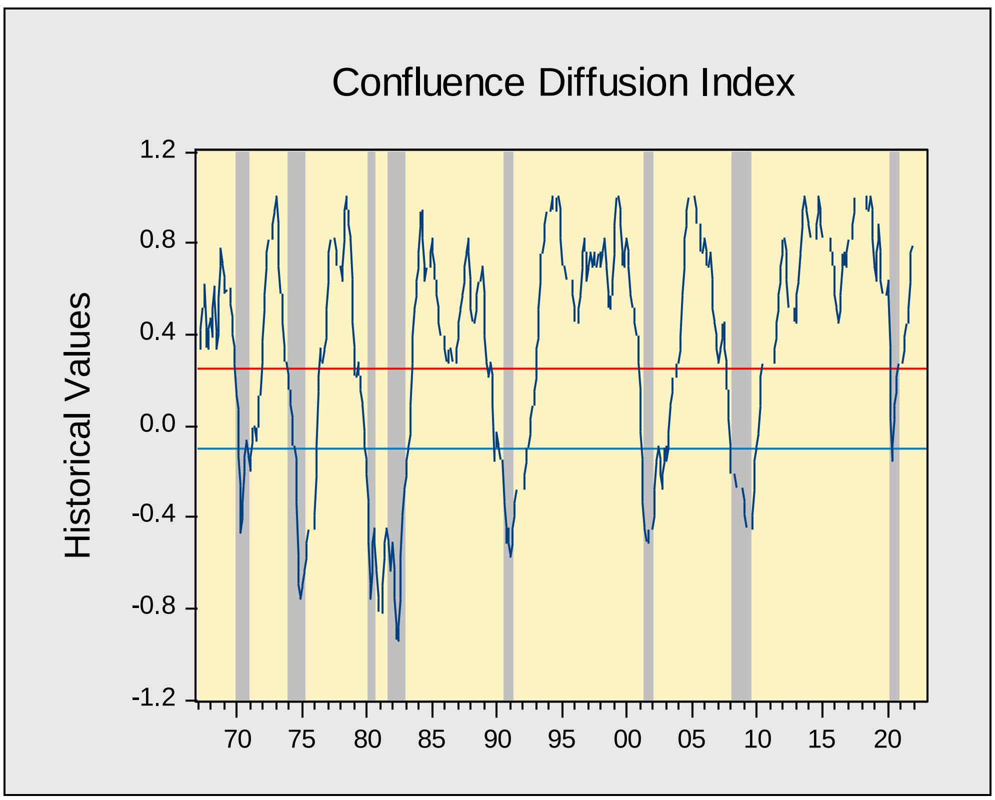
Business Cycle Report

By Thomas Wash

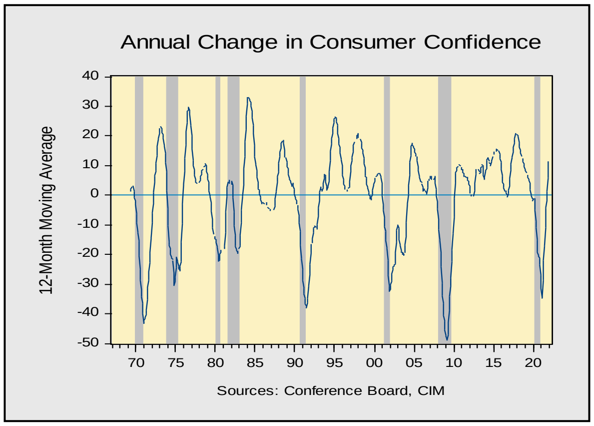
The business cycle has a major impact on financial markets; recessions usually accompany bear markets in equities. The intention of this report is to keep our readers apprised of the potential for recession, updated on a monthly basis. Although it isn't the final word on our views about recession, it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

In December, the diffusion index rose further above the recession indicator, signaling that the economy is still in expansion. In the financial markets, equities cooled following indications from the Fed that it was going to tighten monetary policy in 2022. Meanwhile, construction and manufacturing activity improved as supply chain disruptions showed signs of easing. Lastly, the labor market appears to be strong, with the unemployment rate falling for the eighth consecutive month. That being said, ten out of the 11 indicators are in expansion territory. The Diffusion Index rose from +0.7576 to +0.8182, remaining well above the recession signal of +0.2500.



