# 7:00's Report

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

***September 5th, 2013***

## Pre 7:00 Look

- Futures flat and most markets little changed ahead of central bank decisions later this morning.
- It was a good night for India as the Rupee and Sensex surged after new RBI Governor Rajan announced measures to help the banking sector & support the Rupee.
- Economic data o/n was light. The BOJ upgraded its outlook for the Japanese economy, as expected, but made no changes to policy, while German manufacturers orders were largely in-line.
- Econ Today: BOE Rate Decision (7:00 AM), ECB Rate Decision (7:45 AM), Jobless Claims (E: 330k), ADP Employment Report (E: 177k).

| Market | Level | Change | % Change |
|---|---|---|---|
| S&P 500 Futures | 1652.50 | -1.00 | -.05% |
| U.S. Dollar (DXY) | 82.255 | .05 | .06% |
| Gold | 1394.90 | 4.90 | .35% |
| WTI | 107.76 | .52 | .48% |
| 10 Year | 2.897 | .049 | 1.72% |


***Biotech shares have quietly been one of the best performing sectors in 2013, as a multi-year underwhelming drug pipeline appears to be ending.***

## Equities

*Market Recap*

Stocks had a nice rally Wednesday as strong auto sales, a positive Fed Beige Book, and lack of any deterioration in the Syria situation led to a 0.81% rally in the S&P 500.

There certainly were positive catalysts and a reason for the rally Wednesday, and chief among them were the aforementioned auto sales, which not only beat in aggregate, but the company numbers were also strong. (F, GM, TM and NSANY all reported strong sales numbers.) Although it's been somewhat overlooked in the tech-dominated economy, this country is still about cars and housing, and both industries continue to see growth. I'm not sure how many times the stock market has logged a significant decline when both housing and auto sales were rising, but I can't think that it's been very often.

Stocks keyed off the good data yesterday and spent most of the session grinding steadily higher, as shorts were caught off-guard by the rally (most everyone expected a dull market yesterday and into the jobs number) and covered throughout the morning, pushing stocks to their highs around midday.

Other positive catalysts were Senator John McCain's initial withdrawal of support in the Syria resolution (it'll still pass, but McCain's non-support was taken as showing the military plans must be very limited), and the August Beige Book, which contained language that implied a mild upgrade in the economy.

Stocks spent most of the afternoon near the highs of the day, and bulls will be encouraged by the fact that the

| Market | Level | Change | % Change |
|---|---|---|---|
| Dow | 14930.87 | 96.91 | .65% |
| TSX | 12757.81 | 17.31 | .14% |
| Brazil | 51716.16 | 90.66 | .18% |
| FTSE | 6473.42 | -1.32 | -.02% |
| Nikkei | 14064.82 | 10.95 | .08% |
| Hang Seng | 22587.97 | 271.75 | 1.22% |
| ASX | 5142.51 | -19.13 | 0.37% |

Prices taken at previous day market close.

market didn't fade into the close, as it had been doing all last week, and stocks went out yesterday just off their highs.

| Market | Level | Change | % Change |
|---|---|---|---|
| Gold | 1389.7 | -22.30 | -1.58% |
| Silver | 23.410 | -1.019 | -4.17% |
| Copper | 3.2445 | -.06 | -1.81% |
| WTI | 107.14 | -1.40 | -1.29% |
| Brent | 114.85 | -0.83 | -0.72% |
| Nat Gas | 3.682 | .016 | 0.44% |
| Corn | 469.25 | -6.00 | -1.26% |
| Wheat | 646.25 | -1.00 | -0.15% |
| Soybean | 1351.75 | -35.00 | -2.52% |
| Prices taken at previous day market close. | | | |

*Trading Color*

Cyclicals continued to outperform yesterday. The Russell 2000, Dow Transports and Nasdaq all led the averages higher, while sector trading was decidedly "pro-cyclical" as well.

Strong international and domestic data helped industrials become the best-performing S&P 500 sub-sector for the second day in a row, while consumer discretionary rallied hard on the auto sales data. AAPL rising 2% helped tech outperform, and financials also saw a nice move higher.

The only S&P 500 sub-sector to finish lower yesterday was utilities, which continues to see outflows as rates stay at these elevated levels.

Healthcare was one of the best-performing sectors yesterday, pushed higher again by biotech names. I'm not a healthcare analyst, but I've been reading a lot about how there is an ongoing renaissance in drug company R&D, after years of little innovation. We've seen an increase in biotech M&A over the past few weeks, and high-quality stocks like PCYC and others (a bunch in the sector were upgraded yesterday) have absolutely skyrocketed.

