7:00's Report

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

December 12th, 2013

Pre 7:00 Look

- Futures are slightly lower after international markets saw moderate declines overnight.
- European shares are again lagging this morning, after EMU industrial production for October badly missed expectations, falling 1.1% vs. (E) 0.3%.
- Positively, Chinese loan growth in November beat expectations (626 bln yuan vs. (E) 580 bln), although that increase is seen as providing justification for the PBOC to further drain liquidity from the economy, so markets didn't rally off it.
- Econ Today: Weekly Jobless Claims (E: 325K), Retail Sales (E: 0.6%).

Market	Level	Change	% Change
S&P 500 Futures	1779.75	-2.00	-.11%
U.S. Dollar (DXY)	79.94	.05	.06%
Gold	1243.90	-13.30	-1.06%
WTI	97.78	.34	.34%
10 Year	2.844	.047	1.68%

Equities

Market Recap

Stocks saw their deepest declines in over a month Thursday as investors continued hedging and trying to preserve performance ahead of the FOMC meeting next week and year-end. The S&P 500 fell 1.13%.

Stocks opened lower and spent the entire day in the red. News-wise, the outlook for the Fed tapering QE as well as analysis of the budget deal struck in Washington dominated the markets yesterday, and both were cited as "reasons" for the sell-off. In particular, despite being a

The Russell 2000 has now traded back to support, and the 1097ish level should hold on a closing basis, if this is just a typical consolidation.

positive, the budget deal was used as a reason to account for the drop in stocks because clarity in Washington increases the likelihood of Fed tapering next week.

In truth, though, fears of Fed tapering weren't the real catalyst behind the selling yesterday. Hedging and preservation of year-to-date gains were the real reasons for the drop, and the hedging I mentioned in Tuesday's issue clearly accelerated yesterday. But, the drop came on very low volume and selling was not aggressive – the reason stocks dropped as deep as they did was a lack of buyers (again reinforcing the performance-protection thesis – no one wants to buy this dip and risk a further decline so late in the year). The declines in stocks continued throughout the afternoon despite any material news, and equities saw a relatively ugly close as stocks went out at their lows.

Trading Color

It was definitely a "risk off" day yesterday, although the drop in stocks must be taken in context with the continued low volumes and activity by real money, which remains largely on the sidelines, except for hedging and protecting some profits.

Market	Level	Change	% Change
Dow	15849.31	-123.82	-0.78%
TSX	13152.79	-171.22	-1.29%
Brazil	50067.99	-925.03	-1.81%
FTSE	6507.72	-15.59	-0.24%
Nikkei	15515.06	-96.25	-0.62%
Hang Seng	23338.24	-405.95	-1.71%
ASX	5104.25	-39.30	-0.76%

Prices taken at previous day market close.

The Russell 2000 dropped more than 1.5% and is now sitting on support at an uptrend line that dates back well over a year – so there is some substantial support there. Sector-wise there wasn't a lot of news, but high beta and cyclicals definitely lagged.

Market	Level	Change	% Change
Gold	1252.60	-8.50	-0.67%
Silver	20.28	-.035	-0.17%
Copper	3.326	.0245	0.74%
WTI	97.51	-1.01	-1.03%
Brent	109.73	.35	0.32%
Nat Gas	4.338	.101	2.38%
Corn	439.25	3.25	0.75%
Wheat	640.75	2.00	0.31%
Soybean	1344.00	5.75	0.43%
Prices taken at previous day market close.			

Consumer staples were the only sector to finish trading yesterday in the green, while tech, financials, energy, industrials and homebuilders all finished lower by more than 1%. With the exception of consumer staples, though, traditional "defensive" sectors didn't offer much cover, either. Healthcare was the worst-performing S&P 500 sub-sector, while utilities dropped nearly 1% and REITs fell 2%. So, really there weren't many places to hide in the market yesterday.

S&P 500: The bears will be quick to point out that it looks like we're getting a double top in the S&P 500. Their argument will become much stronger if the S&P breaks decisively through 1780.

The one sector with actual news out yesterday was retail, which relatively outperformed. Costco (COST) missed earnings and dropped 1.5% yesterday, but the miss was due mostly to higher SG&A expenses, and the actual retail trends were "OK" as revenues and margins held up.

On the charts, things are now a bit more interesting. The late-day dive in the S&P 500 saw it take out the closing low from last week (1,785) and the 20-day moving average. So, the S&P 500 is sitting on key short-term support, as is the Russell 2000. And, there will almost certainly be people pointing out it looks like the S&P 500 made a "double top" over the past week. Short term, the technical situation has definitely turned a bit for the worse.

