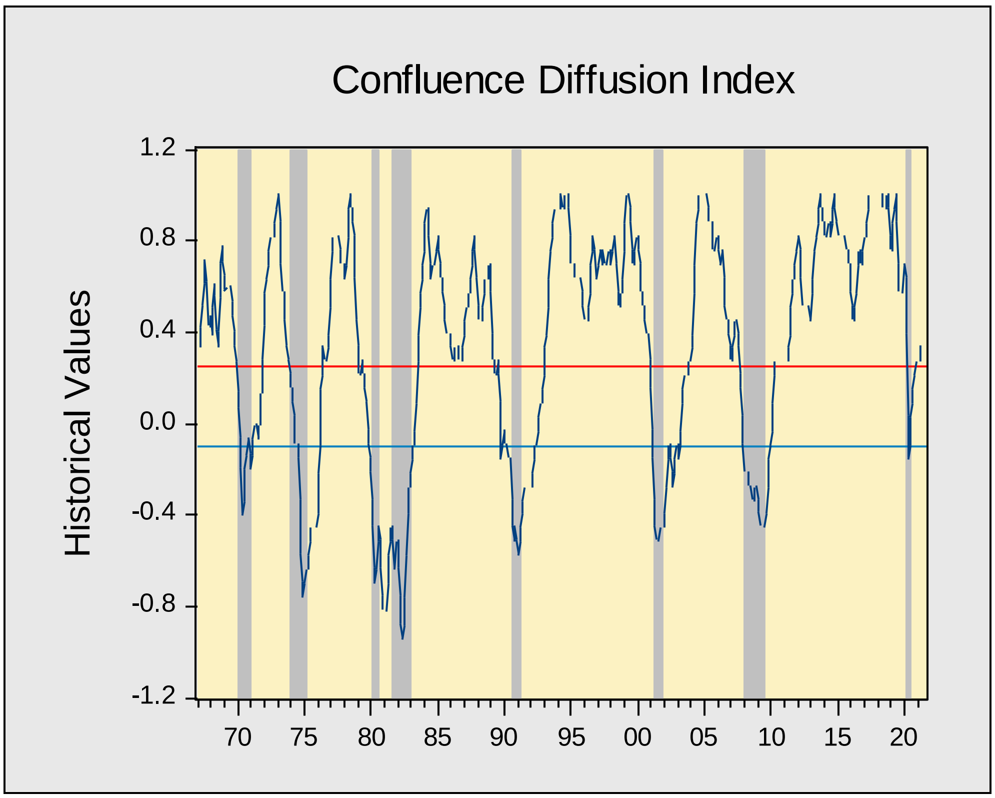
Business Cycle Report

By Thomas Wash

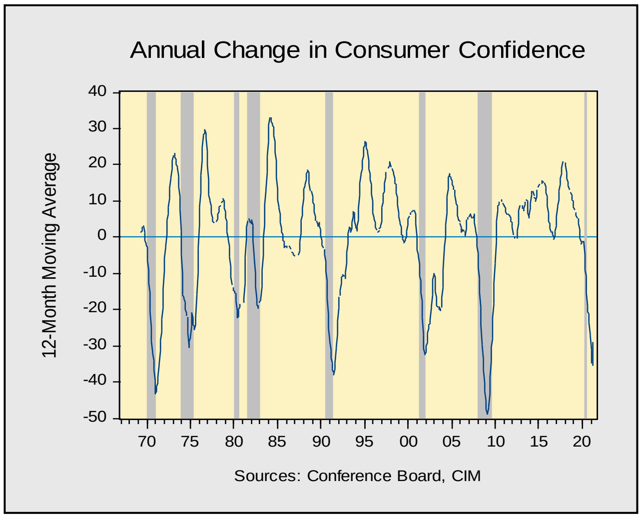
The business cycle has a major impact on financial markets; recessions usually accompany bear markets in equities. The intention of this report is to keep our readers apprised of the potential for recession, updated on a monthly basis. Although it isn't the final word on our views about recession, it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

In April, the diffusion index rose further above the recession indicator, signaling that the recovery remains in place. In the financial markets, positive economic data and reassurances that the Fed will continue to support the economy led to a moderation in Treasury yields and a rise in equities. 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 weakness as hiring slowed and the unemployment rate rose. As a result, three out of the 11 indicators are in contraction territory. The reading for April rose from +0.2727 to +0.3484, above the recession signal of +0.2500.



