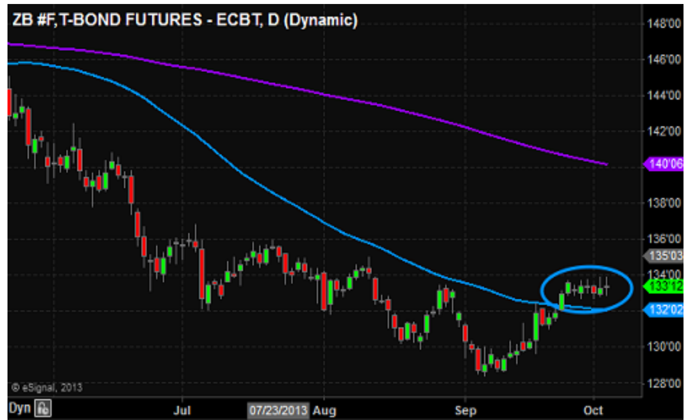
7:00's Report

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

October 4th, 2013



The counter trend rally in bonds has stalled because of the government shutdown. But, the rally will likely resume on resolution of the CR and debt ceiling. Point being, I don't think this is the end of this short term rally, and that's coming from a big bond bear.

Pre 7:00 Look

- Futures slightly higher this morning during a very quiet night.
- The Bank of Japan, as expected, made no changes to policies or its assessment of the economy, which the bank again said is "recovering moderately."
- Econ Today: No reports (the jobs report is cancelled today because of the government shutdown).
- Fed Speak: Fisher (8:30AM), Stein (9:30AM), Lacker (12:30PM), Kocherlakota (1:45PM).

Market	Level	Change	% Change
S&P 500 Futures	1673.75	4.00	.24%
U.S. Dollar (DXY)	79.985	.14	.17%
Gold	1315.60	-1.90	-.14%
WTI	103.57	.26	.25
10 Year	2.606	-.02	-.76%

Equities

Market Recap

In a familiar refrain, stocks declined moderately Thursday on a combination of continued political angst and soft economic data. The incident at the Capitol, while troubling, didn't really have that much of an effect on trading yesterday. The S&P 500 fell 0.9%.

Stocks opened lower yesterday mostly on peripheral Washington concerns, after Wednesday night's meeting between congressional leaders and the president appeared useless. But, stocks took a leg lower midmorning on an ISM non-manufacturing miss vs. expectations, and hit their lows of the day—down nearly 2% on the release of a report from the Treasury detailing that any breach of the debt ceiling could create an '08-style financial crisis (link to the Report here).

Markets bounced in the early afternoon on a comment John Boehner made, stating that he won't allow the U.S. to default. A Washington Post article that got lost in the Capitol Hill shooting coverage implies that Boehner will potentially bring a debt-ceiling extension to the floor of the House and pass it with Democratic support, if the situation warrants (link to the article here). Stocks faded into the close on exhaustion if nothing else, and went out not far off their lows of the day.

Trading Color

The defining factor of trading this week has been the dichotomy between the size of the moves in the market (large and volatile swings in the averages) and the total lack of conviction and participation of real money behind those swings.

Market	Level	Change	% Change
Dow	14996.48	-136.66	-.90%
TSX	12735.12	-103.88	-.81%
Brazil	52489.86	-610.32	-1.15%
FTSE	6448.99	0.13	0.00%
Nikkei	14024.31	-132.94	-.94%
Hang Seng	23138.54	-75.86	-.33%
ASX	5208.02	-26.87	-.51%
Prices taken at previous day market close.			

Again on Thursday we saw big movements in the averages (at the lows, the Dow was down nearly 200 points and the S&P 500 20 handles), but there was little to no volume and trading continues to be driven by fast money and algos reacting to headlines. Real money remains on the sidelines, mostly waiting to buy any sort of a decent dip.

Market	Level	Change	% Change
Gold	1317.10	-3.60	-0.27%
Silver	21.705	-.192	-0.88%
Copper	3.2705	-.0455	-1.37%
WTI	102.93	-1.17	-1.12%
Brent	108.68	-.51	-0.47%
Nat Gas	3.504	-0.038	-1.07%
Corn	439.25	.25	0.06%
Wheat	689.25	3.25	0.47%
Soybean	1288.25	14.50	1.14%

Prices taken at previous day market close.

