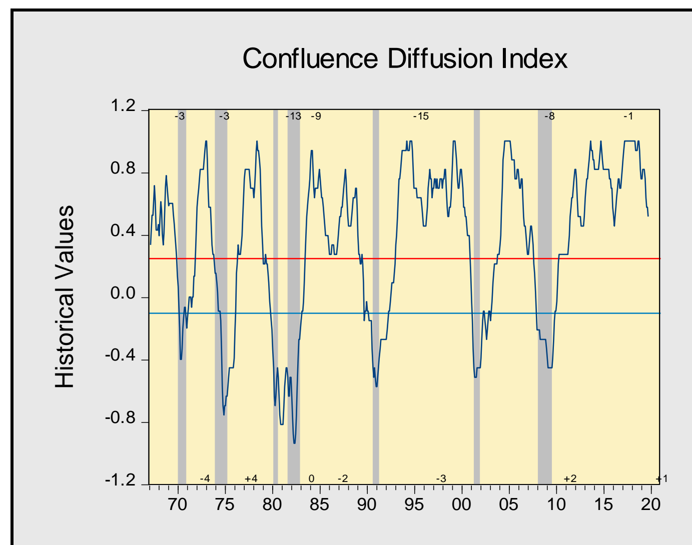
Confluence INVESTMENT MANAGEMENT

Business Cycle Report

By Thomas Wash

The business cycle has a major impact on financial markets; recessions usually accompany bear markets in equities. We have created this report to keep our readers apprised of the potential for recession, which we plan to update 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, Q3 earnings came in stronger than expected, the Federal Reserve cut rates for a third time this year and the U.S. and China continued to negotiate what is being called a "phase-one" trade deal. Meanwhile, the manufacturing sector continued to show signs of weakness and consumer confidence slowed. Currently, our diffusion index shows that seven out of 11 indicators are in expansion territory, with several indicators approaching negative territory. The index for October fell 60 bps from +0.575 in the prior month to +0.515.

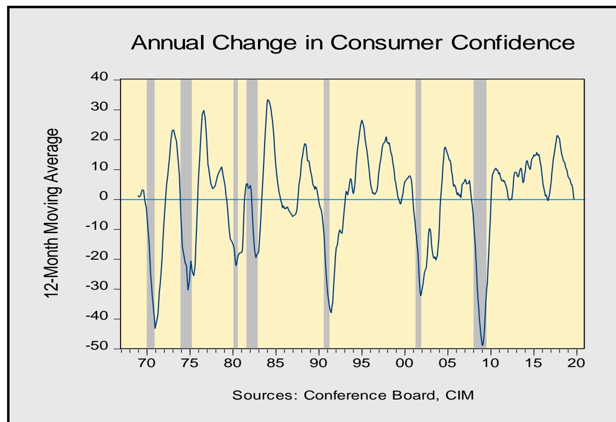


The chart above shows the Confluence Diffusion Index. It uses a three-month moving average of 11 leading indicators to track the state of the business cycle. The red line signals when the business cycle is headed toward a contraction, while the blue line signals when the business cycle is headed toward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

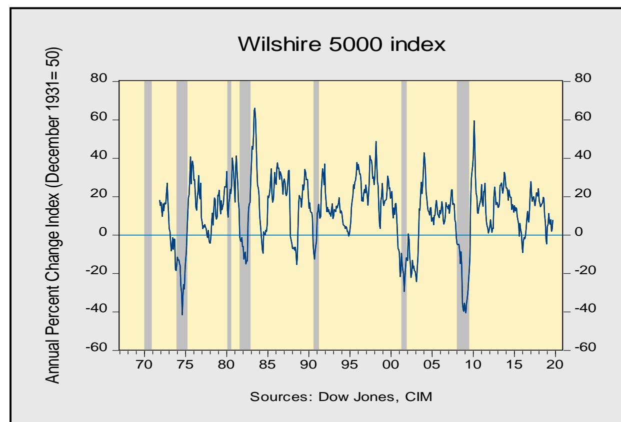
Notable Indicators	
Data Series	Commentary
Annual Change in Consumer Confidence	Fell into negative territory based on consumer expectations
ISM Supplier Delivery	Latest reading reflected a contraction in october but the 6-month average remains in expansion teritory.
36-Month Moving Change in Housing Starts	Fell into negative territory, but will likely rebound next month

Consumer Confidence

The 12-month annual change in consumer confidence has slowed from +1.7 to -0.3 in October. Last month's report fell from 126.3 to 125.9, pushing the indicator into negative territory for third time during this cycle. According to the report, consumer confidence about their present situation improved from 170.6 to 172.3, as more respondents expressed optimism about current business conditions. Meanwhile, consumer future expectations fell from 96.9 to 94.9, as consumers are becoming more reluctant to make big ticket purchases such as a new car. Over the last three years consumption has become practically the sole driver of growth. If this trend continues it likely weigh on our GDP growth expectations.

