7:00's Report

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

December 20th, 2013

Pre 7:00 Look

- Futures and most international markets are flat this morning after a quiet night.
- Economically, UK GDP was unchanged for Q3, while Italian retail sales slightly missed expectations. Neither number is moving markets this morning.
- The Bank of Japan made no changes to policy at its interest rate meeting o/n, as expected. The yen traded to new yearly lows, though, as expectations for more stimulus from the BOJ early next year are rising.
- Econ Today: Final Q3 GDP (E: 3.6%).

Market	Level	Change	% Change
S&P 500 Futures	1804.75	2.50	.14%
U.S. Dollar (DXY)	80.845	.057	.07%
Gold	1194.90	1.30	.11%
WTI	98.75	-.29	-.29%
10 Year	2.925	.040	1.39%

Equities

Stocks were virtually unchanged Thursday as markets rebounded from early losses and continued to digest the FOMC "taper" decision. The S&P 500 declined 0.06%.

Equities opened yesterday basically at their lows, down close to 0.5%, and spent much of the morning session in negative territory thanks to two main factors: soft economic data and a stronger 10-year bond yield.

Yesterday's economic data was, compared to expectations, a clean sweep of misses as jobless claims, the Philly Fed and existing home sales all missed estimates. That, combined with the fact that the 10-year yield opened yesterday solidly above 2.90%, weighed on stocks throughout the morning.

But, there remains zero conviction to this market on the upside or downside, again mainly because of the calendar. Sellers didn't really press despite the early weakness in stocks and although markets spent the entire morning yesterday in the red and there were no positive catalysts to speak of, stocks started a slow grind out of negative territory in the late morning and rallied into the early afternoon, hitting their highs around 2 p.m. From there, the indices basically treaded water into the close to finish the day almost perfectly flat.

Trading Color

As to be expected, the markets were quiet yesterday from an activity and volume standpoint, and once again intra-day trading was driven by day trading firms and algos. It seems the larger mutual and hedge funds have largely called it a year, and I don't expect to see much activity from them until January.

From a market internals standpoint, most S&P 500 sub-sectors declined, with industrials, basic materials and energy the only sub-sectors to finish in the green. From a trend standpoint, clearly there was an acceleration of selling in the "bond proxy" stocks as REITS and utilities were the definitive laggards (both down around 1%). Homebuilders also got hit on the soft pending home sales data and higher rates. It wasn't a true "higher interest rate" rotation in the market yesterday, though, as banks also lagged, dropping .5%.

With the exception of the selling of the bond proxy stocks, most of the other sector trading felt much like random trading noise and year end book squaring.

Looking at the charts, the situation remains largely the

Market	Level	Change	% Change
Dow	16179.08	11.11	0.07%
TSX	13391.28	56.55	0.42%
Brazil	51633.43	1070.00	2.12%
FTSE	6584.70	92.62	1.43%
Nikkei	15870.42	11.20	.07%
Hang Seng	22812.18	-76.57	-.33%
ASX	5265.22	62.99	1.21%

Prices taken at previous day market close.

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same for the S&P 500: Resistance at 1813 (the intra-day highs) and support at 1780-1785ish.

Bottom Line

With Fed tapering now in gear, our focus needs to turn back to "taper-sensitive" assets as leading indicators for risk assets, because stocks can only rally further if the rise in interest rates isn't inflicting damage on other assets and the economic data continues to improve. Remember, tapering is only "ok" as long as the economy is getting better and the rise in interest rats is "orderly."

So, we all need to start watching: 1) The 10-year yield (and the 2.98% level, which is the high for the year), 2) Emerging market currencies and bonds, and 3) The yield curve (is it steepening or flattening?). Those will be the "tells" that will let us know if the tapering of QE, and the rise in interest rates, is starting to become a negative, because we will see stress in those indicators first.

In that context, yesterday's rally was kind of impressive, seeing as the yield curve flattened, the 10-year was in the mid-2.90%s and economic data was soft.

But, before we get too impressed, it's important to remember that the dominant factor in the market is preservation of year to date gains, now that there are just seven trading sessions left in the year. And, although it looks like the year is "over" for all intents and purposes from a news perspective, managers remain skittish, and no one wants to see the market deviate from its current level (so everyone is just hanging on). That's why we can't get any serious momentum to the upside (no one wants to add exposure) or downside (no one wants to sell anything and risk making the declines worse). And, that pattern likely will last until Jan. 2.

More broadly, the bond market is once again key. As long as overall sentiment toward the equity rally remains skeptical, economic data stays good and those bond indicators I referenced earlier "behave," then stocks can and likely will rally further in the medium term.

