# 7:00's Report

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

***August 5, 2013***

## Pre 7:00 Look

- Futures flat after a very quiet weekend, as economic data is in focus once again this morning.
- EU economic data continues to be better than estimates: EU & UK services and composite PMIs beat expectations, helping European markets rally modestly.
- Chinese service and composite PMIs also beat expectations, again implying the pace of economic growth may be leveling off. Chinese shares rallied small on the news.
- Econ Today: ISM Non-Manufacturing Index (53.0).

| Market | Level | Change | % Change |
|---|---|---|---|
| S&P 500 Futures | 1703.50 | -0.25 | -.01% |
| U.S. Dollar (DXY) | 81.92 | -.06 | -.07% |
| Gold | 1310.10 | -1.40 | -.03% |
| WTI | 106.57 | -.38 | -.36% |
| 10 Year | 2.602 | -.121 | -4.44% |

## Equities

Stocks surged last week thanks to better-than-expected economic data, as the S&P 500 broke through 1,700 and traded to a new all-time high. The S&P 500 is now up 19.88% year-to-date.

Stocks spent the early part of last week flat, and they remained that way through the dovish FOMC statement Wednesday before staging a big rally Thursday on the back of strong international and domestic economic data. Markets were also able to shrug off the mildly disappointing jobs report Friday and close slightly higher.

Last week was also the final big week of earnings, and generally the results were in line with what we saw all earnings season. From Bloomberg: 390 of 500 S&P 500 companies have reported; 74% have beaten estimates while 56% beat on revenues. Those final numbers held pretty firm the entire reporting period. So, the takeaway from earnings is that 1) the results weren't enough to derail the rally and 2) more importantly, the outlooks for the second half of the year and 2014 weren't materially downgraded, leaving many to expect a significant uptick in growth and earnings later this year.

The fact that the good economic data last week is driving this rally can be seen in the sector trading, as the strong ISM manufacturing PMIs and better-than-expected Q2 GDP report resulted in strong outperformance from industrials, financials, consumer discretionary (helped by Friday's spending report) and homebuilders (which were aided by the FOMC signaling out higher mortgage rates as a risk).

Conversely, higher-yielding, less-cyclical stocks underperformed despite the volatility in interest rates (so we definitely saw a resurrection of the "out of safety /into cyclicals" rotation from earlier this year). REITs, utilities, telecom and consumer staples all lagged the market as money searches for higher-beta exposure.

So, bottom line is the sector trading and certain market internals are confirming the rally we are seeing in the broader averages. Meaning: As of last week there weren't any big divergences that would make you nervous that this rally can't continue.

Volumes and activity were both elevated last week, further confirming the strength in stocks. On the charts the S&P is at new highs, while support lies lower in the mid-1,680s.

| Market | Level | Change | % Change |
|---|---|---|---|
| Dow | 15658.36 | 30.34 | .19% |
| TSX | 12603.25 | 9.29 | .07% |
| Brazil | 48474.04 | -666.74 | -1.36% |
| FTSE | 6658.85 | 10.98 | .17% |
| Nikkei | 14258.04 | -208.12 | -1.44% |
| Hang Seng | 22222.01 | 31.04 | .14% |
| ASX | 5111.25 | -5.51 | -.11% |
| Prices taken at previous day market close. | | | |

*This Week*

It should be quiet in the markets this week, with much more focus internationally than domestically. The Chinese economic data is the highlight of the week, but also look for markets to further monitor the evolving "Who will replace Bernanke?" saga. Right now it's down to three candidates: Yellen, Summers and Kohn. Although they seem to be the "final three," none of them appear to have a distinct edge. Finally, there are some Fed speakers this week, but none of the "Big Three" of Bernanke, Yellen or Dudley are speaking, so the speeches shouldn't be too market-moving. Expect a slow week.

