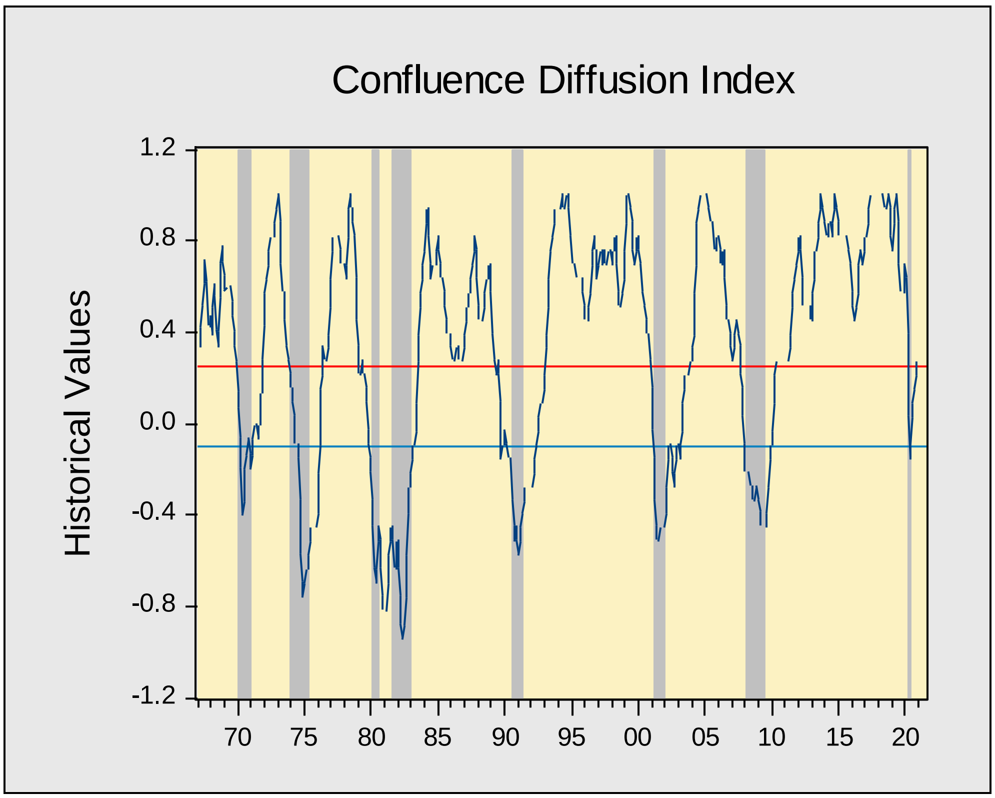
Business Cycle Report

By Thomas Wash

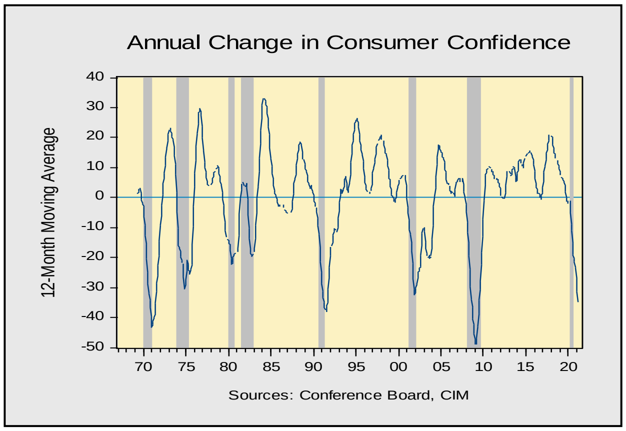
The business cycle has a major impact on financial markets; recessions usually accompany bear markets in equities. The intention of this report is to keep our readers apprised of the potential for recession, updated on a monthly basis. Although it isn't the final word on our views about recession, it is part of our process in signaling the potential for a downturn.

