7:00's Report

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

September 24th, 2013

Pre 7:00 Look

- Futures flat and international markets are little changed as investors the world over debate the next move for the Fed.
- The German IFO Business Survey was the only economic release o/n and it largely met expectations.
- Econ Today: Case Shiller HPI (E: 0.8%). Fed Presidents Pianalto and George speak (8:30AM and 12:30PM respectively)

Market	Level	Change	% Change
S&P 500 Futures	1692.50	-0.50	-.03%
U.S. Dollar (DXY)	80.65	.079	.10%
Gold	1317.50	-9.50	-.72%
WTI	103.11	-.48	-.46%
10 Year	2.714	-.018	-.66%

Equities

Market Recap

Stocks saw mild declines to start the week, as soft economic data and continued Fed/Washington angst weighed on equities. The S&P 500 fell 0.47% and is now below the "pre-FOMC" levels of one week ago.

Futures started the week modestly higher, as the good Chinese economic data helped risk assets. But, stocks turned negative off the U.S. flash Purchasing Managers' Index miss and didn't get much of a bounce from the dovish Bill Dudley comments. After those hit the wires shortly after the open, stocks spent most of the rest of the day treading water as this market continues to feel fatigued. There was an effort to turn stocks positive midafternoon, but that ran out of gas and markets faded a bit into the close.

Trading Color

Yesterday wasn't a particularly encouraging day for the bulls, as markets saw no bounce from Friday's sell-off and largely dismissed the good international economic data. Index-wise, the Nasdaq outperformed, but that was largely due to Apple (AAPL) rallying more than 5% after stronger-than-expected 5C and 5S sales.

Sector-wise, the big story of the day was the continued carnage in the financials. Money continues to pour out of the banks as the reality of "no tapering" from the Fed weighs on the sector, as the expected increase in net interest margin isn't going to materialize as quickly as expected. The Financial Select Sector SPDR (XLF) fell 1.42%, making financials the worst-performing S&P 500 sub-sector.

Also contributing to the weakness in financials were two articles from the Financial Times that cautioned investment banks are going to see a significant drop in trading revenues. This comes of the heels of Jefferies' awful earnings report (there was a huge drop in bond volumes). One article specifically cited Citi as suffering from a drop in trading revenues, but Deutsche Bank also made comments that they too are seeing trading revenues fall off.

I point this out because financials are historically a leading indicator for the broader market, so if they break down from here, that's a potentially bearish omen.

Outside of the financials, we saw "bond proxy" and safety sectors generally outperform off the dovish comments

Market	Level	Change	% Change
Dow	15401.38	-49.71	-.32%
TSX	12811.20	4.73	.04%
Brazil	54602.38	492.35	.91%
FTSE	656.21	4.84	.07%
Nikkei	14732.61	-9.81	-.07%
Hang Seng	23179.04	-192.50	-.82%
ASX	5234.16	-18.30	-.35%

Prices taken at previous day market close.

from Dudley as more shorts get squeezed out. (If his comments are interpreted correctly, then we may be a lot further from tapering than the market thinks—more on that below.)

Market	Level	Change	% Change
Gold	1323.7	-8.80	-0.66%
Silver	21.790	-.137	-0.62%
Copper	3.2995	-.21	-0.63%
WTI	103.59	-1.16	-1.11%
Brent	108.18	-1.04	-0.96%
Nat Gas	3.600	-.087	-2.36%
Corn	453.25	2.25	0.50%
Wheat	653.50	7.25	1.12%
Soybean	1307.75	-7.50	-0.57%
Prices taken at previous day market close.			

Conversely, most cyclical sectors again underperformed (consumer discretionary and tech ex-AAPL were particularly weak), although industrials relatively outperformed the market. They continue to be one of the most-resilient "deep cyclical" sectors out there. (The China numbers no doubt helped.)

Volumes were pretty light and overall sentiment felt cautious and somewhat confused. On the charts the S&P 500 held 1,700, and that's near-term support.

Why Was Dudley's Dovish Comments Bullish for Bonds but Not Stocks

The important takeaway from Fed President Dudley's comments yesterday were twofold. First, Dudley is a Vice Chairman, so he's part of Fed leadership. Second, he's neither a hawk nor a dove, and generally represents the consensus of the FOMC—so Dudley's opinion is close the aggregate opinion of the FOMC.

