7:00's Report

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

October 31st, 2013

S&P 500: The S&P 500 came very close to trading a bearish "outside reversal" yesterday, and that will make technicians a touch nervous in the short term.

Pre 7:00 Look

- Futures and int'l markets are modestly lower thanks to soft economic data from Europe and follow through selling from yesterday's declines.
- Economic data in Europe continues to wobble a bit: Retail Sales in Germany for September badly missed expectations, falling –.4% vs. .4% (E).
- Bank of Japan rate meeting went as expected with no change to policy.
- Econ Today: Weekly Jobless Claims (E:335K).

Market	Level	Change	% Change
S&P 500 Futures	1756.75	-3.75	-.21%
U.S. Dollar (DXY)	79.985	.148	.19%
Gold	1334.60	-14.80	-1.10%
WTI	96.77	0.00	0.0%
10 Year	2.527	.02	.80%

Equities

Market Recap

Stocks reminded everyone on Wednesday that they can actually go down, as a combination of profit-taking and temporary Fed angst led the S&P lower by 0.49%.

Stocks started yesterday trading flat, again dismissing the latest soft economic data point (the ADP jobs report). Equities mostly churned throughout the morning and early afternoon, although profit-taking ahead of the Fed (by both short-term and long-term accounts) had the market close to the lows of the day before the Fed announcement. Stocks accelerated to the downside following a Jon Hilsenrath article in the WSJ that hit about 15 minutes after the Fed statement (more on that later).

Stocks doubled their daily losses in the span of a few minutes before the declines stopped, with most major averages down about 1%. But, not surprisingly, stocks slowly grinded higher into the close to finish the day well off the lows.

Trading Color

There was broad weakness in the market yesterday with all major averages and all 10 S&P 500 sub-sectors trading in the red. Given the "complacency" with regard to expected QE tapering and the resulting decline in the bond market, we saw the "bond-proxy" sectors lead the way down yesterday, as some of the complacency in those sectors was removed from the market. Consumer staples (down 0.86%), homebuilders (down 1.2%) and healthcare all underperformed, while REITs and telecom were also lower.

Additionally, the market leaders continue to get killed,

Market	Level	Change	% Change
Dow	15618.76	-61.59	-.39%
TSX	13455.33	14.72	.11%
Brazil	54172.82	-365.98	-.67%
FTSE	6749.56	-28.07	-.41%
Nikkei	14327.94	-174.41	-1.20%
Hang Seng	23206.37	-97.65	-.42%
ASX	5425.50	-5.36	-.10%

Prices taken at previous day market close.

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with the exception of Facebook (FB), which exploded higher after the close on strong earnings, although it's traded lower since then on concerns about user trends). Netflix (NFLX), Tesla (TSLA), Groupon (GRPN) and Salesforce.com (CRM) were all down multiple percentage points yesterday.

Market	Level	Change	% Change
Gold	1343.20	-2.30	-0.17%
Silver	22.69	.198	0.88%
Copper	3.3135	.0355	1.08%
WTI	96.76	-1.44	-1.47%
Brent	110.03	1.02	0.94%
Nat Gas	3.628	-.0001	-0.03%
Corn	430.25	-1.75	-0.41%
Wheat	675.00	-6.25	-0.92%
Soybean	1287.50	8.50	0.66%
Prices taken at previous day market close.			

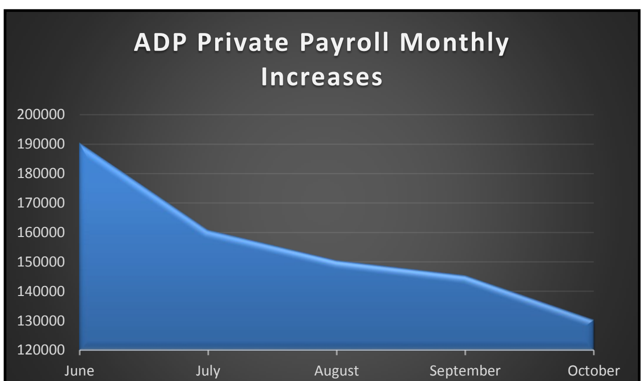
And, while the loss of these "momentum" stocks isn't a direct harbinger of a correction, it is something to watch. (More importantly, what sector will assume a leadership role going forward?)

On the charts, we saw a bearish "inside reversal" yesterday, but just barely. The close yesterday of 1,763.31 was just above Tuesday's close of 1,771.95. So, while it wasn't the more-powerful "outside reversal," technicians will point out that, on the charts, yesterday wasn't a great day for the bulls.

