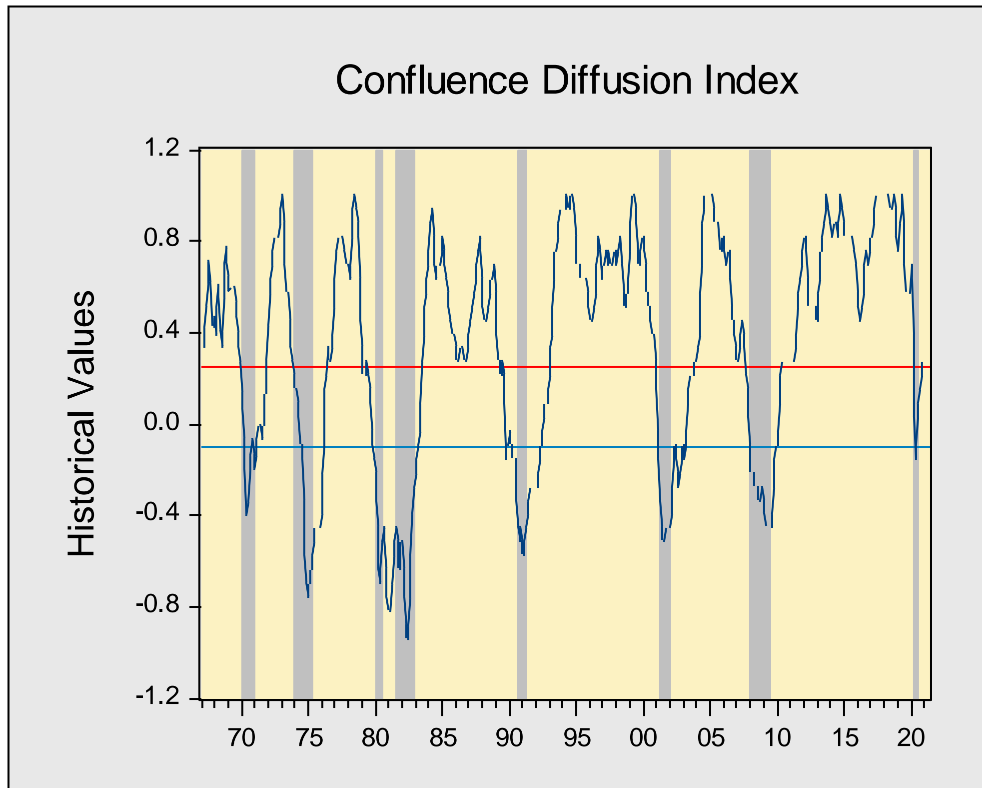
Business Cycle Report

By Thomas Wash

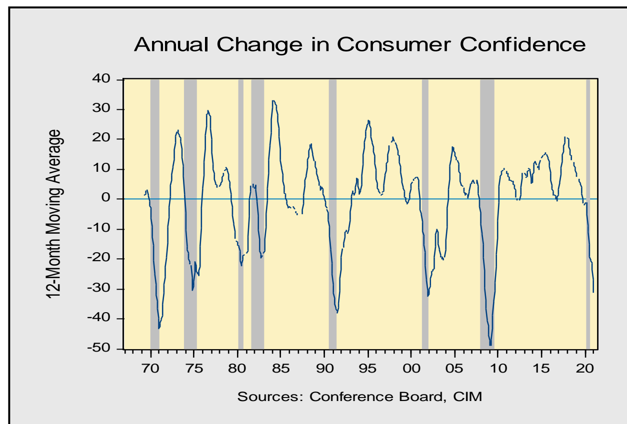
The business cycle has a major impact on financial markets; recessions usually accompany bear markets in equities. The intention of this report is to keep our readers apprised of the potential for recession, updated on a monthly basis. Although it isn't the final word on our views about recession, it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

In January, the diffusion index rose further above the recession indicator, signaling that the recovery continues. Financial markets were mixed as investor optimism about the economy and rising inflation concerns resulted in stronger equities and wider yield spreads. Meanwhile, the labor market worsened due to new COVID-19 restrictions, forcing firms to lay off workers. That being said, manufacturing activity continues to be a bright spot in the economy as factories were able to avoid many of the new restrictions. As a result, four out of the 11 indicators are in contraction territory. The reading for January was unchanged from the previous month at +0.2727, above the recession signal of +0.2500.



