7:00's Report

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

October 3rd, 2013

Pre 7:00 Look

- Futures modestly lower this morning on general Washington concerns, but there was no new news.
- Econ data o/n was good: Chinese service sector PMIs rose to a 6 month high at 55.4 and EMU service PMIs met expectations at 52.2. Also, EMU retail sales beat expectations in August, rising 0.7%.
- Econ Today: Jobless Claims (E: 313K). ISM Non-Manufacturing Index (E: 57.0).
- Fed Speak: Williams (11AM ET), Fisher (12:30PM ET), Powell (1:30PM ET), and Fisher (5:30PM ET).

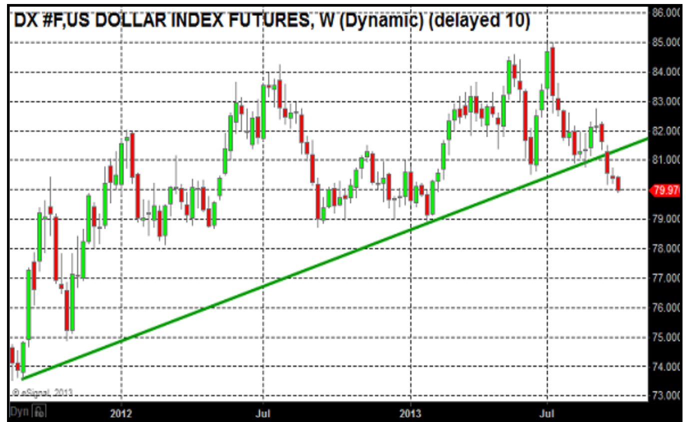
Market	Level	Change	% Change
S&P 500 Futures	1677.75	-5.25	-.33%
U.S. Dollar (DXY)	79.925	-.064	-.08%
Gold	1306.50	-14.20	-1.08%
WTI	103.76	-.34	-.34%
10 Year	2.626	-.02	-.76%

Equities

Market Recap

Stocks saw mild declines Wednesday after rallying off early morning lows throughout the day. The S&P 500 fell just 0.07%.

Stocks opened at their lows, down 1% on a combination of Washington angst and a soft ADP report. But there was no follow-through to the selling, as markets remained more paralyzed than anything. Stocks gradually drifted higher as several "good headlines" hit throughout the day. Among them were news Obama was



The dollar continues to be the main casualty of the shutdown drama, and is moving toward the lows of 2013.

meeting with Congressional leaders late Wednesday, as well as the "it's going to work out" quote Boehner made just before the close that sent stocks out at their highs of the day.

Trading Color

Despite the volatility of the past few trading days, Washington-induced paralysis is still gripping markets, and largely we are running in place. Yesterday, like Tuesday, saw very little participation from "real money" that continues to only be interested in buying any weakness in shares. Action continues to be dominated by fast money and day trading firms, making the daily gyrations in the market somewhat inconsequential. More importantly, a close below the 50-day MA in the S&P 500 or above 1,700 would be something more-consequential.

Looking at sector trading, there remain no real patterns given Washington's influence on markets. Yesterday energy and basic materials were the best-performing sub-sectors, thanks to higher commodity prices and despite a downgrade of Alcoa (AA) and earnings miss from Monsanto (MON). And, generally speaking "safety" outperformed "cyclicals" as utilities, telecom and REITs

Market	Level	Change	% Change
Dow	15133.14	-58.56	-.39%
TSX	12830.32	-17.12	-.13%
Brazil	53033.42	-146.04	-.27%
FTSE	6448.54	11.04	.17%
Nikkei	14157.25	-12.24	-.09%
Hang Seng	23214.40	229.92	1.00%
ASX	5234.89	19.33	.37%

Prices taken at previous day market close.

were flat. Industrials were the big laggards yesterday, as investors take profits in a sector that has vastly outperformed the market over the past several weeks.

Market	Level	Change	% Change
Gold	1316.90	30.80	2.39%
Silver	21.78	.605	2.86%
Copper	3.318	.044	1.34%
WTI	104.02	1.98	1.94%
Brent	109.08	1.14	1.06%
Nat Gas	3.554	-.055	-1.52%
Corn	436.00	UNCH	0.00%
Wheat	685.75	4.50	0.66%
Soybean	1274.50	6.50	0.51%
Prices taken at previous day market close.			

Homebuilders and airlines were two cyclical sectors that bucked the trend, as homebuilders got a boost from the RE/MAX (RMAX) IPO, which jumped more than 20%. (Hope you or your clients had some of that.) Delta Air Lines (DAL) upped guidance and Texas withdrew from the AMR Corp. (AAMRQ)/US Airways Group (LCC) anti-trust suit, raising the hope that the merger will be allowed. (The trial is expected to start on the 25th.)

While participation from real money was light yesterday, volumes were in line with recent averages, and as mentioned the S&P is stuck right in the middle of the 1,680-1,700 range in the S&P 500.