<u>Beware of "Air Pockets" in Stocks.</u>

If you ignore the 30-minute period between 2:00 and 2:30 PM yesterday, it was a pretty quiet day. But, that sharp drop we saw in stocks has two important takeaways I want to point out.

First, the market had become pretty complacent with a "March" taper expectation. While I don't think this consensus changed yesterday, the complacency got shaken a bit out of the equity market and we were reminded the Fed is data-dependent.



A scary chart: Clearly we've been losing positive momentum in the jobs market over the past several months.

Second, there remain "Air Pockets" in this market. (The term seems *apropos* since I just got off a plane that did a great impersonation of a roller coaster.) Very few managers, especially those who are being forced to get long by this relentless rally, believe in this market. And they are sitting there with a hair trigger on the "Sell" button.

So, like we've seen so many times this year, this creates "air pockets" in stocks where they can drop sharply and violently as weak longs jump ship at the first sign of trouble. It's happened several times this year and the market is set up for it again.

But, the important thing to realize here is that every time we've hit one of these "air pockets" (June, October) it's been a buying opportunity.

So, based on recent history, we should expect more of these short, sharp drops—and, although I'm not advocating it outright, the "right" thing to do on these drops all year has been to buy them.

Bottom line is I wouldn't be allocating new money into equities at these levels (into bigger "air pockets," maybe), but I continue to look toward the "Long Europe/ Short U.S." spread trade as the best idea for new money right now.

Economics

<u>September ADP Jobs Report</u>

- October payrolls increased 130K vs. (E.) 150K.
- September payrolls revised down to 145K from 166K.

<u>Takeaway</u>

The trend of disappointing economic data continued Wednesday, as the ADP October jobs report missed expectations. Of course, the report had to be taken with a pretty large grain of salt, given the government shutdown. And, the market largely did just that Wednesday, as the disappointing report didn't cause the sharp sell-off that it normally would have.

But, what can't be discounted is the fact that the September report was revised down somewhat substantially

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to 145K from 166K. As always with these jobs reports, the direction of the revisions can be just as important as the latest headline number with regard to the trend in the labor market.

Certainly this newest disappointing data release tempers expectations for the government jobs report and, government shutdown or not, clearly we have seen the labor market lose significant momentum. (Just a few months ago we were seeing 200K+ job adds.) While the stock market didn't really trade off the data, other assets did as gold and bonds rallied and the dollar sold off (a dovish reaction) because this implies more delay in the tapering of QE.

<u>FOMC Statement</u>

The FOMC statement was expected to be a non-event, and it met expectations (the market did trade with volatility after the statement was released, but that was off the Jon Hilsenrath article I mentioned, which I'll cover in a moment). Back to the Fed, there was no change to policy, as expected. And while the economic growth outlook was very slightly downgraded, overall this statement was extremely similar to September's—leaving the market in limbo about what the Fed is thinking.

With regard to what changed in the statement, the Fed noted the slowdown in the housing recovery by adding this line: "The recovery in housing slowed somewhat in recent months." Also, it acknowledged the decline in bonds yields since mid-September and removed a sentence from the September statement that noted the "tightening of financial conditions."

Those were really the only two material changes to the statement from September, and on balance **I consider them marginally "dovish" because the Fed is acknowledging the slowdown in the housing rebound, while *de facto* celebrating the fact that bond yields have fallen.**

Market	Level	Change	% Change
Dollar Index	79.835	.165	0.21%
Euro	1.3726	-.000985	-0.07%
Pound	1.6031	-.000105	0.01%
Yen	.010141	-.000054	-0.53%
CAD $	.9527	-.0021	-0.22%
AUD $	.9448	-.0004	-0.04%
Brazilian Real	.4540	-.00115	-.25%
10 Year Yield	2.527	.02	.80%
30 Year Yield	3.632	.01	.28%
Prices taken at previous day market close.			

But, as mentioned, the markets did trade "hawkishly" after the Fed meeting, but again it was because an article by the WSJ's Jon Hilsenrath (link here) contained this sentence: "Taken together, the Fed isn't taking a December adjustment to the bond-buying program off the table."

That caused the speed-reading programs to put on a "hawkish" trade and subsequently gold, bonds and stocks sank to the lows of the day while the Dollar Index rallied. But, I suppose the speed-reading programs didn't read the next sentence Hilsenrath wrote: "But that comes with the strong caveat that it depends on whether the economy is living up to expectations." So, the "keen" insight that moved markets was that "The Fed remains data-dependent."

