By Thomas Wash

The business cycle has a major impact on financial markets; equity bear markets usually accompany recessions. The intention of this report is to keep our readers apprised of the potential for a 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.

August 28, 2025

The US economy sustained its expansion in July, and our proprietary *Confluence Diffusion Index* stayed out of contraction territory for the sixth straight month. Two indicators entered expansion territory, which helped lift the overall diffusion index. Despite initial concerns, the equity markets were positively affected by the reduction in trade uncertainty. Bond markets, however, showed concern about the potential removal of Federal Reserve Chair Powell. Signs of improvement were also seen in the real economy, with both business spending and construction showing growth. The labor market remained stable but did show some signs of weakening.

Financial Markets

Equity markets are proving resilient, with the ongoing trade friction having little apparent impact on investor sentiment. This optimism has spurred a rally, led by strong performances in the Utilities and Information Technology sectors. In the bond market, yields are rising, a reflection of growing investor unease over a potential threat to the Federal Reserve's independence. The concern is that if its autonomy is compromised, the Fed could be pressured to prioritize maximum employment over its core mandate of price stability, an outcome that would have significant implications for monetary policy.

Goods Production & Sentiment

July brought encouraging signs of resilience across key economic sectors. The goods production and sentiment segments notably improved, marked by the first expansion in our indicator that tracks the three-month average of new orders for core nondefense capital goods since 2022. This industrial strength was complemented by a significant jump in housing starts, driven by a pivot toward larger multi-family projects. Furthermore, consumer confidence rebounded noticeably as expectations began to normalize following earlier tariff-related shocks, although the indicator remains in contraction territory.

Labor Market

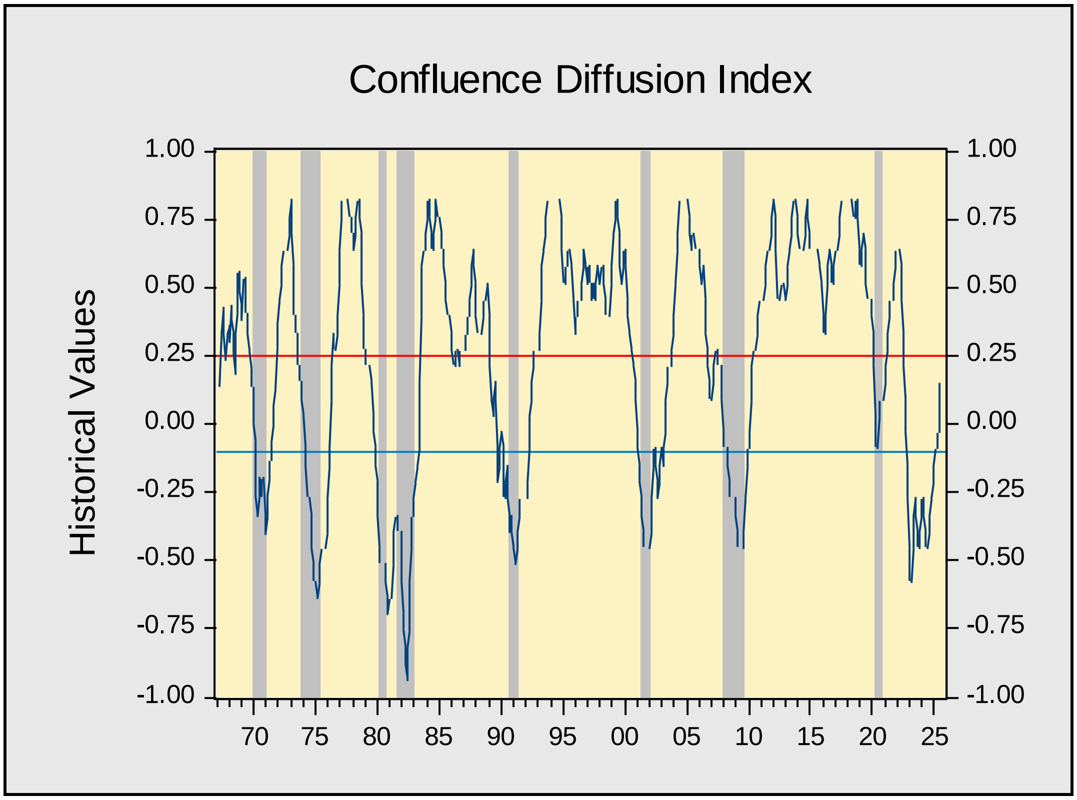
The labor market was the sole category exhibiting signs of weakness, but conditions remain broadly healthy. A slight increase in the unemployment rate weighed on the index, pulling it further into contraction territory. However, downward revisions to July's nonfarm payrolls pushed the indicator to just above the contraction threshold. Some of this weakness is attributable to firms adopting a more risk-averse approach amid ongoing trade uncertainties; this should improve as greater policy clarity emerges.