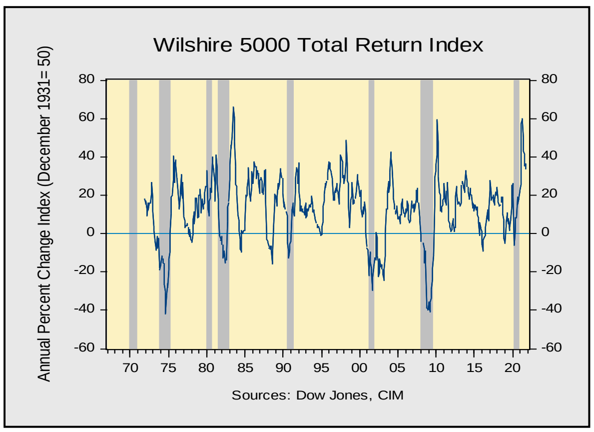
The chart above shows the Confluence Diffusion Index. It uses a three-month moving average of 11 leading indicators to track the state of the business cycle. The red line signals when the business cycle is headed toward a contraction, while the blue line signals when the business cycle is moving toward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

Consumer Confidence



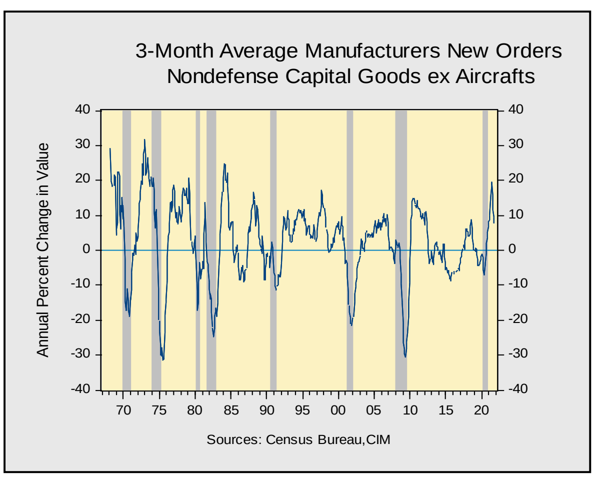
The Consumer Confidence Index contributed positively to the index in December. Last month, the Present Situation Index and the Consumer Expectations Index rose as respondents' fears over the Omicron variant eased. The latest reading for the Consumer Confidence Index stands at 115.8, up from 111.9 in the previous month and well above last year's level of 87.1. The 12-month moving average of the annual change in the index rose from +5.90 to +11.72, as seen on the chart to the left. As a result, the Present Situation Index increased from 144.4 to 144.8. Meanwhile, the index for consumers' six-month outlook rose from 90.2 to 96.9.

Wilshire 5000 Index



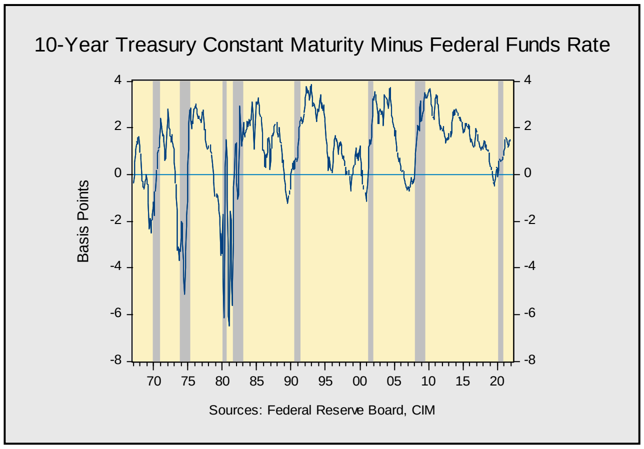
The annual change in the Wilshire 5000 Total Return Index fell in December. Last month, the index came in at 228.44, down 1.4% from the prior month. Additionally, the yearly change slowed to 24.3% in December, down from 33.5% in the previous month. The deceleration in the year-over-year change can be attributed to expectations that the Federal Reserve will raise rates in 2022. The three top-performing sectors in the index were Consumer Staples, Real Estate, and Utilities, while the bottom-performing sectors were Consumer Discretionary, Communication Services, and Energy.

