7:00's Report

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

August 7, 2013

Pre 7:00 Look

- Futures lower as markets continue to consolidate while a sharp drop in the Nikkei weighed on sentiment.
- The Nikkei fell 4% in thin trading as the yen rallied to a 6 week high this morning ahead of a BOJ announcement tomorrow., where there are expected to be no policy changes.
- The Bank of England's inflation report was released and, following the Fed, the BOE set a 7% unemployment threshold before QE is scaled back or rates are increased. Overall the guidance is mildly dovish, although the pound had pretty much priced this result in.
- Econ Today: No reports today.

Market	Level	Change	% Change
S&P 500 Futures	1687.00	-7.25	-.43%
U.S. Dollar (DXY)	81.55	-.11	-.13%
Gold	1278.10	-4.40	-.34%
WTI	105.56	.26	.25%
10 Year	2.642	.002	.08%

Equities

Market Recap

Stocks declined moderately Tuesday, with the S&P 500 falling the most since late June as concerns about the housing market, Fed tapering and general profit-taking weighed on stocks.

Markets started Tuesday mostly flat, but shortly after the open they traded lower. The S&P 500 spent basically the entire day down around 10 points (about 0.6%). There were a few reasons cited for the weakness. First, President Obama's backing of a bill in Congress to wind down Freddie Mac and Fannie Mae raised some concerns of a potential headwind for the housing market (more on that later). Second, Fed-speak so far this week has been a touch hawkish as Dallas Fed President Richard Fisher was hawkish (as he always is) Monday, while Chicago Fed President Charles Evans (who is considered neither a hawk nor a dove) made comments Tuesday where he said he couldn't rule out tapering in September. Finally, weakness in the retail sector after American Eagle Outfitters' (AEO) earnings cut weighed on the entire retail sector. (AEO was down 12% yesterday!)

But, while these factors contributed to lower share prices yesterday, they weren't really causal. Freddie and Fannie aren't going anywhere anytime soon, the market is "OK" with tapering in September, and retail isn't enough to bring down the entire market. Instead, stocks were stretched and in need of a correction in the short term. Throw in low participation and weak volumes, and a small decline can turn into a modest one with little to no volume, which is exactly what happened yesterday.

Trading Color

There was notable underperformance yesterday from the leaders of the recent rally. The Russell 2000 fell more than 1% and the Nasdaq underperformed, as clearly there was some profit-taking occurring.

It was also a pretty textbook "risk off" day in sector trading, as industrials and basic materials led declines, while financials and homebuilders were also very weak in reaction to the housing finance reform proposals. Utilities, healthcare and consumer staples all relatively outperformed, but every sub-sector of the S&P 500 was lower yesterday.

Volumes remain well-off their recent averages, although they were heavier than Monday, while on the charts the

Market	Level	Change	% Change
Dow	15518.74	-93.39	-.60%
TSX	12469.32	-133.93	-1.06%
Brazil	47421.85	-1014.59	-2.09%
FTSE	6533.10	-71.11	-1.08%
Nikkei	13824.94	-576.12	-4.00%
Hang Seng	21588.84	-334.86	-1.53%
ASX	5011.30	-94.33	-1.85%
Prices taken at previous day market close.			

Copyright 2013, Kinsale Trading LLC. All Rights Reserved. www.sevensreport.com

S&P closed back below 1,700 and support sits lower at 1,680-ish.

Bottom Line

Market	Level	Change	% Change
Gold	1277.90	-4.60	-.36%
Silver	19.29	-.24	-1.22%
Copper	3.16	-.02	-.44%
WTI	105.51	.21	.20%
Brent	107.82	-.88	-.81%
Nat Gas	3.31	-.01	-.12%
Corn	4.72	.02	.59%
Wheat	6.50	.04	.70%
Soybean	11.93	-.14	-1.16%

Prices taken at previous day market close.

Overbought markets correct, and at the moment there's no reason to think this is anything other than a correction in an upward trending market. The "reasons" for yesterday's sell-off were more coincidental than causal, and the truth is, this market has seen a big rally in the short term and needs another round of consolidation. The general market narrative remains the same, and until that changes, the benefit of the doubt remains with the bulls.

