7:00's Report

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

September 19th, 2013

Pre 7:00 Look

- Futures moderately higher this morning as the global Fed induced rally continues.
- Global markets rode the positive momentum from the US session yesterday, as virtually every major global stock market closed sharply higher.
- Economic data o/n, though, was disappointing as Japanese exports & UK retail sales missed estimates.
- Econ Today: Jobless Claims (E: 341K), Existing Home Sales (E: 5.255M), Philadelphia Fed (E: 10.0).

Market	Level	Change	% Change
S&P 500 Futures	1725.50	8.00	.47%
U.S. Dollar (DXY)	80.225	-.142	-.18%
Gold	1365.80	58.20	4.46%
WTI	108.83	.76	.70%
10 Year	2.708	-.145	-5.08%

Equities

Market Recap

Stocks spent most of the day marginally lower Wednesday ahead of the Federal Open Market Committee, but stocks exploded to new all-time highs after the "No Taper" surprise. The S&P 500 rallied 1.1%.

While the Fed dominated the conversation yesterday as expected, there were actually several pieces of positive news in the market.

The S&P 500 moved to new all time highs yesterday on the back of a surprisingly dovish Fed. This rally isn't over.

- Silvio Berlusconi gave his much-anticipated television address where he promised to remain in politics if he's expelled from the Senate. Importantly, he didn't threaten to bring down the government, removing a major source of uncertainty.
- FedEx (FDX) beat earnings estimates, and although the commentary on the global economy wasn't great (with "tepid" global economic growth), they did see an uptick in international express business, which is a proxy for global economic growth.
- Finally, Oracle (ORCL) traded higher after the close on well-received quarterly results.

But, those positives aside, yesterday was all about the Fed.

Stocks gapped higher immediately following the release and then took another leg higher during the Chairman's press conference, where he was non-committal on whether the Fed was still planning on tapering QE this year (which was perceived as more dovish).

Stocks held most of their gains into the close and finished just off the highs. It's seldom the market is truly surprised, but it happened yesterday, as very few people expected no taper from the Fed. (I think Merrill was one

Market	Level	Change	% Change
Dow	15676.94	147.21	.95%
TSX	12931.40	97.29	.76%
Brazil	55702.90	1431.65	2.64%
FTSE	6657.36	98.54	1.50%
Nikkei	14766.18	260.82	1.80%
Hang Seng	23502.51	385.06	1.67%
ASX	5295.55	57.41	1.10%
Prices taken at previous day market close.			

of the few firms that was staunchly "Team No Taper," so hat-tip to them.)

Trading Color

From a sector perspective, the reaction to the Fed wasn't the typical "risk on" move you would expect to see on such a strong day in the market. Instead, sector trading was defined by mixed cyclical outperformance and a big unwind of shorts in the "bond proxy" sectors.

Market	Level	Change	% Change
Gold	1344.70	35.30	2.70%
Silver	22.52	.736	3.38%
Copper	3.297	.0755	2.34%
WTI	107.89	2.47	2.34%
Brent	110.54	2.35	2.17%
Nat Gas	3.712	-.033	-0.88%
Corn	456.75	2.75	0.61%
Wheat	646.25	3.25	0.51%
Soybean	1347.75	5.45	0.39%
Prices taken at previous day market close.			

The global cyclicals were the best performers on the day (basic materials, energy, industrials), while utilities, REITs and homebuilders (bond-proxy/interest-rate-sensitive stocks) also saw big rallies in reaction to the "dovish" Fed. Financials were actually the laggard sector-wise yesterday, given the reversal in rates, although all 10 S&P 500 sub-sectors finished the day higher.

On the charts, the S&P 500 exploded to new all-time highs, and trading volumes were heavy, as the dovish Fed totally caught investors off-guard and a combination of short-covering and price-chasing pushed volumes sharply higher.

The Fed Is Staying Dovish, But Washington Dysfunction Still Looms Large

While the Fed's decision was resolved dovishly and it supported markets yesterday, it's worth pointing out that the looming clouds in Washington just got darker.

First, the FOMC in part maintained QE because of potential Washington dysfunction, so that shows you how confident they are in our politician's ability to quickly solve the continuing resolution and debt ceiling debates.

More concretely, though, the House Republicans yesterday decided to send a "continuing resolution" bill to the Senate that will link the funding of the government to the de-funding of ObamaCare, which is 100% not going to pass the Senate. So, we are already starting on the wrong foot here, and with a shutdown looming on the 30th, time is already being wasted.

Bottom Line

Emerging markets, both their bonds (PCY & EMB) and their equity markets (VWO) are the biggest winners from yesterday's "No taper" surprise and dovish guidance. Anything EM related jumped yesterday on the news, but emerging markets remain well below their May highs, when the sectors began to get sold because of impending Fed tapering. Now that any tapering appears to have been "punted' to December at the absolute earliest, emerging markets have room to further recover.

More broadly, the question I asked myself yesterday was "Is this dovish Fed a game changer on my thesis of international and basic material/hard asset outperformance over domestic equities into year end?" And, the answer, I believe, is no.