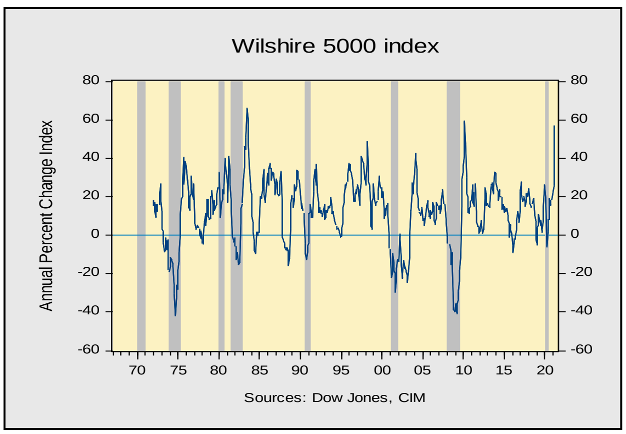
The chart above shows the Confluence Diffusion Index. It uses a three-month moving average of 11 leading indicators to track the state of the business cycle. The red line signals when the business cycle is headed toward a contraction, while the blue line signals when the business cycle is headed toward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



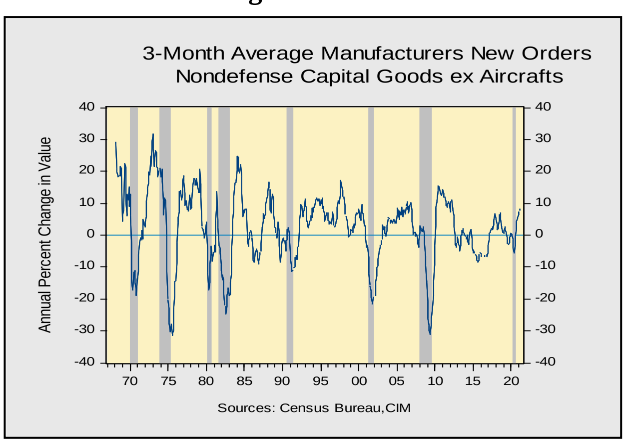
In April, the Consumer Confidence Index surged, largely due to respondents being more optimistic about their present situation. However, the index still contributes negatively to the diffusion index. Last month, the index rose by 12.7 points from 109.0 to 121.7. This reading is well above last year's level of 85.7. That being said, the rise led to an improvement in the 12-month moving average of the annual change from -35.4 to -28.8. The boost can be attributed to a growing belief that the pandemic is coming to an end. In April of last year, confirmed cases of COVID-19 began to rise throughout the country; this year, cases have fallen as a result of mass vaccinations. As a result, the index measuring consumer sentiment regarding the present situation rose from 110.1 to 139.6, well above last year's level of 73.0. The index for consumers' six-month outlook rose 1.5 points from the prior month, from 108.3 to 109.8. This is well above the prior year's reading of 94.3 and the pre-pandemic reading of 108.1.

