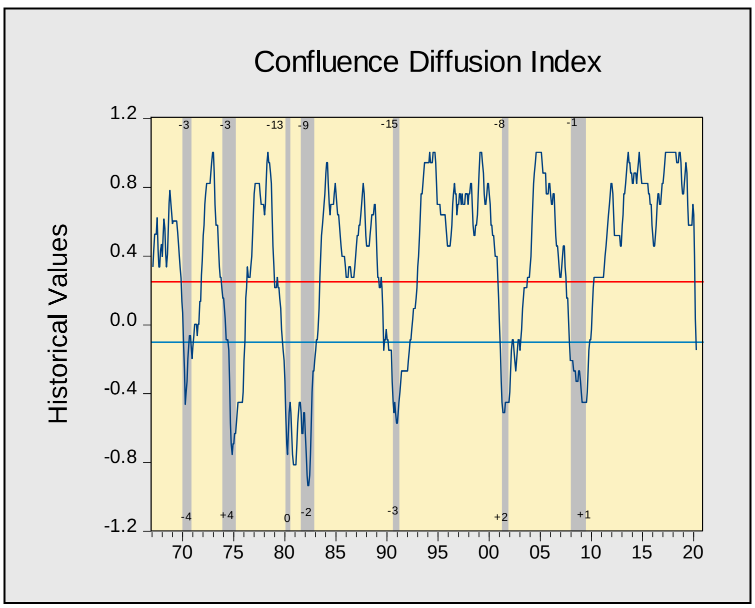
Confluence INVESTMENT MANAGEMENT

Business Cycle Report

By Thomas Wash

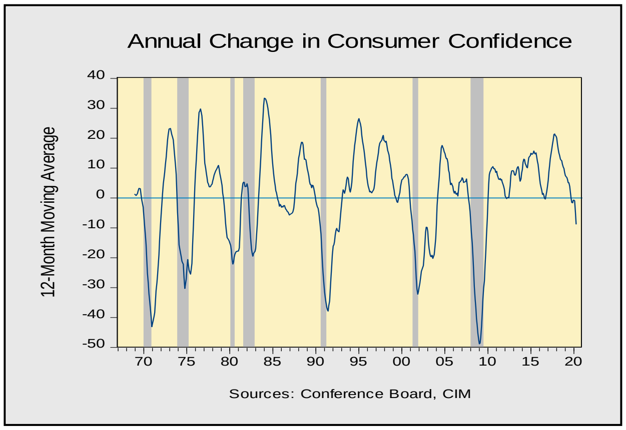
The business cycle has a major impact on financial markets; recessions usually accompany bear markets in equities. The intention of this report is to keep our readers apprised of the potential for recession, updated on a monthly basis. Although it isn't the final word on our views about recession, it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

In May, the diffusion index fell deeper into recession territory as improvements in several indicators could not outweigh the negative impact of the previous two months. Last month, states started reopening their economies which resulted in a rise in economic conditions. The financial market continued to show signs of improvement as the Federal Reserve offered reassurances that it would continue to intervene in markets when needed. Additionally, increased economic activity led to a sharp rise in equities. Meanwhile, a reduction in lockdown restrictions allowed firms to hire workers in record numbers. However, the impact of the pandemic continued to weigh heavily on both investor and consumer confidence as concerns persist surrounding economic outlook. As a result, six out of the 11 indicators are in contraction territory. The reading for this month fell to -0.152 from +0.030 in April, well below the recession signal of +0.250.