If this is the start of more than another round of consolidation, the Russell 2000 will be the "tell." It's led markets higher and will break first. Write down 1,040 in the Russell; it's the low from this latest correction and that support shouldn't be violated. If it is, it may be a sign this is something more.

Housing Initiative Review—Not Something to Worry About

The market-moving news yesterday centered on the housing finance reform speech that President Obama gave, where he voiced support for a bill aimed at winding down Fannie Mae (FNM) and Freddie Mac (FRE).

Generally speaking, markets—and housing sectors in particular—sold off because the general takeaway from the speech was, "If Freddie and Fannie go away, then mortgage rates will go up, which is bad for the economy." But, while that logic is correct, the market's reaction to the housing announcement more reflected the lack of any real market=moving news yesterday, more so than any potentially negative, real economic effect from the proposed legislation.

Recap

Basically President Obama yesterday reiterated his support for legislation currently in the Senate that would wind down Freddie Mac and Fannie Mae in five years, and replace them with an FDIC-like insurance system for the mortgage-backed security market called the Federal Mortgage Insurance Corporation (FMIC). But, before I go any further into what the legislation proposes, there are two important things to know.

First, this legislation was proposed by Senators Bob Corker (R-Tenn.) and Mark Warner (D-Va.) nearly two months ago (June 25) so the proposal detailed by the president yesterday isn't anything new. Second, the White House voiced its support for the legislation when it was originally proposed back then, so yesterday was just a more-public endorsement of housing finance reform. Point being, for all the press coverage, nothing really new was revealed yesterday.

With regard to what the bill does, as mentioned, it replaces Fannie Mae and Freddie Mac with the FMIC, and proposes that private pools of capital take over the two main functions of FNM and FRE—mainly mortgage securitization and private mortgage insurance. The private pools of capital would pay a fee to help capitalize the FMIC (like banks do with the FDIC). The FMIC would act as an insurer of last resort in a catastrophe scenario, like '08, but only after these private pools of capital took the first 10% of losses on the securities. Finally, the FMIC would only insure the "qualified mortgage" portion of any mortgage-backed securities (so more-risky tranches like subprime, etc. would go uninsured).

Again, the main concern the market has is that this legislation would increase mortgage rates. It almost certainly would because these private pools of capital would have to charge higher interest to offset their risk, which they currently don't have, given that FNM and FRE guarantee the vast, vast majority of the mortgage market currently.

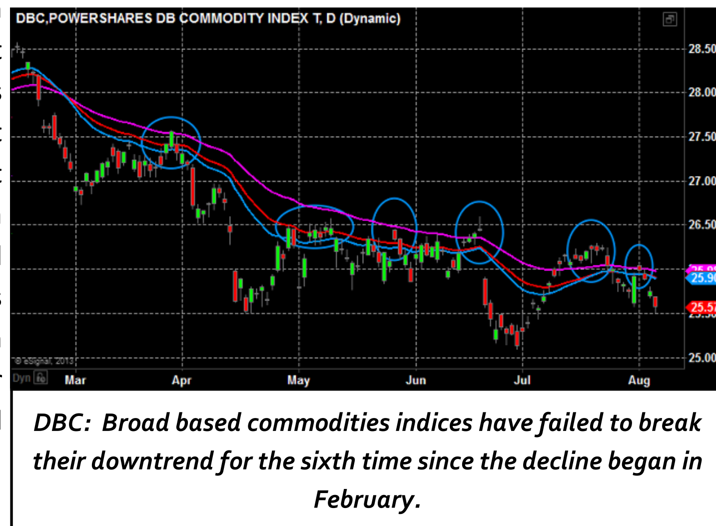
Bottom Line

Nothing is going to come of this anytime soon, for three reasons: First, this is one of many proposals currently floating through Congress, so there isn't even an agreed-upon path forward. Second, this is one of the most-incompetent Congresses in history (both parties), and the smart money bets on it to get nothing done every

Copyright 2013, Kinsale Trading LLC. All Rights Reserved. www.sevensreport.com

time—acting on this legislation should be no different. Finally, and most importantly, we're fast approaching an election year, and there is no way anyone in Congress wants to touch something as important as housing right before an election.

