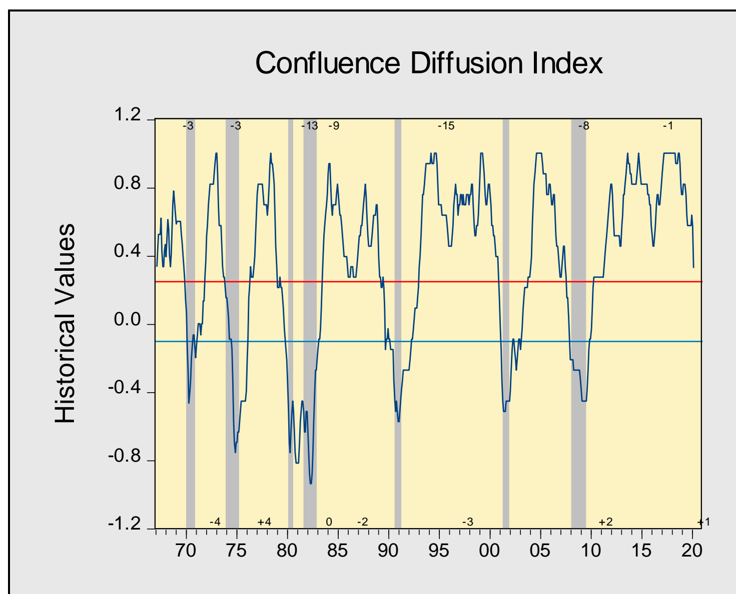
Confluence
INVESTMENT MANAGEMENT

Business Cycle Report

By Thomas Wash

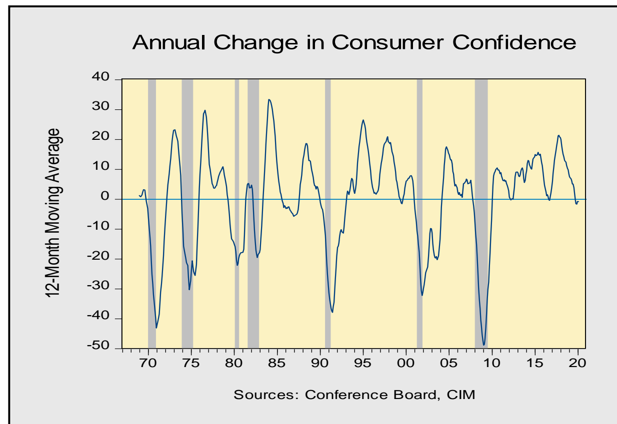
The business cycle has a major impact on financial markets; recessions usually accompany bear markets in equities. We have created this report to keep our readers apprised of the potential for recession, which we plan to update on a monthly basis. Although it isn't the final word on our views about recession,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

In March, the diffusion index nearly fell into recession territory. The weakness in the report was primarily due to the coronavirus pandemic, turmoil in the financial markets and the Saudi-Russia oil dispute. Last month, confirmed cases of COVID-19 in the U.S. rose from 74 at the start of the month and grew to over 180,000. Meanwhile, the oil price war between Saudi Arabia and Russia led oil prices to fall to a near-20-year low. As a result, equities dropped and Treasuries rallied. The interest rate on the 10-year T-note fell below 1.0% for the first time ever. Additionally, the manufacturing sector showed mixed signals as a slowdown in delivery times reflected positively in the report despite a drop in new durable goods orders. The employment numbers were abysmal and will likely be worse in next month's report. In this report, six out of the 11 indicators were in recession territory. The reading for March fell to +0.333 from +0.57, a hair above the recession signal of +0.250.



