7:00's Report

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

October 11th, 2013

Pre 7:00 Look

- Futures flat this morning and international markets modestly higher as anticipation grows for a deal to be announced today that extends the debt ceiling and potentially ends the government shutdown.
- It was very quiet o/n outside of Washington. Economically, German CPI met expectations.
- Econ Today: No reports today. Fed Speak: Powell (11:00AM).
- Earnings Today: JPM (E: $1.27), WFC (E: $0.97).

Market	Level	Change	% Change
S&P 500 Futures	1686.25	1.25	.07%
U.S. Dollar (DXY)	80.38	-.137	-.17%
Gold	1284.40	-12.50	-.96%
WTI	101.68	-1.33	-1.29%
10 Year	2.865	.035	1.32%

Equities

Market Update

Stocks staged a huge rally Thursday on apparent progress in Washington that would take a possible debt ceiling breach off the table. The S&P 500 rose 2.18% and is now flat on the week.

There's not a ton to recap from yesterday, as stocks started strong and got stronger throughout the day on growing optimism about a debt-ceiling extension. Stocks opened Thursday up 1% on news that there was consensus coalescing around a six-week debt-ceiling extension, and news the Republicans were actually willing to bring a six-week extension to the House floor had stocks up more than 2% by mid-day. More positive comments from some House members late in trading and a uplifting Politico article (link here) helped stocks go out at the highs of the day. It was the biggest one-day gain for the market since January.

Trading Color

It was a prototypical "Risk On" rally yesterday. The Russell 2000 and Nasdaq reversed their underperformance earlier in the week by rallying 2.5% and 2.26% respectively—outperforming the Dow and S&P 500—while cyclical sectors were the big outperformers within the S&P 500. Financials, industrials, homebuilders, and consumer discretionary (the worst performers over the past week) all rallied more than 2% each. Meanwhile utilities, consumer staples, and telecom lagged—but only slightly (they were all up close to 2% also).

Volumes were very heavy as initial short-covering gave way to quasi-panic-buying, as once again investors are scared to miss a "resolution rally," as many have several times this year. That's "chasing" by some investors is part of why stocks accelerated into the close. (Some people expected a pullback as the afternoon wore on. But as sentiment toward Washington improved, buyers threw in the towel and got long.) There was more participation from "real money" funds yesterday, although I wouldn't say it was a full on "buying panic." There was more activity by the long funds, but there remains a healthy dose of skepticism in the market as well.

On the charts the S&P 500 has now reclaimed the 50-day moving average (1,678) while 1,700 remains resistance.

Bottom Line

I talked about there being a potential "snapback" rally

Market	Level	Change	% Change
Dow	15126.07	323.09	2.18%
TSX	12894.41	164.08	1.29%
Brazil	52996.64	448.93	.85%
FTSE	6470.68	40.19	.62%
Nikkei	14404.74	210.03	1.48%
Hang Seng	23218.32	267.02	1.16%
ASX	5230.87	83.73	1.63%

Prices taken at previous day market close.

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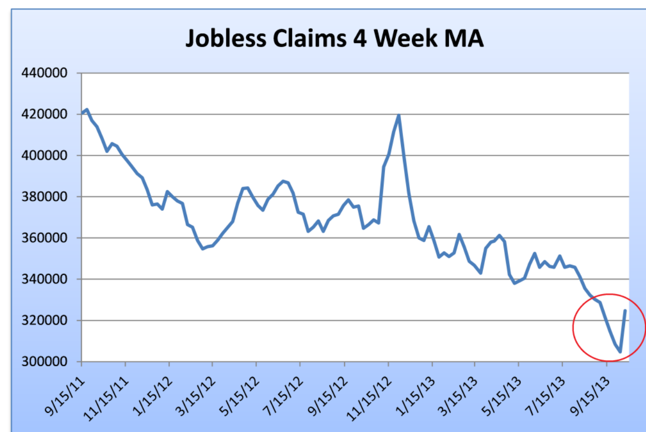
on resolution in Washington, and yesterday was it. Stocks rallied as much as they did yesterday for two main reasons:

Market	Level	Change	% Change
Gold	1286.90	-20.30	-1.55%
Silver	21.63	-.261	-1.19%
Copper	3.2435	.0125	0.39%
WTI	102.92	1.31	1.29%
Brent	111.95	2.89	2.65%
Nat Gas	3.733	.054	1.47%
Corn	438.25	-5.25	-1.18%
Wheat	685.50	-5.00	-0.72%
Soybean	1288.00	.25	0.02%
Prices taken at previous day market close.			