So, while there is a big need to reform FNM and FRE, don't expect it to happen anytime soon. If the market "sold off" in reaction to this news yesterday (and I don't think it caused the sell-off; it was more coincident with a market that seems stretched in the short term and needs to again consolidate), then you'd buy any further "housing reform"-related dip.



DBC: Broad based commodities indices have failed to break their downtrend for the sixth time since the decline began in February.

Economics

No Reports Yesterday.

Commodities

Commodities were again almost universally lower Tuesday, with weakness evenly distributed between both industrial and non-industrial commodities. The weakness came despite a modestly lower dollar and continued positive "chatter" from China regarding officials there defending economic growth. (There was some speculation Chinese officials may let the yuan depreciate later this year to help increase exports.)

Starting with the positive, copper was the only major industrial commodity to finish stronger yesterday, rallying small throughout the day. The positive "chatter" from China and good economic data from Europe clearly helped, and copper continues to try to break its months-long downtrend.

Market	Level	Change	% Change
Dollar Index	81.58	-.08	-.10%
Euro	1.33	.001	.08%
Pound	1.5351	.0007	.05%
Yen	1.0294	.0052	.51%
CAD $	.9592	-.0044	-.46%
AUD $	.8918	-.0043	0.48%
Brazilian Real	.4324	.0006	.14%
10 Year Yield	2.642	.002	.05%
30 Year Yield	3.73	.002	.05%
Prices taken at previous day market close.			

Certainly there is short-covering in copper ahead of the Chinese economic data Thursday, but if the data is good and copper can get above $3.18 and then $3.23, the decline will be over, and that's a good thing for China (and may be a signal to potentially look to the iShares FTSE/Xinhua China 25 Index (FXI) as a source of potential outperformance).

Elsewhere in the metals the outlook isn't too positive. Gold broke clearly though $1,300, falling 1.5% on a day the dollar was down 0.3%, so not exactly good relative performance. It appears that unless something changes, the gold decline isn't over. And if support is broken at $1,273-ish, look for a retest of $1,200 sooner rather than later.

Energy was broadly lower as well, with WTI crude falling 1% while Brent declined about half that (reflecting the stronger economic data from Europe Tuesday morning). But, although I'm not crazy about WTI's failure to make a new high last week, I still think the benefit of the doubt lies with the bulls given rising demand domestically and better economic data. So, I'd look to add to energy on a dip in WTI between $103.75 and $104.50 (the range between the 23- and 30-day exponential moving averages where WTI bounced last week).

The outlook for commodities seems to be turning a bit for the worse, and that's a touch confusing given the better global economic data. Maybe this is just reallocation or some peripheral selling of commodities as banks exiting the physical business continue to get more and more press. But broad-based commodity ETFs like the PowerShares DB Commodity Index Tracking Fund (DBC) appear to be rolling over, again.

Given that stocks have been able to rally all year despite commodity underperformance, I'm not sure commodi-

Copyright 2013, Kinsale Trading LLC. All Rights Reserved. www.sevensreport.com

ties rolling over is a necessarily a negative omen for the equity market. But I would like to see WTI crude hold last week's lows in the high-$103 level. If it doesn't, I'll get a bit more nervous in the short term for equities.

Currencies & Bonds

The Dollar Index declined 0.3% yesterday as money rotated into the euro and pound after Tuesday's better-than-expected data. The euro rise mirrored the amount of the dollar's drop (0.3%) while the pound finished flat after being higher most of the day. This came ahead of the release of the Bank of England's Inflation Report this morning, which was expected to contain dovish "forward guidance." (The BOE will pledge to keep rates low and counter any general lift in rates that occurs as the Fed tapers QE.)

I read in a few places yesterday that the euro was rallying because some investors were anticipating the stronger economic data to result in less accommodation from the European Central Bank going forward (which would imply continued euro strength/dollar weakness). That is not correct. First, the EU economy is merely stabilizing—it is a very long way from being strong enough to withstand the reduction of accommodation, and that's not on the horizon for the ECB.

