Business Cycle Report

Confluence Investment Management

By Thomas Wash

The business cycle has a major impact on financial markets; equity bear markets usually accompany recessions. The intention of this report is to keep our readers apprised of the potential for a 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.

May 29, 2025

In April, the US economy continued to grow broadly with no immediate signs of contraction. The composite economic index remained just above the recession threshold and showed minimal change from the previous month's reading. While employment indicators continued to demonstrate resilience, other sectors presented a more nuanced picture. Financial markets and real economic data sent mixed signals, suggesting an economy at a crossroads between sustained growth and potential softening. This dichotomy between strong labor markets and weaker production indicators bears close monitoring in coming months.

Labor Market

The labor market showed gradual easing from its recent peaks while remaining tight by historical standards. Initial jobless claims and employer payrolls pointed to ongoing strength in the demand for labor. In contrast, the two-year change in the unemployment rate signaled potential weakness. This divergence suggests that while hiring may be cooling from its torrid post-pandemic pace, underlying demand for workers remains robust. The continued labor market tightness provides an important buffer against broader economic weakness, supporting consumer spending and overall growth.

Financial Markets

Financial markets delivered conflicting messages about economic prospects. Equity markets rallied on optimism that potential trade restrictions might be less severe than initially anticipated, reflecting confidence in corporate earnings. However, bond markets told a more cautious story, with Treasury yields ending the month slightly lower as investors priced in greater economic uncertainty. This disconnect between equity and fixed income markets typically signals investor debate about future growth trajectories, with bond markets often proving more prescient about economic turning points.

Goods Production and Sentiment

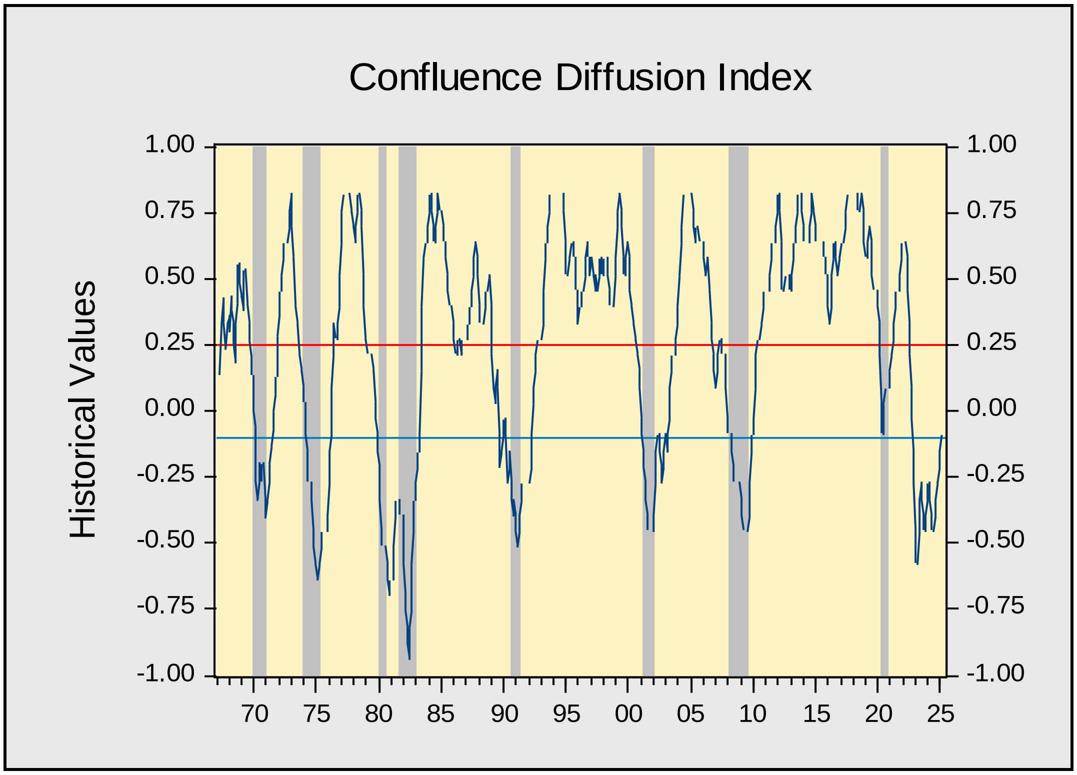
The goods-producing sector emerged as the economy's weakest link in April, with three of four key diffusion indicators in contraction territory. Consumer sentiment remained depressed, potentially foreshadowing softer spending ahead. Business investment showed particular weakness, evidenced by sluggish housing starts and declining capital expenditures. These trends suggest corporate leaders are growing more cautious about future demand. However, supplier delivery times — often an early indicator of economic activity — remained elevated, pointing to persistent underlying demand that could support continued expansion.

