7:00's Report

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

October 21st, 2013

Pre 7:00 Look

- Futures and most international markets little changed after a quiet weekend.
- Economic data o/n was light, with Japan Sept trade balance the only release. It missed expectations with exports increasing less than expected.
- Econ Today: Existing Home Sales (E: 5.3M), Fed Speak: Evans (8:00 A.M.).
- Earnings: HAL (E: $0.83), MCD (E: $1.50), VFC (E $3.77), NFLX (E: $0.48), TXN (E: $0.57), VMW ($0.82).

Market	Level	Change	% Change
S&P 500 Futures	1737.25	0.75	.04%
U.S. Dollar (DXY)	79.75	.033	.04%
Gold	1315.30	0.70	.05%
WTI	99.92	-.89	-.88%
10 Year	2.589	0.00	0.0%

Equities

Market Recap

Stocks surged to new all-time highs last week on an extension of the debt ceiling into early '14 and "OK" earnings. The S&P 500 is now up 22.32% year-to-date.

Stocks started last week in the red, as markets remained concerned about a solution in Washington regarding the debt ceiling. But, expectations for a deal remained, and the declines early last week were relatively muted.

When the debt ceiling was passed Wednesday night, though, most expected a "sell the news" reaction. But that never materialized (other than for a few hours Thursday morning). As such, the move higher in markets caused a mild "buying panic" as investors once again weren't "long enough" going into the resolution of this macro-economic drama. Last week's late rally was more sentiment-driven than fundamentals-driven, as it seemed just as much a chase to get long as it was a response to the improving economic and business outlook.

It was a broad rally last week. While cyclical stocks certainly led the market higher (banks, materials and airlines were the best-performing sectors), more "safety"-oriented sectors also rallied on a combination of sharply lower interest rates (which benefited utilities) and good earnings (telecom surged on VZ earnings, while KO and other staples also posted good results). Healthcare and homebuilders were the real laggards last week, thanks to soft UNH earnings and the disappointing Housing Market Index report.

Volumes were elevated late in the week, and that confirms the "buyers' panic" that I mentioned earlier. On the charts, the S&P 500 broke to new all-time highs (obviously bullish) but also finished trading Thursday and Friday basically on the highs of the day.

Earnings Season Update

Turning to earnings, we are in the thick of things right now. Although it's still early, it's fair to say earnings reports are meeting or slightly exceeding cautious expectations.

The headline statistics, as seems to always be the case, are very good: 100 S&P 500 companies have reported so far, and close to 70% have beaten estimates. But, to a point that's somewhat meaningless, as there's always a huge number that "beat" estimates. More importantly,

Market	Level	Change	% Change
Dow	15399.65	28.00	.18%
TSX	13136.09	99.73	.77%
Brazil	55378.46	20.33	.04%
FTSE	6632.50	9.92	.15%
Nikkei	14693.57	132.03	.91%
Hang Seng	23438.15	98.05	.42%
ASX	5351.77	30.30	.57%

Prices taken at previous day market close.

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on the revenue front, the picture remains mixed, with about 50% of those 100 companies reporting top-line beats.

Regardless of the stats, though, so far we've seen more "good" reports from the super caps than red flags (and that's really what people are looking at). Friday's results were particularly impressive, with GE and GOOG posting strong numbers. Materials and industrials—like IR, SLB, PH and KSU—have also done well.

Market	Level	Change	% Change
Gold	1315.20	-7.80	-0.59%
Silver	21.89	-.057	-0.26%
Copper	3.2915	-.0055	-0.17%
WTI	100.82	0.15	0.15%
Brent	109.94	.83	0.76%
Nat Gas	3.762	.005	0.13%
Corn	441.50	-1.50	-0.34%
Wheat	705.75	19.75	2.88%
Soybean	1291.25	-200	-0.15%
Prices taken at previous day market close.			

Of note, materials continue to have the biggest surprises to the upside, beating estimates by more than 20% so far. This reflects 1) the global recovery and 2) depressed sentiment toward the space.

This week will be the heaviest week of earnings, with multiple reports from virtually every sector of the market. In particular, though, there will be a big focus on tech. That's because, excluding GOOG, that sector has been a touch weak. (IBM & EBAY were two of the biggest "misses" so far this year.)

Some names that will be closely watched are VMW (tonight), EMC/JNPR (Tuesday), SYMC (Wednesday) and MSFT (Thursday).

Bottom Line

For the fifth time this year, investors (this time including me) underestimated the market, as the rally last week was more the result of sentiment being too cautious/ bearish. The surprising rally to new highs caused another bout of performance anxiety as underinvested managers were "forced" into the market and chased stocks higher.

Normally, that type of occurrence brings about market tops. But it's fair to say that, even with the market up more than 20%, sentiment remains more skeptical and cautious than it is outright enthusiastic. While most people I talked to can easily imagine a run by the S&P 500 to 1,800 into year-end, none of them were very happy about it; most seemed to believe it wouldn't be justified fundamentally (which is exactly how they've felt all year). So, the "pain trade" remains higher.

