7:00's Report

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

December 13th, 2013

SHY: The last few days have seen the short end of the curve sell of moderately as a December taper becomes a possibility. As long as the decline doesn't accelerate materially, though, tapering won't kill the rally in stocks.

Pre 7:00 Look

- Futures are higher this morning and international markets are seeing a small rally, as stocks bounce a bit from several days of weakness.
- The House of Representatives passed the budget easily last night, removing the prospects of another government shutdown for at least two years.
- There was no material economic data overnight.
- Econ Today: PPI (E: -0.1% M/M).

Market	Level	Change	% Change
S&P 500 Futures	1776.00	7.50	.42%
U.S. Dollar (DXY)	80.35	.142	.18%
Gold	1228.60	3.70	.29%
WTI	97.10	-.40	-.41%
10 Year	2.8777	.033	1.16%

Equities

Market Recap

Stocks closed Thursday close to unchanged, after markets staged a nice rally off their lows in the late afternoon. The S&P 500 fell 0.38%.

Stocks opened lower yesterday and immediately resumed the decline we saw on Wednesday, as the major averages fell sharply within 20 minutes of the opening bell. Once again the most-cited "reason" was growing fears of a December QE taper. Specifically, the stronger-than-expected retail sales number was cited as the "reason" for the weakness, as it would make Fed tapering next week likelier. Stocks spent pretty much the entire morning lower, and hit their lows in the low-1,770s around midday, although support at 1,772-ish held. Once again demonstrating just how little conviction this market has in either direction, however, the S&P 500 reversed and moved steadily higher throughout the afternoon to finish the day down only marginally. Stocks dipped a bit into the close again, although all things considered it was a pretty resilient day for the markets, and not quite as bearish as the 100-point loss in the Dow would suggest.

Trading Color

There is definitely a growing sense of skittishness in this market as we inch closer to next week's FOMC meeting and the end of the year. And, that skittishness, combined with the lack of volumes and participation from real money, is making for volatile and seemingly random intraday trading.

Market	Level	Change	% Change
Dow	15738.73	-104.80	-0.66%
TSX	13137.70	4.28	0.03%
Brazil	50121.61	53.62	0.11%
FTSE	6456.51	11.27	.17%
Nikkei	15403.11	61.29	.40%
Hang Seng	23245.96	27.84	.12%
ASX	5062.52	-41.73	-0.82%

Prices taken at previous day market close.

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Case in point, there was substantial dichotomy yesterday in the performance of the various major indices. The Dow was the worst-performing major index, dropping 0.6%, while the Russell 2000 managed to close solidly in the green, up 0.2%. Normally when we see that sort of underperformance in the Dow, it's because one stock blew up. But, that wasn't the case yesterday, as the Dow's underperformance was due to several Dow components dropping by more than 2%, including PG, KO and JNJ.

Market	Level	Change	% Change
Gold	1227.90	-29.30	-2.33%
Silver	19.505	-.851	-4.18%
Copper	3.3335	.002	0.06%
WTI	97.47	.03	0.03%
Brent	108.65	-1.05	-0.96%
Nat Gas	4.41	.073	1.68%
Corn	434.25	-5.00	-1.14%
Wheat	633.75	-7.00	-1.09%
Soybean	1323.75	-20.25	-1.51%
Prices taken at previous day market close.			

Meanwhile, the Russell 2000 held support along the uptrend line I pointed to in yesterday's Report, while the Dow Transports and the Nasdaq also relatively outperformed. Point being, there was no clear trend in how the various indices traded yesterday.

Sector-wise it was a mixed trading day as well. The big laggard Thursday was consumer staples, which dropped nearly 1.5% on broad weakness (there didn't appear to be any specific reason for the dip). Conversely, banks were the big outperformers, although you can't really say there was a true "taper" trade on as utilities finished stronger while REITs basically traded in line with the overall tape (and if the market was discounting a higher likelihood of Fed tapering, you would have seen those bond-proxy sectors decline).

As mentioned, volumes and participation remain very subdued. On the charts we did close below that 1780-1785 area of support, but I think it's a touch early to say its been decisively broken.

Bottom Line

For all the consternation in the markets this week, nothing has really changed. Sentiment and lack of volumes are having a much greater effect on trading than is being realized, and really all we've seen happen is markets continue to consolidate in the range they've been in since late November.

Bottom line is sentiment remains skeptical of the rally (no one agrees with it and many think the first taper of QE will signal an end to the rally), but all the while the macro horizon continues to get "more clear," with passage of the budget being the latest macro-threat being removed.

As a result, the path of least resistance likely remains higher, and tapering by itself won't signal an end to the rally, as long as the market believes the Fed's ZIRP (zero interest rate pledge), and SHY will tell us if that changes.

