# 7:00's Report

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

***September 3, 2013***

## Pre 7:00 Look

- Futures sharply higher as US markets play catch up to international markets, which rallied yesterday on good data.
- Final reading on Chinese and EU manufacturing PMIs were released yesterday, and all beat expectations, further implying we're seeing a positive turn in the global economy.
- The surprise of the weekend came when President Obama announced he would see Congressional approval for any strike against Syria, delaying any action into mid-September.
- Econ Today: ISM Manufacturing PMI (E: 53.8).

| Market | Level | Change | % Change |
|---|---|---|---|
| S&P 500 Futures | 1645.50 | 14.25 | .87% |
| U.S. Dollar (DXY) | 82.35 | .21 | .25% |
| Gold | 1393.50 | -2.70 | -.19% |
| WTI | 107.28 | -.37 | -.34% |
| 10 Year | 2.749 | -.002 | -.07% |

## Equities

*Market Recap*

Markets were lower last week as continued weakness in emerging market currencies and angst over several events (but mainly the potential of a Syrian military strike) weighed on stocks. The S&P 500 fell over 1% and is now up 14.5% year to date.

The market was dominated by three things last week: Syria, emerging markets, and extremely low volumes. Most of the headlines last week centered around the Syrian situation, after the Secretary of State came out last Monday and all but said a military strike was imminent. But, action was delayed after the UK Parliament rejected participating in a strike, and events stayed fluid through the weekend with the latest being that on Saturday, President Obama shocked just about everyone (including his staff, apparently) by saying he would seek Congressional approval before launching any strike against Syria.

I'll let the pundits talk the politics of the move, but from a market standpoint this announcement serves to delay, not derail, a strike against Syria, as approval from Congress is ultimately expected. But, from a timing perspective, since the House doesn't return for another week, this puts the expected time for a vote somewhere around the 12th or 13th of September. Bottom line for the market, though, is Syria isn't a real headwind as long as any missile strike is limited and an isolated event, which is what expectations are at this point.

While Syria got all the headlines last week, emerging markets, and specifically their plunging currencies, were actually the much more "important" occurrence, and were the real driver of stock prices last week. The Indian Rupee, which is at the center of the EM crisis, may have potentially seen some sort of short term capitulation selling last week, as it declined 4% on Wednesday before the RBI stepped in to support the currency. It was joined by interest rate hikes from the Central Bank of Brazil and Indonesia, and those moves helped steady EM currencies into the end of last week.

Bottom line, though, is emerging markets remain the biggest near term headwind on stocks, and until we can have further stabilization, markets will have a hard time rallying. And, despite the progress last week, the Indian situation remains grim, as the latest PMI, released yesterday, fell below 50 for the first time since '09.

| Market | Level | Change | % Change |
|---|---|---|---|
| Dow | 14810.31 | -30.64 | -.21% |
| TSX | 12653.9 | -50.83 | -.40% |
| Brazil | 51835.15 | 1826.77 | 3.65% |
| FTSE | 6498.97 | -7.22 | -.11% |
| Nikkei | 13978.58 | 405.52 | 2.99% |
| Hang Seng | 22394.58 | 219.24 | .99% |
| ASX | 5196.57 | 8.29 | .16% |

Prices taken at previous day market close.

The lows of last week in the Rupee (ETF to watch is ICN) and emerging market bond ETFs (EMB, PCY) are now key support levels. If they can hold, then stocks can mount a decent rally. If that support is broken, then I'd expect more downside in equities in the near term.

| Market | Level | Change | % Change |
|---|---|---|---|
| Gold | 1393.50 | -2.60 | -.21% |
| Silver | 24.185 | .67 | 2.90% |
| Copper | 3.28 | .05 | 1.40% |
| WTI | 107.24 | -.44 | -.39% |
| Brent | 114.93 | -.23 | -.20% |
| Nat Gas | 3.672 | .10 | 2.51% |
| Corn | 4.80 | -.01 | -.21% |
| Wheat | 6.54 | .01 | .04% |
| Soybean | 13.56 | -.12 | -.88% |

Prices taken at previous day market close.

Finally, despite the recent weakness in the broad markets, it has to be pointed out that volumes and attendance these last two weeks of August have been very, very low. And, although we'll see increased activity levels starting today, the end of this week brings Rosh Hashanah, so really it won't be until next week that Wall Street is back at full staff. Point being, while the recent market weakness in certainly legitimate, I'm hesitant to read too much into anything given the very low volumes and attendance. How the market trades going forward will be much more important than the how it traded over the past two weeks (which wasn't very good).

*Bottom Line*

I still think the emerging markets are the main driver of equities, other headlines aside. During a very slow August, the market has filled the news void by scrutinizing several impending events: Syrian military strike, Bernanke's successor, debt ceiling debate. And, throughout August, each of those impending events has led to a market sell off. So, it'll be interesting to see if, as these events actually come to pass over the next few weeks, we see a "sell the rumor/buy the news" reaction from markets, because 1) Syria doesn't look like a big event, 2) Summers is now widely expected to be Bernanke's successor, and 3) the debt ceiling, political theatrics aside, will almost certainly be raised.

