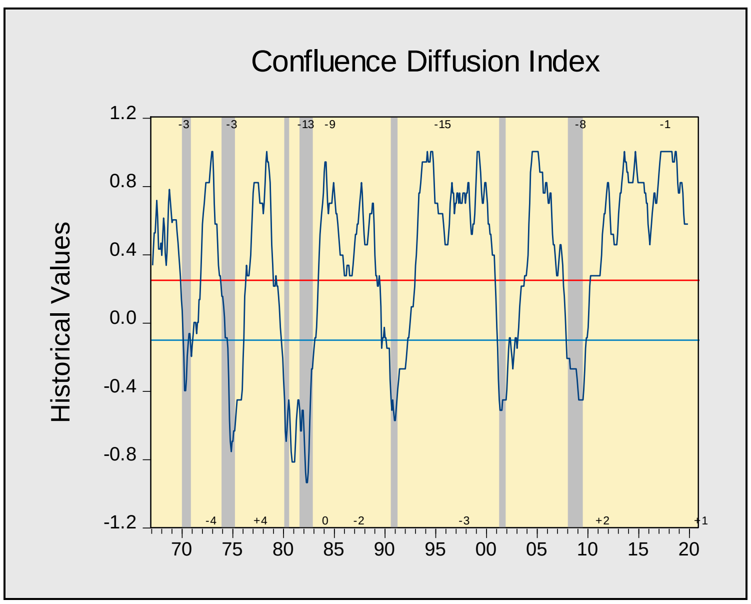
Business Cycle Report

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.

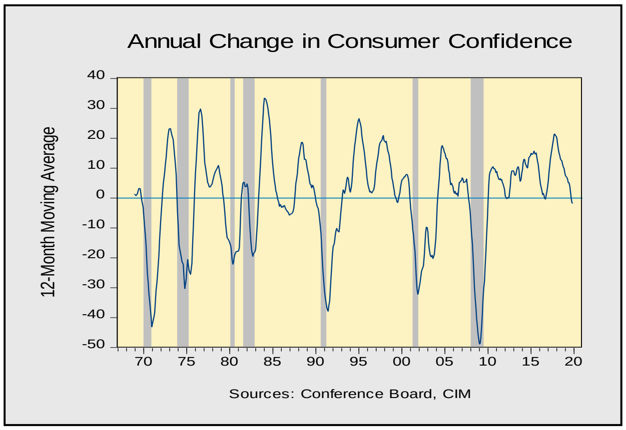
December brought a wave of positive news about the economy. U.S. large and mid-cap equities ended the year at record highs largely due to strong performance in the Technology sector.[1] Moreover, the U.S. and China announced an agreement for the "Phase One" trade deal. Additionally, strong retail sales around the holiday break offered reassurance that U.S. consumption, which is the largest contributor to GDP, remains strong. However, not all was positive. The manufacturing sector continued to show signs of weakness that will likely persist into 2020. Last month, Boeing (BA, 323.89), arguably the largest U.S. manufacturing exporter, announced that it will suspend production of its Boeing 737 Max starting in January. It is estimated that the production cut will reduce annualized GDP by 30 to 50 bps. That being said, our diffusion index has remained unchanged from the previous month with nine out of 11 indicators in expansion territory. The reading for this month came in at +0.575.



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.

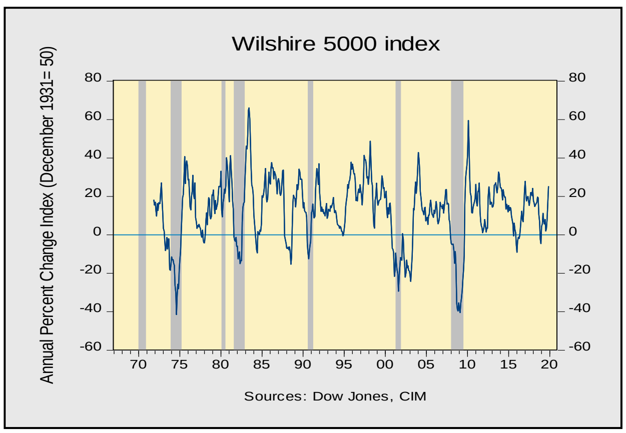
[1] The basis used is the S&P 500 and S&P 400.

