7:00's Report

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

October 2nd, 2013

Pre 7:00 Look

- Futures and international markets lower on general concerns toward Washington. Treasury Secretary Lew announced the Treasury is now using "extraordinary measures" to fund the government.
- UK Construction PMIs slightly missed expectations at 58.9vs. (E.) 59.5, anecdotally implying the economic recovery in the UK is plateauing a bit.
- Econ Today: ECB Rate Decision (E: No change to rates or current policies). ADP Employment Report (E: 180K). Fed Speak: Rosengren (Noon EST), Bernanke (3:00 PM EST).

Market	Level	Change	% Change
S&P 500 Futures	1677.25	-12.25	-.73%
U.S. Dollar (DXY)	80.24	-.01	-.01%
Gold	1295.80	9.70	.75%
WTI	101.87	-.17	-.18%
10 Year	2.646	.031	1.19%

Equities

Market Recap

Stocks staged a surprising rally Tuesday shrugging off the start of a US government shutdown. The S&P 500 rallied 0.80%.

Stocks surprised a lot of people by mounting a decent rally Tuesday in the face of the government shutdown, opening slightly higher and holding steady throughout the day, thanks to the better-than-expected Institute for Supply Management's manufacturing PMIs.

Stocks maintained their gains throughout the president's 1 p.m. address, and actually accelerated during the last hour of trading to go out near their highs on the back of comments that Republicans are banding together and the shutdown may last several days. (This, oddly, is being viewed as a positive—more below.)

U.S. Political Update—1 Week Shutdown a Positive?

Based on yesterday, it appears markets don't seem too concerned with the current government shutdown, unless it looks like it might last for more than a few weeks. And, news that hit late in trading yesterday that the Republicans aren't budging—and, as a result, the shutdown will probably last nearly a week—was welcomed, and here's why:

The hope is that a longer shutdown will allow for real negotiations on the major issues we have to fix: 1) the debt ceiling, 2) a more-permanent continuing resolution (not one that lasts six weeks) and 3) finally settling the "Affordable Care Act."

From the market's point of view, it's a lot better to have these negotiations and break a CR deadline than it is having them and breaching the debt ceiling, which would have several potentially severe consequences.

With the pressure of a deadline off, the hope is lawmakers can take their time to work out a longer-term deal and avoid a debt ceiling showdown. So, in some ways, this shutdown—as long as it doesn't last too long—is viewed as a potential longer-term positive.

Italian Political Update—Berlusconi is Done (Hopefully).

The Italian mini crisis appears to have resolved itself, as most expect Enrico Letta will survive the confidence vote today in the Italian Senate. Multiple reports suggest that Silvio Berlusconi's PDL party has fractured, and Letta will generate enough support to (barely) survive

Market	Level	Change	% Change
Dow	15191.70	62.03	.41%
TSX	12847.44	60.25	.47%
Brazil	53179.46	841.27	1.61%
FTSE	6413.92	-46.09	-.71%
Nikkei	14170.49	-314.23	-2.17%
Hang Seng	22984.48	124.62	.55%
ASX	5215.56	8.76	.17%
Prices taken at previous day market close.			

the confidence vote and avoid snap elections. This is a positive for two reasons.

Market	Level	Change	% Change
Gold	1289.50	-37.50	-2.83%
Silver	21.16	-.548	-2.52%
Copper	3.2745	-.0485	-1.46%
WTI	101.89	-.44	-0.43%
Brent	108.00	-.37	-0.34%
Nat Gas	3.608	.048	1.35%
Corn	439.50	-2.00	-0.45%
Wheat	683.50	5.00	0.74%
Soybean	1268.00	-14.75	-1.15%

Prices taken at previous day market close.

First, in the short term, it allows the Italian government to continue implementing needed reforms to help the economy and keep its budget and deficits in line with EU requirements.

