

## **Midsummer stock rally continues**

### *Weak jobs data worries investors*

*August 6, 2010* – Stock markets posted another weekly gain last week, adding to a month-long summer rally. With a generally satisfactory second-quarter earnings season out of the way, an easing of eurozone debt tensions, and growing appetite for risk, those investors not away on vacations plowed money into back into equity portfolios through July and into the first week of August.

But with disappointing employment data released last week, the rally came under some pressure through a volatile Friday trading session before finishing the week in the black. As we are in the dog days of summer and trading volumes are low, we are likely to see a few more gyrations before the gales of November.

Part of what influenced investors' animal spirits last week was the state of the world's factories. While manufacturing activity continued to expand in July, the pace of growth slowed somewhat. The US Institute for Supply Management's US manufacturing index, for example, dropped to 55.5 from 56.2 in June, with 10 industry sectors showing expansion.

In Europe, however, the pace of manufacturing activity sped up somewhat as the eurozone manufacturing index climbed to 56.7 from 55.6 in June. But this was driven mostly by strong manufacturing growth in Germany, which managed to offset the slowing pace growth in France, the Netherlands, Ireland, and Austria. Both the European Central Bank and the Bank of England kept their key policy rates unchanged last week, at 1.00% and 0.50% respectively, as inflation levels in countries comprising the Organisation for Economic Co-operation and Development (OECD) fell to 1.5% in June from 2.0% in May.

Asian manufacturing slowed markedly, as Chinese manufacturing contracted, with the HSBC China manufacturing PMI sliding to 49.4, from 50.4 in June. Anything above 50 is considered expansionary. Chinese government official figures show a modest slowdown, to 51.2 in July, the third consecutive monthly decline.

Inventory rebuilding has contributed to manufacturing growth so far this year, but as the need for restocking eases, the pace of growth will slow. That's already been discounted by the stock markets, which explains the seeming paradox of markets rising on bad news.

Now, say observers, consumer and business spending must pick up to advance economic recovery at something more than a slow walk.

Ben Bernanke, the Chairman of the US Federal Reserve Board, alluded to this in a speech last Monday, saying that the US has “a considerable way to go” before anyone can proclaim a full recovery. While he expects consumer and business demand to pick up, he says the Fed is “maintaining strong monetary policy support for the recovery.” Most likely, this means a commitment to near-zero policy rates and a refusal to rule out further quantitative easing (money printing) measures. One signal of the Fed’s intentions will be its portfolio strategy in coming months. Any indication that the Fed is backing off from its plan to let its bond holdings shrink will be a sign that the Governors have become alarmed by the deterioration in economic fundamentals and are willing to fuel the dying economic embers with some fast-burning paper.

As Mr. Bernanke said, the Fed needs “to make sure that monetary policy continues to provide support the economy needs until we begin to see sustained growth and particularly growth in jobs.” So far, that job growth is notable by its absence, at least on the surface, with US unemployment hovering around 9.5%. Total US non-farm payrolls dropped by 131,000 jobs in July, although the private sector payrolls grew by 71,000. The US Labor Department reported a 4.1% increase in initial jobless claims for the week to July 31, to 479,000, but the far less volatile four-week average rose to 458,500. The rise in weekly numbers is believed to be a result of seasonal factors, such as factory shutdowns. If the trend continues through August, however, it would be more of a cause for concern.

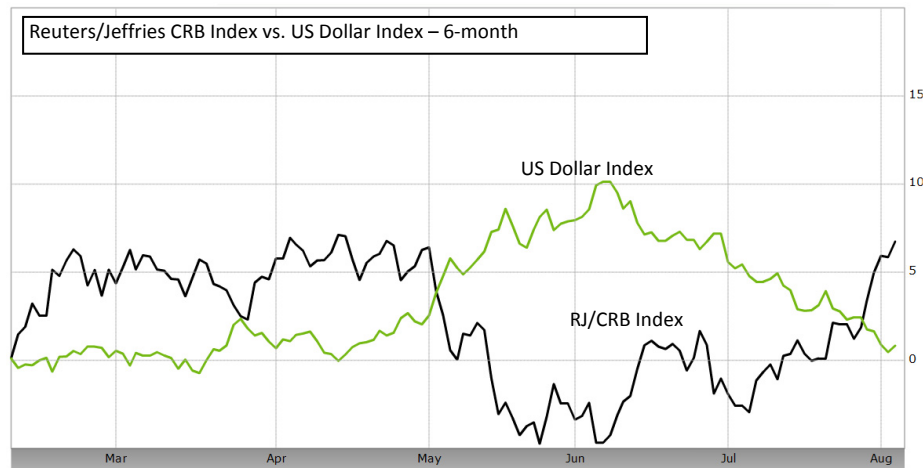
Meanwhile, the ISM’s survey of the US non-manufacturing industries showed that the service sector in fact expanded even more in July, with the index rising to 54.3 from a reading of 53.8 in June. That helped quell some of the jitters over the sliding manufacturing readings and the jobless numbers.

Indeed, the top-line jobless claims numbers tell only part of the story. The ISM’s service sector employment index climbed to 50.9, the highest since December 2007. And ADP Employer Services reported that non-government payrolls expanded by 42,000 jobs in July. Clearly it’s premature to declare the US economic recovery a writeoff.

In Canada, the economy shed a net 9,300 jobs, as the data were skewed somewhat by a “decline” of 65,000 jobs in the education sector, mostly a result of the summer break. Canada’s manufacturing sector actually added 28,500 jobs. Ottawa-based economic think-tank the Conference Board does not believe that the global economy will sink into a double-dip recession this year – a view we agree with, by the way – mostly because of the strong recovery in emerging markets, specifically Asia and Latin America. The Conference Board projects 5.9% growth for the Asia Pacific region this year, or 8.3% excluding Japan, while it projects Latin American growth at 4.5%.

Counterintuitively, commodities have been staging something of a rally in recent weeks, with the Reuters/Jeffries CRB commodity Index advancing 10% since its June lows. But

it's really no surprise, as the US dollar has been moving in the diametrically opposite direction, weakening against a basket of major currencies, including the Canadian dollar, with predictable effects on commodity prices.



Courtesy Bloomberg LP

No doubt the fuss over wheat supply had something to do with it last week, as prices for soft commodities surged across the board. Russia's decision last week to ban wheat exports fanned the flames of both speculative and hedging activity in most grain futures. A severe drought in Russia, the third largest grain grower in the world, sent prices soaring on fears of global wheat shortages.

Oil continued its rally last week, touching US\$82 per barrel, and gold regained some of its luster, climbing to US\$1,199 per ounce, as the US dollar weakened and the appetite for risk grew once more. Part of that appetite appears to have been satisfied by a tasty meal of equities as most of the major North American, European, and Asian indexes advanced on the week.

Against a backdrop of mixed signals from the North American labor markets, stock markets added to their month-long bullish bias through July. Toronto's S&P/TSX Composite Index gained 0.7% on the week, as strength in the gold and materials sectors overcame weak employment readings that put pressure on the Toronto index early in Friday's session.

The Dow Jones Industrial Average recovered from early losses on Friday, which were also a result of instantaneous changes in sentiment arising from undigested employment numbers. The DJIA advanced 1.8% on the week. Similarly, the S&P 500 Composite Index closed Friday with a 1.8% week-over-week gain.

Our summer theme continues – and continues to be borne out by events. Low trading volumes can give rise to sudden gyrations as sentiment shifts quickly. It's a fertile ground for nimble and experienced professional traders and options experts. All others should probably stick to predetermined investment policy for now. ■

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