Consumer Confidence



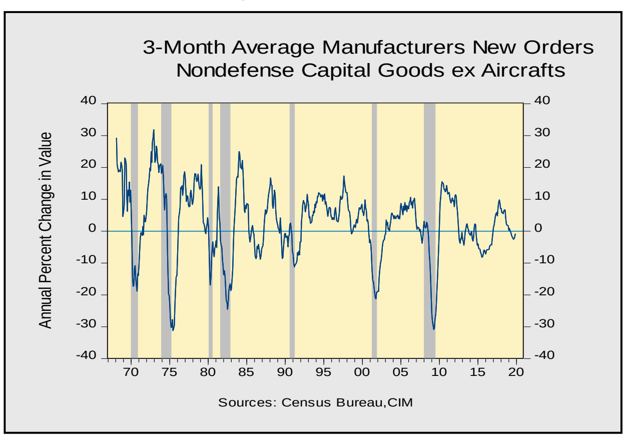
The annual change in the 12-month average for consumer confidence remains in contraction territory at -1.98. The December reading for consumer confidence was 126.5, which is below the previous month's reading of 126.8. The drop in consumer confidence can be attributed to weakening expectations. The survey measuring consumer short-term outlook, consumer expectations, fell from 100.3 to 97.4, which suggests consumers are becoming more pessimistic. However, it is also worth noting that consumer sentiment about the present situation rose from 166.6 to 170.0. According to the Conference Board report, concerns about the labor market weighed on consumer short-term outlook as respondents stated they were pessimistic about the availability of jobs and the likelihood of an increase in income. Nevertheless, consumers are generally upbeat about the current state of the economy.

Wilshire 5000 Index



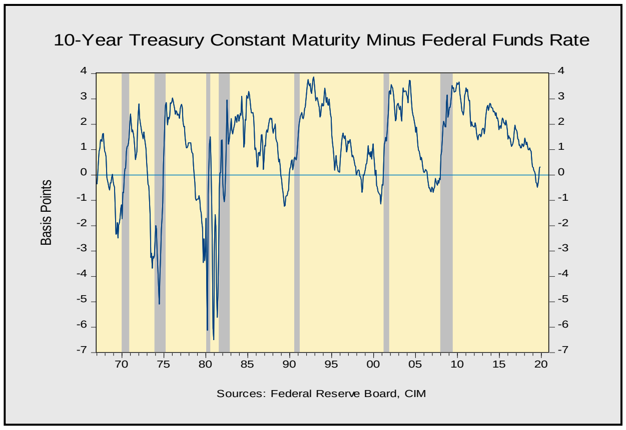
The latest reading of the Wilshire 5000 Index shows an annual change of 25.03%. The strong performance of equities in December was largely due to trade. In the middle of the month, the Trump administration announced it had an agreement with China for a "Phase One" trade deal that was reported to reduce tariffs and increase Chinese purchases of some U.S. goods. Equities rose in response to a thaw in trade relations between the two countries. Additionally, strong economic data improved sentiment about the economy. Higher wages, stronger than expected payroll numbers and reportedly strong sales over the holiday break all eased fears of an economic downturn. The sectors that saw the biggest gains in December were Energy and Information Technology.

