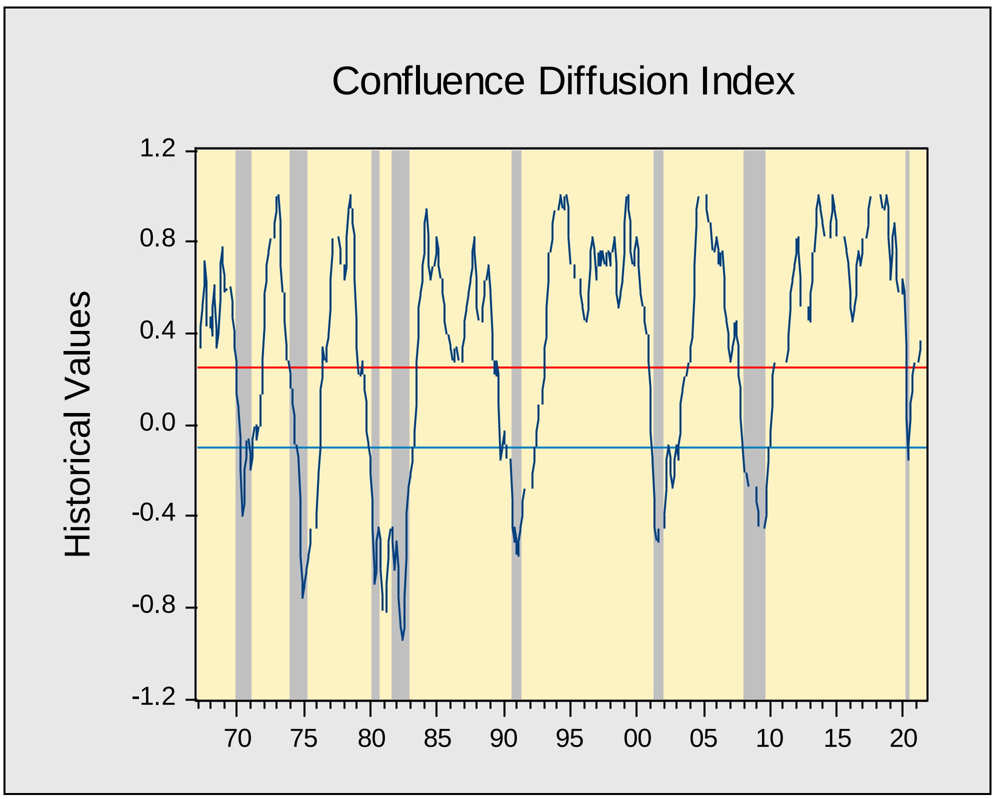
Business Cycle Report

By Thomas Wash

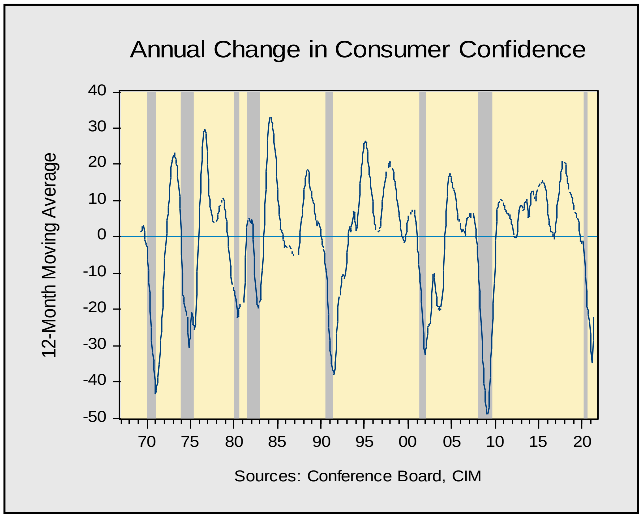
The business cycle has a major impact on financial markets; recessions usually accompany bear markets in equities. The intention of this report is to keep our readers apprised of the potential for recession, updated on a monthly basis. Although it isn't the final word on our views about recession, it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

In May, the diffusion index 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 showed signs of strengthening as hiring increased and the unemployment rate dropped. As a result, eight out of the 11 indicators are in expansion territory. The diffusion index rose from +0.333 to +0.3939, above the recession signal of +0.2500.



