7:00's Report

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

November 4th, 2013

Pre 7:00 Look

- Futures and European markets are starting the week higher thanks to better than expected economic data. Outside of the economic data it was a quiet weekend.
- European manufacturing PMI data o/n was "ok" to "good": UK and German PMIs both beat expectations, while EMU PMI met expectations.
- There was also good data from China, as Oct. non-manufacturing PMI beat estimates (56.3 vs. (E) 55.4).
- Econ Today: No Reports Today.
- Fed Speak: Powell (11:40 A.M.), Rosengren (4:00 P.M.).

Market	Level	Change	% Change
S&P 500 Futures	1758.75	4.00	.23%
U.S. Dollar (DXY)	80.69	-.12	-.15%
Gold	1312.40	-0.80	-.05%
WTI	94.68	.07	.07%
10 Year	2.62	.078	3.07%

Equities

Market Recap

The S&P 500 continued to grind higher last week thanks to a Friday rally on more "OK" earnings and decent global economic data. The S&P 500 rose 0.1% on the week and is now up 23.52% year-to-date.

The S&P 500 hit new all-time highs early last week ahead of the Fed meeting, thanks to a decline in Chinese short-term borrowing rates, more "OK" earnings and some positioning ahead of the Fed and into the end of the month (window-dressing) The new highs came in spite of some weak domestic economic data.

But, stocks moved off their highs midweek after the FOMC Wednesday, as the statement and subsequent events were taken as marginally "hawkish." The S&P 500 very nearly traced out a bearish "outside reversal" but closed 1 point above the Tuesday low. Despite the mid-week declines, stocks eked out a positive weekly gain thanks to a 0.7% rally on Friday off of good manufacturing data from China and the U.S.

Looking at the market internals, despite the underperformance of small caps (more on that later) it was the Fed outlook that mostly dictated the sector trading, which wasn't nearly as bullish as the performance of the averages.

"Bond-proxy" sectors had outperformed over the past several weeks thanks to expectations of a QE tapering delay. But, after the "hawkish" FOMC statement Wednesday, that trade reversed sharply. Money flowed out of consumer staples, telecom, homebuilders and REITs as rates rose sharply.

But, despite the move out of these "bond-proxy" sectors, we didn't see cyclical outperformance, either. So, there was no textbook "out of safety, into cyclicals" rotation.

Financials traded down more than 1% on the week, while basic materials and energy also lagged thanks to some soft energy company earnings and lower oil prices. Consumer discretionary was one of the few outperformers on the week, thanks to earnings and a "not as bad as feared" retail sales report.

Volumes weren't heavy outside of earnings-related names or sectors. On the charts, the S&P 500 again hit a new all-time high, and that level is now resistance (1,775) while support lies lower at 1,729-ish.

Market	Level	Change	% Change
Dow	15615.55	69.80	.45%
TSX	13337.46	-23.80	-.18%
Brazil	54013.24	-242.96	-.45%
FTSE	6759.99	25.25	.37%
Nikkei	14201.57	-126.37	-.88%
Hang Seng	23189.62	-60.17	-.26%
ASX	5390.53	-20.59	-.38%

Prices taken at previous day market close.

This Week

Compared to last week, this week should be relatively quiet. The jobs report and European Central Bank meeting (Thursday/Friday) are the highlights of the week, as focus begins to shift from earnings back to the macro-economic.

But, earnings aren't exactly done yet, either. Media especially will be in focus this week: 21st Century Fox (FOX), Time Warner (TWX), CBX Corp. (CBS), Qualcomm (QCOM), AOL Inc. (AOL), DirecTV (DTV) and Walt Disney Co. (DIS) all report this week.

Finally, given last week's FOMC meeting, focus will again be on Fed speakers, as there are speakers pretty much every day but none of the "Big 3" (Bernanke, Yellen, Dudley), and the commentary will be watched.

What Are Small Caps Saying About This Market?

One of the biggest "things" that happened last week was the massive divergence between the "market" and the small caps. While the S&P 500 rose slightly on the week, the Russell 2000 fell 2%, and has declined for six-straight days. So, the underperformance of small caps can be added to the list of "anecdotal" warning signs that includes plunging oil prices, underperformance of the financials, and sharp declines in momentum stocks like Netflix (NFLX), Tesla (TSLA), Salesforce.com (CRM), Priceline.com (PCLN), etc.

And, under normal times these indicators would be enough to warrant a more-defensive stance or even outright de-risking. But, sentiment remains the wild card as investors remain more skeptical than enthusiastic toward this market. Everyone I talk to expects the market to head higher, but at the same time "knows" it's not fundamentally justified and that a correction (likely a big one) is looming. And, because that is so, the pain trade remains firmly higher.

