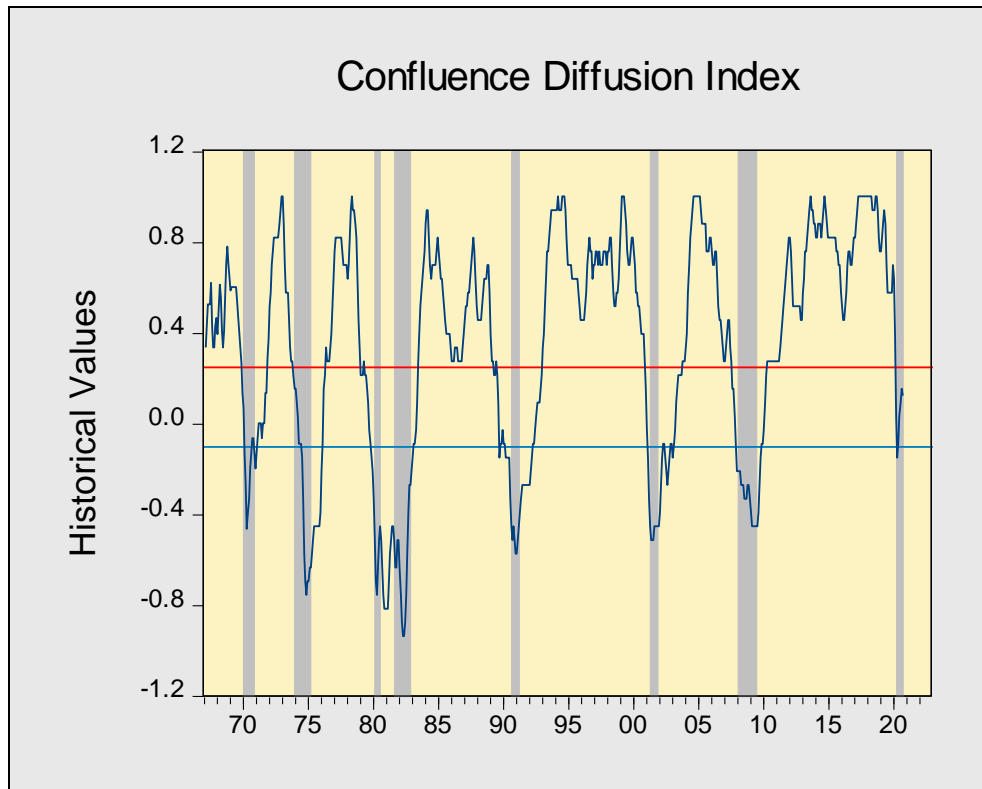


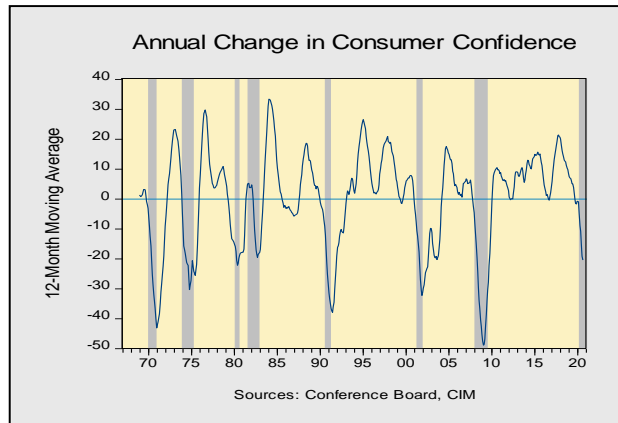
The business cycle has a major impact on financial markets; recessions usually accompany bear markets in equities. The intention of this report is to keep our readers apprised of the potential for recession, updated on a monthly basis. Although it isn't the final word on our views about recession, it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

In October, the diffusion index rose further above contraction territory, signaling that the economy remains on track to expand in Q4. Financial markets were weaker as equities dipped and the yield spreads widened. Meanwhile, the labor market continues to show signs of improvement as firm hires remain strong. However, the lack of progress on additional fiscal stimulus continues to weigh on growth expectations as concerns over slowing consumer spending continue to mount. As a result, four out of the 11 indicators are in contraction territory. The reading for October rose from +0.1515 to +0.2121, above the recovery signal of -0.100.