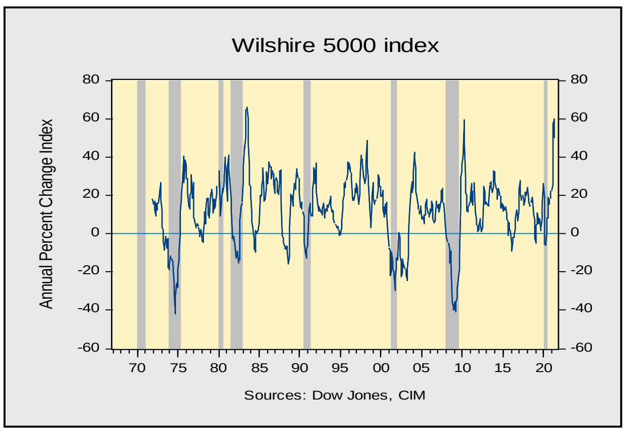
The chart above shows the Confluence Diffusion Index. It uses a three-month moving average of 11 leading indicators to track the state of the business cycle. The red line signals when the business cycle is headed toward a contraction, while the blue line signals when the business cycle is headed toward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



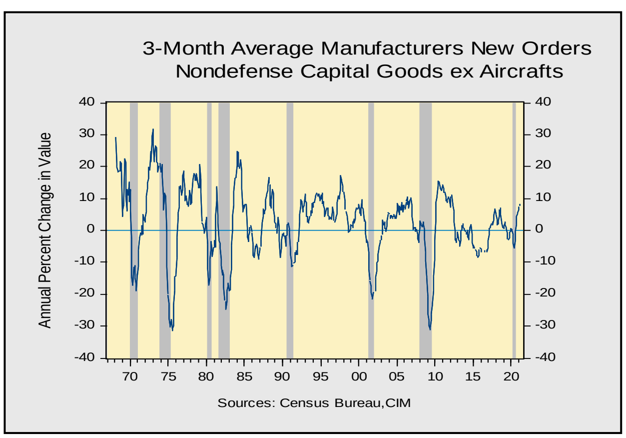
In May, the Consumer Confidence Index moderated, largely due to respondents being less optimistic about the future. Currently, the index contributes negatively to the diffusion index. Last month, the index fell by 0.3 points from 117.5 to 117.2. This reading is well above last year's level of 85.9. Despite the decline, the indicator improved from the previous month. The 12-month moving average of the annual change in the index rose from -28.4 to -22.0, likely the result of a steady improvement in consumer confidence. As the pandemic shows signs of ending, consumers appear ready to return to normal life prior to COVID-19. However, a sudden rise in inflation has raised some concerns. As a result, the present situation index rose from 131.9 to 144.3, well above last year's level of 68.4. Meanwhile, the index for consumers' six-month outlook fell from 107.9 to 99.1, but still remains above last year's level of 97.6.