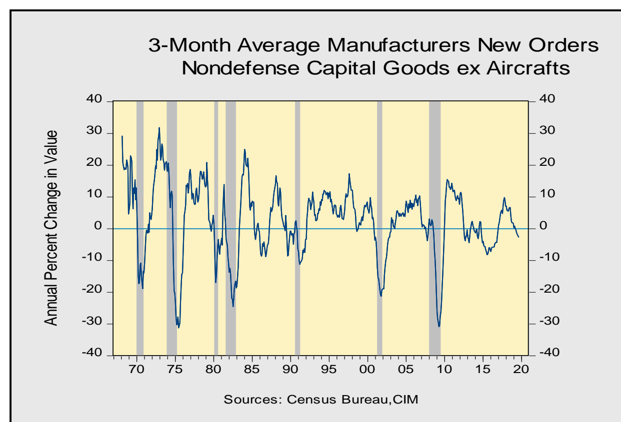


Wilshire 5000 Index



The latest reading of the Wilshire 5000 Index shows an annual change of 7.67%. October was a great month for equities as fears of an earnings recession were abated and progress in trade negotiations boosted economic optimism. At this time, we believe some investors have jumped the gun as economic data shows that the economy is still relatively weak. In addition, we suspect that as long as global growth remains a concern, fears of an earnings contraction will continue to persist. Earlier this month, OECD trimmed its previous forecast for 2020 from about 4% growth to 2.9%.

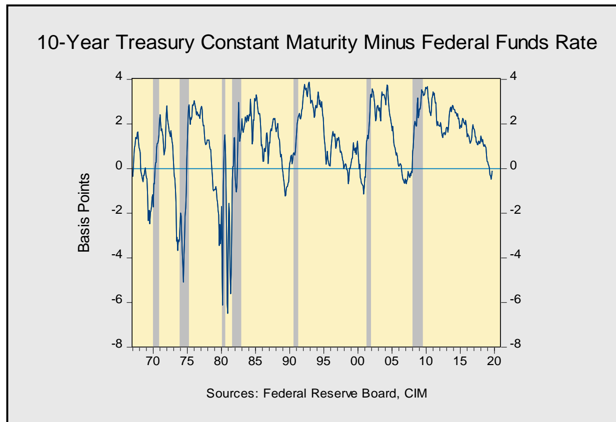
Three-Month Average Manufacturers New Orders Nondefense Capital Goods excluding Aircrafts



The current reading shows the moving average fell 2.8% from the prior year. In October, new orders for capital goods continued to weigh on the diffusion index for the seventh consecutive month as manufacturing activity slowed in response to rising global trade tensions and a broadening global economic slowdown. Despite growing expectations that the U.S. and China will come to a trade truce next month, we are not convinced it will lead to a reversal in manufacturing activity as many of the underlying issues will likely be left unresolved. Therefore, we expect businesses may be reluctant to restore manufacturing output. That being said, there has been some speculation that firms are preferring to hire workers instead of investing in new capital in order to keep their budgets flexible in case the economy worsens.[1]

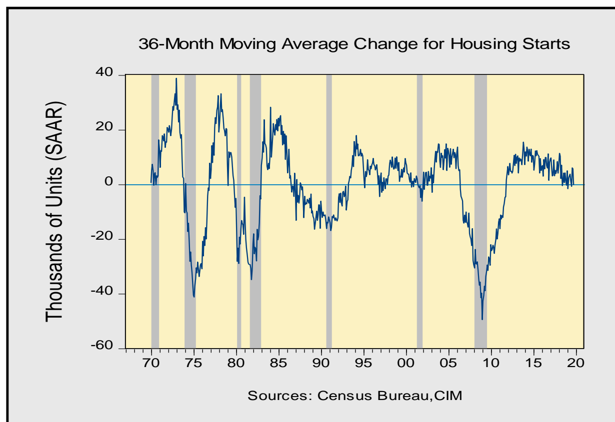
[1] https://www.axios.com/bad-news-about-historically-low-unemployment-9e2c14af-cf48-49c6-bd69-fdd8fa94a9f2.html

