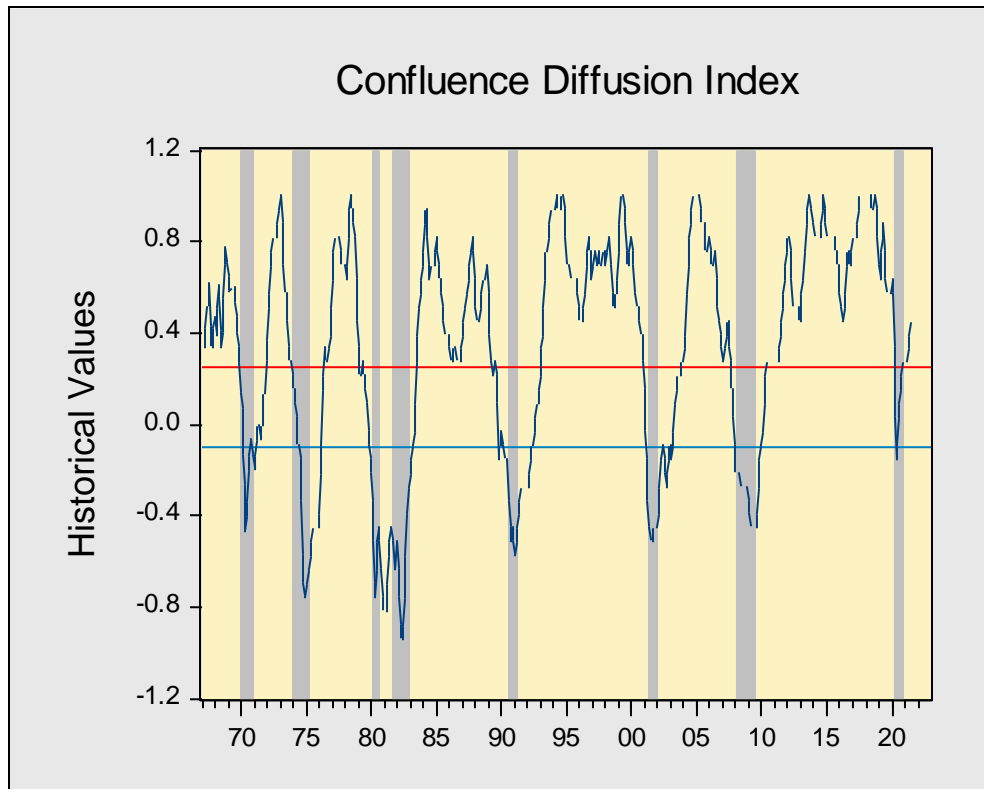


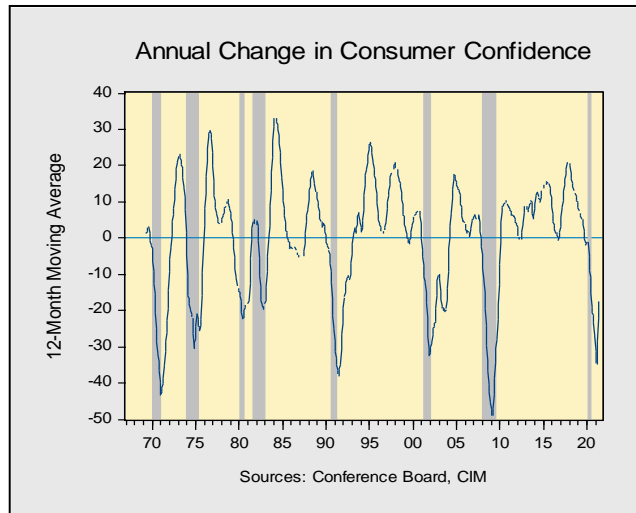
The business cycle has a major impact on financial markets; recessions usually accompany bear markets in equities. The intention of this report is to keep our readers apprised of the potential for recession, updated on a monthly basis. Although it isn't the final word on our views about recession, it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

In July, the diffusion index rose further above the recession indicator, signaling that the recovery continues. In the financial markets, a sharp rise in COVID-19 cases led to a modest sell-off in equities throughout the month. Meanwhile, construction and manufacturing activity slowed as increasing costs for materials and labor continue to be a problem for homebuilders and factories. Lastly, the labor market remains strong as payrolls expanded at a faster than expected pace. As a result, eight out of the 11 indicators are in expansion territory. The diffusion index rose from +0.3939 to +0.4545, remaining well above the recession signal of +0.2500.



