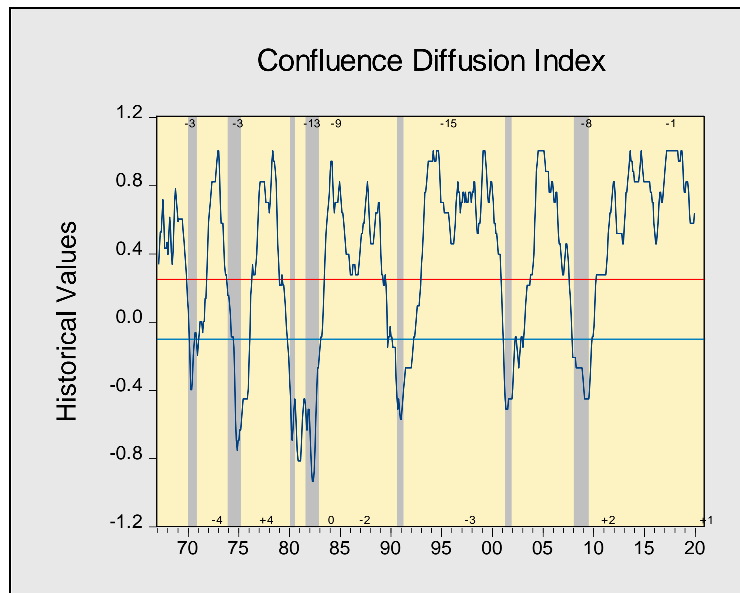
Confluence
INVESTMENT MANAGEMENT

Business Cycle Report

By Thomas Wash

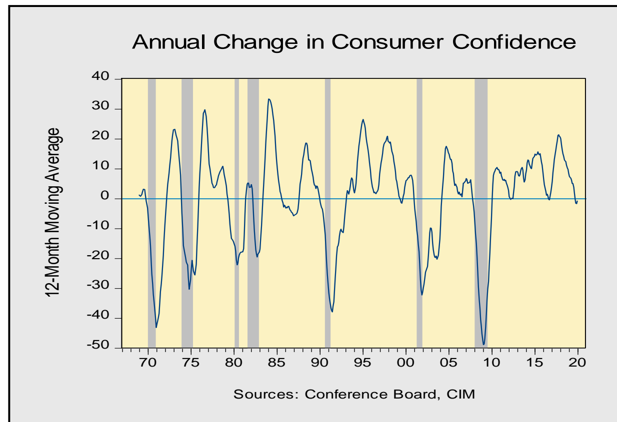
The business cycle has a major impact on financial markets; recessions usually accompany bear markets in equities. We have created this report to keep our readers apprised of the potential for recession, which we plan to update on a monthly basis. Although it isn't the final word on our views about recession,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

January saw broad improvement in the economic data. The signing of the "Phase One" trade deal offered reassurance that the impact of the trade war would be limited in 2020. Several sentiment indicators surged, likely in response to the development. The NFIB Small Business Optimism Index, Chicago National Activity Index, Philly Manufacturing Outlook and Consumer Confidence, which is featured in the diffusion index, all improved during the month. In addition, financial markets offered mixed signals about the resiliency of the economic expansion due to growing uncertainty about the global economy. Conflict between the U.S. and Iran following the death of Qassem Soleimani and the COVID-19 outbreak in China reignited fears of the U.S. economy's exposure to geopolitical risks. As a result, there was a slight deterioration in the gains made in equities and flattening along certain areas of the yield curve. Nevertheless, positive gains in employment and improvement in manufacturing activity suggests the economy remains strong. Our diffusion index has improved from the previous month with nine out of 11 indicators in expansion territory. The reading for January rose to +0.636 from +0.576.



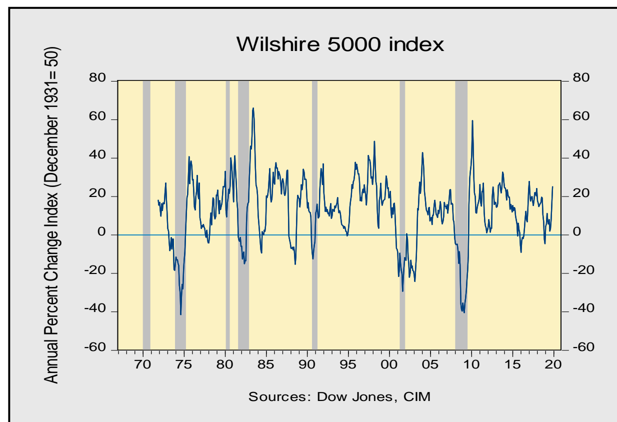
The chart above shows the Confluence Diffusion Index. It uses a three-month moving average of 11 leading indicators to track the state of the business cycle. The red line signals when the business cycle is headed toward a contraction, while the blue line signals when the business cycle is headed toward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



