7:00's Report

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

October 28th, 2013

Pre 7:00 Look

- Futures are extending last week's rally after a very quiet weekend with no new news.
- Asian shares are rebounding as the Nikkei is rallying 2% thanks to "dovish" comments by BOJ member Iwata.
- SHIBOR rates in China are stable this morning, although clearly the situation needs to be monitored this week.
- Econ Today: Industrial Production (E: 0.4%), Pending Home Sales (E: 0.0%).
- Earnings Today: AAPL (E: $7.89), STX (E: $1.31).

Market	Level	Change	% Change
S&P 500 Futures	1757.50	3.50	.21%
U.S. Dollar (DXY)	79.235	-.011	-.01%
Gold	1351.10	-1.10	-.09%
WTI	97.91	.06	.06%
10 Year	2.503	-.019	-.75%

Equities

Last Week

Stocks rallied to new all-time highs last week, as a trifecta of expectations of the Fed further delaying its QE tapering, "good enough" earnings and continued skeptical sentiment offset several pieces of disappointing economic data. The S&P 500 rose 0.8% last week, and is now up 23.3% year-to-date.

Stocks methodically grinded higher last week, keying off good earnings each day and embracing the fact that, while economic data was disappointing, a QE tapering delay is imminent. And, although earnings grabbed the headlines, the further delay of tapering was the dominant theme in the markets last week and it was especially evident Tuesday, when stocks rose despite the jobs report miss.

Speaking of earnings, last week was the busiest week of earnings season. While the results were mixed overall, the bottom line is that they won't result in any changes to the Street's expected S&P 500 earnings-per-share for this year ($110) or next year ($120-$123). Because of that, earnings won't be enough to de-rail the rally and although there are some high profile releases this week, earnings will quickly move to the back burner.

Late last week markets wavered a bit on Chinese repo rates and the Shanghai Interbank Offered Rate (SHIBOR) spiking higher, and that caused some concerns we may be seeing a repeat of the June Chinese credit crunch that sent stocks lower, but at this point the situation remains largely under control.

Finally, for all the news last week, continued skeptical sentiment and near-disdain for the market's relentless rally were as much responsible for the grind higher as anything else. Portfolio managers have once again largely missed the near-7% rally off the "debt ceiling" lows of nearly three weeks ago and they continue to be pulled in on the long side on any dip or pause.

Looking at individual sectors, with so many earnings reported last week, there really wasn't much to glean from the sector trading. There was no definitive outperformance of "cyclicals" over "safety," although I will note that "bond-proxy" stocks—which got killed leading up to expected tapering of QE in September—continue to enjoy a nice rebound, as expectations for tapering continue to be delayed.

Market	Level	Change	% Change
Dow	15570.28	61.07	.39%
TSX	13399.42	74.66	.56%
Brazil	54154.15	-723.00	-1.32%
FTSE	6725.44	4.09	.06%
Nikkei	14396.04	307.85	2.19%
Hang Seng	22806.58	108.24	.48%
ASX	5441.41	55.06	1.02%
Prices taken at previous day market close.			

Airlines (good LUV & DAL earnings and an LCC upgrade), retail (good AMZN earnings), and transports (good UPS earnings, strong railroad performance) all outperformed. Conversely, banks and healthcare were the laggards on the week. (These two sectors remain the relative "dogs" in this market. Regulatory concerns continue to weigh on the banks, and confusion over the "Affordable Care Act" and UNH's surprising earnings miss weighs on the healthcare space.)

Market	Level	Change	% Change
Gold	1351.90	1.60	0.12%
Silver	22.62	-.202	-0.89%
Copper	3.2685	.0005	0.15%
WTI	97.84	.73	0.75%
Brent	106.92	-.07	-0.07%
Nat Gas	3.707	.078	2.15%
Corn	440.00	-.25	-0.06%
Wheat	691.50	-5.00	-0.72%
Soybean	1300.00	-9.75	-0.74%

Prices taken at previous day market close.

On the charts, the S&P 500 remains in a bullish pattern, as it hit new all-time highs last week. Volumes were elevated, but that was more because of earnings. However, there was certainly decent activity in the market, further validating the new highs.

Bottom Line

The path of least resistance remains higher in this market, and continued skeptical sentiment toward the rally remains one of the biggest positive factors, as the "pain trade" remains decidedly higher.