Wilshire 5000 Index



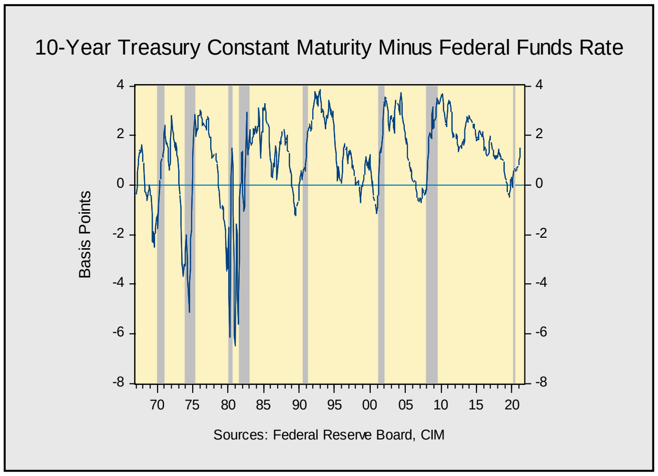
The annual change in the Wilshire 5000 Total Return Index slowed for the first time in nine months. In May, the index rose 49.4% from the prior year, lower than the previous month's rise of 59.5%. The slowdown appears to be the result of an equity sell-off following the CPI report that showed a faster than expected rise in inflation. However, this sell-off was temporary after the Fed's reassurances that accommodative policy would remain in place. The three top-performing sectors in the index were Energy, Materials, and Financial Services, while the bottom-performing sectors were Information Technology, Utilities, and Consumer Discretionary.

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



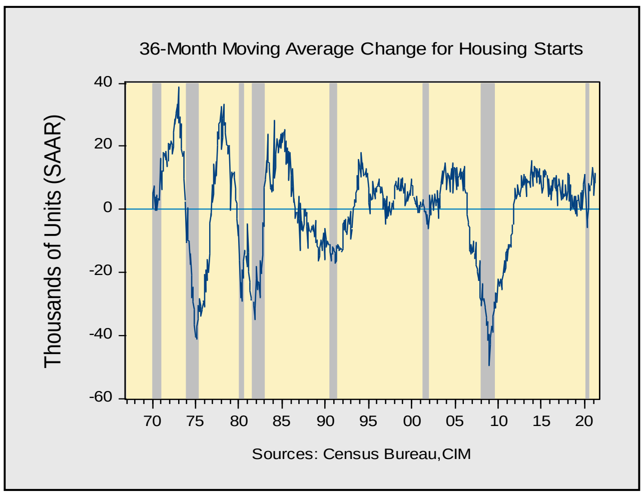
According to the Conference Board LEI, the value for new orders of durable goods adjusted for inflation fell 0.72% from the previous month. The latest report showed that new orders for nondefense capital goods came in at $40.742B in 1982-chained dollars, which is 18.98% higher than the previous year. New orders for the previous month were revised higher, from $40.458B to $41.039B. The three-month moving average came in at $40.727B, up from the previous year's value of $34.521B. The indicator, which tracks the annual change in the three-month moving average for new orders, came in at 18.09, higher than the previous month's reading of 14.93.

10-Year Treasury Constant Maturity Minus Federal Funds Rate



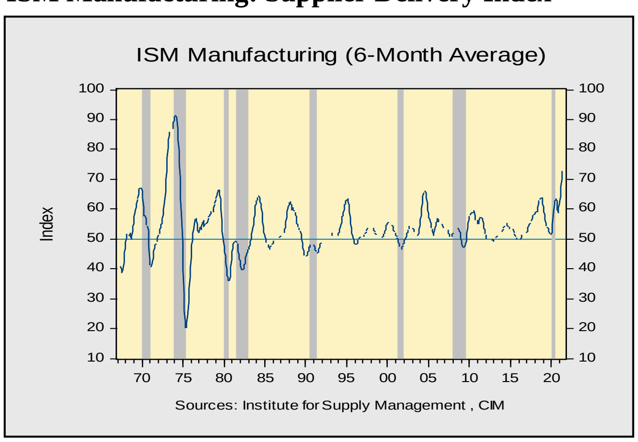
The 10-year Treasury yield minus the effective federal funds rate, also known as the financial spread, remained in expansion territory in May. The spread declined from +1.57 to +1.56. The narrowing of the spread can be attributed to a slight easing of inflation concerns. The sell-off in the 10-year Treasury slowed in May, which led to a slight decrease in the interest rate. Despite the strong CPI readings, there are still doubts as to whether inflation will continue to rise at its current pace. As a result, the effective fed funds rate declined from 0.07% to 0.06%. Meanwhile, the 10-year Treasury rate fell from 1.64% to 1.62%.