Turning away from sentiment for a moment and actually looking at the valuation, the S&P 500 is now trading at 14.2 times '14 EPS (I'm using $122). Although, with a macroeconomic backdrop devoid of any foreseeable risks into year-end—as long as the economy doesn't falter—I'm hearing some chatter about expectations of multiple expansions, to say 15 times (which is 1,800) or even 16 times (1,920) earnings.

I personally think that's pretty aggressive (especially 16 times) given a 2-ish% GDP, but I point it out because multiple expansion will be the next catalyst higher in this market.

Regardless, I continue to think Europe offers more upside into year-end. "Europe" has outperformed the S&P 500 since the summer, and is up "just" 15% (vs. 22% for S&P 500).

More importantly, though, the EURO STOXX 50 (SX5E) blue-chip index is trading at just 12.3 times '14 EPS. In a recovering global economy, it's a lot easier for me to accept "Europe" trading to 14 times earnings than it is the S&P 500 trading to 16 times.

Bottom line is, the path of least resistance remains higher for the equity markets, although I continue to favor allocations to "Europe" (both the core and periphery) via VGK (Europe), EWU (United Kingdom), EWI (Italy), EIRL (Ireland) and GREK (Greece), and to markets more exposed to the global economic recovery like PICK (metals and mining producers) and EWA (Australia).

Economics

Last Week

Although last week was dominated by the temporary resolution in Washington, there were two important takeaways from the domestic and global economic data that was released.

First, last week was important with regard to Chinese data and their economy, and largely the results met expectations (which is a positive). Q3 GDP met expecta-

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tions, rising 7.8%.

The Consumer Price Index was a touch higher, but mostly because of vegetable prices. Importantly, it's not high enough to have the Chinese government start to remove economic stimulus.

Plus, industrial production and retail sales data for September met expectations. Finally, commodity imports were surprisingly strong, implying there is underlying strength in the Chinese economy.

From a market standpoint, this data was important because it further reassures the markets that the Chinese economy isn't seeing a significant slowdown in the pace of growth. (Meaning ,there is little risk of a Chinese economic "hard landing.") From an investment perspective, it implies the "global economic recovery" investment thesis remains valid, which is positive for cyclical stocks, multi-national industrials, global industrial miners and transportation stocks.

Second, here in the U.S., we got our first look at the state of the economy in October via the Empire State and Philly Fed reports. The takeaway is that the shenanigans in Washington did have a negative effect in the near term, but the manufacturers surveyed in the reports continued to see positive momentum building beyond the temporary government shutdown. We know that because, while both headline indices declined from September levels, the new orders index (a leading indicator) rose for both reports—again implying that the government shutdown hasn't significantly altered expectations of activity in the future.

So, to word it simply: For the next several weeks, the market will be wondering: "How Much Damage Did Washington Do?"

And, although it's still early, both the Empire State and Philly Fes surveys gave us an answer of "some, but not a lot."

If that answer proves valid, then that's bullish for risk assets into year-end.

Market	Level	Change	% Change
Dollar Index	79.720	.002	0.00%
Euro	1.3677	.001335	0.1%
Pound	1.6161	.00137	0.08%
Yen	97.872	-.1805	-0.18%
CAD $	1.02962	.000255	0.02%
AUD $	.96654	.00435	0.45%
Brazilian Real	.45505	-.00285	-.62%
10 Year Yield	2.589	0.00	0.0%
30 Year Yield	3.655	.001	.001%
Prices taken at previous day market close.			

This Week

This week will be very important in providing more insight into the three key questions before the market: 1. "How much damage did Washington do to the U.S. economy?" 2. "Is the global economic recovery continuing or losing some steam?" and 3. "Will the Fed taper in December?"

Right now the market "expects" the data to reflect these answers: 1. "Some but not much." 2. "Yes it's continuing but with a small loss of momentum" and 3. "No, unless the economic data comes in much, much better than expected."

First, the September jobs report will be released tomorrow morning at 8:30 a.m. Right now the expectation is for around 180K jobs added, but make sure to watch the revisions.

The August number was very low (153K), almost borderline shockingly low, and there is some expectation that this number may be revised significantly higher. So, point being, look at the revisions to the August data as much as you do the headline number for clues as to how the market will trade.

Second, global "flash" Purchasing Managers' Indexes for October hit Wednesday night (China) and Thursday morning (Europe & U.S.). Obviously this is the next key round of data for the "global economic recovery" thesis.