The real risk to further downside in equities is the pace of the rise in interest rates, which for now seems to have stabilized (remember, it was the big increase in interest rates in mid-August that ignited the emerging market turmoil). So, while I think ultimately interest rates head much, much higher, I think 2.90% in the 10 year is potentially a short term top, and hopefully that can help emerging markets further stabilize. If that happens, stocks can rally.

From a "where do we put money now" perspective, though, I'd continue to look for outperformance from Europe, commodities and basic materials, as those laggards will be the biggest beneficiary of the positive turn we're seeing in global economic growth.

## Economics

*Last Week*

Economic data last week was sparse, and what we did get largely missed expectations. But, the data wasn't important enough, nor were the misses big enough, to materially alter the expected course of Fed policy. So, the net effect was that last week's data further solidified that the Fed will announce QE tapering this month, but the amount of the taper will be very, very small (say $10 billion, give or take $5 billion).

Looking at last week's data, the durable goods number was probably the "worst" of the week, showing a pullback in capital expenditures from businesses in July. But, while a disappointing number, there has been undeniable improvement in capex over the past several months. For now, this one bad report isn't materially changing the economic outlook, although some firms noted their projections for 3Q GDP may be revised down because of the weak durables number.

While durable goods was the biggest miss last week, pending home sales was probably the most-important number. Pending home sales declined from a six-year high in May but generally met expectations. More importantly, pending home sales—which reflect contract signings in June—didn't fall off a cliff like new home sales did.

So, while there is now a lot of proof to show that higher mortgage rates are slowing the housing recovery, the recovery itself has not stalled. The economy can continue to grow even with the housing recovery moving at a slower pace—the important thing is that housing hasn't reversed course. Remember, don't confuse a slowing of the pace with a turn in direction—the former the economy can live with; the latter, it can't.

Other notable reports last week included the revised look at 2Q GDP, which beat expectations at 2.5% vs. the 1.7% reading from the first look. But, a lot of the positive revisions came from exports and inventories, not from an increase in Personal Consumption Expenditures or Non-Residential Fixed Investment, which would signal that the "real" economy is accelerating.

Jobless claims were flat last week, and continue to imply small but incremental improvement in the labor market. Meanwhile personal income and consumer spending both increased in July but missed expectations.

Importantly, the core PCE price index (the Fed's preferred inflation measure) contained in Friday's income and outlays report showed that year-over-year price increases remain well-below the Fed's 2% target at 1.2%. That's important because it means concern about "disinflation" will remain, which is another reason the Fed will keep the September taper very, very small.

*This Week*

This is a busy and potentially decisive week with regard to what will happen at the Sept. 18 Fed meeting. That's because it's "jobs" week for August. So, we get ADP Wednesday, Challenger job openings and weekly claims Thursday, and then the government report Friday.

Right now expectations are for a number similar to what we've seen over the last several months (in the high-100K job adds), but **here is the key to the number this week**: Unless the report is awful, and by awful I mean fewer than 100K jobs added, then tapering in September is definitively "on."

Away from employment, we get the latest official manufacturing and composite Purchasing Managers' Indexes from around the globe.

One of the biggest themes we've been talking about during the past several weeks is the stabilization of global economic growth—which, if it continues, is a major foundational positive for risk assets. I've said it before, but it's been years since we've had the four largest economies in the world (EU, China, Japan, U.S.) all growing at the same time, and I think a lot of strategists and analysts are underestimating the positives of that environment, if it truly materializes.

We got official Chinese and European manufacturing PMIs already, and they were universally better than expected, but China's composite PMI comes tonight, and European numbers are released Wednesday morning. Domestically, the manufacturing PMI comes this morning, and the services PMI comes Thursday.

Finally, there are multiple central banks with announcements this week: the Reserve Bank of Australia on Tuesday; the Bank of Japan Wednesday; and the European Central Bank, Bank of England and Bank of Canada Thursday.

No one is expecting any movement on the interest rate or policy front from any of them, and I'll cover ECB/BOE expectations as we get closer. But here's the overarching theme to look for: The Fed, via its intention to taper, is exporting higher interest rates to the rest of the world. Other central banks need to more-effectively counter that rise in rates, either through rhetoric ("forward guidance") or, ultimately, via more accommodation. (That means more QE from the BOE, and more Long-Term Refinancing Operations from the ECB).

