7:00's Report

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

December 18th, 2013

Pre 7:00 Look

- Futures and most international markets are higher this morning on a combination of good data and positioning ahead of the Fed.
- Economic data from Europe continued to impress. German IFO Business survey, UK Labor Market Report and UK Distributive Trades (which is retail sales) all beat estimates.
- In Japan, November export growth beat expectations, pressuring the yen and sending the Nikkei up 2%.
- Econ Today: Housing Starts (E: 952K). FOMC Announcement: (E) No Change to Rates or QE Program.

Market	Level	Change	% Change
S&P 500 Futures	1777.00	4.00	.23%
U.S. Dollar (DXY)	80.245	.031	.04%
Gold	1232.10	2.10	.17%
WTI	97.57	.10	.10%
10 Year	2.839	-.0004	-.005%

Equities

Stocks traded largely unchanged yesterday during a quiet session ahead of the Fed announcement later this afternoon. The S&P 500 fell 0.31%.

Stocks opened flat Tuesday but sold off shortly after the open, mostly on light de-risking ahead of the Fed. Reflecting the fact that the move was little more than random positioning, the dip in stocks came despite the release of the Housing Market Index, which rose basically to the highs for the recovery, and as 3M (MMM) and Honeywell (HON) released pretty upbeat (or at least in-line) 2014 business outlooks. But, in this Fed-dominated market, those two events were largely ignored yesterday.

Reflecting the fact that investors have little to no conviction in this market, stocks bottomed right around the European close at 11:30, down about 0.5%, and then steadily rallied throughout a quiet afternoon session afternoon to close basically in the middle of the day's trading range.

Trading Color

I wasn't sure it was possible to get lower volumes and participation than we have seen over the past few weeks, but yesterday proved it was. Algos, day traders and fast-money funds again ran the market yesterday. Most major indices finished not far from unchanged (the S&P 500 was the big mover yesterday), while sector trading was a mixed bag.

Industrials were stronger after generally positive outlooks from some bellwethers including the aforementioned MMM, HON and Boeing (BA), and semiconductors also logged strong gains (up 1%) to close just off 52-week highs. (This, incidentally, is usually a bullish sign for the general market—you don't see semis hitting new highs and the broad market breaking down, usually.)

As far as the laggards, you could make the case that there was some positioning ahead of the Fed today, as banks and financials lagged despite a lack of negative news. Meanwhile, consumer staples continued to trade poorly (down about 0.5% yesterday). Healthcare also lagged, although the underperformance of the biotechs certainly had something to do with it.

On the charts, the S&P remains at the 1,780-1,785 level. Watch 1,772 and 1,800 for support/resistance out of today's Fed meeting.

Market	Level	Change	% Change
Dow	15875.26	-9.31	-.88%
TSX	13180.16	-4.25	-.03%
Brazil	50090.35	-189.25	-.38%
FTSE	6499.39	13.20	.20%
Nikkei	15587.80	309.17	2.02%%
Hang Seng	23143.82	74.59	.32%
ASX	5096.10	-7.09	-.14%
Prices taken at previous day market close.			

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Bottom Line

All eyes are on the Fed, and it seems the wide consensus (say 70%ish) as we approach the meeting is for no tapering of QE, but for strong hints or pledges that the Fed will taper QE in January or March.

If that is the actual result, don't expect major moves in the markets. And, in that case, we can also expect that the desire to protect performance into year end will continue to be the dominant force on markets in the very short term (as it has been for the past few weeks). From a market standpoint, that likely means more of the same into year end—a market with little to no conviction in either direction, that will largely chop around this 1780-1785ish area, with probably some light pressure to the downside due to managers protecting profits. But, importantly, there would be no material change to the market dynamic (meaning beyond the very short term, the path of least resistance would remain higher, and we should be buyers of any decent dip into year end, if we get one).

Market	Level	Change	% Change
Gold	1230.00	-14.40	-1.16%
Silver	19.865	-.236	-1.17%
Copper	3.3685	-.0075	-0.22%
WTI	97.21	-.027	-0.28%
Brent	108.33	-1.08	-0.99%
Nat Gas	4.286	.007	0.16%
Corn	426.75	3.50	0.83%
Wheat	619.75	-2.00	-0.32%
Soybean	1346.50	8.75	0.65%
Prices taken at previous day market close.			

