7:00's Report

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

December 17th, 2013

Pre 7:00 Look

- Futures and European markets are mostly drifting as they digest yesterday's gains.
- EU inflation remained low but unchanged from the previous reading, at just .9% yoy increase. Dis-inflation remains a threat to the region.
- Positively, though, economic data was again good in Europe o/n. The German ZEW business expectations index beat estimates, as did UK Industrial Trends.
- Econ Today: CPI (E: 0.0%).

Market	Level	Change	% Change
S&P 500 Futures	1779.25	-1.00	-.06%
U.S. Dollar (DXY)	80.235	.009	.01%
Gold	1238.90	-5.50	-.44%
WTI	1359.70	-.40	-.03%
10 Year	2.877	.009	0.31%

Equities

Market Recap

Stocks rallied Monday thanks to a triple threat of good European economic data, several M&A deals, good industrial production numbers and traders positioning ahead of the FOMC Wednesday. The S&P 500 rose 0.63%.

Yet, for all the coverage of M&A and the Fed, it was Europe that was the real reason behind the rally yesterday. S&P futures were lower early Monday morning (they traded below 1,760), but the markets reversed after the surprisingly strong EU flash manufacturing PMIs (which hit at about 4 a.m.). European markets rallied off the news and pulled U.S. markets higher pre-open, and the rally here accelerated after the good Industrial Production data was released.

Stocks hit their highs about 35 minutes after the open, and as news quieted they spent most of the day treading water. Of note, stocks did not see another late-day selloff (that's been becoming a bit of a trend), and managed to close not far off the highs.

Trading Color

Unfortunately for the bulls, yesterday's rally didn't see any uptick in volumes or activity by "real money." Trading remains dominated by hedge funds, algos and day traders.

Sector-wise, it was another day of macro outperformance. Consumer staples continued the trend of badly lagging the markets (XLP finished lower yesterday), despite there being no material negative news. Other "bond proxy" sectors also lagged, with utilities, REITs, telecom and healthcare all relatively underperforming.

Winners on the day included semiconductors (which drove tech higher), industrials, energy (thanks to XOM's 2% move higher) and banks (so, again, the rotation into macro-sensitive sectors).

On the charts the market traded back into its support range of around 1,785-ish, and I'd be shocked if we deviate from it too much heading into the FOMC announcement Wednesday afternoon. Chartists are pointing to 1,772-ish as support, if the market break lower, while 1,800 is first resistance.

Bottom Line

The market narrative remains largely unchanged. Last

Market	Level	Change	% Change
Dow	15884.89	129.53	0.82%
TSX	13207.44	81.74	0.62%
Brazil	50279.61	228.43	0.46%
FTSE	6522.20	82.24	1.28%
Nikkei	15278.63	125.72	.83%
Hang Seng	23069.23	-45.43	-.20%
ASX	5103.19	13.56	.27%

Prices taken at previous day market close.

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week's declines weren't due to "tapering fears" and yesterday's rally wasn't because of "reduced fears of potential of tapering." Despite the obsession with it in the media, the market remains largely "ok" with tapering as long as it meets current expectations (more on that below).

Market	Level	Change	% Change
Gold	1243.20	8.60	0.70%
Silver	20.055	0.451	2.30%
Copper	3.374	.022	0.66%
WTI	97.44	0.84	0.87%
Brent	110.46	1.64	1.51%
Nat Gas	4.262	-.089	-2.05%
Corn	423.25	-2.25	-0.53%
Wheat	621.75	-7.00	-1.11%
Soybean	1337.75	10.25	0.77%
Prices taken at previous day market close.			

Skittish sentiment and the desire for managers to preserve gains into year end are the dominant influences in the market right now, and will remain so into year end unless we get a tapering surprise.

FOMC Meeting Preview

I usually wait until the morning before to do a Fed meeting preview, but I talked to subscribers yesterday who were already fielding calls from clients about what to expect, how to be positioned, etc. So, I figure it'd be worth sending this out a day early given the enormous focus on the meeting.

The Expected:

- No tapering of QE in December, but a strong signal by the Committee that tapering of QE will happen in January or March.
- Tapering Logistics: If asked about how tapering will work, the market expects to see an initial tapering of $10 billion-$15 billion, and the process to be linear (tapering the same amount each month or quarter, whichever they decide). And, markets expect the first taper to be weighted toward Treasuries, while mortgage-backed securities are left alone (to help soften the blow on the mortgage market, although I'm not sure it'll make much of a difference).

