7:00's Report

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

December 11th, 2013

Pre 7:00 Look

- Futures are drifting slightly lower while international markets are little changed, with the exception of China, which sold off hard.
- Chinese shares dropped sharply (Hang Seng down 1.7%) on concerns the '14 GDP target will be reduced to 7%.
- In Washington, the budget deal was announced, although concerns linger about whether it can make it through the House of Representatives (it likely will, though).
- Econ Today: No Reports Today.

Market	Level	Change	% Change
S&P 500 Futures	1801.25	-1.75	-.10%
U.S. Dollar (DXY)	79.945	-.019	-.02%
Gold	1256.40	-4.70	-.37%
WTI	98.37	-.15	-.14%
10 Year	2.797	-.06	-2.10%

Equities

Market Recap

Stocks sold off modestly Tuesday as investors hedge a bit into next week's Fed meeting amidst still-shifting tapering expectations. The S&P 500 fell 0.32%.

Stocks opened basically flat yesterday, but got spooked shortly after the open on a combination of factors: First, CNBC's Steve Liesman proclaimed a December tapering of QE is very much on the table. Second, reports started to surface that while it looked like a budget deal would be agreed upon by Rep. Paul Ryan and Sen. Patty Murray (and that agreement was announced after the close yesterday) there may not be enough votes to get it through the House of Representatives.

Stocks hit their lows of the day shortly after lunchtime. But, once again reflecting the fact that there remains little conviction in this market one way or the other, stocks rebounded and rallied throughout the afternoon, before selling off a bit again into the close. The afternoon was quiet from a catalyst perspective, and really the market didn't do much more than continue to consolidate yesterday.

Trading Color

Despite the news items yesterday, volumes and participation remained subdued, basically at levels we saw on Monday. Real money remains firmly on "hold" as money managers collectively cross their fingers and hope that next week's Fed meeting doesn't contain any market-moving surprises.

In that vein, although volumes were low again yesterday, I did talk to colleagues on the desk who said they definitely saw an uptick in hedging as we move closer to the FOMC meeting (it remains the last landmine for the year), and that's likely something that will continue as we get closer to it.

From a sector standpoint, the clear trend yesterday was that of weakness in defensive sectors. (I don't want to say "bond proxy" sectors, because REITs actually traded with the market.) But, utilities, consumer staples and telecom were the worst-performing sub-sectors, despite the drop in interest rates. As to "why" those sectors underperformed, likely there was some selling in anticipation of the Fed next week. (If they do taper, we'll see those sectors get hit, thereby cushioning any potential dip in the market.) That thinking may not be the sound-

Market	Level	Change	% Change
Dow	15973.13	-52.40	-.33%
TSX	13324.01	11.21	.08%
Brazil	50933.02	-172.36	-.34%
FTSE	6536.48	13.22	.20%
Nikkei	15515.06	-96.25	-.62%
Hang Seng	23338.24	-405.95	-1.71%
ASX	5104.25	-39.30	-.76%

Prices taken at previous day market close.

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est, but if you're a money manager looking for some downside protection just in case, it makes some sense.

Basic materials and retail were the only two sub-sectors to finish positively yesterday, and that was thanks mostly to short-covering (remember those two sectors have lagged recently). Basic materials saw some short-covering thanks to the decent Chinese data, and retailers saw some short-covering into this morning's Costco (COST) earnings.

Market	Level	Change	% Change
Gold	1259.80	25.60	2.07%
Silver	20.285	.584	2.96%
Copper	3.297	.0015	0.05%
WTI	98.49	1.15	1.18%
Brent	109.58	.19	0.17%
Nat Gas	4.237	.005	0.12%
Corn	436.00	-2.00	-0.46%
Wheat	638.75	-11.75	-1.81%
Soybean	1338.25	-5.50	-0.41%
Prices taken at previous day market close.			

Finally, the details of the "Volcker Rule" that somewhat bans banks from proprietary trading were finally announced yesterday. On the whole, the details seemed "less bad" than were generally feared, and there weren't any big surprises (it's been known for a few weeks that the rule would be tougher than generally expected earlier this year). Banks actually rallied in the morning on the actual news release (sell the rumor, buy the news), but finished the day moderately lower, trading down with the broader market.