Yesterday, Dudley's comments were "dovish" because he emphasized several times that he is looking for "forward momentum" in GDP growth, which most are thinking means 3% GDP growth or better. So, the focus on what constitutes QE "tapering" conditions seems to be economic growth, not necessarily the unemployment rates hitting 7% or 6.5%.

This is important for two reasons: First, the economy isn't close to sustainable 3% GDP growth, so if that's the main trigger for tapering, we're still several months away. Second, this is another small blow to Fed credibility. Initially, the Fed told the market that employment was the key "threshold" for a dial-back of QE. Now, perhaps growth is becoming that threshold, because the reduction in the unemployment rate we've seen is due mainly to a shrinking labor force, not because of material improvement in hiring.

Interestingly, bonds rallied off the Dudley comments but stocks did not, and we should all get used to that going forward. I've been saying for months that the marginal benefit of QE is basically zero at this point. An extension of QE is no longer sufficient to spur an equity-market rally. Only if QE engenders incremental economic growth will continued/additional stimulus lead stocks and risk assets higher. And frankly, Dudley's comments on the economy were pretty downbeat.

So, expect "dovish" comments by Fed members to marginally push rates lower (but not cause a significant decline) … and not send stocks higher.

No tapering until late this year/early next year isn't a reason, by itself, to buy stocks. The market needs a good economy a lot more than it needs more QE—plain and simple.

Bottom Line

If we ignore, for a second, the FOMC surprise rally last Wednesday, this market has acted tired for more than a week.

Fed confusion is getting worse, and while everyone expects ultimate Washington resolution with regards to the continuing resolution and fiscal cliff, there's certainly more drama on the immediate horizon. Those two factors, and the market being up nearly 20% year to date, have resulted in a "buyers' strike." Stocks fell Friday and Monday not because of very aggressive selling, but instead because of a lack of buy interest. Until there is some incremental clarity with the Fed or Washington, I think we'll continue to see this drift/consolidation with a mild bias lower.

Frankly, I don't like the way this market feels, and while I'm not ready to say the Fed confusion is a bearish game-changer, it's certainly a new headwind. But, this market's hallmark is its resiliency, and until proven otherwise, the burden of proof remains with the bulls. I'd hold longs and add incrementally to foreign names or industrials domestically if you have to put money to work, but the dynamic feels like it's changing a bit.

Economics

After a quiet weekend the September Flash PMI was released yesterday morning, missing analysts' estimates.

PMI Manufacturing Index Flash

- September Manufacturing PMI was 52.8 vs. (E:54.0)

Takeaway

The flash PMI was a disappointment. The headline missed expectations and new orders—the most-important statistic next to the headline index number and the leading indicator in the report—was especially soft at 52.7 vs. last month's 55.7, a level we have not seen since April. Other details in their report were soft, as employment indices also declined since August.

The equity markets showed little interest when the report was initially released but, after a little bit of "information digestion," stock futures and crude oil began to sell off.

Yesterday's flash PMI index was not a strong signal for the state of the economy. It was the second pullback in a row and employment growth registered a three-month low.

Although the numbers still show expansion in the manufacturing sector (it is above the 50 level), this flash PMI implies we're seeing a slowdown in the pace of growth. (This is at odds with most regional surveys and the accelerating national ISM manufacturing PMI, which will come out next week.) Bottom line is this miss will put additional focus on that report.

Commodities

Commodities were universally lower yesterday as the weak domestic flash PMIs and news of Iran's desire to restart negotiations with the West regarding its nuclear program outweighed strong Chinese economic data and a weaker dollar.

Market	Level	Change	% Change
Dollar Index	80.550	.001	0.0%
Euro	1.3501	-.0023	-0.17%
Pound	1.6037	.0027	0.17%
Yen	.010124	.000054	0.54%
CAD $	.9706	.0011	0.11%
AUD $	.9392	.0038	0.41%
Brazilian Real	.4460	.0019	.43%
10 Year Yield	2.714	-.018	-.66%
30 Year Yield	3.742	-.018	-.48%
Prices taken at previous day market close.			

Energy was the big laggard yesterday, weighed down by a trifecta of soft economic data, further reduction of geo-political risk premium and benign weather. Natural gas led the way down, off almost 2% as weather turns decidedly cooler now that autumn is now upon us. Focus now turns from heat to cold, as incremental demand will now come from heating demand, not cooling. And, as we've been saying for a while, natural gas has needed constant support from weather to rally. Given the balmy temperatures across the country, that support is absent at the moment.

