

7:00's Report

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

October 18th, 2013

Pre 7:00 Look

- Futures and European markets are marginally higher as Chinese economic data met expectations.
- Chinese Q3 GDP increased at a 7.8% annual rate, meeting expectations and further reducing concerns about an economic "hard landing." Industrial production and retail sales also met expectations.
- Econ Today: No reports today. Fed Speak: Evans (2:00 P.M.), Stein (4:30 P.M.).
- Earnings Today: GE (E: \$0.35), HON (E: \$1.24), MS (E: \$0.43), SLB (E: \$1.24).

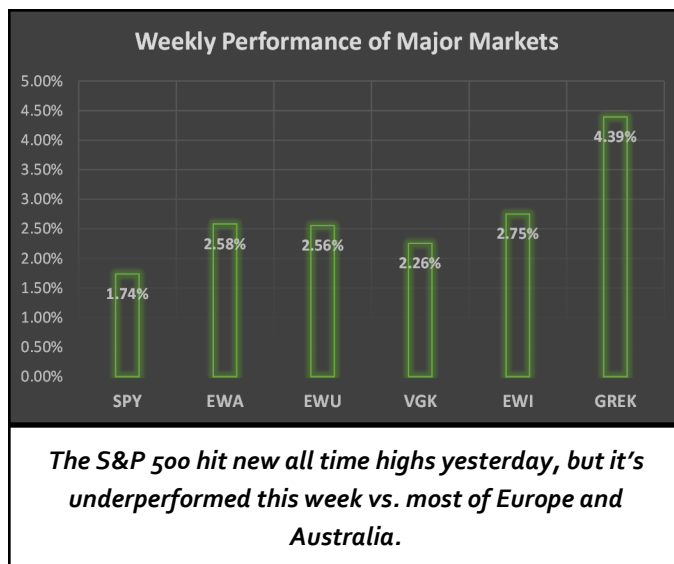
Market	Level	Change	% Change
S&P 500 Futures	1729.00	1.25	.07%
U.S. Dollar (DXY)	79.60	-108	-1.14%
Gold	1320.70	-2.30	-0.17%
WTI	100.88	.21	.21%
10 Year	2.587	-.084	-3.14%

Equities

Market Recap

The S&P 500 traded to new all-time highs as stocks again acted resiliently, shrugging off several weak earnings reports. The S&P 500 closed up 0.67%.

Stocks opened Thursday modestly lower, on a mild "sell the news" reaction to the temporary debt-ceiling suspension. But, the declines weren't material and, in a foreshadowing of the day's trading, stocks largely ignored some pretty high-profile earnings misses from EBAY, GS and IBM.



Stocks opened near what would turn out to be the lows of the day, but the lack of any follow-through selling after the open and a strong Philly Fed report unleashed a slow grind higher in the market. The S&P 500 turned positive right before lunchtime and continued to rally throughout the afternoon in quiet, uneventful trading. Stocks went out basically at their highs of the day, as the afternoon was characterized by buyers throwing in the towel and grudgingly adding long exposure.

Trading Color

With Washington behind us (for now) the market's focus is turning much more to the micro (earnings) than the macro, and that was reflected in the internals yesterday. While the S&P 500, Russell 2000 and Nasdaq all made new all-time highs, the Dow lagged and finished negative, thanks to the big IBM miss.

Sector-wise there wasn't really a true "risk on" bid. Cyclical didn't universally outperform safety sectors, and things were more dominated by individual earnings releases than any big rotation of money. Telecom was the best-performing sector yesterday, thanks to the VZ beat, while basic materials and homebuilders were also

Market	Level	Change	% Change
Dow	15370.43	-3.40	-.01%
TSX	13036.36	79.15	.61%
Brazil	55358.13	-614.90	-1.10%
FTSE	6589.53	13.37	.20%
Nikkei	14561.54	-24.97	-.17%
Hang Seng	23340.10	245.22	1.06%
ASX	5321.47	38.36	.73%

Prices taken at previous day market close.

strong, with the latter rallying thanks to the plunge in yields. Conversely, healthcare and tech were laggards because of weak earnings (UNH and EBAY, respectively).

On the charts, the market is at all-time highs, and the first rule of technical analysis states that “you buy what’s making new highs, and sell what’s making new lows.” Support now sits at 1,729. Volumes were elevated but not heavy, which has been typical this year.

Bottom Line

Resiliency and skeptical sentiment have been the hallmarks of this rally all year long; this was true again yesterday. IBM was the big earnings “disaster” Thursday, but instead of causing a sell-off, investors viewed the dip as a buying opportunity—reflecting the resiliency of this market. Additionally, yesterday the market made new highs, yet sentiment remains cautious and skeptical. As such, the pain trade remains higher.