I'm not a banking analyst, but the people I have talked to generally don't see the Volcker Rule as a material negative for the banks, as most of them have acted ahead of implementation. One rule I learned early on in Wall Street (and in life) is that banks will find ways to make more money if the regulators take away something. Mandate lower rates on credit cards, and annual fees go up. Limit interchange fees, and no more free checking. So, I remain confident that whatever revenues the Volcker Rule will remove will be replaced somewhere else.

On the charts the situation remains the same as markets continue to consolidate. 1,785-ish remains support in the S&P 500, while 1,813 is resistance.

Bottom Line

The market reaction to these "news" events reflects the fact that intraday trading is still totally dominated by fast-money funds and algos. First, tapering in Dec/Jan/March really isn't the huge deal it's being made out to be, at least from a fundamental perspective. The broad "tapering" narrative hasn't changed – the market, unlike in May, thinks tapering is "OK" this time because economic data is stronger than in June. Plus, the short end of the yield curve isn't selling off (remember to watch SHY), implying the market finally believes short-term rates will stay low for a long time. Part of the reason I can confidently say that is because all the assets that would be most negatively affected by a "sooner than expected taper," specifically gold and Treasuries, saw big rallies yesterday.

Second, while Congress is absurdly dysfunctional, the chances of another budget battle are slim, and I'd chalk a lot of the "no passage" rhetoric to hardliners in both parties who are trying to get some headlines to use in their campaigns next year to show they are "tough" on the opposing party. It's a lot easier to be a hard-headed ideologue when you're not six months or so from an election.

Bottom line is this market remains jittery due to the calendar (money managers want the year to end) and the persistent lack of "agreement" with the rally. But, stocks for now are merely consolidating—nothing more. And, as long as investors remain skeptical and the macro horizon remains clear, the path of least resistance is higher.

Term Structure in Natural Gas is Becoming Bullish

I've consistently said natural gas, at least in the short term, is a weather-dominated market, in that when temperatures get very cold or very hot, it spurs electricity demand and consumption of natural gas. Certainly this big rally we've seen since early November (where gas rallied from $3.40 to $4.20) has largely been driven by cold weather drawing on inventories.

But, the term structure of natural gas could be sending an important signal that it's seeing an uptick in demand beyond what's considered short-term weather-related.

The term structure of natural gas has become significantly "backward-dated" in that the current month's

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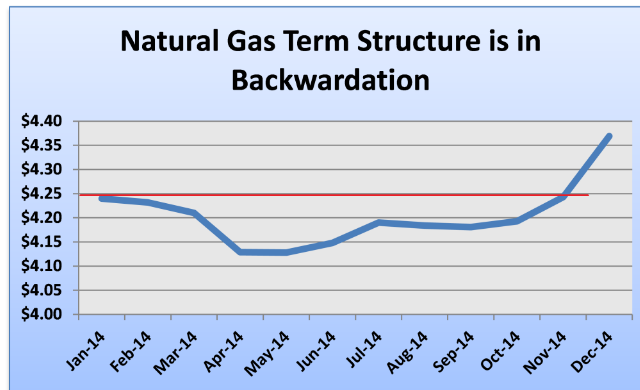
prices (for January delivery) are trading higher than February's price. Prices for February delivery are trading at a higher price than March delivery, and this lasts all the way out until June 2014. Term structures can be an important indicator of physical demand for a commodity, and as the backwardation in natural gas implodes, we are seeing a systemic increase in demand for natural gas—not just a temporary uptick in demand due to cold weather to start the winter. And, that is potentially bullish not just for natural gas, but for natural gas producers.



Last week I mentioned that the natural gas "E&Ps" (short for exploration and production companies) have badly lagged this spike in natural gas, and oftentimes that happens as the market assumes the spike in natural gas is temporary.

But, if the term structure in natural gas is telling us a more bullish story, then the case can be made that natural gas E&Ps offer potential value in the market over the medium and longer term.