Outlook & Risks

The economy is on solid footing, with some metrics reaching post-pandemic highs. This trend is expected to continue, provided policy remains predictable. Markets are likely to focus on the potential for monetary easing. While lower rates could mitigate the impact of tariffs on businesses, they also risk fueling inflation by stimulating consumption. Consequently, we are cautiously optimistic on risk assets due to strong fundamentals but await confirmation that this growth is sustainable for the medium term.

The Confluence Diffusion Index for August, which encompasses data for July, remains well above the recovery indicator. However, two of the 11 benchmarks remained in contraction territory from last month. Using July data, the diffusion index rose from -0.0303 to +0.1515, above the recovery signal of -0.1000.

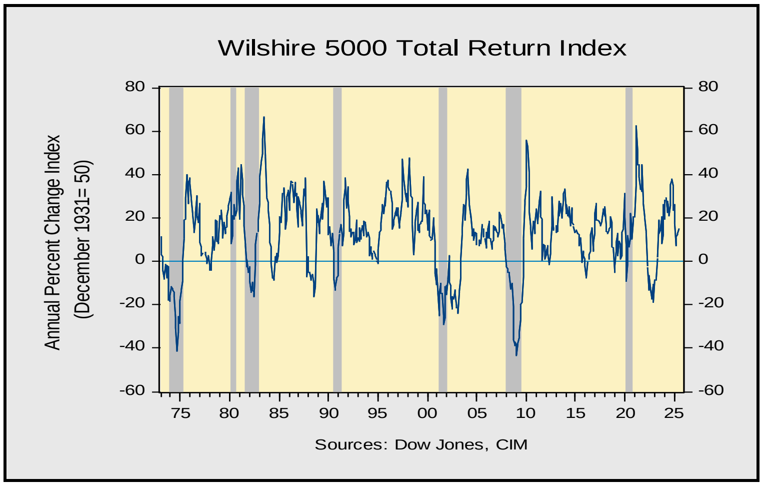
- Equities softened due to trade tensions but remain elevated.
- Business spending showed signs of picking up.
- Revisions hurt job numbers but not enough to enter contraction territory.



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 in recovery. The diffusion index currently provides about six months of lead time for a contraction and five months of lead time for recovery. Continue reading for an in-depth understanding of how the indicators are performing. At the end of the report, the *Glossary of Charts* describes each chart and its measures. A chart title listed in red indicates that the index is signaling recession.