Despite the S&P 500 being at all-time highs, sentiment remains skeptical of the rise in stocks (as evidenced by the Barron's cover article this weekend that laments slow economic growth). And, instead of celebrating yet another new high for the market, the focus was on a new set of potential pitfalls: The rise in China's repo rate and SHIBOR, the relative underperformance of Asian stock markets (which has been going on for weeks) , the dip in European banks, collapsing oil prices.

And, while each of those events bear watching, it seems investors are much more interested in finding the event that will finally kill this rally, rather than ways to ride the trend. And, until that changes, the path of least resistance will be higher.

Of the risks facing the market, though, I believe the one we need to watch most closely is the pace of domestic economic growth. Data last week implied the economy was slowing before the government shutdown, and the return to higher economic growth remains the key to a medium- and longer-term extension of this rally.

If you want to be optimistic about stock prices in the coming quarters, you have to start with the idea that the economy will continue to recover. If we see growth stagnate, then the entire bullish case gets materially damaged. So, despite QE and the Fed, economic growth remains the key to materially higher equity prices.

Given potential concerns about domestic economic growth, I continue to like long exposure to Europe, Australia and global industrial miners/basic materials (i.e., the "global recovery" investment thesis) over additional long exposure in the U.S.

Incidentally, the Vanguard FTSE Europe ETF (VGK) and the iShares MSCI United Kingdom Index (EWU) rose 1.6% and 1.8% respectively last week, vs. 0.8% for the SPDR S&P 500 ETF Trust (SPY).

Economics

Last Week

With the drama in Washington successfully postponed, focus last week turned to the question of "How much damage has the shutdown and drama done to the economy?"

While it's still early, based on last week's data, the answer so far is "definitely some" because economic data almost universally missed expectations last week. Perhaps more disconcerting than that, though, were the weak jobs and durable goods reports. These are from September (and pre-shutdown), and they imply that the economy may have been losing momentum before the last round of drama in Washington.

With regard to WWFD (what will the Fed do), the soft data last week further solidified March 2014 as the "consensus" date for the first tapering of QE. However, many analysts think it could come as soon as January, depending on the data. But, from a Fed standpoint, last week was marginally "dovish."

The September jobs report showed 148K jobs added, with a net 9K positive revision for July and August, which was well-below expectations of 180K. As mentioned, this data was compiled *before* the shutdown, and the bottom line is that the jobs market remains largely stuck in neutral—adding between 150K and 200K jobs/month, as it has been doing over the past quarter. Progress in the labor market has clearly stalled.

Manufacturing data was also disappointing. October flash manufacturing PMI, which is inclusive of the shutdown, missed expectations. New orders, the leading indicator in the report, fell to a multi-month low. Although, importantly, the PMI did stay above 50—signaling continued expansion in the manufacturing sector—the pace of that expansion is slowing.

On Friday, the September durable goods report was also weak. The headline number was a beat, but as always with durable goods, you can ignore the headline and instead look at the "New Orders for Non-Defense Capital Goods Excluding Aircraft." NDCGXA fell 1.1% in September (so, before the shutdown). This will raise some concerns that businesses are now starting to reduce spending and investment amidst all this uncertainty, which puts our 2% growth rate at risk.

Bottom line is the economy remains a major concern, and also the single-most-important catalyst for higher stock prices. (More QE won't make the market go substantially higher; we need real economic growth.)

Interestingly, the stock market didn't sell off in reaction to last week's data, and that's because it's impossible to try and figure out how much of the weakness in the economic data was just temporary (because of the shutdown) and what was more structural.

And, we can expect the market to continue to largely "ignore" weak data for the next few weeks, given the noise from the shutdown.

The economy returning to above-trend growth (meaning 3%-plus) remains the key to substantially higher equity prices. If the data stays soft into December, the dynamic in the market will change, and not for the better.

Market	Level	Change	% Change
Dollar Index	79.260	.015	0.02%
Euro	1.3803	.000885	0.07%
Pound	1.6169	-.002575	-0.16%
Yen	.010272	-.000003	-0.03%
CAD $	.9554	-.0026	-0.27%
AUD $	.9583	-.00278	-0.29%
Brazilian Real	.4532	.0033	.73%
10 Year Yield	2.503	-.019	-.75%
30 Year Yield	3.593	-.02	-.55%
Prices taken at previous day market close.			

__This Week__

This week's highlight is undoubtedly the FOMC meeting Tuesday/Wednesday. I'll give a more in-depth preview of what's expected, but at this point no one expects any tapering of QE, and in all likelihood this should be a relative non-event.