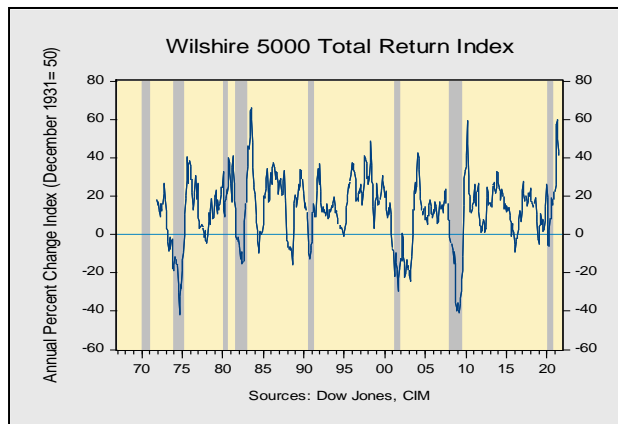
The chart above shows the Confluence Diffusion Index. It uses a three-month moving average of 11 leading indicators to track the state of the business cycle. The red line signals when the business cycle is headed toward a contraction, while the blue line signals when the business cycle is headed toward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



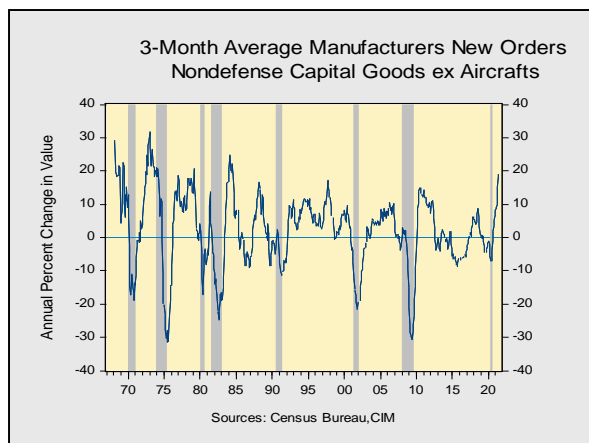
In July, the Consumer Confidence Index was relatively unchanged from the previous month as both the Present Situation Index and Consumer Expectations Index held steady. The latest reading for the Consumer Confidence Index stands at 129.1, up from 128.9 in the previous month. This reading is well above last year's level of 91.7. The 12-month moving average of the annual change in the index rose from -17.1 to -10.3 as seen by the chart on the left. The recent rise in COVID-19 cases has not had the same negative impact on the economy as previous outbreaks. As a result, the Present Situation Index rose from 159.6 to 160.3. Meanwhile, the index for consumers' six-month outlook fell from 108.5 to 108.4.

Wilshire 5000 Index



The annual change in the Wilshire 5000 Total Return Index slowed for the third consecutive month. In July, the index rose 41.0% from the prior year, lower than annual rise of 42.8% recorded in the previous month. The slowdown can be attributed to weaker than expected economic data, an increase in inflation expectations and rising COVID-19 cases. However, strong earnings have kept investors optimistic. The three top-performing sectors in the index were Real Estate, Utilities, and Healthcare, while the bottom-performing sectors were Consumer Discretionary, Financial Services, and Energy.

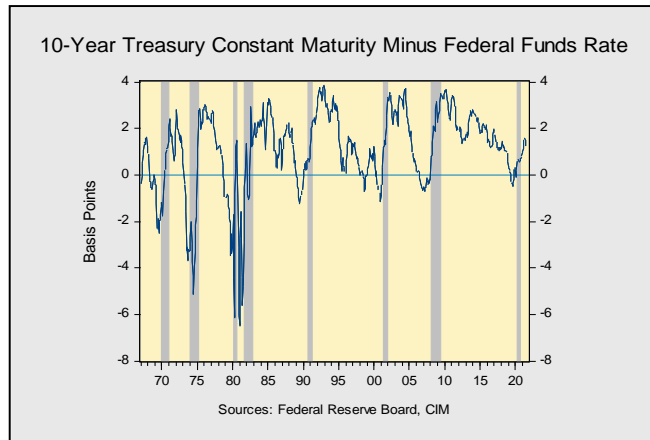
Three-Month Average Manufacturers New Orders Nondefense Capital Goods excluding Aircraft



New orders for durable goods orders, a proxy for business investment, remained strong in July. According to the Conference Board LEI, the value for new orders of durable goods adjusted for inflation rose 0.39% from the previous month. The latest report showed that new orders for nondefense capital goods came in at \$41.283B in 1982-chained dollars, which is 11.83% higher than the previous year. New orders for the previous month were revised higher, from \$41.054B to \$41.123B. The three-month moving average came in at \$41.190B, up from the previous year's value of \$35.694B. The indicator, which tracks the annual change in the three-month moving average

