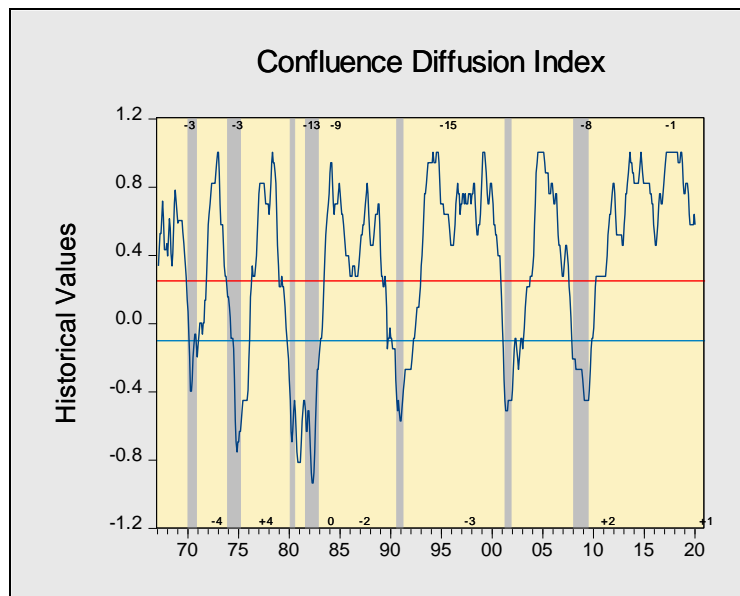


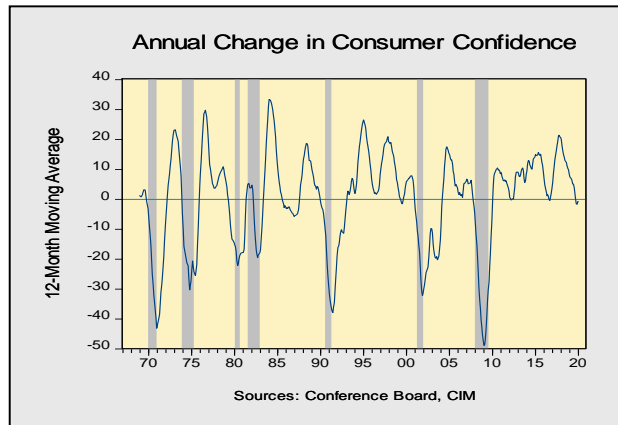
*The business cycle has a major impact on financial markets; recessions usually accompany bear markets in equities. We have created this report to keep our readers apprised of the potential for recession, which we plan to update on a monthly basis. Although it isn't the final word on our views about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

In February, the economic data was slightly weaker than the prior month but not enough to signal recession. The coronavirus spread from China into South Korea, which raised concerns of the impact the virus would have on the global economy. As a result, equities weakened and U.S. Treasuries rallied. That being said, manufacturing showed signs of a recovery as purchasing managers were optimistic that the trade deal signed in the previous month would finally lead to an improvement in orders. Additionally, the employment numbers were strong, suggesting that prior to March there was a lot of optimism about the economy. In this report, three out of the 11 indicators were in recession territory. The reading for February fell to +0.576 from +0.636.



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.

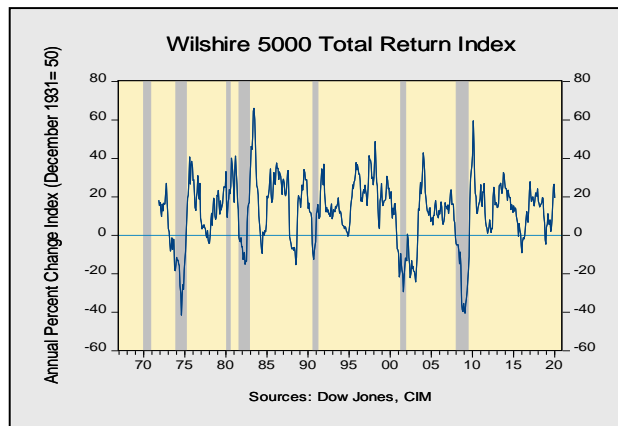
## Consumer Confidence



Although consumer confidence improved in February, the index remains in recession territory due to a shift in the moving average. As a result, the annual change in the 12-month average for consumer confidence remains in contraction territory at -1.08. The February reading for consumer confidence was 130.7, below the reading of 131.4 a year ago. It appears the report shows that consumers' view of the present situation declined slightly from 173.9 to 165.1, while their short-term outlook improved from 101.4 to 107.8. This suggests that consumers were somewhat worried about the coronavirus but were pretty confident that

