7:00's Report

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

December 30th, 2013

Pre 7:00 Look

- Futures are flat this morning, as are most international markets following a predictably uneventful weekend.
- The euro is extending Friday's rally after ECB President Mario Draghi was quoted over the weekend saying there was no need for further rate cuts at the moment.
- Troubled Italian bank Monte dei Paschi pulled a rights offering, raising concerns it'll ultimately have to be bailed out by the Italian government. Italian markets are taking the news relatively in stride, though and are off small.
- Econ Today: Pending Home Sales (E: 1.5% m/m).

Market	Level	Change	% Change
S&P 500 Futures	1383.25	1.75	.10%
U.S. Dollar (DXY)	80.41	-.128	-.16%
Gold	1203.40	-10.80	-.89%
WTI	100.27	-.05	-.05%
10 Year	3.006	.016	0.54%

Equities

Market Recap

Stocks grinded to new highs again last week in low-volume holiday trading as risk assets ignored the move higher in interest rates. The S&P 500 is up 29.11% year-to-date.

Stocks rallied three out of four days last week (the market closed very slightly negative Friday) despite the lack of any real positive catalysts. There was good economic data Monday and Tuesday, but that was about the only "news" to speak of last week, and neither release was material enough to spark a broad rally.

Given the low trading volumes, various market closures and calendar, stocks moved higher last week mostly because of a total lack of any supply of stock for sale. This lack of stock for sale helped the market rally almost by default, as low-volume buying trumped lower-volume selling.

Stocks closed out the week during a very, very quiet session Friday just off the all-time highs (1,840 in the S&P 500).

Trading Color

All major indices made new 52-week highs last week, so there was broad strength despite the low volumes. From an internals standpoint, there isn't a lot to read into given the holiday trading, although the main takeaway was the continuation of the rotation into cyclical sectors and out of the "bond proxy" and safety sectors. Materials, industrials, tech, homebuilders and banks outperformed the market, while utilities, REITs and consumer staples continued to not just relatively underperform, but outright decline several days last week.

Looking a bit more into the "micro-economic," homebuilders traded very well last week thanks to the strong New Home Sales data, and are now one of, if not the, best-performing market sub-sectors in December.

Several weeks ago I pointed out that the homebuilders would act as the "canary in the coalmine" with regard to higher rates, as homebuilders will likely be the first sector to break down if/when the absolute level of rates becomes a headwind. Clearly by the reaction of the homebuilders over the past few weeks, rising rates aren't a major headwind on risk assets, yet.

The retail sector had a mixed week, after the space

Market	Level	Change	% Change
Dow	16,478.41	-1.47	-0.01%
TSX	13,587.98	69.96	0.52%
Brazil	51,266.56	45.55	0.09%
FTSE	6732.77	-18.10	-.26%
Nikkei	16291.31	112.37	2.65%
Hang Seng	23244.87	1.63	.01%
ASX	5356.80	32.74	.61%
Prices taken at previous day market close.			

caught a bid early in the week after UPS and FDX reported overwhelming volumes of shipments ahead of the Christmas holiday. That news was viewed as a positive contradiction of the belief that the holiday shopping season was "poor." Retail sold off a bit on Friday, however, after both ComScore and MasterCard SpendingPulse reported just "OK" holiday shopping data.

Market	Level	Change	% Change
Gold	1214.00	1.70	0.14%
Silver	20.049	.133	0.67%
Copper	3.385	-.0135	-0.40%
WTI	100.32	.77	0.77%
Brent	112.11	.13	0.12%
Nat Gas	4.368	-.108	-2.14%
Corn	427.50	1.25	0.29%
Wheat	609.00	3.00	0.50%
Soybean	1313.75	8.50	0.65%
Prices taken at previous day market close.			

Next up for the retail space will be the same-store sales releases Jan. 9 and the TIF holiday sales recap on the 10th.

Finally, tech was volatile last week. AAPL and FB led the space higher early in the week on news of a China Mobile (CHL) deal and FB's good mobile usage numbers. But, Friday TWTR plunged 12% after a Macquarie downgrade and a negative WSJ article. That, in turn, dragged down most of the Internet/social media space, which pulled the Nasdaq down 0.25% Friday.

On the charts the S&P continues to make new and higher highs. Initial support keeps being dragged upward, and now sits at 1,828 (the 20-day moving average).

Bottom Line

Last week and this week are basically devoid of any material data or releases, so unless something totally comes out of left field, nothing is going to change the current market narrative.

