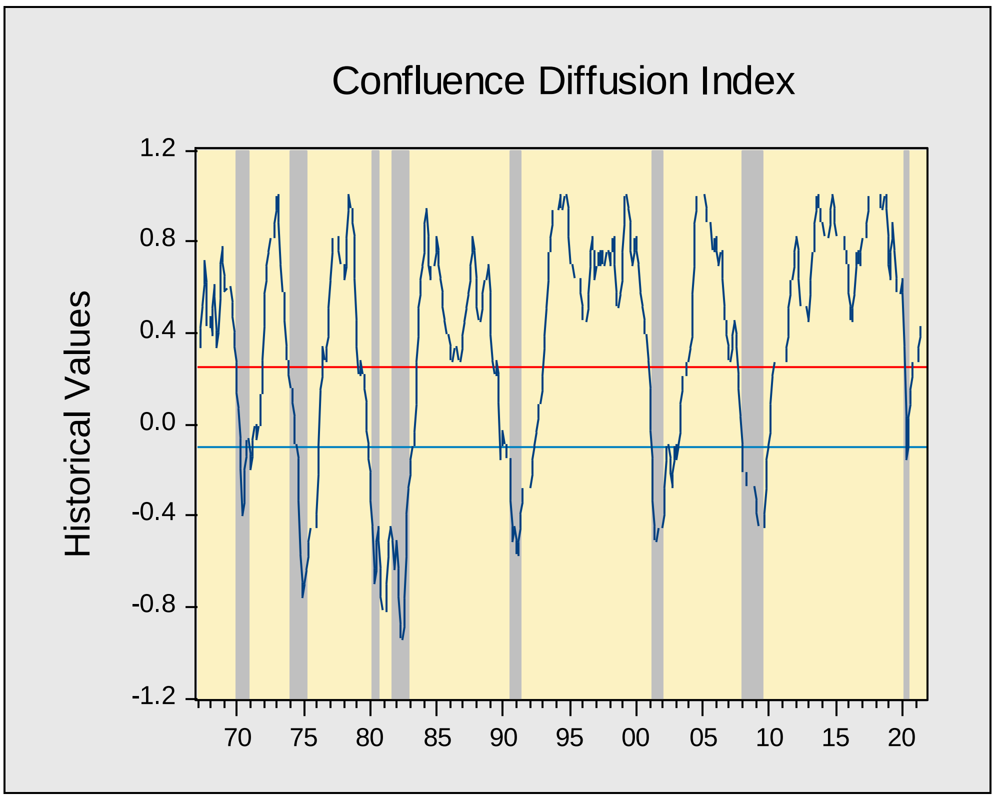
Business Cycle Report

By Thomas Wash

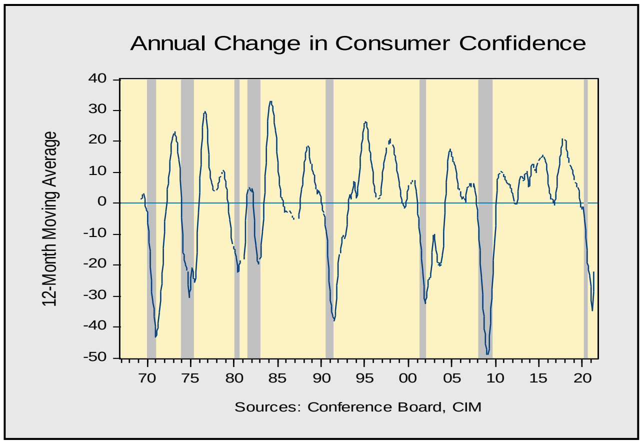
The business cycle has a major impact on financial markets; recessions usually accompany bear markets in equities. The intention of this report is to keep our readers apprised of the potential for recession, updated on a monthly basis. Although it isn't the final word on our views about recession, it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

In June, the diffusion index rose further above the recession indicator, signaling that the recovery continues. In the financial markets, a sharp rise in inflation expectations led to a modest sell-off in equities in the middle of the month. Meanwhile, construction and manufacturing activity slowed as increasing costs for materials are becoming a problem for homebuilders and factories. Lastly, the labor market remains strong as payrolls rose at the fastest pace in 10 months. As a result, eight out of the 11 indicators are in expansion territory. The diffusion index rose from +0.3939 to +0.4545, above the recession signal of +0.2500.