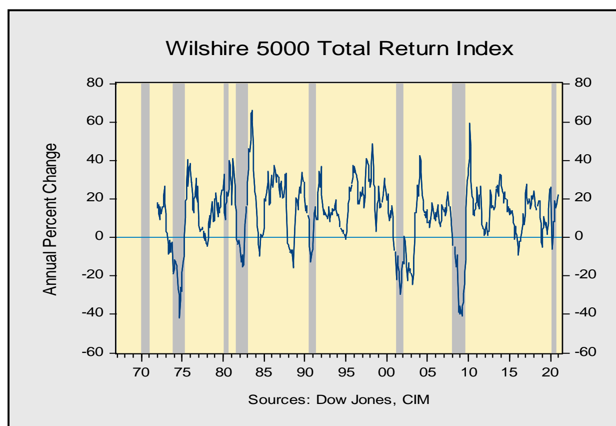
The chart above shows the Confluence Diffusion Index. It uses a three-month moving average of 11 leading indicators to track the state of the business cycle. The red line signals when the business cycle is headed toward a contraction, while the blue line signals when the business cycle is headed toward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



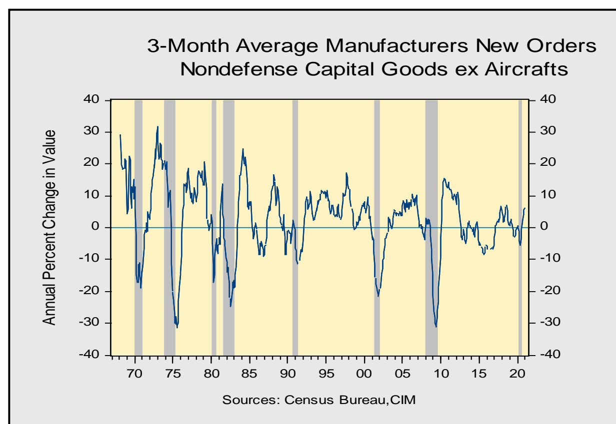
Despite a stronger Consumer Confidence report in January, the indicator remains below the recession signal. Last month, the index rose by 2.2 points from 87.1 to 89.3. This reading is much lower than the previous year's reading of 130.4. As a result, the 12-month moving average of the annual change fell from -27.2 to -31.4. The drop in the index is primarily due to the contrast in views about future expectations compared to last year. A month before the pandemic, developments in the "Phase One" trade deal provided a boost to consumer optimism. Following months of pandemic restrictions and a recession, consumers are now more concerned about virus containment than trade developments. Nevertheless, consumer expectations were the primary drivers in consumer confidence. The consumer six-month outlook rose 5.5 points from the prior month, from 87.0 to 92.5. However, uncertainty about fiscal spending may have dampened current sentiment. The index for consumer optimism present situation fell from 87.2 to 84.4, well below last year's level of 173.9. We expect the index to improve as the economy begins to normalize.