The best "pure play" E&P ETF is the First Trust ISE Revere Natural Gas Index Fund (FCG), which I mentioned last week. That ETF got hit late last week thanks to a drop in Penn Virginia Corp. (PVA), the second-largest holding. But, medium/longer term, it does offer the best "pure play" exposure to natural gas E&Ps. A secondary, and more liquid option, is the SPDR S&P Oil & Gas Exploration & Production ETF (XOP). But, XOP isn't as much of a "pure play" on natural gas E&Ps, as they only make up 75% of the fund. Refiners (15%) and integrated oils (5%) represent the other sub-industries in this ETF.

Market	Level	Change	% Change
Dollar Index	79.945	-.195	-0.24%
EUR/USD	1.3766	.0029	0.21%
GBP/USD	1.6447	.0019	0.12%
USD/JPY	102.72	-.55	-0.53%
USD/CAD	1.0606	-.0021	-0.20%
AUD/USD	.9153	.0041	0.45%
USD/BRL	2.3065	-.013	-0.56%
10 Year Yield	2.797	-.06	-2.10%
30 Year Yield	3.829	-.05	-1.54%

Prices taken at previous day market close.

Finally, and I'm not a single-stock guy so everyone needs to do their own research, I did ask some colleagues for their favorite names in the natural gas E&P space, so here are some of them: COG, AR, EOG, NFX, ATLS, ARP. Again, I haven't "explored" these single stocks, but I wanted to provide some individual names for people to look at, If interested.

Bottom line is, longer term the future for natural gas is attractive, even in the face of surging supply, because natural gas is one of the few commodities where the market is inventing new sources of demand (gas-fired power plants, natural-gas-powered cars, exports of LNG, etc.). And, although in the short term natural gas itself is stretched and I wouldn't buy the commodity at these levels, the equities may offer value if the term structure is forecasting a structural rise in demand.

Economics

There were no economic reports yesterday.

Commodities

There was broad strength in the commodities sector yesterday and the benchmark commodity ETF DBC was up 0.24% as it continues the rally that began over a month ago.

Gold and silver have been the commodities to watch this past week due to the rare market conditions regarding short vs. long interest. Precious metals in general saw a decent short squeeze yesterday morning, and gaining over $20 in pre-market trading Tuesday, gold futures drifted sideways for the remainder of the day, closing higher by 2.07% and above resistance at $1250. Silver gained 2.96% and retook the $20/oz level, which can now be considered a psychological support level.

We started pointing out the historically oversold positioning of traders in the metals markets last Monday,

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cautioning that the market was setting up for a short squeeze of some kind. And, that's what we saw yesterday, and what we've been seeing in gold since the lows of a week ago.

But, while it is no longer time to be bearish of gold (it acts like we're seeing a bottom), the fundamentals have not changed and the price movement is simply technical trading noise. Sentiment remains neutral at best, and until any material news breaks on an uptick in inflation, I don't think it makes sense to aggressively get long in the mid to high $1200's (I prefer to get long on declines in the low $1200's, which I suggested in yesterday's Report for those with a trading ilk).

Trading in the energy sector was relatively quiet yesterday as natural gas, although Crude oil rallied 1.18% and closed the day at a six-week high. At this point crude is trading more like a commodity driven by physical supply and demand, rather than some macro economic asset. The rally yesterday was driven by expectations of more inventory draws and on physical traders trading the arbitrage between WTI Crude and Brent Crude (the drop in Brent on expected Libyan production was the catalyst for the WTI rally as the spread compressed).

Bottom line is WTI is through resistance but I'd prefer to buy a dip in "energy" broadly, having missed this rally. The fundamentals haven't changed materially to suggest WTI is heading materially above $100/bbl. Unless there's some geo-political surprise (like a break down in the Iranian agreement).

Currencies & Bonds

The Dollar Index fell modestly Tuesday, declining 0.22% and dropping back below the 80 level for the first time since Halloween. As has been the case for much of the six-week decline, though, the drop in the Dollar Index was mostly a result of strength in other currencies, compared to weakness in the dollar.

