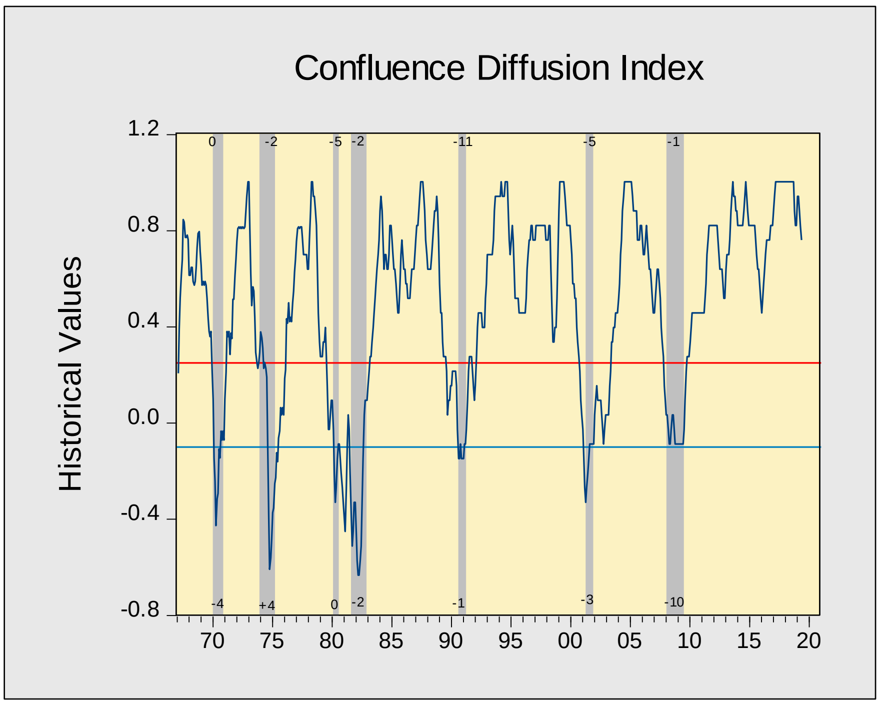
Business Cycle Report

By Thomas Wash

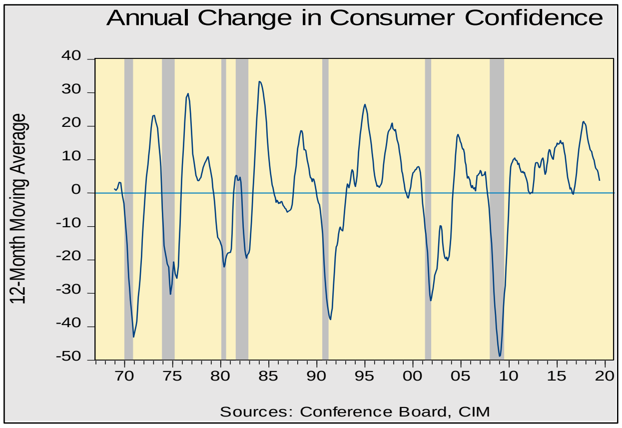
The business cycle has a major impact on financial markets; recessions usually accompany bear markets in equities. We have created this report to keep our readers apprised of the potential for recession, which we plan to update on a monthly basis. Although it isn't the final word on our views about recession,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

Economic data released for June suggests the economy remains strong but is showing some signs of weakness. Currently, our diffusion index shows that 9 out of 11 indicators are in expansion territory, with several indicators approaching warning territory. The index currently sits at +0.757.[1]