- First, if this six-week extension gets done, it implies (hopefully) that Republicans and Democrats "get" that breaching the debt ceiling would be a potential catastrophe. While they may play some politics with the debt ceiling, they won't actually let it be breached (at least that's what we all hope this means).
- Second, positioning and sentiment had once again become very, very negative in the short term, and the potential positive resolution caught people off-guard and again to defensive, and scared to miss another "resolution rally."

From the market's standpoint, this key to all this has always been the debt ceiling. The government shutdown doesn't help anything, and it's a drag on the economy—but it is not a "tail risk" event like the debt-ceiling breach. So, an extension is both good and bad. On one hand, it takes a full-blown crisis next week off the table (which is good). But, on the other hand, there's now a new big deadline. (Nov. 22 would be the new debt-ceiling deadline, if everything goes according to plan.)

Point being, I said we'd get a snapback rally on any good news, which we did, but unless there is a long-term solution, it's still hard for me to see the S&P 500 grinding higher to the old highs (or even much above 1,720) unless we get a blowout earnings season.



Coming back to my "long Europe/Short SPY trade," "Europe" rallied right with the S&P 500 yesterday. The Vanguard FTSE Europe ETF (VGK) was up 2.1%, the iShares MSCI United Kingdom ETF (EWU) was up 1.92%, and the iShares MSCI Ireland Capped ETF (EIRL) was up 2.08% vs. the SPDR S&P 500 (SPY) up 2.16%. I continue to like the prospects of continued outperformance from Europe (and globally) during this apparent six-week extension.

Economics

Economic reports have been scarce since the government shut down last week but we got a look at the labor market yesterday via weekly jobless claims.

Jobless Claims

- Weekly claims leaped to 374K vs. (E) 310K
- 4 Week Moving Average rose to 324K.

Takeaway

Apparently this three-week drop in jobless claims below the 300K mark was largely a head-fake. Officials from California announced that they are experiencing backlog issues, which led to the staggering rise in the jobless claims number this week. The consensus estimate was for just 310K claims, a marginal increase from last week. However, the print revealed an increase of 66K from last week to 374K, a level not seen since March of this year.

With regard to the government shutdown effect on the number, that only accounted for 15K of the new claims in the form of temporary layoffs of federal contractors. (Furloughed federal employees are not included in the weekly jobless claims number.)

Weekly jobless claims are volatile and prone to large fluctuation (although this one is a bit absurd), and that's why the more-important part of this release is the four-week moving average. That number jumped 20K, putting it right back to where it was a month ago at the 325K level.

The broader takeaway is that the labor market, according to the four-week moving average of claims, is basically where it was last month. So, we haven't

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seen any improvement or deterioration; as such, we should expect an employment situation report in the mid- to high-100K level whenever it is actually released. From a Fed standpoint, we're not seeing any improvement in the labor market, so there's nothing here that would increase the likelihood of tapering.

Commodities

Commodities were mixed yesterday but, with strong moves in the energy market, the PowerShares DB Commodity Index Tracking Fund (DBC) finished the day up 1.27%, reaching new three-week highs. Outperformers included both Brent and WTI crude oil, RBOB gasoline, and natural gas while precious metals and agricultural products broadly underperformed.

Natural gas was the strongest performer yesterday, reaching a high of 3.795 and closing well over 1% higher. The move continues a recent uptrend that was further fueled by a slight miss of inventory expectations. Analysts were expecting a build of 92 Bcf and saw a marginally lower build of 90 Bcf, which was enough to attract more buyers into the market.

Natural Gas: Commodities trend, and the trend appears to be changing in Natural Gas. A move through $3.80 would be bullish, and if that happens look for upside in UNG and XOP.

Precious metals were largely range-bound in the primary session yesterday, but gold and silver finished 0.75% and 0.05% lower respectively. The moves lower were supported by a stronger dollar, which found support at the 80 level earlier in the week.

It is important to note that the 1,300 level in gold, which has been holding strong, was broken repeatedly in Thursday's session and closed below it at 1,297. Frustratingly for the gold bulls, gold did not rally near as much as traders expected while the dollar sold off in recent weeks. However, it is now that the dollar has caught a mild bid, gold is again under pressure. That is the hall market of a bearish market. 1,280 and 1,270 are now critical support; if we lose those levels, things could get ugly (meaning a straight shot to 1200.

It seemed as though traders on the NYMEX floor had blinders on early in the trading day yesterday, as WTI remained near two-week support levels and actually broke through Wednesday's lows in the opening half-hour of the primary session yesterday. Shortly thereafter, it appeared energy traders noticed that every other tradable risk asset was substantially rallying in anticipation of a deal in Washington, and they quickly joined the party.

