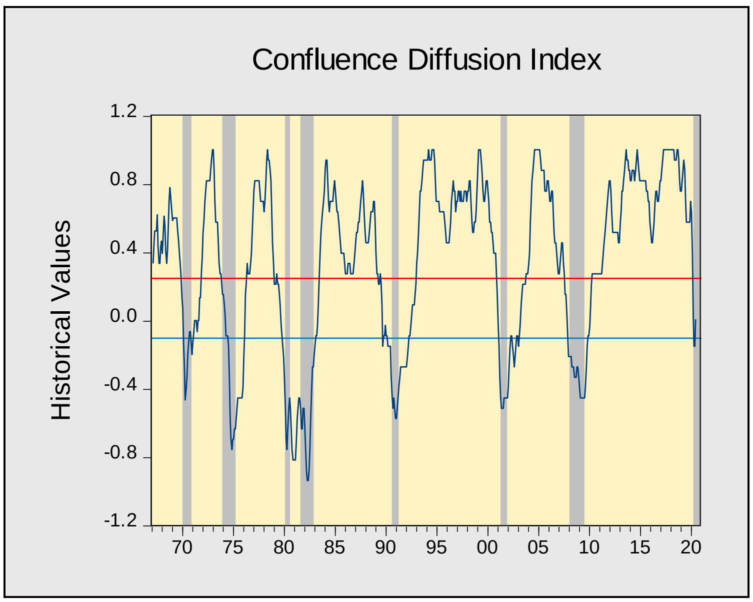
Business Cycle Report

By Thomas Wash

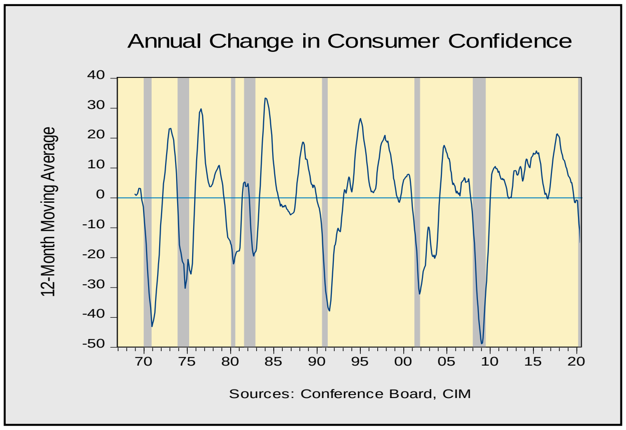
The business cycle has a major impact on financial markets; recessions usually accompany bear markets in equities. The intention of this report is to keep our readers apprised of the potential for recession, updated on a monthly basis. Although it isn't the final word on our views about recession, it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

In July, the diffusion index surged into recovery territory signaling that the economy may be on track to grow in Q3. Financial markets were sending mixed signals as equities surged while the yield curve flattened. Meanwhile, the labor market showed signs of improvement as firms hired workers in record numbers. Firms were likely optimistic about the economy as the month saw an increase in consumption resulting from the reduction in lockdown restrictions. However, economic uncertainty has weighed on consumer and investor confidence as a rise in virus cases has hindered efforts to further ease restrictions. As a result, five out of the 11 indicators are in contraction territory. The reading for July rose from -0.1515 to -0.0303, above the recovery signal of -0.100.