Outlook and Risks

While recession risks persist, current data suggests the economy will likely avoid contraction in the near term. The primary uncertainties center on potential trade policy impacts and whether labor market strength can offset softness elsewhere. There are signs of growing margin pressures that could eventually affect hiring and investment decisions. Our baseline projection anticipates continued modest growth through the third quarter, though the economy appears increasingly vulnerable to external shocks. Investors should remain vigilant for signs of broader economic deterioration, while increasing risk exposure may be warranted as the economic outlook becomes clearer.

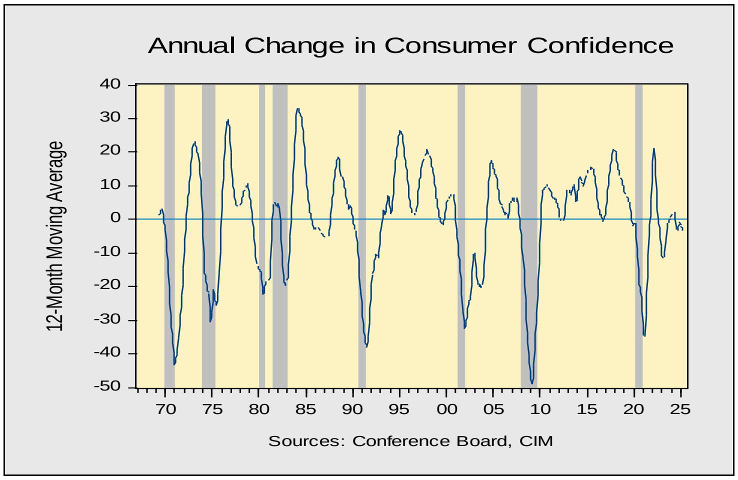
The Confluence Diffusion Index for May, which encompasses data for April, remained slightly above the recovery indicator. However, the report showed that five out of 11 benchmarks are in contraction territory. Using April data, the diffusion index was unchanged at -0.0909 and above the recovery signal of -0.1000.

- Equity prices bounced back following trade progress.
- Manufacturing data offered mixed signals.
- Hiring picked up in a sign that labor conditions remain tight.



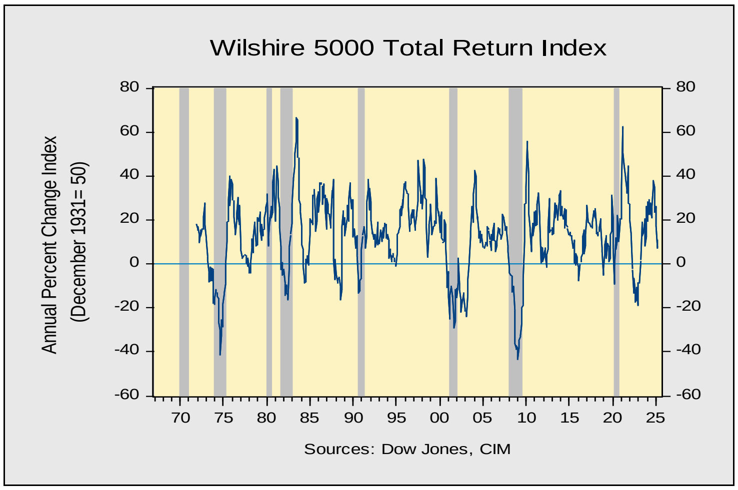
The chart above shows the Confluence Diffusion Index. It uses a three-month moving average of 11 leading indicators to track the state of the business cycle. The red line signals when the business cycle is headed toward a contraction, while the blue line signals when the business cycle is in recovery. 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. A chart title listed in red indicates that the index is signaling recession.

