7:00's Report

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

November 12th, 2013

30 Year Treasury: Clearly the counter trend rally in bonds ended with the strong economic data last week. Now it remains to be seen if the downtrend resumes in earnest.

Pre 7:00 Look

- Futures are drifting slightly lower this morning after an uneventful night.
- The Nikkei was the big outperformer o/n, rallying 2.2% as soft data has the yen inching towards 100/dollar.
- China announced a series of pro-growth reforms o/n, but the market is focused on the updated GDP growth target for 2014 (not yet released). If it's reduced to 7.0% (from current 7.5%) that will be a disappointment.
- Econ Today: No Reports Today. Fed Speak: Kocherlakota (1:00 P.M.), Lockhart (1:50 P.M.).

Market	Level	Change	% Change
S&P 500 Futures	1764.25	-3.25	-.18%
U.S. Dollar (DXY)	81.41	.21	.26%
Gold	1281.00	-0.30	-.02%
WTI	94.85	-.29	-.30%
10 Year	2.751	-.005	-.18%

Equities

Market Recap

Stocks were little changed yesterday as markets digested last week's news amidst low volume holiday trading. The S&P 500 rose .07%.

There was very little in the way of news out yesterday, and that was reflected by major averages not straying too far from unchanged. Stocks opened mildly positive and basically tread water for the remainder of the day, closing very quietly.

Looking at some market internals, despite the quiet trading, we are continuing to see signs of profit taking and rotation from the "momentum stocks" into some of the lagging sectors. Yesterday the retail sector, which has underperformed for the past few weeks, saw a big rally as investors bought the space (and shorts covered) ahead of earnings later this week (the Morgan Stanley Retail Index was up more than 1%).

Financials also caught a small bid, continuing Friday's rally on sooner than anticipated Fed tapering, while the "momentum" stocks that have led the market higher continue to act "heavy." Going forward it'll be interesting to note if the rotation "out of the leaders into the laggards" continues and gains momentum.

On the charts the Dow made a new all time high, but the S&P 500 again couldn't breach 1775, and the technical picture didn't really change much (1775 resistance, 1746 support). Volumes were very low yesterday, as you'd expect given bank and bond market closures.

Is Sentiment Finally Turning?

Market	Level	Change	% Change
Dow	15783.10	21.32	.14%
TSX	13358.39	-19.94	-.15%
Brazil	52623.87	375.01	.72%
FTSE	6712.52	-15.87	-.23%
Nikkei	14588.65	318.84	2.23%
Hang Seng	22901.41	-168.44	-.73%
ASX	5393.09	5.95	.11%

Prices taken at previous day market close.

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Much of the discussion during yesterday's slow day focused on the fact that there were several anecdotal articles in the financial press that implied we may finally be seeing investor sentiment turning a bit "frothy."

Market	Level	Change	% Change
Gold	1282.90	-1.70	-0.13%
Silver	21.37	.053	0.25%
Copper	3.2545	.0005	0.02%
WTI	95.08	0.48	0.51%
Brent	106.36	1.24	1.18%
Nat Gas	3.573	.014	0.39%
Corn	434.75	8.00	1.87%
Wheat	646.25	-3.50	-0.54%
Soybean	1301.00	5.00	0.39%
Prices taken at previous day market close.			

The WSJ noted that "Individual investors are returning to stocks" (link here) and "Hedge funds are launching long-only funds" (link here) and both implied we're seeing over-enthusiasm for equities. But, before we all go de-risking, here are a couple of things to consider.

First, the WSJ article on the individual investors noted that we've seen more cash flow into mutual funds this year than any year since '04 ($76 billion). But, at the same time, we saw nearly $451 billion in outflows from equity mutual funds from 2006-'12. So if retail investors are returning, certainly we're not seeing the level of involvement that would imply "irrational exuberance."