Bottom Line

Although there are plenty of "Doomsday" scenarios out there, the fact that the continuing-resolution talks are bleeding into the debt-ceiling negotiations is being viewed as a positive, which I covered yesterday. The best hope for a resumption of the rally into year-end is for clarity from Washington, meaning an extended CR that lasts more than six weeks and a debt-ceiling extension.

From a sentiment standpoint, it remains decidedly negative, but I get the feeling that investors and traders don't want to get caught underinvested if there is a positive resolution, which has happened multiple times this year.

Whether it was the Italian elections, Cyprus, QE tapering, Fed chairman succession, German elections or emerging-market debt declines, all these potential "tail risk" events have been resolved positively, and each time the majority of investors were too underweighted and defensive.

I get the feeling that, while the pain trade is higher, there isn't quite the same level of caution surrounding the Washington saga as there was previously. And, it'll probably stay that way unless we get within a few days of the debt ceiling with no resolution.

Regardless, I continue to favor international and deep cyclical exposure at this point. It's outperformed over the last several months and, barring a debt-ceiling disaster, it should continue to outperform vanilla domestic equity exposure into year-end. And, with regard to Europe specifically, the fact that Silvio Berlusconi's "coup" failed and we've likely seen his power peak is a positive step forward not only for Italy (the ETF is EWI, for those who like to take risks) but Europe generally.

Economics

ADP Employment Report

- September Private Payrolls rose 166K vs. (E) 180K

Takeaway

The ADP reported weaker-than-expected job creation of 166K new jobs vs. an expected increase of 180K. More important than the headline miss, though, was a substantial revision to last month's number; down to 159K vs. the initial report of 176K. Both the revision and the September miss point toward stagnant employment growth. Although, with the revision considered, 166K new jobs is a three-month high.

As the trend has been in recent months, most of the jobs created (54K) were in service sectors including the trade, transportation and utilities industries, while the financial industry scrapped 4K jobs.

As could be expected, markets responded in a dovish manner as any taper of QE is going to require much-stronger data than what we got yesterday. And, the market responded "dovishly" with the dollar and equity futures declining to morning lows, while gold and Treasuries rallied.

Bottom line is despite the improvement we're seeing in weekly claims, that doesn't seem to be translating to significant improvement in the monthly jobs number, and until it does, tapering is likely off the table. There are three things that need to happen for the Fed to taper: 1) Sustained improvement in economic growth (not happening), 2) An uptick in inflation toward its 2% goal (not happening) and 3) A move lower in the unemployment rate based on significant increase in new jobs (not happening).

Finally, one important takeaway from yesterday's market reaction to the data is that "good" economic news is good for stocks, and "bad" news is bad. The market doesn't want more QE—the marginal benefit of incremental QE is nearing zero. The market needs a strong economy to sustain a rally from here, so as I've said before, more QE is not incrementally equity-market-bullish anymore.

Commodities

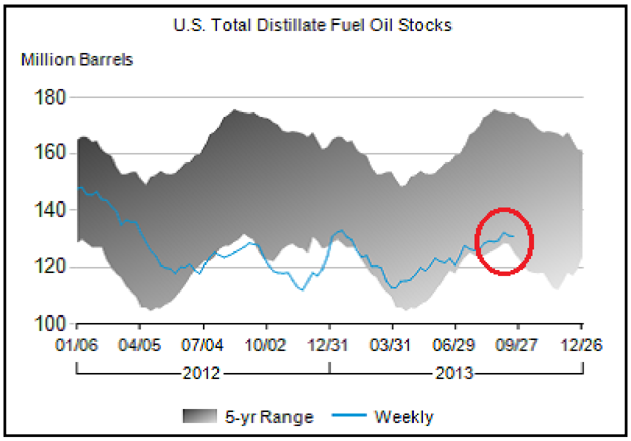
Commodities staged a big oversold rally Wednesday, as the complex was led higher by gold and WTI crude. The PowerShares DB Commodity Index Tracking Fund (DBC) rose 1.13%. The weaker dollar and prospect of "no tapering" from the Fed, thanks to the soft ADP report, helped push precious metals higher, while inventory data and short-covering led to the biggest one-day rally in WTI crude in two weeks.

Gold rose 2.6% yesterday, and the catalyst was the soft ADP jobs report, which then led to a sell-off in the dollar … which led to a rally in gold pre-market that caught aggressive shorts off-guard. A short-covering rally ensued that got gold back above $1,300/oz. and it finished just off the highs of the day. Importantly, the government shutdown was not the reason gold rallied (and unless we are seriously about to breach the debt ceiling, which is an incredibly small probability, don't expect gold to trade off the government).

Market	Level	Change	% Change
Dollar Index	79.995	-.255	-0.32%
Euro	1.3587	.0054	0.40%
Pound	1.6206	.0018	0.11%
Yen	.010268	.000046	0.45%
CAD $	.9662	-.0003	-0.03%
AUD $	.9323	-.0018	-0.19%
Brazilian Real	.44715	.00355	.80%
10 Year Yield	2.626	-.02	-.76%
30 Year Yield	3.71	-.011	-.30%
Prices taken at previous day market close.			