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



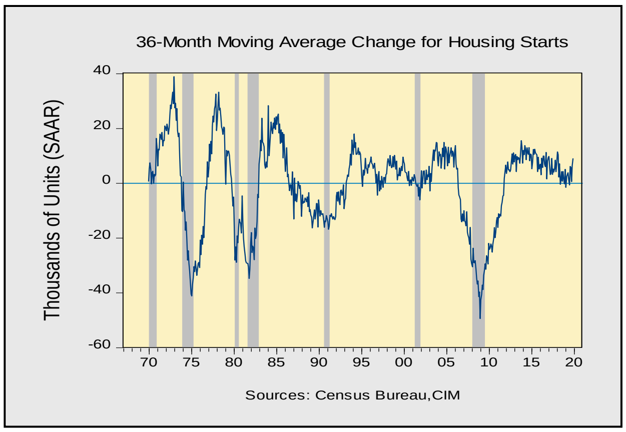
New orders for nondefense capital goods excluding aircrafts recovered slightly, but not enough to push the index into expansion territory. The December reading came in at -0.95, a slight improvement from the previous month's reading of -2.10. The rise in the moving average was due to an improvement in new orders over the prior year for the first time since March 2019. The improvement is consistent with the rise in manufacturing output reflected in the industrial production report. The manufacturing sector, which makes up 11% of the economy, has been weighed down by rising costs due to higher wages and tariffs.

10-Year Treasury Constant Maturity Minus Federal Funds Rate



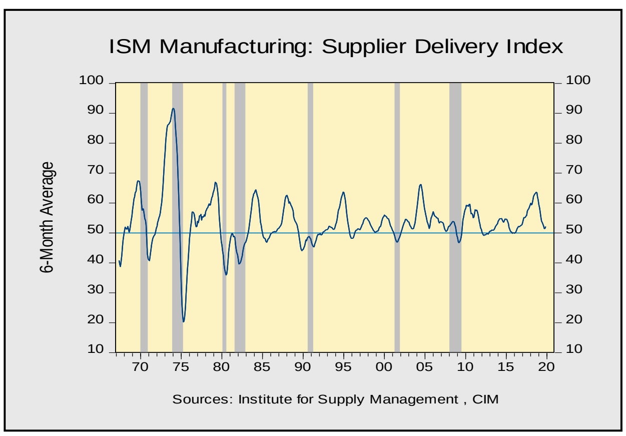
The current reading is +0.31, which is above the recession indicator. In December, the indicator remained in expansion territory as a pause in Fed rate cuts and thawing trade tensions resulted in an unchanged effective fed funds rate and rising 10-year Treasury rate. The trend reversal suggests the economy may be on a more stable path compared to earlier in the year. However, it is possible the economy could be close to recession as reversals can also be a sign that the Fed was too late to act. Thus, it may be too early to tell if the economy has completely avoided a recession. But, the positive economic data for December has improved the outlook.

36-Month Moving Average Change for Housing Starts



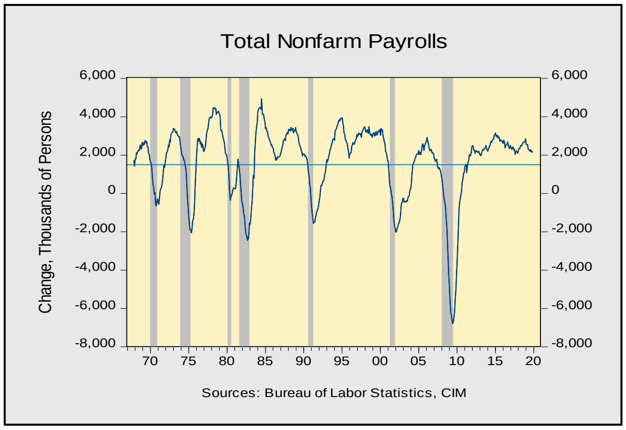
Housing starts surged back into expansion territory in December. The 36-month moving average rose from 6.25 to 8.92. The improvement in the moving average is partly due to mild winter weather in December, which allowed for higher than usual construction activity. On an annual seasonally adjusted basis, housing starts rose to their highest level in 13 years at 1608k. This jump in starts represents an incredible 40.8% rise from last year's pace. Low interest rates and strong growth may have boosted optimism among homebuilders. That being said, a shortage of lots due to municipal regulations has prevented builders from starting as many units as they would like.