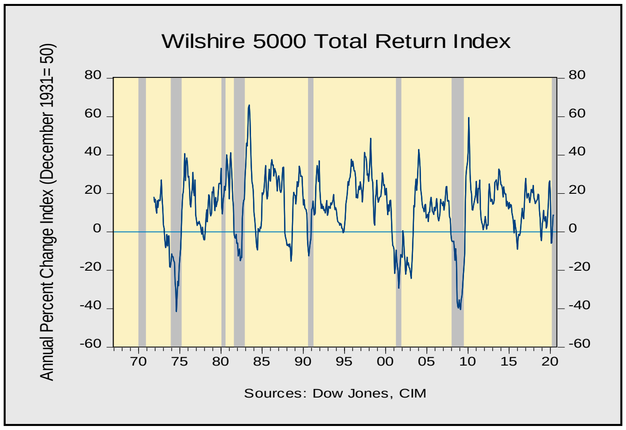
The chart above shows the Confluence Diffusion Index. It uses a three-month moving average of 11 leading indicators to track the state of the business cycle. The red line signals when the business cycle is headed toward a contraction, while the blue line signals when the business cycle is headed toward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



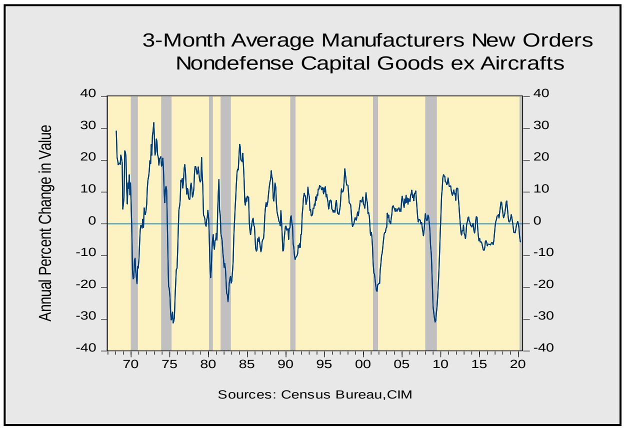
The Consumer Confidence Index contributed negatively to the diffusion index in July as the moving average fell further below the recession indicator. Last month, the index fell by 5.7 points from 98.3 to 92.6. This reading is much lower than the previous year's reading of 135.8. As a result, the 12-month moving average of the annual change fell from -11.0 to -15.2. Despite a drop in consumer confidence, the consumer six-month outlook fell 20.9 points from the prior year, from 112.4 to 91.5. Additionally, the reading of consumer sentiment about their present situation sits at 94.2, well below last year's level of 170.9. As the pandemic eases we expect consumer confidence to rise as people become more optimistic about the economy..

Wilshire 5000 Index



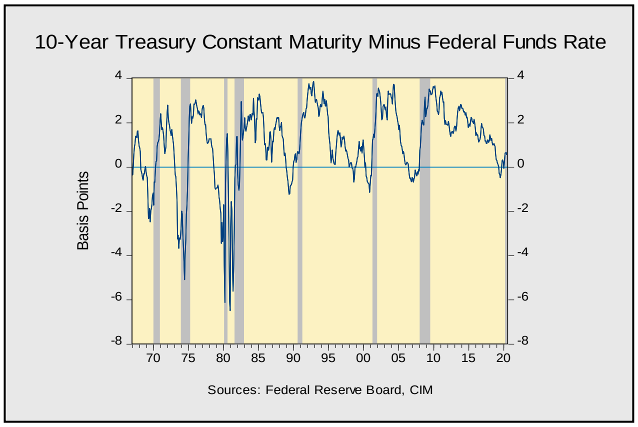
In July, the Wilshire 5000 Total Return Index showed gains for the third consecutive month, rising 8.34% from the prior year, thus the indicator contributed positively to the diffusion index. The improvement in equities can be attributed to corporate earnings beating market expectations and ultra-low interest rates leading to an increase in P/E multiples. However, a rise in COVID-19 cases led to a bias toward safety. The three top-performing sectors in the index were Consumer Discretionary, Utilities, and Consumer Staples. The three bottom-performing sectors were Real Estate, Financials, and Energy.

