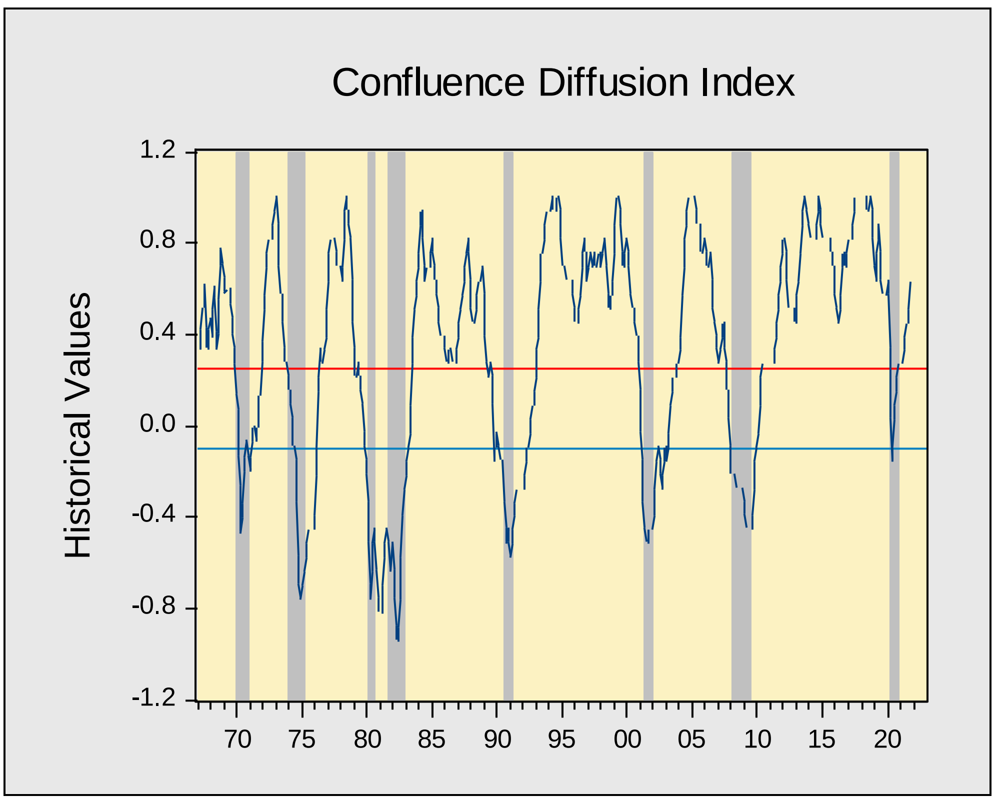
Business Cycle Report

By Thomas Wash

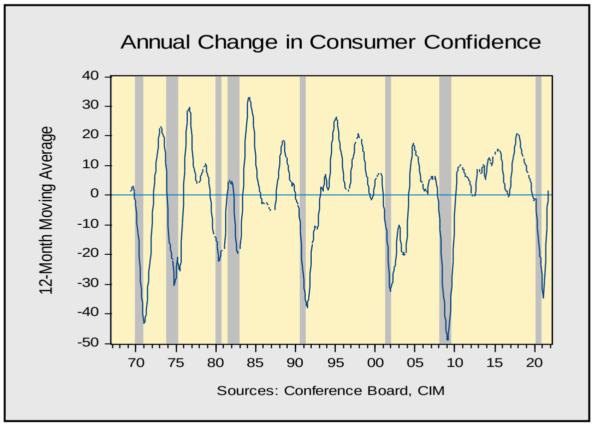
The business cycle has a major impact on financial markets; recessions usually accompany bear markets in equities. The intention of this report is to keep our readers apprised of the potential for recession, updated on a monthly basis. Although it isn't the final word on our views about recession, it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

In October, the diffusion index rose further above the recession indicator, signaling that the recovery continues. In the financial markets, strong earnings boosted equities, while higher inflation led to a sell-off in Treasuries. Meanwhile, construction and manufacturing activity slowed as material costs and labor shortages have hindered production. Lastly, the labor market has shown clear signs of improvement, as firms have ramped up hiring throughout the country. That being said, ten out of the 11 indicators are in expansion territory. The diffusion index rose from +0.5364 to +0.6364, remaining well above the recession signal of +0.2500.