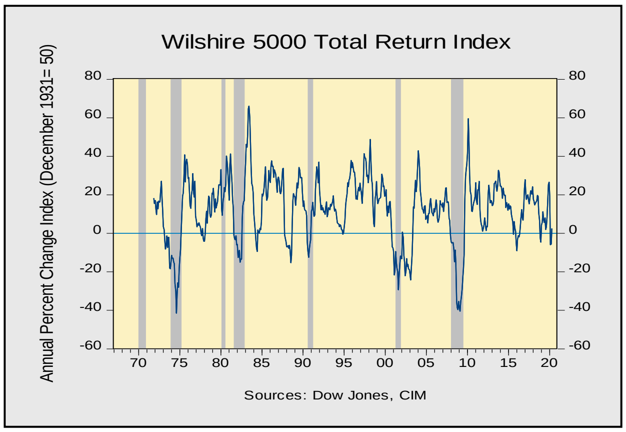
The chart above shows the Confluence Diffusion Index. It uses a three-month moving average of 11 leading indicators to track the state of the business cycle. The red line signals when the business cycle is headed toward a contraction, while the blue line signals when the business cycle is headed toward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



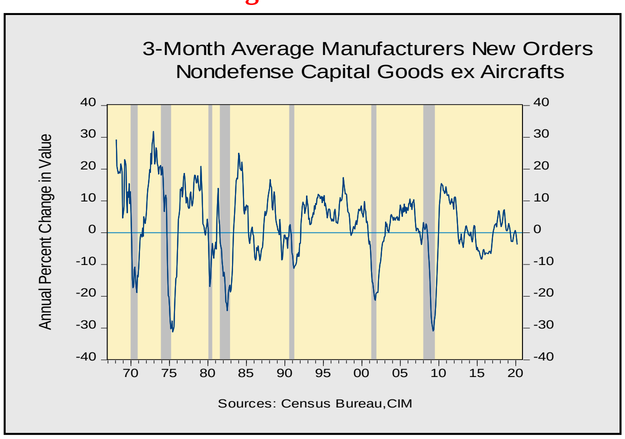
In May, consumer confidence contributed negatively to the diffusion index as the moving average fell further below the recession indicator. Last month, consumer confidence rose by 0.9 points from 85.7 to 86.6. This reading is remarkably lower than the previous year's reading of 131.3. As a result, the 12-month moving average of the annual change fell from -5.1 to -9.0. The pandemic has had a devastating impact on economic optimism and, as a result, the index for consumers' present situation fell 100 points from the prior year. That said, the drop in consumers' six-month outlook was relatively mild as it only dropped 8.1 points from the prior year, from 105.0 to 96.9. We expect consumer confidence to rise as people begin to resume normal activities as the country reopens.

Wilshire 5000 Index



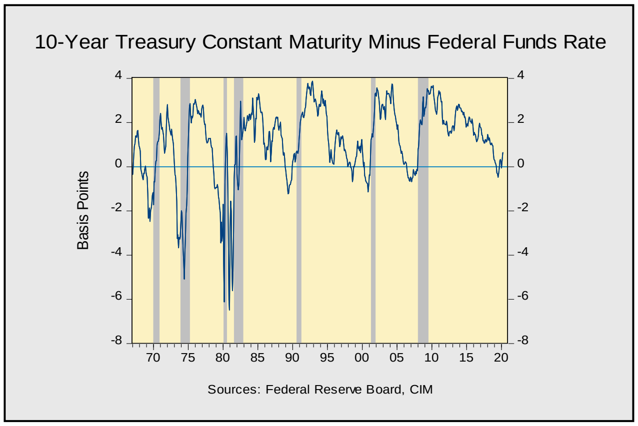
The Wilshire 5000 Total Return Index rebounded back into expansion territory in the month of May. Last month, the index rose 2.22% from the prior year. As a result, the indicator contributed positively to the diffusion index. The improvement in equities was due to growing investor optimism as certain states in the country began to reopen their economies in phases. The best-performing sectors were Information Technology and Materials, while the worst-performing sectors were Energy and Consumer Staples.