Wilshire 5000 Index



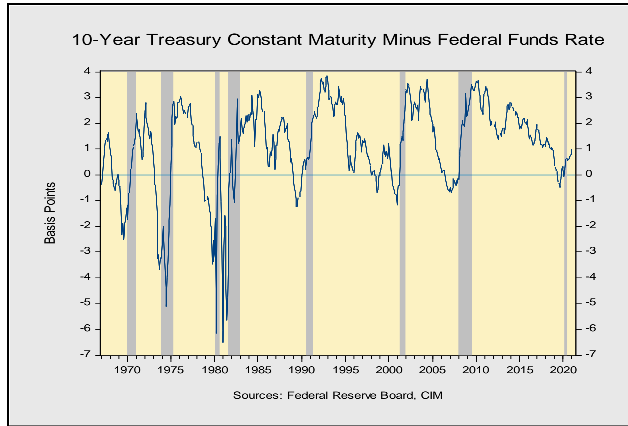
Although the Wilshire 5000 Total Return Index cooled in January, it is higher than it was in the previous year. The index fell from 186.76 to 186.66 last month. The index is 22.4% higher than the previous year. The slowdown in equities was likely the result of rising COVID-19 cases, which led to further lockdown restrictions. The three top-performing sectors in the index were Energy, Healthcare, and Consumer Discretionary. The bottom-performing sectors were Materials, Industrials, and Consumer Staples. We expect equities to remain bullish throughout the year as credit conditions will likely remain favorable for the foreseeable future.

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



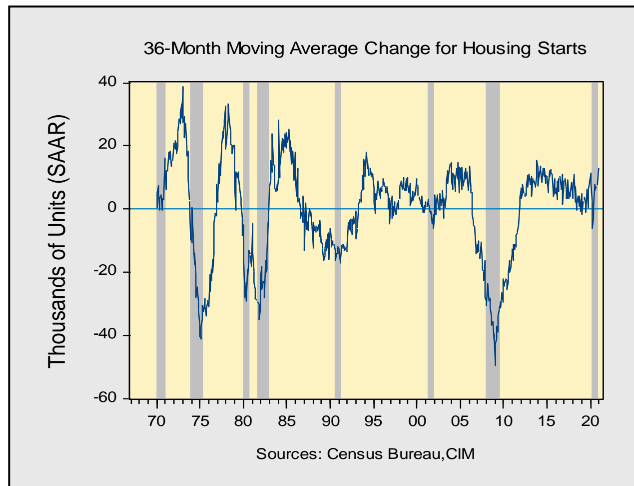
According to the Conference Board LEI, the value for new orders of durable goods fell for the first time in six months. In January, new orders for nondefense capital goods came in at $39.885B in 1982-chained dollars, which is 6.4% higher than the previous year. New orders for December were revised upward from $38.061B to $39.945B. The three-month moving average came in at $39.851B, up from the previous year's value of $37.307B. The indicator, which tracks the annual change in the three-month moving average for new orders, came in at 6.65, higher than the previous month's reading of 6.54.

10-Year Treasury Constant Maturity Minus Federal Funds Rate



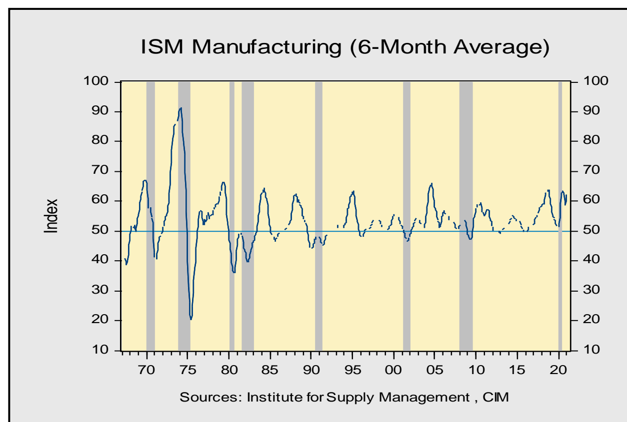
The financial spread, also known as the 10-year Treasury minus the federal funds rate, remained in expansion territory in January. The spread rose from +0.84 to +0.99. The yield curve steepened as the Federal Reserve continues to signal that it is unwilling to raise rates despite a rise in inflation pushing the yield higher on the 10-year Treasury. Last month, the fed funds rate remained unchanged from December at 0.09%. Meanwhile, the 10-year Treasury rose 15 bps from 0.93% to 1.09%.