Financial Markets

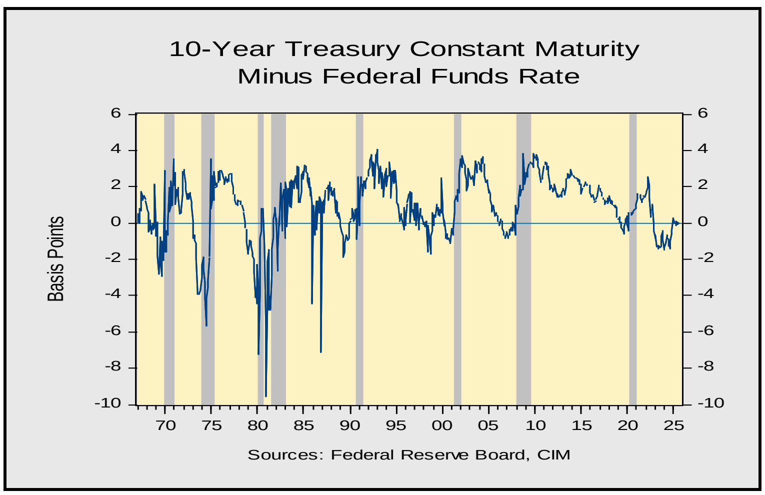
Wilshire 5000 Index



The Wilshire 5000 Total Return Index for July rose 15.7% from the prior year.

- Top-performing sectors: Utilities, Information Technology, and Industrials.
- Bottom-performing sectors: Health Care, Consumer Staples, and Communication Services.
- Indicates recession when the level falls below zero.

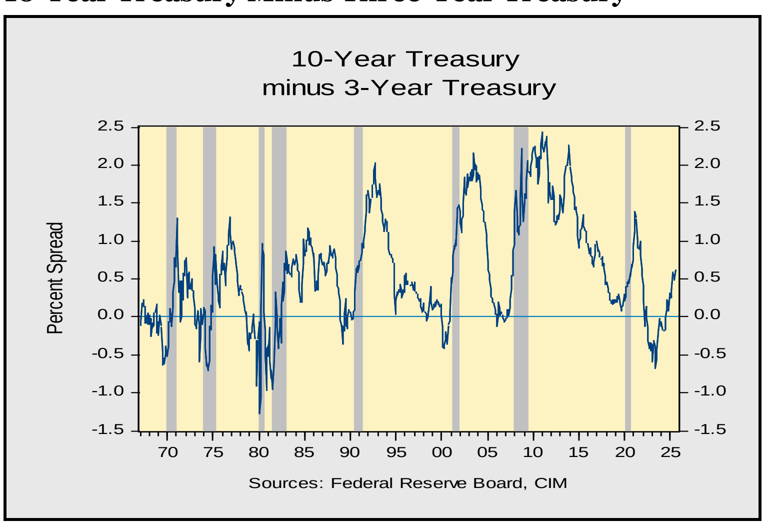
10-Year Treasury Constant Maturity Minus Federal Funds Rate



The financial spread, which is the 10-year Treasury yield minus the effective fed funds rate, improved from -0.09 to +0.04.

- The effective fed funds rate was unchanged at 4.33%.
- The 10-year Treasury rose from 4.24% to 4.37%.
- Indicates recession when the level falls below zero.

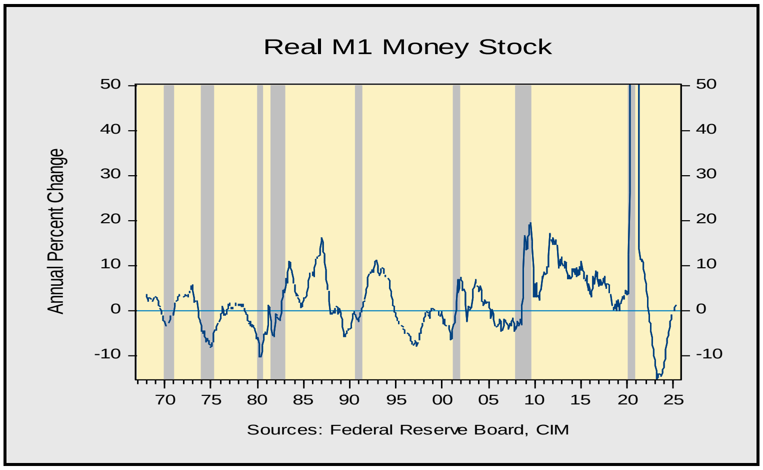
10-Year Treasury Minus Three-Year Treasury



The term spread between the 10-year and three-year decreased from +0.56 to +0.48.