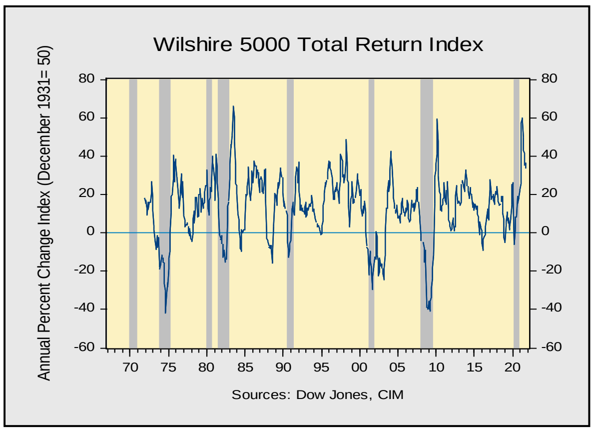
The chart above shows the Confluence Diffusion Index. It uses a three-month moving average of 11 leading indicators to track the state of the business cycle. The red line signals when the business cycle is headed toward a contraction, while the blue line signals when the business cycle is headed toward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



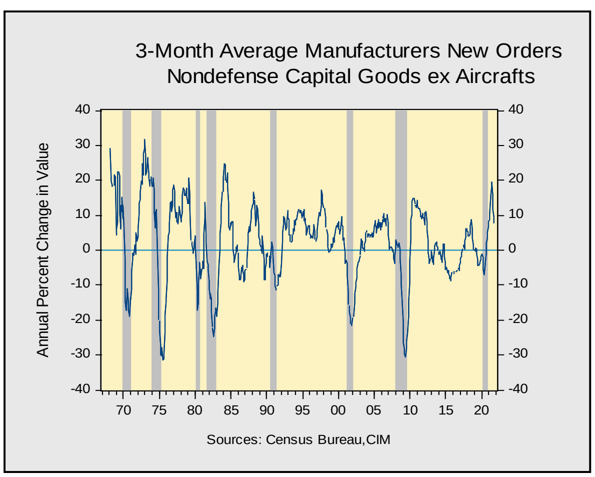
In October, the Consumer Confidence Index contributed positively to the diffusion index for the first time in nearly two years. Last month, the Present Situation Index and Consumer Expectations Index both took a ticked upward as respondents' concerns over the delta variant showed signs of easing. The latest reading for the Consumer Confidence Index stands at 113.8, up from 109.8 in the previous month and well above last year's level of 101.4. The 12-month moving average of the annual change in the index rose from -1.42 to +1.68, as seen on the chart to the left. As a result, the Present Situation Index rose from 144.3 to 147.4. Meanwhile, the index for consumers' six-month outlook rose from 86.7 to 91.3.

Wilshire 5000 Index



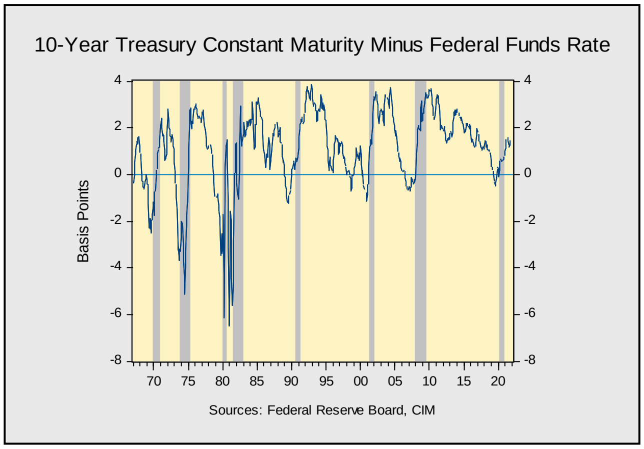
The annual change in the Wilshire 5000 Total Return Index increased for the second consecutive month. In October, the index came in at 222.07, up 0.5% from the prior month and 33.5% from the prior year. The slight increase can be attributed to a boost in optimism due to the drop in COVID cases and strong earnings. However, fears of elevated inflation resulting from ongoing supply chain issues are still a major concern for investors. The three top-performing sectors in the index were Financials, Communication Services, and Information Technology, while the bottom-performing sectors were Energy, Industrials, and Consumer Staples.