Second, the rise in interest rates here in the U.S. isn't occurring in isolation. Interest rates have moved higher in Europe too, and if anything that will cause the ECB to be *more* accommodative. That's because, as ECB Chief Mario Draghi alluded to in the July meeting, they are not going to let Fed "tapering" undo the progress they've made. If you want to be a euro bull, which I am not, don't be a euro bull because of monetary policy—it's going to stay very, very accommodative for some time. And, I think this rally in the euro may offer a great short entry point via the ProShares UltraShort Euro ETF (EUO) for those who like that sort of thing.

Asian currencies were strong, as the Aussie rose nearly 1% vs. the dollar while the yen rallied 0.6%. The Aussie was higher despite the 25-basis-point cut in rates by the Reserve Bank of Australia, as that move was largely priced in thanks to last week's big declines in the Aussie.

The RBA statement was pretty neutral. (It didn't explicitly say there was more scope for interest-rate cuts like in the previous statement, but didn't imply the rate-cutting cycle was ending either.) Given the neutral statement, and considering how sharply the Aussie fell last week, it's not surprising there was a bounce in the currency after the statement, and it very well could last another couple of days. But, it's clear that the RBA doesn't want a higher Aussie dollar, so I'd short any material rally in the CurrencyShares Australian Dollar Trust (FXA) going forward. This trade is getting a bit long in the tooth, but there's still money to be made shorting the Aussie.

The yen traded below 98/dollar yesterday and below 97/dollar temporarily this morning, mostly because of general dollar weakness and short-covering ahead of the Bank of Japan meeting later this week. There are no new policy initiatives that are expected to be announced, as the Bank of Japan and the Shinzo Abe administration seem content to let current policies continue to work, for the time being.

Treasuries started the day lower but rallied back to flat by the close, as there was a pretty well-received three-year auction. (The bid-to-cover was a touch low compared to other auctions this year, but the actual yield was one basis point below the "When Issued" yield showing the bidders who were there were aggressive.) That, combined with chatter about Obama's housing speech weighing a bit on risk sentiment, helped bonds rally to flat. But, yesterday was a relatively uneventful day in the bond market and, while I wouldn't be shocked to see a bit more of a bounce in bonds, the trend remains decidedly lower.

Have a good day,

Tom

Copyright 2013, Kinsale Trading LLC. All Rights Reserved. www.sevensreport.com

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 last week on the back of strong economic data. Markets are consolidating recent gains, but the path of least resistance is 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.* *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.

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.**

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.**

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.**

Copyright 2013, Kinsale Trading LLC All Rights Reserved www.sevensreport.com

Disclaimer: **The 7:00's Report is protected by federal and international copyright laws. Kinsale Trading, LLC is the publisher of the newsletter and owner of all rights therein, and retains property rights to the newsletter. The Newsletter may not be forwarded, copied, downloaded, stored in a retrieval system or otherwise reproduced or used in any form or by any means without express written permission from Kinsale Trading LLC. The information contained in the 7:00's Report is not necessarily complete and its accuracy is not guaranteed. Neither the information contained in The 7:00's Report or any opinion expressed in The 7:00's Report constitutes a solicitation for the purchase of any future or security referred to in the Newsletter. The Newsletter is strictly an informational publication and does not provide individual, customized investment or trading advice to its subscribers. SUBSCRIBERS SHOULD VERIFY ALL CLAIMS AND COMPLETE THEIR OWN RESEARCH AND CONSULT A REGISTERED FINANCIAL PROFESSIONAL BEFORE INVESTING IN ANY INVESTMENTS MENTIONED IN THE PUBLICATION. INVESTING IN SECURITIES, OPTIONS AND FUTURES IS SPECULATIVE AND CARRIES A HIGH DEGREE OF RISK, AND SUBSCRIBERS MAY LOSE MONEY TRADING AND INVESTING IN SUCH INVESTMENTS.**

Copyright 2013, Kinsale Trading LLC. All Rights Reserved. www.sevensreport.com