Additionally, the flash PMIs (which are collected by the private firm Markit and will reflect activity throughout the government shutdown) will give a lot more insight into the "how much damage has been done to the economy" question

Third, we get the latest look into the health of the housing market via Existing Home Sales (today) and New Home Sales (Thursday). Obviously a recovering housing market remains a key driver for the growing economy. And, as has been the case, investors will be looking for clues about the effects of higher interest rates on home purchases. Incidentally banks, in their

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earnings calls, have had generally "OK" commentary toward mortgages and housing, so most expect these numbers to reflect a bit more slowing, but with the recovery still intact.

Commodities

The broad based commodity ETF DBC rose just under 1% last week, on a combination of a sharply lower US Dollar, Chinese data largely meeting expectations, and a debt ceiling extension.

Precious metals were the big outperformers last week, as gold rallied close to 5% thanks to the extreme dollar weakness, and the rally caught most off guard and it was expected gold would decline once any chance of a crisis in Washington was removed (for now). But, the imploding dollar proved to be the stronger influence.

Gold will continue to be directed by the dollar and, once again, expectations of tapering of QE. $1330 is stiff resistance in gold, and unless we get a few closes above that levels I'd say gold remains range bound at best between $1270—$1330.

Energy, and in particular WTI Crude, was the laggard in the commodity markets last week, falling on demand concerns (back to the "How much damage did Washington do to the economy?" question) and also on positive sentiment surrounding the Iranian nuclear negotiations (nothing actually was resolved, but another meeting is scheduled for early November). WTI is testing support at 100/bbl this morning, and the weakness in WTI remains a non-confirming indicator to watch (oil shouldn't be this weak with other risk assets so strong).

This week look for commodities in general to trade off the dollar and on the global flash PMIs coming Wed/ Thurs.

Currencies & Bonds

The dollar collapsed last week, crashing through support to trade at a 9 month low, closing solidly below the 80 level. Despite the temporary resolution in Washington (which you would think is dollar positive) the dollar fell because focus of the currency markets turned back to when the Fed will taper QE. And, since the government shutdown, the expectations for the first taper of QE have steadily been moving out on the calendar, with January now the consensus expectation, although some are saying the Fed may wait until June. So, the dollar was lower last week primarily on that "Dovish" expectation.

With the dollar index so much lower, every other currency surged. The euro rose to a 9 month high, just below 1.37, the pound rallied close to the highs of the year, and the Aussie dollar traded to levels not seen since June on a combination of dollar weakness, strong Chinese commodity import data, and "hawkish" RBA minutes.

The yen also rallied versus the dollar last week, but continues to be the relative laggard. The yen is slightly weak this morning as September trade balance missed expectations, and I continue to like yen as the "weakness" currency versus the dollar over the medium and longer term, and think any rallies (like the ones last week) should be shorted for accounts with anything other than very short term time horizons.

Mirroring the "dovish" trade in the currency markets last week, Treasuries rallied to 2 month highs post Washington compromise, again on the expectation of delayed tapering of QE. The ten year yield broke down through 2.6%, and this counter trend rally will likely continue for a few more weeks (although I'll keep saying the rally is a great shorting opportunity).

Expectations of when the Fed will taper are once again the dominant force in the bond and currency markets. That said, though, I'm not sure we'll see material further downside in the dollar index, given other countries currencies are at multi-month highs and that's not helpful to their exports (so they will start to push back). The big winner from the U.S. dollar being range bound to modestly lower continues to be emerging market currencies.

This week, expect the dollar and bonds to trade off the data (employment and flash PMIs) and off "dovish" or "Hawkish" expectations for the first Fed tapering. Currency and bond markets are officially back on Fed watch.

Have a good week—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 traded to new all time highs last week as the market remains resilient, shrugging off some disappointing earnings, and sentiment remains far from euphoric. While valuations are elevated, until sentiment becomes much more enthusiastic, the path of least resistance for stocks remains higher.* *The S&P 500 support again sits at the old highs of 1729 while there is no real resistance on the charts.*

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 VGK (Europe ETF), 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 and Global Miners: **Domestically, I'd look to allocate to deep cyclicals like industrials (XLI), basic materials (IYM) and global industrial miners (PICK). Those sectors are most exposed to the "global economic recovery" thesis.**

	Fundamental Outlook	Technical Outlook	Overall	Comments
Commodities	Bullish	Neutral	Neutral	*With Washington drama removed from the markets, commodities hopefully can resume the rally based on the global "economic recovery. Commodities remain on of the few asset classes where you can make a "value" argument.*

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 will now once again trade off Fed expectations and economic data, and with tapering expectations being pushed out to early next year, there is little reason to expect a rally in the Dollar Index.*

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 further upside as Fed tapering has likely been delayed until early '14.**

	Fundamental Outlook	Technical Outlook	Overall	Comments
Treasuries	Neutral	Bearish	Bearish	*Bond will likely resume their counter trend rally given that Washington is out of the headlines, as Fed tapering looks to be pushed out to next year. But, remember this rally is just one enormous shorting opportunity.*

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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