And, as for the "long-only hedge fund products," they may be a sign of overconfidence in a perpetually rising market, but: 1)Hedge funds aren't in the business of creating strategies they think are going to produce horrible returns, even if there is consumer demand, and 2)Hedge funds aren't retail investors, so I don't think we can use them as a contrary indicator.

Finally, the fact that these articles were so widely circulated and discussed only reinforces the fact that everyone is looking for a reason for this rally to end, instead of looking for reasons it *won't* end.

I'm not a perma-bull (in fact, I usually am a skeptic and generally lean bearish more than anything else). But while there are warnings signs and stocks absolutely can't keep this pace up forever, until the investing public starts believing this rally won't end, the pain trade will likely remain higher. We can probably expect corrections to be more sideways consolidations rather than significant declines (as has been the case for well over a year now).

A Declining Bond Market Playbook

With the bond market decline apparently resuming in earnest, I want to just throw out a list of things that worked over the summer during the bond market decline and that should work again as the decline resumes. Most of you know this already, but I've found it useful in the past to have one place to find information of this sort.

The bond market decline, which I think is just getting started, will be the single-biggest theme in the investing landscape for the coming months and quarters. And, like all major trends, it comes in fits and starts.

Well, it looks like the second leg is starting, although we should expect significant volatility given the effect of Fed tapering expectations on short-term bond trading (point being, don't expect a straight line down).

To get short bonds: You can buy the ProShares UltraShort 20+ Year Treasury Bond ETF (TBT) or ProShares Short 20+ Year Treasury Bond ETF (TBF). They focus on the long end of the curve, which should fall the hardest.

To profit from a steepening yield curve: As yields rise and the Fed stays at 0% on the Fed Funds rate, the yield curve should get very steep. The easiest way to make money off this is with the iPath US Treasury Steepener ETN (STPP), although a steepening yield curve is also a positive for banks. That's because their "net interest margin" (the difference between what they pay in interest vs. what they take in) should increase, leading to more profitability.

A couple of the more popular bank ETFs are KRE (the regional bank ETF) and KBE (a larger banking ETF that encompasses money center banks as well as the regionals).

Theoretically speaking, the rise in Net Interest Margins should provide a greater boost to the regional banks, although obviously it's a case-by-case basis. But, there wasn't much difference in returns over the May-to-mid-September period (where we saw interest rates move decisively higher into the Fed tapering head-fake in September), so either one should do the job.

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To make sure you're not lagging performance, avoid or underweight "yield oriented" Stocks. Utilities and REITs especially badly underperformed during the summer as rates rose, so we should expect more of the same. Telecom, consumer staples and healthcare also lagged, but not as badly. Broadly, allocate more to cyclical sectors (financials, tech, consumer discretionary, materials) than defensive sectors like those mentioned above.

Economics

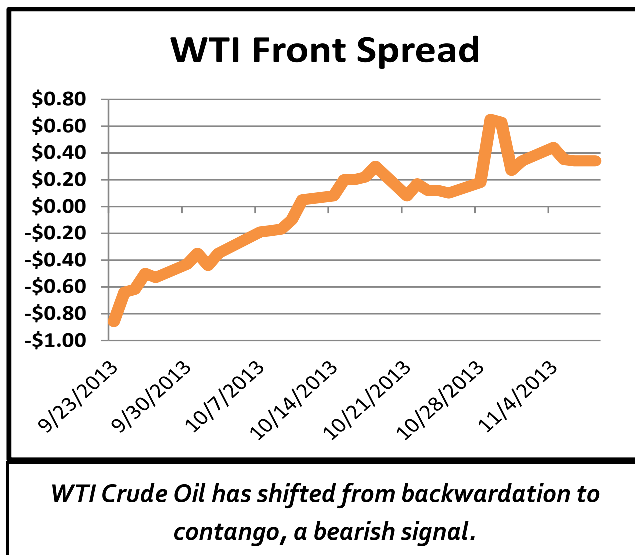
No economic reports yesterday.