So, look for all these central banks to reiterate their commitment to very accommodative policy, which is an underlying positive for those respective economies (especially Europe) as the global economy turns for the better amidst a backdrop of still-historic monetary accommodation.

| Market | Level | Change | % Change |
|---|---|---|---|
| Dollar Index | | | |
| Euro | 1.3176 | -.0032 | -.24% |
| Pound | 1.5493 | -.0003 | -.02% |
| Yen | 1.0049 | -.0139 | -1.36% |
| CAD $ | .9488 | -.0004 | -.04% |
| AUD $ | .9024 | .0132 | 1.48% |
| Brazilian Real | .4130 | .0015 | .36% |
| 10 Year Yield | 3.676 | -.027 | -.73% |
| 30 Year Yield | 2.749 | -.002 | -.07% |

Prices taken at previous day market close.

## Commodities

Commodities finished a volatile week as concerns about Syria dominated the market narrative. Energy (especially oil) and metals led broad-based commodity indices to levels not seen since March. (DBC, the PowerShares DB Commodity Index Tracking

Fund, hit a five-month high.) Markets anticipated some sort of military action in Syria, largely based off Secretary of State John Kerry's comments last Monday. But, after the UK failed to authorize the use of military force, the situation became less-certain, and the "Syrian strike" premium that went into commodities came out of the markets on Thursday.

WTI crude finished the week about 1% higher, but well-off the highs of the week (above $112/bbl.), while Brent traded 3% higher, reflecting the concerns of potential supply disruptions should the U.S. strike Syria.

Gold followed a similar pattern, trading above $1,400/oz. and rallying into the $1,420s before closing back below $1,400/oz. on Friday. Specifically, gold continues to rebound, but it needs to hold around the $1,400/oz. level to maintain positive momentum. Obviously the jobs report will be a big influence on gold, but with a lot of shorts in the market and Fed "tapering" expected to be very, very small, I remain cautiously optimistic on gold.

Bottom line with commodities is the Syrian concern resulted in a temporary spike higher, but really the story for commodities is the return of global growth. That's the reason to own commodities right now, not Syria.

So, this week is critically important, not so much because of the jobs report, but instead because of the global PMI releases. The PMIs this week will be key toward cementing the belief the global economy is stabilizing and growing, and if that's the case then commodities as an asset class are cheap.

## Currencies & Bonds

Emerging-market currencies remain the key asset class dictating all others (despite the media's focus on Syria). Last week offered some hopes of stabilization, but the jury remains out.

Emerging currencies were sharply lower early last week, resulting in a steep equity market sell-off. The Indian rupee plunged to another record low, trading nearly 4% lower on Wednesday, while the Mexican peso and Turkish lira were also sharply lower. But, this past Thursday morning, several central banks acted to defend their currencies (the Reserve Bank of India, most importantly). This helped to stabilize EM currencies into the end of the week.

But, the situation remains very fluid, and it's way too early to tell whether their respective central banks' actions are enough to calm markets.

Bottom line is to continue to watch the rupee (via ICN, the WisdomTree Indian Rupee Fund). The lows of last week are now critical, and they need to hold if this emerging-market turmoil is to subside and allow equities to rally.

The dollar strength I've been looking for during the past several weeks finally materialized in the second half of last week. The Syria situation and the acceptance that, barring a horrid jobs report, the Fed will tapering in September, helped push the dollar higher in most major crosses.

Of note, the only two days the Dollar Index traded higher than 82 in August were the 1st and the 30th. But, I continue to think we'll see dollar strength against most major currencies going forward. While the Fed is tapering, other central banks are more-inclined to do more accommodation to counteract the rise in rates.

Fundamentally, the dollar should be heading higher—and it looks like we may finally be seeing a bit of a rally.

Treasuries fell last week as the idea of a small September taper is now fully priced in. I said multiple times that 2.90% could be the top for a bit in the 10-year yield ("a bit" meaning weeks, not months), unless the economic data all of a sudden significantly accelerates, which is unlikely.

Bottom line, though, is rates are heading higher as the Fed tapering and central banks try and keep rates lower via the use of "Forward Guidance," a policy tool that I think will underwhelm.

At this stage, I would use any material rally in Treasuries to add to medium- and longer-term positions, as I think replacing QE with forward guidance only strengthens the bearish Treasury case.

Have a good week,

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 | *US equities have been consolidating recent gains and going through a typical correction. But, turmoil in emerging markets is threatening to be a potentially bearish game-changer. EM bonds haven't moved to new lows yet (which would be a signal to de-risk) but stocks will have a hard time rallying until the emerging markets stabilize.* *The S&P 500 support is now around 1620ish while resistance is at 1660ish.* |

**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 | 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. The Syrian conflict has resulted in WTI and Brent moving to multi-month highs, but I'd wait for a bit of a pull back as at this point any military strike will be a one off, as opposed to a greater intervention in the region.**

**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 | Bullish | Bullish | Bullish | *The dollar index has traded to support at the 81.00 level, which should hold if the trend is still higher in the dollar. I remain dollar bullish based on the marginal direction of monetary policy, but if the uptrend at 81.00 is decisively broken, I'll have to admit I'm wrong.* |

**Trade Ideas**

***Short*****: Japanese Yen on any decent bounce (YCS being the ETF to use), like we've seen now, especially in the face of weak GDP reports. 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.**