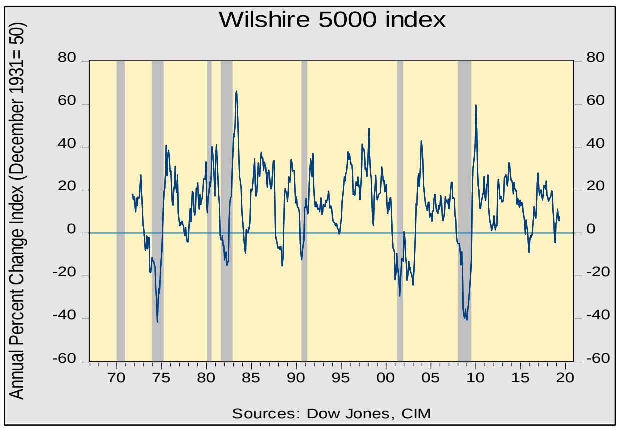


The chart above shows the Confluence Diffusion Index. It uses a three-month moving average of 11 leading indicators to track the state of the business cycle. The red line signals when the business cycle is headed toward a contraction, while the blue line signals when the business cycle is headed toward a recovery. On average, the diffusion index provides about four months of lead time for a contraction and two months of lag time for a recovery. Continue reading for a more in-depth understanding of how the indicators are performing.

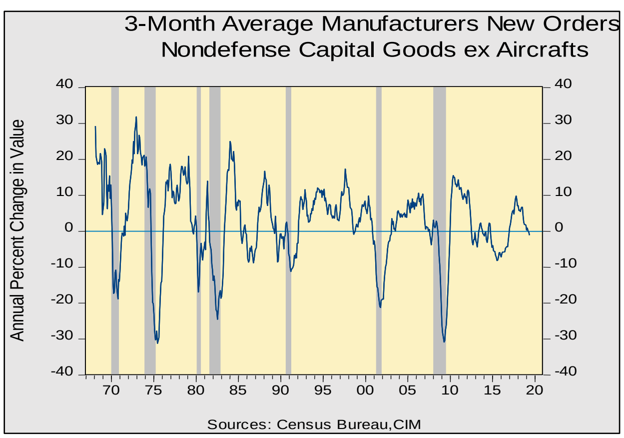
[1] The diffusion index looks slightly different from last month due to adjustments we made to the formula and revisions in certain data sets.



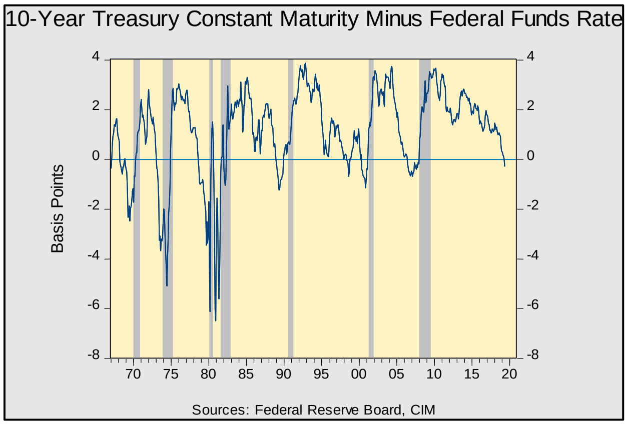
The Consumer Confidence Index is an economic indicator that measures the level of consumer optimism about the overall state of the economy and consumers' personal financial situations. The chart on the left shows the 12-month moving average of the annual change of the index. The 12-month average has risen 3.51% from the prior year.



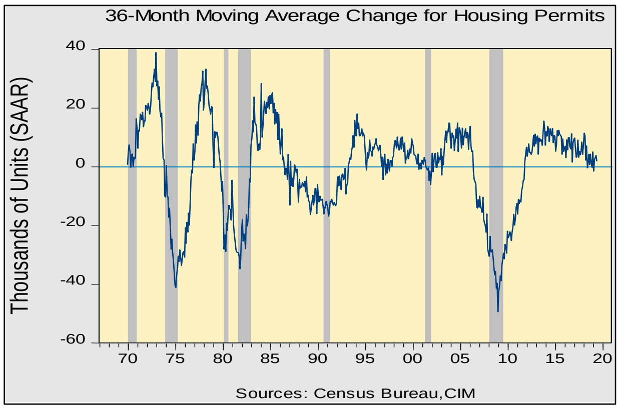
This chart shows the annual change in the Wilshire 5000 Index, which is the broadest U.S. equity index. The index contains 3,500 stocks and is designed to track overall performance of the U.S. stock market. It is an important indicator because steep equity pullbacks have often coincided with economic contractions. The latest reading shows an annual change of 4.95%. Last month, equities rose due to expectations that China and the U.S. would restart trade discussions at the G-20 meeting.