Commodities

The commodities space saw modest gains yesterday as most markets drifted sideways in quiet trading. Commodities in general popped due to weakness in the dollar as well as an oversold bounce that could be expected after the broad sell-off we saw last week. Copper, Nymex crude oil, natural gas and corn all rallied, with corn being the largest outperformer. Precious metals were mixed with gold down just 0.16% and silver up by 0.25%. The commodities benchmark ETF, the PowerShares DB Commodity Index Tracking Fund (DBC), was up 0.32%.

WTI Crude caught a small oversold bounce yesterday, thanks mostly to short covering and no deal on the Iranian negotiations. Going into the weekend, a deal to reduce sanctions on Iran was expected, but obviously things broke down. Brent Crude caught a 1% bounce on the news, although before anyone gets too bullish, we have to realize another meeting is scheduled for November 20th, and likely there will be a deal struck there. Brent has fallen from above $110/bbl partially on an expected Iranian deal, though, so don't look for the announcement of an agreement over the next few weeks to be a major negative catalyst for oil.

Looking at fundamentals in the oil market, it's worth nothing that WTI crude oil futures have gone from "backwardation" to "contango" over the past two months, meaning back-month futures are priced higher than the front month, which shows a lack of immediate demand. This lack of demand coupled with the rising supply levels suggests that the path of least resistance is still lower in WTI crude oil, and I'd be hesitant to buy this dip. Support at the $93.07 level remains critical for the bulls (the lows from last week).



WTI Crude Oil has shifted from backwardation to contango, a bearish signal.

The metals market was technically mixed but essentially unchanged yesterday. Both gold and silver futures bounced sideways in tight range-bound trading following the violent drops on Friday after the jobs report was released. But, the fact that the dollar declined today and gold couldn't even muster a small rally is not a good sign for the bulls.

Key for gold now is the $1268 level, which is the closing low of mid-October. If that level is "given," look for prices to move toward the $1,200 area pretty quickly. And, with no inflation on the horizon, gold remains at the mercy of Fed tapering expectations, with little positive catalysts on the horizon.

Currencies & Bonds

Currency markets saw a reversal of last week's moves Monday, as the euro enjoyed an oversold bounce (rising 0.41%) while the Dollar Index fell 0.3%. Most of the move can be chalked up to profit-taking after last week's huge moves in the currency markets, but there were also some fundamentals at work, too.

Market	Level	Change	% Change
Dollar Index	81.16	-.227	-0.28%
EUR/USD	1.3408	.005255	0.39%
GBP/USD	1.5986	-.00285	-0.18%
USD/JPY	99.19	.137	0.14%
USD/CAD	1.0473	-.00044	-0.04%
AUD/USD	.9355	-.00212	-0.23%
Brazilian Real	.4268	-.00305	-.71%
10 Year Yield	2.751	.005	.18%
30 Year Yield	3.848	.006	.16%
Prices taken at previous day market close.			

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First, this has mostly been missed: Late Friday, when speaking on a panel, Chairman Ben Bernanke made comments that basically said he thought the recent decline in the unemployment rate is over-exaggerating the progress we've seen in the labor market. Broadly, he remains disappointed by the state of the labor market. That statement was pretty dovish, and weighed a bit on the dollar yesterday.

Turning to the euro, there was an article in the Financial Times that stated there's a relatively big rift occurring in the European Central Bank between ECB President Mario Draghi and the German members of the committee. As expected, the Germans are worried about inflation, and were against last week's rate cut, although obviously they ultimately supported it. But, extrapolating this out, it's reasonable to assume that any more accommodation will be hard to pass unless the economy begins to stall—and with inflation very low, that's a risk to the European Union's economy. The euro stabilized for now, and it's important to watch support, which lies lower at 1.33 (the spike low from last week).

Turning to Asia, things were relatively quiet. The yen failed to bounce after Friday's big drop, and was down marginally. And, it looks as though the yen has finally broken the uptrend in place since May. If we can get another close or two below 99 yen/dollar, then I think the downtrend resumes in earnest.