Consumer Confidence



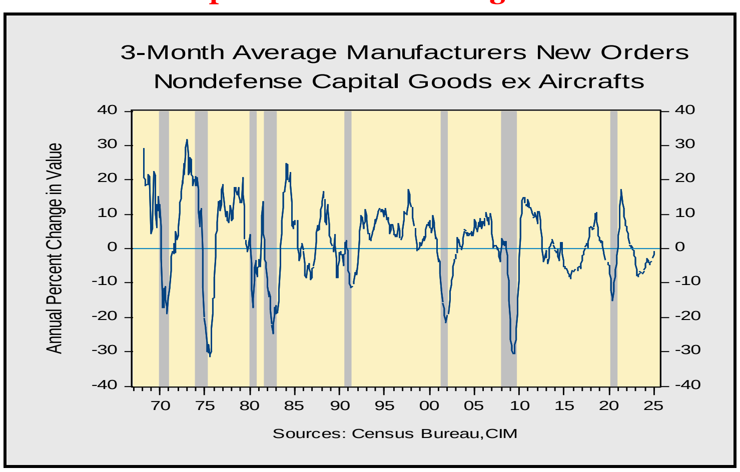
- In April, the 12-month moving average of the annual change in consumer confidence fell from -3.0 to -3.4.
  - Consumer confidence came in at 86.0, down from 97.5 in April 2024.
  - The sub-index for the current situation came in at 133.5, down from 140.6 last year. Meanwhile, the sub-index for future expectations decreased from 66.9 to 54.4 in the same period.
  - Indicates recession when the level falls below zero.

Wilshire 5000 Index



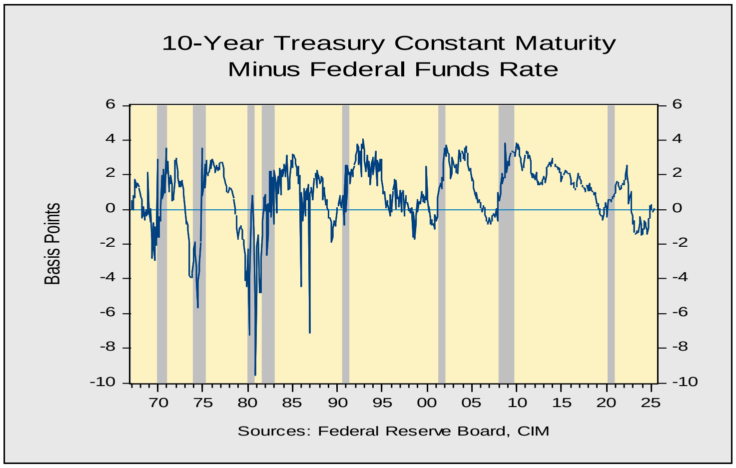
- The Wilshire 5000 Total Return Index for April rose 11.3% from the prior year.
  - Top-performing sectors: Technology, Consumer Staples, Industrials.
  - Bottom-performing sectors: Energy, Health Care, and Materials.
  - Indicates recession when the level falls below zero.

