7:00's Report

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

October 9th, 2013

Pre 7:00 Look

- Futures and most international markets modestly higher thanks to news that President Obama will formally nominate Janet Yellen as the next Fed Chair at 3:00 PM today.
- Economic data o/n was again mixed, as UK Industrial Production missed estimates, while German IP beat.
- AA earnings beat after the close yesterday, and the stock is higher. Management called the debt ceiling threat a "Giant Taser."
- Econ Today: FOMC Minutes (2:00PM), Fed Speak: Evans (10:00AM)

Market	Level	Change	% Change
S&P 500 Futures	1656.25	5.75	.35%
U.S. Dollar (DXY)	80.38	.25	.31%
Gold	1310.20	-14.40	-1.09%
WTI	103.42	-.08	-.08%
10 Year	2.636	.002	.08%

Equities

Market Recap

Stocks logged their second-straight day of moderate declines Tuesday, as no discernible progress is occurring in Washington and investors are starting to get a bit nervous. The S&P 500 fell 1.23%.

Stocks started Tuesday flat amidst little news, and mostly drifted throughout the day in modestly negative territory before selling off hard into the close for a second-straight day.

The S&P 500 is now through support at both the 50- and 100-day MAs, and the August lows are now the next major level to watch.

There wasn't really any concrete "reason" for the declines, although you could point to President Obama's presser as the catalyst (although that was more coincidental than causal).

Obama spoke for 90 minutes and didn't reveal anything new, although his lengthy comments only served to remind everyone that despite the government being shut down for more than a week, there has been little to no progress (and there are few positive signs of impending progress). Stocks started to sell off toward the end of his comments and the selling accelerated into the close, with the S&P 500 going out on the low ticks.

Trading Color

The outperformance of "safety" sectors continued Tuesday, reflecting growing concern in the market (that had been absent last week). The Nasdaq and Russell 2000 were down much more than the Dow, utilities were the only S&P 500 sub-sector to finish the day positive (rising 0.6%), while consumer staples were flat.

Homebuilders, basic materials, consumer discretionary and tech were the underperformers, and you can't get

Market	Level	Change	% Change
Dow	14776.53	-159.71	-1.07%
TSX	12692.41	-95.84	-.75%
Brazil	52312.44	-104.66	-.20%
FTSE	6363.43	-2.40	-.04%
Nikkei	14037.84	143.23	1.03%
Hang Seng	23033.97	-144.88	-.63%
ASX	5152.99	3.54	.07%

Prices taken at previous day market close.

more "cyclical" than that group.

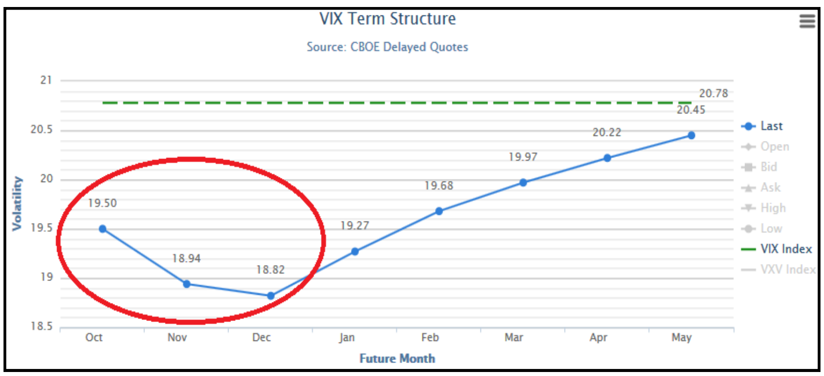
On the charts the S&P 500 clearly broke support at the 50-day moving average. And, while it's a few percentage points from current levels, the August low of 1,627 is the next level of critical support to watch.

Market	Level	Change	% Change
Gold	1319.10	-6.00	-0.45%
Silver	22.33	-.056	-0.25%
Copper	3.2925	-.004	-0.12%
WTI	103.51	.48	0.47%
Brent	110.07	.39	0.36%
Nat Gas	3.713	.084	2.31%
Corn	441.75	-7.50	-1.67%
Wheat	693.50	-1.25	-0.18%
Soybean	1288.75	-7.75	-0.60%
Prices taken at previous day market close.			

2 Warning Signs You Shouldn't Ignore

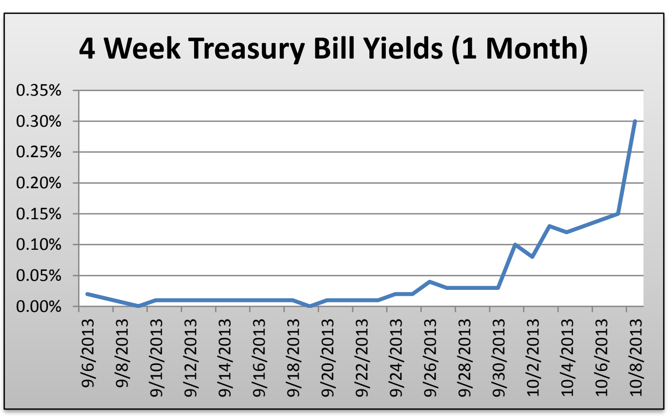
There are two things I want to point out that tell us the market is starting to legitimately consider (and is starting to price in) a potentially negative outcome from the fiscal crisis.

First, for the first time since June, Volatility Index (VIX) futures are in backwardation. Backwardation, for those who don't know, is when the front month of a futures contract trades at a premium to the deferred month. And, it's very often a bullish sign.



Well, we got it in the VIX—the October and November contracts are trading at a premium to December. This represents an elevated level of concern that something negative might occur in the immediate term (so it's pricing in an increased probability of a default or some other calamity).