Market	Level	Change	% Change
Gold	1188.30	-46.70	-3.79%
Silver	19.205	-0.854	-4.26%
Copper	3.296	-.023	-0.69%
WTI	98.77	.97	0.99%
Brent	110.03	.40	0.36%
Nat Gas	4.438	.187	4.40%
Corn	430.50	5.50	1.29%
Wheat	610.75	-2.00	-0.33%
Soybean	1319.00	5.25	0.40%
Prices taken at previous day market close.			

Economics

Weekly Jobless Claims

- Initial Claims jumped to 379K vs (E) 337K
- 4-week moving average rose by 13.25K to 342.25K

Takeaway

Initial jobless claims jumped to their highest level since March, gaining 10K to 379K from last week's revised number of 369K. The four-week moving average also moved higher, increasing by 13.25K to 342.25K.

While a bit of an eye-popper of a number, the rise in claims is largely being dismissed as being "skewed" from the holiday season and the very late Thanksgiving. For instance, over the past three weeks we've seen multi-month lows in claims (300K) and multi-month highs (379K).

Bottom line is the four-week moving average is still at about the same levels it was in mid-November (340K-ish), which implies we should continue to see monthly job adds in the high-190K to low-200K areas, as we've been seeing for the past few months, which is good. But, we're not seeing incremental improvement in the labor market.

Philly Fed

- December Philly Fed Manufacturing Index was 7.00 vs. (E) 10.00.

Takeaway

Philly Fed mirrored both the "Flash" Manufacturing PMI and the Empire State Manufacturing Index, both released earlier this week, showing that manufacturing activity slowed a bit in December. But also like those other two indices, the Philly Fed data remain positive, showing that expansion in the manufacturing sector is ongoing, just at a slower pace.

Additionally, the details of Philly Fed were better than the headline. Specifically, new orders rose to 15.4 from 11.8 in November, implying activity should pick up over

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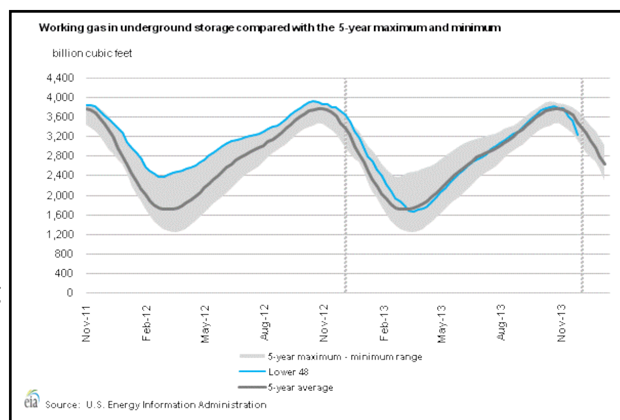
the coming months.

Existing Home Sales

- Existing Home Sales were 4.9 million (saar) vs. (E) 5.02 million (saar).

Takeaway

Not surprisingly, existing home sales for November dropped by 4.3% from October, again showing that higher interest rates are a headwind on the housing market. I say not surprisingly because pending home sales in September and October declined, and pending home sales usually lead existing home sales by 2-3 months (existing home sales are counted when contracts are signed). Somewhat disconcertingly, the annual pace of existing home sales turned negative year-over-year for the first time in 2013.



But, it's important to note that part of the reason for the dip in sales is because inventory is still extremely low, at just 5.1 months' supply. So, lack of inventory is negatively affecting sales.

On a positive note, pricing remains good, with the median home price up 9.4% from one year ago—and that, more so than the pace of sales, is the important statistic. That's because consumers not being "underwater" on their homes is important to both the local and national economy.

Bottom line is we know the housing recovery has slowed, but the critical issue is whether the recovery continues (even at a slower pace), and it appears that it is doing exactly that.

Commodities

Commodities were mixed yesterday, although natural gas was by far the best performer, rallying more than 4% to a new high for the year after the weekly inventory data showed the **largest weekly draw on natural gas—ever, at 285 Bcf (estimates were for 253 Bcf).**

You don't have to be an energy trader to know that's bullish, and natural gas levels are now roughly 7% below the five-year average, and I honestly can't remember the last time natural gas inventories were that far below the five-year average.

Natural gas remains weather-dominated in the very short term, but as we pointed out over two weeks ago, the term structure in natural gas has turned bullish, which implies we're seeing structural (and longer-term) demand coming into the market. Although we saw a big jump in natural gas itself, I prefer to acquire the natural gas equities (via FCG or XOP) for two reasons.

First, trading natural gas, unless you own physical assets or are on the floor, is merely a classy form of gambling, because the volatility is extreme. Second, with demand turning structurally bullish, the equities offer some value (they've underperformed this year) and upside leverage on rising natural gas prices. Natural gas E&Ps continue to be one of the areas of the market where I think we could see significant outperformance in 2014.