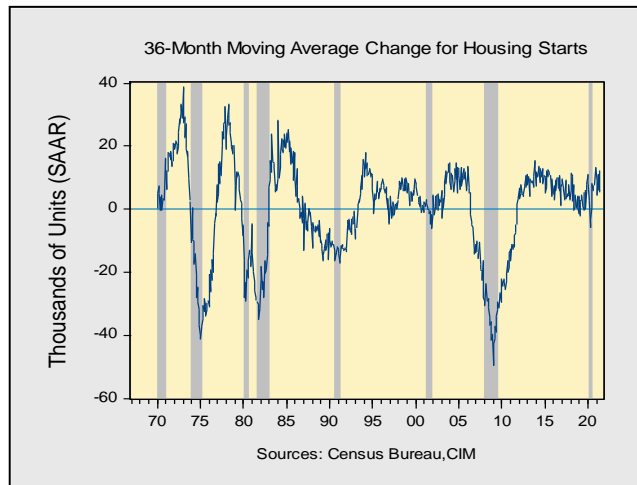
for new orders, came in at 15.51, higher than the previous month's reading of 19.33.

10-Year Treasury Constant Maturity Minus Federal Funds Rate



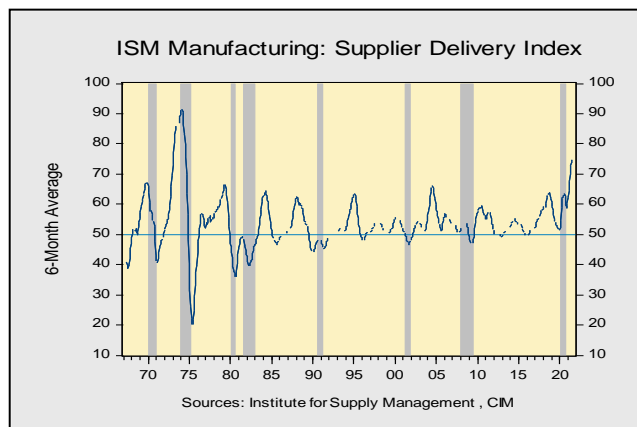
A growing preference for safe haven assets as well as steady monetary policy compressed yield spreads in July. That being said, the 10-year Treasury yield minus the effective federal funds rate, also known as the financial spread, contributed positively to the diffusion index. Last month, the spread declined from +1.44 to +1.22, above the recession indicator of 0. In July, Federal Reserve officials hinted that the central bank could withdraw stimulus sooner than expected. This policy shift likely influenced bond investors' preferences for longer-duration Treasuries. As a result, the 10-year Treasury rate fell from 1.52% to 1.32%, while the fed funds rate increased from 0.08% to 0.10%.

36-Month Moving Average Change for Housing Starts



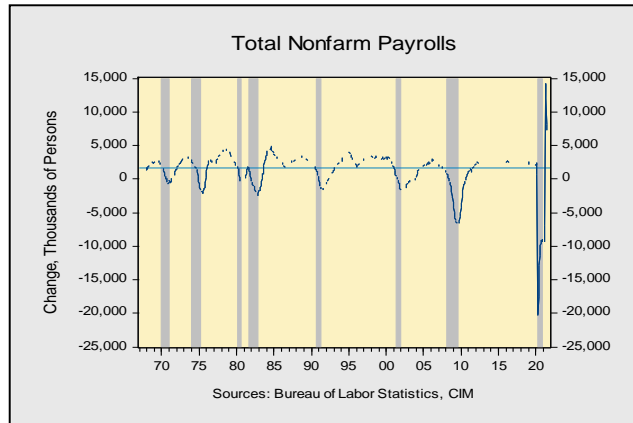
Rising material costs and labor shortages have forced homebuilders to delay projects, leading to a slowdown in residential construction. Last month, annualized housing starts expanded at an annualized pace of 1,534K, lower than the previous month's report of 1,650K. The latest NAHB report showed that the Housing Market Index fell to its lowest point in more than a year. The dip in homebuilder confidence may have contributed to the unexpected decline in building permits for single-family homes. The 36-month moving average for the change of housing starts fell from 12.53 to 9.47, well above the recession signal of 0.

ISM Manufacturing: Supplier Delivery Index



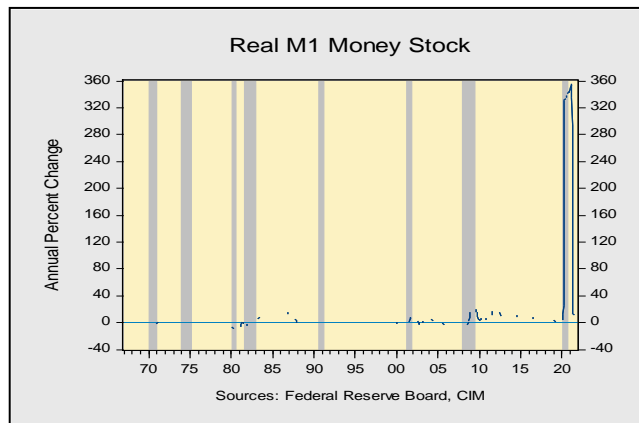
Strong demand for goods has led to an overall improvement in the ISM Manufacturing Index. However, the Supplier Delivery Index fell from the previous month due to expanding production capacity. In general, the index views faster shipments as a negative due to the assumption that it reflects weakening demand. Although in this case the index is wrong, its overall impact on the indicator is limited by the moving average. As a result, the ISM Supplier Delivery Index came in at 72.5 in July, below the previous month's reading of 75.1, while the six-month moving average improved for the eighth consecutive month, rising from 74.3 to 75.0.

