yesterday, it was not a good day. The S&P 500 and Dow smashed through last Wednesday's low, and the next level of support is in the mid- to low-1,600s. Volumes remain low and trading very thin, but the technical situation in the market is deteriorating.

Commodities are up 2% this week, and appear to have clearly broken out to the upside.

Bottom Line

Bottom line is the renewed turmoil in the emerging markets is continuing to weigh on stocks, and until those markets settle down (especially India), it'll be hard for stocks to rally. Syria, the issue of Bernanke's successor, and the looming debt ceiling battle aren't helping things either, although none of those are "bearish game changers" like a potential EM crisis. And, we are still a ways from a crisis, concern grows as each day passes with no stabilization.

All that said, from a positioning standpoint, I think it's hard to get outright defensive even after some very sloppy trading in August, because this decline has come on such low volume and thin trading. And, for context, the S&P 500 is only off 4.6% from the all-time highs. I obviously could be wrong, but I think it behooves everyone to see how markets act once people are off the beach and back at their desks in early September. But, I wouldn't be adding to domestic equity exposure down here either, and if I needed to add incremental risk exposure in some tactical accounts, I'd continue to look to the UK (EWU) and basic materials/commodities if you have anything beyond a very short term time horizon (commodities are a touch overbought in the near term). If we see stabilization in emerging markets, those two sectors should continue their outperformance on the back of improving economic data.

Economics

No reports yesterday.

Commodities

Commodities were up big yesterday (DBC up 1%) as worries over Syria resulted in big rallies in the precious metals and energy. Another piece of stronger-than-expected Chinese economic data (industrial profits were better than estimates) and a weaker U.S. dollar also helped push commodities higher, but really yesterday was all about Syria.

And, showing the benefits of diversification: Although commodities have lagged badly this year, I want to point out that while most major global stock markets are down around 2% so far this week, the commodity ETF DBC is *up* 2.3%, to a 4+ month high.

Since Syria was behind the moves in commodities, instead of recapping the moves in the energy and metals markets (energy, including oil, was up about 2.5% yesterday, while gold rallied 1.5% and silver 2%), it's more useful to explain exactly why Syria matters, and whether it's going to be an ongoing positive for the commodity markets.

First, we've got to think about Syria in the context of everything else going on in North Africa and the Middle East. Egypt, which continues to teeter, has been pushed to the back burner, but the debate about whether to suspend U.S. aid is still ongoing. If the U.S. suspends aid, that's a serious blow to the military-controlled government. The Saudis, the world's No. 2 oil producer, have expressed support for the military rulers, so if the U.S. does suspend aid, we can assume the Saudis will be none too pleased.

Now let's move on to Syria, where we are considering a military strike. The Russians, the world's No. 1 oil exporter, support Syrian President Bashar al-Assad's regime. It's very safe to say that they will be upset by any U.S. military strike, as they want to see the current administration stay in place. And, the Syrian conflict has further cooled already-frosty U.S./Russian relations. (Russian Deputy Prime Minister Dmitry Rogozin said on Twitter yesterday that "the West behaves toward the Islamic world like a monkey with a grenade.")

So, there are two situations where U.S. interests seem, potentially, at odds with the world's two largest oil producers. Point being, while it's unlikely that either situation will escalate too much further (even if we strike Syria it's likely to be very limited, which will result in Russian criticism in the press but little else), the potential fallout, if either one does escalate significantly, is serious with regard to the world's immediate energy needs. That is why Syria, a country of approximately 145K bbls/day of oil production, is causing so much consternation right now.

WTI crude yesterday broke through resistance at $108/bbl and hit a new high for the year, as geo-political premium is pumped into the contract. Gold also rallied through resistance at $1,400/oz. and silver traded through the $24.43 level, breaking a downtrend in place since last fall.

Market	Level	Change	% Change
Dollar Index	81.150	-.257	-.32%
Euro	1.3389	.0021	.16%
Pound	1.5538	-.0038	-.24%
Yen	97.10	-1.41	-1.43%
CAD $	.9537	.0014	.15%
AUD $	.8973	-.0057	-.63%
Brazilian Real	.4217	.0020	.48%
10 Year Yield	2.72	-.071	-2.61%
30 Year Yield	3.693	-.074	-2.00%
Prices taken at previous day market close.			

