7:00's Report

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

October 8th, 2013

Pre 7:00 Look

- Futures flat after a quiet night. Things in Washington remain unchanged, although there is an small undercurrent of optimism forming around a short term CR and debt ceiling deal.
- Economically data from Europe were mixed as German exports met expectations, increasing 1%, while manufacturers order missed.
- Fed Speak: Pianalto (12:25PM), Plosser(12:30PM).
- Earnings Today: AA (E: $0.06), YUM (E: $0.93).

Market	Level	Change	% Change
S&P 500 Futures	1667.25	-0.50	-.03%
U.S. Dollar (DXY)	80.095	.069	.09%
Gold	1323.10	-1.90	-.15%
WTI	103.81	.78	.76%
10 Year	3.702	-.03	-.80%

Equities

Market Recap

Stocks declined modestly Monday as Washington angst again weighed on the market. The S&P 500 declined 0.85%.

Stocks started trading Monday sharply lower, mostly in reaction to no weekend progress on the debt ceiling and off House Speaker John Boehner's comments on Sunday that there aren't enough votes in the House to pass a clean CR or debt-ceiling increase.

Don't laugh, but the Greece ETF is close to making a new high. With funding secured and a growing EU economy, the PIIGS may not be the worst place for some risk capital.

But, stocks followed a similar pattern to last week in that traders bought the early morning lows, and the S&P 500 methodically rallied throughout the morning and early afternoon, hitting the highs of the day around 2 o'clock, very close to flat.

The "reason" for the move higher, other than day traders trying to buy a dip, was that several press reports signaled the White House is open to a temporary CR and debt-ceiling extension (say 4-6 weeks). (Press Secretary Jay Carney also echoed those sentiments at the daily briefing.) So, the Washington update from yesterday is a touch of optimism, as it seems there is some momentum building for a short-term solution, which I first mentioned in Monday's issue.

But, despite that, stocks sold off during the last hour of trading and went out just off their lows, not due to anything Washington-related, but instead on an FT article (link here) that stated EU regulators would penalize banks reliant on ECB liquidity starting in 2015, which would, in effect, make policy more "tight."

Market	Level	Change	% Change
Dow	14936.24	-136.24	-.90%
TSX	12788.25	29.60	.23%
Brazil	52417.10	-431.87	-.82%
FTSE	6391.82	-45.66	-.71%
Nikkei	13894.61	41.29	.30%
Hang Seng	23178.85	204.90	.89%
ASX	5149.45	-11.67	-.23%
Prices taken at previous day market close.			

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That plan, in this environment, is about the most stupid thing I've heard in some time (and that includes this latest dose of Washington incompetence). Although I'm sure the FT article is credible, I would be more than shocked if such a policy actually were enacted, and I think any substantial weakness in Europe this morning, if we get any, should be bought. This kind of foolishness is why I prefer to own the iShares MSCI United Kingdom ETF (EWU) over Europe in general.

Market	Level	Change	% Change
Gold	1324.90	14.7	1.12%
Silver	22.380	.625	%
Copper	3.3190	.02	.67%
WTI	103.82	.79	.77%
Brent	110.41	.95	.87%
Nat Gas	3.66	.034	.94%
Corn	4.49	0.00	0.0%
Wheat	6.99	.04	.58%
Soybean	13.02	.05	.42%
Prices taken at previous day market close.			

Trading Color

Interestingly, the main theme in sector trading yesterday was the outperformance of "safety" compared to traditional cyclicals—something that I pointed out in yesterday's issue had been missing in the market.

Perhaps concerns about a default are starting to creep in a bit as the shutdown approaches week two. Telecom, utilities and consumer staples all relatively outperformed yesterday, while homebuilders, financials, basic materials and consumer discretionary all traded down more than 1%. Consumer discretionary was the worst performer, being hit after Burberry (BURBY) made cautious comments on Chinese luxury-demand trends. (China is the growth market for all things luxury.) Also confirming that we're seeing some fear start to seep into investor's minds—the VIX yesterday rose to a three-month high, and is now just off the June high, which was the peak of the tapering inspired emerging market mini-crisis.

Volumes were very low yesterday as paralysis continues to grip the market, and trading remains totally dominated by fast-money funds, algos and day traders. There is absolutely zero conviction in this market, and that's why we are seeing the tape rally off lows (like it did yesterday) yet, at the same time, have absolutely no follow-through to the upside. (Do you want to buy 1,685+ SPY in this environment? I don't.) And, we can expect that to continue.