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.

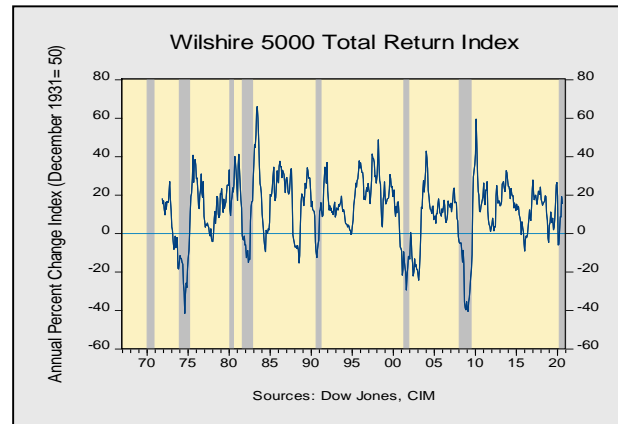
Consumer Confidence



Despite a strong Consumer Confidence report in October, the indicator fell further below the recession signal. Last month, the index fell by 0.4 points from 101.3 to 100.9. This reading is much lower than the previous year's reading of 126.1. As a result, the 12-month moving average of the annual change fell from -20.6 to -21.8. The drop in the index is primarily due to consumers being less confident about their respective futures. The consumer six-month outlook fell 4.5 points from the prior year, from 102.9 to 98.4. However, it appears that rising infections are still a concern for consumers. The index for consumer sentiment about the present situation sits at 104.6, well below last year's level of 173.5. As a result, we expect this indicator to become more volatile going forward as consumers focus less on the pandemic and more on the recovery.

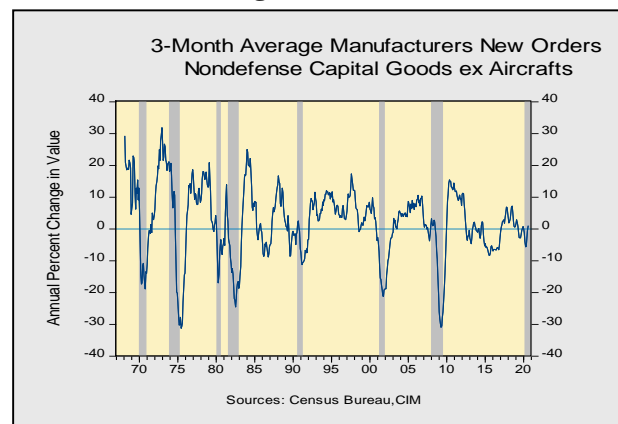
the present situation sits at 104.6, well below last year's level of 173.5. As a result, we expect this indicator to become more volatile going forward as consumers focus less on the pandemic and more on the recovery.

Wilshire 5000 Index



Although the Wilshire 5000 Total Return Index cooled in October, it is still higher than it was in the previous year. Last month, the index fell from 162.49 to 159.09, which is 18.4% higher than the previous year. The slowdown in equities was likely the result of lack of progress in stimulus talks and rising election jitters. The three top-performing sectors in the index were Utilities, Materials, and Communications. The bottom-performing sectors were Information Technology, Energy, and Real Estate. We expect equities to remain bullish throughout the year as credit conditions will likely remain favorable for the foreseeable future.