There aren't a ton of biotech-specific ETFs out there, but the most-liquid one appears to be IBB. (There are a million healthcare ETFs, but obviously those aren't a pure play on the biotech sector.) Again, I'm not a biotech analyst, but anecdotally I keep reading about how we're seeing a strong comeback in drug research and pipelines, and perhaps that's one area to investigate further or potentially buy on any emerging-market-related dips (if they occur).

Volumes yesterday resembled mid-August, as activity was very low and trailed off into the afternoon. On the charts the S&P 500 is approaching resistance at its 50-day moving average (1,661-ish).

*What "Fixes" the Emerging Markets?*

The emerging-market problems are twofold: On one hand, India, Brazil, Indonesia and others have structural economic problems that can only be fixed internally through reforms and a modernization of their respective economies. On the other hand, the recent rise in global interest rates, led by Treasury yields, has exacerbated those structural problems. It has also raised concerns that countries like India, Brazil, etc. will see a "balance of payments" crisis as investors sell their bonds and currencies, increasing the possibility these countries will literally run out of dollars.

And, that's big problem, because global trade is conducted in dollars, so when the Indian government and Indian companies go to pay for oil, food and other goods, they generally need to pay for those things with dollars. If they don't have any, they have a hard time securing these necessities, as companies don't like to get paid in currencies that have the ability to decline 20% in one year, like the rupee has done. So, really, what we're looking at here in the immediate term in the emerging markets is a liquidity scare, centered around the availability of U.S. dollar.

There's no easy "fix" to the emerging-market issues, but one term I want you to be aware of is "currency swap" agreements between central banks. If those are announced between the Fed and other major central banks, that will be a positive game-changer for the emerging-market crisis. And as long as interest rates don't gap higher, this should lead to some stabilization.

Currency swaps between central banks are just what they appear to be: The Fed agrees to "swap" dollars for another currency (rupees, reals, etc.) at a certain exchange rate for a limited period of time (think of it like a bridge loan of dollars), so that the emerging market can have adequate dollar reserves to pay debts and participate in global trade.

Basically, currency swaps act like a backstop on a balance of payments crisis, and they serve to break the panic that a foreign government might run out of dollars in the immediate future, which could halt any panic-selling.

There are some rumblings that we may see some global, coordinated currency-swap arrangements to help quell the emerging-market crisis. If that is announced, then that is a significant, game-changing positive in the short term. And, while it won't "fix" the problems emerging markets are facing as global interest rates rise, it will go a long way toward stabilizing the EM currency and bond markets, which will let stocks resume their rally. Point being, if swap agreements are announced, look for stocks to rally hard.

## Economics

*ECB & BOE Preview*

- No change to interest rates from the BOE or ECB.
- No change to the UK's quantitative-easing program.

I've made the case for several weeks now that Europe is a potential region that can outperform into year-end, especially the UK ETF (EWU) and the Ireland ETF (EIRL). But, central to that thesis is a continued recovery in the EU economy. One of the threats to that investment thesis is the rise in interest rates we are seeing in Europe, as the Fed is exporting higher rates thanks to impending QE tapering.

So, the bigger theme to monitor here, beyond the rate decisions today, is how the major European central banks are responding to these higher rates. If rates continue to rise and start acting as an economic headwind, then obviously that changes the bullish outlook for European equities.

So far, both the ECB and BOE have used "forward guidance" to counter rising rates from the U.S. The general expectation is that we'll see some stronger rhetoric with regard to "forward guidance" from the ECB and potentially the BOE (if they release an accompanying statement with the rate decision).

| Market | Level | Change | % Change |
|---|---|---|---|
| Dollar Index | 82.195 | -.206 | -0.25% |
| Euro | 1.3210 | .0041 | .31% |
| Pound | 1.5626 | .0064 | 0.41% |
| Yen | .010027 | .000026 | -0.26% |
| CAD $ | .9527 | .0039 | 0.41% |
| AUD $ | .9168 | .0122 | 1.35% |
| Brazilian Real | .4155 | .00085 | .20% |
| 10 Year Yield | 2.897 | .023 | .61% |
| 30 Year Yield | 2.897 | .049 | 1.72% |
| Prices taken at previous day market close. | | | |

The problem, of course, is that so far forward guidance hasn't worked, as interest rates have moved steadily higher since early July when both banks came out with their guidance. So, just issuing more-forceful forward guidance likely won't bring down rates. Instead, the key in these meetings will be to see if the BOE or ECB hint at any other measures they are considering to counter rising rates.

Specifically with the ECB, many will be looking for hints from ECB President Mario Draghi during his press conference about the issuance of new LTROs (Long-Term Refinancing Operations, which provided cheap capital to banks during the height of the financial crisis). While no one expects the announcement of new LTROs at this meeting, most expect them sometime this year. Any hint of new LTROs would be seen as a "dovish" event and likely send European equity prices, and especially European banking stocks, higher.