Second, yesterday's four-week T-Bill auction was the worst in several years. I mentioned yesterday that the bond market will tell us when we should start to get nervous about what's happening in Washington, because yields will move sharply from 2.60% in the 10-year. Well, concern starts in the present and moves to the future as it gets worse, and we are definitely seeing some concern in the very short-term bond market. Yesterday's $30 billion auction of four-week bills saw a yield of 0.35%, more than 2.5 basis points higher than expected (and when the yield is only 35 basis points, that's a lot), while the bid to cover was the lowest since March 2009.



So, clearly concerns are starting to creep in that Washington won't fix this in time, but as I said in Monday's issue, that's to be expected as we move deeper into the week with no resolution. The key now is to watch if this concern spreads out the curve—if we see five-year and 10-year yields start to move decisively (the 10-year moving from 2.60%), then we've got a problem.

Bottom Line

Things are starting to unravel a bit in this market. I pointed out a potential caution sign last Thursday that the momentum stocks that have had huge runs (NFLX, PCLN, TSLA, FB, YELP, P and the entire biotech space) broke down badly for the first time in a while. Well, that happened again yesterday, with most of those names down more than 4%.

The heavy selling in the momentum stocks over the past week has been almost all profit-taking, as investors in those names are taking money off the table given there are only 2 1/2 months left in the year. And, that's a trend that can gain momentum regardless of Washington.

I'm pointing this out not because I'm saying we all need to get ultra-bearish, but instead because I want everyone to be paying attention to the calendar (this is something I brought up a few weeks ago).

To be clear, the overwhelming likelihood is that a debt-ceiling deal does get done and we avoid default, but even if that does happen, it's October and the S&P 500 is still up 16%. I'm not sure how much material upside there is left in the market, even on a debt ceiling/CR resolution. And, while it's not time to hit the panic button yet and massively hedge up, there is likely going to be more pressure on stocks in the short term and we shouldn't expect the "snapback" rally we've seen after the positive resolution of macro events so far this year.

Bottom line is I continue to think international exposure (especially on this dip) makes sense, and hedging it with an S&P 500 short makes even more sense—that's a trade I think we can ride into year-end.

Economics

No reports yesterday.

Commodities

Commodities again rallied in the face of equity-market declines, led by strength in energy and mild declines in metals.

Natural gas again was the best-performing commodity in the markets yesterday, rallying on continued short-covering from the weather events mentioned in yesterday's Report. (Tropical Storm Karen's Gulf production shut-ins and a reminder that winter is on the way via the first cold front of the season.)

Fundamentally the supply/demand outlook for gas remains largely balanced, and weather will again be the deciding factor (as it was late last winter when lingering cold erased much of the big surplus we had built up). For those technicians out there, though, an interesting situation appears to be forming in natural gas.

The downtrend from late May was clearly broken in late September, and if natural gas can close above $3.75, that'll be a new closing high and a bullish signal. I'm skeptical it can do it without more cold weather coming, but it bears watching nonetheless.

WTI and Brent crude also saw small rallies yesterday, although volumes were low and really it was more trading "noise" than anything else. "Reasons" for the rally can be attributed to the turmoil in Egypt and U.S. military strikes in Libya and Somalia, although even that's a bit of a stretch.

Brent was again higher and traded above $110/bbl. There actually has been some fundamental (in addition to the geopolitical) news underlying Brent, as there is concern there will be a full-on strike at Scotland's Grangemouth oil refinery, which processes 200K bbls/day of crude oil. It's not expected to be a sustained outage, but in a otherwise-quiet market, the possibility of the stoppage has put some support under Brent, which is now at a three-week high.

Precious metals "hung in" yesterday, declining marginally (0.45% for gold and 0.29% for silver) in after-hours trading, despite a stronger dollar (which recently has resulted in substantially lower prices). So, the precious metals, and silver in particular, continue to trade more resiliently than they have in several weeks. Although, for now, the best case remains a range-bound trade. But, it's possible that "green shoots" of a rally may be forming again, and I'll continue to watch the space. A trade to $23.00 in silver will pique my attention and have me threaten to get bullish.

Currencies & Bonds

Despite the weakness in equities, currencies and longer-dated Treasuries were all unchanged yesterday. The Dollar Index closed up 0.07% and none of the major currencies moved more than 0.1% vs. the dollar, as Washington-induced paralysis has truly gripped the currency markets.

Market	Level	Change	% Change
Dollar Index	80.085	.059	0.07%
Euro	1.3577	-.0003	-0.02%
Pound	1.6080	-.0004	-0.02%
Yen	.010317	-.000008	-0.08%
CAD $	.9630	-.0053	-0.55%
AUD $	.9393	-.0003	-0.03%
Brazilian Real	.44730	-.00045	-.10%
10 Year Yield	2.636	.002	.08%
30 Year Yield	3.695	-.007	-.19%
Prices taken at previous day market close.			

Interestingly, while I've covered the weakness in the Treasury bills, longer-dated Treasuries didn't really move at all yesterday, which is a bit surprising (and a bit bearish) given the sharp drop in stocks. As I talked about yesterday, I'm not sure anyone has a ton of conviction about how bonds will trade as we get closer to a technical default, as you can make the case for both a rally and a sell-off—but if we get very close to a default, expect some significant volatility.

With regard to the weakness in the Treasury bills I discussed earlier, keep an eye on the iShares 3-7 Year Treasury Bond ETF (IEI). If the concern in the bond market about a default starts to spread out the curve (meaning the probability of something bad happening is going up), then IEI will start to fall—and that may be a sign that it's time to rent a some protection.

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	*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 broke support at the 50 and 100 day MA, and now the August lows of 1627 are support.*

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.**

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.**

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.**

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.**