I wouldn't put any new money to work at these levels unless it's some sort of a spread trade (Long Europe/Short U.S remains my "best" idea, and it'll get better if the ECB cuts rates this Thursday), and would look to buy consumer staples on any decent dip, as I don't think the Fed was quite as "hawkish" as the market made it out to be.

Market	Level	Change	% Change
Gold	1315.50	-8.20	-.62%
Silver	21.855	-.012	-.05%
Copper	3.2985	-.002	-.06%
WTI	94.60	-1.78	-1.85%
Brent	106.09	-2.75	-2.53%
Nat Gas	3.513	-.07	-1.90%
Corn	4.27	-.02	-.35%
Wheat	6.68	.004	.07%
Soybean	12.51	-.15	-1.16%

Prices taken at previous day market close.

Bottom line is the path of least resistance, for now, remains higher despite all these warnings signs (which are still valid and require monitoring, but the resiliency of the market, for now, trumps those warnings signs) and likely wills stay that way until investors are actually enthusiastic about higher equity prices.

Economics

Last Week

The most important thing that happened last week economically was that expectations for Fed tapering of QE were pulled forward a bit—from the previous "consensus" of mid-2014 to the early part of 2014—thanks mainly to an FOMC statement that wasn't as "dovish" as expected plus a Jon Hilsenrath sentence that stated a December taper remains "on the table." Interestingly, this change in expectation came despite decidedly mixed economic data.

Starting with the FOMC statement from last Wednesday, it seems most are calling it slightly "hawkish," but that's really only because it didn't feature any material downgrade of the economy in the commentary (as was widely expected).

Looking at the actual statement, it was hardly changed from September, although the two important takeaways were that the FOMC noted the labor market had slid a bit and also somewhat celebrated that interest rates had declined.

Both changes are, on balance, slightly "dovish." So even though the market didn't trade that way, I think the meeting didn't really change anything with regard to when the Fed will taper QE (and certainly didn't materially pull it forward, as they remain data-dependent).

Outside of the FOMC, as I said, economic data was at best mixed. Early in the week, things looked somewhat grim:

- The manufacturing indicator of the September industrial production report was weak and August was revised down.
- Pending home sales dropped 5.6%, the biggest monthly drop since April 2011.
- The October ADP employment report missed expectations at just 130K jobs added, and the September figure was revised lower as well.

These reports were especially disconcerting because they implied the economy was seeing a slowing of growth *before* the government shutdown, as this data was from before October.

Later in the week, though, the data surprisingly turned better. Chicago PMI, which isn't usually a watched number, caught people's attention. It exploded to a multi-year high, and the details of the report were equally strong. And, on Friday, the national ISM manufacturing PMI increased 0.2 to 54.4, beating expectations of a small decline. So, if anything, the beginning of the week was considered "dovish" but turned "hawkish" as the week went on.

I'm spending time talking about how the market interprets the data (hawkishly or dovishly) because right now it's as important as the actual data itself. As was the case prior to the government shutdown, the question of "When will the Fed taper QE?" remains the single biggest driving factor in the markets (for bonds, the dollar, commodities and equities).

The first three assets have traded (and will trade more immediately) to shifting "tapering" expectations, as we saw last week. But, although stocks won't trade off daily shifting of tapering expectations, it very much remains to be seen if stocks can rally in a "QE-less" world.

Market	Level	Change	% Change
Dollar Index	80.805	.542	.68%
Euro	1.3493	-.0099	-.73%
Pound	1.5922	-.0126	-.79%
Yen	1.0127	-.0045	-.44%
CAD $	.9578	-.0007	-.07%
AUD $	.9409	-.0022	-.23%
Brazilian Real	.44025	-.00515	-1.16%
10 Year Yield	2.62	.078	3.07%
30 Year Yield	3.686	-.065	1.79%

Prices taken at previous day market close.

Ultimately, if the Fed has to taper QE and the economy isn't very strong, that could usher in "stagflation" and be a rally-killer. So when and how this whole thing works out remains the key to any medium-term outlook for equities.

<u>This Week</u>

There aren't many economic releases this week, but the October jobs report is Friday and clearly that's important from a WWFD (What Will the Fed Do?) standpoint, although this jobs report will be taken with a hefty grain of salt given the government shutdown.

Also on Friday is the "Personal Income and Outlays" report, which is particularly important because it gives us a look at the Fed's preferred measure of inflation—the core Personal Consumption Expenditures deflator. Stubbornly low inflation has been a growing concern of the Fed's for some time, so a weak core PCE deflator will be "dovish."