10-Year Treasury Constant Maturity Minus Federal Funds Rate



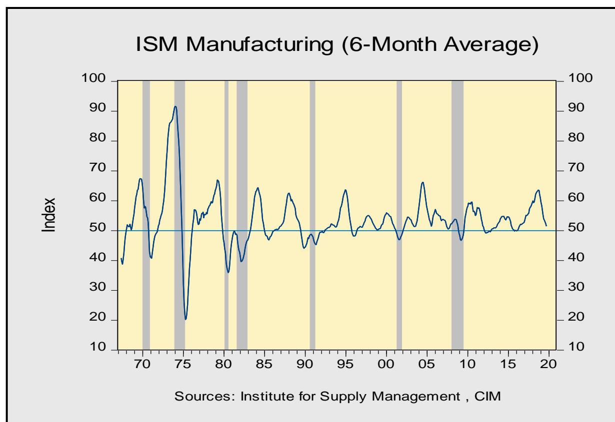
The current reading is -0.12, which is below the recession indicator. The Federal Reserve's decision to lower rates and improved outlook on the economy led to a widening of the spread. It should be worth noting that unless the Fed is successful in navigating a soft landing, a return to positive territory generally signals that a recession is imminent. A soft landing is when the Fed lowers rates fast enough to prevent the economy from going into recession. The last time the Fed was able to do this was in the mid-90s. At this point, there may be enough time for the Fed to prevent a downturn but it is a close call.

36-Month Moving Average Change for Housing Starts



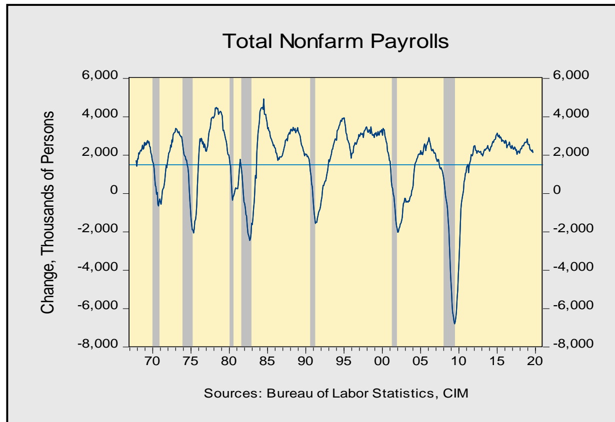
This chart is the moving average of the annual change in housing starts. The current reading of -0.3 is below the recession indicator. The drop in the indicator is due to the shift in the moving average. October 2016 was an unusually strong month for housing starts, while the prior month only had a modest change. Assuming that November housing starts show gains from the previous month, it is likely this indicator will reverse. Housing starts is the most volatile indicator included in the diffusion index. The volatility is due to its sensitivity to both financial and weather conditions. Nevertheless, it is one of the most reliable indicators used among economists to predict recession.

ISM Manufacturing (Six-Month Average)



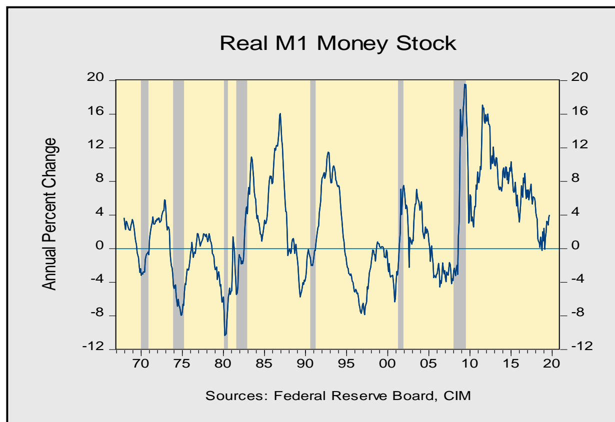
The ISM Manufacturing Index monitors employment, production, inventories, new orders and supplier deliveries. The current reading of 51.3 suggests manufacturing activity is quickly losing momentum. Out of the 10 components tracked in the survey only export orders remained in expansion territory. In general, ISM reflected an improvement in overall manufacturing sentiment. The overall ISM manufacturing indicator improved from 47.8 to 48.3, largely due to a rise in new exports. However, the ISM index, unlike our smoothed version, remains in contraction territory.

Total Nonfarm Payrolls



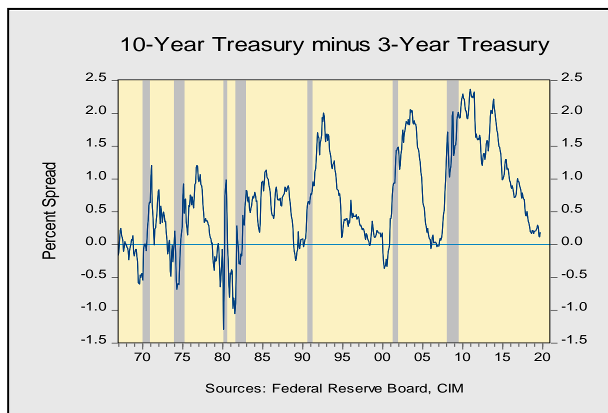
The latest reading is 2.093 mm, which is well above the recession indicator of 1.800 mm and is below last month's 2.119 mm.[2] Payrolls for October came in at 128k, well above expectations of 80k but below the 150k monthly average needed to keep this indicator above the recession signal.[3] The strength in payrolls provides further evidence that manufacturing's role in the economy has declined. Fears that the General Motors (GM, 36.52) strike would lead to a sub-100k payroll report were unfounded, but the strike did contribute to a loss of 41.6k auto jobs. The end of the strike should lead to a rebound in payroll numbers in November. It will take 196k+ jobs to reverse the downward trend, while job losses that exceed 97k will tip the indicator into negative territory.

