7:00's Report

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

October 1st, 2013

Pre 7:00 Look

- Futures modestly higher this morning, bouncing from yesterday's declines as the US government shut down.
- Global manufacturing PMIs were in-line to slightly weaker than estimates, but remain above 50, showing expansion. Official Chinese PMI was 51.1 vs. (E.) 51.7, EU PMI met expectations at 51.1, and UK PMI was 56.7 vs. (E.) 57.7.
- In Japan, the Nikkei rallied as Abe announced he will go through with the sales tax increase next year, while the Tankan survey of business confidence rose to a 6 year high.
- Econ Today: ISM Manufacturing Index (E: 55.0).

Market	Level	Change	% Change
S&P 500 Futures	1682.50	8.00	.48%
U.S. Dollar (DXY)	80.14	-.183	-.23%
Gold	1331.80	4.80	.36%
WTI	102.51	.17	.17%
10 Year	2.615	-.004	-.15%

The S&P 500 is down more than 2% from all time highs, and is now sitting on support at the 50 day moving average.

Equities

Market Recap

Stocks saw modest declines but finished well off their worst levels of the day Monday as political concerns from Washington and Rome weighed on stocks. The S&P 500 fell 0.63%.

Stocks opened at their lows on a trifecta of negative news: First, the U.S. government appeared headed for a shutdown, Second, the Italian government appeared to have collapsed as Silvio Berlusconi surprisingly withdrew his party's support over the weekend. And finally, Chinese September manufacturing PMIs were revised lower than original estimates, although they stayed above the key 50 level. But, markets made their lows in the first several minutes of trading, and then slowly started a grinding rally that saw the declines basically cut in half as markets hit their highs in the early afternoon.

But, Washington was quick to squash any hope of higher equity prices. A Politico report signaled the House would once again send a continuing resolution back to the Senate that included a one-year delay of the "Affordable Care Act's" individual mandate and also cut health-insurance subsidies for Congress, the executive branch and their staff. Markets traded near their early morning lows after the story broke, but bounced a bit into the close. The day was totally dominated by Washington and Italian political stories, with virtually all other news ignored.

Trading Color

Despite the size of the losses, it was actually a relatively boring day. Washington-induced paralysis gripped the

Market	Level	Change	% Change
Dow	15129.67	-128.57	-.84%
TSX	12787.19	-56.89	-.44%
Brazil	52338.19	-1400.73	-2.61%
FTSE	6445.55	-16.67	-.26%
Nikkei	14484.72	28.92	.20%
Hang Seng	22859.86	-347.18	-1.50%
ASX	5206.80	-12.08	-23%
Prices taken at previous day market close.			

market yesterday, and most of the trading was in ETFs and futures—there was very little single-stock trading going on.

From a sector standpoint it was a pretty standard "bearish" day, as defensive sectors outperformed while cyclicals lagged. Utilities were the only sub-sector to trade higher yesterday (and only fractionally so), while telecom and healthcare also relatively outperformed. Elsewhere, energy, financials and consumer staples (PG and CVS weighed on the sector) and industrials lagged.

Market	Level	Change	% Change
Gold	1329.90	-9.30	-0.69%
Silver	21.73	-.101	-0.46%
Copper	3.3235	-.006	-0.18%
WTI	102.67	-0.2	-0.19%
Brent	108.59	-.04	-0.04%
Nat Gas	3.565	-.024	-0.67%
Corn	441.50	-12.50	-2.75%
Wheat	678.50	-4.50	-0.66%
Soybean	1282.75	-37.00	-2.80%
Prices taken at previous day market close.			

Volume-wise, activity was below the recent three-month average. On the charts, the S&P 500 violated its 50-day moving average intraday, but managed to close just above it at 1,681 (the 50-day MA is 1,680). That level remains support.

Political Update

It's a sad day when I have to write about dueling political crises in Washington and Italy, and admit it's probably likely that Italian politicians will find a way to work together to avoid a crisis before our own politicians will.

In Italy things actually look a bit better, as it appears Mr. Berlusconi has overplayed his hand. Current Prime Minister Enrico Letta has scheduled a pivotal confidence vote tomorrow to confirm support for this government. And, the prospects for a successful outcome are increasing, as there appears to be some fracturing of Berlusconi's PDL party. Reports have it that 20-plus PDL members are willing to break ranks and support the Letta government, as they think Berlusconi has, finally, gone too far this time. (Perhaps they weren't invited to his "Bunga Bunga" parties.)

So, at this point, we may very well be seeing the peak of Mr. Berlusconi's power in Italian politics. If that were to occur, it would be an unexpected, but welcomed, positive by the rest of Europe and the markets.