On the charts, the S&P 500 closed below the 50-day moving average (1,681), although it remains to be seen if that support is really broken (today will tell).

The Best Idea for the Current Environment

This is a frustrating environment to trade and invest in, because basically the "smartest" thing to do is nothing and wait for resolution from Washington.

But, doing nothing sometimes isn't an option, especially when clients are calling looking for ideas. So, I spent the weekend thinking about ideas that can work in this environment.

I've spoken since late July about being overweight Europe, and continue to think it remains one of the best places to be invested (the FT article notwithstanding). But, putting on a naked long or short into an event as binary and potentially volatile as the debt ceiling isn't necessarily a great idea, depending on your risk tolerance.

So, I think one of the better ways to play the current environment is through a spread: long Europe via something broad, like the Vanguard FTSE Europe ETF (VGK) or EWU, and then short an equal amount of SPY (or buy an inverse). So, a long Europe/short U.S. spread trade.

In this environment this should work: If the debt ceiling is raised, as is widely expected, then U.S. stocks will see a snapback rally—but so will global shares. And, any short-term outperformance in the U.S. will likely only last until the S&P 500 gets to around 1,720-ish. Unless the economy accelerates into year-end, I don't think we'll see material upside from there in the S&P 500. Conversely, if there's resolution in Washington, I don't believe there's a cap on European shares in the fourth quarter, so they could rally into the end of the year.

On the other hand, if there is a disaster and the U.S. breaches the debt ceiling, the S&P will likely fall harder than Europe, which will still result in a profitable trade. Take yesterday, for instance. The SPY ended down 0.86%, while EWU and VGK were down basically half that (0.46%).

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For those who are looking to be a bit more aggressive, consider splitting the long side of the spread and doing a mix of VGK or EWU and adding the Greek ETF (GREK) and the Italian ETF (EWI), say 70%/15%/15% split.

Before you laugh, there are value-hunters lurking in the PIIGS, and I'll point out that both those markets were higher yesterday. Again, in a rising global tide, those markets should outperform the S&P into year-end—and relatively outperform if we see a disaster scenario. Food for thought.

Economics

No economic data yesterday.

Commodities

Commodities finally traded the way they "should" be in a lower-dollar, better global economic growth environment, as there was broad strength and the PowerShares DB Commodity Index Tracking Fund (DBC) rallied 0.73%.

Natural gas was best performer in the commodity space yesterday, thanks to a combination of factors, all of which were weather-related. First, although it was a non-event from a weather standpoint, Tropical Storm Karen resulted in the shut-in of about 40% of the natural gas production from the Gulf, which is now in the process of being brought back online. Coincidentally, that shut-in occurred right as the first cold front of the season swept through the Midwest and is now headed to the Northeast, and the combination of the two led to some serious short-covering in the natural gas market.

Elsewhere in energy, WTI crude was actually one of the few commodities that finished negative Monday (declining 0.77%) as the extended government shutdown has negative implications for WTI crude demand going forward. (Fewer government employees driving into work, at a minimum, will reduce some demand.) Support in the $101 range remains, but the longer this shutdown extends the more that support will be tested.

Market	Level	Change	% Change
Dollar Index	79.97	-.25	-.31%
Euro	1.3580	.0022	.16%
Pound	1.6084	.0067	.42%
Yen	1.0325	.0057	.56%
CAD $	.9683	-.001	-.04%
AUD $	.9396	.0008	.09%
Brazilian Real	.44775	.0006	.13%
10 Year Yield	2.634	-.018	-.68%
30 Year Yield	3.702	-.03	-.80%

Prices taken at previous day market close.

I'd look to buy energy on a dip but not at these levels, unless we get resolution in Washington.

Precious metals had a good day Monday, thanks to the weaker U.S. dollar, as gold rallied 1% and silver 2.6% on short-covering. Interestingly, I don't think gold rallied yesterday because of any "Washington angst." The reason I say that is because of silver's outperformance. On days when gold rallies as a true "crisis hedge," it outperforms silver, and the opposite happened yesterday. More broadly, silver has outperformed gold recently (silver was flat last week compared to gold's declines), and that is often a sign of an impending rally in the precious metals. I'm skeptical of that given the environment, but historically that's what has happened.

If silver could trade to $23.00/oz. perhaps I'd change my tune, as the downtrend from last November would then be decisively broken—but until then I believe the precious metals are, at best, in a trading range. But, I'll put GDX and SIL on my screen for monitoring just in case—because if silver does break the downtrend, and signals that a rally is starting, then the upside is substantial in the miners and the metals.