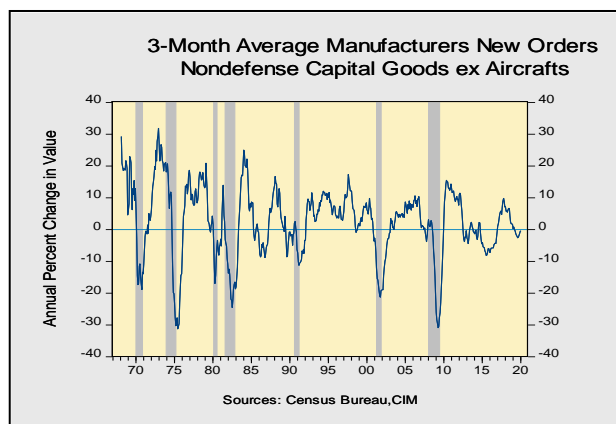
any negative impact on the economy would be short-lived. We would expect a sharp deterioration of this variable next month.

## Wilshire 5000 Index



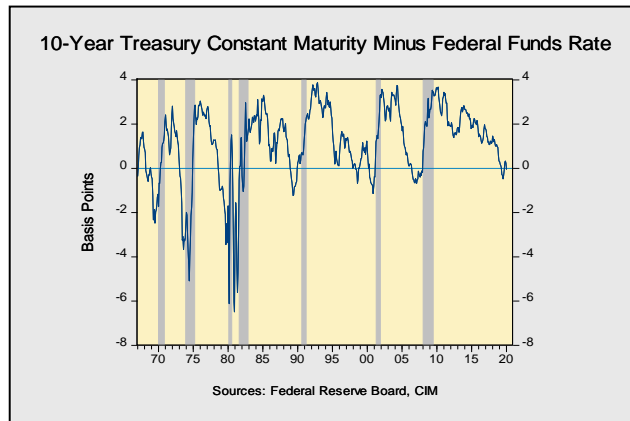
The Wilshire 5000 Total Return Index remains in expansion territory despite growing worries about the coronavirus. Equity markets slowed modestly from a rise of 26.33% from the prior year to a rise of 19.17%. The slowdown in equities was likely due to investors believing that the coronavirus, which at the time was primarily in Asian countries, would have a mild impact on the global economy. As a result, investors began reducing risk in their portfolios. The top performing sectors in February were Healthcare, Communication Services and Real Estate.

## 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 February reading came in at -0.51, an improvement from the previous month's reading of -0.72. The improvement in new orders mirrors other indicators, such as the ISM Manufacturing Composite Index, in signaling a broad pickup in manufacturing activity. Additionally, the report shows the eagerness manufacturers had to return to production capacity following a reduction in trade tensions between the U.S. and China. It was likely because of this eagerness that manufacturers were reluctant to accept the risks posed by COVID-19.

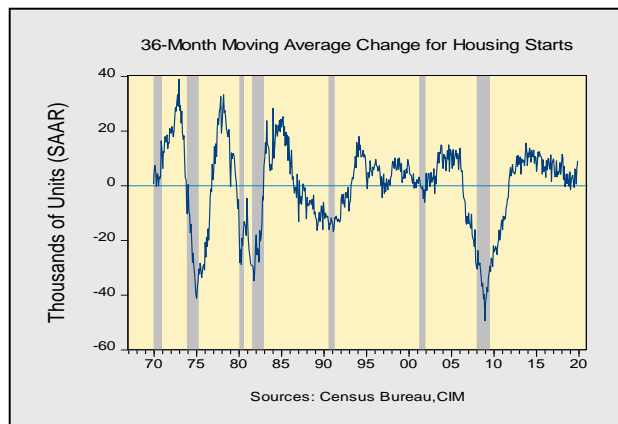
### 10-Year Treasury Constant Maturity Minus Federal Funds Rate



The financial spread, also known as the 10-year Treasury minus the federal funds rate, returned to contraction territory for the first time since October 2019. The spread reversed from +0.21 to -0.08. The spread of the coronavirus out of China into other Asian countries led to a flight to safety into U.S. Treasuries. As a result, the 10-year yield fell from 1.76% to 1.50%, while the effective fed funds rate rose slightly from 1.55% to 1.58%. In February, Fed officials were reluctant to cut rates as they believed that, given the three rate cuts in 2019, there was enough stimulus to offset any impact the virus may have on the economy. Hence,