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



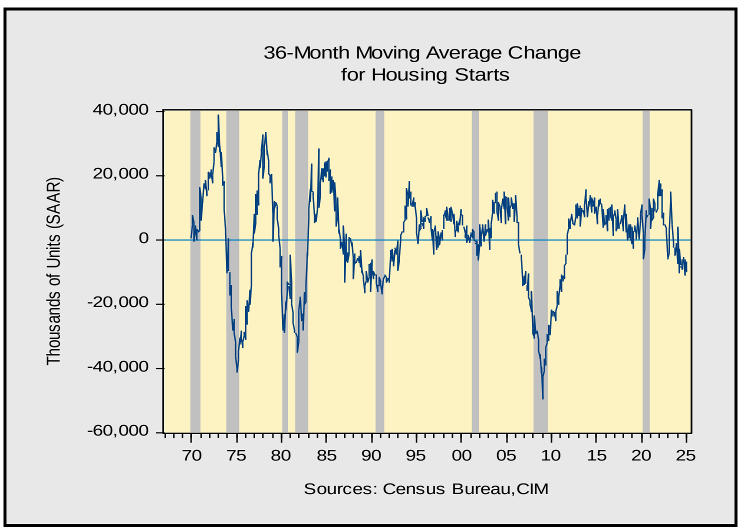
- The three-month moving average of the annual change in new orders for nondefense capital goods fell 0.3% from the prior year.
  - In April, new orders rose 0.6% from the prior month and rose 0.1% since 2024.
  - Indicates recession when the level falls below zero.

10-Year Treasury Constant Maturity Minus Federal Funds Rate



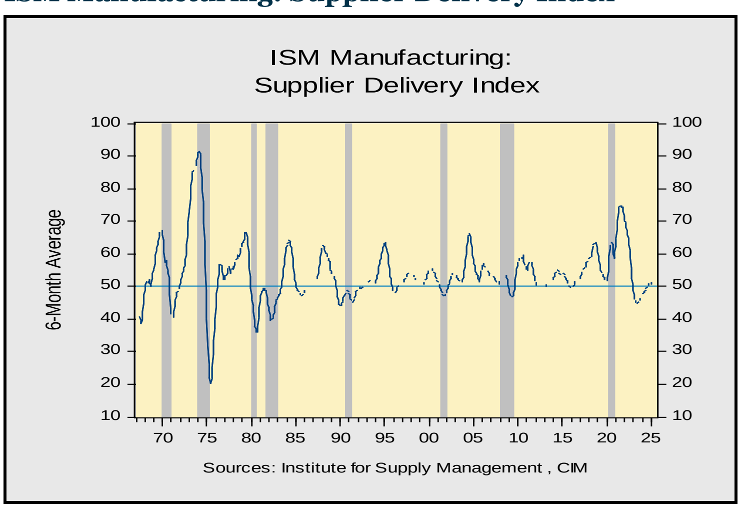
- The financial spread, 10-year Treasury yield minus effective fed funds rate, worsened from -0.10% to -0.16%.
  - The effective fed funds rate was unchanged at 4.33%.
  - The 10-year Treasury fell from 4.23% to 4.17%.
  - Indicates recession when the level falls below zero.

36-Month Moving Average Change for Housing Starts



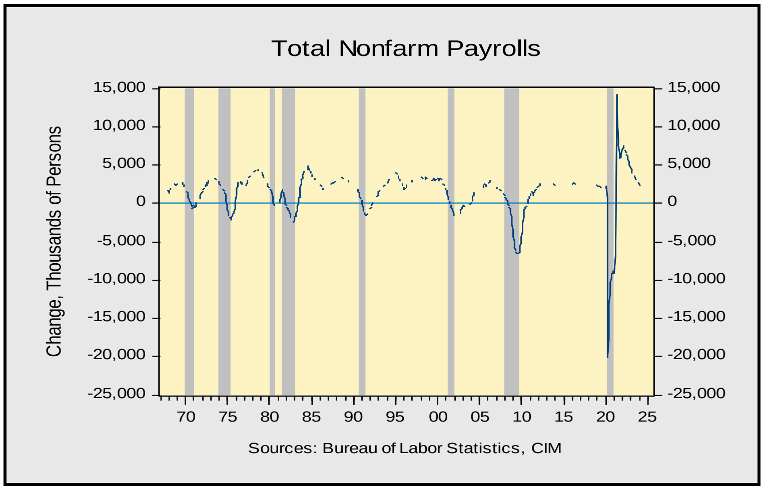
- The 36-month moving average change for housing starts worsened from -10.36 to -12.75.
  - Housing starts expanded at an annualized rate of 1,361k, above the previous month's revised pace of 1,339k.
  - Single-family starts fell from 947k to 927k. Multi-family dwellings rose from 378k to 420k.
  - Indicates recession when the level falls below zero.