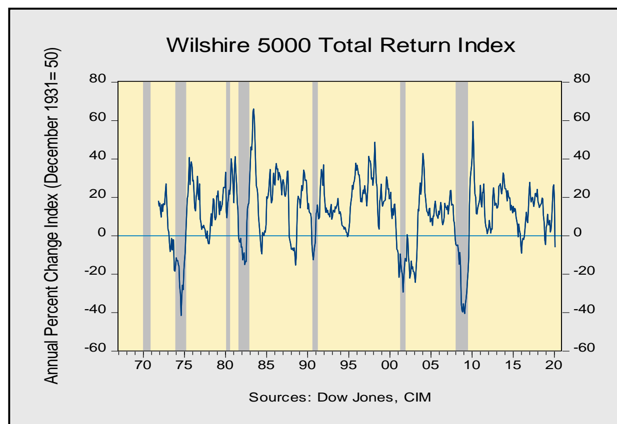
The chart above shows the Confluence Diffusion Index. It uses a three-month moving average of 11 leading indicators to track the state of the business cycle. The red line signals when the business cycle is headed toward a contraction, while the blue line signals when the business cycle is headed toward 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



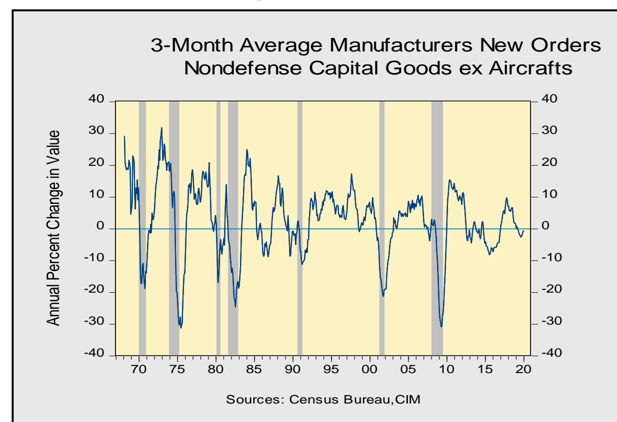
Consumer confidence slowed in March as the coronavirus weighed heavily on consumer expectations. As a result, the annual change in the 12-month average for consumer confidence remains in contraction territory at -1.03. The March reading for consumer confidence was 120.0, below the reading of 124.9 from a year ago. Surprisingly, according to the report, consumers' confidence regarding their present situation remained relatively unchanged from the prior month at 167.7, down from 169.3, whereas the consumer six-month outlook fell by the most since 2011 at 88.2, down from 108.1.

Wilshire 5000 Index



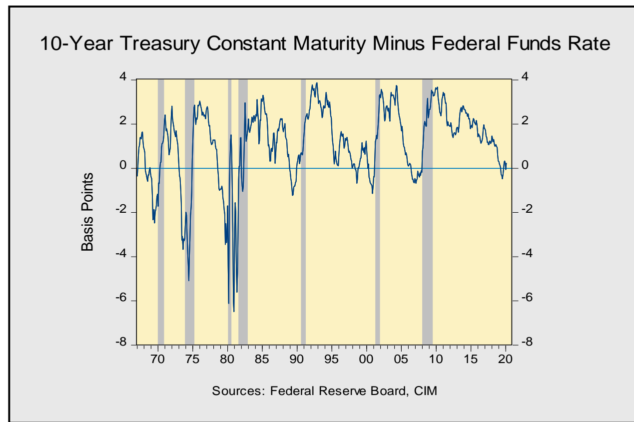
The Wilshire 5000 Total Return Index fell into contraction territory. Equity markets slowed dramatically from an annual increase of 19.17% in February to a drop of 6.22% in March. The decline in equities was undoubtedly due to concerns over the economic impact of COVID-19 as countries from across the world began imposing nationwide lockdowns to combat the spread of the virus. The industries that were least affected by the virus were health care and consumer staples, which saw month-end losses of 4.79% and 5.79%, respectively.

