7:00's Report

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

September 4, 2013

Pre 7:00 Look

- Futures and global markets are modestly lower this morning as Syria angst weighs on risk assets. Good econ data and strength in the Rupee are helping to limit the losses.
- The Rupee and Sensex rallied Wednesday as the RBI again intervened in the currency markets and the bank considered other measures to support the currency.
- Economic data was good o/n: Service sector PMIs from Japan, China, Germany, France & UK all beat expectations, although EU PMI was a touch light and retail sales missed.
- Econ Today: (Beige Book 2 PM EST).

Market	Level	Change	% Change
S&P 500 Futures	1637.25	-1.75	-.11%
U.S. Dollar (DXY)	82.295	-.106	-.13%
Gold	1402.00	-10.00	-.71%
WTI	107.82	-.75	-.69%
10 Year	2.848	.099	3.60%

Equities

Market Recap

Stocks started the holiday-shortened week with a mild rally, as good global and domestic economic data pushed markets higher. But, a spike higher in bond yields, a sell-off in emerging-market currencies, and some saber-rattling from leaders of Congress weighed on stocks, and markets pared their gains throughout the afternoon to finish well-off their best levels. The S&P 500 closed up 0.42%.

Commodities vs. S&P 500: Since August, commodities have outperformed U.S. equities, as a positive turn in the global economy benefits commodities most directly.

Stocks started the day sharply higher, thanks to the need to play catch-up to a big, economic-data-inspired global rally Monday. Adding to the positive sentiment were two relatively large M&A deals (VZ & VOD, and MSFT & NOK). These were seen anecdotally as evidence there might be a wave of M&A coming as companies use cheap capital while it still exists. Finally, the better-than-expected ISM manufacturing PMIs helped push markets to their highs of the day mid-morning.

But, markets couldn't hold the gains. While most of the headlines blamed the declines on comments by House Speaker John Boehner and Majority Leader Eric Cantor expressing support for the president's resolution for striking Syria (meaning it'll almost certainly pass), really it was more the spike in Treasury yields (specifically the 10-year), which came within a hair of last week's highs of 2.90%, that led to the market selling off.

At one point, the Dow actually turned negative (although that was mostly due to the MSFT's 6% merger-related decline), but stocks bounced a bit during the final hour of trading to finish soundly positive, but well-off the highs.

Trading Color

Market	Level	Change	% Change
Dow	14833.96	23.65	.16%
TSX	12740.50	86.60	.68%
Brazil	51625.50	-209.65	-.40%
FTSE	6428.38	-40.03	-.62%
Nikkei	14053.87	74.53	.54%
Hang Seng	22326.22	-68.36	-.31%
ASX	5161.64	-34.93	-.67%
Prices taken at previous day market close.			

Not surprisingly, with yields spiking higher, the trend of underperformance from "bond proxy" sectors continued. In a confusing and choppy tape, this remains the most-consistent trend within sector trading. Utilities fell more than 1% on the jump in yields, while REITs fell almost 1%.

Market	Level	Change	% Change
Gold	1412.2	16.10	1.15%
Silver	24.375	.862	3.67%
Copper	3.3105	.0775	2.40%
WTI	108.55	.90	.84%
Brent	115.74	1.41	1.23%
Nat Gas	3.662	.082	2.29%
Corn	475.25	-6.75	-1.40%
Wheat	647.25	-6.75	-1.03%
Soybean	1386.25	28.75	2.12%

Prices taken at previous day market close.

In addition to the weakness in "bond proxy" sectors, there was also a definitely "out of safety, into cyclicals" rotation evident yesterday (which isn't that surprising given the improving global economic data and domestic data). Financials were the best-performing S&P 500 sub-sector, while consumer discretionary, energy, industrials (thanks to the ISM PMIs), and tech outperformed. Additionally, telecom lagged and staples finished fractionally negative.

There certainly was some evidence that the summer holidays were over, as trading volumes were above their recent three-month averages, but things weren't all that much busier. (As I said yesterday, with Rosh Hashanah at the end of this week, things will really be back to full speed next week.) But, I imagine some of this cyclical outperformance yesterday was managers allocating for the sprint into the end of the year.

On technicals, the S&P 500 remains caught between support around 1,620 and resistance at the 50-day moving average at 1,661.

Bottom Line

The media only cares about Syria, but emerging markets are still driving this market in the short term. Boehner and Cantor's comments yesterday weren't surprising—no one thought the resolution wouldn't pass Congress. Unless something radically changes, the strikes, when they happen in mid– to late-September, will be surgical and a one-off—not the start of a broader intervention.