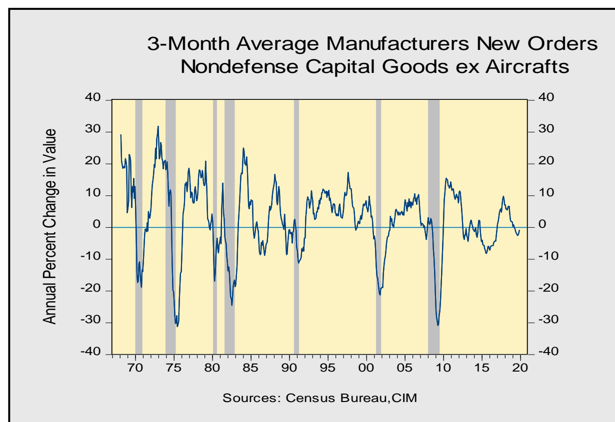
The annual change in the 12-month average for consumer confidence remains in contraction territory at -0.80. The January reading for consumer confidence was 131.5, above the previous month's reading of 128.2. The rise in the index is due to an improvement in consumers' assessment of their present situation and short-term outlook. According to the survey, there was an improvement in the percentage of respondents who claimed business conditions were "good" and that jobs were "plentiful." Additionally, there was an increase in the percentage of respondents who expect conditions and the amount of jobs to improve over the next six months.

Wilshire 5000 Index



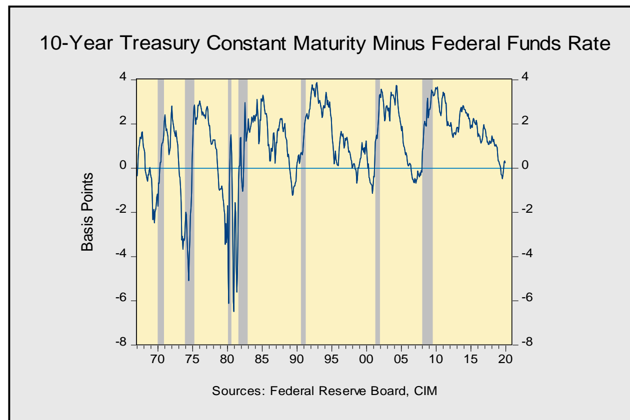
The latest reading of the Wilshire 5000 Index shows an annual change of 26.33%. Although January was a turbulent month for equities, solid corporate earnings and the easing of trade tensions led equity indices, including this one, to reach record highs. The strongest performing sectors of the Wilshire 5000 Index were Utilities and Information Technology, which rose at an annualized pace of 6.28% and 4.00%, respectively. The underlying strength of equity markets is rooted in confidence that the economy will continue to grow, but we suspect that performance may wane if the severity of COVID-19 exceeds market expectations. So far, companies with exposure to China have been hurt more than companies with less exposure.

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



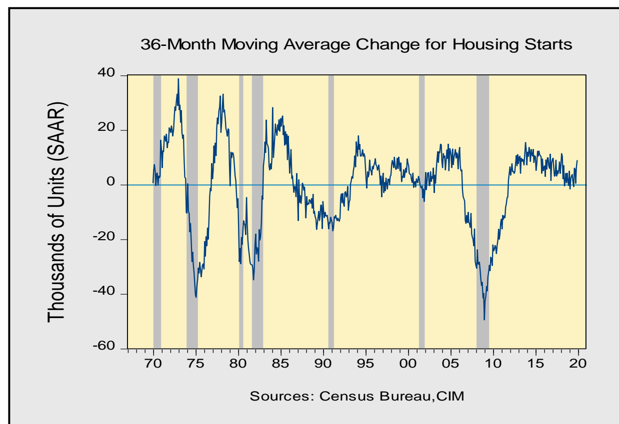
New orders for nondefense capital goods excluding aircrafts recovered slightly but not enough to push the index into expansion territory. The January reading came in at -0.85, an improvement from the previous month's reading of -1.48. The improvement in new orders mirrors other indicators, such as the ISM Manufacturing Composite Index, in signaling a broad pickup in manufacturing activity. A pickup in new orders is likely the result of rising optimism following the signing of the "Phase One" trade deal. However, manufacturing activity could be hurt by supply disruptions due to the coronavirus outbreak.