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



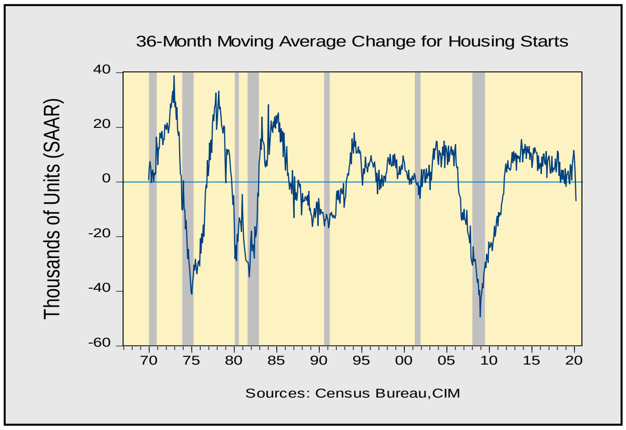
In May, new durable goods orders improved, according to the Conference Board LEI, but remain relatively low. Although orders increased for the first time since January, orders are still much lower than they were last year. As a result, the annual change in the three-month moving average for new orders came in at -4.79, lower than the previous month's reading of -3.87. The value of new orders for nondefense capital goods came in at $35.669 billion in 1982 chained dollars, which is 3.5% higher than the previous month. New orders for April were revised down from $37.171 billion to $34.475 billion. Despite the month's increase, the three-month average fell from $37.394 billion in the previous year to $35.599 billion. The decline in orders suggests that the pandemic has had an adverse impact on investment intentions. Although we do expect orders to pick up soon, the possible reemergence of the virus could further depress investment activity.

10-Year Treasury Constant Maturity Minus Federal Funds Rate



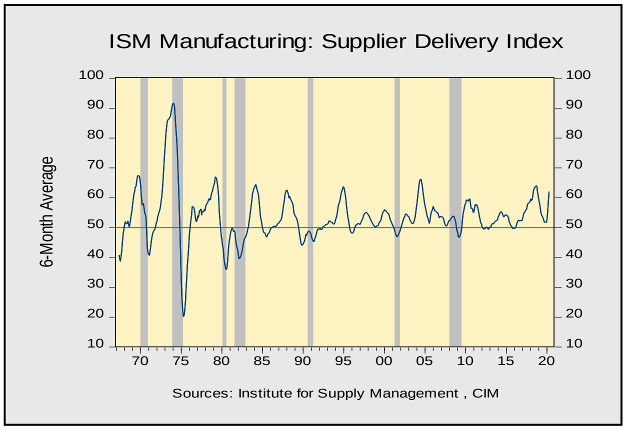
The financial spread, also known as the 10-year Treasury minus the federal funds rate, remained in expansion territory in May. The spread widened slightly from +0.61 to +0.62. In May, the yield remained relatively unchanged as the Federal Reserve stated that, in spite of market speculation, it will not employ negative rates and implied that it would focus on managing the yield curve. As a result, the effective federal funds rate held steady at 0.05%, while the 10-year Treasury rose by 1 bp from 0.66% to 0.67%. As economic conditions improve, we expect the yield curve to steepen.

36-Month Moving Average Change for Housing Starts



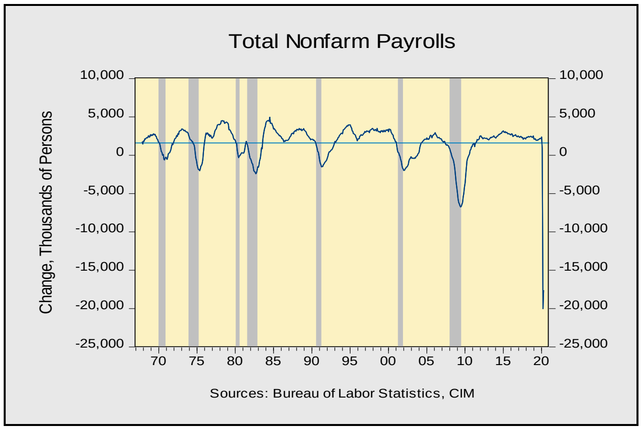
In May, housing starts were relatively low as homebuilders prioritized multi-family over single-family homes. As states began easing lockdown restrictions, contractors began restarting stalled construction projects. As a result, annualized housing starts rose from 891k to 974k. Despite the rise, the 36-month moving average change was -4.14, suggesting that housing construction is still relatively soft. The weakness in housing construction can be attributed to economic uncertainty. Although the average 30-year fixed mortgage rate is near record lows, homebuilders are not confident there will be enough demand for new homes as the unemployment rate is still very high.