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



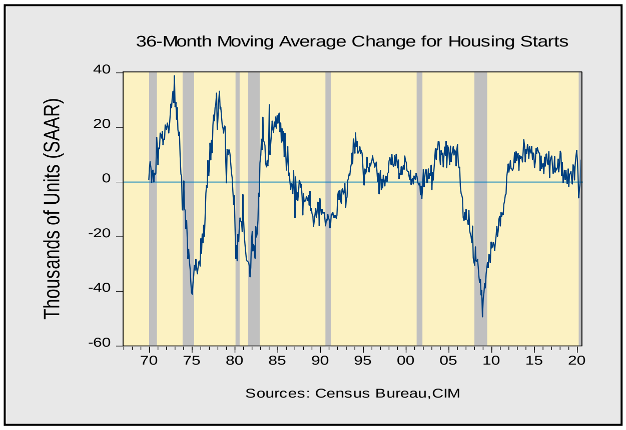
New durable goods orders fell in July, according to the Conference Board LEI. The drop is likely the result of weaker global consumption weighing on the manufacturing sector. As a result, the annual change in the three-month moving average for new orders came in at -5.88, lower than the previous month's reading of -4.84. The value of new orders for nondefense capital goods came in at $35.391 billion in 1982 chained dollars, which is 5.1% lower than the previous year. New orders for June were revised upward from $35.125 billion to $35.923 billion. The three-month moving average came in at $35.359 billion, down from the previous year's value of $37.157 billion. The decline in orders suggests that companies are still waiting for the economy to recover before deciding to invest. Although we do expect orders to pick up soon, the reemergence of the virus could further depress investment activity.

10-Year Treasury Constant Maturity Minus Federal Funds Rate



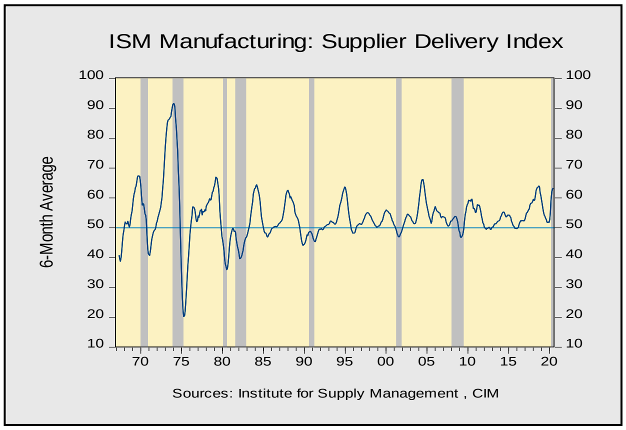
The financial spread, also known as the 10-year Treasury minus the federal funds rate, remained in expansion territory in July. The spread narrowed slightly from +0.65 to +0.53. In July, Fed Chair Powell stated that he didn't expect the Fed to change its path in the near term, but there is growing concern regarding the strength of the recovery. Although there was no indication that the Fed would look to provide additional stimulus to the economy, Powell's comments could be interpreted as a way to nudge Congress to passing the stimulus bill. There was a slight uptick in the fed funds rate as it rose 3 bps in June from 0.05% to 0.08%. Meanwhile, the 10-year Treasury rose 6 bps from 0.67% to 0.73%.

36-Month Moving Average Change for Housing Starts



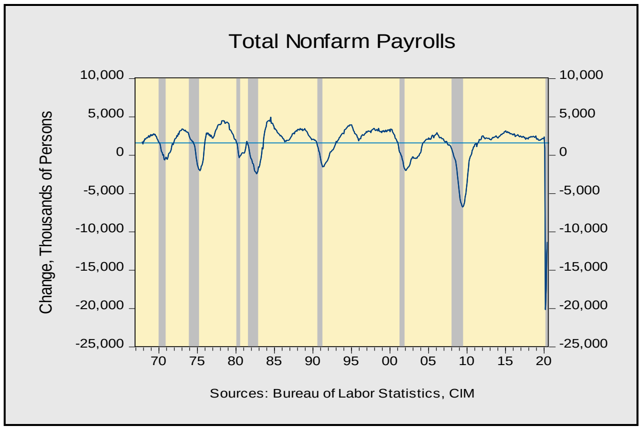
In July, housing starts surged as homebuilders prioritized multi-family over single-family homes. The preference for multi-family homes can be partially attributed to stronger demand and growing confidence amongst homebuilders. Hence, the construction of new homes may be the result of a faster than expected recovery. As a result, annualized housing starts rose from 1,220k in May to 1,496k in the following month. At the same time, the 36-month moving average change rose 8.03 from the prior month, suggesting that housing construction is recovering.