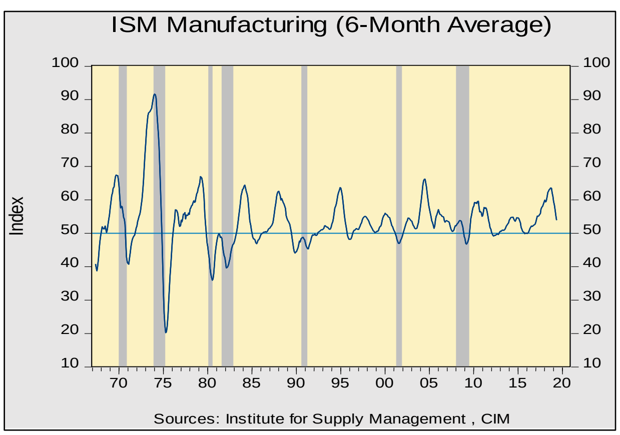
This chart shows the annual change in the value of core capital goods orders. This indicator gives insight into the amount of business investment spending. A positive reports suggests that manufacturers are optimistic about future demand. The current reading is negative as the moving average fell 1.28% from the prior year. The moderation in the pace of capital goods orders suggests businesses are becoming pessimistic about future demand.



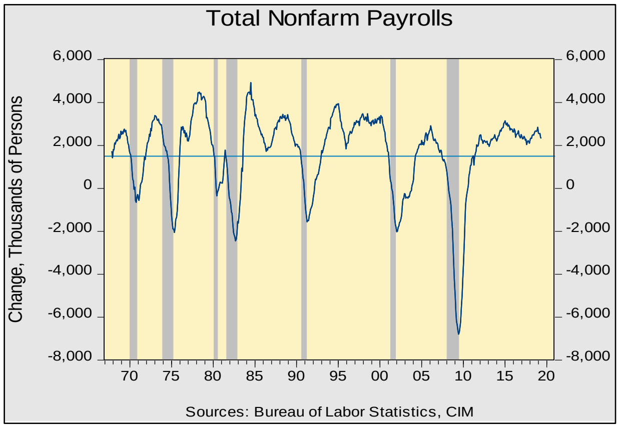
This chart shows the spread between the 10-year maturity and the Fed funds rate. It reflects market sentiment of the future state of the economy. Generally speaking, a negative spread suggests a contraction is likely to occur within 24 months. Currently, the reading is -0.31%, which is below the recession indicator. Because banks use short-term debt to issue long-term loans, lending becomes less profitable when the Fed Funds rate (the rate at which banks lend to each other) rises above the 10-year Treasury rate. Hence, a negative reading represents a constraint on bank lending.



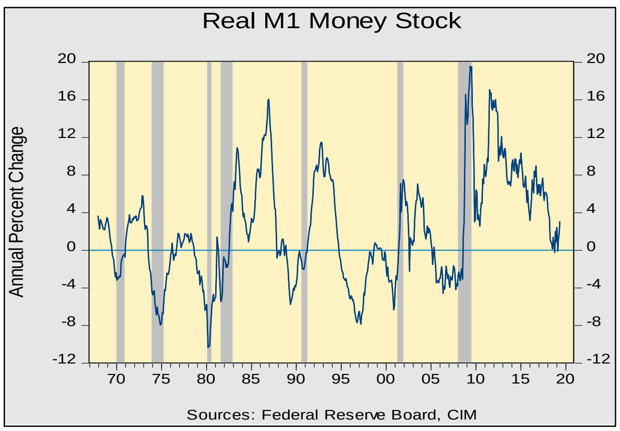
This chart shows the 36-month moving average of the annual change in housing permits. This is an important indicator because it provides a gauge of future construction activity. When demand for housing permits is strong it implies that builders are optimistic about future demand, and vice versa when demand for permits is weak. A reading below zero suggests the economy may be losing steam. The current reading is 1.7%, slightly above the recession indicator.