Economics

Weekly Jobless Claims

- Initial Claims jumped to 368K vs. (E) 325K
- 4 Week Moving average rose 6K to 328.75K

Takeaway

Initial jobless claims rose sharply last week, rising by 68K to 368K. The move higher is just the second increase we have seen since the Government Shutdown (the other time was a mere 3K increase back in early November). The substantial spike higher in jobless claims was enough to reverse the 4 week moving average's recent trend lower. The 4 week moving average rose for the first time in 6 weeks by 6K to 328.75K.

The data this week was skewed by the Thanksgiving holiday, so just like the recent dip in claims wasn't as good as it seemed—so too this jump isn't as bad as it seems.

In any event, the weekly jobs report remains a volatile indicator and, for the most part, it has been taken with a grain of salt by the markets. This can be expected to continue until there is some consistency/accuracy in the data.

Retail Sales

- November Retail Sales rose 0.7% vs. (E) 0.6%
- Retail Sales ex-gas and autos rose 0.6% vs. (E) 0.2%

Takeaway

The November Retail Sales report was better than expected on the headline number, which was an increase of 0.7% in November compared to an increase of just

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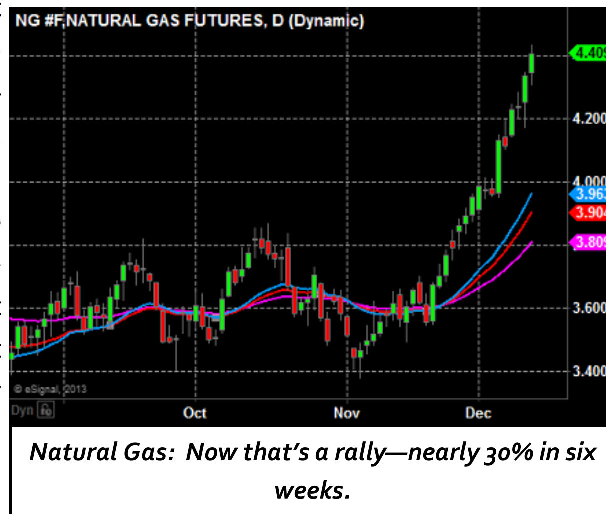
0.4% in October.

The key to watch in the retail sales report is the so called "control group"—which consists of Retail Sales minus autos, building materials and gasoline sales. Generally it gives a better picture of the state of the consumer with regards to discretionary goods. Encouragingly, it also showed strength in November, rising .53% and confirming the positive headline.

Given comments from retailers regarding holiday sales, this retail sales report was a welcome positive, and implies that the consumer isn't slowing down, with regards to spending. Obviously that's a positive for the economy. Finally, with regards to WWFD (what will the Fed do), this is a positive to consider perhaps makes the possibility of tapering of QE next week very slightly more likely, but I doubt it'll turn the tide one way of the other.



Natural Gas: Now that's a rally—nearly 30% in six weeks.

Commodities

Commodities were almost universally lower Thursday, as U.S. dollar strength weighed on the complex. The commodity ETF DBC fell 0.93%. Precious metals led the way lower yesterday, as gold fell 2.3% and silver collapsed 4.2%, thanks to increasing expectations that the Fed may start to taper QE at next week's meeting. Although still a low probability, chances of tapering of QE next week have risen over the past week, thanks to the strong November jobs report, yesterday's strong retail sales report, and a budget compromise in Washington.

At these levels (meaning the low-$1,200s) a Dec/Jan/March tapering of QE is largely priced into gold, so even if there is tapering of QE next week, I wouldn't expect material downside in gold prices unless the amount of the taper is materially above $10 billion-$15 billion.

Bottom line is while there aren't many positive catalysts for gold, given the number of shorts in the market and the absolutely hated nature of the commodity, from a risk/reward standpoint buying in low-$1,200s makes some sense. I bought some March calls yesterday on the dip and will likely add to them on any spike lower toward $1,200/oz. this or next week. But, it's not a trade for the faint of heart, so buyer beware. But, I want to reiterate that this is a trade, not a call that the uptrend in gold has resumed. Inflation remains the next major positive catalyst for gold going forward, and we're just not seeing any right now.

The best-performing commodity in the markets yesterday was again natural gas, which rallied 1.8% on the day and closed above $4.40/MCF for the first time since April (and was a penny from breaking the 52-week highs). Yesterday was inventory day, and we actually saw a smaller draw on inventories than expected (81 BCF vs. (E) 86 BCF). Natural gas initially declined off the news, but turned back to positive around midday as reports of more cold weather moving across the country in the 7-10 day forecast hit the wires.