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



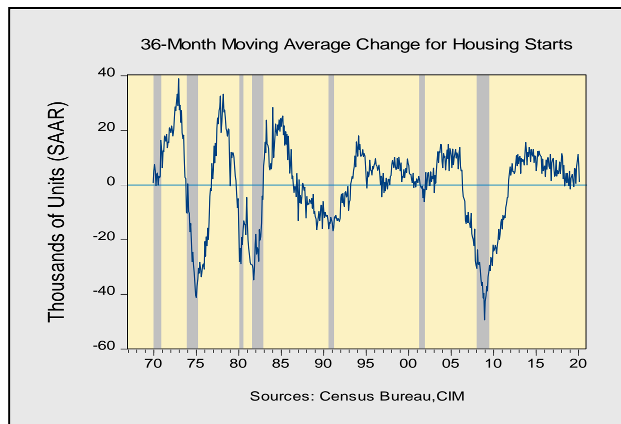
New orders for nondefense capital goods excluding aircrafts eased slightly and remains in contraction territory. The March reading came in at -1.15, slightly lower than the previous month's reading of -0.86. Last month, new orders slowed as the national lockdown likely led to a cancellation of orders, and the slowdown of economic activity caused inventory levels to remain elevated.

10-Year Treasury Constant Maturity Minus Federal Funds Rate



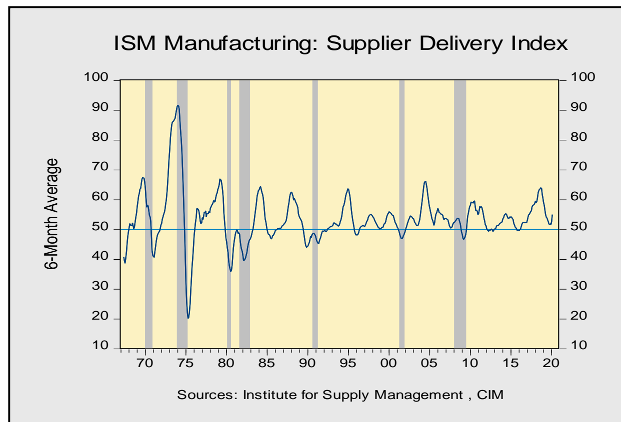
The financial spread, also known as the 10-year Treasury minus the federal funds rate, returned to expansion territory in March. The spread is now +0.22, up from the -0.08 in the previous report. Last month, the Federal Reserve lowered interest rates twice by 50 bps each. The aggressive moves caused the effective funds rate to drop to 0.65% from 1.58% the previous month. Meanwhile, the 10-year Treasury fell to 0.87% from 1.50% as investors were confident that the Fed would prevent markets from cratering. Thus, the reversal of the financial spread was due to Fed actions as opposed to an improvement in financial conditions.

36-Month Moving Average Change for Housing Starts



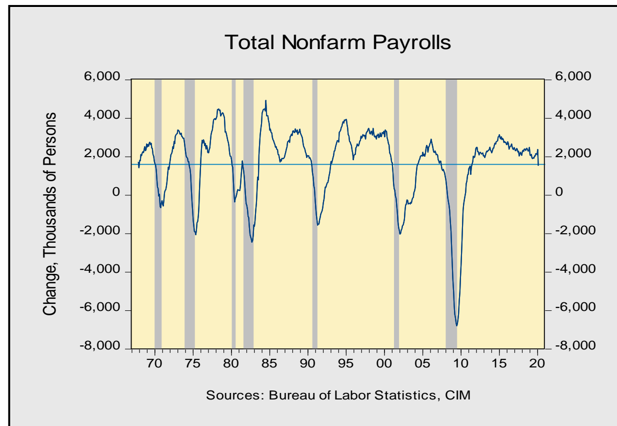
March housing starts expanded at their slowest pace in 36 years. However, the indicator remains just shy of crossing into recession territory. In March, the 36-month moving average change fell from 7.56 to 1.02. The slowdown in construction was largely due to the pandemic putting a strain on resources as well as the number of available workers. Although many states have declared construction an "essential" service, disruptions in supply chains have made it difficult for homebuilders to get necessary resources. Additionally, workers have been hard to find because many have already gotten sick or fear getting sick.