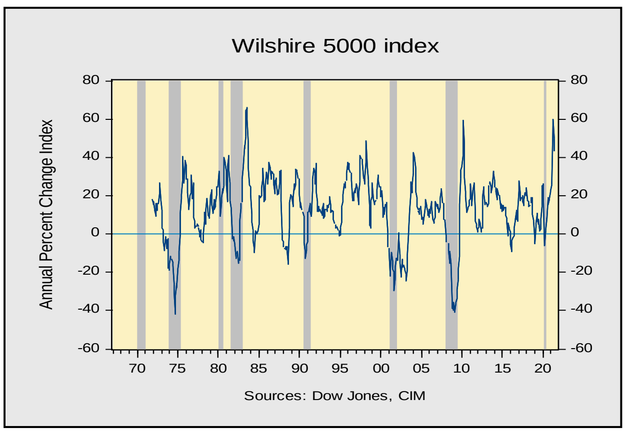
The chart above shows the Confluence Diffusion Index. It uses a three-month moving average of 11 leading indicators to track the state of the business cycle. The red line signals when the business cycle is headed toward a contraction, while the blue line signals when the business cycle is headed toward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



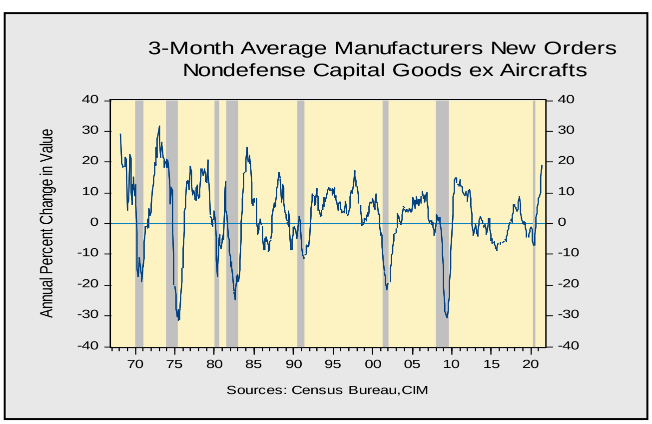
In June, the Consumer Confidence Index rose due to more respondents expressing optimism about their present situation. Currently, the index contributes negatively to the diffusion index. Last month, the index rose by 7.3 points from 120.0 to 127.3, well above last year's level of 98.3. The 12-month moving average of the annual change in the index rose from -21.8 to -17.2. As the pandemic continues to show signs of ending, consumers appear ready to return to normal life conditions prior to COVID-19. However, a sudden rise in inflation and the spread of the delta variant may have raised some concerns about the future. As a result, the present situation index rose from 148.7 to 157.7, well above last year's level of 86.7. Meanwhile, the index for consumers' six-month outlook rose from 100.9 to 107.0. Although consumer expectations rose sharply, it is still relatively low when compared to the Consumer Sentiment Index, suggesting that consumers may still be worried about the pandemic.

Wilshire 5000 Index



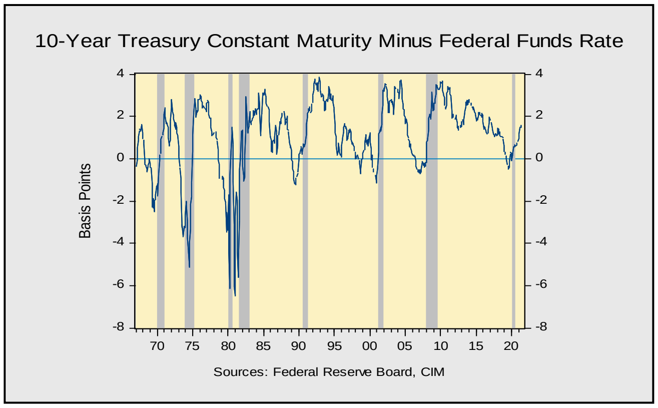
The annual change in the Wilshire 5000 Total Return Index slowed for the second consecutive month. In June, the index rose 42.8% from the prior year, lower than the previous month's rise of 49.4%. The slowdown appears to be the result of a decline in upside momentum due to growing speculation that the Federal Reserve may decide to withdraw monetary stimulus. However, this weakness proved temporary after the Fed reaffirmed its commitment to maintaining accommodative policy. The three top-performing sectors in the index were Information Technology, Energy, and Consumer Discretionary, while the bottom-performing sectors were Industrials, Financial Services, and Materials.

