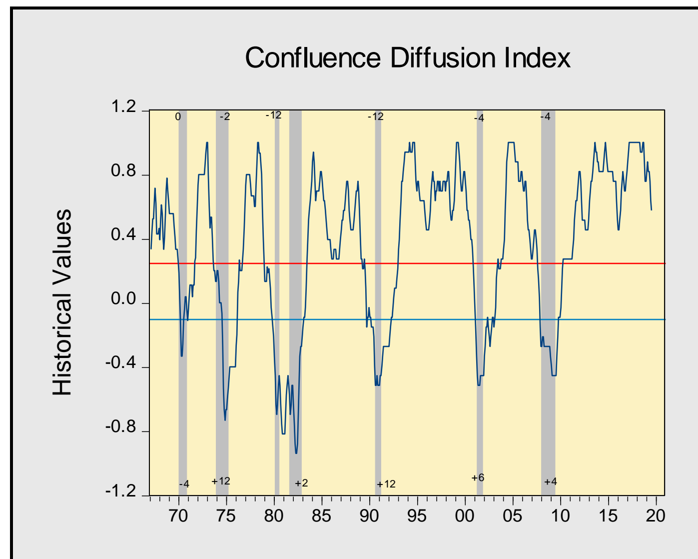
# Business Cycle Report

**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.*

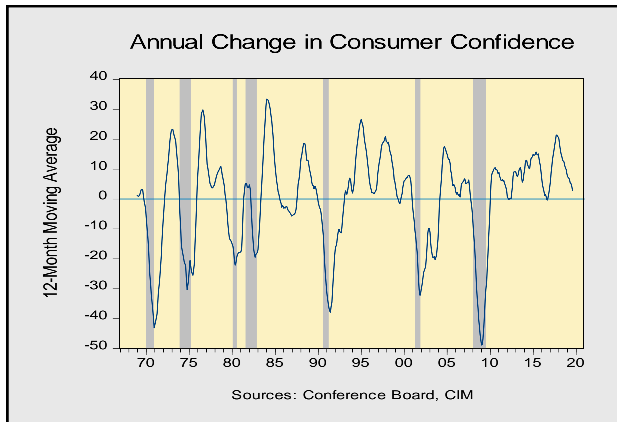
Data released for September suggests the economy is still firmly in expansion, but a slowdown in manufacturing and signals of financial weakness continue to be a drag on the index. Currently, our diffusion index shows that nine out of 11 indicators are in expansion territory, with several indicators approaching warning territory. The index remains unchanged from the prior month at +0.575.[1]



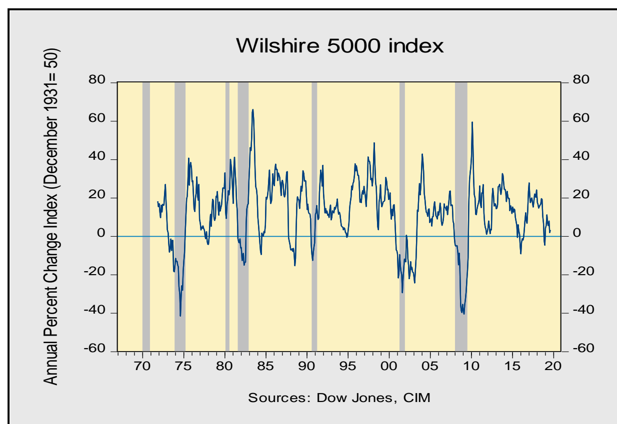

The chart above shows the Confluence Diffusion Index. It uses a three-month moving average of 11 leading indicators to track the state of the business cycle. The red line signals when the business cycle is headed toward a contraction, while the blue line signals when the business cycle is headed toward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

| Notable Indicators | |
|---|---|
| Data Series | Commentary |
| Annual Change in Consumer Confidence | Fell sharply in September and is slightly above the recession indicator |
| ISM Supplier Delivery | Positive, but was the only component of ISM not to fall into negative territorty |
| 3-Month Average Manufacturing New Orders Nondefense Capital Goods ex Aircrafts | In negative territory for the sixth consecutive month. |