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



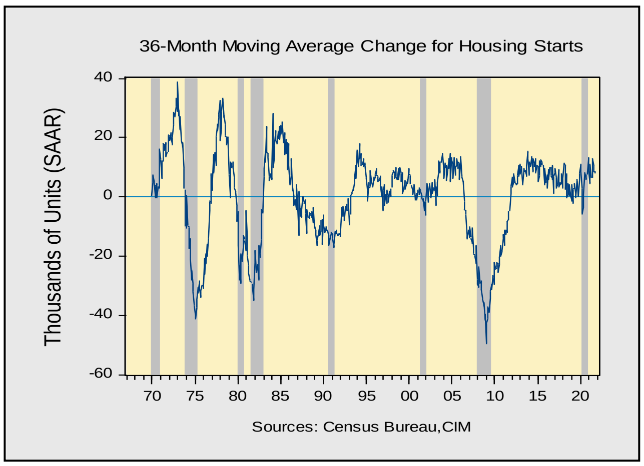
New orders for durable goods, a proxy for business investment, increased in December, according to the Conference Board LEI. The report showed the value for new orders of durable goods adjusted for inflation rose 0.51% from the previous month. The figure for new orders for nondefense capital goods came in at \$41.455B in 1982-chained dollars, which is 4.4% higher than the previous year. The prior month's report was revised lower, from \$41.483B to \$41.244B. The three-month moving average came in at \$41.397B, up from the previous year's value of \$39.216B. The indicator, which tracks the annual change in the three-month moving average for new orders, came in at 5.57, lower than the previous month's reading of 6.92 but still well above the recession indicator of 0.

10-Year Treasury Constant Maturity Minus Federal Funds Rate



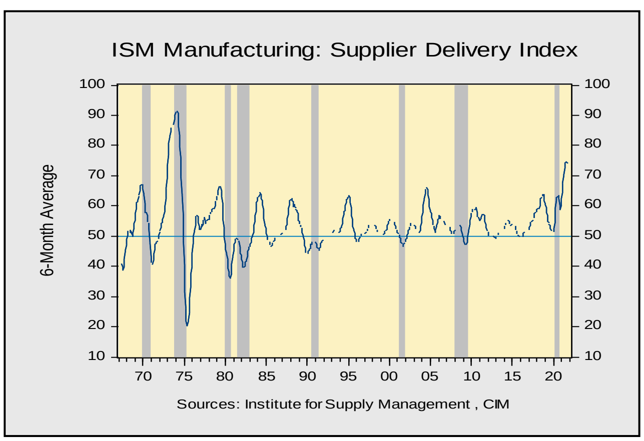
The financial spread narrowed in December due to a sell-off in the 10-year Treasury. The spread narrowed from +1.45 to +1.38, above the recession indicator of 0. Fears of new lockdowns in Europe and Asia led to flight-to-safety from abroad into U.S. Treasuries. As a result, the 10-year Treasury rate fell from 1.56% to 1.47%, while the fed funds rate remained unchanged at 0.08%.

