7:00's Report

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

December 23rd, 2013

Pre 7:00 Look

- Futures and most international markets are moderately higher, as markets further digest last week's FOMC decision and Friday's strong GDP report.
- Economically there was no data o/n, although the IMF did upgrade the growth outlook for the US to 2.6% in 2014.
- Chinese liquidity concerns continue to get headlines (7 day repo rate rose again on Monday), but that is mostly due to year end funding concerns and should be temporary.
- Econ Today: Personal Income and Outlays (E: 1.5%), Core PCE Price Index (E: 0.1%).

Market	Level	Change	% Change
S&P 500 Futures	1822.50	8.00	.44%
U.S. Dollar (DXY)	80.62	-.13	-.16%
Gold	1194.60	-9.10	-.75%
WTI	98.91	-.41	-.40%
10 Year	2.887	-.038	-1.30%

Equities

Market Recap

Stocks surged to new all-time highs last week as the Fed's intent to start tapering QE next month was viewed as a positive reflection on the economy. Bonds and emerging markets relatively behaved in the wake of the taper (both bonds and emerging markets traded lower, but not materially so). The S&P 500 is now up 27.5% year-to-date.

Stocks spent the early part of last week treading water ahead of the Fed in the 1,780-1,785 support zone, but then exploded higher post-FOMC on Wednesday to close up more than 2% on the day and just below the all-time highs. Markets digested the previous day's gains Thursday, before grinding to new highs Friday thanks to the good Q3 GDP data. Stocks went out last week just off the high ticks (the new intraday high in the S&P is 1,823).

Looking at the market internals, there was definite "macro" outperformance from a sector-trading standpoint last week. Banks saw a nice move higher on Wednesday and Friday off Fed tapering (as expected), while "bond proxy" and safety sectors all relatively underperformed. (All S&P 500 subsectors rose on the week yet utilities, consumer staples, and REITs relatively lagged the broader market.)

Of all the discernible trends in the market, the "higher rates" trade of bank/financial outperformance and "bond proxy" underperformance remains the strongest trend in sector trading right now. And, despite the fact that it's been going on since May, there's still a lot of room for it to run.

Looking at the micro-economic landscape, industrials were higher last week thanks to several large names issuing good 2014 guidance or upping their capital return programs (i.e., increasing their stock buybacks). GE, BA, MMM and HON all issued positive 2014 outlooks last week. The broader market largely ignored this data, however, as it was Fed-obsessed. But, these outlooks were a positive worth noting.

Homebuilders also traded well last week despite the uptick in rates, as good LEN earnings and strong New Home Sales data helped. Homebuilders remain an indicator of the market's "tolerance" for higher interest rates. So far, with the 10-year yield at 2.90%, the market isn't

Market	Level	Change	% Change
Dow	16221.14	42.06	0.26%
TSX	13399.60	7.40	0.06%
Brazil	51185.74	-447.69	-0.87%
FTSE	6642.44	35.86	.54%
Nikkei	15870.42	11.20	.07%
Hang Seng	22921.56	109.38	.48%
ASX	5291.95	26.73	.51%
Prices taken at previous day market close.			

viewing the absolute level of rates as a detriment. (And part of the reason we know that is because homebuilders are close to recent highs.) But, if the market does start to get worried about the absolute level of rates, homebuilders will start to decline first—so they are worth monitoring.

Market	Level	Change	% Change
Gold	1203.70	10.10	0.85%
Silver	19.453	.267	1.39%
Copper	3.308	.0125	0.38%
WTI	99.32	.28	0.28%
Brent	111.84	.00	0.00%
Nat Gas	4.418	-.042	-0.94%
Corn	433.25	2.75	0.64%
Wheat	613.50	2.75	0.45%
Soybean	1331.00	12.00	0.91%
Prices taken at previous day market close.			

From an activity standpoint, volumes and participation remain slow, despite the rally. Friday was a big-volume day, but that was more because of the "quad witch," and intraday trading remains dominated by hedge funds and algos. Real money is not chasing the market up here given the calendar.

On the charts the S&P 500 has surged to new highs, and the first rule of trading is you don't sell things when they're marking new highs. First support sits at 1,813 (the old highs).

Bottom Line

Last week the market welcomed and embraced Fed tapering of QE, but despite that and new highs in most major averages, the search is once again "on" for the next calamity that will end the rally. Over the weekend I read about some potential candidates:

"Negative corporate pre-announcements are at all-time highs." "The ECB banking union is a Frankenstein and too complex." "Tapering will kill the stock market rally."