If anything the Fed staying very dovish only strengthens the argument (evidenced by international market outperformance yesterday after the news).

First, Washington is still a large looming headwind. Second, the S&P 500 is not cheap on a valuation basis, and while performance chase may send the S&P 500 a few percentage points higher from here, I still think at some point in the 1700's there's a valuation argument to be made against further material gains.

But, with the Fed standing pat, we should see a gradual reduction in rates across the globe, which will further aid the global economy, helping Europe especially. Additionally, we'll see further dollar weakness so anything "hard asset" related, like DBC, IYM or HAP, should outperform, and basic materials stocks will get a double benefit, an uptick in global growth and building inflation concerns.

Economics

FOMC Meeting

- The FOMC surprised markets by not tapering its QE program.
- Growth projections for 2016 were slightly lower

than expectations, another small dovish surprise.

Takeaway—Why Did The Fed Not Taper

For the second time in two weeks, something Fed-related surprised markets (Larry Summers' withdrawal from Fed chair consideration was the first) as the Fed kept the QE program unchanged and was much more "dovish" than virtually anyone expected (Bernanke was dovish at the presser).

So, the question is "Why?" The answer appears to be threefold, starting with the most-important factor.

- **First, the Fed doesn't trust Washington.** The statement cited multiple times—"fiscal" threats to the economy— which basically means the Fed is concerned that Congress will once again create another slowdown in the economy … as it did with the healthcare law debate in early '10, debt-ceiling crisis in summer '11, and fiscal cliff drama and sequester in late '12/early '13. Those events served to counter Fed stimulus (QEs and Operation Twist), so it looks like the Fed doesn't want to reduce QE into another potential Washington debacle.
- **Second, the Fed is concerned that the big backup in rates since May could be a major headwind on growth**, so it wants to ensure extreme accommodation as interest rates have moved higher.
- **Finally, persistently low inflation is becoming a bigger worry for the Fed**, as inflation well below the 2% target was mentioned several times as potential threat to economic growth.

But the Fed, after seeing previous rounds of QE fail to stimulate the economy, apparently wants to make sure recent gains in the economy stick. So, for the first time that I can remember, the Fed is staying ultra-accommodative beyond when the current economic data would support less accommodation, because they want to make sure these gains aren't given back, as they have been with QE1, QE2 and Operation Twist. And, if that proves to be inflationary down the road, so be it. This was not a decision based on the current economic data, it was a decision based on future risks to the recovery, and being that forward thinking is a first for any Fed I've ever watched, because the risks of imbalances (bubbles) given QE are building. But, that's apparently a problem for another day.

Market	Level	Change	% Change
Dollar Index	80.555	-.742	-0.92%
Euro	1.3489	.127	0.95%
Pound	1.6075	.0175	1.10%
Yen	.010190	.000097	0.97%
CAD $	.9760	.0066	0.68%
AUD $	.9426	.0126	1.35%
Brazilian Real	.44795	.012	2.75%
10 Year Yield	2.708	-.145	-5.08%
30 Year Yield	3.755	-.085	-2.21%
Prices taken at previous day market close.			

Housing Starts

- August Starts: 891K vs. (E:915K)

Takeaway

Housing starts were a mixed bag. August starts were 891K, missing estimates of 915K but rising from July's 883K. Permits, which are a leading indicator of starts, also came in a little light at 918K compared to estimates of 950K.

Importantly, though, while the headline numbers were a "miss," the more-crucial number in the release, single-family home starts, increased to 627K, up from 520K in 2012. Additionally, single-family permits also rose in August to 627K from July's 609K. Multi-family starts, which aren't really indicative of the state of the residential housing market, saw big declines and were responsible for the disappointing headline number concealing a relatively healthy report.

Market reaction was muted, as everyone was focused on the impending FOMC meeting. And, although the Street barely seemed to notice the Housing Starts report, it is an important number because the strong details in yesterday morning's report show the housing recovery is continuing. Although it has certainly lost some momentum because of higher mortgage rates, we're not seeing the recovery derailed, which is a continued positive for the economy.

Commodities

Prior to the FOMC meeting commodities saw a reversal of Tuesday, as WTI and Brent crude rebounded. They rallied more than 1% each and pushed the PowerShares DB Commodity Index

Tracking Fund (DBC) up more than 1%, as it reclaimed support at $26.00 pre-Fed.

The rally in the commodities markets accelerated significantly after the "No Taper" surprise from the FOMC, and DBC rallied another 1% to close up more than 2%.

The entire commodity complex had come under severe selling pressure over the past two-plus weeks, and yesterday's surprise from the Fed caught sellers off-guard. This resulted in a broad and intense short-squeeze. Every single commodity, except natural gas, rallied sharply, with gold (up 4%), silver (up 6%), oil (up 2.7%) and RBOB gasoline (3%) leading the way higher.

While the FOMC dominated commodity trading yesterday, oil also traded off some fundamental data.

Crude rallied hard before the Fed, thanks to bullish weekly inventory data which showed a much larger-than-expected decrease in crude supplies (4.4 million bbls vs. (E) 1.2 million barrels). The refined products were also bullish, with RBOB gasoline and heating oil registering draws on supplies when builds were expected.