Specifically it was the Brent crude and refined-product prices that allegedly got the attention of WTI traders, who quickly bid the price up over $2 in 2 hours—putting WTI Crude back in the upper portion of its recent trading range ($101-$104/Bbl). But, WTI rallied in sympathy with risk assets yesterday, and generally this market continues to feel "heavy." Rumors are out this morning the government shut down will be ended in a deal announced this morning also, and if so that's a peripheral positive for oil demand, but $101.05 (the lows from last week) remains critical support.

Market	Level	Change	% Change
Dollar Index	80.570	.104	0.13%
Euro	1.3526	.0001	0.01%
Pound	1.5961	.0013	0.08%
Yen	.010185	-.00009	-0.88%
CAD $	.9603	-.0002	-0.02%
AUD $	.9418	.0012	0.13%
Brazilian Real	.4535	.0055	1.23%
10 Year Yield	2.685	.035	1.32%
30 Year Yield	3.742	.018	.48%
Prices taken at previous day market close.			

Currencies & Bonds

Despite the big rally in equities, most currencies were little changed yesterday, as apparently the short-term debt ceiling fix was priced into the dollar by Wednesday's close. The Dollar Index rose 0.1%, and actually made a marginal two-week high

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although, oddly, the dollar was only stronger vs. one major currency yesterday, and that was the yen.

The yen fell sharply (0.9%) thanks to the "risk on" trade in the markets yesterday, and also because of good economic data (machine orders rose more than expected in August). But, the intensity of yesterday's declines underscore what I said earlier in the week – that this latest rally in the yen was due much more to concern about the U.S. fiscal situation than anything going on in Japan (a machinery orders beat is nice but it's not worth a 1% fall in the yen).

Yesterday's declines aside, though, if all these domestic fiscal issues are merely "punted" for six weeks, then I still don't think we'll see material downside (meaning a significant decline through the 100/dollar level) in the yen until we get long-term fiscal resolution. So, I'd continue to use any "risk off" rallies in the yen to accumulate a bigger position for when the downtrend starts again in earnest later this year or a early next.

Elsewhere in currencies it was boring: The euro, pound and Aussie dollar all rose less than 0.2% vs. the dollar while the Loonie was flat.

Bonds initially declined sharply Thursday, with the 30-year falling 0.75% in early trading. But, a strong 30-year Treasury auction (the bid to cover was the highest since February at 2.64, and the yield was two basis points below the "When Issued" yield—another strong sign of demand) helped bonds rally and the 30-year basically halved its losses by the end of the day. The strong 10- and 30-year auctions this week show that there is little concern at the far end of the curve about a default.

The same cannot be said for Treasury bills. With the can likely kicked six weeks on the debt ceiling, Nov. 29 Treasury bills saw yields soar (meaning people were selling them—remember the new big deadline is likely Nov. 22) while the Oct. 17 bills, which got hit badly earlier this week, saw huge rallies. So, the concern at the front end of the curve isn't dissipating; it's merely shifting.

<u>Six-Week Debt Ceiling Extension = Tapering of QE in '14.</u>

Interestingly, while the dollar appears to have a bit more room to run on the upside given how oversold it is, the six-week debt ceiling extension, in my opinion, is near-term dollar-bearish and bond-bullish because this all but guarantees no tapering in '13.

I say this for two reasons: First, although the situation is fluid, there is no concrete deal to re-open the government, and even if there is, some small damage has already been done and that will likely subtract from GDP. Second, with six more weeks of uncertainty, we can reasonably assume that businesses will continue to hold off on any significant capital investment, hiring, etc. (all the things mentioned by the FOMC that I quoted in yesterday's Report).

So, this extension of uncertainty, while better than a disaster, won't help the economy or the labor market. Unless there is improvement there, the Fed won't taper QE. As result, it's another reason for me to think we're not done with this counter-trend rally in bonds, and I'd continue to look to sell any further rallies and get better entry points for the longer term down trend. Patience is required in this market at the moment.

Have a good weekend,

Tom

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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 S&P 500 rallied hard on news of a potential deal to end the week long government shutdown and extend the debt ceiling. While the news, if true, removes a potential "tail risk" event, further substantial upside in the S&P from 1700ish is tough to see, although the benefit of the doubt remains with the bulls.* *The S&P 500 support again sits at the 50 day MA (1679), while 1700 is resistance.*

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 Dollar Index bounced back above 80 on hopes of a resolution to Washington fiscal drama, but expectations for the Fed continue to get more dovish, and any upside in DXY*

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.**

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