36-Month Moving Average Change for Housing Starts



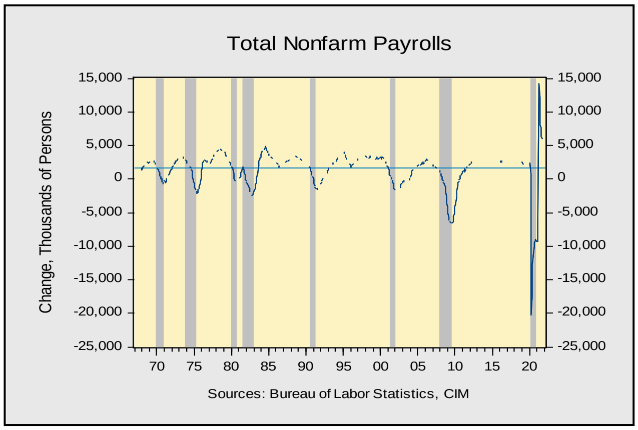
Residential construction accelerated last month as warmer than expected weather allowed for more homebuilding. In December, annualized housing starts expanded at an annualized pace of 1,702K, higher than the previous month's report of 1,650K. The rise in construction contrasted with a dip in homebuilder confidence. The latest [NAHB report] showed that the Housing Market Index fell for the first time in three months. The drop in sentiment is related to continued supply chain disruptions and inflation fears. Hence, residential construction may slow over the next few months. The 36-month moving average for the change of housing starts rose from 13.75 to 16.86, well above the recession signal of 0.

ISM Manufacturing: Supplier Delivery Index



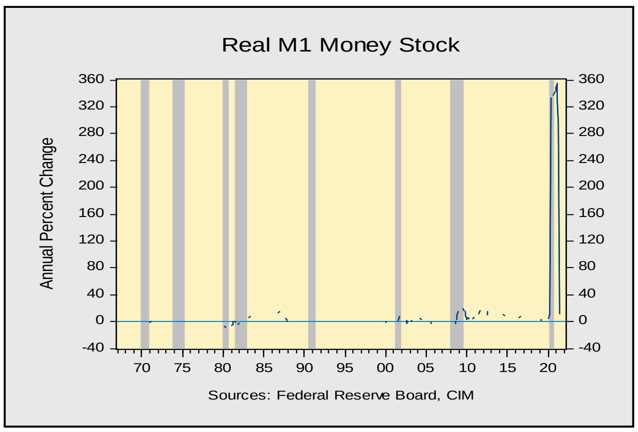
The Supplier Delivery Index fell from the previous month, as manufacturers were having an easier time making orders in December. In general, the index assumes that slower deliveries reflect strengthening demand. Although in this case, the assumption is wrong, and the indicator is still contributing positively to the diffusion index. As a result, the ISM Supplier Delivery Index came in at 64.9 in December, below the previous month's reading of 72.2, while the six-month moving average fell slightly from 73.1 to 71.4.

Total Nonfarm Payrolls



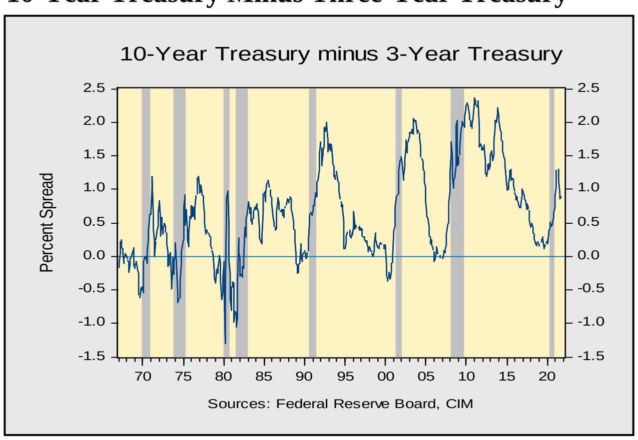
Nonfarm payrolls were relatively weak in December. Last month, the country gained 199K jobs for a 12-month moving sum of 6.448MM. Most of the jobs added came from the private services-providing sector, primarily in *Leisure & Hospitality, which* added 53K. In total, the services-providing sector accounted for 211K new jobs. The government sector lost 12K, while the goods-producing sector added 54K. Currently, the indicator is significantly above the recession signal of 1.600MM. Given the transitory nature of this indicator, the moving sum will continue to decline sharply over the next few months but should remain in expansionary territory for the foreseeable future.