10-Year Treasury Constant Maturity Minus Federal Funds Rate



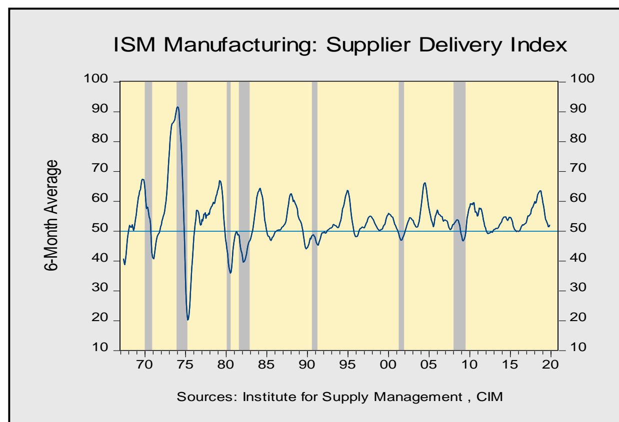
In January, the indicator retreated slightly from +0.31 to +0.21. COVID-19 has dampened manufacturing production and consumption in China as the government tries to contain the epidemic. Government officials from countries such as South Korea and Australia have expressed concerns that the outbreak could weigh on growth in their respective economies. As a result, investors from around the world have increased their purchases of U.S. Treasuries to reduce risk. Meanwhile, improving economic data has encouraged the Fed to maintain rates at current levels. Fed Chair Powell has expressed concerns about the possibility of the virus hurting American businesses, which could open the door for rate cuts later this year.

36-Month Moving Average Change for Housing Starts



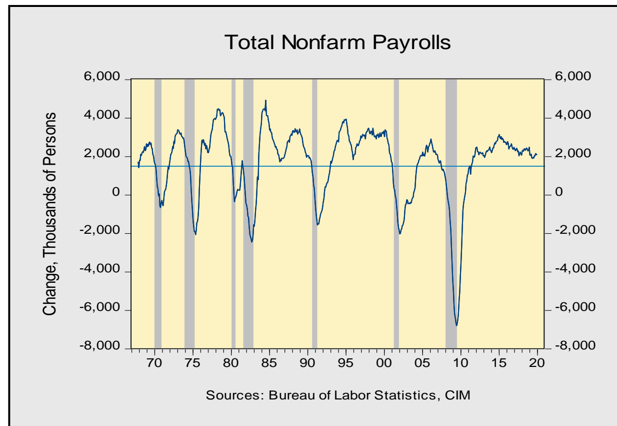
Housing starts remained in expansion territory in January as the 36-month moving average rose from 9.42 to 9.61. The improvement in housing starts suggests homebuilders are becoming more optimistic about the economy. According to the National Association of Home Builders/Wells Fargo Home Market Index, homebuilders' confidence remains elevated. The confidence is likely supported by mortgage rates near record lows, while rising wages and a strong labor market have boosted optimism about consumer demand. However, there are still some concerns lurking in the background as regulations limit the number of homes that can be built.

ISM Manufacturing: Supplier Delivery Index



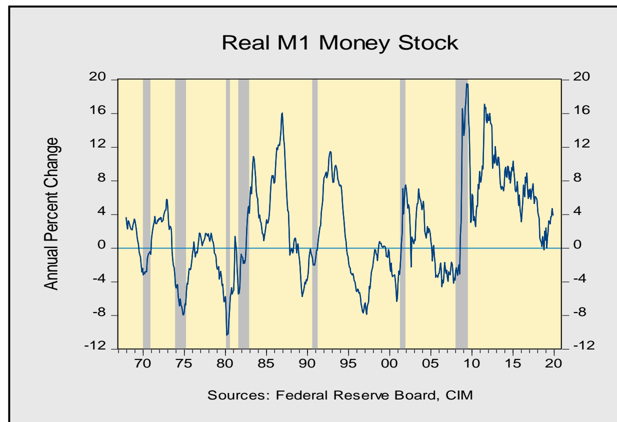
January saw broad improvement in the supplier delivery index. The latest reading came in at a six-month high of 52.9, up from the previous month's report of 52.2. However, the strong month did not improve the moving average. The index has moderated from 51.7 to 51.6 but remains in expansion territory. The drop in the moving average was due to a timing shift. The July 2019 reading of 53.5 fell out of range of the moving average, resulting in a decline in the indicator. Additionally, the ISM Manufacturing Composite Index rose to 50.9 from 47.8, suggesting that manufacturing has generally returned to expansion territory after being in contraction territory for five months.