I'm not saying that there aren't risks out there, and each of those headlines needs to be watched. But the reality is the macroeconomic horizon is as clear as it's been in 5+ years (no financial crisis, no banking crisis, no Washington crisis, no European crisis). While stock valuations aren't cheap (the S&P 500 is currently at 15.5X 2014 EPS of $120), the total lack of agreement with this rally (and relentless skepticism toward it) still makes the pain trade higher for stocks.

From a risk standpoint, I think the biggest risk we all need to watch during the coming months is whether or not the market continues to believe the Fed's "ZIRP" (Zero Interest Rate Pledge), and if "Forward Guidance" works as a policy tool. Tapering of QE was welcomed because the market does believe the Fed's "Forward Guidance" on rates, specifically that they will be low well into 2015. But, if that starts to change because of better economic data, as is happening in the UK, that could become a headwind in 2014 for stocks. And, that's why we need to continue to watch SHY and the shape of the yield curve (the steeper, the better).

For now, though, the path of least resistance remains higher. While once again stocks are a bit stretched in the short term and we could see some volatility to start the new year, I'd be a buyer of cyclicals on any dip, as long as the three conditions mentioned earlier hold.

Long Japan via DXJ and short Treasuries remain the two strongest trends in the market, and despite big moves already, both have more room to run. And, I continue to look to companies exposed to the "global reflation" trade as the contrarian investment in the market right now, and would accumulate/buy on dips the global industrial miners, shippers and Australia (EWA).

Economics

Last Week

The FOMC decision to taper QE was the big news from an economic perspective, but beyond that, there were a few other notable takeaways that are important in light of the new trajectory of Fed policy.

Specifically, we learned last week that the economy in Q3 was stronger than we thought, that the manufacturing sector in December is a little slower than we thought and that the housing recovery is still ongoing, but concerns about a loss of momentum in the face of rising rates remain.

Starting first with the Fed, though, you all know by now the Fed announced it would "taper" its QE program by $10 billion a month (from $85 billion to $75 billion) starting in January. In a feat of monetary policy wizardry, though, the FOMC managed to taper QE yet come off somewhat “dovish.” They strengthened their “forward guidance” for keeping interest rates at 0%, saying the would keep rates at 0% well past 6.5% in the unemployment rate (thereby effectively raising the bar for when rates would start to rise). Overall the market welcomed the news, and stocks saw a big post-FOMC rally Wednesday afternoon. And bonds, while they did decline, largely “behaved.” It was the best-possible outcome for the Fed and for stocks.

Turning to the real economy, the other big surprise of the week came on Friday, when Q3 GDP was revised sharply higher from 3.6% to 4.1% (it was the first “4” print on GDP since ‘11).

As I’ve been saying, inventories are skewing the number higher (and did so again on the final revision), but there was also some evidence the “real” economy was stronger than initially thought: Final Sales of Domestic Product (which is GDP less inventories) was revised to 2.5% from 1.9%, and Personal Consumption Expenditures (which is consumer spending) were revised slightly higher to 2.0%. It’s likely that the big inventory builds that made Q3 GDP so strong will negatively affect Q4 GDP (now that manufacturers have tons of inventory, there’s no need to buy more), but it’s fair to say the economy was stronger than it looked in the third quarter.

But, just as we learned Q3 growth was better than expected, we also saw pretty consistent data that showed manufacturing-sector activity cooled a bit. The December “Flash” Manufacturing PMI, Empire State Manufacturing Index and Philly Fed Manufacturing Index all missed expectations this week, although each also remained in “positive” territory. This shows the manufacturing sector continues to grow, just a slower pace than expected (and slower compared to November).

The misses aren’t enough to cause concern regarding the economy, but now that the Fed is tapering QE, economic data will be scrutinized more closely, and any sign of real economic weakness (which this wasn’t) will weigh on stocks.

Finally, housing remains a mixed bag. Last week, housing starts handily beat estimates, but existing home sales missed, and the pace of existing home sales turned negative on a year-over-year basis. But, before we get too nervous about housing, low inventories are partially to blame for the existing home sales miss, and importantly pricing remains strong (up nearly 10% over last year). Bottom line is the housing recovery is ongoing, but clearly rising rates are a risk, and we’ll just have to keep watching.

In sum, I think that the No. 1 takeaway from last week was the validation by the market of something I’ve been saying for months now: that “good” economic data is once again “good” for the market. And by the same token, “bad” is “bad.” It’s been a long time since that was definitively clear, but it is once again, and that’s a positive for the markets and the economy.

This Week

Predictably, this is going to be a very slow week from an economic standpoint. The only material releases domestically are Personal Income and Outlays this morning, Durable Goods and New Home Sales Tuesday and Jobless Claims Thursday. And, barring a total disaster in any of these reports, expect them to have little effect on trading.