With the macroeconomic horizon relatively clear into year-end, the onus for a continued rally will fall to earnings primarily and to sentiment secondarily. So far, earnings season is inconclusive with some good “beats” (VZ, AXP, BTU, JPM) and some big “misses” (IBM, GS, EBAY). But, given the skeptical sentiment toward a rally, the tie goes to the bulls.

Until sentiment gets much more euphoric and bullish, the path of least resistance will be higher. I continue to favor international equity exposure (as a bet on a continued global recovery) over the U.S. into year-end.

Economics

Jobless Claims

Claims remained elevated but—between the government shutdown and California’s inability to provide the numbers accurately and on-time—at this point the data is so screwed up, everyone is pretty much ignoring this report for the next two weeks.

Philadelphia Fed Survey

- General Business Conditions Index: 19.8 vs. (E) 15.0

Takeaway

The Philadelphia Fed’s business outlook survey beat analysts’ estimates and showed strength for the month of October—printing a number of 19.8 vs. September’s reading of 22.3, a smaller slide than expected. Importantly, the report refutes the disappointing Empire State Manufacturing Survey miss we saw earlier in the week.

The New Orders index came in at 27.5, a 6.3-point jump from September. That is the first back-to-back 20 reading since 2004 (think about that). An overall strong report also showed an optimistic six-month outlook number of 60.8, which is approaching record highs and serves as the first bit of positive employment information in weeks.

This was a strong report, and implies the rebound in manufacturing is continuing, even despite Washington dysfunction.

From a “What will the Fed do?” standpoint, by itself this won’t be enough to pull forward any expected QE tapering. But the most important part of this release is that it didn’t tank like Empire State Manufacturing did, because everyone is now looking to see how much damage Washington did to the fragile economy. Philly Fed data imply the answer is “some, but not that much,” which is a good thing.

Commodities

Despite the sharply lower dollar, commodities were mixed yesterday. Precious metals rallied hard on that dollar weakness while industrial commodities underperformed, ostensibly on concerns about the economy and future demand, given the damage to the U.S. economy from the government shutdown.

Also, there was undoubtedly some de-risking in the industrials space ahead of the Chinese economic data released overnight. The commodity ETF DBC declined 0.6%.

Market	Level	Change	% Change
Gold	1320.30	38.00	2.96%
Silver	21.875	.51	2.39%
Copper	3.292	-.016	-0.48%
WTI	100.65	-1.65	-1.61%
Brent	108.94	-1.65	-1.49%
Nat Gas	3.763	-.006	-0.16%
Corn	443.00	0.25	0.06%
Wheat	686.00	4.50	0.66%
Soybean	1293.25	16.75	1.30%

Prices taken at previous day market close.

The precious and semi-precious metals were by far the stars of the commodity show yesterday. Platinum, palladium, silver and gold all rallied more than 2% each, with palladium leading the way up 3.6% and gold 2.9% higher. Obviously it's not hard to figure out why – the dollar plunged and is likely to remain somewhat capped, so that's obviously good for the precious metals.

I heard one commentator say gold rallied yesterday because of lingering fiscal concerns, given that Congress “kicked the can” to early next year. But, that didn't have anything to do with the metal's rally. Our fiscal situation has been poor for years and gold has never traded off it.

Please, please don't buy gold because you think it'll rally due to Congress' ability to address fiscal issues. One day, our poor fiscal state may be a reason to buy gold, but that time is years away.

Despite the big move yesterday, though, unless gold can trade above (and hold for a few closes) \$1,330/oz., I remain skeptical about a further rally, and for now think gold is simply continuing to trade in a very large and volatile range between \$1,270 and \$1,330, with temporary violations on either side.

Long term, with Fed tapering delayed for a while, inflationary risks down the road have moved higher. Medium/longer term, the bull case for gold got stronger, but that's in the future and I'm not sure gold will trade in anticipation of that yet. At present, there is no inflation, nor signs of impending inflation. Until we get some hints of it in the air, I think gold will remain range-bound.

Turning to the industrial commodities, yesterday's weakness was pretty universal.

WTI and Brent crude declined 1.5% each, as WTI broke somewhat decisively through support at \$101.05. Most other industrial commodities also fell, with RBOB gasoline falling 2.15% and copper declining a more modest 0.5%. Again, the weakness was due to a combination of short-term profit-taking from Wednesday's rally, some de-risking ahead of the China numbers last

night, and peripheral concern about the strength of the U.S. economy.

