7:00's Report

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

December 19th, 2013

Pre 7:00 Look

- Futures are flat this morning as the market digests yesterday's gains, although international markets were higher as they played catch up to yesterday's afternoon rally.
- Chinese markets were the outlier o/n as they declined 1% on a spike higher in short term interest rates.
- Economically it was a quiet night. Another reading of retail sales in the UK slightly missed estimates (0.3% increase vs. (E) 0.4%), but there is little reaction from the markets.
- Econ Today: Weekly Jobless Claims (E: 337K), Philadelphia Fed Survey (E: 10.0), Existing Home Sales (E: 5.02M).

Market	Level	Change	% Change
S&P 500 Futures	1803.50	-1.25	-.07%
U.S. Dollar (DXY)	80.64	.392	.49%
Gold	1207.20	-27.70	-2.24%
WTI	98.06	0.00	0.0%
10 Year	2.885	.042	1.48%

Equities

Market Recap

Stocks surged yesterday after the Federal Open Market Committee initiated a tapering of QE, but at the same time it pledged low interest rates for "longer" than previously expected and sounded decidedly upbeat on the economy. The S&P 500 rose 1.66%, its biggest daily gain in over two months, and is now just 3 points below its intraday all-time highs.

For all the focus on the Fed, though, it was actually "micro-economic" situations that dominated trading for most of the day yesterday. FedEx (FDX) earnings, Ford's (F) negative guidance, strong Housing Starts and good Lennar (LEN) earnings, CVS Caremark's (CVS) increase in Q1 guidance and the announcement of a $6 billion share buyback, and a Deutsche Bank (DB) downgrade of the semiconductors were just some of the macro data points that affected trading pre-FOMC.

Generally speaking, those "micro" data points were pretty positive. Overall guidance for 2014 this week from companies has been positive (with the exception of F), and even though FDX missed earnings, the macro commentary was pretty good. (The miss was more company-specific than indicative of slowing macroeconomic demand.)

But, as you know, the FOMC announcement at 2 p.m. and the outgoing chairman's press conference were the major catalysts of the day, and as my friend Eric said in a text yesterday, "Good news is finally good news; about damn time." The positive commentary on the economy and promise for longer ZIRP trumped the tapering of QE. And for the nth time this year, investors were caught being too cautious and buyers chased the rally into the close.

Trading Color

Stocks saw a broad rally post FOMC yesterday, as all S&P 500 subsectors traded higher. And, while the Fed decision did have an influence on the sector trading (we saw the now familiar out performance of the financials and banks on the expectation of higher rates, and the relatively underperformance of the "bond proxy" sectors), a lot of the moves yesterday were more "micro" influenced than you would think (as I mentioned earlier).

Healthcare was one of the best performers thanks in part to strong GILD numbers and the aforementioned

Market	Level	Change	% Change
Dow	16167.97	292.71	1.84%
TSX	13352.94	172.78	1.31%
Brazil	50563.43	473.08	0.94%
FTSE	6492.08	5.89	0.09%
Nikkei	15859.22	271.42	1.74%
Hang Seng	22888.75	-255.07	-1.10%
ASX	5202.23	106.13	2.08%

Prices taken at previous day market close.

CVS buyback. Home builders also rallied on good LEN numbers and strong housing starts, while autos dropped on the F guidance.

Volumes on the day were elevated, but the calendar is still impacting trading. There was an uptick in "real" money participation during the post Fed rally, but hedge funds and day traders were still driving trading.

On the charts, the S&P 500 is now smack up against its all time high (1813) while real support remains in the 1780-1785 region.

Market	Level	Change	% Change
Gold	1230.60	.50	0.04%
Silver	19.97	.13	0.66%
Copper	3.367	.00	0.00%
WTI	97.77	.55	0.57%
Brent	109.45	1.01	0.93%
Nat Gas	4.259	-.028	-0.65%
Corn	425.00	-1.75	-0.41%
Wheat	612.75	-7.00	-1.13%
Soybean	1324.00	-22.50	-1.67%
Prices taken at previous day market close.			

Bottom Line

On balance the Fed yesterday was a mild positive surprise as the strong forward guidance more than offset the small taper. But, while that is a positive, it doesn't mean any material positive change in the outlook for the Fed or market (point being, despite the rally, yesterday's FOMC announcement wasn't a bullish game-changer).

Year end positioning and sentiment continues to be an underappreciated influence on the markets, and I got the feeling that yesterday's rally into the close was more do to managers want wanting to maintain participation in the market than it was a hugely bullish vote of confidence.

Bottom line is taper is not a rally killer, as we've been saying, as long as the rise in rates is "orderly" and the market believes in ZIRP (and we'll know that by watching SHY). This morning bonds in general are flat, and as long as that ten year yield doesn't start spiking higher, the path of least resistance for stocks, beyond any year end positioning, will remain higher.