If this is what we get Thursday, don't expect any significant, volatile reactions from the various asset classes, as again this is what's priced in. As far as how markets will trade beyond the immediate reaction, that's a tough one to call. We could either see a "sell the taper rumor/buy the taper news" reaction. Or we could see markets drop on the news, due as much to the calendar and the skittishness of money managers I've been talking about, given the gains so far this year.

Regardless of the short-term reaction, I don't think this expected scenario really alters the market dynamic beyond the short term, as long as the short end of the yield curve stays buoyant (SHY). So, point being, I still think the path of least resistance would remain higher beyond the very short term if this is how the meeting goes.

The "Hawkish" Scenario:

- The Fed tapers QE in December –or—
- The Fed doesn't taper in December but strongly implies the first taper will be beyond the anticipated $15 billion (say $20 billion-$25 billion).

This would get a hawkish (and negative) response from markets, and you'd see bonds spike lower, gold sell off hard and equities decline as well (the only thing that would go up would be the Dollar Index). Short-term selloff aside (and there would be one), it would remain to be seen how "bad" this would be for markets over the medium term. The keys to watch would be SHY (short-term Treasuries), and PCY and EMB (emerging market bond ETFs). If they all went into freefall, it would be a major negative for stocks. If they stabilized after an initial dip, then the "hawkish" tone might not mean decidedly lower equity prices.

The "Dovish" Scenario:

- The Fed pulls a "September" and doesn't taper, nor does it give the impression that tapering is imminent.

This would elicit a "dovish" response from the markets, as bonds would rally, gold would see a big jump given the number of shorts in the market, and the dollar would drop. The surprise in this scenario, though, would be that equity prices would likely fall (and personally, I think this outcome would be the worst for risk assets).

Stocks would drop for two important reasons: First, tapering isn't really viewed as a major positive anymore,

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and the market would much prefer to get the economy back to normal with no tapering. If the Fed can't taper with improving economic data and clarity in Washington, the idea that the Fed is "trapped" in QE will start to get legs, and that implies the Fed has lost control. Second, the market again would have gotten the Fed totally "wrong" and I think this communication breakdown would start to weigh on risk assets, as it would become clear that the market can no longer read the Fed, thus introducing significant macroeconomic uncertainty.

Bottom Line

This will obviously be an important event in the short term for all asset classes. Given the growing level of skittishness among managers and their desire to protect year-to-date performance, and the fact that we'll have eight trading days left in the year after the meeting, the short-term reaction will be hard to guess.

But, beyond the short term, tapering of QE and rising rates aren't a rally-killer as long as: 1) The rise in rates is "orderly," which means we don't see a spike higher in rates like we did last summer, and 2) The short end of the curve stays buoyant, meaning SHY doesn't see the big drop that we saw earlier in the summer. So, bottom line is still keep an eye on SHY.

Economics

Industrial Production

- Production rose 1.1% vs. (E) 0.6%
- Manufacturing rose 0.6% vs. (E) 0.5%

Takeaway

Industrial production levels handily beat analysts' expectations of 0.6% yesterday, printing a month-over-month increase of 1.1% for November while October production levels were revised higher from -0.1% to 0.1%. The big increase in the headline is a touch misleading, though, as utility production, due to the cold weather, was a big factor in the monthly increase.

But, that notwithstanding, the report was still good. The manufacturing component of the report, which is the important part of IP, increased by 0.6% in November and October manufacturing index was revised higher to 0.5% from 0.3%.

Bottom line in this report is that the manufacturing sectors maintained positive momentum in November, which is obviously good for the economy.

December Flash Manufacturing PMI & December Empire State Manufacturing Index.

- Dec. Flash Manufacturing PMI was 54.4 vs. 55.0.
- Empire Manufacturing Index was 0.98 vs. (E) 4.50.

Takeaway

While the hard data from November (the industrial production report) showed continued momentum in manufacturing, the first look at the industry in December shows a slight cooling. The Flash Manufacturing Index PMI produced by Markit and the Empire State Manufacturing Survey both missed analysts' expectations yesterday, and the new orders index for both, which is the leading indicator, declined from November. But, the "Flash" manufacturing PMI remains well above the 50 level (signaling expansion), and Empire is still (barely) above zero. So, while disappointing vs. expectations, the indices won't change the perception that we are seeing continued expansion in manufacturing (it just implies the recovery is slowing a touch).