Real M1 Money Stock



The current Real M1 Money Stock measure is 3.94%, which is above the recession indicator. In October, the Federal Reserve began expanding its balance sheet in order to keep the repo market stable. The balance sheet expansion led to a boost in the money supply. The increase in real M1 is good for the economy as it suggests that financial institutions are not starved for liquidity and consumers are not being harmed by inflation. As a result, we believe that Fed policy is providing accommodative policy stimulus.

10-Year Treasury Minus Three-Year Treasury



The spread between the 10-year and three-year Treasury widened from +0.11 to +0.18, suggesting that investors are becoming more optimistic about the economy. The Fed's lowering of the policy rate has led to a 6-bps drop in the three-year Treasury, while a modestly improving economy and trade optimism have led to a modest rise in the 10-year yield. We like using this version of the yield curve because it is less sensitive to Fed monetary policy and as a result has been a relatively conservative gauge of financial market sentiment.

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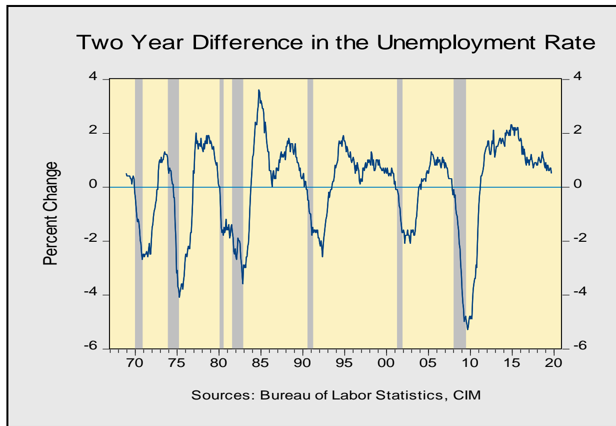
[2] Payroll revisions added 44k to the previous report.

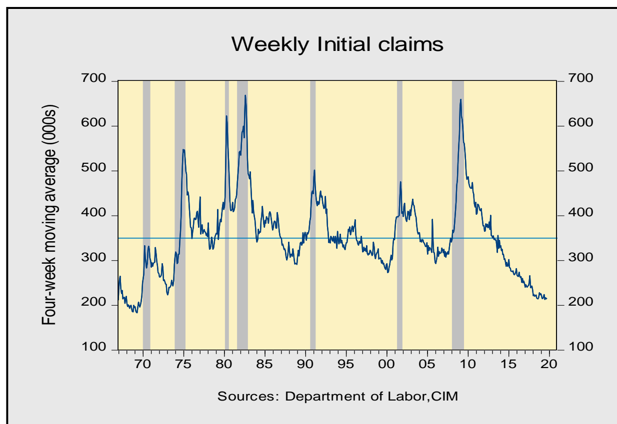
[3] We obtain minimum level of hires to maintain the expansion by dividing recession indicator of 1,800 by total months in a year.

Two-Year Difference in the Unemployment Rate



This chart measures slack in the labor market by looking at the difference between the current unemployment rate and the unemployment rate two years ago. The latest reading shows a gap of +0.5, the lowest reading of this expansion. The October unemployment rate came in at 3.6%, up from last month's 3.5%. The rise in the unemployment rate was largely due to more people entering the workforce; labor force participation rose from 63.2% to 63.3%. Most of the workers entering the labor force were reentrants as rising wages have been attracting more people into the workforce.

Weekly Initial Claims



This chart shows the four-week moving average of initial jobless claims. The latest reading of 215k indicates the labor market remains strong, which is a slight increase from the prior month. Last month's strike didn't have much of an impact on initial claims as strikers cannot file for unemployment. Additionally, the impact on the industries that supply autos appears to be minimal at best. Despite initial claims being well below the recession indicator of 350k, we suspect that a sharp rise in claims could be more telling of the business cycle as states have made it more difficult for the unemployed to file a claim.

Thomas Wash
November 27, 2019

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 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 1,800 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.