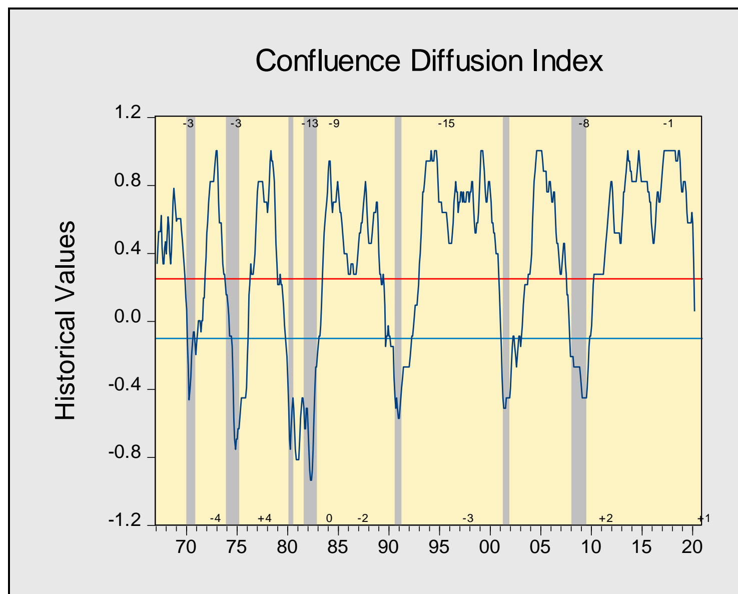
Business Cycle Report

By Thomas Wash

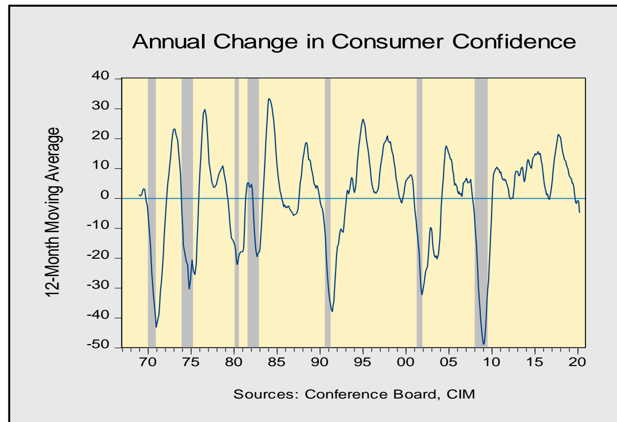
The business cycle has a major impact on financial markets; recessions usually accompany bear markets in equities. The intention of this report is to keep our readers apprised of the potential for recession, updated on a monthly basis. Although it isn't the final word on our views about recession, it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

In April, the diffusion index fell into recession territory for the first time since the financial crisis. Last month, the nationwide shutdown led to the sharpest decline in employment payrolls in the country's history, while initial claims remain elevated at all-time highs. The financial markets showed some signs of revival as equities rallied the most in history in a month and bond prices rose due to heightened demand for U.S. Treasuries as investors flocked to safety while lockdown orders remained in place globally. Additionally, manufacturing production in certain industries has continued, in spite of the shutdown, to address supply shortages. However, the pandemic continued to weigh heavily on both investor and consumer confidence as there are growing concerns that the impact could continue even after the economy reopens. As a result, seven out of the 11 indicators are in contraction territory. The reading for April fell to +0.030 from +0.393 the previous month, below the recession signal of +0.250.



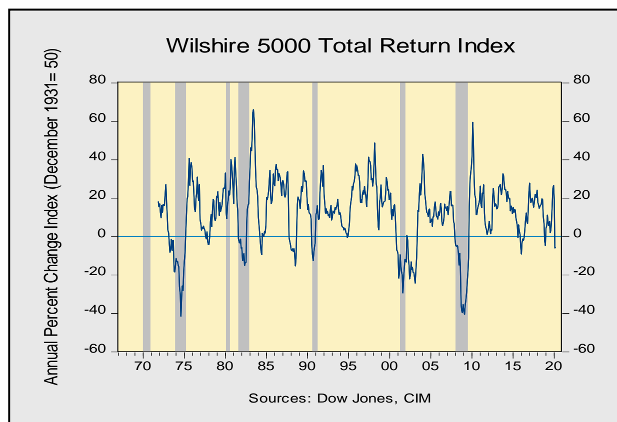
The chart above shows the Confluence Diffusion Index. It uses a three-month moving average of 11 leading indicators to track the state of the business cycle. The red line signals when the business cycle is headed toward a contraction, while the blue line signals when the business cycle is headed toward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



