7:00's Report

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

October 10th, 2013

Pre 7:00 Look

- Futures and most international markets rallying close to 1% on the growing expectation that we will get a short term CR and debt ceiling extension.
- Economically there wasn't much of consequence o/n. Australia's Labour survey beat expectations, while French and Italian IP missed estimates.
- Econ Today: Jobless Claims (E: 310K). Bank of England Rate Decision (E: No change to rates or the QE program.).
- Fed Speak: Bullard (9:45AM), Tarullo (1:45PM), Williams (2:30PM).

Market	Level	Change	% Change
S&P 500 Futures	1663.75	15.00	.91%
U.S. Dollar (DXY)	80.55	.084	.10%
Gold	1298.60	-8.60	-.66%
WTI	101.97	.36	.35%
10 Year	2.65	.014	.53%

Equities

Market Recap

Stocks saw small gains Wednesday in tentative trading, as some glimmers of hope emerged from Washington. The S&P 500 rose 0.06%.

Compared to very recent history when it comes to Washington, yesterday was actually an "OK" day. Futures were marginally higher yesterday morning on the news that Janet Yellen would be nominated as the next Fed chair. While in no way surprising (there was no reaction to the news in currencies or the dollar as Yellen was already priced in) the announcement did help to distract people from Tuesday's ugly close. In some ways, people were happy because at least we got one piece of clarity from Washington.

Stocks meandered for much of the day on either side of flat, as both sellers and buyers are reluctant to do much of anything, and real money remains firmly in spectator mode. The FOMC minutes, however, helped stocks turn decidedly positive and actually hit the highs of the day about 90 minutes before the end of trading.

The minutes were taken initially as "hawkish" and that translated into a better view of the economy and, thus, a reason to buy stocks—at least for a few ticks. (The minutes weren't really anything new, and certainly no reason to be bullish.) Stocks wavered a bit in the last 30 minutes of trading, but managed to close in the green.

Trading Color

Defensive indices and sectors continue to outperform, as investors are clearly "dialing down" their long exposure into lower-volatility sectors. The S&P 500 and Dow finished positive, while the more-cyclical Nasdaq and Russell 2000 both declined nearly 0.5% each. Looking at the sectors, utilities were again the best performers, followed by financials (the banks got a bit of a bounce as we approach earnings), telecom and consumer staples. Tech, energy and consumer discretionary lagged (the latter thanks to YUM's earnings miss).

Also of note, the "momentum" stocks I mentioned yesterday were again under pressure, representing the fact that we are seeing continued profit-taking. The chatter I'm hearing from trading desks about investors moving to protect performance is growing louder.

AA's earnings beat helped the basic materials sector buck the negative trend of cyclicals and finish higher yes-

Market	Level	Change	% Change
Dow	14802.98	26.45	.18%
TSX	12730.33	37.92	.30%
Brazil	52547.71	235.27	.45%
FTSE	6339.03	61.12	.96%
Nikkei	14194.71	156.87	1.12%
Hang Seng	22951.30	-82.67	-.36%
ASX	5147.14	-5.85	-.11%
Prices taken at previous day market close.			

terday. Although the beat was due to cost-cutting, it is a positive for the global economy that AA kept its worldwide growth forecasts unchanged, and actually slightly increased China's growth outlook.

Market	Level	Change	% Change
Gold	1307.30	-17.30	-1.31%
Silver	21.945	-.498	-2.22%
Copper	3.235	-.0575	-1.75%
WTI	101.44	-2.05	-1.98%
Brent	108.97	-1.19	-1.08%
Nat Gas	3.691	-.025	-0.67%
Corn	443.50	1.75	0.40%
Wheat	690.50	-3.00	-0.43%
Soybean	1287.75	-1.00	-0.08%
Prices taken at previous day market close.			

Despite the lack of volatility, volumes were elevated, although trading is still being dominated totally by algos and fast-money funds. Real money is looking to buy more of a dip or simply wait things out.

Small Signs of Optimism in Washington, but at Best They Are Only Temporary.

I mentioned yesterday there is a growing undercurrent of cautious optimism surrounding the prospects for a short-term deal on the CR and debt ceiling over the next week. CNN and others first reported the positive movement early this week, and although we still have days of posturing by both sides, cautious optimism is growing that we won't go past the 17th.

The leaders of this rally, like PCLN and NFLX, have sold off hard over the last week on profit taking. That may be the start of a larger trend, short term fiscal resolution or not.

But, while that is a positive, it still means that we are going to have to deal with this issue again at a minimum once more this year (and perhaps more than that).

So, while it's good that we will likely avoid a total catastrophe, this cloud of uncertainty will still hang over the markets. And, if a short-term deal is struck, I think that will be the final nail in the coffin for any hope of a strong rally into year-end. Who would want to get long into another round of this nonsense looming 6 weeks in the future?