- The 10-year Treasury yield rose from 4.24% to 4.37%.
- The three-year Treasury yield increased from 3.68% to 3.89%.
- Indicates recession when the level falls below zero.

Real M1 Money Stock

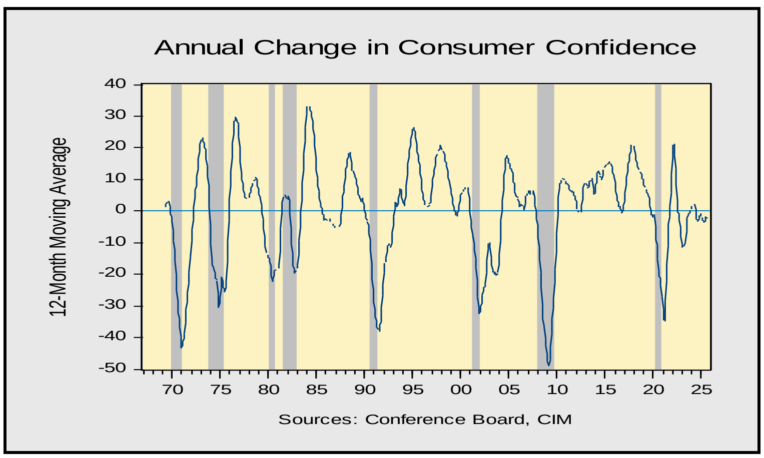


Real M1 money stock rose 1.8% from the prior year.

- Headline CPI rose 2.7% from the prior year.
- M1 money stock rose 4.5% from the prior year.
- Indicates recession when the level falls below zero.

Goods Production & Sentiment

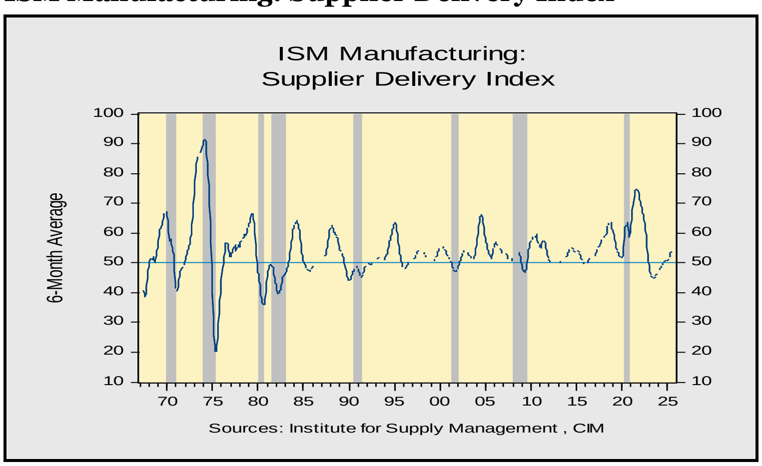
Consumer Confidence



In July, the 12-month moving average of the annual change in consumer confidence improved from a revised -2.8 to -2.0.

- Consumer confidence came in at 97.2, down from 101.9 in July 2024.
- The sub-index for the current situation came in at 131.5, down from 133.1 last year.
- Meanwhile, the sub-index for future expectations decreased from 81.1 to 74.4 in the same period.
- Indicates recession when the level falls below zero.