What Could Go Wrong in '14—A Thought Experiment

As I start to think about the outlook for 2014, my mind almost always wanders first to "what could go wrong in the financial markets this year?" Having been raised in this business as a trader, I learned early that avoiding disaster is the first step to making money. So, I've spent some time thinking about what could go "wrong" in 2014.

Maybe I'm just a product of my environment, but I entered this business in the dot-com bubble burst of the summer of 2000, started on the floor one year after 9/11, and after a few good years then ran smack into the financial crisis. So, despite my relative youth, I've seen a lot of mess over a relatively short time.

Now, in fairness, the macro-horizon is as "clear" as it has been for some time. Europe is no longer teetering on the brink of a breakup or massive sovereign default. The financial system and banks are well-capitalized and as healthy as at any time since the crisis. Even the U.S. government appears to be trying to behave, as we've got a budget for the next two years (and the debt ceiling won't be a drama in an election year—I don't care what the Republicans say now). So, all things considered, the horizon looks pretty clear.

But, as I look for places where something could go "wrong," I keep coming back to the bond market. I don't think there are many people who would argue that the bond market, in general, reached "bubble" territory (or at least a blow-off top of a 30+ year bull market) over the past few years.

There are multiple measures to imply this is the case, whether it's the amount of assets that have poured into the bond market, the amount of corporate issuance, or risk spreads compressing to historic lows, etc.

But, importantly, a declining bond market, by itself, doesn't mean a crisis. Bonds can go down like any other asset and not cause a crisis that infects other asset classes. But, what makes me nervous about a crisis emanating from the bond market is the fact that we have a market in a blow-off top that was largely manufactured by government policy (the Fed), combined with government-mandated structural changes to the industry that has drained liquidity and will likely have multiple unintended consequences. (I'm referring to Dodd-Frank.)

And, this sort of dangerous cocktail should sound familiar to people. The potential negative consequence of this, of course, is a stampede to the exit by investors, but no one to buy the dip—causing a liquidity crisis in the bond market, and specifically the corporate bond market (with ground zero potentially being the high-yield market). And, the potential set-up is for a liquidity crisis in the corporate bond market that infects all other asset classes (like subprime did to everything else).

Throw in the explosion of bond-related ETFs and the retail money that's flooded into them, and I can imagine a scenario where there is lots of selling of these ETFs and mutual funds. This in turn results in the bonds them-

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selves having to be sold, but there simply being "no bid" for the specific corporate bonds, which then breeds a liquidity crisis that begins to feed on itself.

This report isn't the venue for an in-depth analysis of the risks, but a client sent me an excellent report by McKinsey on this subject (I'm lucky to have a lot of smart people as subscribers), and the link is here. We got a warning shot on this in May/June of last year, and this is a concern that is starting to make the rounds among smart people.

I'm not a Pollyanna, but as I think of risks coming out of left field that could result in an end to this rally, this is the one that keeps popping up in my head. Again, this is a very, very low probability scenario, and one that likely won't ever come to fruition. But if we're looking for something that could go wrong next year, the pieces are in place.

Economics

Consumer Price Index

- CPI Y/Y rose 1.2% in Nov. vs. 0.9% in Oct.
- Y/Y Core CPI increase was unchanged from October at 1.7%.

Takeaway

Inflation remains soft according to the CPI report released yesterday. The headline number was unchanged (0.0%) after falling into negative territory last month (-0.1%). A weak energy component was offset by higher rent equivalent, leaving the month-over-month number unchanged.

But, because the "core CPI" statistic cuts out energy and food prices, we saw an uptick in the core reading (a hike in housing and airline fares accounted for the majority of the increase). Overall the report was largely status quo, as core CPI continues to track the 1.7% year-over-year increase, the same as last month.

Market	Level	Change	% Change
Dollar Index	80.185	-.041	-0.05%
EUR/USD	1.3767	.0007	0.05%
GBP/USD	1.6264	-.0032	-0.20%
USD/JPY	102.67	-.34	-0.33%
USD/CAD	1.0612	.0018	0.17%
AUD/USD	.8898	-.0049	-0.55%
USD/BRL	2.3196	-.008	-0.34%
10 Year Yield	2.839	-.0004	-.005%
30 Year Yield	3.872	0.00	0.0%

Prices taken at previous day market close.