ISM Manufacturing: Supplier Delivery Index



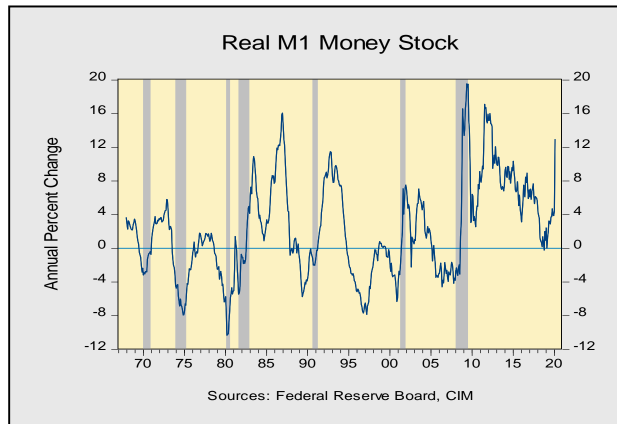
In March, the supplier delivery index rose to its highest level since June 2018. The reading of 65.0 raised the six-month moving average from 52.6 to 54.5. As a result, the index moved further away from the contraction point of 50.0. The rise in the survey is due to a reduction in the amount of purchasing managers reporting faster delivery times. Typically, slower deliveries suggest that factories were operating near capacity, but given recent events that is unlikely to be true this time around. Hence, the report is incorrectly signaling strength.

Total Nonfarm Payrolls



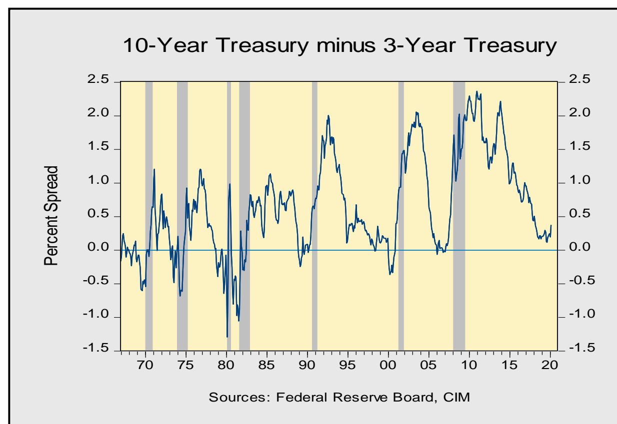
In March, the country dropped 701k for a 12-month moving sum of 1,504k. Most of the jobs lost came from the private service-providing sectors, especially "leisure and hospitality," which lost 495k. In total, the services sector accounted for 695k of the job losses. Meanwhile, the goods-producing sector lost a relatively modest 54k, primarily in construction. Finally, the government sector added 12k jobs mostly through the census. Local government added 8k and the federal government added 18k, while state governments lost 14k. Currently, the indicator is below the recession signal of 1,600k. Given that stay-at-home orders have remained in place throughout the month of April, it is unlikely this indicator will reverse in the next report.