ISM Manufacturing: Supplier Delivery Index



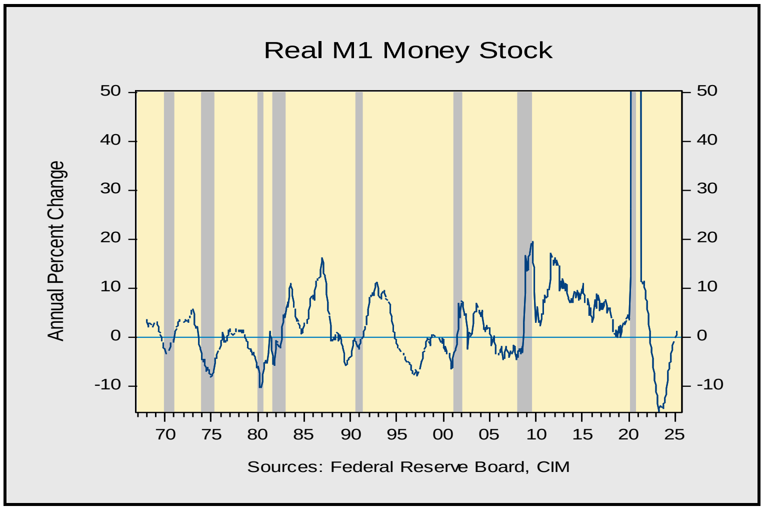
- The six-month moving average of the Supplier Delivery Index rose from 51.6 to 52.2.
  - The overall index fell from 49.0 to 48.7.
  - The Supplier Delivery Index increased from 53.5 to 55.2.
  - Indicates recession when the level falls below 50.

Twelve-Month Sum of Nonfarm Payrolls



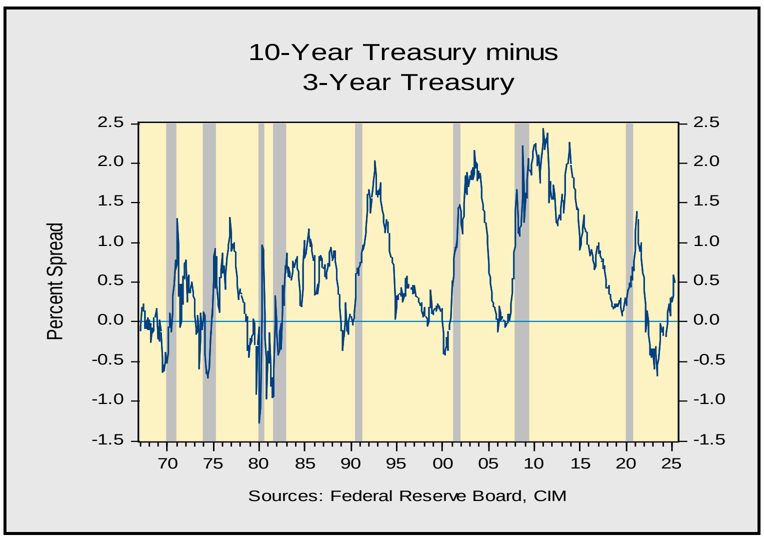
- The 12-month moving sum increased from 1,823k to 1,882k.
  - Nonfarm payrolls showed that the economy added 177k jobs in April.
  - Service-Providing industries added 156k jobs. The Goods-Producing sector added 11k from the previous month, while the Government sector gained 10k jobs.
  - Indicates recession when the level falls below 1,500k.

