# 7:00's Report

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

**September 17th, 2013**

***New Highs or a Double Top? The Russell 2000 made a new intra-day high yesterday, but the afternoon fade is disconcerting.***

## Pre 7:00 Look

- Futures flat and most international markets are little changed as investors look towards the FOMC announcement tomorrow.
- China was the exception & laggard o/n, as Shanghai fell 2% on profit taking due to lower than expected foreign direct investment and an uptick in money market rates.
- Economically it was quiet o/n. The highlight was the German ZEW survey, as business expectations increased more than expected to 49.0 vs. (E) 45.0.
- Econ Today: CPI: (E) 0.1%, Core CPI (E) 0.2%.

| Market | Level | Change | % Change |
|---|---|---|---|
| S&P 500 Futures | 1688.50 | -2.75 | -.16% |
| U.S. Dollar (DXY) | 81.33 | -.118 | -.14% |
| Gold | 1319.20 | 1.40 | .11% |
| WTI | 106.10 | -0.49 | -.46% |
| 10 Year | 2.874 | -.024 | -.83% |

## Equities

*Market Recap*

Stocks started the week with a "No Larry Summers" rally that took markets basically to their highs for the year. But, despite that fact, it wasn't a strong day. Stocks faded from their highs throughout the session, with the S&P 500 closing in the middle of the daily range, up 0.57%.

Stocks started the day very strong entirely because of Summers' withdrawal from Fed chairmanship consideration, generally ignoring some "ho-hum" reports from the Empire State Fed and industrial production. But, markets basically saw their highs early in the session, and stocks drifted lower throughout the session.

While the tragedy in D.C.'s Navy Yard didn't help sentiment, if there was one "reason" for stocks losing momentum it was President Obama's speech on the economy, which happened shortly after lunch. The tone of the speech, other than comments regarding the shooting, was very partisan. It underscored the mood in Washington and reminded everyone about this government's ability to be dysfunctional. Stocks slowly drifted lower throughout the afternoon, and gave the distinct impression that if the market closed at 5 instead of 4, stocks would have been flat.

*Trading Color*

There was cyclical outperformance again Monday (industrials, basic materials and financials led the markets higher), but gains were broad-based and it wasn't a typical "risk on" rally. Case in point, the Russell 2000 hit a new multi-year high before giving back pretty much all of the gains and ultimately underperforming, while the Nasdaq closed lower. Apple (AAPL) was mostly responsible for the Nasdaq weakness, as it fell another 3% after a

| Market | Level | Change | % Change |
|---|---|---|---|
| Dow | 15494.78 | 118.72 | .77% |
| TSX | 12816.88 | 93.48 | .73% |
| Brazil | 53821.63 | 24.12 | .04% |
| FTSE | 6602.46 | -20.40 | -.31% |
| Nikkei | 14311.67 | -93.00 | -0.65% |
| Hang Seng | 23180.52 | -71.89 | -.31% |
| ASX | 5251.24 | 3.25 | .06% |
| Prices taken at previous day market close. | | | |

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disappointing iPhone 5C sales update. But, it wasn't just AAPL yesterday—tech lagged overall.

Perhaps what was most interesting yesterday was the strong performance of "safety" sectors, as consumer staples and healthcare rallied just as much as the cyclical sectors. The only real laggards yesterday were the "bond proxy" stocks, which saw big, short-covering-induced rallies early in the session peter out as bond yields started to move higher throughout the late morning and afternoon. Utilities in particular were up nearly 1% at their highs, but finished basically flat.

| Market | Level | Change | % Change |
|---|---|---|---|
| Gold | 1308.7 | .10 | 0.01% |
| Silver | 21.810 | .09 | 0.41% |
| Copper | 3.2215 | .018 | 0.56% |
| WTI | 106.35 | -1.86 | -1.72% |
| Brent | 109.90 | -1.80 | -1.61% |
| Nat Gas | 3.74 | .063 | 1.71% |
| Corn | 456.50 | -2.50 | -0.54% |
| Wheat | 641.25 | -.25 | -0.04% |
| Soybean | 1348.25 | -33.25 | -2.41% |

Prices taken at previous day market close.

Volumes were elevated compared to the end of last week, but not heavy. On the charts, the S&P 500 continues to grind higher toward that old high at 1,709, although it couldn't hold the 1,700 level yesterday. Support sits at the 50-day moving average (1,673).

*Bottom Line*

Yesterday's rally was a knee-jerk reaction to a "dovish" Janet Yellen likely taking over the Fed, but that's not going to be enough to send markets materially higher from here in the short term.

The bigger question we've got to ask is this: "Is this a double-top at around the 1,700 level in the S&P 500, or are we about to move materially higher from here?"

Negative sentiment and positioning are still a tailwind, but that's not enough to get the S&P 500 moving toward 1,750 or 1,800. In order to do that, we need either a further acceleration in economic growth or top-line-driven earnings growth, and I don't see either materializing over the next couple of months. That said, I don't think this market goes to sub-1,600 either unless our fearless leaders in Washington start acting the fool again (although that's a definite possibility).

So, next Fed Chairman aside, I'm focused on trying to figure out in what direction the next 50 or 100 points in the S&P 500 will be, and I just can't find what's going to send us materially higher over the next few weeks or months. So, like a broken record, I'll continue to point to international markets (and commodities/hard assets) as the area of greatest potential outperformance into year-end.

## Economics

There were two manufacturing-related economic reports yesterday, and both reinforced the reality that we are in a slow-growth economy.

Empire State Manufacturing Survey

- September General Business Conditions Index 6.29 vs. (E) 9.00.
- New Orders increased to 2.35 from 0.27 in August.

*Takeaway*

The first look at September economic data showed continued growth in the Tri-State area's manufacturing sector, although the pace of that growth slowed and remains relatively sluggish, in an absolute sense. Despite the headline miss, the survey results weren't enough to derail the "No Summers" equity rally yesterday morning.

The details of the report were mixed. Positively, the New Orders index, which is the leading indicator in the report, moved slightly higher—implying we may see marginally better activity in the months ahead. New orders were the only bright spot in an otherwise "ho hum" manufacturing report. Employment, on the other hand, was disappointing as both the number of employees and the average workweek declined from August.

Industrial Production

- Industrial Production in August increased 0.4% vs. (E) 0.05%.

*Takeaway*

Industrial Production, like Empire State manufacturing, was a mixed bag. On one hand, the manufacturing component of the report (which ignores utility production and is a better gauge of national manufacturing activity) beat expectations, rising 0.7% vs. (E) 0.5% in August. But, the July manufacturing index was revised sharply lower, from an original reading of -0.1% to -0.4%.

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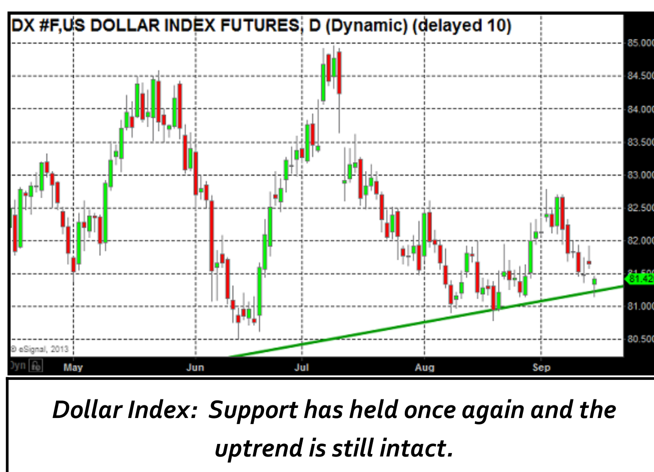
It appears that auto production is largely responsible for the big swings (plant closures in July, re-openings in August), but the most-important takeaway is that the August rebound in IP does confirm the very strong national manufacturing PMIs we saw in August.

*Bottom Line on Both Reports*

Both reports confirm we're seeing continued growth (albeit slow growth) in the manufacturing sector. Neither Empire State manufacturing nor IP are big enough numbers to move any Fed expectations, but it's always refreshing to see that both are showing growth, even if it is slow growth. After years of "false start recoveries" in the manufacturing sector, it appears a slow recovery is indeed sticking this time around.

## Commodities

Commodities continued the recent trend of trading as a bifurcated market, as energy traded sharply lower Monday while metals rallied. The major influences in the commodities market yesterday were further diplomatic progress in Syria (negative for energy) and the Summers surprise (dollar-negative, so positive for metals). Broad-based commodities indices declined sharply yesterday, as the weakness in energy and grains pushed them lower. The PowerShares DB Commodity Index Tracking Fund (DBC) closed just off major support at $26.00.




***Dollar Index: Support has held once again and the uptrend is still intact.***

WTI and Brent crude were two of the worst-performing commodities yesterday. Both traded to nearly three-week lows on momentum selling resulting from progress with regard to Syria. (The major parties in the Syrian drama—the U.S., Russia and Syria—seem to have come to an agreement in principle with regard to the seizure of Syrian chemical weapons.)

| Market | Level | Change | % Change |
|---|---|---|---|
| Dollar Index | 81.435 | -.203 | -0.25% |
| Euro | 1.3339 | .0029 | 0.22% |
| Pound | 1.5891 | .0022 | 0.14% |
| Yen | .010090 | .000012 | 0.12% |
| CAD $ | .9665 | .0014 | 0.15% |
| AUD $ | .9258 | .0063 | 0.69% |
| Brazilian Real | .4351 | .0042 | .97% |
| 10 Year Yield | 2.874 | -.024 | -.83% |
| 30 Year Yield | 3.871 | -.024 | -.62% |
| Prices taken at previous day market close. | | | |

The sellers are in control in the short term, but with the Syria premium "out" of the oil price now, I think energy at these levels is worth a shot on the long side, as the fundamentals continue to gradually improve. The 50-day exponential moving average at $105.56 is key support, and if that level is violated, that's the signal to get out. So, there's limited risk on any long positions at these levels.

Gold and silver rallied yesterday, but not very much considering the Summers surprise was an unexpectedly dollar-bearish event and Yellen is considered an ultra-dove. Gold, frankly, continues to not trade well. It didn't rally on dollar weakness last week, nor could it hold a rally on what should have been a strong positive yesterday. And, unless the Federal Open Market Committee is extremely dovish in its guidance, I think there's a good chance it won't hold $1,300 either.

Fundamentally, the Commitment of Traders report saw, unsurprisingly, a reduction in the net longs from last week in gold, to 64K. Importantly, the reduction of nearly 10K net longs from the previous week came almost exclusively from speculative longs selling, not additional shorts being added. That's not a positive, because:

1) There is plenty of room for more shorting, and
2) If there is a rally, there aren't near-record shorts that need to cover, thus removing a potential positive influence in the short term.

Bottom line is I'm a long-term gold bull, but gold needs inflation to start to move higher, and it needs an increase in longs to get this market moving higher. A break of $1,300 accelerates the decline.

Natural gas was actually the best-performing commodity

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yesterday, rallying 1.7% on forecasts for hotter-than-normal temperatures across most of Northeast U.S. later in the week. This late-summer heat is trying to mimic the late-winter cold from earlier in the year, and it's helping to make the supply/demand balance in natural gas a bit more "tight." Yesterday's rally resulted in natural gas trading to a two-month high.

From a fundamentals standpoint I'm surprised natural gas is at two-month highs, and think it's a bit ahead of itself given the supply/demand situation. But if inventories continue to tighten, then perhaps looking to buy the U.S. Natural Gas Fund (UNG) or the SPDR S&P Oil & Gas Exploration & Production Fund (XOP) on a pullback is worth more research.

Fundamentals for the commodity market continue to improve, and with Yellen being the presumptive Fed chair, there is a new, "dovish" tailwind in the market over the medium and longer term. I'm not a raging commodity bull, and I think we saw the peak of the "super-cycle" back in the late 2000s. But from these levels, given the global economy is turning toward growth, I think commodities offer continued outperformance between now and year-end. Support at $26.00 in DBC will be critical to hold.