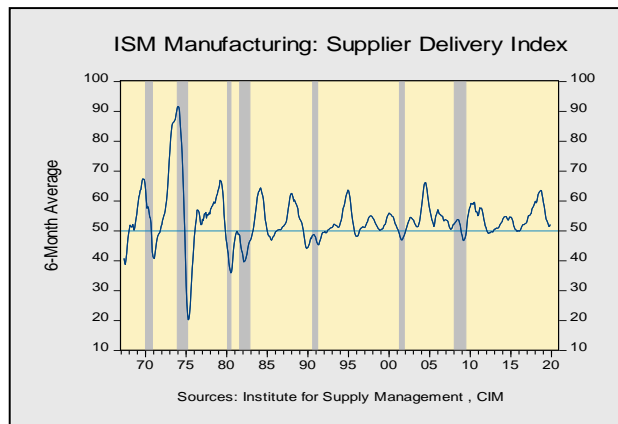
in February, the Federal Reserve did not see enough evidence that the virus would have a serious impact on the economy. Since then, the FOMC has cut its policy rate to near zero, leading to a steepening of the yield curve.

### 36-Month Moving Average Change for Housing Starts



Although housing starts slowed, the index remains firmly in expansion territory. In February, the 36-month moving average change fell from 11.19 to 8.52. The drop was due to a slowdown in multi-family housing starts in the West and the Northeast. According to the homebuilders' survey collected by the National Association of Home Builders, confidence about future sales of single-family homes in the next six months remains near record highs. The confidence of sales is likely due to the strong economic data that came out in January. Nevertheless, recent events will likely put a dent in projection of future sales of single-family homes.

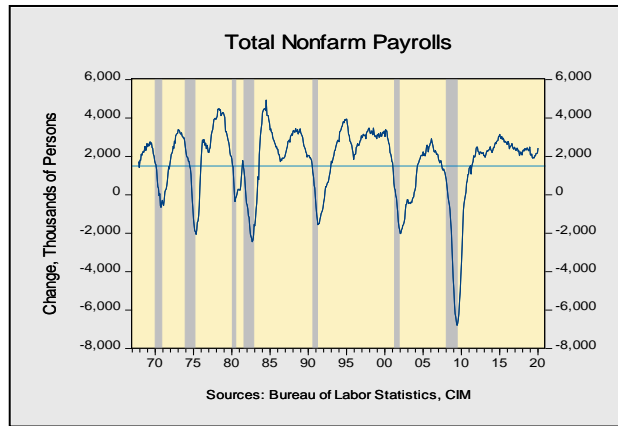
### ISM Manufacturing: Supplier Delivery Index



In February, the supplier delivery index rose to its highest level since November 2018. The reading of 57.3 raised the six-month moving average from 51.6 to 52.6. As a result, the index moved further away from the contraction point of 50.0. The drop in the report is due to a reduction in the amount of purchasing managers reporting faster delivery times. This suggests that fewer factories were operating below capacity. Keep in mind, the strong numbers were before the coronavirus forced U.S. manufacturers to slow production. Thus, it will be difficult to decipher if delivery times are an actual reflection of capacity or a reflection of the

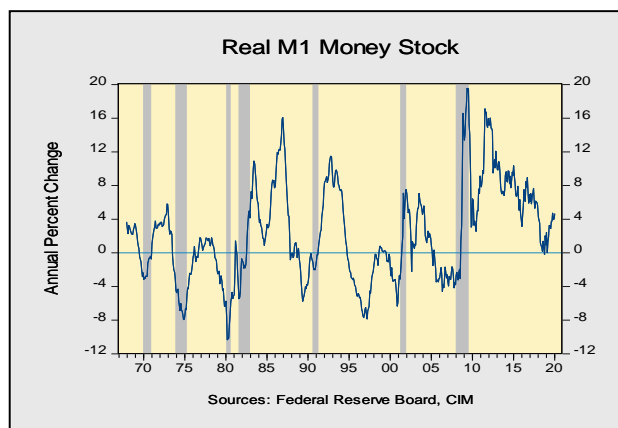
pandemic. On the bright side, the index does suggest that prior to the pandemic there was a lot of pent-up demand for production. This could mean a possible sharp recovery whenever the outbreak subsides.