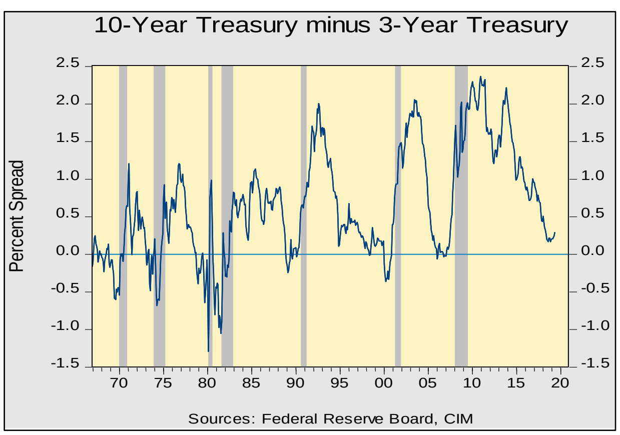
The ISM Manufacturing Index is a report that monitors employment, production, inventories, new orders and supplier deliveries. This index shows a six-month moving average and is used to gauge the level of manufacturing activity. A reading above 50 signals that manufacturing activity is expanding, while a reading below 50 signals that manufacturing activity is contracting. The current reading of 53.8 indicates that manufacturing activity remains robust. That being said, it appears manufacturing activity has slowed in recent months.



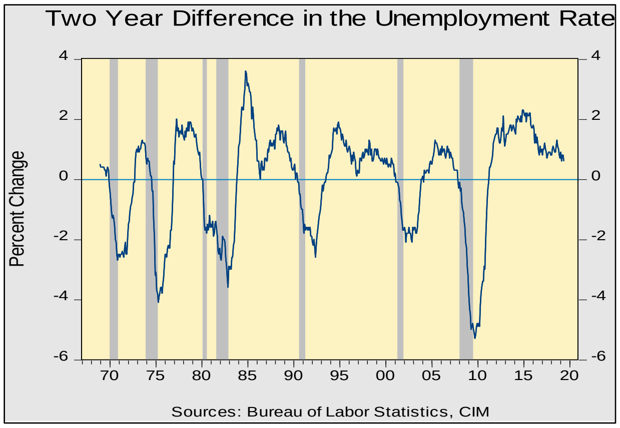
This chart shows the 12-month moving sum of total nonfarm payrolls. This report represents the total number of workers added to the workforce excluding proprietors, private household employees, unpaid volunteers, farm employees and incorporated self-employed. It is a significant indicator of the strength of the labor market. A moving sum that exceeds 1,800 suggests the demand for labor is strong. The latest reading of 2,301 indicates the labor market remains tight.



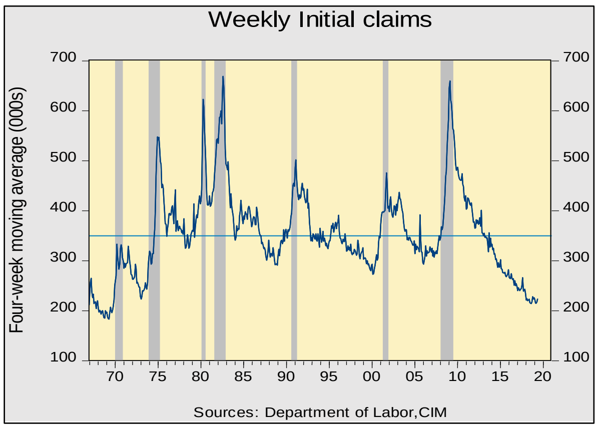
The Real M1 Money Stock report measures the annual change in the money supply minus inflation. M1 is the measure of currency in circulation and represents the amount of money being held for transaction purposes, therefore it can act as a proxy for economic activity. The latest reading is 3.02%, which is above the recession indicator. The rise in Real M1 was due to an increase in demand deposits. It is possible that rising trade tensions may have resulted in some portfolio liquidation, thus increasing the supply of money.



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. The latest reading is +0.28, which indicates the economy may reflect an easing of recession fears.



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. The latest reading of +0.6 suggests the labor market remains tight.



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 that the economy may be headed toward a contraction. The latest reading of 223k indicates the demand for labor is still strong.

Thomas Wash
July 24, 2019

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