I would expect the Fed's commentary on the economy will be downgraded given the government shutdown, and on balance the risk is that the meeting is perceived as "dovish." But really, the only thing that people are trying to figure out is when will the Fed first taper. Given the data, it looks like the answer is "not in 2013."

Away from the Fed, we get several key economic reports. These will be watched, but don't expect the market to necessarily trade off them like we'd normally see, given the "noise" in the data and all that's happened in the economy since September.

We get more insight into the state of the manufacturing industry with industrial production this morning and the final Institute for Supply Management's manufacturing PMIs Friday. In light of the soft durable goods report (and flash PMI), these pieces of data will be watched to see if they confirm the slowing growth we've seen in other recent manufacturing and business investment reports.

On the consumer side, September retail sales will be released tomorrow morning. Recent data have implied consumer spending is slowing a bit, but consumer confidence readings in the wake of the shutdown have plunged lately.

This will keep concerns high that the consumer might materially slow down as we approach the holiday season. It hasn't happened yet, but that's a legitimate concern for the market, because as the American consumer goes, so goes the U.S. economy.

Finally, this week would normally be "jobs week" but because of the shutdown, the October jobs report has been delayed till next week. But, we do get the ADP jobs report Wednesday, so look for that number to potentially move markets more so than normal. That release will include the period of the October shutdown, and will offer a preview of how much damage was done to the labor market by the shutdown.

Commodities

Most major commodity indices declined sharply last week, with DBC falling 1.5%. The two major themes currently dominating trading in the commodity markets are 1) the weaker US dollar and 2) concerns about economic growth domestically and in China. Those two factors resulted some substantial dichotomy in the markets last week: Precious metals traded to a one month high last week, while WTI Crude plunged more than 3%. Copper also declined last week, as investors focused more on the rising Chinese repo rates and SHIBOR, and ignored the fact that the October manufacturing PMI beat estimates.

Gold was the big outperformer last week, rallying nearly 3% and breaking through resistance at the 1330 level. The reason for gold's rally was simple: the US dollar continues to fall as expectations for the first tapering of QE get extended, and as long as that happens gold will have a tailwind.

Conversely, WTI Crude fell more than 3%, and the extreme weakness in WTI Crude remains a "conundrum" for the market. Supply has certainly risen lately and that has to account for some of the decline, but the wild card is whether WTI is forecasting a slowdown in the economy (i.e. a reduction in demand).

Expect commodities this week to continue to trade off economic data and, in turn, the dollar. If the data remains weak, look for a continuation of the underperformance of industrial commodities and a rally in gold, thanks to the weaker US dollar.

Currencies & Bonds

Last week was another "dovish" week in the currency and bond markets, as the soft jobs report was the major catalyst behind the Dollar Index dropping basically to the lows for the year while Treasury bonds rose to a 3 month high, continuing their counter trend rally.

Currency and bond markets are trading almost entirely off when the Fed will taper QE and last week, because of the weak data, those expectations got pushed out, so the dollar continued to its sell off. As a result, the euro traded to nearly a two year high, above 1.38, and the pound traded almost to new highs for the year, and that came despite the economic data from the EU & UK being mildly disappointing (EMU flash PMIs missed while UK Construction Index dropped unexpectedly). But, despite those misses, on a relative basis our economic data was worse last week, so the dollar was punished accordingly.

Even the yen rose versus the dollar last week, as the rise in SHIBOR caused a "risk off" reaction in the Asian currencies and investors moved to the yen for security, resulting in a big rally Thursday. This week brings a lot of Japanese economic data as well as a BOJ meeting, so there's the potential for some significant volatility in the yen depending on those results. Even if there is a further rally in the yen, I'd continue to view that as a golden shorting opportunity, as the fundamentals haven't changed in the yen, and over the coming months and quarters it should head much lower vs. the dollar.

Treasuries saw a good rally last week thanks to soft economic data presumably delaying tapering of QE, and the 30 year Treasury is now at a 3 month highs and ten ear yields are sitting at 2.5%.

It's been a good rally off the lows (remember 10 year yields were 3% in early September) but I still think we've got some more room in this bond counter trend rally, and would remain patient and look to get short at higher levels, as ultimately the Fed *will* taper QE and bonds will resume their declines, and likely in a big way.

Currencies and bonds will continue to trade solely off QE expectations, so the FOMC meeting and economic data will be the key catalysts this week.

Have a good week,

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 expectations of a further delay in tapering of QE. 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.**

Long Gold: **If the Fed is going to delay tapering substantially, then gold is the clear winner and a "value" at these prices, although I'd use a tight stop (around the $1320 level).**

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.**