Economics

FOMC Meeting

- The FOMC "tapered" its QE program by $10 billion to $75 billion per month. The taper was split between $5 billion in mortgage-backed securities and $5 billion in U.S. Treasuries.
- The Fed also further strengthened its "forward guidance" by saying interest rates will stay near zero, well past a 6.5% unemployment rate.

Takeaway

In a feat of monetary sleight-of-hand, the FOMC managed to be "dovish" while tapering the QE program (at least in the very short term). The FOMC moderately surprised the market yesterday by tapering QE by $10 billion, but the key to the FOMC announcement (and the reason stocks rallied) wasn't the taper announcement. Instead, it was that the Fed simultaneously strengthened its forward guidance by stating:

"The Committee now anticipates, based on its assessment of these factors, that it likely will be appropriate to maintain the current target range for the Fed Funds rate well past the time that the unemployment rate declines below 6.5%, especially if projected inflation continues to run below the Committee's 2% longer-run goal."

That was the key phrase in the statement, and the reason markets rallied so strongly on the news. There are two key takeaways here:

- *First*, the market reaction yesterday confirms what we've been saying for some time—that tapering, by itself, isn't a rally-killer, and the market is a lot more comfortable with tapering of QE than the financial media lets on.
- *Second*, the Fed is continuing its "pivot" from QE as the main source of accommodation, to "ZIRP." By pledging ZIRP well past 6.5% in the unemployment rate, the Fed has strengthened its forward guidance. Clearly, based on the reaction from stocks, the market believes the Fed.

Going forward, based on the chairman's press conference and the FOMC statement, we can expect continued tapering of QE by $10 billion at each upcoming meeting, unless the we see a significant uptick or downtick in the pace of economic growth.

Additionally, we should expect equal tapering of Treasuries and mortgage-backed securities (this was a bit surprising because many, including me, would have thought the Fed would have only tapered Treasuries to help keep downward pressure on mortgage rates). Clearly the Fed feels more comfortable about the state of the housing market than it did in September. From a logistics standpoint, based on a taper of $10 billion per meeting, we should expect QE to end at the October or December 2014 FOMC meeting.

Bottom Line

As stated earlier, the market is a lot more comfortable with tapering of QE than the financial media would let on, as long as economic growth continues to accelerate and the market believes in the "ZIRP." And, with the beginning of the end of the QE program under way (and I'd be very happy if this is the last QE I see for the rest of my life), our focus now turns to just how effective "forward guidance" will be as an accommodative tool.

I remain skeptical of the "power" of forward guidance. As I've said before, we have a decent roadmap here, as the UK has turned to "forward guidance" and we've seen yields and the pound there rise as the economy has improved. The switch away from QE to forward guidance as a primary policy tool only furthers the bearish case for bonds. I expect the bond market to call the Fed's bluff, just like it is calling the Bank of England's bluff, should economic data continue to improve. Bottom line is this is equity-positive (as long as economic data continues to improve) and bond-negative (regardless of the data).

Commodities

Commodities were mixed yesterday after seeing wild swings following the FOMC announcement to taper QE. Our benchmark commodity ETF, DBC, gained 0.32% mostly thanks to a bid in the energy sector.

Nymex crude oil futures continued to trade on technicals as prices remain in a pretty tight range, with resistance hovering at last week's high of $98.75 while the first line of support sits on the 50-day moving average at $96.52. Again, we saw WTI futures sell off following the EIA report of a draw in crude supply but a build in gasoline stocks. This indicates that buyers see crude trading on the expensive side here, given expectations of slightly softer demand out of refineries. Crude stockpiles fell by 2.941M barrels, which was pretty close to analysts' estimates of a 2.7M barrel decline.

Turning to gold, its sharply lower this morning (down 2% to $1200/oz.), mostly in reaction to strength in the US Dollar. The rising dollar does present another headwind for gold, but at $1200/oz. I still think its worth a shot on the long side for those who can stomach some risk.

Yesterday the Fed was very focused on how low inflation is, and clearly they want to get inflation higher—and I learned a long time ago to "not fight the Fed." There are no signs of inflation on the horizon yet, so the near term outlook for gold is mixed at best. But, at $1200/oz., I think the risk/reward is worth a small position.

Currencies & Bonds

As you'd expect, bonds declined post Fed yesterday, with the 30 year and 10 year falling .4% each. But, all things considered, the declines were pretty timid and overall implies we aren't going to see a rout in the bond market (at least initially) because of Fed tapering.

More broadly, though, the case for the bond bears, of which I am one, got stronger yesterday over the medium term, as I firmly believe that the policy pivot by the Fed to forward guidance will eventually result in an acceleration in the decline in the bond market. So, if there is any sort of "buy the taper news" reaction in the bond market over the next few days, I would use it to add to positions in TBT and TBF, because bonds are still clearly in a downtrend.