In March, the diffusion index rose further above the recession indicator, signaling that the recovery is continuing. In the financial markets, heightened inflation fears led to a sell-off in equities and 10-year Treasuries. Meanwhile, a slowdown in COVID-19 cases and easing restrictions made it easier to hire workers; thus, last month saw an improvement in labor market conditions. However, poor weather conditions and supply constraints, particularly the lack of semiconductors and lumber, led to a pullback in manufacturing activity. As a result, four out of the 11 indicators are in contraction territory. The reading for March was unchanged from the previous month at +0.2727, above the recession signal of +0.2500.



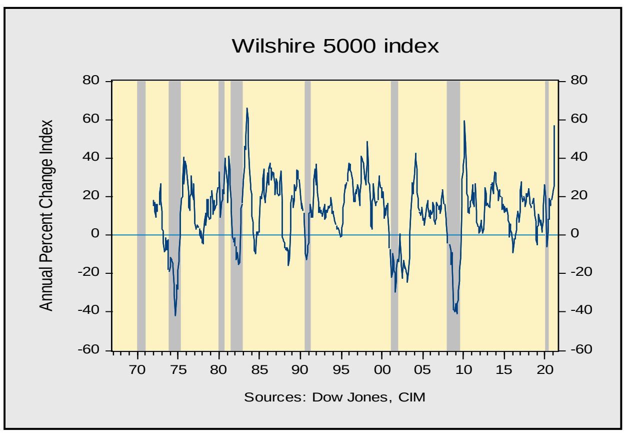
The chart above shows the Confluence Diffusion Index. It uses a three-month moving average of 11 leading indicators to track the state of the business cycle. The red line signals when the business cycle is headed toward a contraction, while the blue line signals when the business cycle is headed toward a recovery. On average, the diffusion index is currently providing about six months of lead time for a contraction and five months of lead time for a recovery. Continue reading for a more in-depth understanding of how the indicators are performing and refer to our *Glossary of Charts* at the back of this report for a description of each chart and what it measures. A chart title listed in red indicates that indicator is signaling recession.

Consumer Confidence



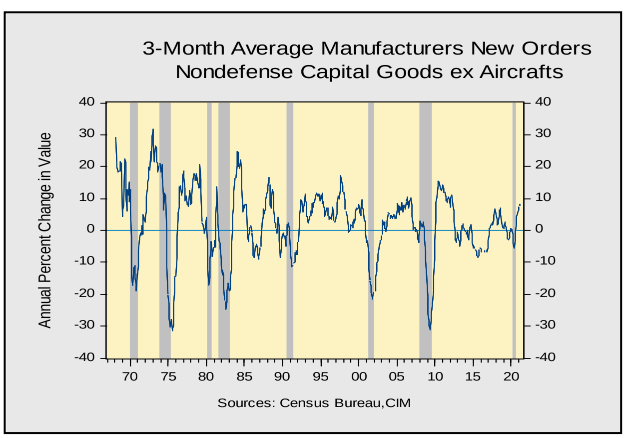
Despite a steep rise in the Consumer Confidence Index, it remained well below the level from the previous year. As a result, the indicator remains below the recession signal. Last month, the index rose by 19.3 points from 90.4 to 109.7. This reading is much lower than the previous year's reading of 118.8. As a result, the 12-month moving average of the annual change fell from -35.0 to -35.4. The drop in the index can be attributed to the contrast in views about the present situation compared to last year. In March of last year, confirmed cases of COVID-19 began to rise throughout the country. Nevertheless, mass vaccinations have led to a steep rise in consumer confidence in the present situation and future expectations. The index for consumer optimism present situation rose from 89.6 to 110.0 but is still well below last year's level of 166.7. The consumer six-month outlook rose 9.7 points from the prior month, from 90.9 to 109.6. This is well above the prior year's reading of 86.8.