ISM Manufacturing: Supplier Delivery Index



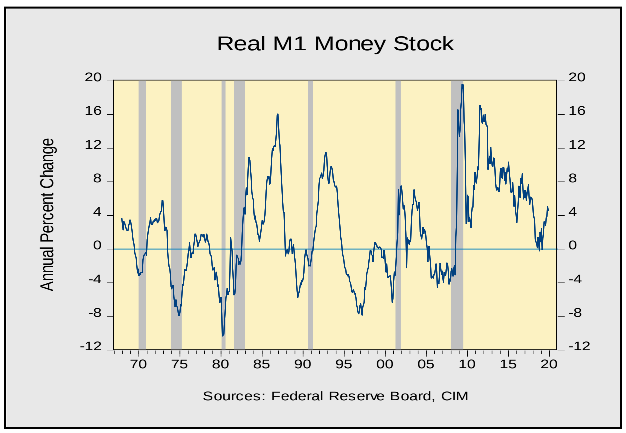
The index improved from 51.3 to 52.0 as fewer purchasing managers reported faster deliveries in December. Despite what most people might expect, fast deliveries are not a good sign for the economy. Generally, when manufacturing activity rises firms have trouble delivering orders as promptly as they would like due to the factory possibly being under staffed, capacity being limited or simply not having enough material to fill orders. As a result, factories are forced to slow deliveries in order fulfill orders adequately. That said, ISM manufacturing composite index remains in contraction territory at 47.2, which is lower than the previous month's reading of 48.1. Additionally, supplier delivery and the price index were the only two components of the survey, within the broader ISM manufacturing index, in expansion territory.

Total Nonfarm Payrolls



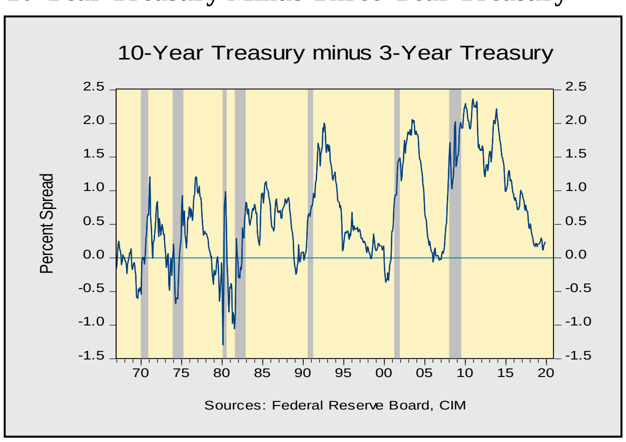
In December, the country added 145k for a 12-month moving sum of 2,108k. Most of the jobs added came from the private service-providing sector such as health services and retail trade. In total, the sector accounted for 140k of the jobs created. Meanwhile, goods-producing sectors, such as manufacturing and mining, lost 1k jobs. Additionally, the government sector added 6k jobs, which came exclusively 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. In order to prevent this indicator from degenerating further, there will need to be at least 170k created in January. Furthermore, if there are more than 309k job losses, which is highly unlikely, this indicator will fall into contraction territory in the next report.