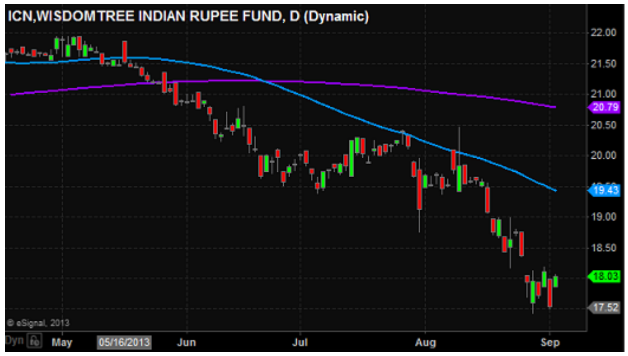
## Commodities

Commodities were sharply lower Wednesday despite more good economic data and a weaker dollar, reversing most of the gains seen on Tuesday. As far as why commodities fell, there wasn't any fundamental reason in the markets yesterday, and mostly it felt like profit-taking and de-risking ahead of the start of Rosh Hashanah.

The holiday basically creates a four-day weekend for our Jewish friends, and it comes as there is a lot of uncertainty in the form of central-bank decisions today, Syria, and the jobs number Friday. So, it makes sense to book some profits and de-risk a bit. With regard to Syria, the situation appears to be mellowing a bit, despite the endless headlines, and that weighed on the commodity complex Tuesday.

Although the Senate Foreign Relations Committee passed the resolution, as expected, Senator McCain pulled support for the measure. Which, if we read between the lines, means that the planned strikes must be pretty limited. (McCain is for a much-larger operation.) So, point being, when strikes do occur, they should be pretty limited.

In an almost-perfect reversal from yesterday, metals led markets lower, as silver fell more than 4%, copper declined 1.7% and gold 1.6%. Again, this fall came despite good economic data and a lower dollar (which should be a positive for metals, generally speaking).




In energy, both WTI and Brent crude also fell, with WTI closing down more than 1%, while Brent fell 0.74%.

The only major commodity that was higher yesterday was natural gas, which rose 0.2% on weather concerns. It's still very hot in the middle of the country, increasing cooling demand. But, more importantly, there are two storms near the Gulf (one off Florida and the other off the Yucatan Peninsula) with some potential to become more organized into tropical storms or worse. In an otherwise-slow day and a still heavily shorted market, it's enough to get some covering.

More broadly, most commodities, which broke out from months-long downtrends in August, now appear to be correcting back down to the levels of that breakout, which is pretty typical. We could see some more weakness in the short term on profit-taking, despite the fact that fundamentals continue to improve for the commodity sector. But, if I'm right about commodities being in a new uptrend, you would want to buy this dip, as you always want to try to buy a pullback from a breakout. On the flipside, if DBC were to violate $26.24 (the 50-day exponential moving average), that would tell me I'm wrong about commodities being in an uptrend. That's about 1% from current levels, so there's decent risk/reward in the trade.

## Currencies & Bonds

Emerging-market currencies and bonds both rallied Wednesday, bouncing back from Tuesday's weakness as the Reserve Bank of India was again in the market supporting the rupee Wednesday.

The lows of last week in the rupee (ICN), and in PCY and EMB, continue to hold heading into the jobs report Friday. If those lows can continue to hold, then stocks and risk assets can rally.

Looking at developed currencies, the Dollar Index fell slightly yesterday in quiet trading, but the losses were mostly because of strength in the euro and pound, which both rallied thanks to better-than-expected economic data.

The big mover vs. the dollar yesterday, though, was the Aussie dollar, which rallied 1.3% after the Reserve Bank of Australia left interest rates unchanged at their latest meeting, as expected. But the statement was taken as somewhat hawkish, causing short-covering in the Aussie. I said several weeks ago that I thought the easy money on the Aussie short was done, and that a range in the high-0.80s to low-0.90s was likely going forward. With the RBA turning slightly hawkish and the pace of Chinese growth stabilizing, that further confirms that opinion. I'd be hesitant to get long the Aussie, though, as the RBA wants a weak Aussie, and will likely move to counter a substantial rally.

Staying in Asia, the yen started the day higher but turned negative throughout the day and finished marginally lower, inching toward the 100 yen/dollar level. Yesterday I advocated shorting the yen/buying YCS based on the break of the May uptrend. Expect the decline in the yen to accelerate once the 100 level is "given," which may happen Friday if the jobs report is good.

Treasuries made a new closing low yesterday, as strong auto sales and the Fed Beige Book made tapering in September all the more likely. But, the declines were mild (0.3%) and the 10-year yield remains below 2.90%, biding some time before the jobs report tomorrow.

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.*<br>*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.**