7:00's Report

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

October 24th, 2013

Chinese shares gapped lower yesterday on concerns of tightening liquidity, and have underperformed other major markets for weeks now.

Pre 7:00 Look

- Futures are bouncing back this morning after global Flash PMIs generally met or slightly exceeded expectations.
- Chinese flash manufacturing PMIs rose to 50.9 vs. (E) 50.5, although short term lending rates also continued to increase.
- In Europe, the two key numbers (German manufacturing PMI and EMU composite PMI) both beat expectations.
- Econ Today: Weekly Jobless Claims (E: 335K), October Flash Manufacturing PMI (E: 52.7), New Home Sales (E: 420K).
- Earnings: MMM (EL $1.76), MO (E: $0.64), CL (E: $0.73), DOW (E: $0.54), F (E: $0.38), XRX (E: $0.25).

Market	Level	Change	% Change
S&P 500 Futures	1748.75	7.00	.39%
U.S. Dollar (DXY)	79.195	-.134	-.17%
Gold	1339.30	5.20	.39%
WTI	97.80	-1.42	-1.43%
10 Year	2.485	-.027	-1.07%

Equities

Market Recap

Stocks declined modestly yesterday, thanks in large part to profit-taking on the quick 7% rally off the lows from just two weeks ago. The S&P 500 gave back 0.47%.

Stocks started Wednesday solidly lower, with three main "reasons" being cited: Weak European earnings (Heineken and STMicroelectronics in particular), Worries about European bank shares as the criteria of the latest round of ECB bank stress tests were released, and concerns about Chinese liquidity, given the sharp increase in the seven-day repurchase rate in China. And, while each of these were legitimate negatives, in reality they seemed more coincidental than causal. Simply put, this market needed to pause and those reasons happened to be there when it did.

Activity was busy early in the day, as yesterday and today mark the height of earnings season. Stocks registered their lows for the day shortly after the open, but after a flurry near the open both news flow and activity slowed throughout the day. Markets lifted in quiet trading into the closing bell and stocks closed well-off their lows.

Trading Color

Looking at the sector trading, there was once again outperformance from the "safety" sectors of the market, which was likely the result of continued downward pressure on interest rates, lingering concerns about the economy and general profit-taking in some cyclical sectors that had done very well over the past two weeks.

Winners on the day included homebuilders, which were

Market	Level	Change	% Change
Dow	15413.33	-54.33	-.35%
TSX	13243.32	-4.74	-.04%
Brazil	55440.03	-1020.35	-1.81%
FTSE	6694.95	-20.47	.31%
Nikkei	14486.41	60.36	.42%
Hang Seng	22835.82	164.13	-.71%
ASX	5372.89	16.79	.31%

Prices taken at previous day market close.

again the best-performing sub-sector. They rebounded after 10-year yields dropped below 2.50% for the first time in 3+ months. Consumer staples, industrials (helped by the good BA earnings) and utilities (falling interest rates) also continued to outperform.

Market	Level	Change	% Change
Gold	1333.40	-9.20	-0.69%
Silver	22.61	-.18	-0.79%
Copper	3.2635	-.072	-2.16%
WTI	96.82	-1.48	-1.51%
Brent	107.47	-2.50	-2.27%
Nat Gas	3.62	.039	1.09%
Corn	442.75	4.50	1.03%
Wheat	701.75	1.00	0.14%
Soybean	1310.00	7.75	0.60%
Prices taken at previous day market close.			

Losers on the day were mostly cyclical stocks, with energy (due to collapsing crude prices), basic materials and financials lagging. CAT was the big earnings "miss" of the day, as the company cited poor mining results as the main driver of the miss. However, outside of the weak mining numbers (which really shouldn't be a surprise) the report was OK (so the takeaway was that the CAT results don't imply a general slowing in the global economy, just weak demand from mining companies for CAT equipment, and that stems mostly from lower commodity prices).

Bottom Line

Sentiment toward this market remains very, very negative. It seems that every time the S&P 500 goes down 10 points, a litany of reasons re-appear about why now is the time for a correction.

And, that happened again yesterday (i.e., China credit crunch/slowing growth, European bank weakness and the sluggish-to-stalling U.S. economy). While all of these concerns are legitimate, it's also the case that the S&P 500 has rallied 7% off the "debt crisis" lows and simply needs to correct, more than anything else.