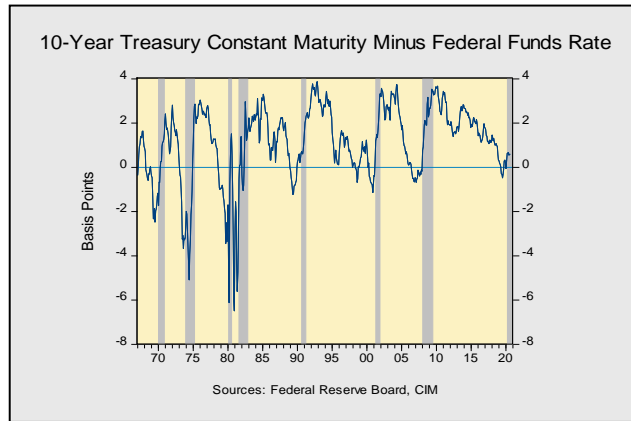
Three-Month Average Manufacturers New Orders Nondefense Capital Goods excluding Aircrafts



According to the Conference Board LEI, the value for new orders of durable goods fell for the first time in six-months. In October, new orders for nondefense capital goods came in at \$38.061B in 1982-chained dollars, which is 2.6% higher than the previous year. New orders for September were revised upward from \$37.395B to \$38.258B. The three-month moving average came in at \$38.094B, up from the previous year's value of \$37.043B. The indicator, which tracks the annual change in the three-month moving average for new orders, came in at 2.84, higher than the previous month's reading of 1.82. The decline in orders was the result of

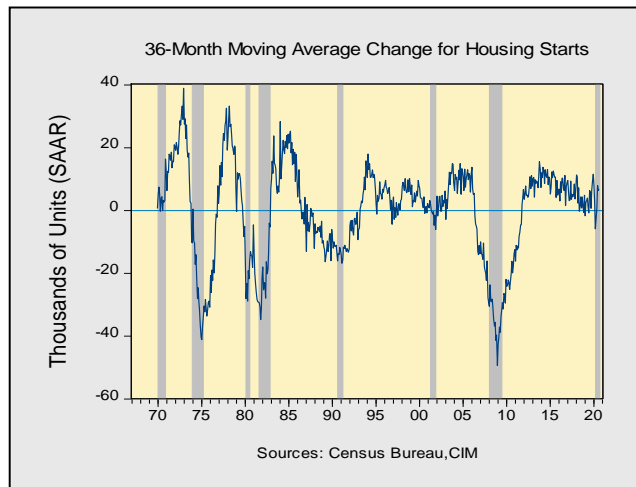
COVID-19 cases making companies less optimistic about future demand. We expect that recent developments in vaccine methods will likely reverse this trend.

10-Year Treasury Constant Maturity Minus Federal Funds Rate



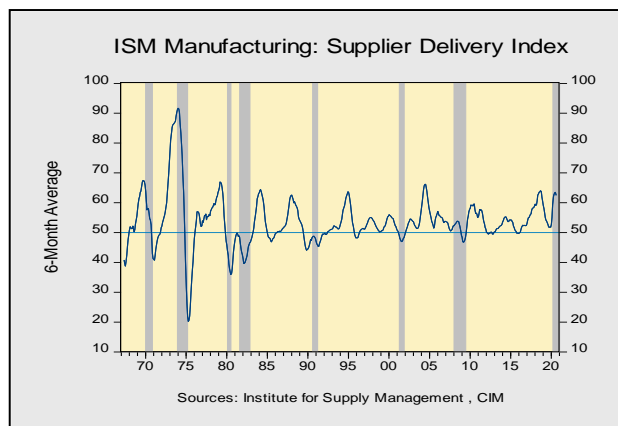
The financial spread, also known as the 10-year Treasury minus the federal funds rate, remained in expansion territory in October. The spread rose from +0.59 to +0.70. The yield curve steepened as employment gains and declining unemployment claims suggest a strong recovery. Last month, the fed funds rate remained unchanged from September at 0.09%. Meanwhile, the 10-year Treasury rose 3 bps from 0.68% to 0.79%.