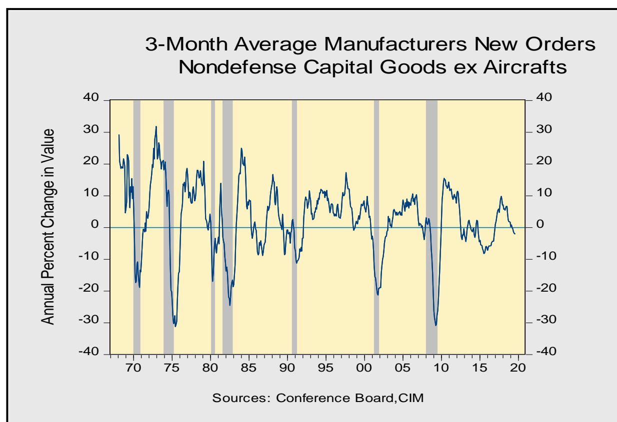
[1] The diffusion index looks slightly different from last month due to adjustments we made to the formula and revisions in certain data sets.



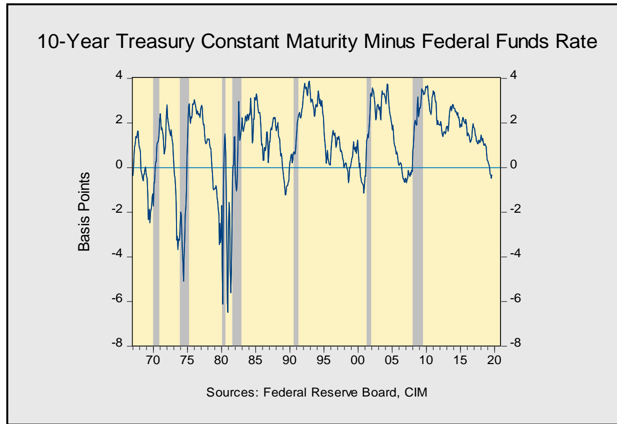

The 12-month annual change in consumer confidence has slowed from +3.7 to +1.6 in September. Last month's report fell from 134.1 to 125.1, which is the fourth biggest drop in the cycle. Consumers' evaluation of their current situations fell in September as most respondents in the survey stated that business conditions are not good and expressed less optimism about job availability. In addition, consumer expectations for the next six months also seemed to have worsened as consumers do not expect business conditions to improve anytime soon. Our assessment of the report leads us to believe that trade tensions may be weighing on sentiment as businesses and consumers appear to be concerned about the spillover effects of the trade war. As a result, if the trade war continues, we expect business investment and consumer spending to slow.



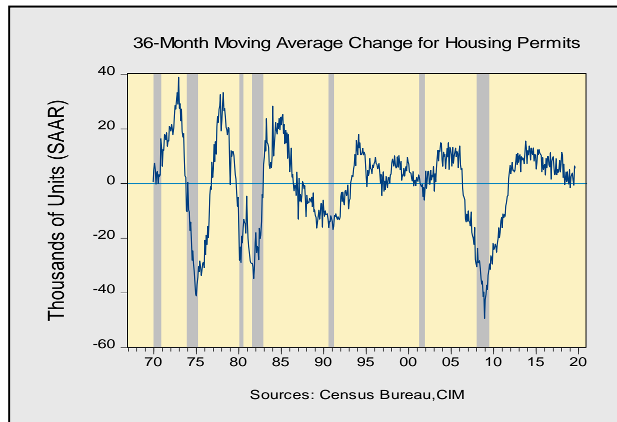

The latest reading of the Wilshire 5000 Index shows an annual change of 3.01%. In September, Financials and Utilities were the biggest gainers, while the only sector showing a loss was Healthcare. Financials benefitted from a surge in investment in value indices, which are typically overweight Financials, that took place in the beginning of the month. Meanwhile, skittishness about the global economy led investors to take a defensive approach when making portfolio adjustments that resulted in a boost in Utilities. That being said, we believe equity markets are signaling there is still confidence that the U.S. economy will continue to expand. As a result, the recovery in Financials may be temporary.



