7:00's Report

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

December 4th, 2013

Pre 7:00 Look

- Futures and international markets, ex-Japan, are flat this morning as good data helped arrest market declines.
- Global service sector PMIs were better than expected. November data from China, Germany and the EMU all beat estimates and rose from October levels.
- The one big laggard o/n was the Nikkei, which dropped 2%, on yen strength. Nothing fundamental changed, however.
- Econ Today: ADP Employment Report (E: 185K), New Home Sales (E: 420K), ISM Non-Manufacturing PMI (E: 55.5), Fed Beige Book (2:00 P.M.).

Market	Level	Change	% Change
S&P 500 Futures	1791.50	0.00	0.0%
U.S. Dollar (DXY)	80.665	.047	.06%
Gold	1212.60	-8.20	-.67%
WTI	97.33	1.28	1.33%
10 Year	2.775	-.026	-.93%

Equities

Market Recap

Stocks declined modestly Tuesday, as investor sentiment turned a bit more cautious and low volumes exacerbated the declines. The S&P 500 fell 0.32%.

Stocks were lower the entire day Tuesday, opening in the red and hitting their lows in the early afternoon before bouncing into the close to cut the losses. As far as "why" stocks declined, there wasn't a specific reason. Instead, general concerns regarding "tapering of QE," another potential fiscal fight in Washington and the

"Europe" has traded poorly over the last several days, and is in danger of definitively breaking the uptrend in place since late June.

growing perception that the European Central Bank won't ease monetary policy further.

But, those are more excuses for the declines than reasons for it. The expectations around tapering haven't changed, and there's actually progress on the fiscal front so there's little to no chance of a repeat of the October fiasco (more on that later). The ECB excuse is probably the one closest to being partially true, as European stocks had an ugly close, but again that wasn't "why" stocks fell.

This pause in the rally (we're still less than 1% from all-time highs in the S&P 500) so far is just markets digesting the recent run-up (stocks have traded higher for eight consecutive weeks), and mostly what we've seen since last Monday is little more than trading "noise."

Trading Color

Low volumes and conviction continue to be the hallmarks of trading these days. Volumes and participation by real money were again light yesterday, and the declines in the averages were again as much a result of no

Market	Level	Change	% Change
Dow	15913.72	-95.05	-0.59%
TSX	13299.40	-120.17	-0.90%
Brazil	50348.89	-895.98	-1.75%
FTSE	6532.43	-62.90	-0.95%
Nikkei	15749.66	94.59	0.60%
Hang Seng	23910.47	-128.08	-0.53%
ASX	5256.07	-23.45	-0.44%

Prices taken at previous day market close.

bids as they were aggressive selling.

From a sector standpoint, though, we did see some evidence of profit-taking and "de-risking" yesterday. Banks, which have enjoyed a big rally since early November, took a hit yesterday (KBE fell 1.23%). Biotech, another recent outperformer, also underperformed (IBB lost 1.8%).

Market	Level	Change	% Change
Gold	1220.60	-1.30	-0.11%
Silver	19.095	-.194	-1.01%
Copper	3.1955	-.022	-0.68%
WTI	95.97	2.15	2.29%
Brent	112.63	1.18	1.06%
Nat Gas	3.964	-.024	-0.60%
Corn	431.25	6.75	1.59%
Wheat	653.75	4.00	0.62%
Soybean	1319.75	-1.50	-0.11%

Prices taken at previous day market close.

On the flipside, we finally saw a pause in the chronic underperformance of "bond proxy" sectors. Utilities were the best-performing S&P 500 sub-sector, while REITs declined only marginally and other "defensive" sectors caught a bid as well: Consumer staples, telecom and energy all rallied. So, broadly, we can say that we likely saw profit-taking on outperformers by the longs, and underperformers by the shorts. But, that's probably due to the fact that we're moving closer to the week's key events (ECB meeting and jobs report). So, despite yesterday's action, the general trend of cyclical outperformance and "bond proxy" underperformance likely isn't ending.

Looking at the charts, resistance lies at the old highs (1,813) while I'm hearing a bit of chatter about support forming at the 20-day moving average, which is about 1,785. If that level is broken, look for the profit-taking to increase a bit.

Bottom Line

Stepping back, the market isn't doing anything but consolidating recent gains—but the fact that people seem to be demanding an explanation as to why stocks went down again implies that, in the very short term, the "pain trade" right now may be lower.

Looking beyond the very short term, the factors behind this rally remain largely in place: a "clear" macroeconomic horizon, an ultra-accommodative Fed, increasing comfort with "tapering" of QE, and a slow-but-positive global recovery. Valuations aren't cheap anymore but they aren't expensive, either. Except in the very short term, the path of least resistance remains higher and I'd be a buyer of cyclicals on any material dip from these levels.