WTI crude was also weak, declining off of weak economic data and the positive Iranian news. To review, at the start of the UN General Assembly, Iran agreed to new talks with the "P5+1" regarding its nuclear program. This follows news last week that the new Iranian president was considering closing a strategic nuclear facility in exchange for a removal of sanctions.

While we've had years of "talks" between Iran and the West regarding its nuclear program that have yielded few results, just the resumption of talks helps reduce the geo-political premium in WTI and Brent crude, and given the improvement in Syria it's fodder for the oil bears.

The weakness in oil, which appears to be breaking out of that $105-$110 range, is surprising—especially in light of the improved global economic data. For the last few years, as crude goes, so goes other risk assets. If oil can't resume the rally sooner rather than later, it should be taken as a potential warning sign for risk assets.

Metals were the outperformers yesterday as gold and silver caught a bid on the "dovish" comments by Dudley. Both gold and silver rallied hard off their early morning lows and briefly turned positive, although neither could hold the gains and finished marginally lower.

The weaker dollar and dovish Fed seem to be giving gold longs a stay of execution, but with inflation still in the distance, I've got to wonder how long gold and silver can hold up given that they can't seem to rally, even with a dovish Fed.

Copper dropped yesterday despite the positive Chinese data, declining 0.5% thanks to general commodity selling. But, the fact that copper couldn't rally despite strong Chinese PMI data is a bit concerning.

Bottom line is commodities are trading very poorly, as the data and the weaker dollar should be making this space rally. Although I'm a bull based on fundamentals, price action is certainly telling me the complex wants to go lower. The lows of last week in DBC should be sacrosanct—if they are violated for more than an hour or two, then the outlook for commodities, fundamentals aside, will turn at best neutral and likely negative.

Currencies & Bonds

Treasuries rallied modestly in relatively quiet trading, thanks to the "dovish" comments by Dudley Monday morning, and the yield on the 10-year note appears to be challenging the 2.70% level.

The Dollar Index was flat yesterday but that was mostly because the euro was lower vs. the dollar. ECB Chief Mario Draghi, during testimony in front of the EU Parliament, added to the speculation that the ECB will unleash another round of Long-Term Refinancing Operations. Specifically, he said another round of LTROs was on the table, if near-term interest rates don't stay anchored. So, the euro traded down modestly on the statement.

Also weighing on the euro was the manufacturing PMI, which missed expectations and declined from August levels. It's pretty simple—the EU needs a weak euro to continue to help the fledgling economic recovery, and the euro at a multi-month high vs. the dollar doesn't help. The fact that German manufacturing also missed expectations will get EU policy-makers' attention, and I think there will be a concerted effort to get the euro weaker in the coming months. A new LTRO could help accomplish that goal.

If we ignore the euro, yesterday was actually a universally negative day for the dollar, as it fell against most major currencies thanks to the Dudley comments. The dollar fell against the pound, yen, Loonie and Aussie.

Yesterday's action in the greenback was a good example of why I don't think we're going to see a material drop in the dollar in the short term. Although the expectations for Fed tapering have changed, and that is dollar-bearish compared to where it was 10 days ago, the rest of the world's central banks are also firmly in easing mode. While the dollar won't rally until tapering expectations are back "on," I don't anticipate a substantial move lower in the Dollar Index, either, if for no other reason than everyone else wants a weaker currency, too.

The one exception is emerging-market currencies, which I think can make further gains vs. the dollar while we are in the "tapering limbo." That's solely because EM currencies have been absolutely destroyed in anticipation of tapering, and with that delayed, there is more room for a recovery.

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 but concerns are growing about the Fed's credibility and plan to unwind QE. At this point, though, the benefit of the doubt remains with the bulls, and performance chase into month/quarter end will be a short term tailwind on stocks.* *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 continue to remain attractive based on improving economic data, and looming political and monetary clouds in Washington. Internationally, European economic data shows the EU economy 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.**

Domestically, I'd look to allocate to deep cyclicals like industrials (XLI) and basic materials (IYM), as they should benefit from continued Fed stimulus.

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, although I don't envision a continued sell off either, as the FOMC will taper at some point (Oct or Dec).*

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.**