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



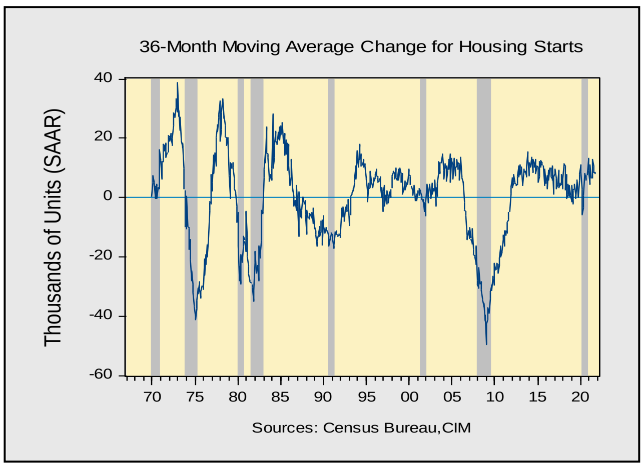
New orders for durable goods, a proxy for business investment, increased in October. According to the Conference Board LEI, the value for new orders of durable goods adjusted for inflation rose 0.19% from the previous month. The latest report showed that new orders for nondefense capital goods came in at \$41.220B in 1982-chained dollars, which is 6.5% higher than the previous year. New orders for the previous month were revised lower, from \$41.238B to \$41.140B. The three-month moving average came in at \$41.128B, up from the previous year's value of \$37.606B. The indicator, which tracks the annual change in the three-month moving average for new orders, came in at 7.66, lower than the previous month's reading of 9.24 but still well above 0.

10-Year Treasury Constant Maturity Minus Federal Funds Rate



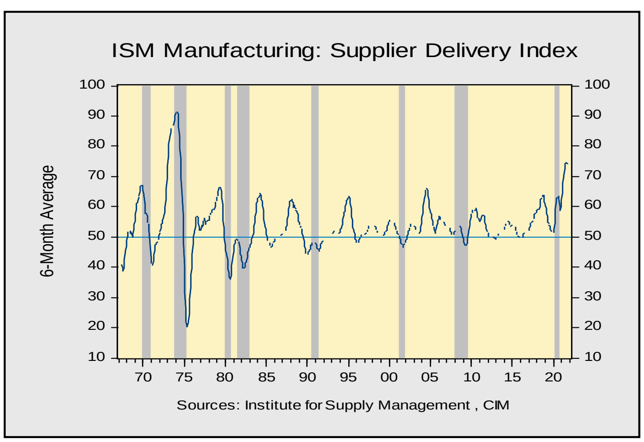
The financial spread widened in October due to Fed policy and a sell-off in the 10-year Treasury. Last month, the 10-year Treasury yield minus the effective federal funds rate, also known as the financial spread, contributed positively to the diffusion index. The spread widened from +1.29 to +1.50, above the recession indicator of 0. In October, strong inflation reports from the BLS and BEA led to speculation that the Fed could start tapering in November and raise rates next year. This policy shift likely contributed to bond investors' disinterest in longer-duration treasuries. As a result, the 10-year Treasury rate rose from 1.37% to 1.58%, while the fed funds rate remained unchanged at 0.08%.

