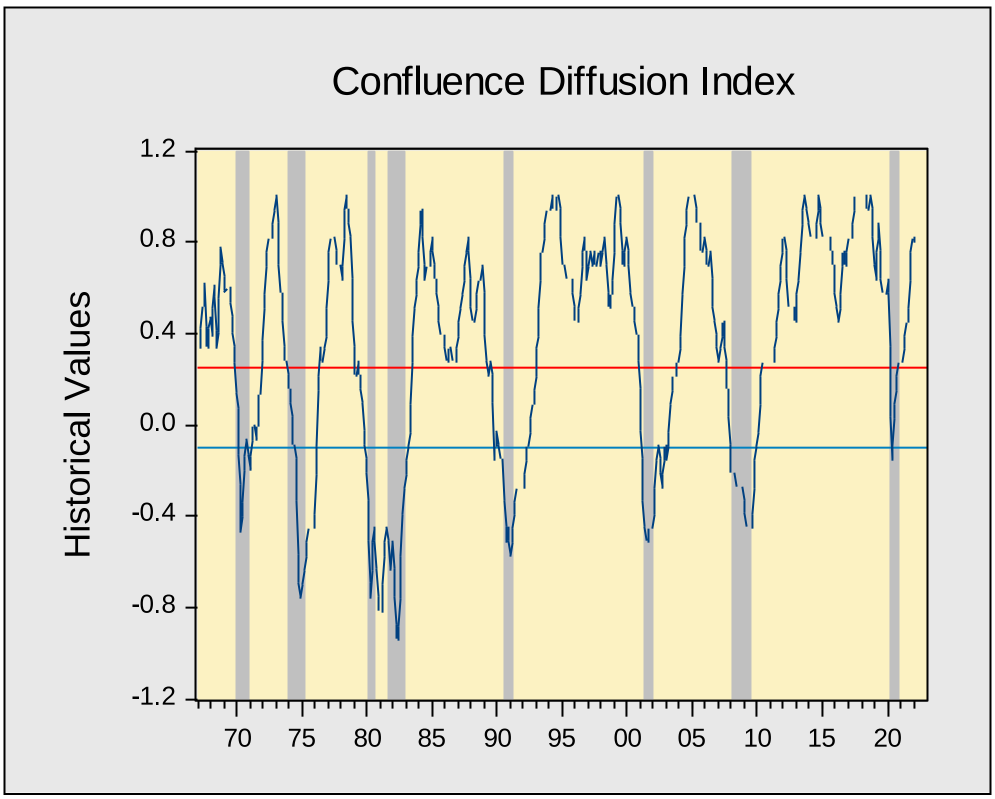
Business Cycle Report

By Thomas Wash

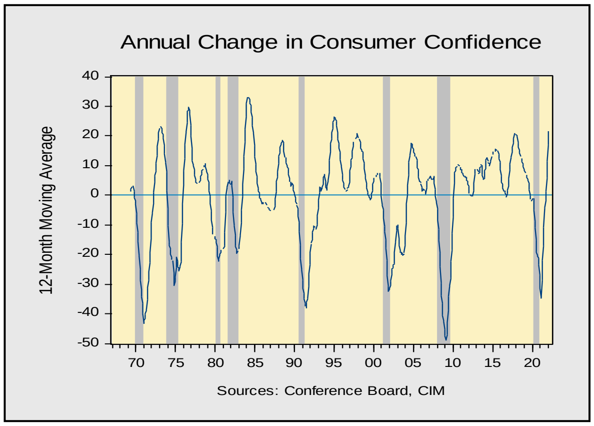
The business cycle has a major impact on financial markets; recessions usually accompany bear markets in equities. The intention of this report is to keep our readers apprised of the potential for recession, updated on a monthly basis. Although it isn't the final word on our views about recession, it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

The Confluence Diffusion Index hit a post-recession high; however, several indicators have deteriorated. In April, elevated inflation and hawkish Fed policy weighed on financial market indicators, leading to a flatter yield curve and a deceleration in the annual change in the stock market index. In the labor market, indicators show firms are reluctant to lay off workers because of concerns of a worker shortage. Lastly, manufacturing and construction indicators suggest that supply chains are still a problem for firms. Consequently, the latest report showed that all 11 benchmarks are in expansion territory. The diffusion index rose from +0.8789 to +0.9394, remaining well above the recession signal of +0.2500.