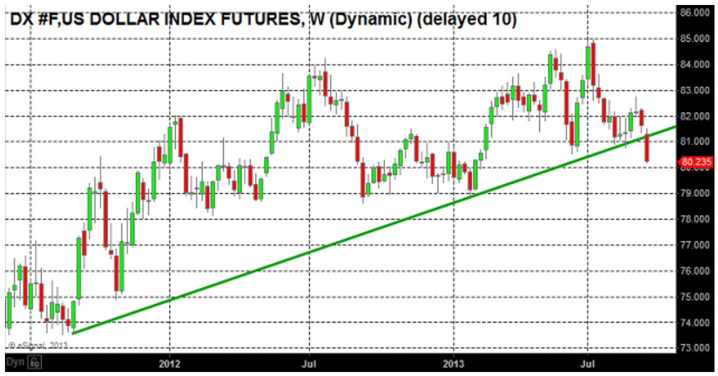
Domestic oil supplies are now 3.3% lower than last year's levels, as positive refiner margins have led to increased processing of raw crude, offsetting increases in production. While not wildly bullish, over the past several months the supply/demand situation in WTI crude has become more '"tight" and fundamentally is supporting the market.

Bottom line in commodities is you have the Fed throwing gasoline on the fire at this point. And with the Fed staying accommodative in spite of a rebounding economy, the bullish thesis for commodities in aggregate just got stronger. I would continue to advocate initiating or adding to DBC positions at these levels, with stops at Tuesday's lows, which shouldn't be violated unless global economic data turns decidedly negative.

Currencies & Bonds

The Dollar Index imploded through support on its multi-year uptrend line yesterday as the Fed not only didn't taper, but Bernanke, at his press conference, appeared to back off the idea that the Fed would definitely taper QE later this year.

This dovishness from the Fed was clearly a surprise, and obviously this changes my stance as a dollar bull. When the facts change, I change, and clearly the Fed isn't nearly as apt to taper QE as I and others had thought.



So, my dollar-bull thesis, based on the perceived differential on the direction of policy between the Fed and its major partners, is no longer valid. The Fed, for now, is going to stay just as "easy" as everyone else in the world. I would close any short dollar positions (including the UltraShort euro and yen ETFs, EUO and YCS). Regardless of the European Central Bank and Bank of Japan are doing, the Fed has decided they aren't about to give up the lead on global monetary accommodation.

The euro, pound, yen, Aussie and Loonie all rose between 0.8% and 1.4% on the Fed surprise. The euro and pound made multi-month highs while the yen broke down through 98/dollar.

Treasuries had their biggest daily gain in 2+ years, as the bond shorts covered en masse. I expect that will continue for several more days, as there are a lot of late bond shorts who are seeing profits go away at an alarming rate. And, with the 10-year yield at 2.70%, I think my call that 2.90%-ish would be the top for a while now appears safe. Eventually the Fed will taper and bonds will decline materially again, but I think we've got a couple months of a drift before the next leg down starts.

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	*Stocks shot to all time highs on a surprisingly dovish "no taper" Fed decision. Although valuation is starting to be a bit of a concern at these levels, performance chase into quarter end will likely be a tailwind on stocks. The benefit of the doubt remains with the bulls, even though markets are stretched.* *Markets are all time highs while support sits at the old highs of 1709 and then the 50 day MA, which is in the 1670ish range.*

Trade Ideas

Long/Overweight: **International markets and basic materials (HAP, IYM) should continue to outperform due to the Fed's surprise no taper decision. 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.**

More broadly, expect cyclicals to outperform, although utilities, which have been killed on a move out of "bond proxy" sectors, are an interesting potential value play at these levels and should see further short covering.

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, and the Fed's decision not to taper QE only will serve to stoke inflationary fires and benefit hard assets as the US Dollar declines.*

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.**

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.

U.S. Dollar	Neutral	Neutral	Neutral	*The US Dollar plunged after the Fed's "No taper" surprise and broke a multi-year up trend. The dollar had risen in anticipation of Fed tapering, and with that out for now, there will be little in the news to push the dollar higher. Eventually the Fed will taper, but its months in the future.*

Trade Ideas

Long: **Emerging market currencies (ETF is CEW) such as the Brazilian Real (BZF), Indian Rupee (ICN) or Mexican Peso, as those currencies should see a large rally after the Fed's "no taper" surprise.**

Treasuries	Neutral	Bearish	Bearish	*The Fed's "no taper" surprise has likely marked the end of this initial leg down in Treasuries. Although the fundamentals long term remain negative, we should see a bounce of some sort, although I would look at that longer term as a great entry point on a bond short. If you missed the intial leg down, now's your chance to get back in over the coming weeks/month.*

Trade Ideas

Buy on a significant dip: **TBF (unleveraged short 20+ year Treasurys) and TBT (2X leveraged short 20+ year Treasury). Finally, with the Fed committed to holding down near term rates, the yield curve will steepen dramatically, so STPP should continue to do well.**