Sector-wise there was broad weakness, as all 10 S&P 500 subsectors declined, with cyclicals leading the way lower. And, although consumer discretionary, industrials, homebuilders and tech all were the worst-performing sectors (down over 1% each), there wasn't really any safety outperformance either, as utilities fell 1.2%, and healthcare and telecom declined just under 1%. Consumer staples, after getting hammered this week on the Unilever (UL) negative guidance, was the "outperformer" yesterday, rallying 0.5%.

Tropical Storm Karen appears headed east of most of the gas-producing rigs in the Gulf.

Of particular note yesterday was the fact that some of the "momentum" stocks of late got hit. Up until yesterday, the "hot" names were able to shrug off the peripheral bad news, making it a bit of a stock-picker's market (remember those—they existed pre-2008). Tesla (TSLA), Netflix (NFLX) and Priceline (PCLN) all got hit yesterday, and while it's just one day, I thought it worth pointing out.

On the charts the S&P 500 closed below support at the 50-day MA, while volumes were elevated. Again, those higher volumes imply a lot more conviction than was actually in the market yesterday (and this week). There is a lot of day/swing trading going on right now.

Bottom line is markets will continue to be held hostage by Washington until we get some clarity on a solution. Sentiment is a bit better this morning on the Boehner comments mentioned earlier, but expect more volatile, headline driven trading today.

Economics

As the government shutdown drags on, jobless claims and the ISM service sector index were both released yesterday morning. They offered mixed reports on the status of the economy.

Jobless Claims

- Jobless claims slightly increased to 308K vs. (E) 313K

Takeaway

Jobless claims continue to hover near multi-year lows, and while we saw a slight uptick in the headline number this week, more importantly, the four-week moving average again fell to a recovery low of 305K claims. This new low is a substantial 20K claims fewer than one month ago, indicating positive momentum in the jobs market as layoffs seem to be easing.

Despite the positive print, markets seemed relatively uninterested in the number—equities moved slightly higher on the news while the dollar, gold, and bonds bounced in fairly tight ranges.

Sooner or later, given the drop in claims, we should see improvement in the monthly employment report, but as ADP showed this week, but we'll likely have to wait until the October report (released in early November) to see if this drop in claims is resulting in a greater number of jobs added. The September report (which is to be released at some point after the government re-opens) likely won't reflect this drop in claims as the survey was taken in mid-September.

ISM Non-Manufacturing Index

- September Non-Manufacturing PMI fell to 54.4 vs. (E) 57.0

Takeaway

The September non-manufacturing index largely missed expectations and broke a multi-month streak of very encouraging numbers. The index reading, at 54.4, is still well into the expansion territory above 50, but well below the August and July reports of 58.6 and 56.0, respectively.

The release indicated a pullback in activity in the service sector of the economy, which is a touch disconcerting given how large a part of the economy services are, but one bright spot in the report was that new orders, the leading indicator in the Report, was little changed at 59.6 vs. August's 60.5 implying the service sector isn't seeing a big loss of momentum.

Both report yesterday complete a week of just "ok" data, and nothing released this week will make the Fed any more keen to taper QE than they had been previously.

Commodities

Commodities in aggregate saw small gains yesterday (DBC was up 0.19%) in mixed trading, as grains, the refined products and Brent crude rallied, while WTI and the metals were weaker.

Copper was one of the worst performers in the commodity markets yesterday, and continues to not be able to generate any upward momentum, despite more strong international data o/n Thursday (the Chinese and EMU service sector PMIs). While not as directly impactful on commodities as the manufacturing PMIs, you would normally expect good data from China to put upward pressure on copper, or at least keep it flat in a down tape. But, that continues not to be the case as copper trades sluggish in the face of the good data.

Staying in the metals, gold and silver saw small declines as the weaker dollar and soft domestic service sector PMIs (which were taken as "dovish") lent support and helped gold and silver both relatively outperform.

Market	Level	Change	% Change
Dollar Index	79.855	-.134	-0.17%
Euro	1.3622	.0037	0.27%
Pound	1.6149	-.0063	-0.39%
Yen	.010287	.000015	0.15%
CAD $	.9668	.0007	0.07%
AUD $	.9357	.0016	0.17%
Brazilian Real	.4470	-.00125	-.28%
10 Year Yield	2.606	-.025	-.76%
30 Year Yield	3.07	-.003	-.08%

Prices taken at previous day market close.