36-Month Moving Average Change for Housing Starts



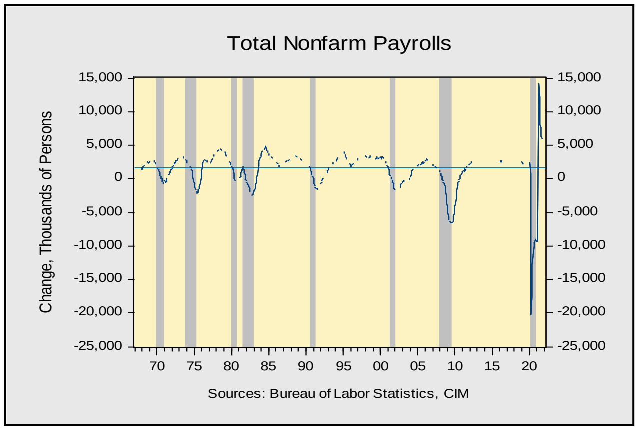
Residential construction slowed last month as homebuilders are still struggling to find labor and secure materials. In October, annualized housing starts expanded at a pace of 1,520K, lower than the previous month's report of 1,530K. The slowdown in construction was in contrast to an uptick in homebuilder confidence. The latest [NAHB report] showed that the Housing Market Index rose for the third consecutive month. Hence, sluggish construction is likely related to home builders not being able to build as opposed to not being willing to build. The 36-month moving average for the change of housing starts rose from 8.11 to 8.67, well above the recession signal of 0.

ISM Manufacturing: Supplier Delivery Index



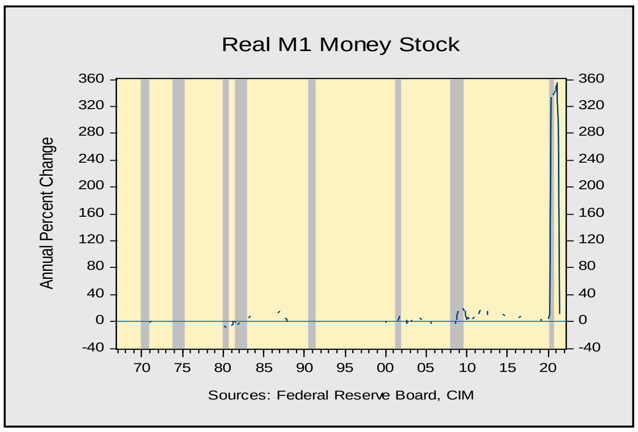
In October, the Supplier Delivery Index rose from the previous month as manufacturers were struggling to obtain necessary inputs and attract workers. In general, the index views slower shipments as a net positive due to the assumption that it reflects strengthening demand. Although in this case, the assumption is wrong, and the indicator is still contributing positively to the diffusion index. As a result, the ISM Supplier Delivery Index came in at 75.6 in October, above the previous month's reading of 73.4, while the six-month moving average rose slightly from 74.1 to 74.6. That being said, the ISM Manufacturing index slipped last month due to supply chain disruptions and the ongoing labor shortage.

Total Nonfarm Payrolls



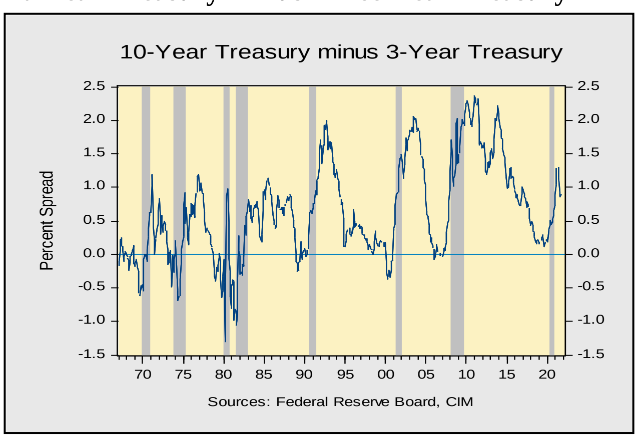
Nonfarm payrolls surged above expectations in October. Last month, the country gained 531K jobs for a 12-month moving sum of 5.774MM. Most of the jobs added came from the private services-providing sector, primarily in *Leisure & Hospitality*, *which* added 164K. In total, the services-providing sector accounted for 604K new jobs. The government sector lost 73K, while the goods-producing sector added 108K. Currently, the indicator is significantly above the recession signal of 1.600MM. Given the transitory nature of this indicator, the moving sum will continue to decline sharply over the next few months but should remain in expansionary territory.