As always with European drama, the best gauge of the level of crisis is that country's 10-year bond yields. So, it's encouraging then that 10-year Italian yields barely budged yesterday, rising just two basis points. Over the coming days, as events unfold, look at the move in Italian yields as the best barometer of the crisis. (For those without a Bloomberg terminal, a link to the Bloomberg.com charts is here.) If they move decidedly higher today, that's a sign the market is getting nervous about the confidence vote. If they stay grounded, then the government should stand.

In the U.S., as you now know the government started shutting down at midnight. Again the important question here is "how long" and right now the general expectation is for around 5 days. If it goes beyond a week with little progress, expect political gridlock to start to weigh on risk assets. For now, though, it's almost a relief we're behind the gamesmanship and can hopefully start working on a real solution.

Bottom Line

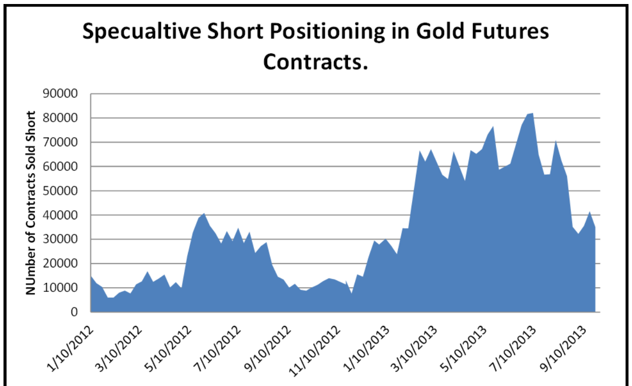
All things considered, the market was pretty resilient yesterday. While month-/quarter-end positions may have had something to do with it, as I've been saying, this political drama isn't a rally-killer unless the current expectation of a short-term shutdown is materially altered. So far that hasn't happened, but it's important to realize that a government shutdown—as long as it's temporary and potentially ushers in a debt-celling deal (if they can negotiate a few more days)—could be a preferable solution to having this fight with a debt-ceiling deadline looming. Point being, if we shut down for a few days but get a bigger debt-ceiling deal done, it's a lot better than getting a short-term CR and having this fight again up against the debt ceiling, where there is no wiggle room.

Keep an eye on a repeal of the medical-device tax—this is a potential point of agreement that might usher in a bigger compromise on the "Affordable Care Act" and the budget.

The benefit of the doubt remains with the bulls and cyclical and international remain the best places to be, I think. But if there isn't some broader solution to these budget issues (meaning a "punt" on the CR to mid-November), I have to think some investors will start to call it a year and begin to get very hedged or else sell winners, as the upside would be limited, and the downside potentially significant.

Japanese Real Rates Turn Negative

There was a little-followed occurrence on Friday in Japan that largely strengthens the medium-term bullish case for the WisdomTree Japan Hedged Equity Fund (DXJ). Real interest rates in Japan—as measured by the annual interest paid on a 10-year Japanese government bond, which was 0.72% on Friday, minus the year-over-year change in core CPI, which was 0.8%—turned negative for the first time since 2008. Real interest rates turning negative is a highly inflationary occurrence, and is a sign that "Abenomics" is achieving its goal of breaking deflation.



Speculative shorts in the gold market are well off their highs, and covering by itself won't be enough to propel gold substantially higher.

Negative real rates have the effect of encouraging investors to move out of bonds and into riskier assets. With real rates negative, you're losing money every year to inflation. So, it's bullish for stocks and other risk asset (and, hence, DXJ).

With all the political drama surrounding the U.S. and EU, "Long Japan" remains one of the most fundamentally backed trades in the global market today, and the bullish case just got stronger. I would buy any dip on a "buy the rumor/sell the news" off Prime Minister Shinzo Abe's announcement of the sales tax increase going into effect.

Market	Level	Change	% Change
Dollar Index	80.330	-.047	-0.06%
Euro	1.3527	.0006	0.04%
Pound	1.6175	.005	0.31%
Yen	.010182	.000004	0.04%
CAD $	.9689	0	0.00%
AUD $	.9282	.001	0.11%
Brazilian Real	.4441	.00735	1.68%
10 Year Yield	2.615	-.004	-.15%
30 Year Yield	3.686	.005	.14%
Prices taken at previous day market close.			

Economics

No reports yesterday.

Commodities

Commodities fell Monday in sympathy with stocks as political angst centered in Washington and Rome weighed on all risk assets. The soft final Chinese manufacturing PMI didn't help things either, although it was not a major catalyst yesterday (partially because another reading came last night). Commodities again failed to rally despite a weaker U.S. dollar.