The rules of technical trading say that we should buy gold, silver and oil here, as they've broken through resistance and made new multi-month highs. But, I have a very hard time buying anything when an extraneous event like Syrian military conflict is behind the move. That's because in reality we're just guessing, as we've got no edge or insight as to when and how the U.S. will strike Syria, and what the reaction will be. And, guessing with no discernible edge in this business inevitably leads you into trouble.

So, if you're long commodities and made the good buy back in June and July, I think you enjoy this rally. However, just realize it's fickle and that, if the global macro backdrop settles down, we'll see WTI and gold give back yesterday's gains.

But, more importantly, looking beyond Syria, I believe both gold and oil are seeing the environment get more-bullish for the remainder of the year. If we see continued progress in the global economy, expect consistently higher prices once all this Syria turmoil settles down.

And, I think the commodity space in general, while a bit overbought, continues to offer an attractive place for incremental capital and potential outperformance between now and the end of the year. If you're not long commodities already, though, I'd be inclined to wait for a pullback before getting broad commodity exposure via DBC or a similar ETF.

Currencies & Bonds

Emerging markets remain at the center of market turmoil, so until that changes, I'm going to continue to lead this section off with analysis of EM currencies and debt.

EM currencies weren't universally lower yesterday (the Brazilian real rallied). But for all intents and purposes it was another ugly day, and clearly emerging markets haven't yet stabilized. The rupee hit another record low vs. the dollar, as did the Turkish Lira, while the Mexican peso traded 0.4% lower vs. the greenback.

Emerging market bonds, as measured by PCY and EMB, also declined modestly. They look to be headed to test last week's lows, which need to hold—otherwise this whole situation will likely get substantially more ugly. Watch $105.68 in EMB and $26.28 in PCY (last week's lows) as levels of key support.

Staying with bonds, Treasuries saw a big rally, with the 30-year rallying 1% as geo-political tensions are causing bond shorts to cover. Treasuries, regardless of their medium- to longer-term outlook, remain the asset of last resort whenever military conflict looms.

I said yesterday that 2.90% may be the top in 10-year yields for a bit in the bond market, and that seems to make even more sense this morning, as yields have fallen to 2.72% and appear headed lower. Sooner or later every market corrects (or in the case of bonds, bounces) and it appears if Syria or the EM crisis escalates further, we'll be entering that type of period. But, the larger trend in bond remains lower, so I'd look to use any material bounce to either get short, or get more short, via ETFs like TBF, TBT and STPP.

Turning to the developed-market currencies, the Dollar Index declined yesterday, which isn't what usually happens when the stock market is down well over 1%. But before I get to why I think that happened, we need to first point out that the yen was the huge outperformer yesterday, rallying 1.6% vs. the dollar solely on a "risk aversion" trade.

The yen has now held support exactly on the uptrend line dating back to the May lows, and it looks as through Syria and emerging-market concerns are prolonging this counter-trend rally in the yen. So, point being, it's not time to initiate or add to shorts yet, although it's important to note there was no fundamental reason for the big yen rally yesterday—it was just scared money flows searching for a safe haven ... which will reverse just as quickly if Syria and emerging markets both settle down.

As mentioned, the dollar decline was surprising yesterday. First, the dollar is typically a "safe haven" currency, in that it rallies when stocks decline. Second, CNBC reported yesterday that they had sources from "Team Obama" indicating that Larry Summers will be the next Fed chairman, which should be taken as slightly hawkish (if it does indeed happen).

But, as opposed to finding some meaning in the dollar decline, the simple fact is the Dollar Index is very heavily weighted to the euro and yen (together they make up more than 60% of the index). So, on a day when the euro was slightly stronger vs. the dollar (off the positive German IFO business-sentiment indicator) and the yen was very strong vs. the dollar, it's going to be almost impossible for the Dollar Index to go up. The declines aside, through, the 81 level remains key support, and until it's decisively broken, I remain a dollar bull.

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 yet (which would be a signal to de-risk) but stocks will have a hard time rallying until the emerging markets stabilize. The S&P broke through the lows of last week, and support is now around 1620ish.*

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	Bullish	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.**