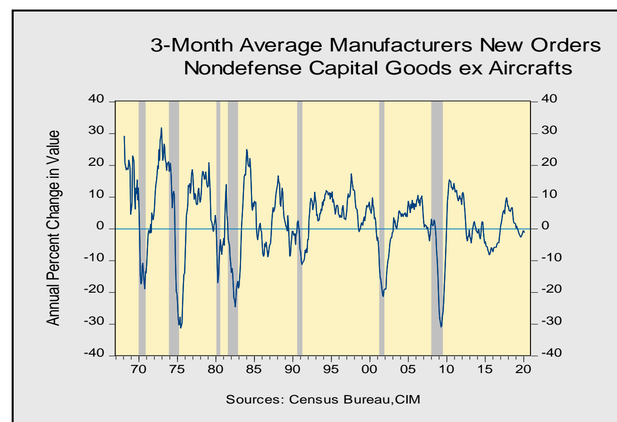
The consumer confidence index continued its descent in April as sentiment about the current situation fell to its lowest level since 2014. As a result, last month the annual change in the 12-month average for consumer confidence remains in contraction territory at -4.96. The April reading for consumer confidence was 86.9, below the reading of 129.2 from a year ago. Surprisingly, according to the report, consumers' expectations rebounded from 86.8 in March to 93.8 in April. The rise in expectations are the result of more consumers saying they believe there will be more jobs and improved business conditions within six months.

Wilshire 5000 Index



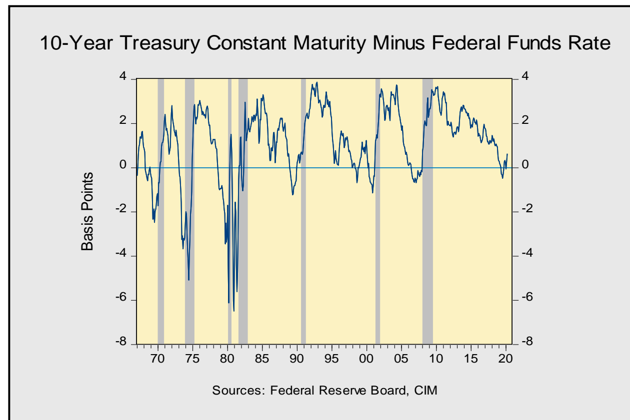
The Wilshire 5000 Total Return Index remained in contraction territory in the month of April. Equity markets moderated from a decrease of 6.22% in March to a drop of 5.89% in the following month. The decline in equities was due to the economic ramifications of the pandemic becoming more apparent as initial claims began to surge to unprecedented levels, manufacturing production slowed to a near halt, and consumption began to slow considerably. The worst-performing sectors over the past month were Utilities, Consumer Staples and Real Estate, while the best-performing sectors were Energy, Consumer Discretionary and Materials.

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



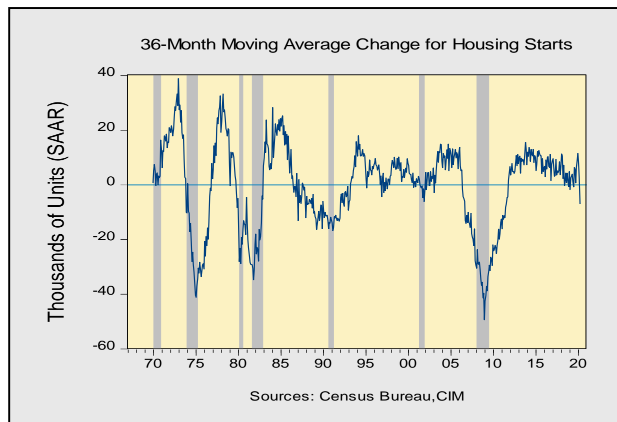
New orders for nondefense capital goods excluding aircrafts eased slightly but remain in contraction territory. The April reading came in at -1.30, slightly higher than the previous month's reading of -1.33. The value of new orders for nondefense capital goods came in at $37.171 billion in 1982 chained dollars, which is 0.9% higher than the previous month. The rise in orders could be due to an increase in machinery needed to help hospitals combat the coronavirus. Last month, President Trump implemented the Defense Production Act which prevented factories from closing down in order to produce medical goods and, in some cases, resulted in an increase in production.