Real M1 Money Stock



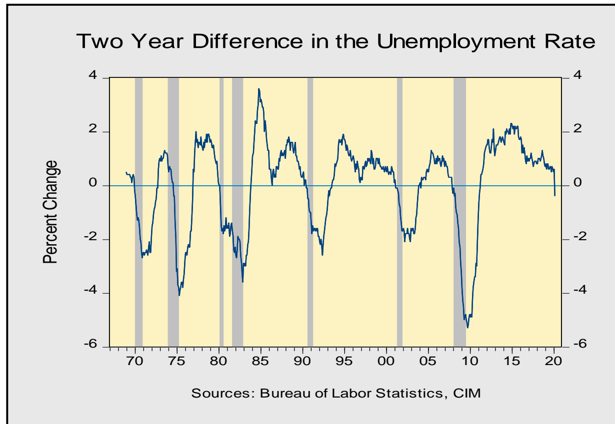
In March, the increase in demand deposits, currency and other checkable deposits surged, while inflation slowed, leading to a sharp increase in the indicator. Real M1 money stock rose 12.92% from the prior year, higher than the previous month's reading of 4.34%. Additionally, CPI rose 1.50% from the prior year, and M1 rose 14.42%. In March, the Federal Reserve lowered the benchmark interest rates twice, by 50 bps each. In addition, it instituted a $700 billion quantitative easing program. As a result of these aggressive actions, the money supply expanded dramatically. Additionally, a substantial drop in oil prices and airfares led to deceleration of inflation.

10-Year Treasury Minus Three-Year Treasury



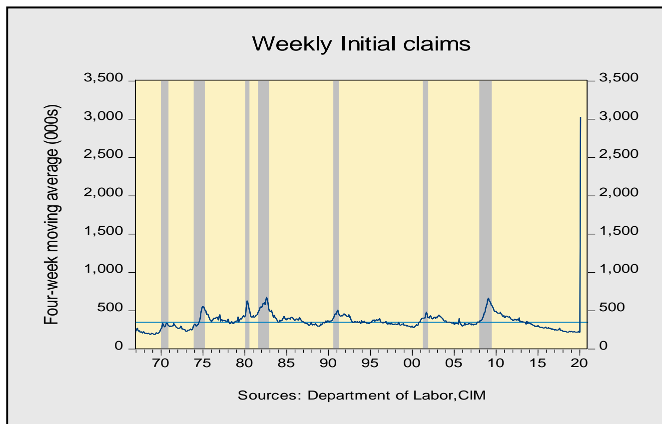
The spread between the 10-year and three-year Treasury widened from +0.19 to +0.37 as angst about the impact of COVID-19 on the global economy worsened. Fed action to reassure investors that the markets would remain liquid led to a steep drop in the three-year Treasury, which fell from 1.31% to 0.50%. Additionally, the drop of the 10-year Treasury slowed as uncertainty about the fiscal stimulus led investors to liquidate some of their Treasury holdings, which resulted in a decline from 1.50% to 0.87%. In all, the steepening of the yield curve is the result of the combination of Fed action and market reaction to government bureaucracy. At this time, it is too soon to say whether the downturn will be short-lived but we expect the yield curve to flatten if the impact of the virus is worse than previously thought.

Two-Year Difference in the Unemployment Rate



In March, the labor market widened as the unemployment rate rose from 3.5% to 4.4%. As a result, the two-year difference between the unemployment rate dipped from +0.5 to -0.4, moving well past the contraction indicator of 0.0. The increase in the unemployment rate was the result of employers laying off workers due to expectations that sales revenue would be hit by the stay-at-home orders. The participation rate fell from 63.4% to 62.7% and the employment/population ratio fell from 61.1% to 60.0%. That being said, the drop in the labor force participation report prevented the unemployment rate from being even worse as many who lost their jobs left the labor force completely. The exit of workers from the labor force suggests that many workers who were laid off expect to be rehired when economic conditions improve.

Weekly Initial Claims



Average weekly initial claims rose *drastically* in March, coming in at a staggering 3,025k, up from 214k the previous month. The rise in average weekly initial claims is due to massive layoffs as a result of the pandemic. The increase in claims surged well past the recession indicator of 350k. Furthermore, the sharpest increase in initial claims came from states in the Southeast. The states that saw the largest increases in initial jobless claims since the start of the year were Louisiana and North Carolina.

Thomas Wash
April 23, 2020

This report was prepared by Confluence Investment Management LLC and reflects the current opinions of the author. It is based upon sources and data believed to be accurate and reliable. Opinions and forward-looking statements expressed are subject to change. This is not a solicitation or an offer to buy or sell any security.

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.