More broadly, as I mentioned yesterday, the bigger positive is that we may have seen the peak of Mr. Berlusconi's influence not only on Italian politics but also the EU and markets. For those of us who remember fall 2011 when he nearly took down the whole EU, that is a good thing from a stability standpoint.

Bottom Line

Yesterday's rally was more about positioning and sentiment than anything fundamentally positive. Investors were very short term negative heading into the shutdown, and with whispers of a deal starting to form around the medical device tax and apparent resolution in Italy, the market just got too short term bearish and the market didn't fall yesterday morning, it prompted some covering. But, there were no fundamental "bulls" getting long yesterday.

As with all politically driven markets, we are at the mercy of the headlines, and this morning sentiment towards the stalemate is a bit more sanguine, so futures are down moderately.

Bottom line is to expect more of a chop—"real" money remains on the sidelines watching and waiting, and that's leaving the intra-day trading up to the algos and fast money funds. Support in the S&P 500 remains at the 50 day MA (1680) while any sentiment based rally probably won't get much beyond the 1700 level. So, expect a range bound, volatile trade, as we all watch headlines.

The benefit of the doubt remains with the bulls and, as I mentioned, this shutdown in some ways is a positive in the context of the debt ceiling. But, as we get deeper into the fall, I have to think at some point managers with double digit gains will start calling it a year and hedging up and reducing risk.

Economics

ISM Manufacturing Index

- September Manufacturing PMI was 56.2 vs. (E): 55.7.
- New Orders fell to 60.5 vs. 62.3 in August.

Takeaway

September manufacturing PMI was 56.2, showing an acceleration in the pace of activity in the manufacturing sector from August and beating analysts' estimates of 55.0. New Orders remained above the 60 level for the third month in a row. This is a strong showing, although they did decline slightly from August's high print of 63.2.

Bottom line is the economic data implies continued strength in the manufacturing sector, and there are no signs of losing momentum. From a "what would the Fed do" standpoint, the report was strong but by itself, with governmental dysfunction looming, it isn't enough to materially change any tapering expectations. (So, December remains the next most-likely tapering date.)

Commodities

Commodities fell out of bed Tuesday, despite generally good economic data and the U.S. dollar hitting a near-eight-month low. The PowerShares DB Commodity Index Tracking Fund (DBC) gapped lower (down .6%) on the day, and clearly commodities are not responding the way they should be, given the positive fundamentals (improving global economic growth and a sharply lower dollar).

Gold was the worst-performing commodity on the screen Tuesday, and I could hear the screams of the gold bugs from my office as, once again, gold failed to be the safe haven it's often described as. Nothing particularly negative happened in the gold space—in fact, the fundamentals were actually positive. For example, India's current account deficit improved and the manufacturing PMIs increased, leading to a stronger rupee. Yet, heavy selling hit gold at 8 a.m., 8:30 a.m. and then 9 a.m., breaking support at $1,300/oz. The best explanation I could get for the selling—other than the typical conspiracy-theorist government selling—was that a large fund rebalancing in London broke through stops and then the rout was on.

Regardless of today's who or why, gold hasn't traded well for weeks, and has now given up the entire "no tapering" bounce. As I've been saying for a while, the next catalyst for gold is inflation, and until we start to see inflation, gold will be hard-pressed to mount any decent near- to intermediate-term rally.

Industrial commodities were also weak Tuesday, despite the global PMIs being "OK" to "strong." Copper declined more than 1%, presumably on the "disappointing" official Chinese manufacturing PMI, which confirmed the HSBC manufacturing PMI from Sunday night that showed a slight deceleration in activity. But, the new-orders component of the government report increased from August, and both PMIs remain above the 50 level (showing expansion). To boot, JPMorgan (JPM) upped its Q3 GDP forecast for China to 8.5% from 7.8%, so copper's decline wasn't as a result of "bad" Chinese data.