Bottom Line

Yesterday was a nasty day but overall nothing really changed, and the declines had more to do with PMs and traders being nervous about preserving performance into year end than it did a shifting outlook for stocks.

Impending tapering of QE remains the excuse for any dip in risk assets, but other than in the very short term the market is much, much more comfortable with upcoming Fed policy than the headlines would imply. There's no reason to think, at this point, that tapering of QE is a rally killer, despite the fears.

We could easily see the market continue to churn into the FOMC meeting (it is the last potential "land mine" event of 2013 and further hedging by skittish PMs and traders could weigh on the market), but unless stocks trade materially through the 1780ish region of support that's been in place since November, this dip remains more about consolidation than anything else.

Boring But Important: Are We Seeing the Start of Wage-Push Inflation in Japan?

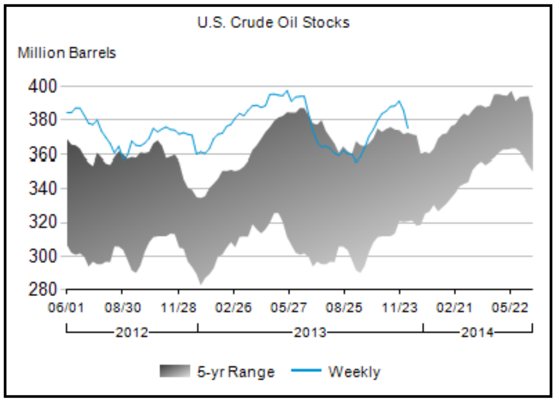
There was an important but largely ignored article in Reuters last week (link here) that stated the All Toyota Workers' Unions in Japan will push for higher wages next year. This seems relatively boring, but it's important—because if other unions in Japan follow this push for higher wages, it could finally start the process of "wage-push" inflation.

Wage-push inflation is basically a fancy term for explaining that, as people get paid more (higher wages), they spend more and prices rise for goods and services, because more money chases the same amount of goods. Normally, economies don't want "wage-push" inflation, but in the case of Japan, where the administration is trying to manufacture inflation, this could be a very positive sign.

One of the main reasons Japan hasn't been able to break the cycle of deflation is because companies have been reluctant to increase wages (Toyota hasn't increased wages since '08), so the fact that incomes are stagnant acts as a deflationary force, especially in a world of rising costs.

But, if Japanese companies finally move and wages start to increase, it'll be a big positive for the potential of inflation restarting in Japan. From an investment standpoint, that would be very bullish for the WisdomTree Japan Hedged Equity Fund (DXJ), as stock prices would inflate along with everything else, and the yen would decline.

So, while we still may be seeing some short-term exhaustion in the rally in Japanese stocks/drop in the yen, the news from last week is a potentially significant positive for the "long Japan" trade, and we should all be buying dips in DXJ.



Economics

There were no economic reports yesterday.

Commodities

Commodities were mixed yesterday with natural gas trading to another new high while the rest of the energy space was down. The PowerShares DB Commodity Tracking Index ETF (DBC) was down 0.05% despite the dollar trading lower for the 7th straight session.

Natural gas continued to grind higher yesterday, gaining 2.34% and closing the session a tick away from the high of the day. After brief consolidation on Tuesday, natural gas futures were able to crash through the last level of resistance at $4.30 while some technical support lies around the $4.10 level. It is worth noting that the spot price traded to within 10 cents of the high of the year yesterday.

Market	Level	Change	% Change
Dollar Index	79.885	-.079	-0.10%
EUR/USD	1.379	.0031	0.23%
GBP/USD	1.6385	-.006	-0.36%
USD/JPY	102.52	-.30	-0.29%
USD/CAD	1.0589	-.001	-0.09%
AUD/USD	.9072	-.0078	-0.85%
USD/BRL	2.341	.0323	1.40%
10 Year Yield	2.844	.047	1.68%
30 Year Yield	3.88	.051	1.33%
Prices taken at previous day market close.			

The somewhat-obvious "path of least resistance" remains higher for natural gas; however I would not recommend buying in at these levels. Nat gas has rallied 26% since November 4th, finishing 20 of the last 27 sessions higher with essentially no pullbacks or consolidation. Again, I believe the best way to benefit from the recent rally in nat gas is through buying dips in the E&P ETFs (FCG and XOP).

Staying in energy, WTI Crude fell just over 1% yesterday, despite "bullish" inventory numbers. The EIA reported a second-consecutive draw on inventories in WTI supplies, down 10.6M barrels.