Fundamentally there wasn't much news, although the latest rounds of negotiations between Iran and the P5+1 group (the United States, Britain, France, China and Russia, plus Germany) were taken as positive. Nothing concrete ever comes from these talks, so instead the market looks to see when the next round of talks is scheduled.

Generally, if a specific date is set that's good, and the sooner the better. So, it was a mild positive that they agreed to the next round of talks in early November, just a few weeks from now. But, at this point the resumption of talks is priced into oil. So, in order to get a further reduction of geopolitical risk premium, something concrete will actually have to happen, and we're still a ways from that.

The fact that WTI crude seems to be breaking down is worth noting. Normally, you don't see a day when stocks hit new highs (which implies a stronger economy), bonds trade sharply higher (which doesn't imply a strong economy), gold surge, and WTI trade sharply lower (that's the one that doesn't make sense).

For now, we can discount it as short-term trading noise. But if the weakness continues, it'll go from an oddity to something more worrisome if that slide continues. I say that because extended weakness in WTI (and the entire energy complex) begs the question: “If WTI is trading lower on concerns about the economy, then how much longer can stocks ignore the same concern?” For now, though, we can chalk it up to short-term trading noise, but if \$100/bbl. is a “given” then I think that's a potential warning sign for the economy and other risk assets.

Currencies & Bonds

The financial media was focused on the fact that the S&P 500 traded to new intraday highs yesterday, but the most “important” moves

of the day came from the currency and bond markets, which saw some pretty substantial moves as those mar-

Market	Level	Change	% Change
Dollar Index	79.735	-.828	-1.03%
Euro	1.3671	.012485	0.92%
Pound	1.6161	.018385	1.15%
Yen	97.855	-.779	-0.79%
CAD \$	1.0292	-.00318	-0.31%
AUD \$.96316	.009	0.94%
Brazilian Real	.4574	.0015	.34%
10 Year Yield	2.857	-.084	-3.14%
30 Year Yield	3.657	-.067	-1.80%

Prices taken at previous day market close.

kets accept the new “dovish” reality post-Washington drama.

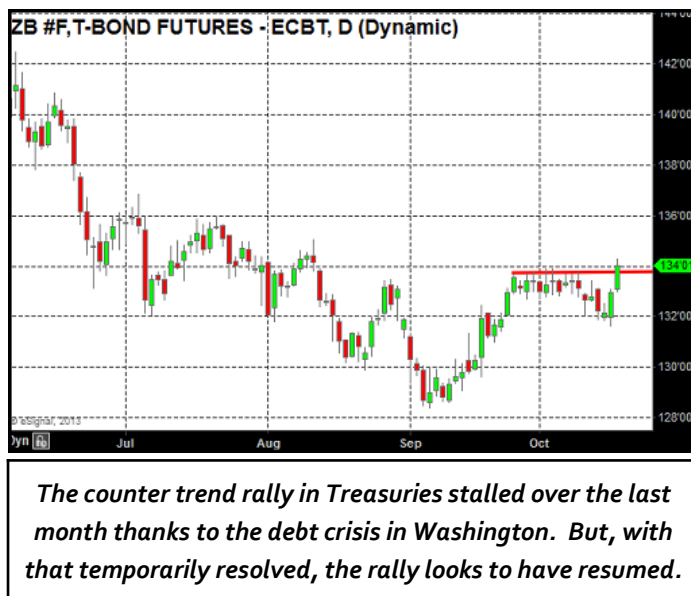
The Dollar Index plunged 1% yesterday, breaking the lows of early October and trading to a 10-month low. That extreme dollar weakness led to most major currencies trading up more than 1% vs. the dollar. The pound led the way, as it rallied 1.3% thanks to a combination of dollar weakness and good economic data (UK retail sales for September beat expectations). The euro traded counter to the dollar, rising 1%, while the Aussie and the yen both rose 0.8%, again trading solely off extreme dollar weakness.

Treasuries did the opposite of the dollar, as the 30-year Treasury rose 1% and traded to a 2-month high—breaking out of the channel it had been in since late September, and likely opening the door to higher prices in the near term. Several weeks ago I pointed out that we could very easily see a Fibonacci retracement of the May-September decline in the long bond. I continue to think this, despite being a long-term bond bear. A move in the 30-year above 138'00 certainly isn't out of the question (it's currently at about 134'05). The wild-card is if the economic data gets materially better, but because we won't get any “clean” data until early December, even good data will likely be discounted.