36-Month Moving Average Change for Housing Starts



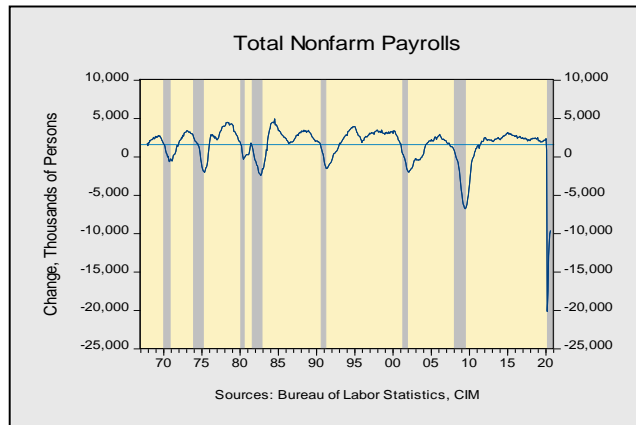
In October, housing starts surged as homebuilders prioritized single-family over multi-family homes. The preference for single-family homes can be partially attributed to homebuilders becoming more optimistic about demand for homes in the suburbs. This could be the result of record-low mortgage rates attracting young adults into the housing market. As a result, annualized housing starts rose from 1,459K in September to 1,530K in the following month. The 36-month moving average change of housing starts rose 7.61K from the prior month, suggesting that housing construction is strong.

ISM Manufacturing: Supplier Delivery Index



The ISM Supplier Delivery Index rose from 59.0 in September to 60.5 in October. The rise in the index was due to fewer firms reporting faster deliveries. However, a transition in the moving average prevented the indicator (located to the left) from strengthening. As a result, the moving average fell from 62.3 to 59.7. In the coming months, this indicator will likely begin to dip as distortions caused by the lockdown months will start to fall out of the moving average. Hence, the drop in this indicator will likely be a signal of normalization as opposed to weakness in the supplier delivery.

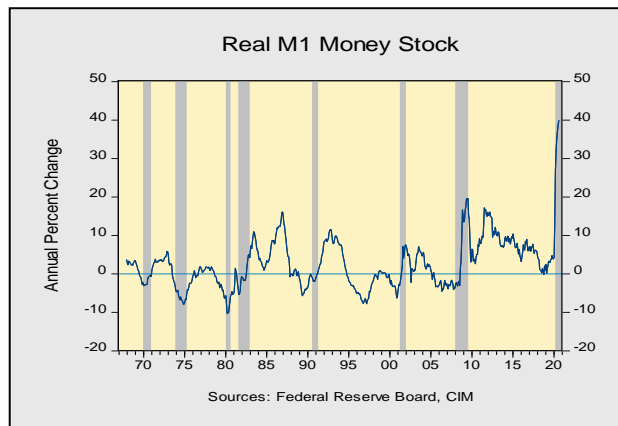
Total Nonfarm Payrolls



In October, the country gained 638K jobs for a 12-month moving sum of -9.180MM. Most of the jobs added came from the services-providing sector. In total, the services-producing sector accounted for 783K added jobs. Meanwhile, the goods-producing sector contributed 123K, primarily in construction, which added 84K. The government sector lost 268K jobs. Local and state governments saw the least job losses at 65K, respectively, while the federal government lost 138K. Currently, the indicator is significantly below the recession signal of 1.600MM. At this rate, the indicator will likely be signaling recession for the foreseeable future.

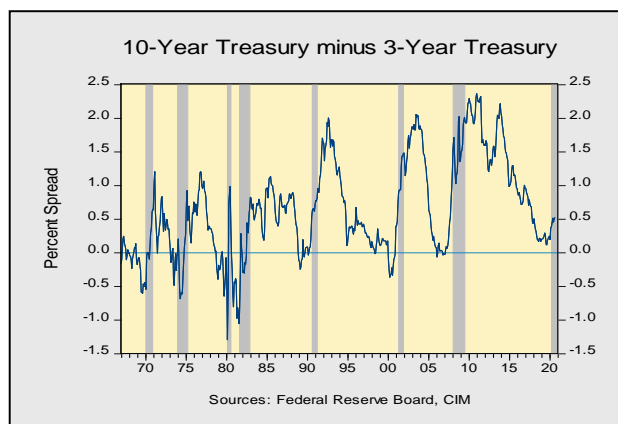
Barring a setback, this will likely be brushed off by most analysts as job losses due to the lockdown were by far the largest in history.