Wilshire 5000 Index



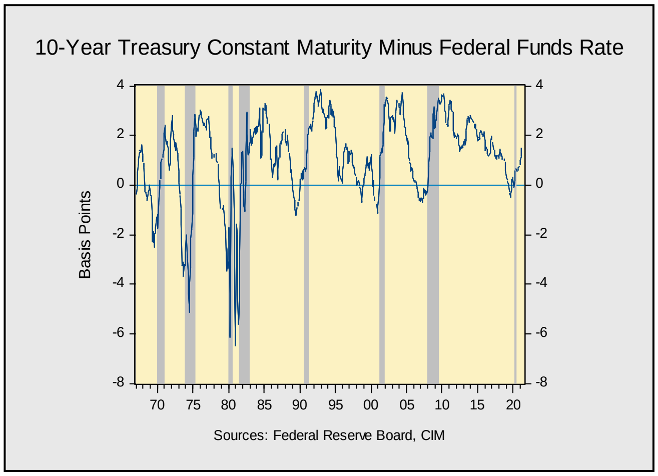
The Wilshire 5000 Total Return Index rose 59.6% from the prior year. The rise in equities can be attributed to vaccination progress and growing optimism about the economy. The three top-performing sectors in the index were Communication Services, Real Estate, and Consumer Discretionary. The bottom-performing sectors were Industrials, Consumer Staples, and Energy. Although yields are elevated, we currently expect equities to perform well throughout the year.

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



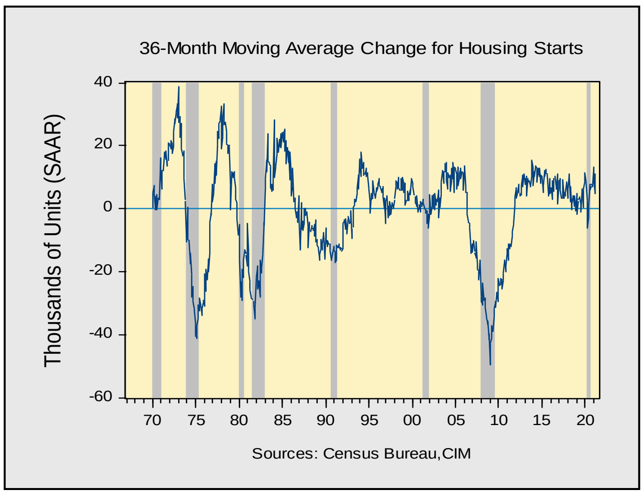
According to the Conference Board LEI, the value for new orders of durable goods adjusted for inflation fell 0.01% from the previous month. The latest report showed that new orders for nondefense capital goods came in at 40.458B in 1982-chained dollars, which is 18.14% higher than the previous year. New orders for the previous month were revised downward from $40.255B to $40.463B. The three-month moving average came in at $40.305B, up from the previous year's value of $36.056B. The indicator, which tracks the annual change in the three-month moving average for new orders, came in at 11.95, higher than the previous month's reading of 8.53.

10-Year Treasury Constant Maturity Minus Federal Funds Rate



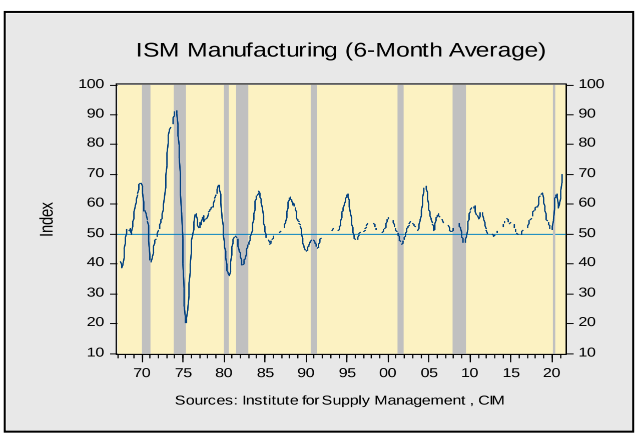
The 10-year Treasury yield minus the effective federal funds rate, also known as the financial spread, remained in expansion territory in April. The spread rose from +1.54 to +1.57. The widening of the spread can be attributed to inflation concerns after CPI came in above expectations in April. The sharp jump led to a brief sell-off of the 10-year Treasury. In order to calm fears, the Fed reaffirmed its willingness to maintain the effective fed funds rate at its current level. As a result, the effective fed funds rate held steady at 0.07%. Meanwhile, the 10-year Treasury rose 3.5 bps from 1.61% to 1.64%.