Wilshire 5000 Index



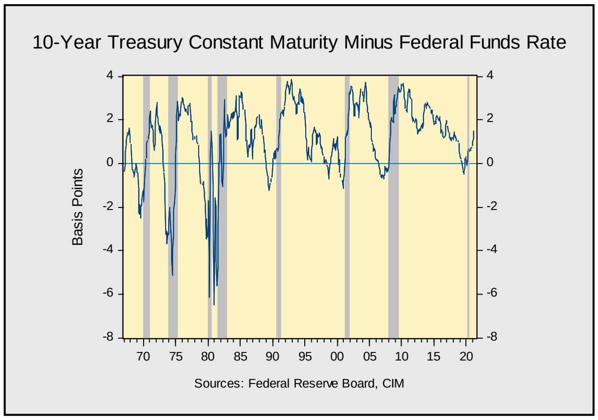
The Wilshire 5000 Total Return Index rose from 192.2 in February to 198.3 in March, which is 57.5% higher than the previous year. The rise in equities can be attributed to the market's eagerness for another round of fiscal stimulus and vaccination progress. The three top-performing sectors in the index were Utilities, Consumer Staples, and Industrials. The bottom-performing sectors were Communication Services, Health Care, and Information Technology. Although yields are elevated, at this time we expect equities to perform well throughout the year.

Three-Month Average Manufacturers New Orders Nondefense Capital Goods excluding Aircrafts



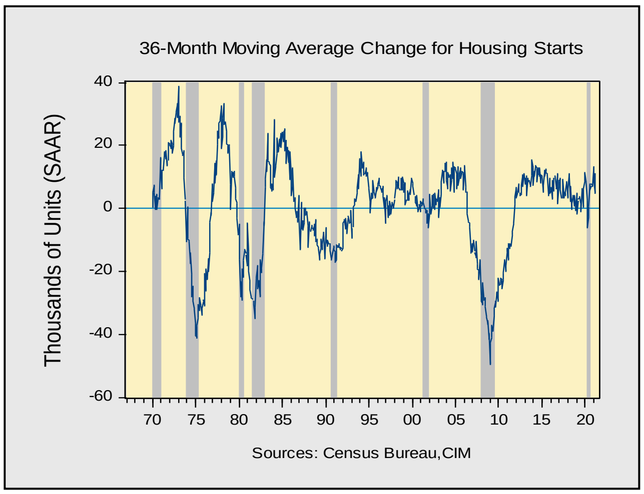
According to the Conference Board LEI, the value for new orders of durable goods adjusted for inflation rose 0.74% from the previous month. In March, new orders for nondefense capital goods came in at $40.255B in 1982-chained dollars, which is 9.6% higher than the previous year. New orders for February were revised downward from $40.283B. The three-month moving average came in at $40.215B, up from the previous year's value of $37.133B. The indicator, which tracks the annual change in the three-month moving average for new orders, came in at 8.30, higher than the previous month's reading of 7.82.

10-Year Treasury Constant Maturity Minus Federal Funds Rate



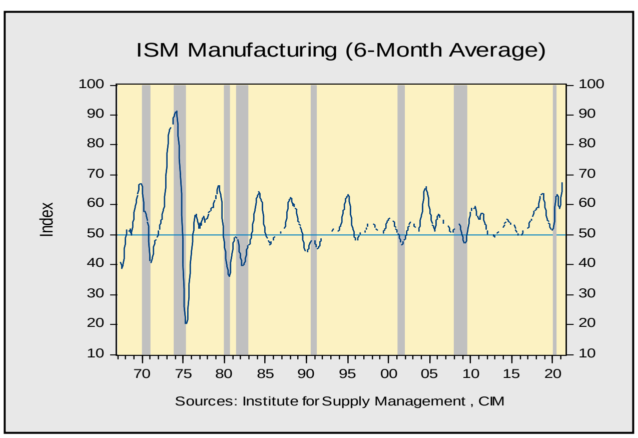
The financial spread, also known as the 10-year Treasury minus the federal funds rate, remained in expansion territory in March. The spread rose from +1.18 to +1.54. Inflation fears due to concerns that the stimulus could overheat the economy led to a sell-off on the 10-year Treasury. In response to growing market angst over a premature rate hike to combat inflation, the Federal Reserve reaffirmed its willingness to maintain the fed funds rate at its current level. Last month, the fed funds rate fell from 0.08% to 0.07%. Meanwhile, the 10-year Treasury rose 35 bps from 1.26% to 1.61%.