Real M1 Money Stock



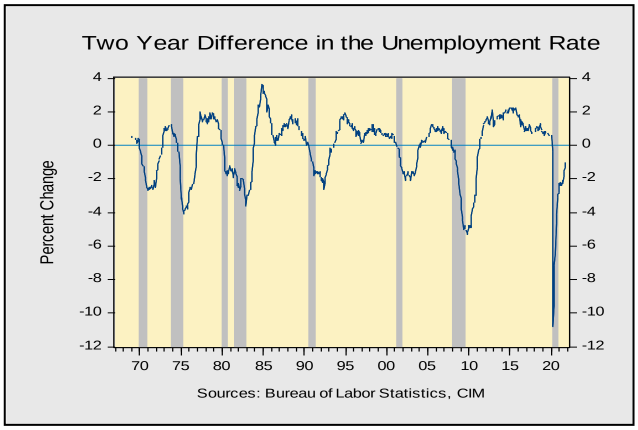
A surge in *Demand Deposits* partly offset the rise in inflation, leading to a slower rise in the Real M1 money stock. In October, Real M1, which is M1 minus inflation, rose 9.57% from the prior year, down from the previous month's reading of 10.43%. The slump in the indicator was heavily influenced by a change that the Federal Reserve made to its calculation of M1 in March of last year. M1 now includes other liquid deposits, which include 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. The impact of the moderation has started to dissipate; however, the change is still observable in the graph.

10-Year Treasury Minus Three-Year Treasury



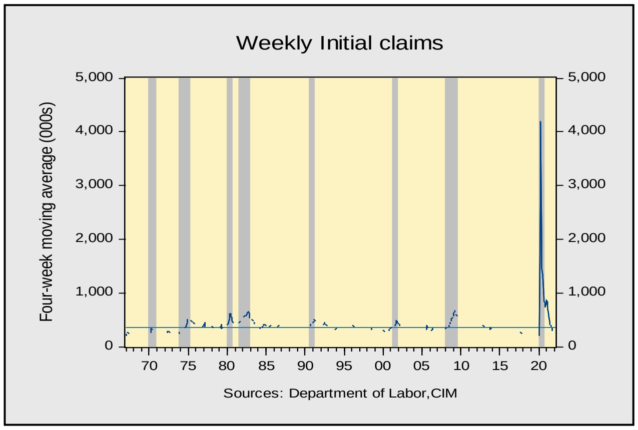
The yields for long and short-duration bonds increased in October. The rise in yields can be attributed to an increase in inflation fears and a more pessimistic outlook of the U.S. recovery. Goods prices remain elevated as firms have struggled to obtain the related inputs and labor needed to produce them. Last month, [freight prices] showed signs of some easing but remain 10 times the cost it was in January 2020. As a result, the spread between the 10-year and three-year Treasury increased by 1 bp from +0.90 in the previous month to +0.91. Last month, the 10-year Treasury yield rose by 21 bps from +1.37 to +1.58, while the three-year Treasury rose by 20 bps from +0.47 to +0.67.

Two-Year Difference in the Unemployment Rate



In October, the two-year spread in the unemployment rate narrowed from -1.3 to -1.0, contributing negatively to the diffusion index. Last month, the unemployment rate fell from 4.8% to 4.6%, well above its level of 3.6% two years prior. The fall in the unemployment rate was largely due to workers finding employment. The number of workers employed rose 0.23% from the prior month, while the civilian labor force rose by 0.06%. Meanwhile, the number of unemployed workers declined by 3.32% from the prior month. Nevertheless, we do not expect this indicator to contribute positively to the diffusion index in the foreseeable future. Labor market recoveries generally take longer than economic recoveries. As a result, it is unlikely that the unemployment rate will dip any time soon below the historic lows we saw in 2019.

Weekly Initial Claims



In October, average weekly initial claims fell below the recession indicator for the first since the pandemic. Last month, initial claims fell by 54K from the prior month, falling to 287K from 341K. The drop in initial claims can be attributed to the general improvement in the economy.

Thomas Wash
November 29, 2021

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.