36-Month Moving Average Change for Housing Starts



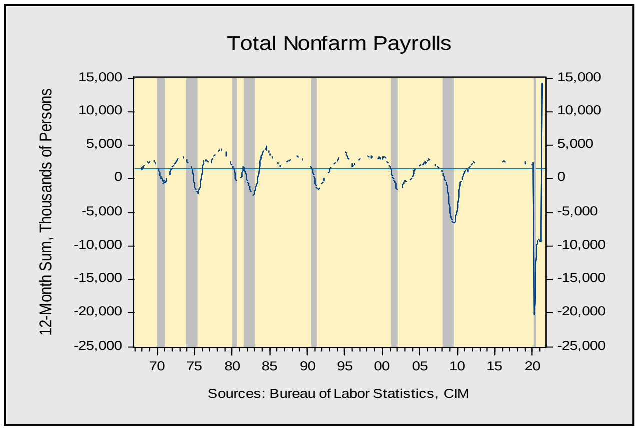
In May, shortages in building materials and labor made it difficult for homebuilders to start new construction projects. Despite these issues, construction still showed signs of strengthening. Last month, annualized housing starts came in at 1,572K, higher than the previous month's report of 1,517K. That being said, homebuilder confidence is starting to show signs of waning. The latest Housing Market Index fell to a 10-month low. At this time, the diffusion index does not appear to be affected by this market weakness but that could change if supply issues persist. The 36-month moving average for the change of housing starts rose 6.05K from the prior month, well above the recession signal.

ISM Manufacturing: Supplier Delivery Index



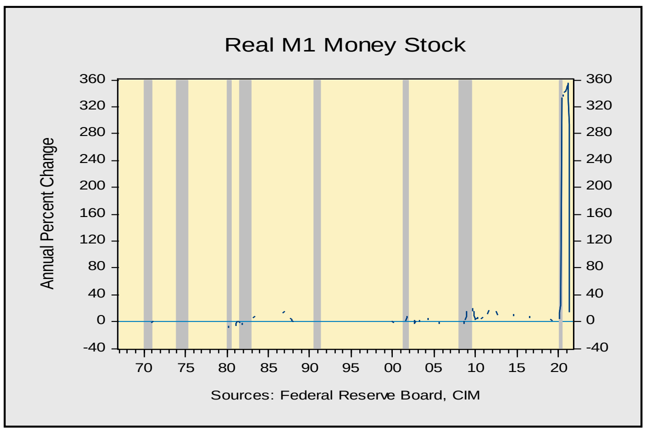
Strong demand for goods has led to an overall improvement in the ISM Manufacturing Index; however, supply and labor shortages continue to be a problem. The ISM Supplier Delivery Index came in at 78.8 in May, above the previous month’s reading of 75.0. The rise in the index can be attributed to demand exceeding production capacity. Supply constraints have made it difficult for firms to meet consumer demand, resulting in a slowdown in deliveries. As a result, the indicator has improved for the sixth consecutive month, rising from 70.2 to 73.1.

Total Nonfarm Payrolls



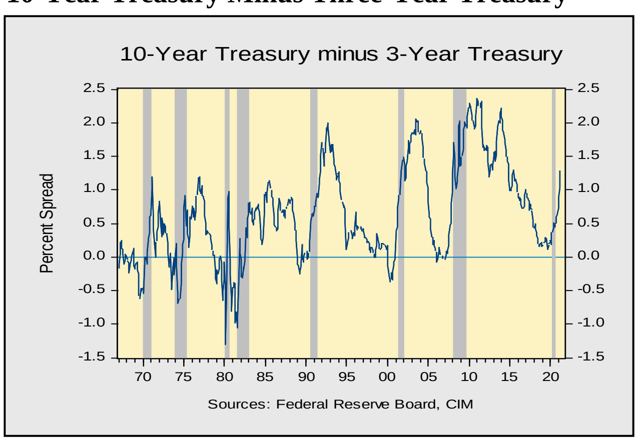
In May, the country gained 559K jobs for a 12-month moving sum of 11.900MM. Most of the new jobs came from the private service-providing sector, primarily in *Leisure and Hospitality*, which added 292K. In total, the service-providing sector accounted for 489K new jobs. The government sector added 67K, while the goods-producing sector added 3K. 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