However, when the market had time to digest the report, WTI futures began to fall for a couple reasons. First, the lower supply levels in crude oil are skewed due to industry-wide destocking, where companies shed inventory to reduce tax costs at year end. Second, the builds in gasoline and distillates of 6.7M Bbls and 4.5M Bbls, respectively, suggest there will be a pullback in refinery demand in the near term. Lastly, with the crack spread narrowing in recent weeks (crude has rallied while gasoline and heating oil have sold off), refiners are less likely to increase utilization levels due to the weaker margins, which means less crude demand.

Bottom line is the rally in WTI crude oil has at the very least stalled here and very well may have found a short-term top.

Precious metals were largely unchanged yesterday as the market digested the recent rally. . Gold and silver were down 0.67% and 0.17%, respectively in quiet trading. But, both gold and silver are weaker this morning, and are mostly trading of tapering expectations (as the odds rise of tapering next week, we'll see gold come under pressure). Again, given how "short" the number is of gold, for those that can tolerate risk, I'd be a buyer on any taper related dip towards $1200/oz. either via GLD or call options. It's a risky trade, but one with significant short term return potential.

Currencies & Bonds

The dollar continued to bleed marginally lower yesterday, dropping by 0.11%, again due more to strength in the euro than anything dollar-negative. Looking at the euro, for the second-straight day Benoit Coeure, a member of the ECB Governing Council, made comments that reinforce the view that the ECB remains very much "on hold" from a policy standpoint.

Tuesday Mr. Coeure said he didn't see the need for "spectacular" monetary intervention like in the U.S. Yesterday he went further, saying that while the ECB remains ready to act, no more action is needed at this time. You can't get any more "on hold" than that.

The euro continued its grind higher on the news, trading back above 1.38 vs. the dollar for the first time since late October. I imagine it's basically a formality that the euro will break the highs of the year at 1.3834.

The yen was also stronger vs. the dollar (which also contributed to the Dollar Index weakness), although the rally was modest (0.2%). There was no news to account for the rally in the yen (there were some press reports that the BOJ isn't as eager for more stimulus as the market expects, but these were ancillary).

Bottom line is the yen sits at the lows of the year vs. the dollar, and those lows are proving a bit formidable. Short term, I continue to think we'll see a bit of a bounce from these levels toward the 101 yen/dollar level. But that's a bounce that should be shorted rather enthusiastically, as at the end of the day the yen simply isn't weak enough to get the Japanese economy where Messrs.'. Abe and Kuroda need and want it to be.

Treasuries were weak yesterday, reversing much of the Tuesday rally as the expectations for a taper at the December FOMC meeting continue to shift (it's becoming incrementally more likely, although I wouldn't say its consensus at this point).

Fundamentally speaking, there was 10 year note auction yesterday that wasn't all that strong, echoing the reality in the bond market that the "belly" and "long end" of the yield curve remain the weakest part of the bond market. And, given impending Fed tapering (whether its Dec/Jan/March), that weakness in the long end continues to make sense.

The bid-to-cover (a measure of demand) of 2.61 was below the recent average of 2.70, and the when-issued yield (2.815%)—was nearly a full basis point lower the actual yield (2.824%) again implying lack luster demand.

The weak results of the auction sent both 10-year note futures (-0.25%) and 30-year bond futures (-0.55%) to the lows of the day as the market digested the weak auction results. Meanwhile the short end of the curve was unchanged as the 2-year note futures were only down 0.02% yesterday.

Bottom line is that for now the trend of the steepening yield curve continues, but I recommend keeping a close eye on the iShares Barclays 1-3 Year Treasury Bond Fund (SHY) to confirm that the market still has confidence in "forward guidance." As long as SHY can stay relatively flat into and out of the Fed meeting next week, then tapering of QE, and the subsequent rise in interest rates, won't be a rally killer for stocks.

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**	*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).*

Trade Ideas

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 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.**

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). 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.**

Long Natural Gas E&Ps: **Term structure in the natural gas markets has turned bullish, as its in backwardation out nearly a year, implying a structural increase in demand. But, natural gas equities remain under pressure, and could potentially offer some value in the market over the medium/longer term. FCG and XOP are the two "pure play" ETFs in the natural gas E&P space.**

Commodities	**Bullish**	**Neutral**	**Neutral**	*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.*

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.**

U.S. Dollar	**Neutral**	**Neutral**	**Neutral**	*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.*

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**	*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).*

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.**