Energy continues to be the worst-performing commodity sector, as every major product from WTI crude to heating oil declined around 1% yesterday. Energy was weaker mainly on a combination of peripheral "risk off" trading given the dual political crisis. But, further improvement in sentiment toward the Iranian nuclear negotiations, and the beginning of the cataloguing of Syrian weapons, contributed to an incremental reduction of the geo-political risk premium and mild downward pressure.

Where energy goes over the short term will be dependent on events in Washington and Rome because worst-case scenarios from either, while unlikely, would send all risk assets indiscriminately lower. Looking beyond short-term political effects, though, I'm much more interested in how WTI crude reacts to the economic data. Good data is a reason to buy WTI, plain and simple—and if the data stays good but there is further selling from geo-political concerns, I continue to think that's a buying opportunity.

Encouragingly, WTI basically opened on the lows yesterday and then rallied throughout the day to close on the highs. Washington and Rome will dominate in the short term, but if the data stays strong, then energy is a buy.

Gold and silver also declined yesterday—but relatively speaking they outperformed, falling 0.5% and 0.2% respectively. Both gold and silver benefited from support given the political uncertainty. (There was a mild “crisis” bid in gold, but that’s likely a one-off. Chances are that it will come out of gold upon resolution to one or both of the crises.)

Fundamentally, the Commitment Of Traders report didn’t really change, and at this point is pretty neutral—if not slightly bearish. First, the number of shorts has been drastically reduced from several months ago, and while elevated in an absolute sense, it isn’t really enough to create a sustainable rally. Second, the number of longs in gold continues to fall, and is just off nearly one-year lows. I point this out because gold needs people to become bullish on it to propel the next leg higher—short-covering won’t do it. And, that’s simply not happening right now—and until it does, I remain neutral on gold in the shorter term.

Copper, interestingly, was little-changed yesterday. That’s surprising given the negative revision to the Chinese September manufacturing data. But, I believe there are two reasons copper largely ignored the negative report.

First, copper never rallied off the strong “flash” manufacturing PMIs from last Monday. So, either traders correctly expected this number to be revised lower, or else the market focused on the fact that—while Chinese manufacturing PMIs were virtually unchanged from August at 50.2 vs. 50.1—the PMIs were still above 50, implying expansion, albeit slow, in the Chinese manufacturing sector.

Like every other financial asset, commodities in aggregate are held hostage by Washington and Rome. But, while it’s hard to cut through the noise, there is a lot of important economic data coming this week.

If the PowerShares DB Commodity Index Tracking Fund (DBC) falls on government concerns (from Washington or Rome) but the data continues to improve, I believe you then buy DBC on that dip, as the chance of Armageddon in either situation is very slim.

Currencies & Bonds

The Dollar Index finished Monday flat after opening the week basically at seven-month lows, with the trade completely dominated by Washington concerns. But, the declines in the Dollar Index were somewhat limited given the dueling concerns in Washington and Rome. The pound was the real beneficiary of the dueling political dysfunction, as it rallied 0.3% vs. the dollar to trade to a new high for the year.

The big mover in the currency markets yesterday, though, was once again the yen. The data overnight Monday was universally yen-bearish: The Japanese September manufacturing PMI, industrial production and retail sales all beat expectations. And in the bizarre world of yen trading, good economic data is actually yen-negative. That’s because it shows “Abenomics” is working and encourages more of it! Also, as I referenced earlier in the Report, real interest rates turning negative in Japan at the end of last week is a very “yen-bearish” occurrence to top it all off.

Despite these negatives, the yen opened nearly 1% higher vs. the dollar Monday morning, thanks to safe-haven demand emanating from the Washington and Italian problems. But, that bid proved somewhat temporary, as the negative fundamentals and anticipation of Abe formally announcing his intention to go forward with the sales tax increase next spring weighed on the yen, which declined throughout trading Monday and closed basically flat.

Treasuries were flat yesterday on peripheral governmental angst, although trading was quiet. Treasuries in general aren’t that worried about a potential governmental catastrophe (meaning an extended shutdown). And Washington drama aside, it’s important not to forget there is a lot of important economic data this week—and the results of that data are much more important to the direction of Treasuries than any Washington shutdown/debt ceiling/Armageddon scenarios.

Watch the data this week – Washington theatrics aside, economic data is the most-important thing happening in the coming days.

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	*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.

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 fundamentally bullish commodities, as increasing domestic demand should help push oil higher over the coming months. Reduction in geo-political risk has weighed on WTI, but at $100/bbl, if the US economy is still in slow growth mode, then oil (via USO) and energy (via XLE) are a buy.**

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 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.**