Importantly, the Washington drama isn't really affecting the trade in gold at the moment, and short of us getting very close to breaching the debt ceiling, don't expect gold to rally off the debt ceiling debate.

Unfortunately gold doesn't act like the "crisis" hedge it's marketed as (and this is coming from someone who traded gold all throughout the financial crisis and European crisis). If we get to within a day or so of breaching the debt ceiling, gold will go up. But that remains a remote possibility, and you have plenty of time to buy some gold if you're worried about the debt ceiling.

Inflation and Fed policy outlook are the keys to the gold market right now—uncertainty toward Washington will only cause a rally if there's a potential catastrophe, and the probability of that remains very low.

Turning to energy, WTI crude gave back some of Wednesday's gains during the primary trading session, thanks in part to the soft economic data, but also mainly due to short term profit taking. Brent crude, however, managed a small rally as the economic data internationally was, on balance, better than here in the U.S. (a trend that has been with us for the last few months). But, both came for sale (along with most commodities ex-gold) after-hours on the news that shots were fired near the capital mid-afternoon.

Natural gas was one of the few commodities trading off fundamentals, as natural gas declined more than 1% on a greater than expected inventory build of 101 Bcf vs. expectations of 95 Bcf. This increase in inventories trumped the news of Tropical Storm Karen forming in the Gulf of Mexico. While early, the track appears to be taking it east of the main gas-producing rigs, although as always, a storm in the Gulf will be somewhat supportive of prices.

Currencies & Bonds

The Dollar Index was marginally weaker again Thursday, falling on a combination of peripheral Washington angst, more dovish comments from Fed President Williams, soft ISM non-manufacturing PMIs and a stronger euro. The event outside the nation's capital had more of an effect on futures than on the Dollar Index.

The euro continued to rally as prospects for another round of LTROs late this year continue to be reduced. Wednesday Mario Draghi somewhat threw cold water on the idea of more LTROs this year, and that sentiment was echoed yesterday by Bank of France Governor Christian Noyer, who said he didn't see the need for more long-term loans at the moment.

Of course Draghi hedged it by saying that the ECB stands ready to act as needed, but the truth is the recent fall in global rates since the Fed decided not to taper QE has given the ECB some wiggle room, as rates on the continent have fallen.

Nonetheless, at some point the euro's rally is going to become a headwind on EU exports, and that's not what the fragile recovery needs right now. So, at some point I'd imagine the ECB will act to counter the rising euro, but that's likely in the coming months, and for now the trend remains higher.

More broadly, both the euro and yen fundamentally are currently overvalued vs. the dollar, but this budget mess and governmental deadlock is trumping other countries' negative fundamentals.

Put simply, while the euro and yen are great shorts fundamentally (and if you can withstand the pain, I can almost guarantee over the next 6 – 12 months they will both be lower than current levels), in the short term the dollar is most-dysfunctional currency on the block. So the negative fundamentals of other currencies, and their governments' desire to have them fall in value, is trumped. And, as long as Washington seems intent to chase its own tail while drifting toward the edge of a cliff, things will stay that way.

Bonds saw a small rally, with the 30-year rallying 0.14%, mostly in reaction to the soft ISM non-manufacturing data (which implies less probability of tapering of QE). Fears of governmental incompetence are continuing to stunt any material rally in bonds, regardless of dovish Fed-speak or soft economic data.

For those of the trading ilk, who don't mind taking a chance, there is likely some good money to be made buying Treasury futures on this stall—as the probability of a default is still, headlines aside, virtually zero. And when/if there is a deal, you'll see Treasuries play catch-up in a big way, because the data over the past few weeks has been for "no tapering," which is short term bond-bullish.

Of course, the tail risk is a default, at which point bonds will get killed, so maybe long Treasury futures with a deep out-of-the-money put makes sense. Again I'm not trying to confuse the issue here that I'm still a big long term bond bear – I am. I'm just pointing out there's probably money in that trade in the very short term.

Have a good weekend,

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.* *The S&P 500 has support at the 50 day MA (1680) while 1700 remains resistance*

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 Washington drama aside, they should benefit from continued Fed stimulus.

Commodities	Bullish	Neutral	Neutral	*The commodity complex continues to see the environment turn more favorable, although the commodities are 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. The dollar had risen in anticipation of Fed tapering, and with that out for now, there will be little in the news to push the dollar higher, although I don't envision a continued sell off either, as the FOMC will taper at some point (Oct or Dec).*

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.**