36-Month Moving Average Change for Housing Starts



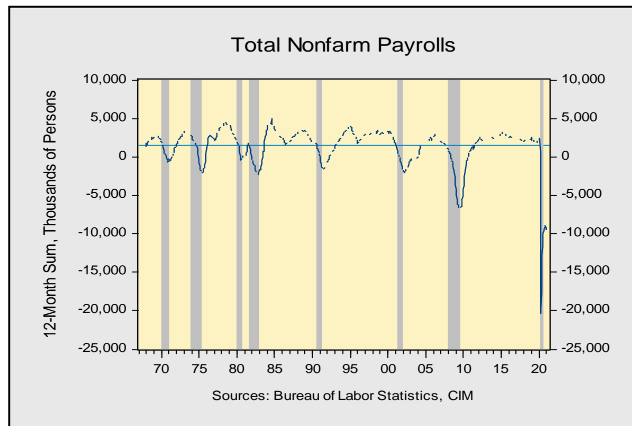
In January, housing starts slowed as a rise in material costs and delays in obtaining those materials slowed construction. The increase in material costs was due to a surge in construction caused by a rise in homebuilder optimism. As a result, annualized housing starts rose from 1,580K in December to 1,680K in the following month. The 36-month moving average change of housing starts rose 7.39K from the prior month, suggesting that housing construction is strong.

ISM Manufacturing: Supplier Delivery Index



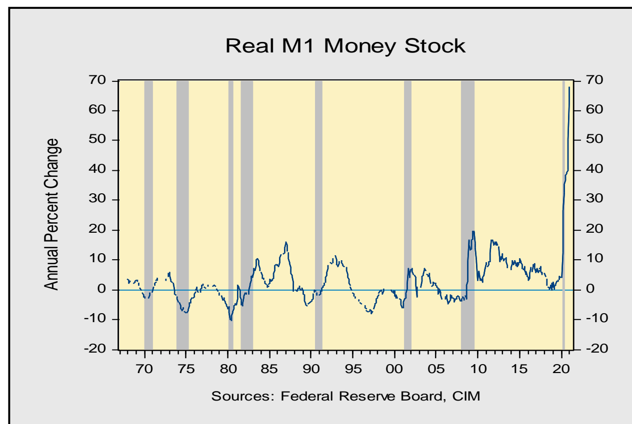
The ISM Supplier Delivery Index rose from 67.7 in December to 68.2 in January. The rise in the index was primarily due to fewer firms reporting faster deliveries. This slowdown in deliveries is likely the result of many firms struggling to get shipments out due to transportation and storage facilities being overwhelmed with orders. Although we believe the rise in orders is partially due to an increase in activity, we suspect the January reading may be slightly exaggerated. Nonetheless, the moving average (located to the left) rose from 60.5 to 62.6.

Total Nonfarm Payrolls



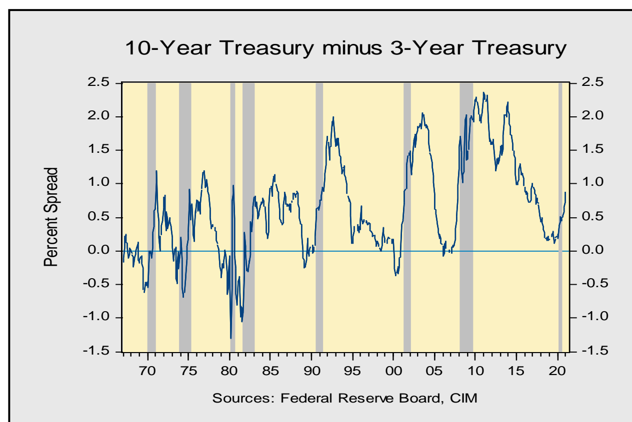
In January, the country gained 49K jobs for a 12-month moving sum of -9.603MM. Most of the jobs added came from the government sector. In total, the government sector accounted for 43K new jobs. The federal government lost 24K jobs, while state and local governments added 31K and 36K, respectively. Meanwhile, the services-producing sector contributed 10K, primarily in *Professional and Business Services*, which added 97K. The goods-producing sector lost 4K jobs. Currently, the indicator is significantly below the recession signal of 1.600MM. At this rate, the indicator will likely be signaling recession for the foreseeable future. Barring a setback, this will likely be brushed off by most analysts as job losses due to the lockdowns were by far the largest in history.

