7:00's Report

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

September 30th, 2013

Pre 7:00 Look

- Futures and international markets sharply lower on a combination of governmental worries and soft economic data.
- Washington appears headed for a short term government shutdown at midnight tonight, while the Italian government is teetering on the brink of collapse after Berlusconi pulled support for the governing coalition this weekend.
- Economic data was also disappointing: Final Chinese Manufacturing PMI fell from last week's "flash" reading of 51.2 to 50.2, implying the recovery may be plateauing.
- Econ Today: No Reports Today.

Market	Level	Change	% Change
S&P 500 Futures	1673.25	-13.25	-.79%
U.S. Dollar (DXY)	80.38	.003	0.01%
Gold	1336.20	-3.00	-.22%
WTI	101.81	-1.07	-1.04%
10 Year	2.619	-.0024	-.91%

Equities

Market Recap

Stocks fell 1% last week in choppy, Washington-headline-driven trading, as conflicting Fed statements and gyrating expectations on a government shutdown caused markets to bounce around all week. The S&P 500 is now up 18.62% year-to-date.

I've warned for several weeks about Washington becoming the dominant market force, and this happened in full last week. Each day's trading was directly affected by either a Fed speaker or the outlook for the continuing resolution and debt ceiling.

Stocks declined last Monday through Wednesday in very quiet, conviction-less trading, with cautious comments from N.Y. Fed President William Dudley on the economy kicking off the week, along with ongoing angst over when the House would receive the "clean" CR from the Senate. The market got a one-day respite Thursday, amid somewhat positive and "hawkish" comments from Fed governor Jeremy Stein. Then, news broke the Senate would return a "clean" CR to the House on Friday, and there was a surprisingly strong jobless claims report. But, Friday morning it became apparent the House would attach more amendments to the clean CR, so the risk of a shutdown increased—sending stocks lower to close the week.

Such is life in a market held hostage by Washington.

As a result of this paralysis, volumes last week were very low, with most investors content to sit on the sidelines and wait to see how all this Washington gamesmanship turns out. Trading last week was dominated by algos, fast-money funds and day traders, and there was zero conviction to the tape.

Given the choppy market, there aren't a ton of takeaways on a sector basis, but a few things do stand out.

First, financials—and the banks in particular—continued to trade heavy last week. The space was already under pressure given the rotation of money out of the space as "no tapering" means no increase in net interest margins (which had been priced in, to a point). But, recent concerns about trading volumes added to the bearish chorus. Although the sector bounced Thursday, the trend appears to be lower for now.

Second, "bond proxy" sectors are not getting the "no tapering" bounce you would expect. Despite last week

Market	Level	Change	% Change
Dow	15258.24	-70.06	-.46%
TSX	12844.08	2.46	.02%
Brazil	53738.92	-44.05	-.08%
FTSE	6461.82	-50.84	-.78%
Nikkei	14455.80	-304.27	-2.06%
Hang Seng	22859.86	-347.18	-1.50%
ASX	5218.88	-88.18	-1.66%
Prices taken at previous day market close.			

being, on balance, "dovish" for the Fed, bond-proxy sectors like utilities, REITs and others didn't outperform. Utilities, telecom, healthcare and REITs have basically given up the entire rally they saw after the Sept. 18 Fed meeting.

Consumer discretionary was one of the bright spots as the sector rallied last week on decent consumer spending numbers Friday and good earnings from Bed Bath & Beyond (BBBY) and Nike (NKE) earlier in the week.

Market	Level	Change	% Change
Gold	1336.7	12.60	0.95%
Silver	21.790	.24	0.11%
Copper	3.3200	.013	0.39%
WTI	102.83	-.20	0.19%
Brent	108.44	-.77	0.70%
Nat Gas	3.589	.022	0.62%
Corn	454.00	-2.75	-0.60%
Wheat	683.00	4.75	0.70%
Soybean	1319.75	3.00	0.23%
Prices taken at previous day market close.			

Finally, international continues to soundly outperform the U.S. "Europe" finished last week flat, compared to the 1% decline in the S&P 500, and is up 7.3% MTD and 12.3% QTD. The Nikkei was also unchanged last week, but is up 10% MTD and close to new 52-week highs.

As mentioned, volumes were anemic last week as markets are in a state of Washington-induced paralysis, and on the charts support in the S&P 500 lies at the 50-day MA (1,680) while 1,700 appears to be the nearest resistance.

Washington Update

In a shocking turn of events, Washington has once again proven dysfunctional, and we find ourselves barreling toward another crisis and likely 11th-hour solution (but not before more drama). Last week I warned that the risk to the current CR drama was if the House sent back a CR with new amendments attached, and that's exactly what's happened.