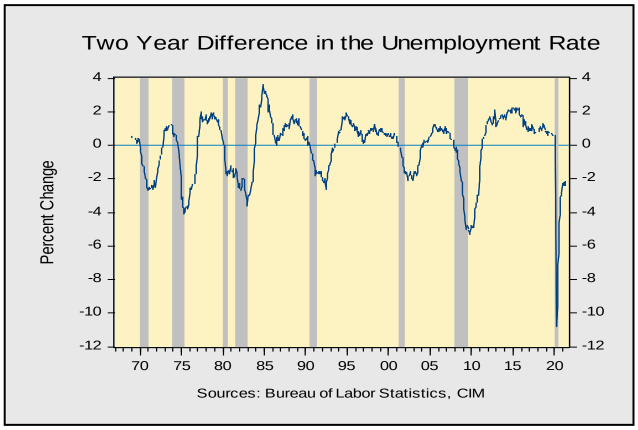
In May, the year-over-year change in Real M1 slowed dramatically as the base distortions caused by the pandemic have started to dissipate. Last month, Real M1 Money Stock, which is M1 minus inflation, rose 13.1% from the prior year, down from the previous month's reading of 292.7%. The unprecedented 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



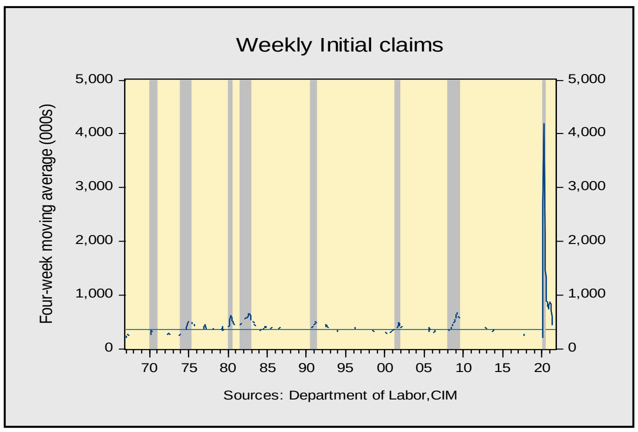
In May, the spread between the 10-year and three-year Treasury widened modestly. A slowdown in Treasury bill issuance led to stronger demand for relatively longer-duration Treasuries. The increase in demand helped pushed down rates in the three-year and 10-year Treasury. As a result, the spread between the 10-year and three-year Treasury only widened by 1 bp, from +1.29 in the previous month to +1.30. Last month, the 10-year Treasury yield declined by 2 bps from +1.64 to +1.62, and the three-year Treasury declined 3 bps from +0.35 to +0.32.

Two-Year Difference in the Unemployment Rate



In May, the two-year spread in the unemployment rate narrowed from -2.4 to -2.1, contributing negatively to the diffusion index. Last month, the unemployment rate fell from 6.1% to 5.8%, well above its level of 3.7% two years prior. The drop in the unemployment rate was largely due to workers finding employment. The number of workers employed rose 0.29% from the prior month, while the civilian labor force declined by 0.03%. Meanwhile, the number of unemployed workers declined by 5.06% 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 take longer than economic recoveries. 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 May, average weekly initial claims fell for the fourth consecutive month, coming in at 426K compared to the 579K recorded in the previous month. The drop in initial claims can be attributed to general improvement in the economy.

Thomas Wash
June 30, 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.