Real M1 Money Stock



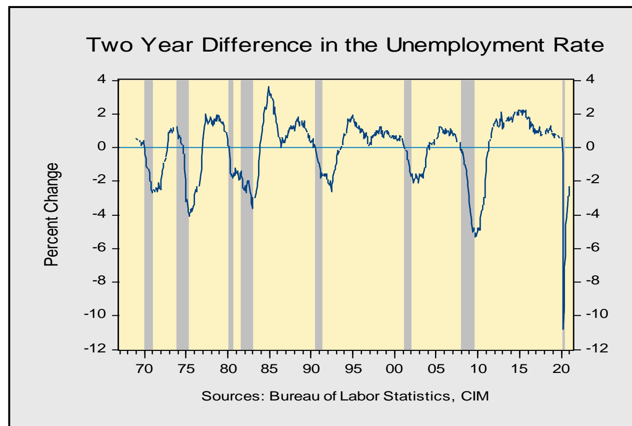
In January, Real M1 rose to its highest level ever for the twelfth consecutive month. Last month, the Real M1 Money Stock, which is M1 minus inflation, rose 68.34%, a new all-time high. The unprecedented rise in the indicator was heavily influenced by a rise in demand deposits. Additionally, a slowdown in airfare and energy prices suppressed the rise in headline inflation. As a result, M1, which rose 69.74% from the prior year, outweighed the rise in CPI, which rose 1.40% from the prior year.

10-Year Treasury Minus Three-Year Treasury



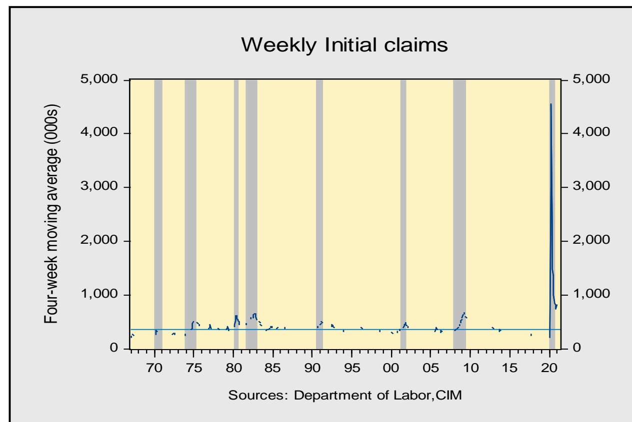
In January, there was a bearish steepening of the yield curve due to optimism over a fiscal stimulus package. As a result, rising inflation fears led to relatively less demand for long-duration bonds. The spread between the 10-year and three-year Treasury widened from +0.74 to +0.88. The widening of 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 15 bps from +0.93 to +1.08, whereas the three-year Treasury rose from +0.19 to +0.20. If the fiscal package passes through Congress, we expect some investors will begin purchasing fewer long-duration bonds.

Two-Year Difference in the Unemployment Rate



In January, the two-year spread in the unemployment rate narrowed from -2.8 to -2.3, contributing negatively to the diffusion index. Despite the drop in the unemployment rate from 6.7% to 6.3%, it remains well above its level of 4.0% from two years ago. Last month, more workers left the labor force than found employment. The number of workers employed rose 0.13% from the prior month, while the civilian labor force fell by 0.25%. Meanwhile, the number of unemployed workers fell 5.64% from the prior month. The drop in the unemployment rate was primarily due to people dropping out of the labor force. That being said, we do not expect this indicator to contribute positively to the diffusion index for the foreseeable future.

Weekly Initial Claims



In January, average weekly initial claims rose for the second consecutive month, coming in at 845K, up from the 825K recorded in the previous month. The rise in initial claims was the result of an increase in COVID-19 restrictions due to rising cases throughout the Midwest and Northeast regions.

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February 25, 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.