Bottom line is that while there are legitimate risks that need to be monitored in the global economy, the declines yesterday felt a lot more like the start of a sideways consolidation than any sort of material correction. And while we should continue keeping an eye on China, the macro-economic horizon remains relatively clear and sentiment remains far from enthusiastic, given where we are in equities.

My "Long the Return of Global Growth" thesis took it on the chin yesterday. But if you think this market isn't about to correct hard, then I think Europe, Australia and global miners (CAT's comments notwithstanding) remain the more-attractive long based on valuation and potential upside. If anything, this gives a nice entry point to the "Long Europe/Short U.S." spread trade I mentioned 2+ weeks ago, which has so far done very well.

Big Trouble in Little China? Not yet, But We'll Watch It

China was the big underperformer yesterday, as the iShares FTSE/Xinhua China 25 Index (ETF) dropped nearly 3%—erasing an entire month of gains. And, while most major Western indices are at 52-week or all-time highs, "China" has lagged and is currently trading well below its September highs.

The weakness in the Chinese market is just the end effect of several pieces of peripherally negative data from China this week. First, as I mentioned, property prices in China continue to surge, and that's raising concerns that 1) there's a property bubble, and 2) the surging property prices might make the Chinese authorities take steps to reduce the availability of credit (and deflate the bubble) and, in turn, slow the economy.

That's been a constant "back burner" concern for months, but yesterday there were some headlines that, in an otherwise-quiet tape, further spooked investors.

First, some major Chinese banks released financial results. They showed that, in China's biggest banks, bad debts spiked higher—increasing by 300% over last years levels.

Second, as I pointed out in yesterday's Report, the seven-day repurchase rate in China rose sharply, jumping more than 45 basis points to just above 4%. That further implies the Chinese authorities are taking some steps to rein in credit availability.

It's also giving investors flashbacks to late May/early June, when Chinese authorities basically engineered a mini-credit crisis to help deflate a growing asset-price bubble. As a result, SHIBOR (the Shanghai Interbank Offered Rate, or the Chinese equivalent of LIBOR) spiked higher, and global equity markets temporarily declined as a result.

Again, to provide context, this all matters because steady-to-accelerating Chinese economic growth is essential to the "global recovery" investment thesis. And if China starts to stall, that's bad for risk assets.

Bottom line is, although ominous, the headlines of "China's biggest banks tripled the amount of bad loans written off in the first half" (link here) don't reveal that profits at those banks also surged, as the banks had already provisioned for these bad debts and previously increased loan reserves.

But, despite the big drop in FXI and the relative underperformance of Chinese shares lately, there's no real sign that we're seeing a stalling of Chinese economic growth. And, the October Flash Manufacturing PMIs from China, released this morning, beat expectations at 50.9 vs. (E) 50.5, showing a slight acceleration in growth. However, from an investment/trading perspective, I'd wait a bit longer before taking a look at buying FXI or something else China-related, as the bottom might not be in yet, although I don't think the drop in share prices reflects the start of something more ominous.

Economics

No economic reports yesterday.

Commodities

Commodities were universally lower yesterday with the exception of grains and natural gas futures, which were bid up by news of a cold front encroaching on the Midwest. The PowerShares DB Commodity Index Tracking Fund (DBC) was down over 1.50%, closing near session lows.

The worst performing commodity yesterday was copper, which traded down over 2% in its largest losing session since early September. China was the reason for the sharp declines, as copper often times trades as a proxy for Chinese economic growth, and a liquidity crunch, if it materializes in China, is obviously bad for economic growth in China. Expect copper to continue to trade with "China" over the next several data as events there unfold (interestingly, Copper isn't getting much of a boost this morning despite the Flash PMI "beat," which I'd take as a bearish sign).

Market	Level	Change	% Change
Dollar Index	79.325	.035	0.04%
Euro	1.3779	-.00068	-0.05%
Pound	1.6169	-.007775	-0.48%
Yen	97.3175	-.227	-0.23%
CAD $	1.0385	.00956	0.93%
AUD $	.96246	-.00771	-0.79%
Brazilian Real	.45370	-.0023	-.50%
10 Year Yield	2.485	-.027	-1.07%
30 Year Yield	3.582	-.027	-.75%
Prices taken at previous day market close.			