| Market | Level | Change | % Change |
|---|---|---|---|
| Gold | 1312.90 | 1.70 | .13% |
| Silver | 19.85 | .22 | 1.13% |
| Copper | 3.17 | .001 | .02% |
| WTI | 106.88 | -1.01 | -.94% |
| Brent | 108.89 | -.65 | -.59% |
| Nat Gas | 3.34 | -.05 | -1.54% |
| Corn | 4.64 | -.03 | -.70% |
| Wheat | 7.07 | 0.0 | 0.00% |
| Soybean | 12.13 | -.22 | -1.74% |
| Prices taken at previous day market close. | | | |

*Bottom Line*

This market remains extremely data-dependent, and the data is getting better. Combine that with relative macroeconomic calm and sentiment that remains pessimistic and skeptical of the rally. This has resulted in continued underinvestment in equities, and that is a recipe for a rally. And, for the "umpteenth" time over the past year, stocks spent two weeks consolidating recent gains before gapping higher to new highs. Until the economic data begins to moderate or sentiment becomes too bullish (neither or which are a risk at this moment), then the path of least resistance remains higher.

From a valuation standpoint, I'll point out that the S&P 500 is trading at 14.8 times its 2013 EPS estimate of 110, and 15.5 times its '14 EPS estimate of 120/share. So, it's not cheap, but not crazy-expensive, either—especially if the economy continues to improve. Point being, if you don't like this market, make sure it's not because you believe stocks are "expensive." Historically, they aren't.

But, before you run out and buy 100% of stocks, risks remain—including a slowdown in the economy. (If the housing recovery stalls, the economy's got a problem, and that's the area of greatest risk given higher rates.) Speaking of higher rates, remember it's the pace of the rise, not the absolute level, that could derail the rally. Yields jumped higher to new highs for the year Thursday, but settled in. As long as the rise is orderly and emerging-market debt "behaves," then higher rates and higher stocks prices can exist.

Bottom line, the market remains strong despite the risks internationally and globally. But, I continue to think the strongest trends are of higher rates (so TBF, TBT, SJB, STPP) and Europe continues to be a source for potential outperformance. (If you've missed the rally in the S&P 500, consider potential European exposure as away to generate some outperformance.)

# Economics

*Last Week*

The economic data and central bank announcements last week were expected to help provide greater clarity on the three major questions in the market right now: When will the Fed taper? Is the European economy stabilizing? Is the slowing of China's growth getting worse?

Despite almost universally better-than-expected economic data (the jobs report being the notable exception), what we got was more clarity on the latter two questions, but surprisingly more confusion on the outlook for Fed "tapering," which is by far the most important topic in the markets right now.

In Europe, manufacturing PMIs rose back above 50 and largely the economic data signaled the EU economy is finally stabilizing. In China, the data wasn't any worse than expected, and Chinese officials were again saying they will defend economic growth as needed. So, bottom line was last week was good for both Europe and China and, with regard to Europe, the numbers point to continued potential outperformance.

Looking at the economic data domestically, last week was a good week and further implies that the economy is continuing to recover. ISM Manufacturing PMI was a very strong number not only on the headline (which hit a multi-year high), but the details of the report were also strong. They further confirmed what we've been pointing out here for over a month: that the manufacturing sector of the economy is finally recovering, and this recovery is starting to accelerate.

Lost in the jobs report hysteria Friday was a strong personal income and outlays report, which showed consumer spending beat expectations for June. (The weak retail sales report of two weeks ago raised some concerns about the health of the consumer, so Friday's report is helping alleviate those concerns, somewhat.) Additionally, the "Core PCE Deflator," which is the Fed's preferred measure of inflation, ticked a bit higher. It shows year-over-year inflation at 1.3%, up from 1.0% in May, and core inflation up 1.2%, up from 1.1% in May. This is important because if inflation ticking up, as it appears to be doing, then that is a good thing for the economy.