Asian currencies were the best performers vs. the dollar yesterday. The "Aussie" continued its oversold bounce as it rose 0.53%, mostly on the back of strong Chinese data, prompting short-covering. Interestingly, the news out of China wasn't all that "Aussie"-bullish, as the strong data came from retail sales, not fixed-asset investment. I point that out because it's fixed-asset investment (like bridges and buildings) that spurs raw material demand. But the newest data from China reflects the changing Chinese economy – from an export-driven to a consumer-driven one. Point being, the economic data was actually marginally raw-material-bearish. But, in the context of a very oversold "Aussie" and headlines purporting "strong Chinese data," it was enough for a bounce in the Australian dollar. But, don't confuse the short-covering with a potential uptrend. Any upside in the Aussie remains limited, and I don't think it's something you want to own, other than for a quick trade.

Staying in Asia, we also saw short-covering in the yen, which also rallied 0.5% vs. the dollar. There was no material news from Japan overnight. The yen is sitting basically on the lows of the year in the high-103 region, and as I said yesterday, I would have to imagine those lows to be at least modestly defended by some buyers and profit-takers on the short side. A counter-trend rally in the yen again wouldn't surprise me in the short term, but that's a rally to short.

Turning to Europe, the euro rallied to just under 1.38 vs. the dollar before giving up some ground later in the day to finish up 0.2%. Economic data in the EU region was "ok" yesterday, but really it was additional "hawkish" comments by ECB members that resulted in a euro rally. ECB Governing Council Member Benoit Coeure said yesterday that there was "No need to use spectacular measures such as U.S.-style large-scale asset purchases" to combat deflation in the EU. This simply reinforces the market's concern that the ECB is "comfortable" with current policy. And, by default, if the ECB isn't doing incrementally "more" to stimulate the economy, the euro will rise, and EU stocks will fall, as happened yesterday late in the European trading session. Bottom line is as long as the ECB seems uninterested in doing anything more to stimulate the EU economy, the euro will rise, and the chances of Europe becoming the next Japan (from a prolonged dis-inflation standpoint) will gradually rise.

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)

<table>
<tr><th></th><th>Fundamental Outlook</th><th>Technical Outlook</th><th>Overall</th><th>Comments</th></tr>
<tr><td>Stocks</td><td>Neutral</td><td>Bullish</td><td>Bullish</td><td>Stocks continue to consolidate recent gains around the 1800 level. A calm macro-economic horizon and still skeptical sentiment towards the rally remain tailwinds, and over the medium term the path of least resistance remains higher.

Support in the S&P 500 lies in the 1780-1785 region, while resistance is 18013 (the old highs).</td></tr>
<tr><td colspan="5"><u>Trade Ideas</u>

<u>Long Japan:</u> 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 yen has broken through 101 yen/dollar level, and DXJ is at multi-month highs. Although we could see a pause, that trend should continue over the coming months, and there remains more money in this trade.

<u>Long Deep, multi-national Cyclicals and Global Miners</u>: Domestically, I’d look to allocate to deep cyclicals like industrials (XLI), basic materials (IYM) and global industrial miners (PICK). It’s a bit of a contrarian idea, and over the past few weeks these sectors have lagged. But, they most exposed to the “global economic recovery” thesis.</td></tr>
<tr><td>Commodities</td><td>Bullish</td><td>Neutral</td><td>Neutral</td><td>Commodities bounced last week thanks to the big rally in the energy space. But, the outlook for commodities remains mixed, as the global economy remains mired in stagnant growth. Given the severe underperformance of commodities this year, though, the asset class remains on of the last corners of value in the market, if the global recovery can accelerate.</td></tr>
<tr><td colspan="5"><u>Trade Ideas</u>

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.</td></tr>
<tr><td>U.S. Dollar</td><td>Neutral</td><td>Neutral</td><td>Neutral</td><td>The Dollar Index traded down last week mostly off euro strength, as a Dec/Jan/March tapering of QE is largely priced in. With the euro in a clear uptrend, it’ll be tough for the Dollar Index to trade materially higher, despite the Fed starting to dial back policy.</td></tr>
<tr><td colspan="5"><u>Trade Ideas</u>

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.</td></tr>
<tr><td>Treasuries</td><td>Bearish</td><td>Bearish</td><td>Bearish</td><td>Bonds resumed their declines last week, but notably we are seeing the long end of the curve sell off while the short end rallies, creating a steep yield curve. Continue to focus on the long end if you short any bounce (which I think you should).</td></tr>
<tr><td colspan="5"><u>Trade Ideas</u>

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.</td></tr>
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