ISM Manufacturing: Supplier Delivery Index



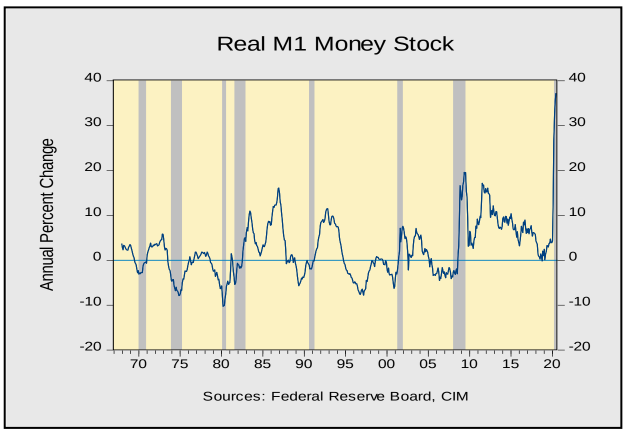
In July, the supplier delivery index dipped as shipments slowed. As a result, last month's reading fell from 56.9 to 55.8. This drop is due to more firms reporting faster deliveries. Despite the decline in the index, the moving average rose from 62.7 to 63.2. The rise in the moving average was due to a shift in the time period. In other words, the moving average rose because the July reading was higher than the January reading, the month that was dropped from the average. Although the indicator suggests that supplier deliveries were improving, this is misleading. The supplier delivery index tracks delivery time. Slow delivery times are considered positive in the model. However, in the current case, slow delivery times are a reflection of pandemic-related disruptions in transportation. Thus, the positive reading is a bit of a distortion.

Total Nonfarm Payrolls



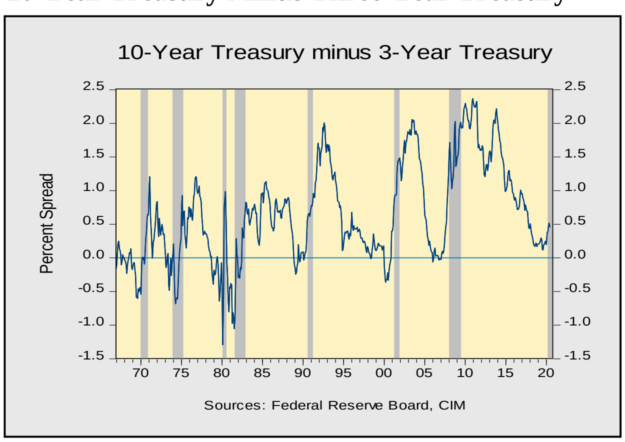
In July, the country gained a record 1.763 million jobs for a 12-month moving sum of -11.371 million. Most of the added jobs came from the private service-providing sectors, especially "leisure and hospitality," which gained 592,000. In total, the services-producing sector accounted for 1.423 million added jobs. Meanwhile, the goods-producing sector contributed 39,000, primarily in manufacturing, which added 26,000. The government sector added 301,000 jobs. Local government had the most job gains at 241,000 and the federal government added 27,000, while state governments added 36,000. Currently, the indicator is significantly below the recession signal of 1.600 million. At this rate, the indicator will likely be signaling recession for the foreseeable future.