So, at the risk of sounding like a broken record, if a short-term extension is the best-case scenario right now, then I think that only reinforces the attractiveness of a "long Europe/short SPY" pair trade into year-end.

Economics

FOMC Minutes

The FOMC minutes from the surprise "No Tapering" September meeting were initially taken as hawkish, mostly off this headline:

"Most participants judged that it would likely be appropriate to begin to reduce the pace of the Committee's purchases of longer-term securities this year and to conclude purchases in the middle of 2014."

While that does strongly imply that we'll see tapering of QE in December (October is a very remote possibility), it's important to keep in mind that a lot of things have happened since mid-September, and virtually none of them have been good.

One phrase I found more interesting was when Fed governors noted:

"Business contacts in selected parts of the country were reported to be cautiously optimistic, consistent with encouraging responses to a number of business surveys. ***Nonetheless, uncertainties regarding the outlook for the economy and fiscal and regulatory policies were reportedly continuing to weigh on business decision-making, with firms focused on improving their balance sheets and enhancing productivity and still quite cautious about expanding their workforces."*** *(Emphasis Added.)*

Translation: This economy is still being hampered by our dysfunctional government, and if that's what they thought back in September, then I can only imagine what they are thinking now. The shutdown and just "OK" economic data don't appear to be enough to turn the tide of tapering, as frankly there was much more justification for tapering in September than there is at present. I don't see that changing materially unless we get some sort of long-term deal in Washington and despite the short term response, most are starting to pencil in a January taper at the earliest.

Commodities

Commodities were universally lower yesterday after rallying on Monday and Tuesday, and a stronger dollar and short-term profit-taking weighed on the complex. DBC fell 0.73% and was led lower by energy, specifically WTI crude, which flirted with last week's lows of $101.05—a critical level for the oil bulls.

The outperformers of the day were agricultural products, specifically corn, which booked modest gains of just over a half a percent.

The dollar has been building a solid foundation at the 80 level where traders are finding it a value play. In electronic trading Tuesday night, the dollar opened below 80 and was steadily bought until the Fed minutes yesterday at 2:00. Comparing most commodities, specifically crude oil and gold to this same time frame, they have a strong inverse correlation.

Gold and silver both declined sharply yesterday in the face of the stronger dollar, with silver collapsing 2.7% and gold falling 1.5%. Earlier in the week I had pointed out silver's recent outperformance vs. gold as a potentially bullish indicator to watch. But as I had cautioned, that outperformance has proven to be a head fake. Both gold and silver remain, at best, range-bound at $1,280-$1,330 and $22.80-$21.25 respectively.

Market	Level	Change	% Change
Dollar Index	80.440	.308	0.38%
Euro	1.3528	-.0041	-0.30%
Pound	1.5954	-.0119	-0.74%
Yen	.010277	-.000039	-0.38%
CAD $	.9610	-.0013	-0.14%
AUD $	.9405	.0021	0.22%
Brazilian Real	.4480	.0007	.16%
10 Year Yield	2.65	.014	.53%
30 Year Yield	3.724	.029	.78%
Prices taken at previous day market close.			

Crude oil futures slumped 2% thanks to a bearish inventory report from the EIA. They reported a build of 6.8 million barrels vs. expectations of a 1.6 million barrel build, which was obviously bearish. Crude inventories are now 1.1% higher than the same period last year, building as refinery utilization fell to a multi-week low of 86%, due to switching season being in full gear (from refining primarily gasoline to heating oil).

Also contributing to the weakness in WTI crude was expected reduction in oil demand that the government shutdown will bring. Every day the shutdown goes on, GDP and energy demand in this country falls. The longer it goes on the more downward pressure it'll put on WTI prices. Key support in this market is now $101.05 (the lows from last week).

On a somewhat unrelated note, something that has caught my attention the past few weeks has been the price movement in NYMEX oil futures before the EIA inventory data is released on Wednesday mornings at 10:30AM. Before the information is released, the market has consistently moved in the direction it would generally move after the inventory print. This has caused many to question whether someone might be getting a "peek" at the data before it's released.

I'm sure nothing like that would ever happen in the oil markets, but just in case, there are some pretty connected people who read this *Report*. So all I ask is you send me the advance copy for the benefit of *The 7:00's Report* subscribers!

Kidding aside, the bottom line is commodities are broadly handcuffed between technical trading levels as the stalemate continues to drag on in Washington. Positive fundamentals are there to help the space. (AA's positive comments about global growth and the uptick in China growth are supportive of basic materials.) But, like everything else in the markets, Washington is driving the bus with regard to commodities.

Currencies & Bonds

The dollar was almost universally stronger yesterday, and while "hawkish" FOMC minutes were cited as the reason. The Dollar Index was higher prior to the minutes release, and it closed basically at the "pre-minutes" level. Additionally, bonds rallied after the minutes, refuting that they were "dovish."