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



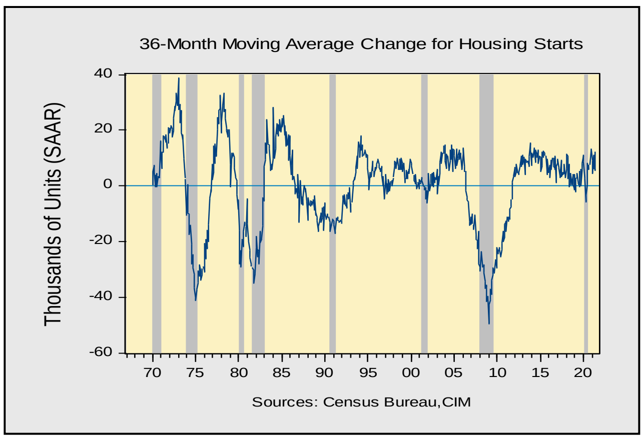
According to the Conference Board LEI, the value for new orders of durable goods adjusted for inflation rose 0.18% from the previous month. The latest report showed that new orders for nondefense capital goods came in at $41.054B in 1982-chained dollars, which is 14.29% higher than the previous year. New orders for the previous month were revised higher, from $40.742B to $40.980B. The three-month moving average came in at $41.093B, up from the previous year's value of $34.538B. The indicator, which tracks the annual change in the three-month moving average for new orders, came in at 19.09, higher than the previous month's reading of 18.53.

10-Year Treasury Constant Maturity Minus Federal Funds Rate



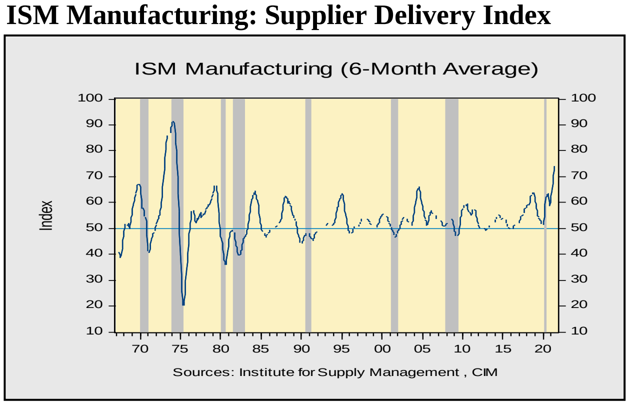
The 10-year Treasury yield minus the effective federal funds rate, also known as the financial spread, remained in expansion territory in June. The spread declined from +1.56 to +1.44. The narrowing of the spread can possibly be attributed to bond investors' speculation of a change in monetary policy. Meanwhile, the fed funds rate remains relatively unchanged as the Fed continues to maintain accodomodative policy. As a result, the effective fed funds rate rose from 0.06% to 0.08%. Meanwhile, the 10-year Treasury rate fell from 1.62% to 1.52%.