10-Year Treasury Constant Maturity Minus Federal Funds Rate



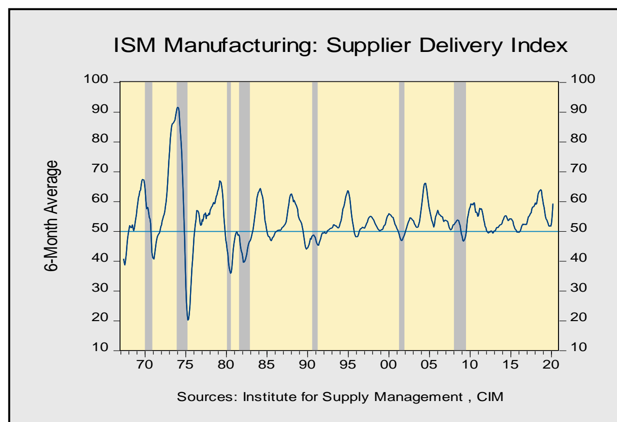
The financial spread, also known as the 10-year Treasury minus the federal funds rate, remained in expansion territory in April. The spread widened from +0.22 to +0.61. In April, the Federal Reserve announced that it would invest up to $2.3 trillion in loans and aid for small and mid-sized businesses and state and local governments, and also expanded its bond-buying program to include high-yield bonds. As a result of Fed action, the bond market began to stabilize and the yield of the 10-year Treasury fell 21 bps from 0.87% to 0.66%. Additionally, the fed funds rate fell 60 bps from 0.65% to 0.05%.

36-Month Moving Average Change for Housing Starts



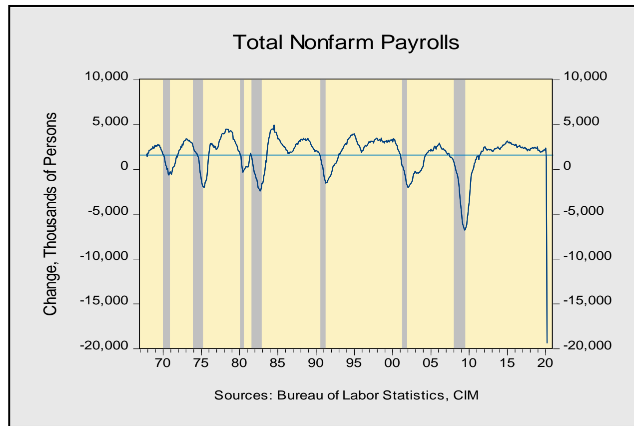
In April, this indicator fell into recession territory. Last month, housing construction fell by the most since 1959 after the lockdown forced many projects into suspension. Annualized housing starts fell 376, resulting in a decline of 7.19 in the 36-month moving average change. As the economy is slowly starting to reopen, we expect housing starts to rebound in the coming months. That being said, we are not confident that housing construction will return to pre-recession levels as we expect consumption to remain relatively subdued while people pay down debt accumulated during the lockdown and stock up on savings.

ISM Manufacturing: Supplier Delivery Index



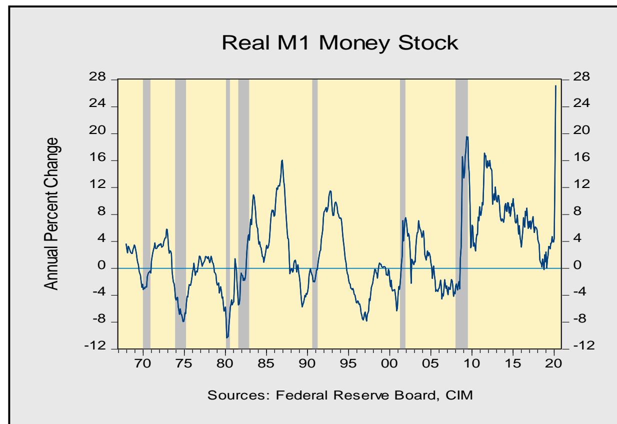
In April, the supplier delivery index rose to its highest level since 1974. The reading of 76.0 raised the six-month moving average from 54.9 to 59.1. As a result, the index moved further away from the contraction point of 50.0. The rise in the survey is due to a reduction in the amount of purchasing 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.

Total Nonfarm Payrolls



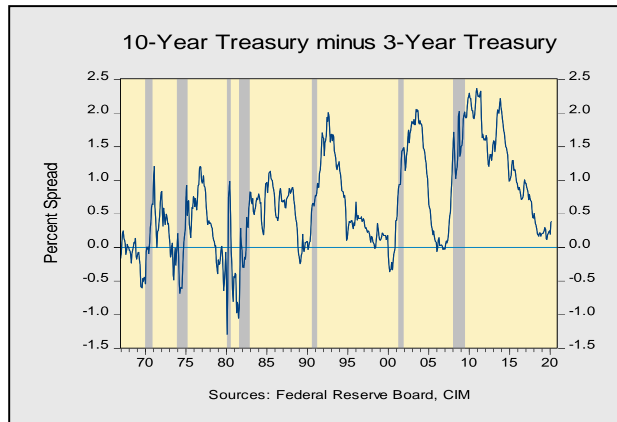
In April, the country lost a record 20.5 million jobs, for a 12-month moving sum of -19.420 million. Most of the job losses came from the private service-providing sectors, especially "leisure and hospitality," which lost 7.095 million. In total, the services sector accounted for 19.557 million job losses. Meanwhile, the goods-producing sector lost 2.335 million, primarily in manufacturing, which lost 1.330 million. Finally, the government sector lost 980k jobs. Local government had the most job losses at 801k, and the federal government added 1k, while state governments lost 180k. Currently, the indicator is significantly below the recession signal of 1.600 million. This indicator will be signaling recession for the foreseeable future.