Real M1 Money Stock



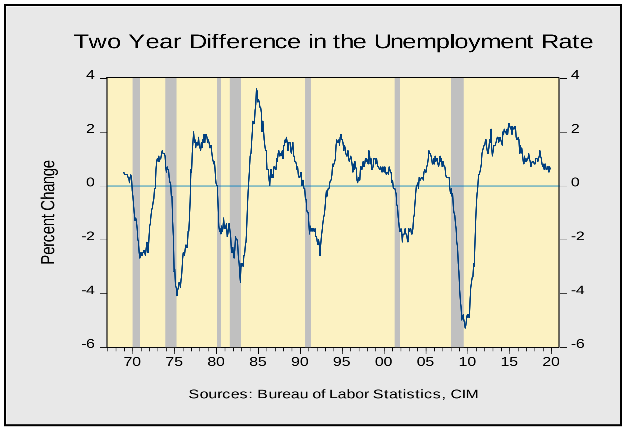
Real M1 money stock rose 5.03% from the prior year. The sharp rise in the indicator was due to a rise in liquidity and stable inflation. In December, M1 rose 7.14% from the prior year, largely due to an increase in demand deposits. Additionally, inflation, as measured by the consumer price index, rose 2.3% from the prior year. The rise in demand deposits can likely be attributed to the Federal Reserve's continued intervention in the repo market. In September 2019 the Federal Reserve inserted cash into the repo market when funding stress, primarily due to financial firms paying taxes, sent the overnight loans rate as high as 10%. Although it isn't clear when the Fed will stop injecting cash into the repo market, there has been speculation that it will continue at least until the end of the first quarter. Therefore, it is highly unlikely that this indicator will dip into recession territory anytime soon.

10-Year Treasury Minus Three-Year Treasury



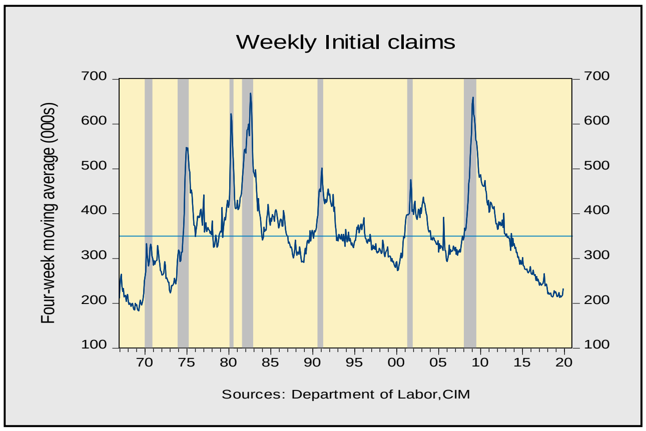
The spread between the 10-year and three-year Treasury widened from +0.20 to +0.23, suggesting that investors are becoming more optimistic about the economy. The widening of the spread was largely due to a rise in the 10-year Treasury outweighing the rise in the 3-year Treasury. In December, the 10-year Treasury rose 5 bps from 1.81% to 1.86%. Meanwhile, the 3-year Treasury rose 2 bps from 1.61% to 1.63%. The rise in the 10-year yield is likely due to increased optimism about the long-term health of the country.

Two-Year Difference in the Unemployment Rate



In December, the two-year difference in the unemployment rate narrowed, signaling a modestly softer labor market. The latest reading shows a drop from +0.7 in November to +0.6 in December. The unemployment rate for December remained steady at 3.5% compared to the 4.1% unemployment rate two years prior. The narrowing of the indicator adds fodder that the unemployment rate may have fallen to its lowest possible level, although there are a few economists who believe the [unemployment rate could potentially fall lower]. The unemployment rate is currently at a 50-year low and has remained under 4% for 19 consecutive months. However, as the expansion continues to lengthen it will be harder for this indicator to remain in expansion territory.

Weekly Initial Claims



The average weekly initial claims rose sharply in December. Last month, average initial claims came in at 232k, up from the 217k of the previous month. The spike in initial claims can be attributed to a later than usual Thanksgiving holiday, which may have pushed potential filings into the following weeks. Claims in the first full week of December came in at an unusually high 252k, but fell to 235k, 224k and 223k in the following weeks. At this time, we are not concerned about the rise in initial claims, but we will be monitoring the number closely.

Thomas Wash
January 30, 2020

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.