36-Month Moving Average Change for Housing Starts



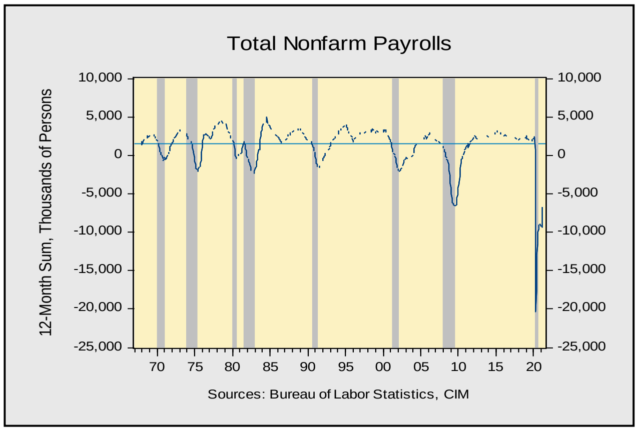
Strong demand and lack of inventory have offset cost and supply chain concerns. Despite rising mortgage rates, demand continues for more homes. Last month, buyer traffic rose to a four-month high. However, supply chains have made it difficult to receive building materials and lumber costs remain elevated. Although these issues have not yet had an impact on housing, it could potentially lead to a slowdown in residential homebuilding if these issues aren't addressed. Annualized housing starts rose from 1,739K in January to 1,457K in the following month. The 36-month moving average change of housing starts rose 11.22K from the prior month.

ISM Manufacturing: Supplier Delivery Index



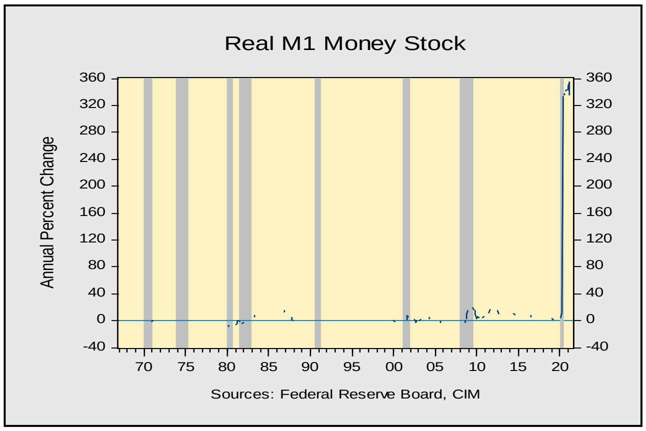
Poor weather conditions and a global chip shortage in March made it difficult for manufacturers to deliver orders. The ISM Supplier Delivery Index came in at 76.6 in March, above the previous month's reading of 72.0. The rise in the index can be attributed to more firms reporting slower deliveries. Typically, when firms report slower deliveries, it suggests demand is strengthening; however, this month's report is a bit misleading as the slowdown is supply related. The moving average has softened this distortion and therefore the positive reading is a relatively better reflection of manufacturing conditions. The moving average improved in March, rising from 64.85 to 67.78.