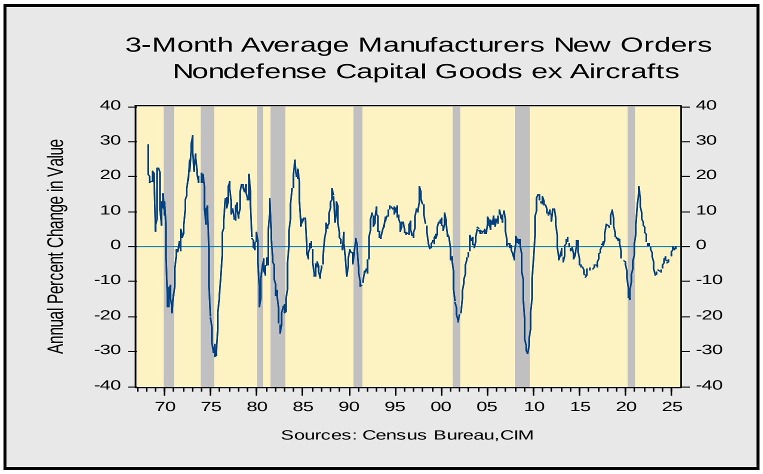
ISM Manufacturing: Supplier Delivery Index



The six-month moving average of the Supplier Delivery Index fell from 54.1 to 53.8.

- The overall index fell from 49.0 to 48.0.
- The Supplier Delivery Index decreased from 54.2 to 49.3.
- Indicates recession when the level falls below 50.

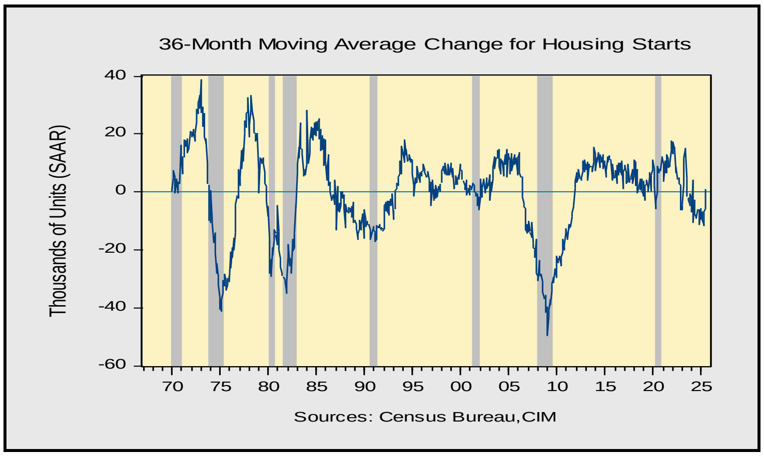
Three-Month Average Manufacturers' New Orders Nondefense Capital Goods excluding Aircraft



The three-month moving average of the annual change in new orders for nondefense capital goods rose 0.2% from the prior year.

- In July, new orders rose 0.5% from the prior month and rose 0.2% since 2024.
- Indicates recession when the level falls below zero.

36-Month Moving Average Change for Housing Starts

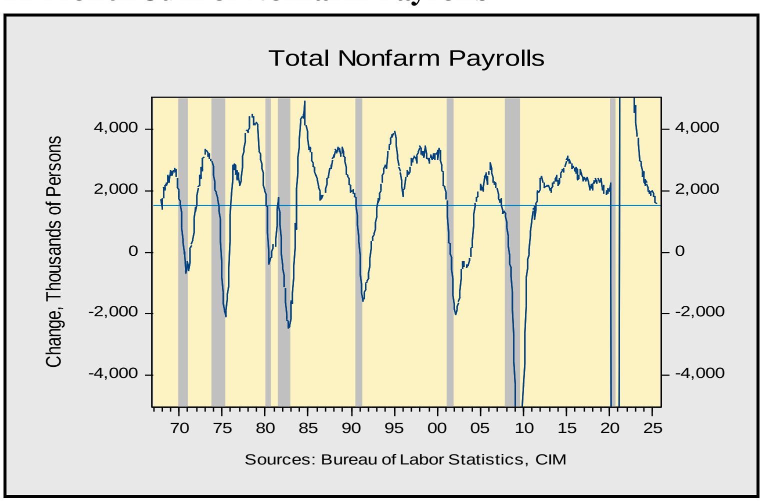


The 36-month moving average change for housing starts improved from -5.36 to +1.31.