The House Saturday night passed a bill that funds the government through Dec. 15, but added a one-year delay on the individual mandate to the "Affordable Care Act" and removed a tax on medical devices. Like the earlier version, this bill is dead in the Senate, so at this point the chances of the federal government shutting down at midnight tonight have increased substantially.

But, although the media will portray it as such, even if the government shuts down for a short period, it's not a bearish game-changer. The real risks here (that would require getting defensive, and fast) are for a protracted government shutdown (not just a few days) and/or a breach of the debt ceiling. Drama aside, both those "Armageddon" scenarios look very, very unlikely.

At this point, the Senate will come back into session around mid-day today, where they will vote down the CR sent from the House. And, at that point, we start the game all over again—will the House pass the "clean" CR or will it add another set of amendments? The answer will result in a shutdown or not (although at this point at least a temporary shutdown is likely, just based on the fact there's not a lot of time to get everything done).

This Week

Besides Washington drama and a heavy calendar of economic data, there will be multiple Fed speakers (highlighted by Ben Bernanke on Wednesday, although there may not be much on monetary policy. The speech is called "Community Banking in the 21st Century").

Internationally, all eyes are on Italy. PM Letta is scrambling to shore up support for his government amidst the with drawl of support by Berlusconi. All this is occurring as the Italian Senate is set to vote on Silvio Berlusconi's expulsion on Friday. Obviously if there is a collapse of the Italian government and new elections, that will be a negative event for Europe peripherally. In Japan, Prime Minister Shinzo Abe is expected to announce tonight whether the planned sales tax increase will go through in the spring. (The wide expectation is "yes it will.")

Micro-economically, the calendar is quiet but we're now in "pre-announcement" season for Q3 earnings, which start with Alcoa (AA) on Tuesday, Oct. 8, so there are potential surprises lurking.

Economics

Last Week

Last week was relatively busy from a data standpoint, and although the economic data was overshadowed by headlines from Washington, there are a few important takeaways with regard to the two most-pressing questions facing the market at the moment: "Is the global recovery on track and accelerating?" and "When will the Fed taper QE?"

The most-important number last week came Monday, and it was the global flash Purchasing Managers' Indexes. China's PMI moved to a multi-month high, while the European Union and U.S. PMIs surprisingly declined from August—although remained above the 50 level, signaling expansion, just at a slower rate. The "flash" PMIs are comprised of about 80% of the data that goes into the official PMIs that are released this week. So, with regard to Question No. 1, the apparent slowing of momentum in manufacturing in the U.S. and EU will mean the official numbers are scrutinized even more closely this week. The resumption of global economic growth is critical to risk assets being able to continue to rally, so it's important that the PMIs show positive momentum.

Looking domestically, the economic data last week largely met expectations. The August durable goods report showed some recovery from July. Non-defense capital goods excluding aircraft, the most-important number in the release, rose 1.5% after a steep drop in July. But, the three-month average turned negative for just the second time this year. So, the outlook for business investment (which is basically what durables goods shows) remains cloudy.

Housing data last week (New and Pending Home Sales) largely confirmed that, while the housing market has lost some momentum, the recovery is still progressing and we're definitely not see a sharp drop-off in activity as a result of higher mortgage rates. And, the final look at 2Q GDP was little changed at 2.5% and reinforces what we already know: We're in a slow-growth economy.

The big positive surprise last week the weekly jobless claims, which weren't revised much higher, as was expected now that the computer problems in California and Nevada were fixed. At basically 300K, claims are making new, multi-year lows, which does imply an acceleration of activity in the labor market.

Finally, Friday brought Personal Income and Expenditures. And, while the headline numbers beat expectations, the more-important detail in this report is the Core PCE Price Index, which is the Fed's preferred measure of inflation. The year-over-year increase in Core PCE was just 1.2%, unchanged from July, and well below the 2.0% the Fed is targeting.

So, with regard to Question No. 2, "When will the Fed taper?"—if we are to believe Fed President Dudley (which we should), the Fed is looking for sustained GDP growth and an uptick in inflation before tapering. So, this week's data showed slow growth and no inflation—and as a result we should not expect QE tapering anytime soon.

<u>This Week</u>

It's another busy week. First, it's jobs week, so we have ADP on Wednesday, weekly claims Thursday and then the government report Friday. While I don't want to suggest the report's importance has been diminished, people are more focused on growth and inflation with regard to the Fed. But, we've seen a marked improvement in weekly claims, so sooner or later that should materialize in the monthly report.

The other, equally big release this week are the official global manufacturing and service sector PMIs.