Real M1 Money Stock



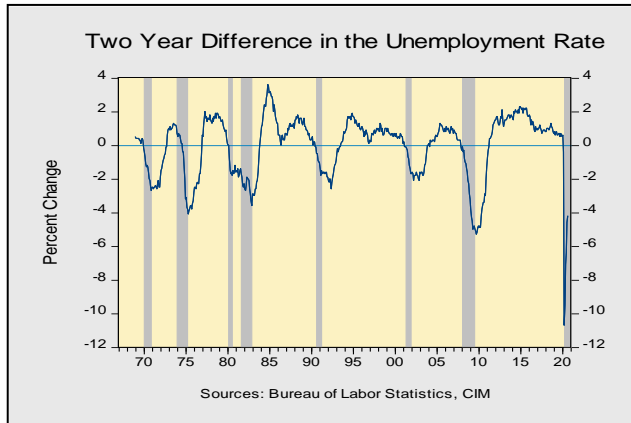
In October, Real M1 rose to its highest level ever for the sixth consecutive month. Last month, the Real M1 Money Stock, which is M1 minus inflation, rose 41.04% from the prior year, higher than the previous month's reading of 39.58%. The unprecedented rise in the indicator was heavily influenced by a rise in other checkable deposits, particularly commercial banks. Additionally, a slowdown in airfare and energy prices led to a deep deceleration in headline inflation. As a result, M1, which rose 42.24% from the prior year, outweighed the rise in CPI, which rose 1.20% from the prior year.

10-Year Treasury Minus Three-Year Treasury



In October, there was a bearish steepening of the yield curve due to optimism over a fiscal stimulus package. As a result, rising inflation fears led to stronger demand for long-duration bonds. The spread between the 10-year and three-year Treasury widened from +0.52 to +0.60. The widening of the spread was due to an increase in interest rates for 10-year Treasuries, which outpaced the rise in three-year Treasuries. Last month, the 10-year Treasury rose by 11 bps from +0.68 to +0.79. The three-year Treasury rose from +0.16 to +0.19. If improvements continue for vaccine development, we expect the spread to widen as investors become more optimistic.

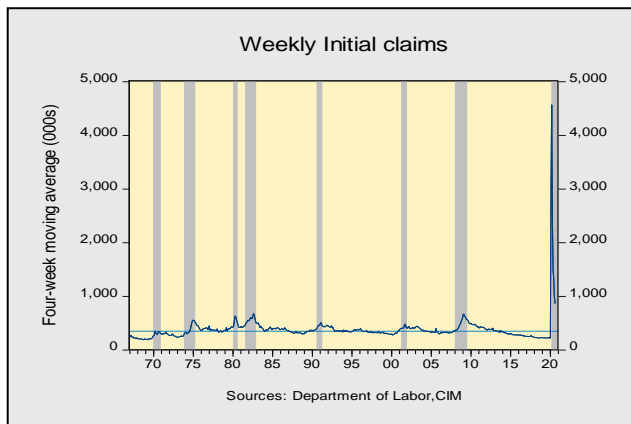
Two-Year Difference in the Unemployment Rate



people finding employment. That being said, we do not expect this indicator to contribute positively to the diffusion index for the the foreseeable future.

In October, the two-year spread in the unemployment rate narrowed from -4.2 to -3.1, contributing negatively to the diffusion index. Despite the drop in the unemployment rate from 7.9% to 6.9%, it still remains well above its level of 3.8% from two years ago. Last month, the labor market tightened as workers continued to return to the workforce following a slowdown in cases. The number of workers employed rose 1.5% from the prior month, while the civilian labor force rose by 0.5%. Meanwhile, the number of unemployed workers fell 12.1% from the prior month. The drop in the unemployment rate was primarily due to

Weekly Initial Claims



In October, average weekly initial claims fell for the fifth consecutive month, coming in at 785K, down from the 855K recorded in the previous month. Initial claims are falling across the country. Initial claims appear to be broad-based, with a disproportionate number of claims coming from retail trade and leisure and hospitality.

Thomas Wash
November 25, 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.