36-Month Moving Average Change for Housing Starts



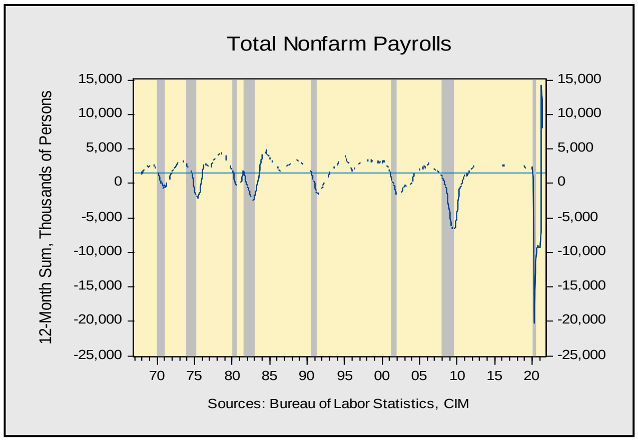
The strong demand for homes offset homebuilder concerns about shortages in labor and materials. As a result, residential construction rose in June. Last month, annualized housing starts expanded at an annualized pace of 1,643K, higher than the previous month's report of 1,546K. Despite the increase in housing starts, homebuilder confidence continues to decline as supply and labor shortages have caused project delays. The latest NAHB report showed that the Housing Market Index fell to a 10-month low. The dip in homebuilder confidence may have contributed to the unexpected decline in building permits. Permits for residential construction expanded at an annualized pace of 1,598K in June, below estimates of 1,696K and the previous month's reading of 1,683K. Furthermore, the indicator remains in expansion territory. The 36-month moving average for the change of housing starts rose 12.33K from the prior month, well above the recession signal.

ISM Manufacturing: Supplier Delivery Index



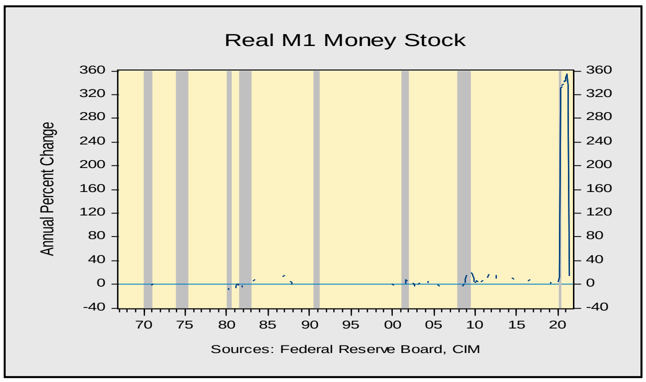
Strong demand for goods has led to an overall improvement in the ISM Manufacturing Index. However, the Supplier Delivery Index fell from the previous month due to firms expanding their production capacity to accommodate for more deliveries. In general, the index views faster shipments as negative due to the assumption that it reflects weakening demand. Although in this case the index is wrong, its overall impact on the indicator is limited by the moving average. As a result, the ISM Supplier Delivery Index came in at 75.1 in June, below the previous month's reading of 78.8, while the six-month moving average improved for the sixth consecutive month, rising from 70.2 to 73.1.

Total Nonfarm Payrolls



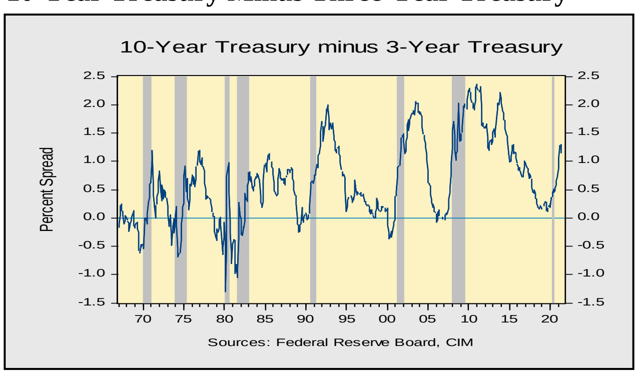
In June, the country gained 850K jobs for a 12-month moving sum of 7.919MM. Most of the new jobs came from the private service-providing sector, primarily in *Leisure and Hospitality*, which added 343K. In total, the service-providing sector accounted for 642K new jobs. The government sector added 188K, while the goods-producing sector added 20K. Currently, the indicator is significantly above the recession signal of 1.600MM. Given the transitory nature of this indicator, the moving sum will likely decline sharply over the next few months but should remain in expansion territory.