Total Nonfarm Payrolls



In July, the country gained 943K jobs for a 12-month moving sum of 7.255MM. Most of the new jobs came from the private services-providing sector, primarily in *Leisure and Hospitality*, which added 380K. In total, the services-providing sector accounted for 703K new jobs. The government sector added 240K, while the goods-producing sector added 44K. Currently, the indicator is significantly above the recession signal of 1.600MM. Given the transitory nature of this indicator, the moving sum will likely decline sharply over the next few months but should remain in expansionary territory.

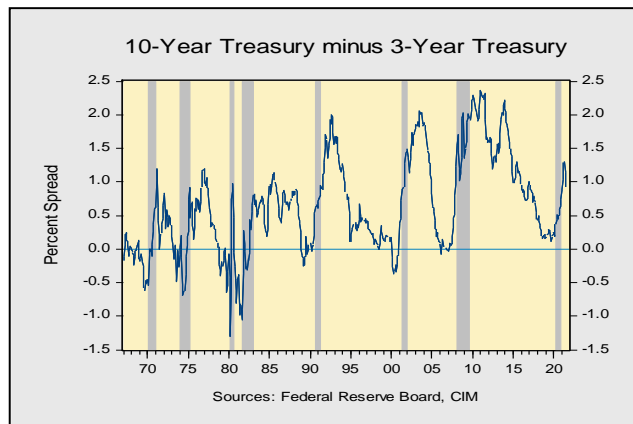
Real M1 Money Stock



In July, the rise in the year-over-year change in Real M1 steadied. Last month, Real M1 Money Stock, which is M1 minus inflation, rose 10.27% from the prior year, down from the previous month's reading of 10.61%. The drop in the indicator was heavily influenced by a change that the Federal Reserve made to its calculation of M1 in March of last year. M1 now includes other liquid deposits, which include 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. The impact of the moderation has started to dissipate, although the change is still observable in the graph.

10-Year Treasury Minus Three-Year Treasury



In July, the spread between the 10-year and three-year Treasury narrowed. Long-duration demand remains strong after the spread of the delta variant increased the attractiveness of safe haven assets. As a result, the spread between the 10-year and three-year Treasury narrowed by 11 bps, from +1.13 in the previous month to +0.92. Last month, the 10-year Treasury yield declined by 20 bps from +1.52 to +1.32, while the three-year Treasury rose by 1 bp from +0.39 to +0.40.

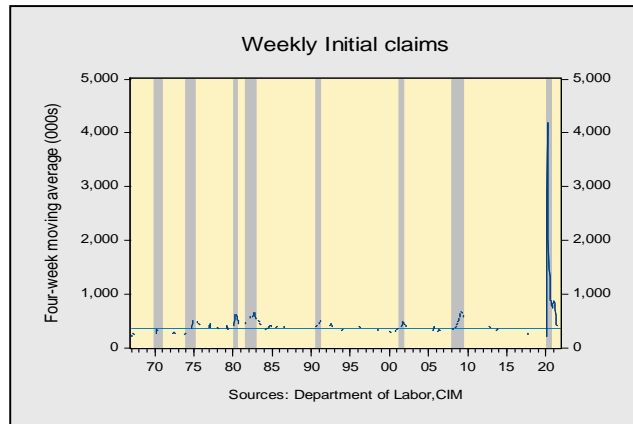
Two-Year Difference in the Unemployment Rate



In July, the two-year spread in the unemployment rate narrowed from -2.3 to -1.8, contributing negatively to the diffusion index. Last month, the unemployment rate fell from 5.9% to 5.4%, well above its level of 3.6% two years prior. The rise in the unemployment rate was largely due to workers finding employment. The number of workers employed rose 0.7% from the prior month, while the civilian labor force rose by 0.16%. Meanwhile, the number of unemployed workers declined by 8.25% from the prior month. Nevertheless, we do not expect this indicator to contribute positively to the diffusion index for the foreseeable future.

Labor market recoveries generally take longer than economic recoveries. As a result, it is unlikely that the unemployment rate will dip below the historic lows we saw in 2019 any time soon.

Weekly Initial Claims



In July, average weekly initial claims remained unchanged from the prior month, coming in at 394K. The drop in initial claims can be attributed to general improvement in the economy.

Thomas Wash
August 27, 2021

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.