Crude also traded down on the weak news out of China (again, it seems like traders were looking for any excuse to sell). EIA data was released as normal yesterday, indicating a higher-than-expected build of 5.2M barrels. However, the release included a draw in gasoline stores, which influenced a mild bid in WTI crude oil futures—taking prices off the lows of the day, although WTI still finished more than 1% lower and at a 5 month low.

Precious metals held their ground, giving back only a small portion of yesterday's gains as the dollar drifted sideways through the trading session.

Gold was down about 0.7% but was able to remain above the $1,330 level, which I will reiterate is vital if prices are going to continue higher.

Tuesday's high of $1,344.70 is the target to trade through. If prices can break $1,350 or, even better, close above $1,350, then it would be a very bullish signal. Don't forget, though, gold has a bad habit of head-faking traders and unfortunately this could be one of those times.

There was clear profit-taking in the commodity space yesterday after the sector went on a bit of a tear this month that took DBC up just shy of 2%. With that said, commodities markets will be looking for further direction out of the global flash Purchasing Managers' Indexes that are due out at 8:58 a.m.

Currencies & Bonds

"Western" currencies (the dollar, euro and pound) were little-changed by the end of trading yesterday, thanks to late-day rallies by the euro and the pound—both of which traded off actual news for the first time in a week, and not simply dollar weakness.

The euro was down modestly early on Wednesday, as news about the latest round of ECB "stress tests" hit the wires. (European banks aren't exactly rock-solid, so there's concern the stress tests might result in more capital-raising, which would hurt the share prices.) But, after some initial reaction, the euro rallied back to flat because: 1) These stress tests were widely expected, and 2) The criteria aren't really anything shocking.

Bottom line is: Unless we get another flare-up of sovereign concerns, which is very unlikely at this point, any material dip in European financials on "stress test" concerns is probably a buying opportunity. (EUFN is the ETF if you're interested.)

Things were the opposite with the pound, which actually rallied in the early morning above Tuesday's highs on the Bank of England's September meeting minutes. The Monetary Policy Committee meeting minutes showed a 9-0 vote to maintain QE, which was taken as a "hawkish" result. (Previously, some MPC members had hinted they wanted to expand the QE program.)

But, the pound couldn't sustain the rally, and it traded down more than 0.4% vs. the dollar by the end of the day—again implying we may have seen the top of this latest pound rally.

Asian currencies traded in a "risk-off" mode thanks to the concern regarding the jump in repo rates in China (so, fears of a credit crunch). The yen rallied 0.8% vs. the dollar, and the Aussie dollar declined nearly 1%.

I've said over the past two weeks that the only thing that can make the yen rally at this point is a peripheral "risk-off" trade, as the fundamentals for the yen continue to deteriorate. But, we got "risk-off" day again yesterday, and as a result the yen traded to a two-week high vs. the dollar. But, concerns about China notwithstanding, I'd continue to use any further rallies to initiate or add to short positions in the yen, as the fundamentals remain decidedly negative.

Treasuries saw a modest continuation of the recent rally. The 10-year yield dipped below 2.5% for the first time since late July, as the reality of a slow-growth economy and a March or June QE tapering is starting to seep into the market. And, although it's slightly overbought, I'd continue to expect this counter-trend rally in bonds to continue for the next several weeks, as there is little "valid" data on the horizon that could show the economy is starting to accelerate (and in turn pull QE tapering forward).

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 S&P 500 traded to new all time highs last week on resolution in Washington and a "clear" macro horizon. While valuations are elevated, cautious sentiment remains one of the bigger drivers of stocks, and 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 Europe: **Although Washington drama is resolved, I continue to favor international exposure as "Europe" is seeing economic stabilization and a return of growth, and remains a better value than the US, and I like VGK (Europe ETF), EWU (UK ETF) or EIRL (Ireland ETF), and, for the gambling ilk, GREK (Greece ETF) and EWI (Italy ETF).The**

Long Japan: **The "Long Japan" trade has stalled a bit thanks to a rising yen (which was 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.**

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 concerns of growth thanks to the debt ceiling drama 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.**

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.**

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.**