- Housing starts expanded at an annualized rate of 1,428k, above the previous month's revised pace of 1,358k.
- Single-family starts rose from 913k to 939k. Multi-family dwellings rose from 421k to 470k.
- Indicates recession when the level falls below zero.

Labor Market

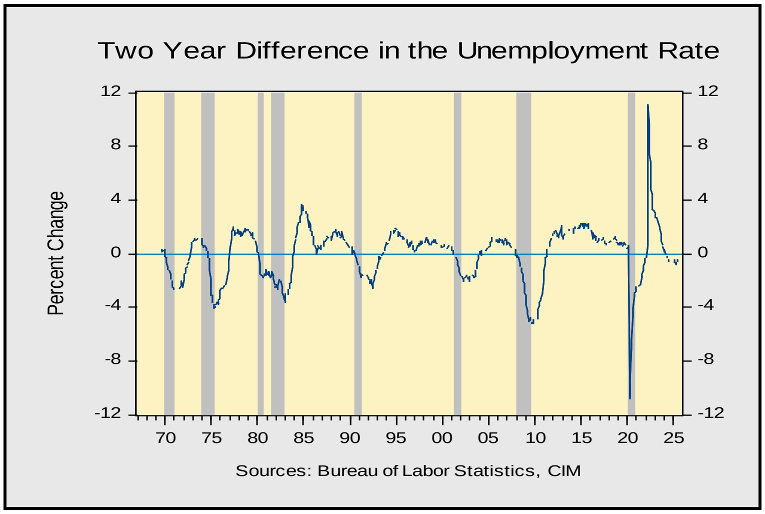
12-Month Sum of Nonfarm Payrolls



The 12-month moving sum decreased from a revised 1,551k to 1,536k.

- Nonfarm payrolls showed that the economy added 73k jobs in July.
- Service-Providing industries added 96k jobs. The Goods-Producing sector lost 13k jobs from the previous month, while the Government sector lost 10k jobs.
- Indicates recession when the level falls below 1,500k.

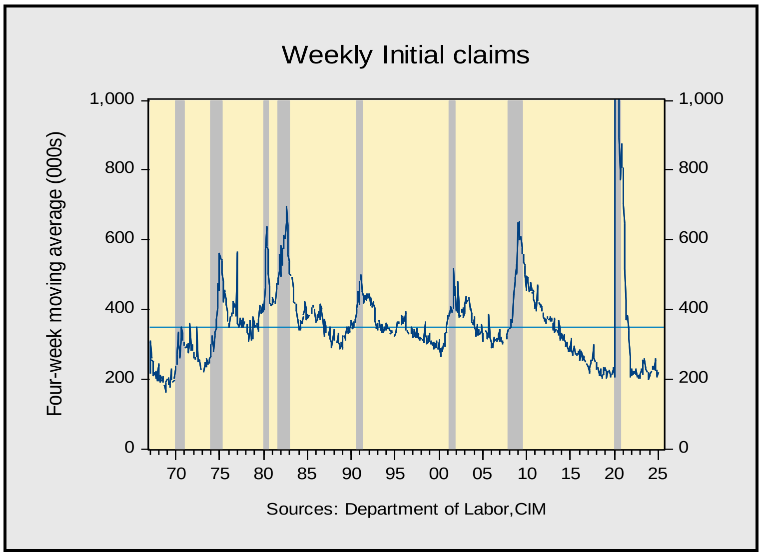
Two-Year Difference in the Unemployment Rate



The two-year difference in the unemployment rate worsened from -0.5% to -0.7%.

- The unemployment rate rose from 4.1% to 4.2%.
- The number of unemployed rose 3.2% from the prior month.
- Indicates recession when the level falls below zero.

Weekly Initial Claims



Average weekly claims for July rose from 228k to 235k.

- Indicates recession when the level rises above 350k.

Thomas Wash, CBE
August 28, 2025

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 US equity index. The index contains 3,500 stocks and is designed to track the overall performance of the US 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 Aircraft: 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 the 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 intense.

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 and gauges 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 July be headed toward a contraction.