The one disappointment last week was, of course, the jobs report. The report itself wasn't particularly good in that, not only did the headline miss, but "leading indicators" of the jobs market were also surprisingly weak. Average hourly earnings and average workweeks were flat to down from the May report (both move higher ahead of jobs gains as employers increase current employees' pay and hours before adding new employees).

For all the gnashing of teeth Friday morning, though, the miss itself wasn't really all that bad (162K jobs added vs. (E) 185K) and I'd characterize it as a "ho-hum" report, not a "weak" report.

Finally, the biggest "event" of last week was the Fed meeting, and this is where things got confusing.

The Fed statement was "dovish" in that they lowered their commentary on economic growth, and also cautioned on low inflation and an uptick in mortgage rates, and the dovish message surprised markets.

Last week the economic data continued to show the economy is recovering, which would imply "tapering" is on schedule for September. But, the Fed has thrown that into doubt with the newest statement. Bottom line is this: Despite the whiplash caused at the end of last week by a dovish Fed, strong data and then a ho-hum jobs report, the expectation remains for tapering of QE to start in September, although that's not as concrete as it was this time last week.

| Market | Level | Change | % Change |
|---|---|---|---|
| Dollar Index | 82.00 | -.427 | -.52% |
| Euro | 1.3288 | .0072 | -.54% |
| Pound | 1.5280 | .0165 | 1.09% |
| Yen | 1.0116 | .0065 | .65% |
| CAD $ | .9616 | -.0039 | -.40% |
| AUD $ | .8884 | -.0027 | -.30% |
| Brazilian Real | .4355 | .004 | .93% |
| 10 Year Yield | 2.602 | -.121 | -4.44% |
| 30 Year Yield | 3.688 | -.086 | -2.28% |
| Prices taken at previous day market close. | | | |

*<u>This Week</u>*

Domestically it is very quiet this week. The three things to watch are: non-manufacturing (service sector) PMIs this morning, the Mortgage Bankers Association's purchase application data Wednesday morning, and jobless claims Thursday. The MBA purchase applications will take on added importance because the Fed singled out higher mortgage rates last week as a potential headwind on the economy. So, a weak purchase application number, one that further implies the housing recovery is losing steam, will be "dovish" ... and not positive for stocks. Finally, jobless claims hit a new, multi-year low last week, and if that trend can continue, it will help alleviate some of the concerns about the labor market raised by last week's jobs report.

Internationally, it's a much-busier week. Most importantly, we get the latest round of Chinese inflation and economic data Thursday night/Friday morning. Clearly, given concerns over Chinese economic growth and whispers of potential stimulus from Chinese officials, these numbers are important. If Chinese growth can level off, that's a big positive for risk assets.

In Europe, there will be a lot more insight into whether the EU economy is indeed stabilizing. Composite PMIs and retail sales this morning—and UK and German industrial production tomorrow and Wednesday—will be watched closely to see if economic data further improves. The big event is the Bank of England's "Inflation Report," which will be issued Wednesday. This is important because the BOE will elaborate more on their use of "forward guidance" as a monetary policy tool to help keep interest rates low. No one knows exactly what they will say, but the expectation is they will use forward guidance and, on balance, be dovish. This should be good for UK stocks.

Bottom line is it's an important week for China and Europe, but domestically, with regard to the Fed, none of the data will change current shaky expectations of "tapering" in September—we will have to wait for the FOMC minutes for more color there.

**Finally, keep this in mind: The market is "OK" with tapering in September as long as the data stays good (which it is). If "tapering" is delayed, it will be because of a weak economy or threat of deflation, and neither are good for stocks. So, if tapering of QE is delayed, it will not be bullish for equities.**

## Currencies, Bonds & Commodities

Currencies and bonds were easily the most-volatile markets last week, as both markets are now trading off Fed expectations, and gyrations around those expectations Wednesday through Friday led to extreme volatility in the dollar and bonds.