Stocks are now pretty stretched in the short term and obviously this march higher can't continue unabated, but the pieces remain in place for the path of least resistance in stocks to go higher: A clear macro-economic horizon, Still-lingering skepticism toward and lack of "agreement" with the rally, Improving economic data, and Lack of over-valuation (the market isn't cheap at 15.3X 2014 EPS, but also not at warning levels, yet).

In the meantime, the biggest risk to the rally—that growth will accelerate too fast and the Fed's "forward guidance" will be called into question (as is happening in the UK)—remains, at earliest, several months away.

A "dis-orderly" rise in interest rates remains the biggest near-term risk to this rally. But so far emerging-market bonds and currencies are holding up "OK," the yield curve is steepening, and the pace of rate increases isn't accelerating too much.

From an exposure standpoint, I wouldn't be adding generic long equity exposure at these levels as the market is short term overbought, although I would continue to re-weight into more-cyclical sectors (and focus on banks in particular, because they have a lot more upside if the current market dynamic holds).

Favorite destinations for new money remain DXJ (the "long Japanese stocks" opportunity is far from over), TBT/TBF (the declining bond market is the most-powerful trend in markets right now) and sectors exposed to the "global recovery"—namely, global industrial miners, shippers, Australia and basic materials, as I think those sectors remain among the few places of relative value in the market right now, assuming I'm right about the global recovery.

Economics

Last Week

It was a slow week economically given the Christmas holiday, but the data that was released was positive and supportive of the growing view that we are seeing economic growth starting to accelerate.

Last week's highlight was the Durable Goods report, which not only was a headline beat, but New Orders for Non-Defense Capital Goods Ex-Aircraft also saw a strong uptick, rising by 4.5% in November. That's important because it implies business spending and investment may be starting to expand again after basically treading water since May. If that is indeed the case, then it's an unexpected positive for the economy.

Housing data was also surprisingly strong, as New Home Sales showed a huge positive revision in October (the November data was down slightly month-over-month, but that's only because of the huge October revision). While it certainly doesn't settle the debate about just how much of a headwind higher interest rates will be on housing (remember October was when we saw the dip in interest rates, so perhaps that pulled more buying forward). Point being, the New Home Sales data was a nice surprise last week, but it's December now, and the housing market will remain a sector to watch in the face of increasing rates.

On the consumer front, November spending—which was contained in the Personal Income and Outlays Report released last Monday—beat expectations, confirming recent strength in the monthly retail sales reports. Also in the Personal Income and Outlays Report was the "Core PCE Price Index" for November, which was unchanged from October. That's the Fed's preferred measure of inflation, and this means inflation remains very, very low and that gives the Fed plenty to scope to keep rates "low for long." (Meaning the low inflation readings help to further validate the Fed's forward guidance, and markets traded slightly "dovishly" off the reading.)

Finally, jobless claims saw a big drop. But because this release is so volatile right now thanks to seasonal distortions, weekly claims are largely being ignored. The key is that the four-week moving average for weekly jobless claims is basically at the same level as August, so the jobs market isn't seeing any incremental improvement.

Bottom line last week was that while most of the data was "second tier" and none of the releases, by themselves, will change current Fed policy, the strong Durable Goods Report and Consumer Spending data in the Personal Income and Outlays Report will put upside risk to most analysts' current Q4 GDP estimates (meaning the economy might be stronger than we currently think).

And, most importantly, the continued strong economic data is helping to make 3% on the 10-year yield "OK" for stocks. As long as there is constant reinforcement by the data that economic growth is accelerating, higher interest rates won't be a major negative for risk assets—at least, not at these levels.

This Week

This will be another slow week economically, given the New Year's holiday, although the release of the global manufacturing PMIs on Thursday morning makes this week a bit more important, economically speaking, than last week.

The flash PMIs for December were released two weeks ago, so markets will be watching to see if the final readings match the trends we saw in the Flashes—that of a slight dip in manufacturing activity in China, and stronger-than-expected activity in Europe. Also, the Chinese government will release its monthly PMIs (not surprisingly, they are almost always stronger than the privately gathered Markit PMIs). But, watch to see if there's also a dip in the government data that confirms the dip in activity in the Markit PMIs.

The Pending Home Sales (this morning) is the only other notable report. It's November data, so it'll be interesting to see what effect the creep higher in interest rates that occurred throughout November had on sales.

Bottom line is this week won't have much of an effect on things here in the U.S. (the ISM Manufacturing PMI release Thursday should only move markets if it's a big miss), but it is an important week to gauge the progress of the global economic recovery, so the reports from China and Europe will be watched closely.