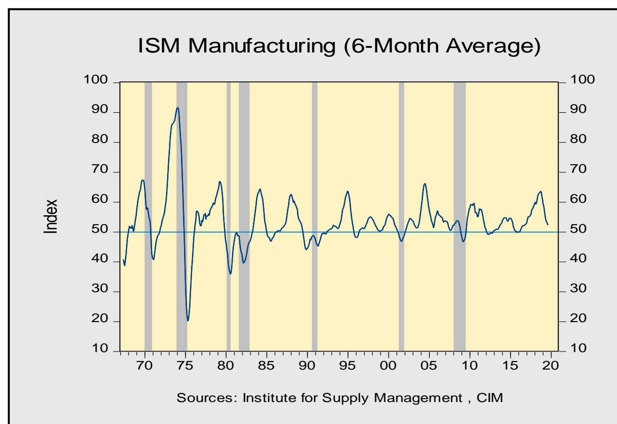

The current reading shows the moving average fell 2.1% from the prior year. In September, new orders for capital goods continued to weigh on the diffusion index for the sixth consecutive month as manufacturing activity slowed in response to rising global trade tensions and a broadening global economic slowdown. Despite growing expectations that the U.S. and China will come to a trade truce next month, we are not convinced that it will lead to a reversal in manufacturing activity as many of the underlying issues will likely be left unresolved. Therefore, we expect businesses owners may be reluctant to restore manufacturing output, especially in an election year.



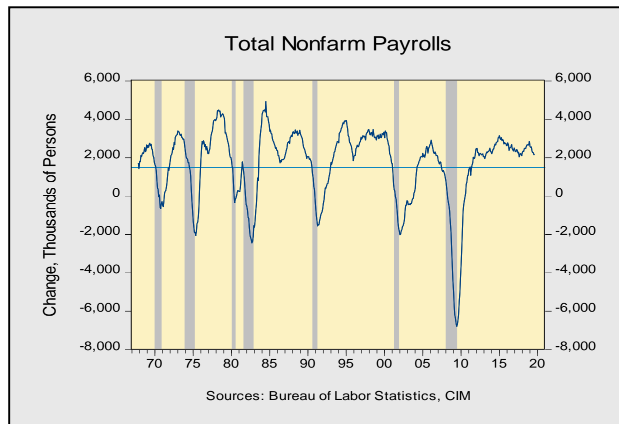

The current reading is -0.34, which is below the recession indicator. The Federal Reserve's decision to lower rates led to a reduction of the spread between the 10-year Treasury and the Fed funds rate. It should be worth noting that unless the Fed is successful in navigating a soft landing, a return 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, we believe there is still enough time for the Fed to prevent a downturn, but time is quickly running out.



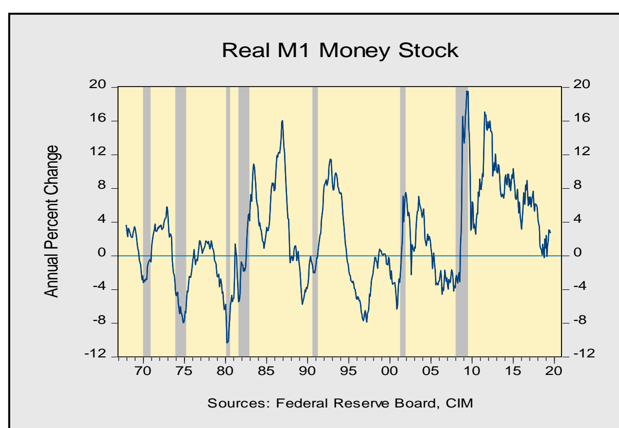

This chart is the 36-month moving average of the annual change in housing starts. The current reading of +5.4 is above the recession indicator. New home construction slowed in September from the 12-year high reached in the previous month due to a large drop in the construction of multi-family homes. