7:00's Report

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

September 18th, 2013

Pre 7:00 Look

- Futures are flat and most international markets are treading water ahead of the FOMC announcement later today.
- The only economic release o/n was the BOE meeting minutes, which contained no surprises.
- The Italian Senate will vote today on whether to expel Silvio Berlusconi. The result of the vote is expected later in the afternoon.
- Earnings Today: FDX (E: $1.49), ORCL (E: $0.56).
- Econ Today: Housing Starts (E): 915K, FOMC Rate Decision 2:00PM ET, Chairman's Press Conference 2:30PM ET.

Market	Level	Change	% Change
S&P 500 Futures	1700	1.75	.10%
U.S. Dollar (DXY)	81.28	-.015	-.02%
Gold	1301.10	-8.30	-.63%
WTI	106.19	.77	.73%
10 Year	2.853	-.021	-.73%

Equities

Market Recap

Stocks continued their grind higher Tuesday in what felt like a mild short-covering rally ahead of today's Federal Open Market Committee meeting. The S&P 500 rose 0.42% and closed above 1,700 for the first time since Aug. 6.

Yesterday's rally came amidst little news, and it almost felt like the market wanted to elicit a bit more "pain" from the shorts and the underinvested before the much-anticipated FOMC meeting. As far as positive catalysts, there really weren't any. Benign inflation, an in-line housing market index and the Congressional Budget Office's long-term deficit outlook (which was unchanged from the last one) were the news events of the day—but none of them affected trading. Silvio Berlusconi apparently not collapsing the Italian government was probably the biggest "positive" on the day.

But, yesterday was mostly about positioning ahead of the Fed, and stocks held their gains throughout the day and basically went out at their highs in quiet trading.

Trading Color

The Russell 2000 rebounded from Monday's afternoon fade by rallying nearly 1% Tuesday and going out on the high ticks, setting a fractional new all-time high. The Nasdaq also rebounded thanks to an Apple (AAPL) bounce and Microsoft's (MSFT) capital return program.

Sector-wise, all 10 S&P 500 sub-sectors finished higher, although financials, tech and homebuilders led the rally. (The housing market index meeting expectations helped the builders, a group where sentiment is very negative at the moment. As such, they are prone to short-covering on "not bad" news.)

Safety sectors also performed well yesterday and again, like Monday, there wasn't any real "cyclical" dominance. Staples, telecom and even utilities rallied in line with the market.

Bottom line, though, is there isn't a lot to read into from the sector trading so far this week. That's because it has come on light volume, and you never know who is simply getting positioned ahead of the Fed. So, the general themes of "cyclical" outperformance and "bond proxy" underperformance—which have been the dominant sector trading themes for weeks—remain in place, unless the Fed provides a "dovish" surprise.

Market	Level	Change	% Change
Dow	15529.73	34.95	.23%
TSX	12834.11	17.23	.13%
Brazil	54271.25	440.62	.84%
FTSE	6583.58	13.41	.20%
Nikkei	14505.36	193.69	1.35%
Hang Seng	23117.45	-63.07	-.27%
ASX	5238.14	-13.10	-.25%

Prices taken at previous day market close.

Looking at the charts, the picture remains unchanged: Resistance in the S&P 500 lies at 1,709 (the old all-time highs) while support is now moderately lower at the 50-day moving average. Volumes were predictably very light ahead of the FOMC today.

Market	Level	Change	% Change
Gold	1311.3	-6.50	-0.49%
Silver	21.810	-.199	-0.90%
Copper	3.2230	.001	0.03%
WTI	105.47	-1.12	-1.05%
Brent	108.13	-1.94	-1.76%
Nat Gas	3.74	.002	0.05%
Corn	454.00	-2.50	-0.55%
Wheat	643.00	1.75	0.27%
Soybean	1342.50	-5.75	-0.43%
Prices taken at previous day market close.			

Berlusconi the Statesman?

Mostly ignored yesterday were developments in Italy that imply Silvio Berlusconi will not collapse Prime Minister Enrico Letta's government if he is indeed expelled from Parliament after the vote in the senate later today.

The situation is still fluid, but Berlusconi is apparently going to back away from his threats to collapse the government, should he actually be expelled.

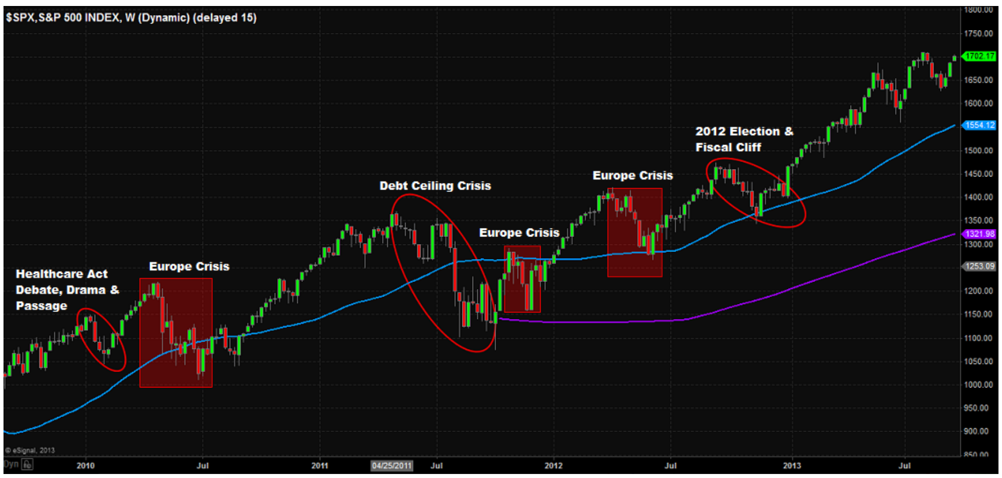
But, before anyone goes erecting a statue to the man, apparently he was convinced by his advisers that collapsing the government would significantly, negatively affect the value of his media interests. Given that he just got hit with a court order yesterday to pay a competitor $721 million in damages stemming from a bribery scandal several years ago, he probably needs to watch his finances! Kidding aside, assuming Berlusconi behaves, this is a positive for the region—and removes a potentially destabilizing threat.

Why Washington Scares Me

Very quietly, most of the major headwinds that made people nervous coming into September have been resolved favorably. Fed Vice Chair Janet Yellen (the market's preferred choice) will likely become the new chairperson ... Syria is on the back burner now that there will be no military action in the near term (and likely ever) ... it looks like Berlusconi won't collapse the Italian government ... and German elections this Sunday look like they'll meet expectations and not contain any surprises (i.e., Angela Merkel will remain its chancellor).

The one issue that still looms large is Washington, and it's a big one.

I say that because, during the past three-plus years, there have only been two things that have derailed the relentless market rally: Washington and the European crisis.



As this chart shows, of the six major pullbacks we've seen since '10, three have been Washington-related, and three Europe-related.

And, judging by the president's confrontational tone—and both the Republicans' and Democrats' leadership seemingly unable to control the rank-and-file—all the ingredients are there for another messy, public battle over the debt ceiling and continuing resolution.

Now, I do want to point out that each Washington-inspired pullback has been a buying opportunity, and any turmoil probably will be this time, too. But I'd sure prefer to buy the dip rather than get long into it. So, I think it pays to be cautious about adding domestic long exposure at these levels, even through we're knocking on the door of old highs.

Economics

FOMC Preview

The market has been looking toward this meeting (and "game-planning" it) since the initial hint of Fed tapering in May, so the odds are it's anti-climatic. But, there's always the possibility of a surprise, and I want to briefly cover each part of it so everyone has a road map as we head into it.

First, there are three areas of interest for today's meeting: The rate/tapering announcement at 2:00 PM, the quarterly growth estimates, and finally the Chairman's press conference at 2:30. I want to cover each section separately so you know what to expect.

Policy & Interest Rate Decision

- Current Expectations: Tapering of QE program of $10 billion to $15 billion a month, with the large majority (at least 2/3) of the taper happening in Treasuries, and the remainder in mortgage-backed securities. Probable market reaction: Not much, as this is widely priced in at this point.
- Hawkish Surprise: Tapering of >$15 billion. Probable market reaction: Stocks/gold/Treasuries down, dollar up.
- Dovish Surprise: No tapering. Probable market reaction: Stocks/gold/Treasuries up, dollar down.

Fed Presidents' Growth Estimates

Of all the pieces of the FOMC announcement today, this is the trickiest one. As longer-term readers know, I'm skeptical of just how effective "forward guidance" will be as a monetary policy tool. And, as such, I think the removal of QE and the reliance on "forward guidance" to keep interest rates down will ultimately not be effective.

Today the Fed presidents will release their forecasts for GDP, unemployment, inflation and the Fed Funds rate for year-end 2016. The Fed has for a while said they expect interest rates to remain exceptionally low into 2016. But, here's the problem: Fed governors, on average, expect between 2.9% and 3.6% GDP growth in 2015. So, we can assume this range will increase when we see the 2016 numbers later today. So, how can the Fed expect the market to believe that—if GDP growth is back to "normal" levels of between 3% and 4% in 2016—the Fed Funds rate will still be exceptionally low?

Market	Level	Change	% Change
Dollar Index	81.305	-.143	-0.18%
Euro	1.3360	.0023	0.17%
Pound	1.5904	.0017	0.11%
Yen	.0100088	.000001	-0.01%
CAD $	.9691	.0024	0.25%
AUD $	.9299	.0046	0.50%
Brazilian Real	.4395	.0047	1.09%
10 Year Yield	2.853	-.021	-.73%
30 Year Yield	3.84	-.031	-.80%
Prices taken at previous day market close.			

Regardless of what the projections say, that is simply not credible. We can't have near-0% interest rates, 3%-ish GDP growth and 2%-ish inflation in 2016—one of those numbers has to be higher, and most think it'll be interest rates ... thereby invalidating "forward guidance." This is part of the reason I think "forward guidance" isn't going to be an effective policy tool.

Bottom line is to watch where the expectations for the Fed Funds rate will be in 2016 in today's projections. If it's much over 2.50%, that may be taken as a "hawkish" surprise by the market.

Chairman's Press Conference

We should all expect Bernanke to reiterate two things at this press conference: 1) that "tapering" isn't "tightening" and 2) the Fed remains data-dependent. If the economy softens, they can stop tapering and maybe even increase purchases. Bottom line is Bernanke will likely be "dovish" in the presser and try to "talk down" interest rates.

Commodities

Commodities continued to decline Tuesday, as a combination of factors pushed the energy complex to multi-week lows, and this weakness led to declines in most commodity indices. But, while energy led the complex lower, weakness was broad in the commodity space as precious metals also declined ahead of the FOMC today. Copper, natural gas and wheat were the only commodities to finish Tuesday higher, and the best performer of the group, wheat, rose just 0.25%.

WTI and Brent crude fell 1% and 1.89%, respectively, on several factors. First, a Reuters article stated Libyan oil production was expected to accelerate after an extended period of curtailment, with output likely to increase to between 400K—450K bpd vs. previous expectations of

230K bpd. So, obviously more supply.

Second, an FT article said Saudi output increased marginally in August to 10.2 million bpd, further adding to supply. Finally, there was even some positives in regard to Iran. Der Spiegel reported new Iranian President Hassan Rohani has offered to dismantle the nuclear site at Fordo, a site which is apparently critical in the Iranian nuclear-enrichment program, if sanctions are lifted.

So, taken at face value, yesterday we saw several articles implying more supply, and a further reduction in geopolitical risk. Given that news, its not surprising energy was sharply lower yesterday, led by Brent crude, given the supply increases most directly affect that market more so than WTI.

On the charts, WTI crude broke through support at $105.58, briefly trading below $105 but rallying into the close. But, despite that violation of support, with the FOMC looming, I'd give oil the benefit of the doubt and see if it can hold that support at $105.58 today. Beyond today, though, I've learned over the years that as goes oil, so too generally go risk assets. So, if WTI crude breaks down from here and I'm wrong about the new higher range in oil between $105 and $110, I'll take that as a potential warning sign for risk assets generally.

Turning to precious metals, gold and silver declined modestly Tuesday, although most of the trading yesterday was just positioning ahead of the FOMC meeting today. You don't need to be a certified market technician to know that gold and silver are at critical support levels, and that the FOMC will be the critical catalyst in the near-term direction of the metals, with risks to the downside.

So, it's important to see if support holds in gold and silver post-FOMC. Key levels to watch in gold are $1,300 and $1,280. If the latter is broken today, look out below, as a revisit of $1,200 isn't out of the question. In silver, $21.42, last week's low, is important.

The broad based commodity ETF, the PowerShares DB Commodity Index Tracking Fund (DBC), has declined more than 5% from the late-August highs—despite the Dollar Index basically being flat over the same period and good economic data, especially out of China. Support was broken yesterday at the $26.00 level, and unless there's a post-FOMC rebound in the complex over the next day or so, regardless of the positive fundamentals, I'll have been wrong about the near-term upside in the asset class.

Currencies & Bonds

Treasuries rallied modestly (30-year up 0.39%) mostly on short-covering ahead of the FOMC today and partially because of another benign Consumer Price Index reading that again showed non-existent inflation.

Yesterday was quiet in the currency markets on the eve of the Fed, as the Dollar Index declined slightly while the euro, pound and yen all saw very small rallies, mostly because of dollar selling.

There was no fundamental news in the markets yesterday with the exception of the Aussie dollar. The Aussie rallied 0.5% despite the soft Chinese economic data and "dovish" Reserve Bank of Australia minutes, which left the door open to more rate cuts this year (although they are unlikely). But, the Aussie is a highly shorted currency and, if anything, we probably saw some covering ahead of the FOMC.

Heading into the Fed, the dollar is sitting on major support. Short of the FOMC surprising the market by not tapering QE, I think this support will hold, and for now, at least, I remain a nervous 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)

<table>
<tr><th></th><th>Fundamental Outlook</th><th>Technical Outlook</th><th>Overall</th><th>Comments</th></tr>
<tr><td>Stocks</td><td>Neutral</td><td>Bullish</td><td>Bullish</td><td>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.

Support in the S&P 500 sits at the 50 day MA (1670ish), while resistance is the old highs of 1709.</td></tr>
<tr><td colspan="5"><u>Trade Ideas</u>

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.</td></tr>
<tr><td>Commodities</td><td>Bullish</td><td>Bullish</td><td>Bullish</td><td>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.</td></tr>
<tr><td colspan="5"><u>Trade Ideas</u>

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.</td></tr>
<tr><td>U.S. Dollar</td><td>Bullish</td><td>Bullish</td><td>Bullish</td><td>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.</td></tr>
<tr><td colspan="5"><u>Trade Ideas</u>

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.</td></tr>
<tr><td>Treasuries</td><td>Bearish</td><td>Bearish</td><td>Bearish</td><td>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.</td></tr>
<tr><td colspan="5"><u>Trade Ideas</u>

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.</td></tr>
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