Total Nonfarm Payrolls



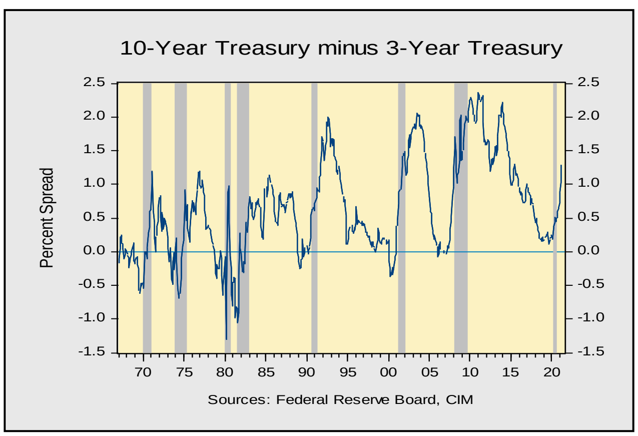
In March, the country gained 916K jobs for a 12-month moving sum of -6.720MM. Most of the jobs added came from the private service-providing sector, primarily in *Leisure and Hospitality* which added 280K. In total, the service-providing sector accounted for 597K new jobs. The goods-producing sector added 183K, while the government sector added 136K. Currently, the indicator is significantly below the recession signal of 1.600MM. Given the transitory nature of this indicator, it will likely move into expansion territory next month.

Real M1 Money Stock



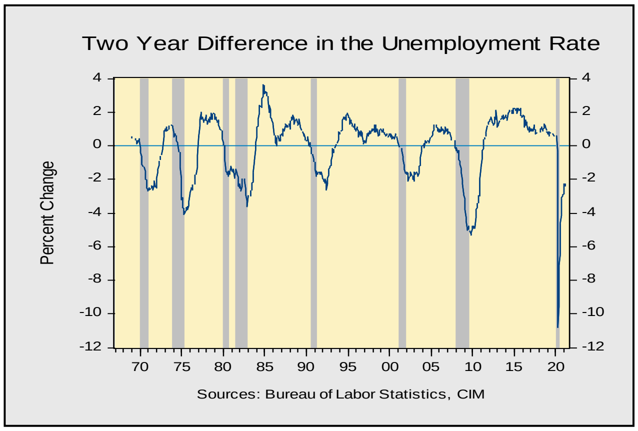
In March, Real M1 slowed for the first time in over a year. Last month, Real M1 Money Stock, which is M1 minus inflation, rose 333.9%, down from the previous month of 355.2%. The unprecedented rise in the indicator was heavily influenced by a change that the Federal Reserve made to its calculation of M1. M1 now includes other liquid deposits, which includes savings deposits in addition to the previously included checkable deposits in thrift institutions and commercial banks. The inclusion of savings deposits means that M1 will now be able to reflect household savings. As a result, we suspect the indicator could be headed for a sharp drop in the coming month as it adjusts to the unprecedented amount of stimulus given to households in 2020.

10-Year Treasury Minus Three-Year Treasury



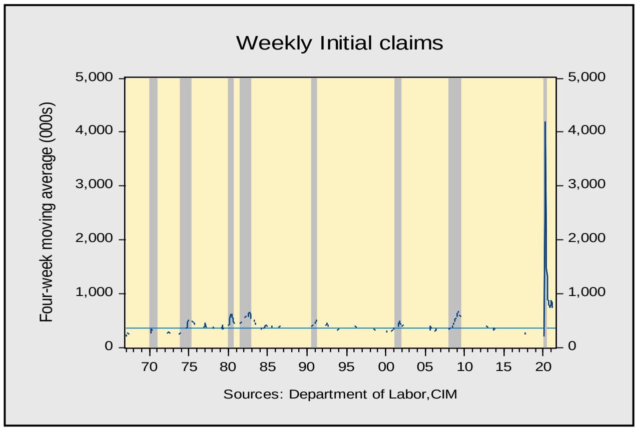
In March, there was a bearish steepening of the yield curve due to inflation fears. The spread between the 10-year and three-year Treasury widened from +1.05 to +1.29. The widening of the spread was due to an increase in interest rates for 10-year Treasuries, which outpaced the rise in three-year Treasuries. Last month, the 10-year Treasury rose by 18 bps from +1.26 to +1.61, whereas the three-year Treasury rose from +0.21 to +0.32.