Real M1 Money Stock



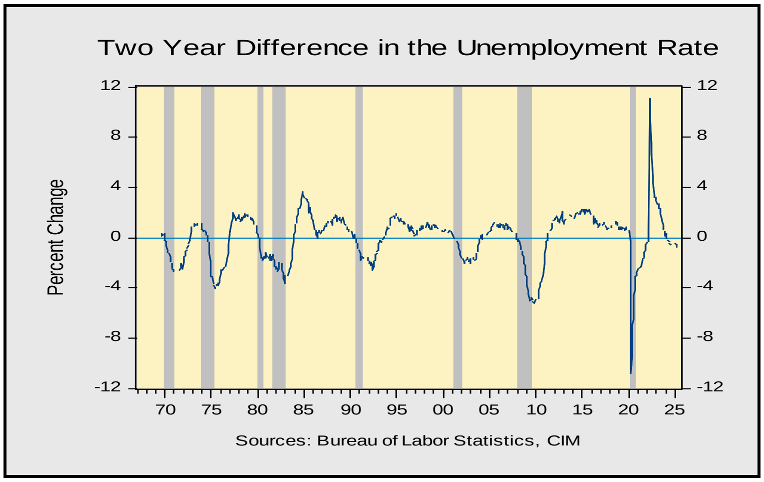
- Real M1 money stock rose 1.6% from the prior year.
  - Headline CPI rose 2.3% from the prior year.
  - M1 money stock rose 3.9% from the prior year.
  - Indicates recession when the level falls below zero.

10-Year Treasury Minus Three-Year Treasury



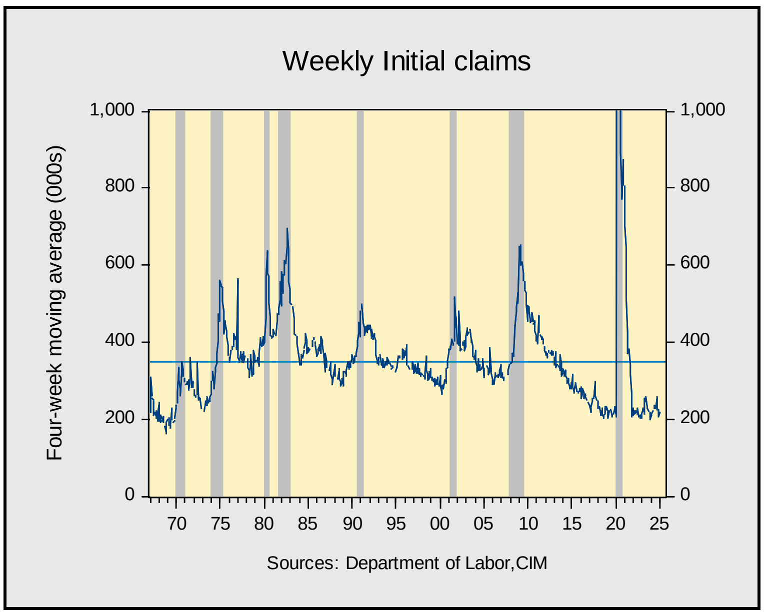
- The term spread between the 10-year and three-year increased from +0.34 to +0.59.
  - The 10-year Treasury yield fell from 4.23% to 4.17%.
  - The three-year Treasury yield decreased from 3.89% to 3.58%.
  - Indicates recession when the level falls below zero.

Two-Year Difference in the Unemployment Rate



- The two-year difference in the unemployment rate worsened from -0.7% to -0.8%.
  - The unemployment rate was unchanged at 4.2%.
  - The number of unemployed rose 1.2% from the prior month.
  - Indicates recession when the level falls below zero.

Weekly Initial Claims



- Average weekly claims for April were unchanged at 229k.
  - Indicates recession when the level rises above 350k.

Thomas Wash, CBE
May 29, 2025

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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 US equity index. The index contains 3,500 stocks and is designed to track the overall performance of the US 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 Aircraft: 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 the 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 intense.

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.