Going from the best performer in the commodity space to the worst, precious metals got killed yesterday on U.S. dollar strength, and both gold broke down through $1,200/oz. to a multi-month low.

Market	Level	Change	% Change
Dollar Index	80.775	.527	0.66%
EUR/USD	1.3662	-.0021	-0.15%
GBP/USD	1.6377	-.0014	-0.09%
USD/JPY	104.21	-.05	-0.05%
USD/CAD	1.066	-.004	-0.37%
AUD/USD	.8861	.0001	0.01%
USD/BRL	2.353	.027	1.16%
10 Year Yield	2.925	.040	1.39%
30 Year Yield	3.901	-.012	-0.31%
Prices taken at previous day market close.			

As I said yesterday, the short-term outlook for gold is, at best, mixed (and really it's negative). But, I continue to think buying gold at $1,200/oz.—in the context of a (hopefully) accelerating economy with interest rates stuck at zero for some time—should eventually lead to inflation, and if that's the case then we are buying some value in gold here. A break of the lows for the

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year at $1,179/oz. tells me I'm wrong, so we're risking $20/oz. for easily $100 or so on the upside. That, to me, is worth a bit of risk capital.

Elsewhere in commodities, WTI crude rallied through $99 per barrel before closing slightly lower. WTI was largely dragged higher by RBOB gasoline, which rallied 1.77% on a continuation from yesterday's move higher. A move to $100/bbl In WTI wouldn't surprise me, although oil is trading much more like a typical commodity (meaning supply/demand forces are moving it day by day) than a macro-indicator. But, if we are in an expanding economy, then regardless of shale production, $99/bbl WTI is cheap over the medium term.

Currencies & Bonds

The strength in the dollar that began Wednesday following the FOMC meeting carried over to Thursday, as the Dollar Index rose by 0.7% and was universally stronger against its major trading partners.

The euro, yen, pound, Loonie and "Aussie" were all lower vs. the dollar, thanks exclusively to dollar strength (nothing currency-negative happened in any of those countries Thursday). The euro and yen were the laggards vs. the dollar yesterday, dropping 0.7% each.

The weakness in most developed-market currencies vs. the dollar yesterday is mostly a factor of short-term positioning (tapering of QE caught the currency market slightly off-guard, so we're seeing shorts cover in the dollar) and can largely be dismissed. However, one thing we do need to keep an eye on is weakness in emerging-market currencies.

We all remember earlier this summer (in June and August) when weakness in emerging-market currencies and bonds unnerved markets, as money poured out of those regions and back into the U.S.—raising fears of another emerging-market debt crisis (in a flashback to the late-1990s).

Yesterday emerging-market currencies were weaker vs. the dollar, but not horribly so. The Mexican peso, Brazilian real, Indian rupee, South African rand and others were certainly down vs. the dollar yesterday, but they weren't in freefall. Similar to bonds, emerging-market currencies can decline without spurring a crisis, as long as the decline is orderly. So, once again it's time to monitor ICN (Indian Rupee Fund), CEW (Emerging Market Currency Fund), and EMB and PCY (Emerging Bond Funds). If tapering of QE is going to have adverse effects on the global economy, signs of trouble will show up in the emerging markets (and those ETFs) first.

Looking at the bond market, long dated Treasuries were relatively well-behaved Thursday morning, as the 30-year Treasury note was little-changed on the day (down just 0.1%). The 10-year Treasury, however, traded down 0.5% and hit a multi-month low, as the yield traded solidly into the 2.90% range.

As far as why the 10-year traded so poorly, likely we were seeing a rotation out of the belly and into the short end of the curve.

Fundamentally, there was a 7-year Treasury auction yesterday that saw lackluster demand. The bid to cover (a measure of demand) was the third-lowest of the year despite the yield on the debt hitting a high for the year. The actual yield was 2 full basis points above the "When Issued" yield (again signaling weak demand).

With regard to the auctions, the ultra-bond-bears keep waiting for a horrible Treasury auction, but that likely won't happen, regardless of how bad the bond-market decline gets. U.S. Treasuries are perceived to be the "safest" securities in the world, and there will always be demand for them (we hope). But, this doesn't mean demand can't drop much, much lower than we are used to seeing over time. Overall, the trend of less-enthusiastic auctions just further confirms that we are entering a period of lower bond prices and higher yields—and that's a trend that likely will last a long time.

Have a great weekend,

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 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.**

	Fundamental Outlook	Technical Outlook	Overall	Comments
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.**

	Fundamental Outlook	Technical Outlook	Overall	Comments
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.**

	Fundamental Outlook	Technical Outlook	Overall	Comments
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.**

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