Is Europe Backsliding?

European shares had an ugly close yesterday and are trading flat this morning. The weakness in European shares continues to be the result of growing concerns that the ECB won't do anything more to stimulate the EU economy, despite the growing risk of disinflation. European shares (both across the European Union and in the United Kingdom) have traded poorly since late last week, and I do want to point out that it looks like the Vanguard FTSE Europe ETF (VGK), my preferred vehicle for broad European exposure, broke the uptrend that's been in place since late June. If the ECB doesn't signal it's willing to do "more" in the near future to stimulate the EU economy, and VGK can't get back above that trend line, then I'll be inclined to exit the "long Europe" trade both as an outright long or as a spread vs. the SPY.

ECB Preview

There's virtually zero chance that any policies will be changed at Thursday's ECB meeting, so expect their loan programs and interest rates to remain unchanged. But, that doesn't mean the meeting will be uneventful. In particular, it's expected that the ECB research staff will release their growth and inflation projections for 2015. This is important because it directly relates to the effectiveness of current ECB policy to stimulate the economy.

Currently, the ECB is relying on "forward guidance" to help stimulate the economy, as the ECB is promising rates will stay "low for long." But, if the ECB research staff projects annual inflation creeping above, say, 1.5% in 2015, then that "low for long" promise will face a credibility problem. After all, how can the ECB keep rates "low for long" when, in two years, inflation will be creeping toward their 2% ceiling? Point being, depending on what the staff projections are, "forward guidance" may become less-credible in the eyes of EU investors, thereby reducing its simulative effect. If that happens, look for a strong euro rally, and for European shares to sell off.

The market will also be looking for hints at Mario Draghi's press conference as to what "more" the ECB is planning to do to stimulate the economy. Although nothing will be announced Thursday, as a reference, the markets' preference would be (in this order):

1. A Fed-style QE program (chances of that ever happening are near zero).
2. A negative deposit rate (chances of that are a bit better than a QE program, but still very low).
3. Another LTRO (Long Term Repurchase Operation), and that seems to be the option with the highest probability of actually occurring at some point, although the odds aren't great.

At its core, the ECB is facing a growing credibility problem. As I've said multiple times, the ECB has a consistent history of acting boldly to avoid a catastrophe (meaning a sovereign default or breakup of the European Monetary Union), but of acting timidly to stimulate the economy. The chances of an EU breakup have been removed, but the EMU is still teetering on the brink of dis-inflation. Until the ECB proves it's ready to act boldly to stimulate economic growth, European markets will face an increasing headwind, given the growing threat of dis-inflation.

Some Clarity From Washington-Maybe

Very quietly, progress is being made in Washington on an agreement that would fund the government for two years. This comes in the context of another government budget battle that looms in early January (remember, the deal in October only funded the government through January).

But, Reps. Paul Ryan (R) and Patty Murray (D) are crafting a compromise that, as mentioned, would fund the government for two years.

The details of the agreement are still hazy, but generally it looks like a pretty middle-of-the-road compromise, one that sets government spending between the lower levels Republicans want, and higher levels the Democrats want. Also, it would ease some of the sequester cuts, so on balance it would likely be slightly economically simulative (but nothing major).

Bottom line is neither party wants to go through another government shutdown, so even if a deal isn't crafted, both the House and Senate will pass another stopgap measure to fund the government at current levels (like they did in October).

So, it looks as though Washington (for the next several months, anyway) won't be a potential headwind, which helps keep the macro-economic horizon "clear" for the coming quarter. Isn't it amazing how an impending election year helps everyone play nicely together?

Market	Level	Change	% Change
Dollar Index	80.615	-.327	-0.40%
EUR/USD	1.3591	.0051	0.38%
GBP/USD	1.6397	.0042	0.26%
USD/JPY	102.30	-.64	-0.62%
USD/CAD	1.0649	.0008	0.08%
AUD/USD	.9139	.0039	0.43%
USD/BRL	2.3679	.0122	0.52%
10 Year Yield	2.775	-.026	-.93%
30 Year Yield	3.837	-.023	-.60%

Prices taken at previous day market close.

Economics

No reports yesterday.

Commodities

Most commodities rallied yesterday as crude oil logged its biggest gain since September 18th. The benchmark commodity ETF DBC was up a solid 0.7% and closed near the highs of the day. The weaker dollar, down 0.4%, played a part in supporting most commodity prices.

WTI crude oil was the big outperformer yesterday rising 2.3%, the largest one-day rally in nearly three months. Refined products also traded higher, with heating oil up 0.56% and RBOB gasoline gaining 1.85%. The substantial move higher was a product of several factors.