Real M1 Money Stock



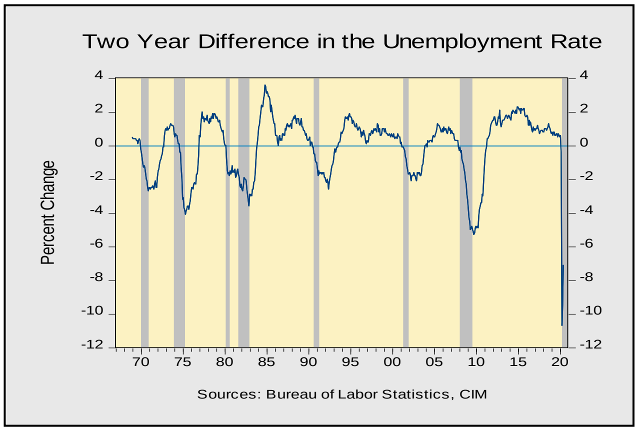
In July, Real M1 rose to its highest level ever for the third consecutive month due to a steep rise in M1. Last month, the Real M1 Money Stock, which is M1 minus inflation, rose 37.13% from the prior year, higher than the previous month's reading of 35.33%. The unprecedented rise in the indicator was heavily influenced by a surge in demand deposits and other checkable deposits at commercial banks, a direct result of accommodative monetary policy and fiscal support for households. Additionally, a slowdown in airfare and energy prices led to a deep deceleration in headline inflation. As a result, M1, which rose 38.13% from the prior year, outweighed the rise in CPI, which rose 0.99% from the prior year.

10-Year Treasury Minus Three-Year Treasury



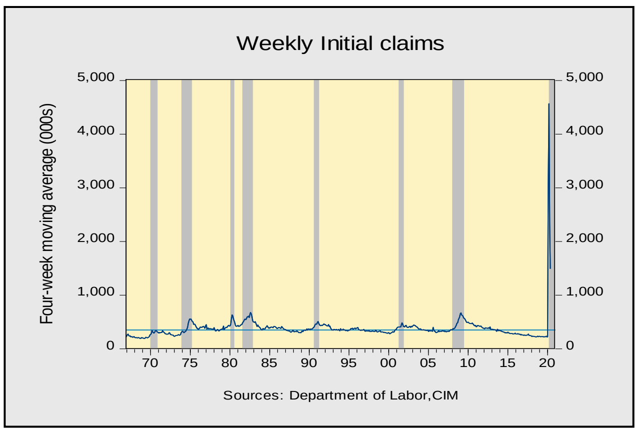
In July, the yield curve flattened as a rise in cases called into question the economic recovery. Additionally, Fed Chair Powell's comments about a slowdown in growth may have led to a flight to safety. As a result, the spread between the 10-year and three-year Treasury narrowed slightly from +0.51 to +0.45. The flattening of the curve will likely continue if cases continue to rise. Last month, the 10-year Treasury fell by 9 bps, while the three-year Treasury fell by 3 bps. As a result, the 10-year fell from +0.51 to +0.45 and the three-year fell from +0.16 to +0.13.

Two-Year Difference in the Unemployment Rate



In July, the two-year spread narrowed slightly as the unemployment rate fell from 11.1% to 10.2%. As a result, the two-year difference narrowed from -7.1 to -6.8. Last month, workers began returning to work which resulted in some labor market tightness. The number of workers employed rose 1.0% from the prior month, while the civilian labor force remained relatively unchanged. Meanwhile, the number of unemployed workers fell 8.0% from the prior month. Despite the drop in the unemployment rate, there is still a large portion of the population that has not returned to the labor force.

Weekly Initial Claims



In July, average weekly initial claims fell for the third consecutive month, coming in at 1.335 million, down from the 1.482 million recorded in the previous month. A bulk of the layoffs came from the "leisure and hospitality" and manufacturing sectors as pandemic fears have hurt travel and shipments. For the most part, individual state reports have begun leveling out. That being said, claims will likely remain elevated until the economy returns to normal.

Thomas Wash
August 27, 2020

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.