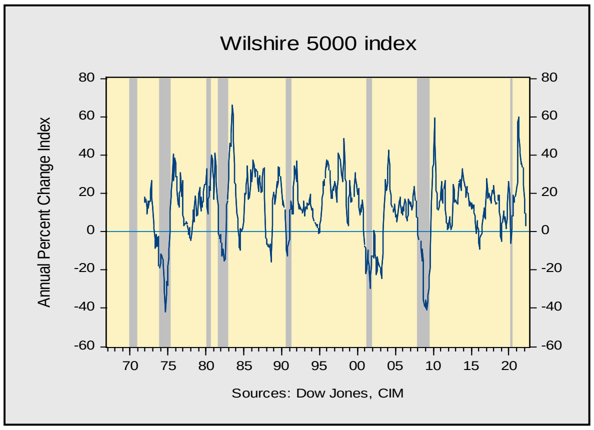
The chart above shows the Confluence Diffusion Index. It uses a three-month moving average of 11 leading indicators to track the state of the business cycle. The red line signals when the business cycle is headed toward a contraction, while the blue line signals when the business cycle is in recovery. The diffusion index currently provides about six months of lead time for a contraction and five months of lead time for recovery. Continue reading for an in-depth understanding of how the indicators are performing. At the end of the report, the *Glossary of Charts* describes each chart and its measures. In addition, a chart title listed in red indicates that the index is signaling recession.

Consumer Confidence



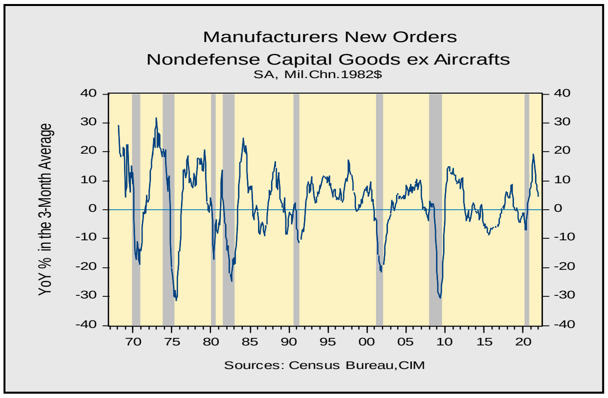
The Conference Board Survey of Consumer Confidence reported a dip in consumer sentiment in April. The Consumer Confidence index dropped below the previous year's level for the second consecutive month, from 117.5 to 107.3. Despite the decline, the twelve-month change remained strongly positive. The survey showed that the short-term consumer outlook had dimmed significantly from the prior year, falling from 107.9 to 77.2. The decline in consumer expectations in the future may relate to fears of elevated inflation. That being said, consumers still believe they are better off than last year. The index for the consumer's present situation is 152.6, much higher than the previous year's reading of 131.9. Hence, consumers' view of their current situation appears to be preventing consumer confidence from harming the overall Diffusion Index. The 12-month moving average of the annual change in the Consumer Confidence was 17.50, slightly below the last month's reading of 20.98 and above the contractional signal of 0.

Wilshire 5000 Index



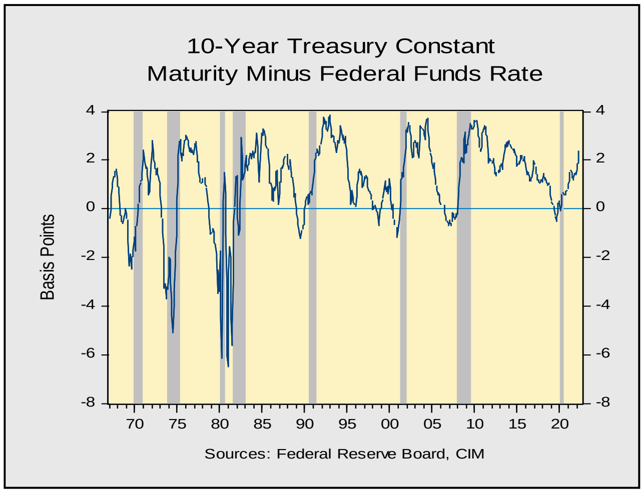
The Wilshire 5000 index approached contraction territory in April. The annual change in the index rose 2.8% from the prior year, slightly above the contraction indicator of 0.0%. The Federal Reserve's hawkish shift has led investors to change their allocation from risky assets toward defensive assets. As a result, the annual rise in the equity index decelerated to its slowest pace of the year.

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



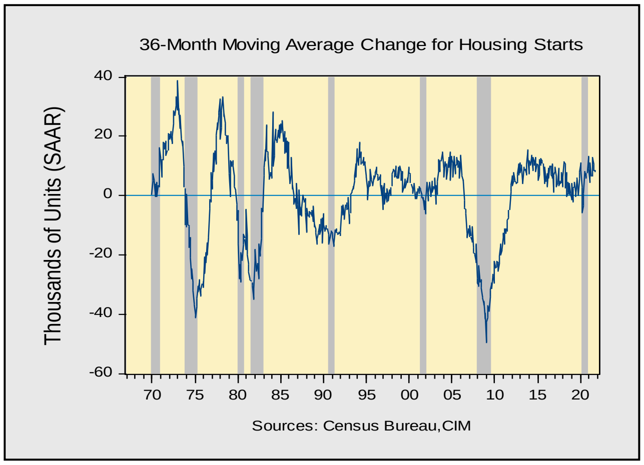
Manufacturing new orders for nondefense capital goods excluding aircraft adjusted for inflation slowed from the previous year. According to the Conference Board, new orders were relatively unchanged from the prior year, rising only 0.05%. This sluggishness in new orders suggests that investment spending is decelerating. Consequently, the three-year moving average of the annual change slowed from a 2.65% rise from the year in March to a 1.52% rise in the following month.