## Currencies & Bonds

The intraday movements of bonds and currencies were important yesterday, not their absolute gain or decline, as the Larry Summers surprise was the dominant factor in those markets yesterday. Importantly, the initial reaction of dollar weakness and bond strength unwound throughout the day, implying the Summers withdrawal won't materially alter the existing trends in currencies and bonds (dollar strength and bond weakness).

As I said in yesterday's Report, the Summers news was a genuine surprise (and there are very few of those anymore these days). And, expectations for a Yellen-led Fed are more dovish than a Summers-led Fed, but only incrementally so in the short and medium term. That's why the immediate effect of the surprise would only last a day or so. Over time, will Yellen be more dovish than Summers? Yes. But it's not like there will be a major departure from current policy expectations regardless of who is Fed chair, and that's why you saw the dollar hit its low and Treasuries hit their highs early Monday, before both reversed those moves methodically throughout the day. In the end, the Dollar Index declined a modest 0.28% after temporarily breaking support early in the morning, while the 10-year yield closed at 2.87%, down two basis points and well off the intraday lows of 2.77%.

The dollar was universally weak as the euro, pound, Loonie, yen and Aussie all rallied although, as the Dollar Index moved higher throughout the day, most currencies pared their gains and closed only marginally higher vs. the dollar (up between 0.15% and 0.25%). The only exception was the Aussie, which rallied 0.65%, but that was more a function of that currency being still heavily shorted (and seeing covering) more than it was anything fundamental.

Treasuries traded sharply higher early Monday, with the 30-year note hitting a two-week high in the morning, before the lackluster economic data reminded everyone that, regardless of who is Fed chairman, we're still dealing with a slow-growth economy that is going to need accommodation well into the future. Treasury bonds closed well off their highs, and the 30-year actually finished fractionally negative on the day.

If there is one near-term consequence of the Summers news, though, it may be that any "forward guidance" from the FOMC at Wednesday's meeting will be a bit more powerful, and could be a slightly greater "dovish" influence than it would have been otherwise. The reason is because if Yellen is going to run the Fed, then if the Fed promises to keep the zero-interest-rate policy in place until '16, you know the new chairman is 100% behind that belief. Longer term, I still think forward guidance will prove disappointing as a policy tool, but this week its potency may rise just a bit. Bottom line, chances for a "dovish" reaction to the Fed meeting, despite tapering of QE, probably went up a bit.

Have a good day and Happy Birthday to my Dad, who is the reason I'm in this business.

Tom

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# 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** | *Equities have rallied to one month highs because of decent economic data and very negative short term sentiment and positioning. Now markets are looking towards the FOMC meeting and developments in Washington. While risks abound, though, the benefit of the doubt remains with the bulls, as this market is resilient.*<br>*Support in the S&P 500 sits at the 50 day MA (1670ish), while resistance is the old highs of 1709.* |

**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" as its broken through resistance, and I'd initiate or add to any positions at these levels or on any dip.**

| | 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. I'd look to buy oil or "energy" in general on any further dip to between $105—$107 on the removal of geo-political risk as the Syrian situation evolves.**

**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 is weaker to start the week on the Summer's news, but regardless of the short term moves, I remain dollar bullish based on the marginal direction of monetary policy. But if the uptrend at 81.20 is decisively broken, I'll have to admit I'm wrong.* |

**Trade Ideas**

***Short*****: Japanese yen (YCS) as three month long support has been broken, and the declines in the yen have once again begun. Short the euro (EUO) on any further bounce to the 1.34 level, as the ECB appears ready to act with more LTROs to combat the general lift we are seeing in interest rates as the Fed prepares to taper QE.**

| | Fundamental Outlook | Technical Outlook | Overall | Comments |
|---|---|---|---|---|
| **Treasuries** | **Bearish** | **Bearish** | **Bearish** | *Recent economic data has cemented the expectation of a small tapering of QE being announced in September. Bonds have sold off hard in anticipation of that announcement, so we may have seen a short term low in bonds, although the longer term trend is still negative.* |

**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.**

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