Two-Year Difference in the Unemployment Rate



In March, the two-year spread in the unemployment rate narrowed from -2.4 to -2.2, contributing negatively to the diffusion index. Despite the drop in the unemployment rate from 6.2% to 6.0%, it remains well above its level of 3.8% from two years ago. The number of workers employed rose 0.41% from the prior month, while the civilian labor force rose by 0.22%. Meanwhile, the number of unemployed workers fell 2.63% from the prior month. The drop in the unemployment rate was largely due to people finding employment. The only group that saw a rise in unemployment are the long-term unemployed, those who have been looking for work for 27 weeks or longer. That being said, we do not expect this indicator to contribute positively to the diffusion index for the foreseeable future.

Weekly Initial Claims



In March, average weekly initial claims fell for the second consecutive month, coming in at 724K, down from the 805K recorded in the previous month. The drop in initial claims was the result of an increase in vaccinations and a reduction in COVID-19 restrictions.

Thomas Wash

April 29, 2021

Glossary of Charts

Consumer Confidence: The Consumer Confidence Index is an economic indicator that measures the level of consumer optimism about the overall state of the economy and consumers' personal financial situations. This chart shows the 12-month moving average of the annual change of the index.

Wilshire 5000 Index: This chart shows the annual change in the Wilshire 5000 Total Return Index, which is the broadest U.S. equity index. The index contains 3,500 stocks and is designed to track overall performance of the U.S. stock market. It is an important indicator because steep equity pullbacks have often coincided with economic contractions.

Three-Month Average Manufacturers New Orders Nondefense Capital Goods excluding Aircrafts: This chart shows the annual change in the value of core capital goods orders. This indicator gives insight into the amount of business investment spending. A positive report suggests that manufacturers are optimistic about future demand.

10-Year Treasury Constant Maturity Minus Federal Funds Rate: This chart shows the spread between the 10-year maturity and the fed funds rate. It reflects market sentiment of the future state of the economy. Generally speaking, a negative spread suggests a contraction is likely to occur within 24 months.

36-Month Moving Average Change for Housing Starts: This chart shows the 36-month moving average of the annual change in housing starts. This is an important indicator because it provides a gauge of future construction activity. If housing starts are strong it implies that builders are optimistic about future demand.

ISM Manufacturing (Six-Month Average): The ISM Manufacturing Index is a report that monitors employment, production, inventories, new orders and supplier deliveries. This index specifically focuses on the six-month moving average of supplier deliveries section in ISM, which we believe is a good gauge of future levels of manufacturing activity. A reading above 50 signals that manufacturing activity is expected to expand, while a reading below 50 signals that manufacturing activity is expected to contract.

Total Nonfarm Payrolls: This chart shows the 12-month moving sum of total nonfarm payrolls. This report represents the total number of workers added to the workforce excluding proprietors, private household employees, unpaid volunteers, farm employees and incorporated self-employed. It is a significant indicator of the strength of the labor market. A moving sum that exceeds 1,600 suggests the demand for labor is strong.

Real M1 Money Stock: The Real M1 Money Stock report measures the annual change in the money supply minus inflation. M1 is the measure of currency in circulation and represents the amount of money being held for transaction purposes, therefore it can act as a proxy for economic activity.

10-Year Treasury Minus Three-Year Treasury: This chart shows the spread between the 10-year and three-year Treasury, a gauge of investor sentiment. A widening spread suggests investors are optimistic about the state of the economy, whereas a negative spread suggests pessimism. This indicator is less sensitive than the financial spread as it is less affected by the Fed's decisions.

Two-Year Difference in the Unemployment Rate: The two-year difference in the unemployment rate measures the amount of slack in the labor market. When the difference of the two-year unemployment rate falls below zero it indicates the labor market is becoming less tight.

Weekly Initial Claims: This chart shows the four-week moving average of initial jobless claims. A rising initial claims number means the demand for labor is weakening, likely due to a worsening business environment. If the four-week moving average rises above 350k, it signals the economy may be headed toward a contraction.