Real M1 Money Stock



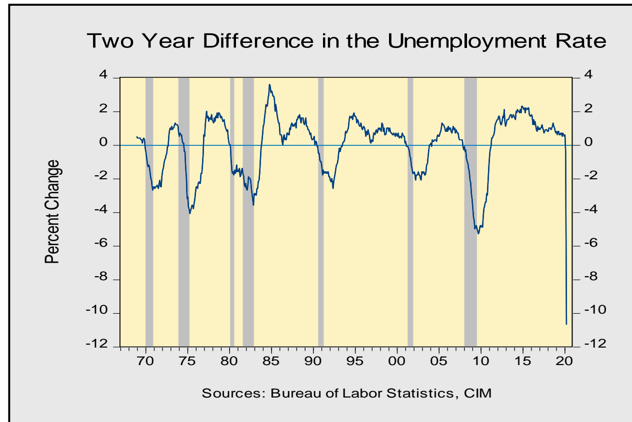
In April, this indicator rose to its highest level ever due to a steep rise in M1 and a slowdown in inflation. Last month, the Real M1 Money Stock, which is M1 minus inflation, rose 27.11% from the prior year, higher than the previous month's reading of 12.92%. The unprecedented rise in the indicator was heavily influenced by a surge in demand deposits and other checkable deposits at thrift institutions. Additionally, a slowdown in airfare and oil prices led to a deep deceleration in headline inflation. As a result, M1, which rose 27.41% from the prior year, outweighed the rise in CPI, which rose 0.3% from the prior year.

10-Year Treasury Minus Three-Year Treasury



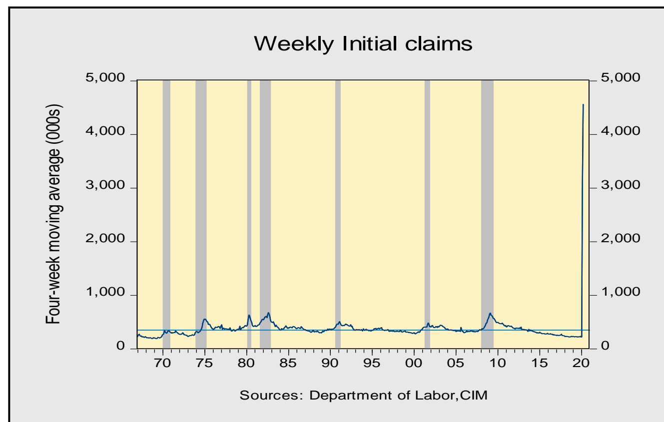
The spread between the 10-year and three-year Treasury widened slightly from +0.37 to +0.38 as fears about the pandemic response began to moderate. In April, both the 10-year and three-year Treasury bond declined due to concerns that the pandemic will likely last longer than most had expected. Additionally, the robust policy response by the Fed restored investor confidence in buying Treasuries as a safe haven asset, which made Treasuries a target for foreign direct investment. As a result, the 10-year fell 21 bps from +0.87 to +0.66 and the three-year fell 22 bps from +0.50 to +0.28.

Two-Year Difference in the Unemployment Rate



In April, the two-year spread widened the most in the indicator's history as the unemployment rate rose from 4.4% to 14.7%. As a result, the two-year difference between the unemployment rate dipped from -0.4 to -10.7, moving further away from the contraction indicator of 0.0. The increase in the unemployment rate was the result of employers laying off workers due to expectations that sales revenue would be hit by the stay-at-home orders. The participation rate fell from 62.7% to 60.2% and the employment/population ratio fell from 60.0% to 51.3%. Hence, the unemployment rate is likely to be much higher than official numbers report.

Weekly Initial Claims



Average weekly initial claims rose further in April, coming in at 4.558 million, up from 3.026 million the previous month. Layoffs continued in April as firms have become more pessimistic about future sales revenue even if the economy begins to reopen. The continued rise in initial claims is a reflection of the difficulties firms will have in adapting to the new normal following the pandemic. However, we expect claims to moderate as the country begins to reopen.

Thomas Wash
May 28, 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.