ISM Manufacturing: Supplier Delivery Index



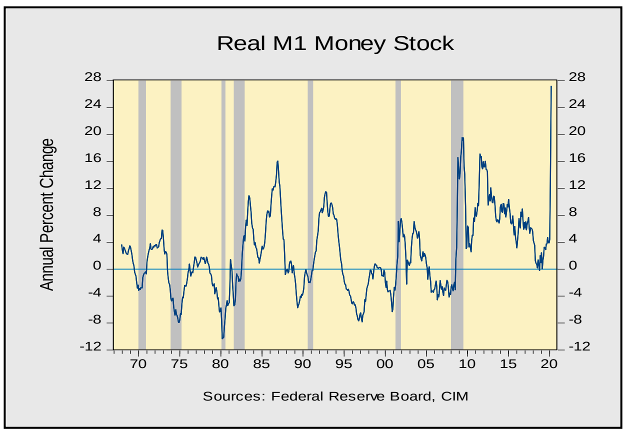
In May, the supplier delivery index rose to its highest level since 1974. The reading of 68.0 raised the six-month moving average from 59.2 to 61.9. As a result, the index moved further away from the contraction point of 50.0. The rise in the survey is due to a reduction in the amount of purchasing managers reporting faster delivery times. Typically, slower deliveries suggest that factories were operating near capacity, but given recent events that is unlikely to be the case this time around. Hence, the report is incorrectly signaling strength. In the coming months we expect delivery times to slow as manufacturers experience less disruptions caused by the pandemic as the economy recovers and the transportation industry normalizes.

Total Nonfarm Payrolls



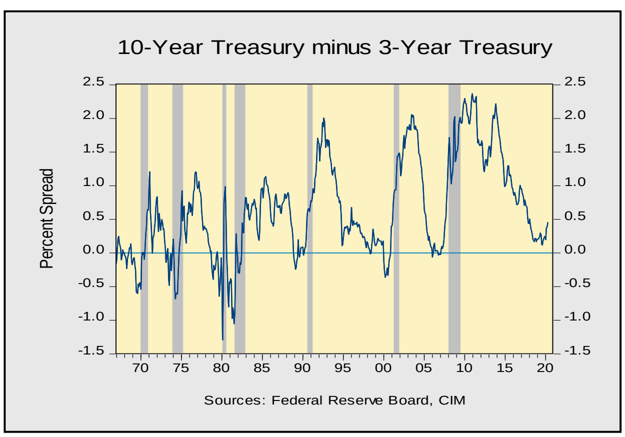
In May, the country gained a record 2.509 million jobs for a 12-month moving sum of -17.665 million. Most of the jobs added came from the private service-providing sectors, especially "leisure and hospitality," which gained 1.239 million. In total, the services sector accounted for 2.425 million added jobs. Meanwhile, the goods-producing sector contributed 669 thousand, primarily in construction, which added 425 thousand. Finally, the government sector lost 585 thousand jobs. Local government had the most job losses at 487 thousand, and the state government lost 84 thousand, while state governments lost 14 thousand. Currently, the indicator is significantly below the recession signal of 1.600 million. At this rate, this indicator will be signaling recession for the foreseeable future.