The Dollar Index rallied off six-week lows last week in volatile trading. After the "dovish" FOMC statement Wednesday, the Dollar Index traded to a new six-week low, only to violently reverse Thursday thanks to the strong economic data, before giving back nearly half of those on Friday post-jobs-report. This week we should see less volatility, but expectations for the Fed will continue to dominate currency trading in the short term, with the dollar being the key catalyst for other currencies, as it was last week.

Both the euro and pound traded mostly in reaction to the dollar last week, as both central bank meetings were relative non-events vs. expectations. The euro rallied slightly last week while the pound was lower, as investors were heavily selling the pound early ahead of this week's inflation report.

The one currency that didn't key off what the U.S. dollar was doing was the Aussie dollar, which imploded to new, multi-year lows vs. the greenback, trading below 0.89 after a Reserve Bank of Australia governor strongly implied the RBA will cut rates at this week's meeting. Although we'll see a bounce in the "Aussie," most expect it ultimately to trade to the low- to mid-0.80s before finding a bottom. Finally, the yen was also volatile, taking its cues from the dollar like most other currencies, but continues to consolidate around the 99-100/dollar level. This week's Bank of Japan meeting is not expected to contain any surprises, so a chop in the yen will likely continue. For you chartists out there, it appears there is a pretty definitive uptrend line from the May lows in the yen, so a break of 0.9970 vs. the dollar would, to me, signal this rally is ending, as the fundamentals over the medium term remain yen-negative.

Turning to bonds, Treasuries were also extremely volatile last week, as the 30-year note declined despite a huge rally Friday. The 30-year bond sold off hard Thursday in reaction to the strong economic data, and overnight Thursday it hit a new 52-week low. But, the jobs report resulted in a big rally Friday, and given the quiet calendar this week I'd expect Treasuries to rally a bit and continue the bounce that started Friday.

But, to keep perspective, while doubts about "When" Fed tapering will begin appear to be lending support for bonds/weighing on the dollar, the Fed will taper, whether it's September or December. The only thing that can stop Fed tapering now is if economic data turns soft—rhetoric from the Fed to "talk down" rates will push rates down, but it won't change the fact that the Fed needs to start tapering QE. So, I would continue to view any rally in Treasuries, including one that might occur over the next few days or weeks, as an opportunity to get more short bonds. The trend remains clearly of higher rates and lower bonds, and it will be so as long as the economy is improving.

There won't be a ton of commodity commentary today because more-important things happened in other markets, but commodities were mildly higher last week as the good economic data helped offset a stronger dollar. WTI crude had a big rally the back half of the week and remains in an uptrend, while gold remains stuck in the $1,300-$1,340 trading range. Commodities remain attractive if you believe we're seeing a turn in the global economy, but for now it's not clear that the downtrends have been broken.

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** | *The S&P 500 rallied to a new all time high this week on the back of strong economic data. The path of least resistance remains higher for stocks as the market is comfortable with Fed "tapering" of QE, investor sentiment remains less than enthusiastic, and cross assets like emerging market are stable.*<br>*The S&P 500 broke through resistance at 1700, while support is lower around 1680.* |

**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 put in a bottom, but are facing stiff headwinds from a "hawkish" FOMC and a slowing growth in China. The recent rally in oil has helped push commodity indices into month's long resistance, and once again commodities are "knocking on the door" of breaking their downtrend.* |

**Trade Ideas**

***Long:*** **WTI crude remains one of the more bullish commodities, as increasing domestic demand will help push oil higher over the coming months. For those who think the global economy will see an acceleration of growth over the coming quarters, then 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 stabilizes. 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 outlook for FOMC tapering is more cloudy after the recent FOMC meeting, but despite the Dollar Index recent correction, the marginal direction of policy in the US is less accommodative, while it is of more "easy money" everywhere else, which is bullish for the Dollar in the medium term. I view this correction as a buying opportunity.* |

**Trade Ideas**

***Short*:** **Japanese Yen on any decent bounce (YCS being the ETF to use). Short the Aussie Dollar, given a weakening economy and dovish central bank (short FXA). 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.**