The headline CPI year-over-year increase did jump to 1.2% from 0.9% in October (again reflecting the boost in rents and airfares). But inflation remains very low, even with the increase, and gives the Fed plenty of room to leave rates low for a long time. (So these readings give more validity to the Fed's ZIRP, zero interest rate pledge, which is a positive.)

Commodities

Movement in the commodity market yesterday was largely a combination of trading noise and speculative positioning ahead of the FOMC announcement today, specifically in the precious metals market. DBC, the benchmark commodity ETF, was down by 0.43%.

Natural gas was the notable outperformer yesterday, not so much for its move in percentage terms (up just 0.16%) but instead for the way it bounced off support again at the $4.20 level. Nat gas was down more than 2% yesterday morning, but as expected, buyers came in on the dip and futures were able to rally for the rest of the day, closing near the highs. The $4.20 level remains solid support and, although some consolidation is possible, the broader rally dating back to early November is expected to continue—with the target being a re-test of the 52-week highs.

The rest of the energy complex was little changed, generally traders looked ahead to the FOMC announcement this afternoon.

After "squeezing" higher on Monday, both gold and silver traded lower yesterday—down 1.16% and 1.17%, respectively. The sell-off yesterday following the rally on Monday again shows there was no conviction to the rally and that the moves are, for the most part, trading noise as the precious metals market waits for the FOMC announcement.

Technically speaking, loose support has formed at the $1,220/oz., although if the announcement today is "hawkish" look for gold to challenge the recent lows of $1210. And, baring anything

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shocking from the Fed today, I'd be a buyer on that dip towards $1210 for those who can stomach some volatility.

Currencies & Bonds

Tuesday was understandably a quiet day in the currency and bond markets ahead of the FOMC announcement later today. The Dollar Index was virtually unchanged as was the euro, as the looming specter of the FOMC decision outweighed another dose of better-than-expected data. (Yesterday it was the German ZEW Business Expectation Index, which beat expectations.)

Staying in Europe, the pound saw small declines as longs continued to book profits ahead of the Fed amid mixed data. UK CPI was a touch under expectations (2.1% year-over-year increase vs. 2.2%) but UK Industrial Trends was a beat.

Bottom line is the pound remains strong, and unless we hear something materially hawkish out of the Fed today, the pound is likely a buy at these levels. The UK economy continues to accelerate, and rhetoric aside, the Bank of England will eventually be forced to start to taper some of its QE programs as well.

Looking at Asia, the yen saw a mild bounce (up 0.30%), but there was no news and most of the rally was book-squaring ahead of the FOMC meeting. (The market is very short of yen, and whenever a market is this one-sided, you almost always get a bit of book-squaring ahead of a potentially volatile event like the Fed.) Regardless of the short-term reaction in the yen to the dollar, though, the larger trend remains down.

Finally, the Aussie dollar was the worst performer vs. the greenback yesterday, dropping 0.6% as the downtrend appears to have resumed once again—hitting a new five-month low and inching ever closer to the 52-week low at 0.8823. The trend in the "Aussie" is clearly lower, as the Reserve Bank of Australia has stated it wants a weaker currency to stimulate the economy, and they likely will get it.

Finally, turning to bonds: Much like the currency markets, book-squaring was the major influence on bonds, although the in-line CPI reading did remind everyone that, tapering aside, the Fed has plenty of room to remain "easy" as inflation is still very low.

Like the yen, the market is very "short" bonds at the moment, and heading into the Fed it's expected some investors would book profits and de-risk a bit, and that's exactly what happened.

As we head into the FOMC meeting today, watch 2.98% in the 10-year if the FOMC is "hawkish" and tapers. That's the high of the year, and if that level is broken, watch to see whether the drop in bonds becomes "disorderly." Remember, how the iShares 1-3 Year Treasury Bond ETF (SHY) trades will tell you whether this is a "good" rise in rates, or a "bad" rise in rates. As long as SHY holds steady in the event of a "hawkish" meeting, stocks can rally. It's a disorderly rise of interest rates that stock investors need to be wary of.

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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