The real reason for the strength in the dollar is there are small undercurrents of optimism surrounding the shutdown and debt ceiling, and value-hunters are stepping in to defend the dollar sub-80. If the likely scenario plays out—that we do get a deal and don't default—then that's probably a pretty good risk/reward trade.

At the end of the day, we aren't going to get any *more* accommodation, and even through tapering will likely be punted to early '14, the Fed is still going to be the first major central bank to reduce accommodation, whenever that is. Does that mean you buy the Dollar Index at 81 or 82? No. But that does make it worth a shot sub-80.

The pound was actually the worst performer vs. the dollar yesterday, as a disappointing September Industrial Production report has led to more profit-taking. The pound has seen a huge rally vs. the dollar, from 1.49 in early July to above 1.62 in early October. But, the British currency was priced to perfection and some of the "froth" is being taken out of that market.

The yen declined 0.5% yesterday, which is a pretty modest decline given the big rally we've seen. Bottom line is it's going to be hard to get the yen to decline materially until we've got some resolution in Washington – and we're probably several days from that, best case.

And, even if we get a short-term extension, we just have to have this fight again before the end of the year. Does that make me no longer a bear on the yen? No, it does not. But, given our political dysfunction, I think it will limit any material downside. You could use this period to establish a position by selling into rallies, so you can be well-positioned for the resumption of the downtrend later this year or early next (and hopefully sooner, but I'm not putting any faith in Washington).

Turning to bonds, Treasuries rallied post-FOMC minutes to finish basically flat. The Treasury auctioned $21 billion of 10-year bonds. Given the results of the auction, which were fine, the concern about the fiscal drama isn't extending past very near-dated securities. The bid to cover of 2.58 was a little light vs. the six-month average of 2.61, although the yield on the auction was 1 basis point below the "When Issued" yield—signaling decent demand. And, we would expect, at this point the "belly" of the curve (which is the 7-10 year space), isn't getting nervous about any sort of a default.

Interestingly, though, we are seeing continued concern in the very near term, as Fidelity yesterday sold all of its very short-term government debt yesterday (which, incidentally, was probably a decent buy if you're running a lot of money, but given the positive sentiment this morning, the opportunity may have been missed already).

But, in the context of what I was talking about yesterday, we're not seeing concern start to creep out of notes and very near-term government debt The iShares 3-7 Year Treasury Bond ETF (IEI) rallied small yesterday, and again that will begin to sell off if no deal and a default start to rise in probability.

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**	*The debt ceiling fight enters its second week, and will continue to be a headwind on stocks. The expectation is still that a deal get done before 10/17, but if we have no progress by the end of the week, expect a sharp sell off, as a "no deal" scenario is **not** priced into markets. That said, though, the benefit of the doubt remains with the bulls, as a deal is likely to get done.* *The S&P 500 broke support at the 50 and 100 day MA, and now the August lows of 1627 are support.*

Trade Ideas

Long International (Europe & Japan): **International markets continue to remain attractive vs. the US based on improving economic data, and looming political and monetary clouds in Washington. I like EWU (UK ETF) or EIRL (Ireland ETF) specifically. The "Long Japan" trade is under pressure thanks to a rising yen (which is a result of the debt ceiling drama) but long Japan remains one of the more fundamentally based trades in the market. DXJ remains the way to play it and I'd buy this dip for medium/longer term accounts.**

Long Deep, multi-national Cyclicals: **Domestically, I'd look to allocate to deep cyclicals like industrials (XLI) and basic materials (IYM), as Washington drama aside, they should benefit from continued Fed stimulus.**

	Fundamental Outlook	Technical Outlook	Overall	Comments
Commodities	**Bullish**	**Neutral**	**Neutral**	*Commodities are at the mercy of Washington, like every other risk asset. Most commodities haven't benefitted from the weaker dollar because of Washington drama, but looking beyond the short term, all major global central banks will be accommodative well into the future, and that should lead to am acceleration of global economic growth, which should be a tailwind for commodities.*

Trade Ideas

Long Industrial Commodities: **If we are seeing a return of global economic growth, then industrial commodities (Oil, Copper, Refined Products, Base Metals) should out perform over the coming quarters. In the short term debt ceiling drama and concerns of growth weigh, but if you believe the global economy Is recovering, the commodity space, and the ETF DBC, is one of the best "values" in the market, and a pretty contrarian idea right now.**

	Fundamental Outlook	Technical Outlook	Overall	Comments
U.S. Dollar	**Neutral**	**Neutral**	**Neutral**	*The US Dollar hit an 8 month low and is under pressure in the short term from fiscal drama in Washington and as Fed "tapering" expectations shift to early '14.*

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.**