10-Year Treasury Constant Maturity Minus Federal Funds Rate



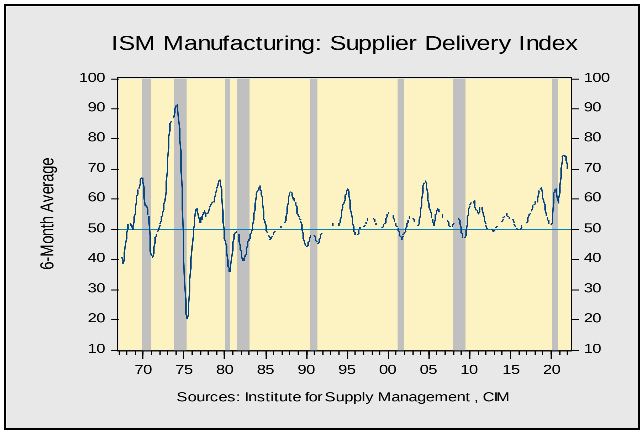
The financial spread, the 10-year Treasury minus the Fed Funds rate, widened in April. The gap increased from 1.93% to 2.42%. The increase was due to the sell-off in longer duration Treasuries before the Fed raised interest rates in early May. The 10-year Treasury rose 62 bps from 2.13% to 2.79%, while the Fed Funds rate rose 13 bps from 0.20% to 0.33%.

36-Month Moving Average Change for Housing Starts



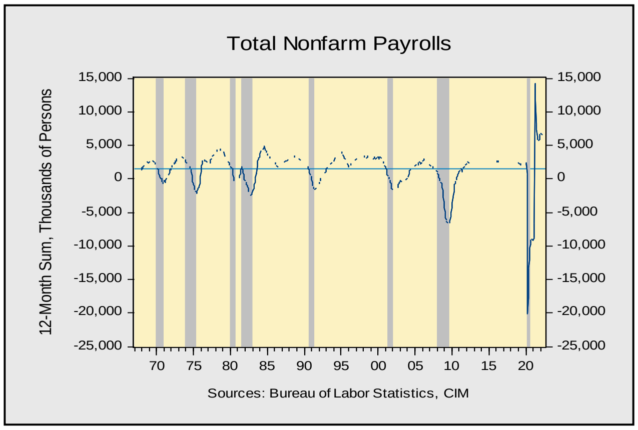
Residential construction slowed in April as homebuilder optimism about future demand waned. Last month, housing starts expanded at an annualized rate of 1,724K, slightly slower than the previous month's pace of 1,728K. The slowdown in construction may be related to rising home prices and mortgage rates, making home buying less affordable. The lack of confidence in consumer demand may have led homebuilders to shift their focus from single-family toward multi-family homes. Housing starts for single-family homes fell from 1,187K to 1,100K, while multi-family dwellings rose from 541K to 624K.

ISM Manufacturing: Supplier Delivery Index



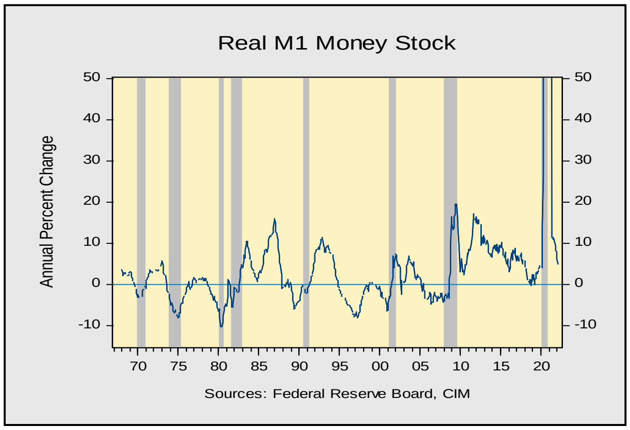
The ISM Supplier Deliveries Index rose in April, while the overall index slipped. The supplier deliveries index rose from 65.4 to 67.2. This slowdown in deliveries was related to the lockdowns in Shanghai, leading to shipment delays. The improvement in the indicator is misleading. Typically, delivery delays are associated with firms meeting strong demand; thus, slower deliveries are generally viewed positively in the index. In this case, the slower deliveries were due to supply side interruptions. In short, the increased supplier delivery times are a signal of worsening manufacturing conditions, which is reflected in the broader index. Last month, the ISM Manufacturing Composite index fell from 57.1 to 55.4.