36-Month Moving Average Change for Housing Starts



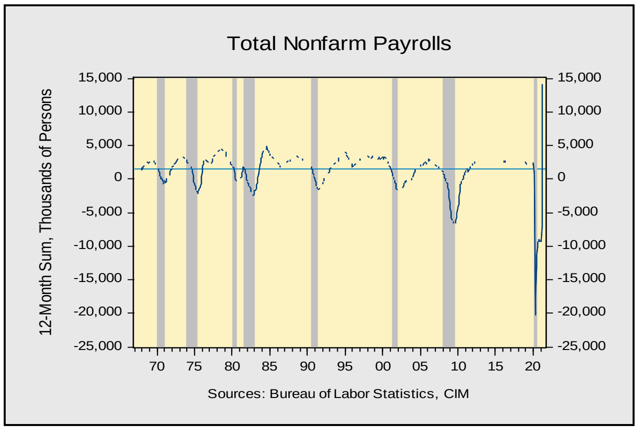
In April, the lack of building materials led to rising costs and contributed to a slowdown in residential construction. Annualized housing starts fell from 1,733K in March to 1,569K the following month. Despite the lack of materials, homebuilder confidence remains high due to the lack of inventory, low mortgage rates, and strong demand for homes outside of cities. As a result, this indicator will likely remain positive for the foreseeable future. The 36-month moving average for the change of housing starts rose 7.89K from the prior month, well above the recession signal.

ISM Manufacturing: Supplier Delivery Index



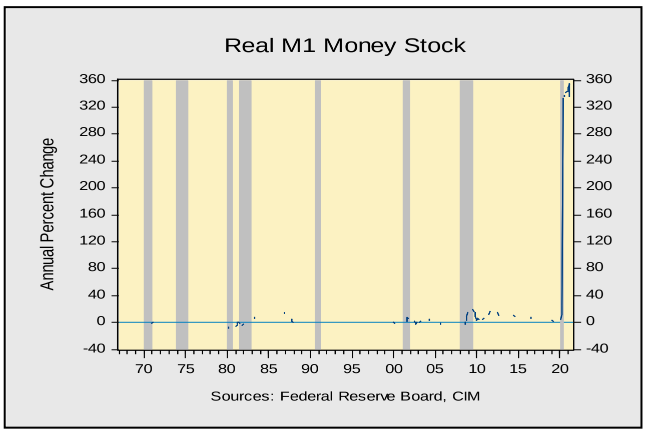
In addition to the global semiconductor shortage, purchasing managers are also reporting higher prices for materials as demand for inputs have outpaced supply. The ISM Supplier Delivery Index came in at 75.0 in April, below the previous month's reading of 76.6 but still elevated. The decline in the index can be attributed to a slight uptick in firms reporting faster deliveries. That being said, overall supplier delivery times remain relatively slow as firms have struggled to meet delivery dates due to "factory labor-safety issues, transportation challenges, and increased demand." The moving average improved in April, rising from 67.8 to 70.2.

Total Nonfarm Payrolls



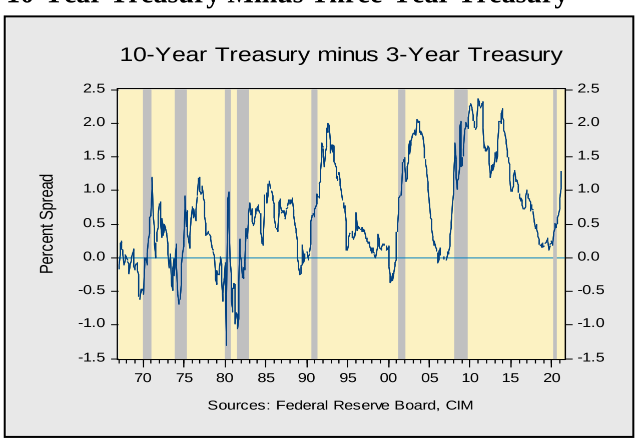
In April, the country gained 266K jobs for a 12-month moving sum of 14.147MM. Most of the new jobs came from the private service-providing sector, primarily in *Leisure and Hospitality*, which added 331K. In total, the service-providing sector accounted for 234K new jobs. The government sector added 48K, while the goods-producing sector lost 16K. Currently, the indicator is significantly above the recession signal of 1.600MM. Given the transitory nature of this indicator, this moving sum will likely decline sharply over the next few months but should remain in expansion territory.