Reflecting the relative outperformance of the U.S. ISM PMIs, WTI crude declined only 0.5% yesterday. With the exception of natural gas, which rallied 1.6% on expected colder weather moving across the country, WTI was the relative top performer in the energy space.

Commodities as a whole have traded poorly since hitting their recent highs in August, and that's troubling because 1) global economic data hasn't really shown any slowdown, 2) the U.S. dollar is sharply lower from levels in late August, and 3) the Fed was "dovish" in that it didn't taper. Especially concerning is the inability of copper and WTI or Brent crude to move higher over that period of time. Commodities *should* be rallying, so either they are just acting like a coiled spring and will play catch-up in a big way, or they are forecasting a stall/slowdown in the global economy. My hope is that it's the former—but the longer this goes on, I get nervous it could be the latter.

Market	Level	Change	% Change
Dollar Index	80.240	-.83	-0.10%
Euro	1.3537	.001	0.07%
Pound	1.6192	.0015	0.09%
Yen	.010223	.000037	0.36%
CAD $	.9663	-.0024	-0.25%
AUD $	.9344	.0065	0.70%
Brazilian Real	.4436	-.0005	-.11%
10 Year Yield	2.646	.031	1.19%
30 Year Yield	3.721	.035	.95%
Prices taken at previous day market close.			

Currencies & Bonds

The Dollar Index briefly broke down through 80 early Tuesday morning to an eight-month low thanks to the government shutdown. But, some dip-buyers and the strong ISM manufacturing PMI helped arrest the declines. The Dollar Index actually finished trading Tuesday down only slightly, exhibiting some strength. But, clearly the Dollar Index is through the post-September FOMC meeting lows of 80.17. While it won't be a straight line, the trend for now in the dollar is lower, as the Fed is clearly on hold and the government is dysfunctional.

The dollar weakness was the dominant force in the markets yesterday, so we saw broad strength in European and Asian currencies, despite some most international manufacturing PMIs missing estimates.

Starting in Europe, the euro and pound were flat, as the PMIs for September were just "OK." On the negative side, PMIs for France, Italy, Germany and the UK declined slightly from August readings and missed estimates. This implies the rebound in those economies may be leveling off a bit. Positively, Germany's PMI remains solidly above 50 as does the EU-wide PMI, which met expectations at 51.1.

In Asia, the yen rallied on the expected "sell the rumor/buy the news" reaction to Prime Minister Shinzo Abe's official announcement that he would go forward with the sales tax increase in the spring. Adding to the yen strength was the fact that, while Abe announced a 5-trillion-yen ($5 billion U.S.) stimulus package to offset the tax increase, the details of such a package were withheld until early December. (This was taken to mean the administration wasn't in agreement about what exactly the stimulus would entail, implying a lack of conviction.)

But, tea leaf reading aside, more stimulus is coming, and there is ample proof that "Abenomics" is working, which will only encourage more of it going forward. Even with the dollar apparently headed lower, I continue to think the yen is one of the best currency "shorts" in the market today over the medium & longer term.

Treasuries declined slightly on the government-shutdown news/strong ISM PMIs, but mostly bonds are treading water until there is more clarity with regard to the government-shutdown/debt-ceiling negotiations. But, the declines yesterday make a subtle point, and I was discussing this with a new customer from Morgan Stanley yesterday. If the budget/debt-ceiling mess turns ugly and we approach the debt ceiling with the possibility of a breach, I don't think you should expect bonds to rally, like they did in the Summer of '11. That was a different market then, and we're in a down-trending bond market now—so "bad news" on the budget/debt-ceiling front is indeed "bad" for the bond market.

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.

	Fundamental Outlook	Technical Outlook	Overall	Comments
Commodities	**Bullish**	**Neutral**	**Neutral**	*The commodity complex continues to see the environment turn more favorable, although the commodity complex is not rallying as you would expect. 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.

	Fundamental Outlook	Technical Outlook	Overall	Comments
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.**

	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.**