Currencies & Bonds

The dollar gave back half of Friday's rally on Monday and finished fractionally above the 80 level, falling 0.25%. You know by now that fiscal concerns are the main negative catalyst.

Dollar weakness was the main driver of most currency crosses Monday, as the euro and pound rallied 0.15% and 0.42% respectively, again off dollar negativity, not anything really positive in those respective economies.

The yen was the big mover vs. the dollar, rallying 0.7% to nearly a 2-month high, on more of a "flight to safety" bid given lack of resolution in Washington, as well as more disappointment over the aforementioned lack of labor reforms at the upcoming legislative session (that PM Abe discussed

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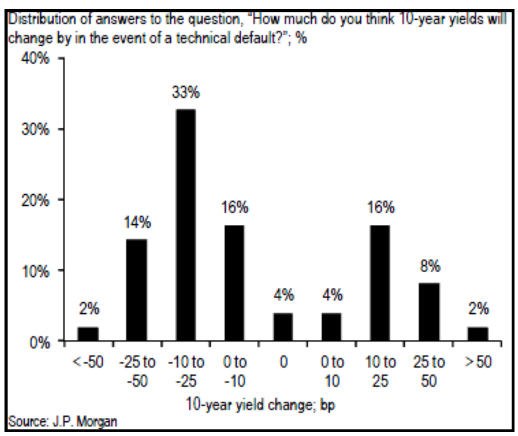
with the FT). But, as I mentioned, the real driver of yen strength right now is the budding crisis in Washington. Expect the yen to not resume its decline until we have some sort of fiscal deal (and the longer it goes, expect the rally to accelerate).

Bonds were modestly higher as the Treasury market continues to monitor the developments in Washington, although we're not seeing any substantial moves (the 10-year yield hasn't strayed too far from 2.60% since hitting that level in late September).

That's important to point out because we aren't seeing the concern toward the shutdown in bonds that we're seeing in equities—at least not in the belly or long end of the curve. And, to a point, that's encouraging, because I'm one of the firm believers that the bond market is the "smarter" market compared to equities.

Interestingly, the answer to the question of "What will rates do if the bond market gets nervous?" isn't exactly clear. The chart on this page, from JPMorgan which I saw on BusinessInsider.com, is interesting, as it shows most investors expect yields will fall if the US technically defaults. I'm assuming that's because that is what happened last time we had a similar crisis (in the summer of '11), but I wouldn't make that a foregone conclusion. This is a different market with a different dynamic, and while rates *probably* will fall, there is also the case to be made that bonds will be sold, depending on how bad it gets.



For our purposes, through, we'll know the bond market is getting nervous once yields on the 10-year move conclusively from 2.60% either higher or lower. That will be the sign from the "smart market" that things are about to get bumpy.

Have a good day,

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 debt ceiling fight enters its second week, and will continue to be a headwind on stocks. The expectation is still that a deal get done before 10/17, but if we have no progress by the end of the week, expect a sharp sell off, as a "no deal" scenario is **not** priced into markets. That said, though, the benefit of the doubt remains with the bulls, as a deal is likely to get done.* *The S&P 500 has support at the 50 day MA (1680) while 1700 remains resistance*

Trade Ideas

Long International (Europe & Japan): **International markets continue to remain attractive vs. the US based on improving economic data, and looming political and monetary clouds in Washington. I like EWU (UK ETF) or EIRL (Ireland ETF) specifically. The "Long Japan" trade is under pressure thanks to a rising yen (which is 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: **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.**

	Fundamental Outlook	Technical Outlook	Overall	Comments
Commodities	**Bullish**	**Neutral**	**Neutral**	*Commodities are at the mercy of Washington, like every other risk asset. Most commodities haven't benefitted from the weaker dollar because of Washington drama, but looking beyond the short term, all major global central banks will be accommodative well into the future, and that should lead to am acceleration of global economic growth, which should be a tailwind for commodities.*

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 debt ceiling drama and concerns of growth 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.**

	Fundamental Outlook	Technical Outlook	Overall	Comments
U.S. Dollar	**Neutral**	**Neutral**	**Neutral**	*The US Dollar hit an 8 month low and is under pressure in the short term from fiscal drama in Washington and as Fed "tapering" expectations shift to early '14.*

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.**

	Fundamental Outlook	Technical Outlook	Overall	Comments
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.**

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