## Total Nonfarm Payrolls



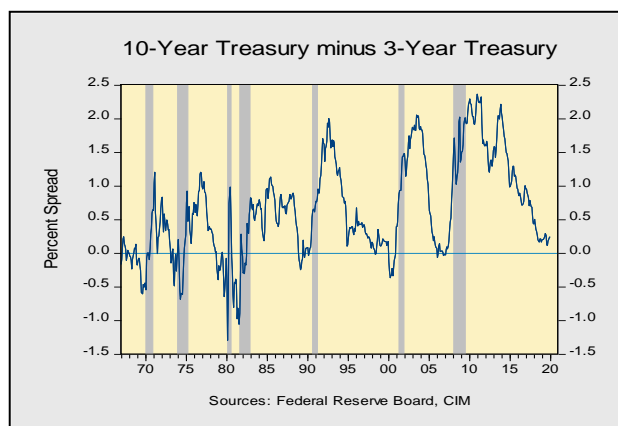
In February, the country added 273k for a 12-month moving sum of 2,409k. Most of the jobs added came from the private service-providing sectors, most notably “health care and social assistance” and “leisure and hospitality,” which added 56.5k and 51k jobs, respectively. In total, the services sector accounted for 167k of the jobs created. Meanwhile, the goods-producing sector added 61k, almost exclusively in construction. Lastly, the government sector added 45k jobs, with the local government adding 19k, state government adding 18k and the federal government adding 8k. Currently, the indicator is well above the recession signal of 1,800k. However, given the slowdown in economic activity in March due to the virus, it is highly unlikely that payrolls expanded by much, if at all, this month. That being said, in order for this indicator to fall into contraction territory there would need to be 462k job losses.

## Real M1 Money Stock



In February, the rise in demand deposits and currency outweighed the rise in consumer prices, leading to a modest rise in the indicator. Real M1 money stock rose 4.61% from the prior year, higher than the previous month’s reading of 3.96%. Additionally, CPI rose 2.30% from the prior year, while M1 rose 6.91%. The steady injection of liquidity into the repo market slowed in February and was expected to slow further in March as it appears that Fed officials believed there was enough liquidity in the financial markets to satisfy demand for short-term loans. The Fed was forced to reverse course as panic over COVID-19 reignited fears of a liquidity crunch.

## 10-Year Treasury Minus Three-Year Treasury



The spread between the 10-year and three-year Treasury narrowed from +0.24 to +0.19 as market optimism moderated due to the coronavirus pandemic. The fall-out from the outbreak reignited fears that global supply disruptions could weigh on global growth. As a result, flight-to-safety from international investors led to a drop in Treasury yields. In February, the 10-year Treasury fell 26 bps from 1.76% to 1.50%, while the three-year Treasury fell 21 bps from 1.52% to 1.31%. At this time, it is clear that the economic impact has become more severe than most anticipated, but investors have expressed even more angst over the effect the virus will have on the U.S. economy.

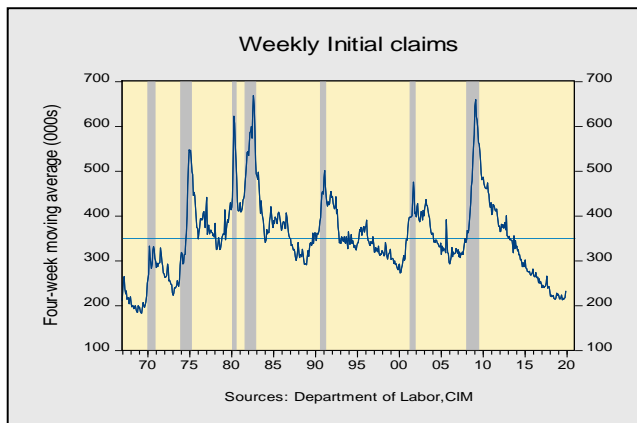
## Two-Year Difference in the Unemployment Rate



In February, the labor market tightened as the unemployment rate fell from 3.6% to 3.5%. As a result, the two-year difference between the unemployment rate widened from +0.5 to +0.6, moving farther away from the contraction indicator of 0.0. The drop in the unemployment rate was largely due to workers dropping out of the workforce. Although the participation rate remained unchanged at 63.4%, the employment/population ratio fell from 61.2% to 61.1%. We expect the two-year difference will likely widen as the reduction in economic activity in March resulted in layoffs in the leisure and hospitality sector. As a result, we suspect

the next report will show that the two-year spread has narrowed significantly.

## Weekly Initial Claims



Average weekly initial claims rose slightly in February, coming in at 214k, up from 210k the previous month. The slight rise in the average in weekly initial claims is reflective of the reluctance business owners had in letting workers go in the midst of the pandemic. It is likely there will be a sharp rise in claims in the coming weeks. However, given that the level of claims is near historic lows, it is likely the economy will be in recession before it surpasses the recession indicator of 350k.

Thomas Wash  
March 26, 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 1,800 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.