Internationally it’s also very quiet, as there is no material data this week out of Europe. In Japan there are several releases Thursday/Friday. But the bottom line is unless there’s a major positive surprise, none of the releases—whether they are “beats” or “misses”—will alter the current expectation of more stimulus from the Bank of Japan in early ‘14 (and none of the data will derail the bearish yen/bullish DXJ investment thesis).

Market	Level	Change	% Change
Dollar Index	80.745	-.043	-0.05%
EUR/USD	1.3672	.0001	0.01%
GBP/USD	1.6332	-.0001	-0.01%
USD/JPY	104.00	-0.07	-0.07%
USD/CAD	1.0637	.0003	0.03%
AUD/USD	.8922	.0001	0.01%
USD/BRL	2.3874	.00	0.00%
10 Year Yield	2.887	-.038	-1.30%
30 Year Yield	3.824	-.077	-1.97%

Prices taken at previous day market close.

Commodities

The FOMC announcement was the dominant influence in the commodity markets last week, just as it was every other market. The Fed's decision to taper QE sent precious metals through the floor and pushed industrial commodities higher, as the decision was taken as positive commentary on the economy, while inflation remains largely non-existent. The benchmark commodity tracking ETF, DBC, rallied 0.8% last week thanks to continued strength in the energy sector.

The energy sector was universally higher last week, with natural gas logging its seventh weekly gain in a row and hitting a new 52-week high, while RBOB gasoline had its largest one-week rally since the first week of July. Natural gas and RBOB gasoline were up 3.2% and 5.7%, respectively.

The big catalyst for natural gas last week was the EIA inventory report, which showed the largest draw in stockpiles ever recorded at -285 Bcf. The large draw now puts inventories well below the 5 year average. Natural gas remains a weather-dominated commodity in the very near term; however, the term structure of natural gas remains bullish, and that indicated growing structural demand, which is longer term bullish. As I have been mentioning for the past few weeks, I think opportunities lie in the natural gas ETFs FCG and XOP, as they have largely underperformed this year, but will benefit if we do see a structural increase in demand, as the futures curve is suggesting.

Crude oil rallied all five sessions last week, posting a weekly gain of 2.6% due to a variety of bullish indications. First, the EIA reported that U.S. stockpiles fell by 2.9M barrels last week, the third weekly draw in supply levels in a row. Second, the Fed's decision to taper QE this month suggested that our economy is strengthening. WTI crude hit resistance at the $100/bbl level last week, and we could see some further consolidation over last few weeks of '13/first few weeks of '14, but if the economy is really starting to pick up, $100 WTI Crude is cheap, relatively speaking.

The underperformers last week were both gold and silver futures, which saw respective declines of 2.8% and 1.3% in response to the dollar rally post FOMC decision. The near term outlook for gold is not good, if the economy is starting to grow then there will be inflation, and in that context I continue to view the "long gold" trade around the $1,200 area as a decent risk/reward play. A break of the 52 week lows ($1179) is my stop.

Currencies & Bonds

The story in the currency markets last week was the Dollar Index, which rallied to a two week high and looks to have broken a downtrend in place since early July. The catalyst for the Dollar strength was obviously the FOMC. The key takeaway from last week was that the era of Dollar weakness is likely over. And, while it may not mean a relentless rally in the Dollar Index because of a strong euro, the time to be short the greenback appears to have passed.

Elsewhere in the currency space it was a relatively quiet week. The euro and pound were little changed despite several pieces of good economic data (most currencies traded off the dollar last week, not off fundamentals). In Asia, the trend of currency weakness accelerated, as the yen broke to new lows for the year, trading above 104 yen/dollar, thanks to dollar strength. There was a BOJ rate meeting last Friday, but nothing material changed.

This week should be quiet in the currency markets given the holidays, so expect some drifting and consolidation amongst major currencies.

The bond market declined last week, but not as much as you'd think given Fed tapering (telling us it was already priced in). Bonds will remain under pressure, but it's almost as important to watch the shape of the yield curve now, as it is the absolute movements in bonds. A "flattening" yield curve, where the yields on the 2, 10 and 30 year Treasuries move closer together, is a negative for stocks, as it implies the market is beginning to doubt "forward guidance." That happened slightly last week, but its currently being attributed to position squaring after the FOMC decision. If the yield curve continues to flatten, though, that will be a warning sign for stocks. That aside, with Fed tapering underway, the decline in bond will accelerate over time, and any dip in TBT/TBF should be bought.

Have a good week—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 to new highs last week after the FOMC began tapering QE and 3Q GDP was stronger than expected. 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.* *Stocks are at all time highs, while first support site at 1813 in the S&P 500.*

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 104 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 with a stop at the old lows ($1179).**

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.**