This “dovish” trade in the currency and bond markets accelerated as investors realized the Washington she-nanigans of the past three weeks have materially delayed tapering of QE (something I'm proud to say we started talking about more than 2 ½ weeks ago). That chorus got louder yesterday, with multiple pundits on CNBC and other stations reiterating that point. Mohamed El-Erian and BlackRock's Larry Fink, who said he thought tapering would be delayed until June, were particularly effective in reminding everyone that the Fed is going to remain very, very accommodative for the coming months. Even the very strong Philly Fed print didn't

cause much of a bounce in the dollar/decline in the bond market.

Despite the extreme weakness yesterday and fractional new lows, I don't see the Dollar Index going into freefall here, for a couple of reasons. First, the euro, pound and Aussie dollar are all at multi-week or multi-month highs (the euro is close to highs for the year). That's a problem for those countries, as they need a weaker currency to help their economic recoveries. And, like earlier this year, we'll start to see them “push back” against the relentless rise of their currencies vs. the dollar. I don't



think we'll get an all-out currency “race to the bottom” like we did earlier this year, but on the margin those efforts should support the dollar. Plus, unless this Washington circus has materially damaged the economy (which is unlikely), the Fed will still be the first central bank to taper QE, even if it is in January or March.

I continue to see the Dollar Index range-bound between say 79.50-ish and 81.00-ish on the absolute high side. And, the question we should be asking ourselves is “Who benefits from that lower, range-bound dollar?” The answer, I believe, is emerging-market currencies. Since the surprise “no taper” on the 18th, I've said that EM currencies are the big winners out of this, because the capital flight that plagued them over the summer, based on expected “tapering of QE,” has been removed. Since then, the WisdomTree Emerging Currency ETF (CEW) is up about 1%, but is probably headed steadily higher over the coming months (at least until the economic data start to turn higher). In a world of a range-bound dollar, EM currencies (and, to a point, the emerging-market equities) should have a nice tailwind—although it gets a bit more complicated with the equities. But for those interested, the Vanguard FTSE Emerging Markets ETF (VWO) is one of the more-liquid ETFs.

Have a good weekend, Tom

The 7:00's Report Asset Class Dashboard

(Outlook on the primary trend for major asset classes over the next month)

	<u>Fundamental Outlook</u>	<u>Technical Outlook</u>	<u>Overall</u>	<u>Comments</u>
Stocks	Neutral	Bullish	Bullish	<p><i>The S&P 500 traded to new all time highs yesterday as the market remains resilient, shrugging off some disappointing earnings, and sentiment remains far from euphoric. While valuations are elevated, until sentiment becomes much more enthusiastic, the path of least resistance for stocks remains higher.</i></p> <p><i>The S&P 500 support again sits at the old highs of 1729 while there is no real resistance on the charts.</i></p>

Trade Ideas

Long International (Europe & Japan): International markets continue to remain attractive vs. the US based on improving economic data, and looming political and monetary clouds in Washington. I like EWU (UK ETF) or EIRL (Ireland ETF) specifically. The "Long Japan" trade is under pressure thanks to a rising yen (which is a result of the debt ceiling drama) but long Japan remains one of the more fundamentally based trades in the market. DXJ remains the way to play it and I'd buy this dip for medium/longer term accounts.

Long Deep, multi-national Cyclical and Global Miners: Domestically, I'd look to allocate to deep cyclicals like industrials (XLI), basic materials (IYM) and global industrial miners (PICK). Those sectors are most exposed to the "global economic recovery" thesis.

Commodities	Bullish	Neutral	Neutral	<p><i>With Washington drama removed from the markets, commodities hopefully can resume the rally based on the global "economic recovery". Commodities remain on of the few asset classes where you can make a "value" argument.</i></p>
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Trade Ideas

Long Industrial Commodities: If we are seeing a return of global economic growth, then industrial commodities (Oil, Copper, Refined Products, Base Metals) should out perform over the coming quarters. In the short term debt ceiling drama and concerns of growth weigh, 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	<p><i>The Dollar will now once again trade off Fed expectations and economic data, and with tapering expectations being pushed out to early next year, there is little reason to expect a rally in the Dollar Index.</i></p>
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Trade Ideas

Long: Emerging market currencies (ETF is CEW) such as the Brazilian Real (BZF), Indian Rupee (ICN) or Mexican Peso, as those currencies should see further upside as Fed tapering has likely been delayed until early '14.

Treasuries	Neutral	Bearish	Bearish	<p><i>Bond will likely resume their counter trend rally given that Washington is out of the headlines, as Fed tapering looks to be pushed out to next year. But, remember this rally is just one enormous shorting opportunity.</i></p>
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Trade Ideas

Buy on a significant dip: TBF (unleveraged short 20+ year Treasuries) 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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