The bond market was closed yesterday for Veterans Day, although Treasury futures still traded. There was follow-through selling in the long bond, which declined 0.21% to a new multi-week low.

The ECB Isn't As Dovish As You Think, and the Outlook for the Euro Isn't That Negative, Either.

Last week's "surprise" 25-basis-point cut by the ECB took the market by surprise, not so much by the fact that the bank cut interest rates, but instead that it did so before December. Obviously you know by now that the euro sold off in response, and rightly so. Since then, I've gotten questions from customers asking if the euro is finally a short here. And, unfortunately I don't think it is.

In some respects, the ECB both surprised markets by cutting rates and also disappointed them. The reason I say that is because the ECB also extended its main refinancing operations (MROs) with "full allotment" for one year, from summer 2014 to summer 2015. Basically, "main refinancing operations with full allotment" are very short-term loans the ECB makes to banks to ensure they have adequate liquidity. Banks can pledge illiquid assets as collateral in exchange for short-term loans to make sure they have the daily liquidity they need to conduct business. The operations are designed to head off a credit crunch the likes of which we saw in the U.S. in the fall of '08 and in Europe in the fall of '11.

The extension of the MROs, while ensuring there won't be a credit crunch in Europe, is actually a bit disappointing from an economic growth perspective. That's because, by extending the MROs, the ECB virtually guaranteed it won't offer another Long Term Repurchase Operation (LTRO).

The difference between MROs and LTROs is mainly time. With MROs, banks get access to liquidity for a few days or weeks. With LTROs, they get access to cheap liquidity for years, and that's obviously much more economically stimulating, because it makes it much easier for the bank to lend the money to more growth-oriented projects given the longer time horizon. So, with the prospects for more LTROs off the table, that, on balance, is a slight negative for EU growth prospects going forward.

So, although the ECB cut rates last week, the action shows a lack of commitment to continue forward with more efforts to stimulate the EU economy (the rate cut won't really help growth that much). The reason I say lack of commitment is because the ECB obviously takes on more risk when issuing LTROs compared to MROs, and once again it looks like the ECB is focused on preserving the euro, not necessarily fostering economic growth.

Add in the FT article mentioned above about the squabbling occurring between Draghi and the Germans on the ECB, and we have the potential for a central bank that won't be as accommodative as needed to get the EU economy rolling again.

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**	*While valuations are elevated, and there are "warning signs" in the market (small cap underperformance, loss of momentum stock leadership) 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 lows of last week (1746) while resentence is last weeks highs of 1775.*

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: **With Fed tapering expectations shifting to early 2014, the dollar should be supported over the coming months, which likely will result in the resumption of the decline in the yen. The weaker yen (and higher Japanese stocks) appears to be the clear winner from last week.**

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**	*Commodities fell to multi-week lows last week as WTI Crude, gold and wheat all fell for various reasons (over supply, stronger dollar, etc.).*

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 Natural Gas around at these levels with a $3.40 stop: **The $3.40—$3.50 level in natural gas has held multiple tests of support over three months, and given we are heading into the winter seasons and inventories, while still elevated, are higher than they were last year, the case can be made for a good risk/reward set up.**

U.S. Dollar	**Neutral**	**Neutral**	**Neutral**	*It was a "perfect storm" for US Dollar Index strength last week, as a 25 basis cut in rates by the ECB and a strong jobs report pushed the Dollar Index to a multi-month high.*

Trade Ideas

Short: **Japanese Yen. The yen has been supported mostly by extreme dollar weakness, and with tapering expectations being pulled forward, the yen should resume its decline vs the dollar. YCS remains the best non-futures way to play the trade.**

Treasuries	**Bearish**	**Bearish**	**Bearish**	*The "counter trend rally" in bonds appears to have ended, thanks to strong economic data last week and shifting Fed tapering expectations. Once again the trend in the bond market appears to be lower.*

Trade Ideas

Buy: **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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