Also on the calendar this week is the first look at Q3 GDP on Thursday (expectations are for close to 2%), weekly jobless claims (this report will be overshadowed by the October report Friday) and ISM Non-Manufacturing (or service sector) PMIs (Tuesday). Really, though, those reports won't move the needle much with regard to WWFD. (GDP is more a media favorite than anything anyone really trades off of.)

Outside of the jobs report, arguably the other "highlight" of the week will be the ECB meeting Thursday. The euro plunged last week (and the Dollar Index spiked) on a very weak inflation reading, and speculation is high as to whether the ECB will cut rates to fend off a hint of deflation potentially hitting the "Continent." Given the falling euro's effect on the Dollar Index, this meeting has implications for the commodity markets particularly.

Commodities

Commodity indices plunged last week, led lower by a nearly 3% decline in WTI crude prices. The PowerShares DB Commodity Index Tracking Fund (DBC) declined nearly 2% on a combination of weakness in gold, WTI crude and wheat. There was no single "reason" commodities declined last week, but instead it was a series of negative sector-specific events (WTI crude over supply, warm weather and a stronger U.S. dollar).

The plunge in WTI crude remains the main story in the commodity markets, as oil traded to levels not seen since June on further supply concerns while weekly inventories continue to build. Other energy commodities also declined, as natural gas fell nearly 5% on forecasts for warm weather and growing supply, although natural gas is now into support at the $3.50 level.

Also, the Brent/WTI spread continues to widen, and is now nearly at $12, as supply concerns from Libya and positive Chinese manufacturing data helped Brent limit declines to a little more than 1% (all of which came Friday). I point these out because the widening Brent/WTI spread is a positive for refining stocks and railroads (the "crude by rail" story).

The only industrial commodity that finished positive last week was copper, which rallied 1% on positive comments on Chinese demand from Codelco and the strong Chinese manufacturing PMI.

Turning to precious metals, gold and silver fell just under 2% and 3% respectively last week, with the bulk of the declines coming Thursday as the Dollar Index surged following the "hawkish" interpretation of the FOMC and changing tapering expectations.

Not even grains were spared last week, as wheat tumbled more than 3% after prospects for the Ukrainian harvest were improved. (There had been concern the Ukrainian harvest was going to be much smaller than anticipated, which is the reason wheat has seen such a strong rally over the past several weeks.)

Focus this week remains on WTI, and until it bottoms (there's support at $94 and then $92) commodity indices will have a hard time stabilizing.

Currencies & Bonds

We have big reversals of the two recent dominant trends in the currency markets last week as the Dollar Index surged more than 2% last week and the euro declined more than 2%. But, the plunge in the euro was the most important event in the currency markets last week, as the Dollar Index rally was as much a function of the plunging euro as it was a recalibration of tapering expectations (so put simply, Fed expectations alone didn't account for the 2% rally).

The euro went into quasi free fall last Thursday after EMU inflation rose at a slower rate than expected (0.7% year-over-year). That soft inflation reading is seen as putting pressure on the ECB to further cut rates, as it implies "dis-inflation" in the EMU economy. Taken in the context of a very overbought euro and the somewhat-"hawkish" interpretation of the FOMC on Wednesday, and the rout in the euro was on.

Conversely, the dollar index traded to a one month high on the combination of a weak euro and changing FOMC tapering expectations, and appears to have broken the downtrend in place since early July.

The ECB meeting this week is now the most anticipated event of the week, as it's certainty possible that the ECB will cut rates to stimulate inflation, and will almost certainly give "dovish" commentary.

This is important for two reasons: First, we want to know if there's any money in a euro short (that's unclear at this point). But, more broadly, if the ECB does ease policy, that's bullish for European equities, and further strengthens the case for the "long Europe/Short U.S." spread trade as the ECB will be easing further into a strengthening economy.

Turning to bonds, Treasuries sold off Wednesday-Friday on the changing Fed tapering expectations, and the 10-year yield traded above 2.60% for the first time in nearly one month. Again the catalyst was the pulling forward of tapering expectations, although I think the move in Treasuries more reflects how complacent the market became with a mid-2014 taper expectation, and not a material shift in the direction of Treasuries in the very short term. (I don't think this counter-trend rally is done yet, unless the economic data turns much better in the near term.)

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 S&P 500 traded to new all time highs last week despite shifting expectations of when the Fed will taper QE. 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 old highs of 1729 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: **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	*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	*Euro weakness and the changing Fed expectations led to a massive rally in the dollar last week, but it remains to be seen if the Fed is actually more hawkish than we thought.*

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	*Bonds declined last week on changing Fed tapering expectations, but at this point it's too early to tell if this counter trend rally in bonds is over, as it's not clear the Fed has actually turned more hawkish than the market previously thought.*

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.**