Stepping back, it's clear there are forces in gold's favor – namely that the prospects of tapering later this year continue to dwindle (a combination of governmental incompetence and a still-sluggish jobs market isn't going to make the Fed any more inclined to taper than before). But, as I've been saying, the next major catalyst higher for gold is inflation, and right now there simply isn't any (statistically speaking). I'd expect gold to remain largely range-bound over the coming weeks between $1,271 (the spike low from August) and $1,375 (the spike high post-FOMC).

Sticking to the theme I talked about yesterday of industrial commodity underperformance, we saw a nice bounce back yesterday (despite the weak economic data), although it's fair to say both copper and WTI crude are still trading "heavy" and I think most of what we saw yesterday was short-covering.



Copper rallied a modest 1.3% and didn't even recapture all of what was lost in Monday's fall, while WTI crude rallied 2% yesterday despite bearish weekly inventory data. Weekly inventories of crude rose 5.5 million barrels vs. (E) 2.5 million barrels, bringing oil supplies basically even with inventory levels from one year ago. But, a bearish inventory report was already somewhat priced into WTI at $102/bbl. And traders focused on the surprisingly large drop in heating oil (inventories fell 1.7 million barrels vs. expectations of a 200K drop) and the impending incremental crude demand it implies. That decline puts heating oil inventories at very low levels heading into winter heating season.

As refineries complete their switch from refining predominantly gasoline to heating oil, expect more demand for WTI crude to help boost heating oil and distillate inventory levels. Thinking about the effects of the government shutdown, obviously that isn't a positive for energy (or oil) demand, and the longer it goes on the more of a drag it'll become. So, there is another headwind to think about in the energy patch. In order for the uptrend to resume, I'd like to see WTI trade through $105/bbl.

Commodities remain a bit of a conundrum. I'm a fundamentals trader, so I continue to look at the improving fundamentals of a rebounding global economy and weaker U.S. dollar and see commodity outperformance. But, the space continues to trade heavy despite no tapering, a weaker USD and decent global economic data. Markets can remain irrational longer than we can stay solvent, so I can't stay a near-term bull based on the trading, but the bottom line is I think buying commodities via DBC down here remains a value (especially the industrials) as long as global economic data doesn't materially falter.

Currencies & Bonds

The Dollar Index traded below 80 again Tuesday and made a new eight-month low, declining in reaction to the soft ADP data and a stronger euro, as yesterday's currency markets were driven much more by expectations of the Fed and the European Central Bank than they were the government shutdown or the resolution of the Italian crisis. (I know that because the dollar was flat Wednesday morning pre-ADP and -ECB, and the selloff occurred and accelerated after those two events.)

Starting with the U.S., the weak ADP report—which took on added significance given the delay of the government data, assuming it's representative of the government data—is seen as potentially pushing any "tapering" of QE into 2014, a clearly dollar-negative event. Conversely, ECB Chief Mario Draghi was taken as a touch "hawkish" at the ECB presser yesterday, not because he said anything "hawkish" (he described the EU recovery as "weak, fragile and uneven") but instead because he didn't really allude to the fact that the ECB was ready to be incrementally more accommodative, and by that I mean more LTROs.

Another set of LTROs is what's next with regard to EU policy, and the market is expecting the ECB to issue another round of LTROs to keep rates low for banks. But, since the "no taper" surprise from the Fed, global rates have declined, and while still expected, it's not as much of a "given" that the ECB will act.

If that is the new reality, a no-taper 2013 from the Fed (which is dovish) and a no-LTRO 2013 from the ECB, then it's possible that the Dollar Index has further to fall, although with the euro approaching 1.36 vs. the dollar, sooner or later that will have a negative effect on exports, and I'd expect the ECB to try and counter that at some point.

If we are indeed looking at a no-taper 2013, then the clear winners remain the emerging-market currencies, which should continue to benefit from a rebound as the EM funding crisis of the summer continues to unwind. CEW, the WisdomTree Emerging Currency ETF, looks to have bounced nicely off support. As the outlook gets more and more dovish in the U.S., and economic growth continues to rebound especially in Asia, then EM currencies should continue to rally.

Treasuries were mildly stronger yesterday (30-year up 0.20%) on the "dovish" ADP data , although any material gains in Treasuries will be muted until there's some clarity or resolution from Washington. But, with the prospects for a no-taper 2013 quickly increasing, the likelihood that we've seen the peak in the 10-year yield for the year is increasing. There will be a time to get aggressively short bonds again, but I don't think it's right now. The threat of government calamity aside, I'd continue to wait for better entry points in TBT, TBF and STPP.

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.

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.

U.S. Dollar	**Neutral**	**Neutral**	**Neutral**	*The US Dollar plunged after the Fed's "No taper" surprise and broke a multi-year up trend, and is now bearing the brunt of Washington dysfunction as it declined to multi-month lows. Until there is clarity in Washington, it'll be hard for the dollar to stabilize.*

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.**

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.**