Yesterday's rally faded because:

1) Yields on the 10-year note spiked 15 basis points higher, to nearly 2.90% again, after the ISM PMIs.
2) That spooked the emerging markets, and those currencies went south in a hurry—letting the air out of the rally balloon.

This market seems stalemated at this point. While I'm still cautiously bullish on risk assets (mostly European equities and commodities) into the end of the year, I'd continue to wait for stabilization in the emerging markets before I allocated more to equities, as a breakdown in EMs will take everything lower, except gold.

Economics

ISM Manufacturing PMI

- August ISM Manufacturing PMI 55.7 vs. (E) 53.8.
- New Orders increased to 63.2 from July's 58.3.

Takeaway

August manufacturing PMI was much better than expectations on the headline, and the details of the report were equally strong. New orders, which is the leading indicator in the report, rose above 60 for the first time in 2.5 years, implying business in the manufacturing sector is accelerating. At the same time, almost all of the subcomponents of the report were also strong in August.

So, this national manufacturing report further implies that the rebound we've seen over the past 3+ months in the manufacturing sector is accelerating, which obviously is a positive for the economy and will help alleviate some concerns from last month's soft durable goods and industrial production reports. The ISM PMI is a positive for industrials and well as industrial commodities, which both rallied off the news.

From a WWFD (what will the Fed do) standpoint, yesterday's data further cements that we will see an announcement of a small tapering of QE at the September meeting, barring a horrific (sub-100K) jobs report Friday.

Commodities

Commodities continued their recent outperformance, rallying hard Tuesday as strong global economic data continued pushing industrial commodities higher while congressional leaders' saber-rattling with regard to Syria led to a bid in gold and oil by midday.

Silver and copper were the best-performing commodities yesterday, rallying nearly 4% and 3% respectively, thanks to the strong global manufacturing PMIs. (Mainly it was the Chinese number, but the EU and U.S. beats didn't hurt either.)

Oil was also higher yesterday thanks mostly to elevated geo-political risk, as the Boehner and Cantor comments in support of the resolution to strike Syria all but guarantee its passage. Brent led energy higher, rallying 1.5% and nearly doubling WTI's 0.6% rally, which makes sense given the geo-political nature of the rally.

But, while more geo-political premium found its way into oil yesterday, I'd be hesitant to think we will see a rally beyond the highs of last week. First, despite the market reaction yesterday, it was widely expected that Congress would pass the resolution (hence the "delayed but not derailed" comments yesterday).

Second, the highs from last week came amidst the unknown type of action—meaning, there was some fear of more involvement than just some isolated missile strikes. But, the action by the U.S. likely will not involve regime change in Syria, which should keep any international fallout from the missile strikes at a relative minimum. (Meaning, it won't be enough to prompt retaliation, economic or otherwise, from Russia or Arab countries.) Point being, unless something really changes with regard to Syria, I think the true range in crude remains around $103-$108 level. This will only be decisively broken when we see a material uptick in the economic data.

Finally, gold traded well yesterday, catching the midday "Syria bid" to finish up 1.2%. But, gold traded well before the Syria saber-ratting, as it held close to the $1,400/oz. range despite a stronger dollar and the events over the weekend (which should have resulted in a gold sell-off, seeing as any potential strike vs. Syria was delayed).

Market	Level	Change	% Change
Dollar Index	82.395	.253	.31%
Euro	1.3172	-.0036	-.27%
Pound	1.5564	.0071	.46%
Yen	.010049	-.000139	-1.36%
CAD $	.9491	-.0001	-.01
AUD $	.9044	.0152	1.71%
Brazilian Real	.42125	.0042	-.75%
10 Year Yield	2.848	.099	3.6%
30 Year Yield	3.776	.10	2.72%
Prices taken at previous day market close.			

Looking at the fundamentals, there was simply massive covering of shorts in gold over the past 10 days. Short positions declined by 20K+ contracts in the latest Commitment of Traders report, and the reduction led to speculative "net longs" reaching their highest levels since early February at 70K contracts.

But, even with the big drop in shorts, the fundamentals of the gold market remain healthy. Speculative longs are only 105K, which is well-below the 150K+ you normally see at the end of rallies. Speculative shorts are 35K, which—prior to the historic shorting of gold earlier this summer—would be considered an elevated level.