First, on a technical level, crude finally broke through and closed above the dominant downtrend line that has been in effect since the late-August highs. The break in the trend caused a decent amount of short-covering and proved to be a good enough reason for spec longs to enter the market.

Second, on a fundamental note, TransCanada Corp (TRP) declared yesterday that it will begin utilizing the southern leg of the Keystone XL Pipeline to deliver oil down to refineries on the gulf, which will start to substantially draw on inventories at Cushing, OK.

Third and finally, although this isn't something that happened yesterday, the nearly 19 dollar drop in crude from the highs has created very favorable refining margins, as the spread between WTI and Brent has widened back out to near $20 dollar, and RBOB gasoline futures have seen much more muted declines compared to oil. As a result of these favorable margins, refineries have been increasing production and demand for WTI crude and I have to think some of the rally yesterday was in anticipation of the weekly inventory numbers, which some thought would finally show a draw on oil supplies. True to form, the American Petroleum Institute reported yesterday evening that there was a draw of 12.5MM barrels in the nations supply last week, and now focus turns to the official government number later today.

As far as whether we buy "energy" here, although the break out was convincing yesterday, I remain a touch skeptical, and would prefer to wait for a bit of a pull back before venturing out on the long side (keep in mind WTI was sub $92.00 last week, so it's been quite a run over the past few days).

The largest underperforming commodity yesterday was gold's less-cooperative and more-volatile sibling, silver. Silver was down 1.01% in a session where the psychological support level of $19 was temporarily broken before the price rebounded and closed above the current support level. Silver futures, unlike gold, were not supported at all by the weaker dollar, which should be rather unsettling to the silver bulls out there (if there are any).

Natural gas futures briefly traded above $4 in yesterday's primary session before buyers became exhausted and the natural gas closed the day down 0.6%. Anticipation of a brief window of warmer weather has spurred some profit-taking, as natural gas has been up eight of the last nine sessions due to much colder than expected weather. Futures are up to a six-month high, however, and another leg higher is very possible as the six- to 10-day forecast is for more frigid temperatures across the Midwest and Northeast.

Currencies & Bonds

Tuesday was almost a complete reversal of Monday, as we saw virtually universal dollar weakness vs. major trading partners. The Dollar Index fell 0.4%, although it did bounce off support at the 80.50 level (that support has held multiple times). Also in a reversal of Monday, the Japanese yen bounced hard vs. the dollar, rallying 0.8% to recoup all of Monday's losses and close back below the 103/dollar level. There wasn't any specific reason for the strength in the yen, and mostly what we saw was short-covering in the face of declines throughout November. But, fundamentals remain clearly in favor of a weaker yen going forward, and any sort of a bounce toward the 100 yen/dollar range should be shorted, as the expectation for more stimulus from the Bank of Japan in early 2014 is growing rapidly.

Turning to Europe, the euro rallied 0.4% vs. the dollar, mostly in anticipation of the ECB meeting Thursday. For reference, if the ECB disappoints and doesn't seem committed to doing "more," that is, by default, euro-positive. And really, what we saw was traders positioning for that potential outcome later this week.

The reason for the rally in the British pound, though, was a bit more fundamental. The pound rallied close to a two-year high vs. the dollar thanks to more strong economic data. UK Construction PMI for November rose to 62.6, much stronger than the 59.0 estimate. Economic data is so consistently "beating" in the UK that investors are starting to question whether the BOE will need to start removing stimulus sooner than expected, and that's behind this rally in the pound. The 2011 highs of 1.67 remain the last piece of resistance in the pound (until the 1.80 level), and if data continues to come in strong, that resistance will be challenged.

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 moved to new all time highs this week the market gets more comfortable with the outlook for Fed policy (ZIRP) and tapering of QE. Skeptical sentiment towards this relentless rally remains a tail wind, and the "pain trade" is still higher.* *The S&P 500 is at new highs, while support sits between 1760-1775ish.*

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 Europe: **Although Washington drama is resolved, I continue to favor international exposure as "Europe" is seeing economic stabilization and a return of growth, and remains a better value than the US, and I like VGK (Europe ETF), EWU (UK ETF) or EIRL (Ireland ETF), and, for the gambling ilk, GREK (Greece ETF) and EWI (Italy ETF).**

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.**

Commodities	**Bullish**	**Neutral**	**Neutral**	*Commodities saw a mild oversold bounce last week, although the complex remains under pressure, despite the continued global economic recovery.*

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.**

U.S. Dollar	**Neutral**	**Neutral**	**Neutral**	*The Dollar Index was flat last week, as a Q1 '14 tapering of QE is priced in at these levels. The next major catalyst for the dollar will be the Jobs Report on 12/6.*

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**	*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.**