Total Nonfarm Payrolls



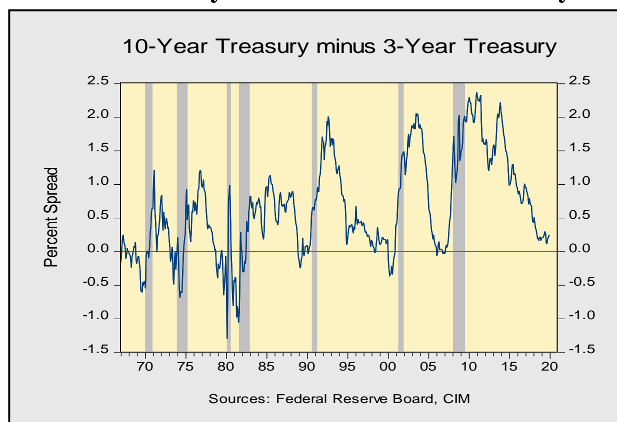
In January, the country added 225k for a 12-month moving sum of 2,052k. Most of the jobs added came from the private service-providing sectors, most notably "education and health services" and "leisure and hospitality," which added 72k and 36k jobs, respectively. In total, the services sector accounted for 174k of the jobs created. Meanwhile, the goods-producing sector added 32k exclusively in construction. Lastly, the government sector added 19k jobs, primarily from local government. Currently, the indicator is well above the recession indicator of 1,800k. However, it does appear that it is struggling to keep pace. Nevertheless, we expect the indicator to improve in February as the minimum needed to increase the sum is 1k. If there are more than 252k job losses, which is highly unlikely, this indicator will fall into contraction territory.

Real M1 Money Stock



In January, the rise in demand deposits and currency outweighed the rise in consumer prices, leading to a modest rise in the indicator. Real M1 money stock rose 3.93% from the prior year, slightly higher than the previous month's reading of 3.89%.[1] Additionally, CPI rose 2.5% from the prior year. The steady injection of liquidity into the repo market has not really changed from the previous reading.

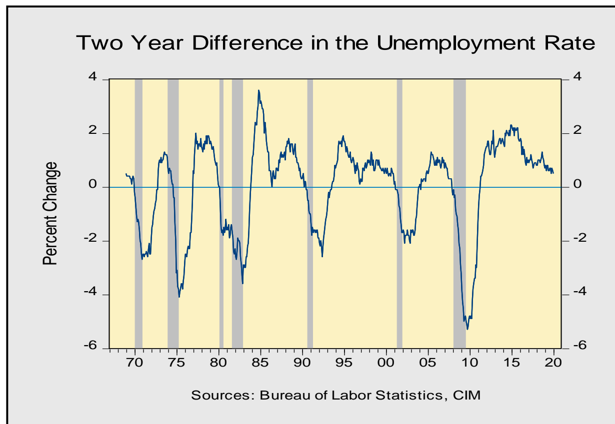
10-Year Treasury Minus Three-Year Treasury



The spread between the 10-year and three-year Treasury widened slightly from +0.23 to +0.24 as market optimism moderated due to the COVID-19 outbreak. The fall-out from the outbreak reignited fears that global supply disruptions could weigh on global growth. As a result, flight-to-safety from international investors led to a drop in Treasury yields. In January, the 10-year Treasury fell 10 bps from 1.86% to 1.76%, while the three-year Treasury fell 11 bps from 1.63% to 1.52%. At this time, it is unclear how much the U.S. economy will be affected, but so far all signs point to a minimal impact.

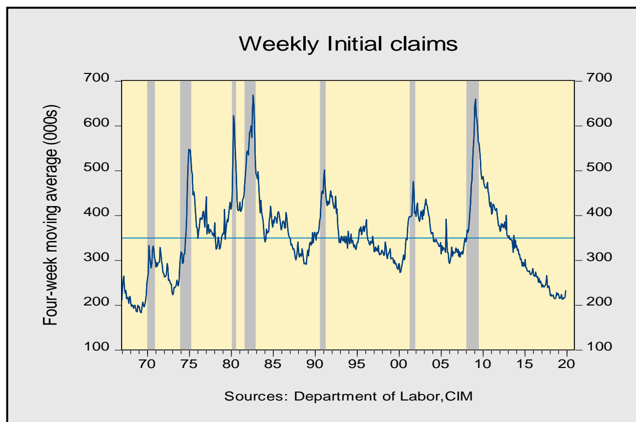
[1] On February 7 the Federal Reserve revised its measure of money stock and the components to incorporate seasonal factors and a quarterly benchmark.

Two-Year Difference in the Unemployment Rate



In January, the two-year difference in the unemployment rate narrowed, signaling a modestly softer labor market. The latest reading shows a drop from +0.6 in December to +0.5 for the current month. The January unemployment rate rose to 3.6% compared to the 4.1% unemployment rate two years prior. The narrowing of the indicator adds to fodder that the unemployment rate may have fallen to its lowest possible level, although there are a few economists who believe the unemployment rate can possibly fall lower. Right now, the unemployment rate is near a 50-year low and has remained under 4.0% for 20 consecutive months. That being said, as the expansion continues to lengthen it will be harder for this indicator to remain in expansion territory.

Weekly Initial Claims



Average weekly initial claims fell sharply in January, coming in at 212k, down from the 232k of the previous month. Initial claims fell to their lowest monthly average during this expansion, providing further evidence that businesses are not under pressure to lay off workers. Hence, business activity remains steady.

Thomas Wash
February 27, 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 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 1,800 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.