At this point, though, we've seen a lot of short-covering, so the next leg higher in gold will have to be driven by people actually getting bullish on gold, not just covering bearish bets. And, for that to happen, I think we've got to see inflation start ticking up, which is what I think ultimately does happen later this year. So, despite the increase in "spec net longs," I remain cautiously bullish of gold here.

More broadly, commodities continue to outperform equities, as they are the primary beneficiary from the uptick in global growth, and that's a trend I think can continue throughout the fall.

Currencies & Bonds

Emerging-market currencies resumed their declines Tuesday, as the spike higher in Treasury yields again led to selling in both EM currencies and bonds. But, encouragingly, the lows of last week held (for now, anyway) and so the rupee, real and peso finished off their worst levels of the day.

The volatility in EM currencies and debt isn't over, but the lows of last week remain key—if they can hold, then risk assets can rally from here. So far, despite yesterday's early weakness, they have … although I'm nervous.

Turning now to the Dollar Index, it rallied Tuesday as you'd expect, given the strong manufacturing PMI, which is viewed as increasing the likelihood of QE tapering at the September Fed meeting.

The euro, despite having strong data of its own, finished marginally lower vs. the dollar. It's clear that if the European Central Bank is going to change policy at all, it'll move toward more accommodation, not less. Also, although the data in the EU is getting better, the ECB, on balance, remains more "dovish" than the Fed. This should exert continued pressure on the euro.

The pound, however, continued to move higher vs. the dollar as more economic data beat expectations Tuesday (this time it was the construction PMI, their version of the manufacturing PMI).

The market continues to call the "bluff" of forward guidance issued by the Bank of England, as the improvement in the UK economy is seen as pulling forward an increase in interest rates. But, the important thing here is that equity investors win whether the market is right or the BOE is right. In other words, either the market is right and the UK economy improves substantially, pulling rates higher (which will be good for UK corporations), or the BOE is right, and they keep monetary policy accommodative despite the improvement in the economy, likely stoking inflation and sending UK shares higher. Point being, either outcome is bullish for the iShares MSCI United Kingdom Index (EWU).

Turning to Asia, that was where the action was in the developed-currency markets yesterday. The Aussie dollar rallied 1.8% vs. the greenback as the strong Chinese data prompted massive short-covering. Meanwhile the yen plunged 1.4% vs. the dollar, as money that stampeded into to the yen last week in a "safe haven" trade in reaction to Syria moved back out. Remember, any military action against the country won't occur for a few weeks and likely will be very limited.

Prior to that safe-haven demand pushing the yen higher last week, the currency had been quietly fading vs. the dollar, and yesterday's declines saw the yen break through an uptrend that has been in place since May.

I've said repeatedly that I don't think the decline in the yen ended in May and that, ultimately, I think the yen heads for 115-120 vs. the dollar. But all trends, regardless of how fundamentally founded they are, have periods of consolidation or counter-trend rallies. In this case, I think that is what we've had in the yen since May, and I also think that is what just ended.

Emerging-market volatility and the Bank of Japan meeting later this week make this a bit risky, but If you're looking to get short yen, I'd initiate a position in the ProShares UltraShort Yen ETF (YCS) on yesterday's break of that uptrend, and look to add to it when 100 yen to the dollar is broken. Shorting yen remains one of the most fundamentally sound trades in the market, as there is simply no way that yen at sub-100/dollar will engender the type of growth Prime Minister Shinzo Abe needs to finally break deflation.

Finally, Treasuries sold off hard yesterday thanks to 1) a negative bond article in the Journal (link here), and 2) the much better-than-expected PMIs, which all but guarantee "tapering."

I said last week that 2.90% may be the top in the 10-year note over the shorter term. Certainly that looked wrong yesterday morning, but yields never got through 2.90% and finished in the mid-2.80%s. So, I'm sticking with my gut and saying I think we've seen the top for a few weeks in the 10-year yield. Yesterday's reaction aside, I think a small taper of some sort in September is largely priced in with yields at current levels. But, I'd be happily shorting any material rally, as we're a long way from the end of the downtrend in bonds.

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	*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**: The Japanese yen looks to have decisively broken an uptrend since in place since the May lows, and I suspect that means the next leg lower in this trend of yen weakness has started (use YCS). 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	*Given recent economic data, a small tapering of QE is now widely expected at the September Fed meeting. But, while the initial move may be small, the trend towards less accommodation is will have started, ultimately leading to an increase in rates.*

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.**