Market	Level	Change	% Change
Dollar Index	80.48	.266	0.33%
EUR/USD	1.371	-.0056	-0.41%
GBP/USD	1.6389	.0128	0.79%
USD/JPY	103.81	1.15	1.12%
USD/CAD	1.0672	.0067	0.63%
AUD/USD	.8849	-.0043	-0.48%
USD/BRL	2.326	.0069	0.30%
10 Year Yield	2.885	.042	1.48%
30 Year Yield	3.913	.041	1.06%

Prices taken at previous day market close.

Turning to currencies, the downtrend in the Dollar Index likely ended yesterday for both fundamental and technical reasons, as the Fed has started its "policy pivot" from QE to forward guidance. The dollar saw a bullish "outside reversal" yesterday.

The dollar initially plunged to two-month lows immediately following the FOMC decision, but started a slow grind higher after the announcement, and the rally accelerated throughout Chairman Bernanke's press conference. While the policy action was neutral-to-"dovish," the chairman, at his press conference, seemed very resolved to the continuing of tapering of QE at subsequent meetings, and was also pretty upbeat about the U.S. economy. The dollar traded to nearly a two-week high by the end of the session.

Turning to Europe, it was basically the opposite of the dollar, falling 0.49% almost entirely because of the dollar strength. The one currency that was stronger vs. the dollar yesterday was the British pound, which saw a 0.8% rally vs. the greenback—and that's something that shouldn't be dismissed, because as I alluded to earlier, what's happening with the pound is foreshadowing what may happen here.

The pound rallied yesterday because the Labour Market Report was stronger than expected (the unemployment rate dropped to 7.4%). That drop in the unemployment rate came despite the minutes of the latest Bank of England policy meeting being relatively "dovish," as the BOE lamented the lack of productivity gains in the economy, and implied the better jobs numbers aren't as good as they appear.

The reason this is so timely is because basically since July, the market has called "B.S." on the Bank of England's "forward guidance," and it did so again yesterday. The market is trading off the economic data, and it correctly assumes that regardless of what the BOE says, as the economy accelerates, the BOE will eventually be forced to remove accommodation and begin to tighten—well before the time the are referencing in their "forward guidance." This is important because the very same thing could happen here down the road.

Shifting from the best performer vs. the dollar to the worst performer vs. the dollar, the yen plunged 1.1% yesterday, basically to new lows for the year. But, the yen weakness wasn't solely the result of the FOMC and stronger dollar. The yen was already weak pre-FOMC, after Bloomberg reported the BOJ, which has a interest rate meeting starting today, is likely to increase its QE program in Q1 2014 to help ensure it hits its 2% inflation target. That report, coupled with the FOMC statement and Bernanke press conference, put severe pressure on the yen. Support at the lows of the year has now been broken.

At this point there is no support for the yen, and with 104 yen to the dollar on the verge of being a given, I'd expect 105 to be challenged shortly thereafter. The next leg in the yen decline (ultimately toward 110/dollar) has begun. If you're short the yen, enjoy the ride and wait for a bounce to add more—and if you're not short, don't get short here. Despite the extreme weakness yesterday and new lows, there will be a bounce of some sort and that's the time to get short—not after the drop yesterday.

Turning back to the near-term direction of the dollar, the question now, of course, is "Do we get long dollars?" Well, first we are all generally long dollars (at least the U.S.-based clients). But, more to the point, I'm not sure that, just because the Dollar Index decline appears to have ended, a material uptrend has begun—and the reason I think that is the euro.

Remember, the euro makes up a huge portion of the Dollar Index. With the ECB seeming intransigent with regard to more-accommodative policy—and that by default being bullish for the euro—it'll be hard for the Dollar Index to mount a significant rally. Although, I think it's safe to say that we'll see an acceleration of the dollar vs. emerging-market currencies, the Loonie, Aussie and yen. Again the pound and euro, though, will depend on central-bank actions going forward.

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 traded back basically to their highs after the Fed tapered QE but also strengthened their forward guidance. Skeptical sentiment towards the market and a strengthening economy remain tailwinds on the market, and as long as the short end of the yield curve remains anchored, the path of least resistance remains higher.* *Resistance sits at the old all time highs (1813) while support remain 1780-1785.*

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	*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.**

Long Gold: **I'm dipping back into the well here with the gold trade. The near term outlook is mixed to negative, but medium term I think $1200 represents a fair risk/reward set up on an acceleration of inflation. I would initiate a small long position around the 1200 level.**

U.S. Dollar	Neutral	Neutral	Neutral	*The Dollar Index traded an outside reversal following the Fed decision to taper, and the multi-month downtrend in the Dollar Index is likely over.*

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	*With the Fed tapering QE and shift to "forward guidance" as the main policy tool, the case for the bond bears has gotten stronger. Continue to short any rallies in the bond*

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.**