This recent drop in inventories now leaves natural gas inventory levels 7% below a year ago and 3% below the five-year average. And, with more cold weather on the way, you can make the case that there's further room to run. But, if the commodity keeps rallying it'll do so without me, and I simply can't buy something this overbought. But, I would buy the natural gas E&P ETFs, and thankfully FCG finally started to trade a bit better yesterday (up 1.6%). Again, short term the natural gas market is very overbought, but fundamentally the situation is

Market	Level	Change	% Change
Dollar Index	80.335	.302	0.38%
EUR/USD	1.3744	-.0041	-0.30%
GBP/USD	1.6348	-.0025	-0.15%
USD/JPY	103.26	0.84	0.82%
USD/CAD	1.0639	.0051	0.48%
AUD/USD	.8936	-.0112	-1.24%
USD/BRL	2.334	-.007	-0.30%
10 Year Yield	2.877	.033	1.16%
30 Year Yield	3.897	.017	.44%
Prices taken at previous day market close.			

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getting more bullish.

Elsewhere in the energy space things were pretty quiet. WTI crude closed the day up a nickel, while Brent dropped just under 1% on soft European industrial production and concern that Libyan oil production would be ramping up over the coming days and weeks (this has been a constant threat over the past few weeks, but at some point Libyan production will start to rise).

Currencies & Bonds

The dominant trend of the week reversed Thursday, as the dollar was universally stronger against other currencies thanks to a combination of "hawkish" tapering expectations and a strong retail sales report. The Dollar Index rose 0.40% to retake the 80 level, and was higher against every major trading partner.

The dollar had a nice bounce yesterday and that likely can continue into the Fed meeting next Wednesday. But a decent chance of Fed tapering in December is priced in (and certainty of tapering in Jan or March). So to see sustained dollar strength, the Fed will have to be more "hawkish" than that with policy, and that's not something I see happening.

The big loser yesterday was another dollar – the "Aussie Dollar." The Aussie fell 1.4% vs. the greenback, plunging through support at the 0.90 level, after Reserve Bank of Australia Governor Glenn Stevens said that he favored a weaker currency as a means to stimulate the economy over lower rates, and wants to see the Aussie at about 0.85 to the U.S. dollar. I had thought that 0.90 in the Aussie Dollar would prove to be decent support, and it had, until Mr. Stevens' comments yesterday.

That sort of explicit commentary on the value of a country's currency has previously been limited to Japan (at least among developed economies), so the frank nature of his comments was surprising. And, as we all know, if a central bank wants its currency to fall in value, it will achieve that goal, and that's exactly what happened yesterday in "Oz." I'd expect some other RBA members to hedge Mr. Stevens' comments over the coming week, but if the RBA wants the Aussie at 0.85 to the dollar, who am I to argue?

Elsewhere in Asia, the yen moved closer to the lows of the year, breaking through 103/dollar yesterday. It was not because of anything that happened in Japan, but instead because of U.S. dollar strength, thanks mostly to the strong retail sales report. The 103.76 level in the yen is being tested, but again I think unless we see a material "hawkish" surprise out of the Fed next week, that resistance in the yen will prove formidable, at least in the short term. Longer term, though, that level will be broken, and I just would prefer to add to yen shorts on either a break of that 103.76 level (so, rising momentum) or on a dip to 101-102-ish level.

Moving on to Europe, both the pound and euro took a rest from their recent rallies, declining modestly (0.3% and 0.25% respectively). The euro was a touch weaker thanks to the poor Industrial Production numbers, but as I've been saying, the euro is trading off ECB expectations, not economic data. And, as long as the ECB appears "comfortable" with current policy and is not easing further, the path of least resistance in the euro will be higher.

There was more of the same in the bond market yesterday as the "belly" and long end of the curve continue to sell off as the short end remains relatively stable. 30-year Treasury bond futures and 10-year Treasury note futures sold off by 0.29% and 0.26% respectively while the short end of the curve, represented by the ETF SHY, was down just 0.02%. The steepening yield curve remains the dominant theme in the bond markets.

There was a 30-year bond auction yesterday and the results are consistent with the 10-year note auction that took place Wednesday, suggesting the fear of a December taper is weighing on bond prices. The Bid to Cover was 2.35, the 3rd lowest of the year—indicating pretty weak demand for the $13B worth of bonds that were auctioned yesterday. The yield awarded was 3.900%, which was a half basis point higher than the "when issued price"—also showing weakness in demand.

Bottom line is the results were just about the same as the 10-year auction on Wednesday, and that trend is likely to continue barring any material surprises out of the Fed announcement next week.

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 continue to consolidate recent gains around the 1800 level. A calm macro-economic horizon and still skeptical sentiment towards the rally remain tailwinds, and over the medium term the path of least resistance remains higher.* *Support in the S&P 500 lies in the 1780-1785 region, while resistance is 18013 (the old highs).*

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.**

Commodities	**Bullish**	**Neutral**	**Neutral**	*Commodities bounced last week thanks to the big rally in the energy space. But, 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.**

U.S. Dollar	**Neutral**	**Neutral**	**Neutral**	*The Dollar Index traded down last week mostly off euro strength, as a Dec/Jan/March tapering of QE is largely priced in. With the euro in a clear uptrend, it'll be tough for the Dollar Index to trade materially higher, despite the Fed starting to dial back policy.*

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.**

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