Insights from Northern Trust

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Stocks rallied last Friday on a better-than-expected U.S. jobs report, but those gains were not enough to offset the week's previous losses. While the Standard & Poor's (S&P) 500 advanced another 3.6% last month, its sixth consecutive monthly gain, an almost 22% fall in Chinese shares during August rattled investor sentiment as trading began in the traditional last week of summer. Concerns were further heightened as several financial market commentators opined that a similar drop in U.S. stock prices was all but certain, given the extended nature of the current rally since early March and widespread apprehensions about equity returns in September, historically the most volatile month in financial markets. For the week, the S&P 500 declined 1.2% while the MSCI EAFE index, a composite of global stock markets, traded down 2.4%.

Despite last week's modest retreat in equities, investors received additional evidence that the global economic recovery, which was well anticipated by steadily rising stock prices since spring, is indeed gathering momentum. Among last week's important data releases was a report that pending home sales in August advanced for the sixth consecutive month, the latest sign that the U.S. housing market is stabilizing following its devastating 2-1/2- year collapse. Domestic manufacturing, meanwhile, registered a much-welcomed return to growth in August. Last month's Institute for Supply Management's survey of manufacturing activity crossed back above 50, the line of demarcation between growth and contraction, for the first time since January 2008. A similar survey of August service sector activity also pushed higher, coming up just shy of the 50 growth/contraction threshold.

These improving domestic trends mirrored a series of upbeat economic reports abroad which culminated last week when the International Monetary Fund (IMF) revising upward its global economic forecast for both this year and next. The IMF now projects the global economy will contract at an annual rate of 1.3% this year, slightly better than the 1.4% decline it predicted earlier this summer. The IMF's global growth forecast for 2010, however, was raised to nearly 3.0%, up meaningfully from the 2.5% rate the IMF had forecasted as recently as July. On the other hand, finance ministers from the world's largest economies, meeting last Friday in London, were quick to signal that despite these improved economic forecasts, massive governmental stimulus programs enacted in response to the severe global recession should not and would not be withdrawn anytime soon.

Last week also featured the return of big mergers and acquisitions, with headline-grabbing deals announced in entertainment, energy and technology. August ended with news of Disney's bold plan to acquire comic book king Marvel Entertainment as well as Baker Hughes' announcement that it would buy oilfield services rival BJ Services. That same day, eBay announced that it would sell a 65% interest in Skype, its internet phone service subsidiary, to a private equity consortium that included Netscape co-founder Marc Andreessen and the Canadian Pension Plan Investment Board. Invigorated corporate ambitions are spilling into this week too: at the time of this writing, Kraft Foods has announced an unsolicited offer to buy U.K. chocolate maker Cadbury for US$16.7 billion!

But last week's most-anticipated release was the U.S. government's August employment report. This report, which each month is comprised of both a business "establishment" survey and a personal or "household" survey, is perhaps the single most scrutinized data release at this particular point in the economic cycle. Specifically, analysts across all industries are keen to determine when the U.S. economy will stop hemorrhaging jobs in order to better understand the likely path of consumer spending. Not surprisingly, the August jobs report defied definitive conclusions, providing ammunition for bulls and bears alike.

The 216,000 job cuts captured in the August establishment survey were fewer than expected, and stocks greeted the positive headline by rallying at Friday's opening bell. But downward revisions to prior months added another 49,000 layoffs to the recession's cumulative total, and the average weekly hours worked, at 33.1 hours per week, remained stuck near record lows. Moreover, temporary employment, among the best harbingers of labor market inflection points, continued falling and lost another 6,500 posts in August. The report's household survey produces the widely cited unemployment rate, which in August jumped to 9.7% from 9.4% in July. Nonetheless, investors' favorable reaction to the August employment report indicates that the establishment survey's better-than-consensus decline in job losses was considered the report's key element.

Following the Labor Day holiday in the United States, trading activity in financial markets will likely increase from its seasonally tepid summer levels. Moreover, a fragile economic recovery and the Obama administration's still-ambitious legislative agenda may present investors with an unusually robust analytic mosaic from which to assess potential returns from stocks and bonds. Our tactical investment recommendations reflect the fact that the global economic recovery now underway is broader than we had originally expected. Accordingly, we have encouraged our investment clients to normalize their short-term risk positions relative to longer-term strategic goals.