Real M1 Money Stock



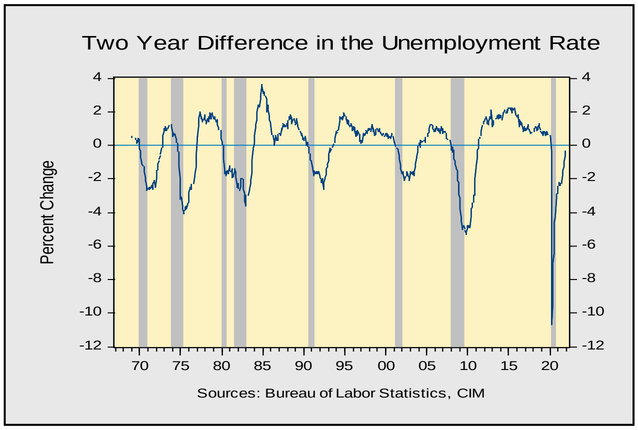
A surge in *Other Liquid Deposits* partly offset the rise in inflation, leading to a slower rise in the Real M1 money stock. In December, Real M1, which is M1 minus CPI, rose 8.39% from the prior year, down from the previous month's reading of 8.87%. The sharp rise in the graph was largely due to a change the Federal Reserve made to its calculation of M1 in March 2020. The Fed replaced *other checkable deposits* with *other liquid deposits*. The latter includes savings deposits in addition to checkable deposits in thrift institutions and commercial banks. The inclusion of savings deposits means that M1 also reflects household savings. The distortion of the change moderated last year; however, the impact is still observable in the graph.

10-Year Treasury Minus Three-Year Treasury



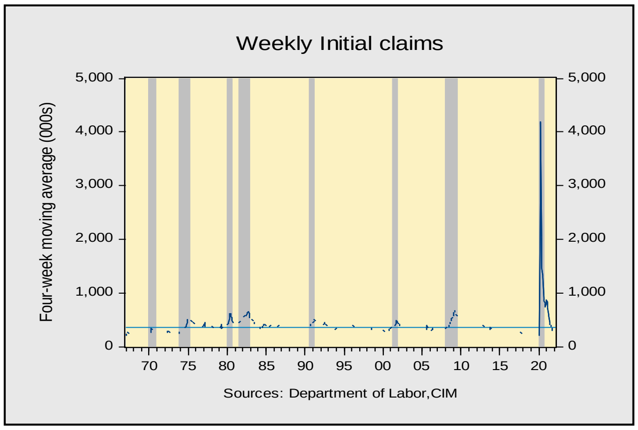
The yields spread narrowed last month due to concerns that the Federal Reserve could raise rates sooner than investors expect and fears related to COVID-19. In December, long-duration bonds fell, and short-duration bonds rose. As a result, the spread between the 10-year and three-year Treasuries decreased by 22 bps from +0.74 in the previous month to +0.52. Last month, the 10-year Treasury yield fell by 9 bps from +1.56 to +1.47, while the three-year Treasury rose by 13 bps from +0.82 to +0.95.

Two-Year Difference in the Unemployment Rate



The two-year spread in the unemployment rate narrowed from -0.6 to -0.3, contributing negatively to the Diffusion Index in December. Last month, the unemployment rate fell from 4.2% to 3.9%, above its level of 3.6% two years prior. The fall in the unemployment rate was largely due to more workers finding employment. The number of workers employed rose 0.42% from the prior month, while the civilian labor force rose by 0.10%. Meanwhile, the number of unemployed workers declined by 7.10% from the prior month.

Weekly Initial Claims



In December, the four-week moving average fell further below the recession indicator. Last month, initial claims fell by 38K from the prior month to 304K from 266K. The drop in initial claims can be attributed to the general improvement in the economy.

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January 27, 2021

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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.