Commodities

Market	Level	Change	% Change
Dollar Index	80.45	-.203	-0.25%
EUR/USD	1.3741	.005	0.37%
GBP/USD	1.6479	.0001	0.01%
USD/JPY	105.15	0.36	0.34%
USD/CAD	1.0702	-.0001	-0.01%
AUD/USD	.8868	-.0022	-0.25%
USD/BRL	2.3373	-.0009	-0.04%
10 Year Yield	3.006	.016	0.54%
30 Year Yield	3.943	.022	0.56%
Prices taken at previous day market close.			

The commodities space saw mild gains last week, as DBC rose .5% amidst very slow trading. Good economic data and slight Dollar Index weakness helped commodities rally.

The energy sector outperformed last week, although natural gas finally saw its relentless rally take a pause. WTI Crude oil futures were able to break through $100/bbl Friday for the first time since October, closing at $100.15 for a gain of 1% on the week. The move higher last week was fundamental in nature:

First, economic data (specifically durable goods) was strong, resulting in increased demand estimates for WTI Crude and the refined products in the coming months.

Second, supply was down, as the EIA reported the fourth supply draw in a row, amounting to nearly 20 million barrels over the last four weeks. National crude reserves now stand at 367.6 million barrels, and are 1% lower than a year ago. WTI inventories have erased the supply surplus from last year, which just a few weeks ago was nearing 10%. Bottom line with oil/energy is this: If we are seeing a legitimate uptick in economic activity, both oil and the energy companies (XLE) are "cheap" because oil won't stay at $100/bbl for very long.

Natural gas was the worst-performing commodity last week, falling 3.4%. The pullback came after a solid seven-week rally that began back in early November, so the sell-off should be viewed as little more than an overbought market correcting itself.

The EIA reported a draw on natural gas inventories of 177 billion cubic feet, which was largely in line with most analysts' expectations. But, given the big run, an "in-line" report is a reason to book short term profits, as it's already been priced in. This type of dip is to be expected in natural gas, and while its still a weather dominated market in the short term, I'd continue to accumulate XOP and FCG on further dips for medium term accounts.

Trading in precious metals was relatively quiet last week, with gold rallying 0.86% while its more-volatile counterpart, silver, added 3.27%. There wasn't much news in either. With Fed tapering on going, focus now turns to "how fast" they taper and inflation. $1200 remains key (it's being tested again this morning), and for those with decent risk tolerance, I think the risk/reward on a gold long at the $1200/oz. level makes sense, with a stop at the old lows ($1179.40).

Currencies & Bonds

Currency markets, excluding the yen, were quiet last week until Friday, when we saw a strong (nearly 1%) rally in the euro that resulted in a spike to nearly 1.39 vs. the dollar. The reason for the rally, other than the very light volumes, was a hawkish comment by German Central Bank President Weidmann. That sentiment was echoed by ECB President Draghi over the weekend, who told *Der Spiegel* that there currently isn't any need for further rate cuts.

As a result of the move higher in the euro, the Dollar Index finished the week down nearly .5%, despite strong economic data. Last week was actually important, because it demonstrates why European unwillingness to do "more" from a policy standpoint, which is by default bullish euro, is one of the main reasons I don't expect a materially higher Dollar Index, despite Fed tapering and good data.

The yen was the other mover in the currency space last week, as it hit a new multi year low and is creeping toward 105 yen/dollar. The reason for the sell off was comments from a BOJ member during the November BOJ meeting that reflected concerns the economic acceleration may be topping out. Keep in mind the market widely expects more stimulus from the BOJ in early '14 (that's why the yen has broken down to new lows lately), and those comments only further cemented that expectation. It should be a quiet week in Japan, and the yen is now short term oversold, so we could see some temporary strength this week. But any rallies should be shorted, as there is still much further to go in the "bearish yen" trade (between 110-115 yen to the dollar seems a reasonable first target).

Bonds continued to decline last week thanks to good economic data and money flows, as there was some evidence we are seeing an acceleration of the "great rotation" out of bonds and into stocks. Volumes were low given the holidays, but the yield on the ten year did trade to a new high for the year, above 3%, and the yield curve did steepen.

Bonds are oversold so we could see a bounce, but the downtrend obviously remains intact, and it's just a question of when, not if, the downtrend begins to accelerate further. TBT and TBF remain the two most fundamentally back investments across all asset classes, and buy them on any dip. 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 amidst thin, holiday trading. 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 1828 in the S&P 500.*

Trade Ideas

Long Japan: **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 declined small last week, but mostly thanks to a strong euro. The Dollar Index should remain largely range bound, as a strong euro caps any material upside.*

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.**