Real M1 Money Stock



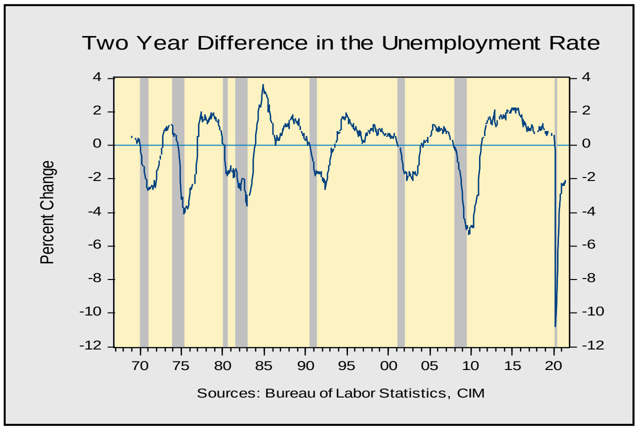
In June, the year-over-year change in Real M1 slowed dramatically as the base distortions caused by the pandemic have started to dissipate. Last month, Real M1 Money Stock, which is M1 minus inflation, rose 10.66% from the prior year, down from the previous month's reading of 13.1%. The unprecedented drop in the indicator was heavily influenced by a change that the Federal Reserve made to its calculation of M1 in March of last year. M1 now includes other liquid deposits, which include savings deposits in addition to the previously included checkable deposits in thrift institutions and commercial banks. The inclusion of savings deposits means that M1 will now be able to reflect household savings. Thus, the sharp drop was expected as it reflects the adjustment to the extraordinary amount of stimulus given to households in 2020.

10-Year Treasury Minus Three-Year Treasury



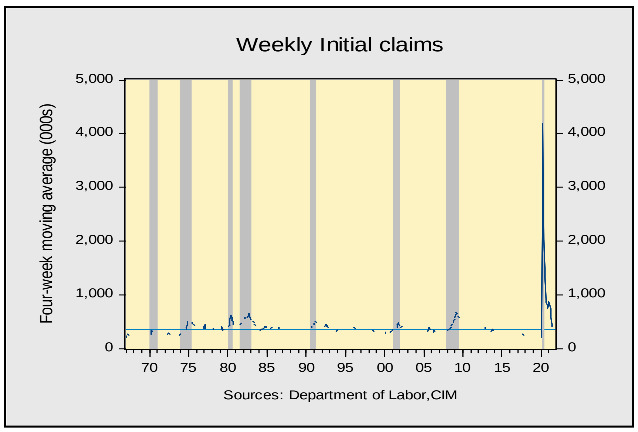
In June, the spread between the 10-year and three-year Treasury narrowed. The reduction in the spread may be due to stronger demand for U.S. Treasuries from foreign investors. The Fed's relatively hawkish tone following the FOMC meeting on June 15-16 led to a strengthening dollar which boosted the return of dollar-denominated assets for foreign investors. The increase in demand helped pushed down rates in the 10-year Treasury. As a result, the spread between the 10-year and three-year Treasury only narrowed by 17 bps, from +1.30 in the previous month to +1.13. Last month, the 10-year Treasury yield declined by 10 bps from +1.62 to +1.52, while the three-year Treasury rose by 7 bps from +0.32 to +0.39.

Two-Year Difference in the Unemployment Rate



In June, the two-year spread in the unemployment rate narrowed from -2.1 to -2.3, contributing negatively to the diffusion index. Last month, the unemployment rate rose from 5.8% to 5.9%, well above its level of 3.6% two years prior. The rise in the unemployment rate was largely due to workers re-entering the labor force. The number of workers employed remained relatively unchanged from the prior month, while the civilian labor force rose by 0.09%. Meanwhile, the number of unemployed workers rose by 1.80% from the prior month. Nevertheless, we do not expect this indicator to contribute positively to the diffusion index for the foreseeable future. Labor market recoveries generally lag the broader economy. As a result, it is unlikely that the unemployment rate will dip below the historic lows we saw in 2019 any time soon.

Weekly Initial Claims



In June, average weekly initial claims fell for the fifth consecutive month, coming in at 394K compared to the 426K recorded in the previous month. The drop in initial claims can be attributed to general improvement in the economy.

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July 29, 2021

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.