How to Play It: Investing in a jobless recovery

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THE ISSUE: News of an improving U.S. labor market eased fears of recession and lifted global equity markets. But how should investors react to Friday's numbers with many hurdles ahead for the U.S. economy and American corporations?

By Herbert Lash

NEW YORK, Oct 7 (Reuters) - The dog days of August may be past for a resilient U.S. economy, but the European debt crisis and an entrenched American consumer point to tricky waters for investors to navigate.

A government labor market report on Friday showed U.S. employers hired more workers than expected in September and job gains for the prior two months were revised higher.

The better-than-expected numbers eased recession fears even as the unemployment rate remains stuck at 9.1 percent. Still, few economists predict the jobless rate to improve greatly, although some may revise upward their growth forecast.

Data has been better than expected and third-quarter economic growth is tracking about 2.7 percent, faster than less than 1 percent growth in the first half, according to senior U.S. economist Ellen Zentner at Nomura Securities.

"We're still not at any kind of job level that could bring the unemployment rate down. That still remains a big concern for the economy," Zentner said. "But this shows that a little bit more momentum in the labor market returned toward the end of quarter. This sets up fourth-quarter growth nicely."

CYCLICALS OR NONCYCLICALS?

Investors still must juggle a slew of uncertainties -- tax rates, regulation and healthcare costs -- that businesses face, concerns that have put a damper on cyclical stocks and pushed investors into the defensive, noncyclical sector. Also, consumers and many governments are still highly indebted.

"Our lack of conviction in growth is related to the secular deleveraging that has not run its course by any means," said Gautam Dhingra, chief executive and portfolio manager at High Pointe Capital Management LLC in Chicago.

"Today's data just keep us bobbling in the waves."

Since fear of recession began to trouble investors in April the cyclical energy, raw materials and industrials sectors have returned a negative 25 percent or worse, Dhingra said.

But noncyclical healthcare, consumer staples and utilities have fared better, with healthcare off about 11 percent and utilities showing a 1 percent positive return, he said.

Cyclicals climb when investors are optimistic about growth, while any news that is dour drives up noncyclicals, where Dhingra said he has been taking shelter.

High Pointe is slowly buying cyclicals like Rockwell Automation Inc , a maker of factory automation systems, and oil fields equipment maker National Oilwell Varco Inc .

"We also continue to find value and safety in stodgy technology companies like Microsoft," he said.

Dhingra is not ready to buy speculative cyclical stocks and he advises to lighten up on such consumer staples as Colgate-Palmolive Co and McDonalds Corp, which have gained due to the recent flight to quality.

PLAY THE SPREAD

Markets this year have been driven by correlation trades, for example, with investors taking long or short positions in the euro, which has been moving in tandem with the S&P 500 depending on the outlook to the European debt crisis.

Another popular "pairs" or spread trade has been the Australian dollar and commodities -- in particular iron ore and copper -- that drive Chinese economic growth.

The jobs report initially lifted stocks and pushed the price of U.S. Treasury debt lower, leading to gains in the price of a new exchange-traded fund called FactorShares 2X: S&P500 Bull/TBond Bear. Its shares rose 1.1 percent.

Factor Advisors launched five ETFs in February to provide investors a way to trade long and short bets between five asset classes: the S&P 500, U.S. Treasuries, dollar, gold and oil.

"We paired them up -- something long, something short -- packaged it up so that each FactorShares ETF is targeting a daily return in one market in excess of another market," said Stuart Rosenthal, chief executive and a co-founder at Factor.

HOW GOOD IS THE BUSINESS?

For Richard Fearon, founder of Accretive Capital Partners LLC, a hedge fund in Madison, Connecticut, the jobs data did not change the unemployment picture in any meaningful way.

Fearon has positioned his portfolio to benefit from companies that managed to grow during the recession in 2008 and 2009, what he called the "ultimate test" of a good business.

His favorite holding is Caribou Coffee Co Inc, the second-largest U.S. coffee chain behind Starbucks, which is quickly expanding outlets and distribution while adding new product lines, such as hot lunch sandwiches, Fearon said.

A growing economy favors ON Semiconductor, he said. The chipmaker bought Sanyo Electric Co's money-losing chipmaking unit last year at a fraction of its intrinsic value, which Fearon said is driving "significant growth."

"The (semiconductor) industry has been beaten up in what we think is unfounded anticipation of another recession," he said.

POSITIONING FOR DOWNSIDE

Discount chain Dollar General Corp would be a good play if the economy continues to falter or turn lower, said Carl Kaufman, a bond manager at Osterweis Capital Management, which oversees about $5.7 billion in assets in San Francisco.

The company's debt level is low at 1.72 times its earnings before interest, taxes, depreciation and amortization, and its free cash flow -- money left over after paying all the bills -- was $473 million over the past 12 months, Kaufman said.

The bond, which has an 11.875 percent coupon, is the type of debt that "I'm not going to get rich on it, but I'm not going to get poor on it," Kaufman said.

While the bond is trading high at about 105 percent of par, it will return about 5.6 percent annually, he said.

Quality companies that pay a good dividend are favored by Steven Wyman, a fund manager at Sun Capital Advisers, the investment arm of Sun Life Financial in Wellesley Hills, Massachusetts.

"Everyone is so negative. Everyone is positioned for the downside, no one is looking for the upside," said Wyman, who believes the economy is doing better than sentiment shows.

He's overweight energy, technology, automobiles, retailers and energy, while neutral on consumer staples and underweight industrials.

Intel Corp and Microsoft Corp have dividend yields over 3 percent and are trading at under 11 times next year's earnings, he said.

To be sure, he said that "if you're betting on a recession, you don't want to own Microsoft or Intel." (Reporting by Herbert Lash; Editing by Walden Siew)