Bottom line is, this market needs a job.

The net effect of yesterday was nothing and we're seeing volatility for volatility's sake. Perhaps the markets were a bit too complacent with expecting a March tapering, but the Fed is no more likely to taper in December than it was on Tuesday, and given the current trend in the economic data, I think tapering in January or March is still the most-likely case.

Commodities

Commodities for the most part traded off the dollar yesterday, and as a result were broadly stronger heading into the Fed (lower dollar) and then abruptly declined as the dollar rallied post Fed announcement/Hilsenrath article. But, like the equity market commodities arrested their declines and turned positive into the close. The PowerShares DB Commodity Index Tracking Fund (DBC) managed to close about 0.3% higher on the day.

Crude oil resumed its recent decline after taking a multiple-session breather earlier this week, which was undoubtedly due to short covering. WTI was the biggest underperformer in the commodity markets, closing down 1.5%. The move was in large part due to yet another build in inventories.

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Crude stockpiles grew by 4.1M barrels compared to analyst estimates of 2.2M. In just six weeks, that puts crude inventories up about 7.9% which has weighed heavily on futures prices and clearly that surging supply is responsible for at least some of this 10 dollar-plus decline we've seen the beginning of September.

Clearly the bear's are in charge at the moment in WTI Crude, with rising supply and lack luster economic data that implies a reduction in demand. The lows of last week ($95.95) remains a critical support level, and should that be broken, a relatively quick run to $92.00 can be expected.

Given the dollar's volatility and the Fed meeting, as you'd expect gold saw big swings yesterday, trading in a range close to $20. The removal of the complacency regarding Fed tapering expectations is weighing on gold this morning as its down 1%, but given I'm not so sure the Fed was "hawkish" yesterday, I would not be surprised to see some support of gold as the day goes on. The $1320ish level remains critical support for gold, and shouldn't be violated if we are indeed seeing a renewed rally.

Currencies & Bonds

After a day of volatility, the Dollar Index finished Wednesday marginally higher (up 0.18%), after the index staged a huge reversal from the lows off the "December taper isn't off the table" article.

The Dollar Index started the day decidedly lower thanks to the soft ADP report, and actually hit the lows of the day right before the Fed announcement as traders tried to get ahead of a "dovish" announcement.

Yesterday we got a good glimpse of why you don't trade ahead of numbers or announcements. That's because if you do and you're wrong, you can get blown out of the water—as many traders did when the Dollar Index surged to nearly the 80.00 level, hitting two-week highs.

But, shorts covered after the Dollar Index came back in, as investors realized that yesterday's Fed Day really doesn't change much. The Dollar Index remains in a solid downtrend, and we can expect it to be data-driven going forward with regard to the Fed outlook. Importantly, though, even with the recent three-day rally in the dollar, it is still priced for an early '14 taper, so keep that in mind.

The movement in the dollar was the dominant force in the currency markets yesterday, as the euro, pound, and yen all declined in reaction to the dollar strength. The yen, not surprisingly, was the biggest decliner (down 0.5%) and is now very close to breaching the 99 yen/dollar level.

Finally, the Aussie was little-changed after the sharp declines of the last few days, despite Aussie housing starts being better-than-expected. Given the weakness in the Dollar Index, I'd expect the "Aussie" to settle in this mid-90s range now, as that seems like "fair value" given the Reserve Bank of Australia's desire for a weak yen, and the soft dollar. I don't see much opportunity in Aussie at the moment.

Turning to bonds, Treasuries, as you'd expect, also saw a high reversal off the "hawkish" FOMC statement. The 30-year note finished down 0.32% and the 10-year yield traded back above 2.50%, reversing the gains bonds saw in the wake of the ADP jobs report.

But, since I don't think the Fed was "hawkish" yesterday, I don't think the counter-trend rally in bonds is done yet, despite yesterday's reversal. Longer term, bonds are headed lower, but I think we've got to be more patient and wait for higher prices before we again aggressively get short the bond market.

Patience, as they say, is required, but in no way do I think what happened in the markets yesterday is a reversal of this recent "dovish" trading pattern.

Happy Halloween,

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 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).**

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: **Industrial commodities have stalled lately, as economic data, especially in the US, has shown a loss of some positive momentum, and it bears close watching as to whether this is a temporary blip, or a bearish game changer. 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.**

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