Real M1 Money Stock



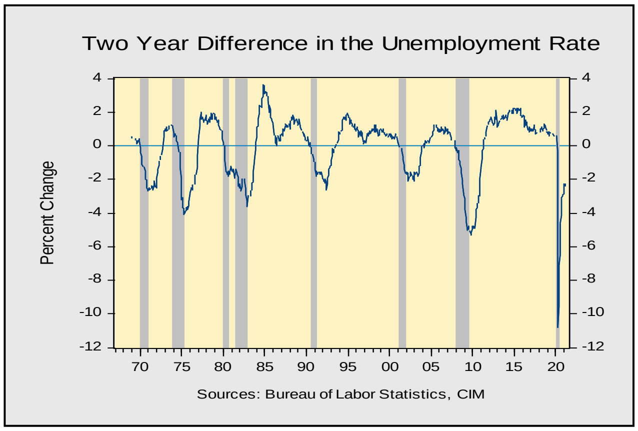
In April, year-over-year growth in Real M1 slowed for the second straight month, posting its first back-to-back declines in over a year. Last month, Real M1 Money Stock, which is M1 minus inflation, rose 292.5%, down from the previous month of 333.9%. The unprecedented rise in the indicator was heavily influenced by a change that the Federal Reserve made to its calculation of M1. M1 now includes other liquid deposits, which includes 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. As a result, we suspect the indicator could be headed for a sharp drop in the coming month as it adjusts to the unprecedented amount of stimulus given to households in 2020.

10-Year Treasury Minus Three-Year Treasury



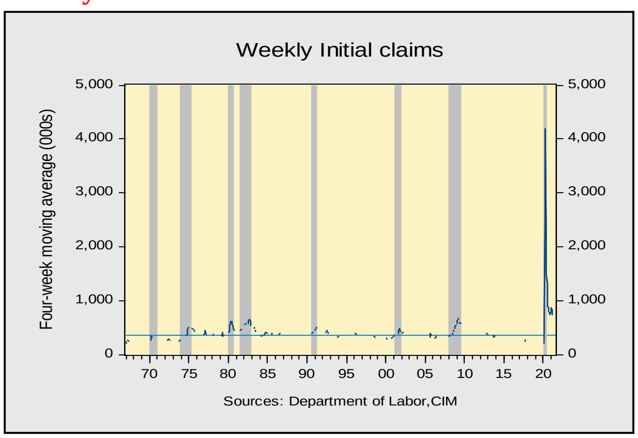
In April, inflation fears led to a rise in 10-year and 3-year Treasury yields. As a result, the spread between the 10-year and three-year Treasury remained unchanged from the previous month at +1.29. Last month, the 10-year Treasury yield rose by 3 bps from +1.61 to +1.64, and the three-year Treasury rose from +0.32 to +0.35.

Two-Year Difference in the Unemployment Rate



In April, the two-year spread in the unemployment rate widened from -2.2 to -2.4, contributing negatively to the diffusion index. In April, the unemployment rate rose from 6.0% to 6.1%, well above its level of 3.7% two years prior. The rise in the unemployment rate was largely due to people rejoining the labor force. The number of workers employed rose 0.22% from the prior month, while the civilian labor force rose by 0.27%. Meanwhile, the number of unemployed workers rose 1.05% from the prior month. The only group that saw a rise in unemployment was the short-term unemployed (six weeks or less). Nevertheless, we do not expect this indicator to contribute positively to the diffusion index for the foreseeable future.

Weekly Initial Claims



In April, average weekly initial claims fell for the third consecutive month, coming in at 579K compared to 724K recorded in the previous month. The drop in initial claims can be attributed to general improvement in the economy.

Thomas Wash
May 27, 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.