Total Nonfarm Payrolls



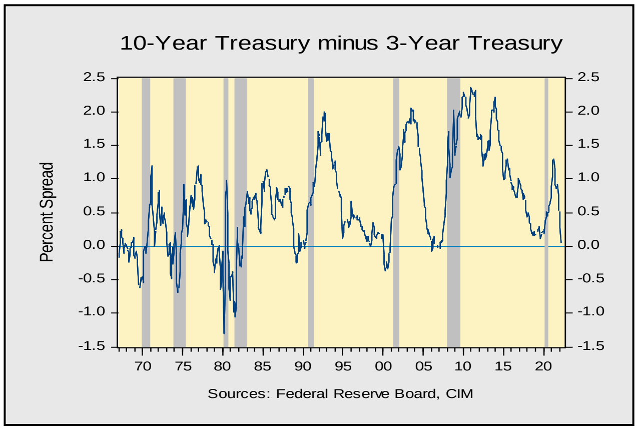
Nonfarm payrolls expanded steadily in April, signaling a tightening in the labor market. Last month, the country added 428K jobs. The bulk of the new jobs came from the service-providing sector, which increased by 340K. The remaining jobs were from the goods-producing and government sectors, adding 66K and 22K positions, respectively.

Real M1 Money Stock



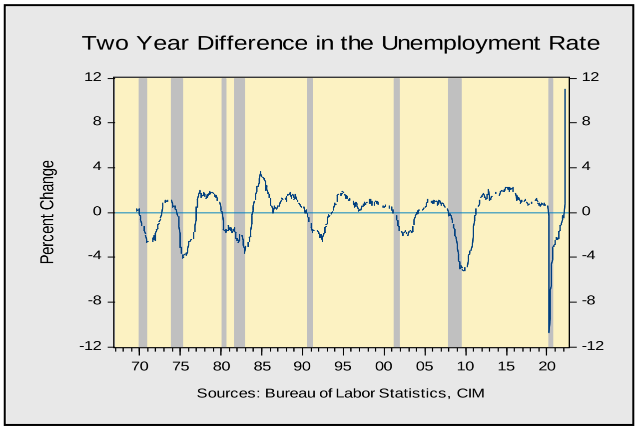
The rise in Real M1 money stock was relatively unchanged. Last month, Real M1, M1 minus CPI, rose 0.65% from the prior year, slower than the previous month's rise of 2.60%. The decline in the Real M1 reflects the Fed's decision to end its balance sheet expansion amid rising inflation. Assuming inflation remains elevated in May, we suspect this indicator will soon fall into contraction territory.

10-Year Treasury Minus Three-Year Treasury



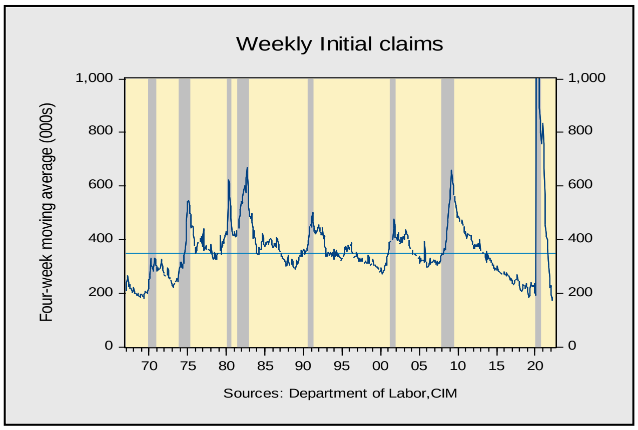
The difference between the 10-year and three-year Treasury narrowed slightly in April. The decline in the spread was due to investor concerns the Fed might trigger a recession in its fight to tame inflation. Last month, the Federal Reserve hinted that it might prioritize inflation over economic growth and unemployment. As a result, the sell-off of short duration bonds exceeded long-duration bonds, leading the spread to narrow by 1bp from 0.04% to 0.03%.

Two-Year Difference in the Unemployment Rate



The two-year spread in the unemployment rate widened to a near-record. The gap between the two-year unemployment rate expanded due to base changes. Although the unemployment rate remains low, the spread surged due to the lockdown in 2020, pushing the unemployment to 14.7%, a record. That being said, the unemployment rate remains low. In April, the unemployment rate was unchanged at 3.6%.

Weekly Initial Claims



Weekly initial claims rose slightly from the previous month's near-record level. The weekly average of initial claims for unemployment benefits rose from 175K to 188K. The low claims number may result from firms being hesitant to let workers go as finding replacements is becoming increasingly expensive.

Thomas Wash
May 26, 2022

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 the 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 and gauges 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.