The Chinese HSBC/Markit PMI was released last night and declined from the "flash" reading and barely improved from August, at 50.2 vs. 50.1. The "official" Chinese number comes tonight (the HSBC estimate was released last night), and manufacturing PMIs from the EU and U.S. come Tuesday morning. Composite PMIs from China and the EU (which combine the manufacturing and service sectors) and U.S. service sector PMIs are released Thursday morning (EU & U.S.) and

Market	Level	Change	% Change
Dollar Index	80.350	-.288	-0.36%
Euro	1.3525	.0035	0.26%
Pound	1.6128	.0095	0.59%
Yen	.010184	.000058	0.57%
CAD $	.9687	.0008	0.08%
AUD $	.9268	-.0042	-0.45%
Brazilian Real	.43675	-.00265	-.60%
10 Year Yield	2.619	-.024	-.91%
30 Year Yield	3.681	-.009	-.24%

Prices taken at previous day market close.

Thursday night (China). As mentioned already, these PMIs provide critical insight as to whether the global recovery is continuing to gain momentum. (And if it's not, I need to revisit my "International Outperformance" thesis, but we'll have to wait and see.)

Commodities

Commodities in aggregate were flat last week, as the commodity ETF DBC was little changed. Strength in gold, copper and the grains offset weakness in energy, as further reduction in geo-political risk globally and U.S. governmental drama outweighed good Chinese economic data and a marginally weaker dollar.

Gold traded 1% higher and definitely acted a bit "better" last week as concerns regarding Washington and the resulting dollar decline helped support gold. With the government shutdown drama rising in Washington, we very well could see a bit of a "safe haven" bid into gold this week, but that's not what's needed to sustain a longer-term uptrend. Unless any "crisis" rally in gold can breach $1,375, I'd consider it a one-off. Rising inflation is the key to the next sustained rally in gold, and data last week showed little statistical inflation. So, I continue to view gold as largely rangebound for now.

WTI crude was one of the worst-performing commodities last week, as apparent improvement in U.S./Iranian relations extended this recent streak of declining geopolitical risk premiums. And, it overshadowed generally supportive economic data. Political concerns and the lack luster Chinese manufacturing data are weighing on WTI Crude this morning, but I continue to be a nervous energy and oil bull, given the continued improvement in the U.S. and global economy, and would somewhat nervously buy these dips in USO or XLE.

Currencies & Bonds

The dollar declined modestly last week thanks to, on balance, dovish remarks from the Fed combined with concerns about the funding of the government. (And also the debt-ceiling fight, which hasn't even started yet.)

The rally in international currencies was pretty universal, as dollar weakness was the dominant catalyst in the markets. In fact, the only major currency to fall last week vs. the dollar was the euro, which was fractionally lower. Some soft economic data (the flash PMIs) and renewed concern over Italian political drama weighed on the euro, so the PMIs this week will be especially important in gauging the health of the European recovery. (The Berlusconi drama also looms as a potential negative outlier for the euro.)

The pound remains one of the strongest currencies in the market vs. the dollar. It had a nice rally last week and is threatening to make new, multi-month highs. Continued good economic data (retail sales) and comments from BOE head Mark Carney that more QE probably wasn't needed given recent economic strength were the reasons for the rally.

Turning to Asia, the yen also rallied vs. the dollar. The main story in Japan is whether Abe will indeed go forward with the sales-tax increase next spring, and more importantly, what he might do to offset those increases (most expect a reduction in corporate taxes). This is a big week for data from Japan: The Tankan corporate-sentiment survey tonight is the highlight, while the BOJ meeting later this week is expected to be a non-event. All eyes will be on Abe tomorrow, though. While we may see a "buy the rumor/sell the news" reaction in the short term, that would be a dip I'd look to buy, as long as there were no surprises later this week.

Turning to bonds, Treasuries rallied during the "dovish" past week to nearly six-week highs, although angst toward Washington put a cap on the rally late last week. Washington theatrics will overshadow policy next week, but don't expect a short-term government shutdown to significantly weigh on Treasuries, as some will say it will. In fact, as counterintuitive as it may seem, look for investors to use any short-term shutdown drama as a buying opportunity in Treasuries, because everyone "knows" that a prolonged shutdown or debt-ceiling breach is very, very unlikely.

While I remain an ardent long-term bond bear, this countertrend rally isn't over yet, even with the government's interference.

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	*Political worries from Washington have seen stocks trade more than 2% off the post FOMC all time highs, and will be the predominant influence on markets this week. More broadly, though, the benefit of the doubt remains with the bulls, and unless there is a extended shut down or debt ceiling breach, and substantial decline is probably a buying opportunity.* *Support in the S&P 500 sits at the 50 day MA (1680) with resistance at 1700.*

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.

	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, 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.

	Fundamental Outlook	Technical Outlook	Overall	Comments
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.**

	Fundamental Outlook	Technical Outlook	Overall	Comments
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 initial 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.**