Real M1 Money Stock



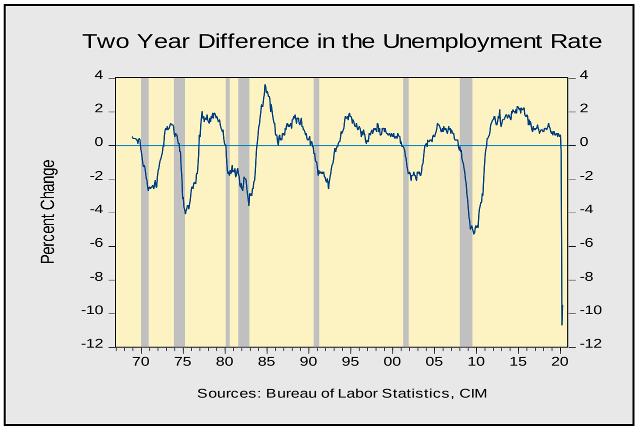
In May, this indicator rose to its highest level ever for a second consecutive month due to a steep rise in M1 and a slowdown in inflation. Last month, the Real M1 Money Stock, which is M1 minus inflation, rose 33.40% from the prior year, higher than the previous month's reading of 27.16%. The unprecedented rise in the indicator was heavily influenced by a surge in demand deposits and other checkable deposits at thrift institutions, a direct result of accommodative monetary policy. Additionally, a slowdown in airfare and oil prices led to a deep deceleration in headline inflation. As a result, M1, which rose 33.50% from the prior year, outweighed the rise in CPI, which rose 0.12% from the prior year.

10-Year Treasury Minus Three-Year Treasury



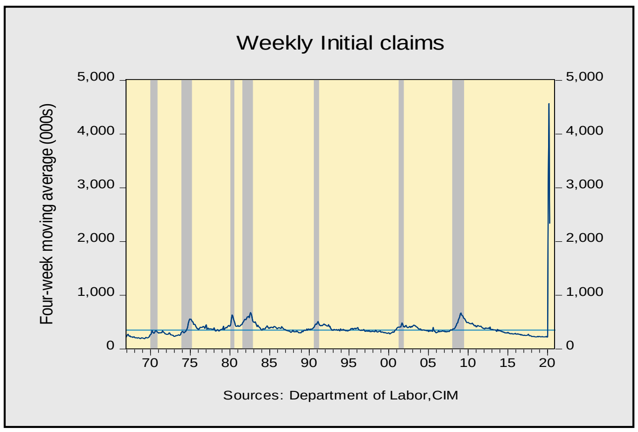
In May, the yield curve steepened as improvements in the economy resulted in stronger demand for short-duration bonds. Additionally, expectations that the Fed will cap yields on Treasuries have resulted in a preference for short- over long-duration bonds. The spread between the 10-year and three-year Treasury widened slightly from +0.38 to +0.45 as states reopening led to a rise in optimism. Last month, the 10-year Treasury rose slightly, by 1 bp, while the three-year Treasury fell 6 bps. As a result, the 10-year rose from +0.66 to +0.67 and the three-year fell 6 bps from +0.28 to +0.22.

Two-Year Difference in the Unemployment Rate



In May, the two-year spread narrowed slightly as the unemployment rate unexpectedly fell from 14.7% to 13.3%. As a result, the two-year difference narrowed from -10.7 to -9.5. Last month, workers began returning to work which resulted in some labor market tightening. The number of employed workers rose by 2.9% and the civilian labor force rose by 1.1%, while the number of unemployed fell by 9.1% from the prior month. Despite the sharp drop in the unemployment rate, there is still a large portion of the population that has not returned to the labor force. That being said, if this downward trend in the unemployment rate continues it will likely lead to a faster than expected recovery.

Weekly Initial Claims



Average weekly initial claims fell for the first time in three months, coming in at 2.331 million, down from 4.558 million the previous month. In May, every state, with the exception of Florida, saw a drop in initial claims. Although claims remain high for the time being, a slowdown does show that the economy is on track to return to normal.

Thomas Wash
June 25, 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 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.