Commodities

Market	Level	Change	% Change
Dollar Index	80.24	-.135	-0.17%
EUR/USD	1.3763	.0022	0.16%
GBP/USD	1.6303	.0007	0.04%
USD/JPY	102.99	-.20	-0.19%
USD/CAD	1.0587	.0005	0.05%
AUD/USD	.8947	-.0015	-0.17%
USD/BRL	2.3284	-.0011	-0.05%
10 Year Yield	2.877	.009	0.31%
30 Year Yield	3.895	.022	0.57%
Prices taken at previous day market close.			

Commodities traded mostly higher yesterday, thanks to a slightly weaker Dollar Index, which was down -0.2%. The PowerShares DB Commodity Index Tracking ETF (DBC) rose by 0.37%.

Silver was the outperformer in the commodity space, gaining 2.3% in a short-squeeze rally yesterday morning. The Commitment of Traders report, released Friday by

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the CFTC, indicated that net long positions have increased slightly; however, they are still hovering near historic lows. Net long positions for silver futures were up to 1,149, from the prior week's reading of -3,775. So, given the FOMC meeting tomorrow, nervous shorts covered, resulting in the bounce

A similar "squeeze"-like move was seen in gold, which closed up 0.7% yesterday.

The energy sector was largely unchanged yesterday, with the exception of natural gas which has been on a tear for the past six weeks. Nat gas futures fell 2.05% primarily on profit-taking after the spot price failed to break out to a new 52-week high last week. As I mentioned in Monday's Report, a decent level of support lies in the $4.20-$4.22 area, and that is the level to watch. And, as I said last week, I'd be a buyer of natural gas equities (FCG, XOP) on any substantial weakness for anything other than very short term accounts.

Currencies & Bonds

Currency markets were understandably quiet yesterday, given the looming FOMC announcement tomorrow. Most of the trading in the Dollar Index, which declined 0.15%, was the result of traders positioning ahead of the FOMC.

As far as actual news, the strong December "Flash" PMIs from Europe were the highlight of the day, although the strong data didn't result in a materially higher euro, partly because it had a nice run last week, and partly because the Fed decision looms. But, the data does imply the drop in growth may not be as bad as initially assumed, and it's another reason for the euro to continue to grind higher vs. the dollar over the medium term.

Turning to Asia, the yen drifted marginally higher vs. the dollar (up 0.18%) after the Tankan business survey showed some caution among corporations, implying the Japanese recovery may be losing some steam. Interestingly, a lot of reports on Tankan focused on the fact that the headline indicator beat expectations, which it did. But, that wasn't what made the market trade.

Instead, executives showed they planned to spend less on capex over the coming months than expected (the capex portion of the survey was 4.5 vs. (E) 5.5). And, since capital spending by business is needed for further economic growth in Japan, the report was a bit disappointing. Bottom line is the yen is basically holding near its lows for the year, and whether those lows hold or are broken likely will depend on the FOMC. Either way, though, the trend in the yen remains lower.

Turning to bonds, Treasuries reversed yesterday and finished lower (30-year down 0.3%) after initially starting trading slightly higher. The good industrial production numbers helped turn the tide although, like currencies, Treasuries are largely at the mercy of positioning ahead of the FOMC decision tomorrow.

A Slightly More Hawkish ECB?

Beyond positioning ahead of the Fed, there is something politically that happened over the weekend that likely will result in the ECB being a central bank less inclined to take extraordinary measures to stimulate the EU economy. Jorg Asmussen will be leaving the ECB to become the new German Labor official in the new German government. This is worth noting because he was generally viewed as one of the most-open Germans to "non-standard" monetary policy to help spur growth—i.e., Quantitative Easing, more LTROs, or negative deposit rates. In short, he was a somewhat "dovish German" central banker, and those are pretty rare. His likely replacement will be Bundesbank Vice President Sabine Lautenschlaeger, and from what I've read it's safe to say she isn't as "dovish" as Asmussen was, nor as open to the use of "non-standard" policies.

The point here (and why I'm spending time on it) is because the probability of the ECB proactively doing "more" to combat dis-inflation and spur growth in the EU economy got smaller over the weekend, and that's bullish for the euro. (Remember, doing nothing incremental from a policy standpoint is by default euro-bullish, and euro-equities-neutral (at best) to -negative.) Maybe the EU economy is stronger than we think, as the data from yesterday may imply. But, if it isn't, then we'll likely see lower European share prices (perhaps materially lower) before the ECB acts further. Longer term I still think Europe's a "buy," but I'd wait for a better entry point. 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	*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.**

	Fundamental Outlook	Technical Outlook	Overall	Comments
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.**

	Fundamental Outlook	Technical Outlook	Overall	Comments
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.**

	Fundamental Outlook	Technical Outlook	Overall	Comments
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.**

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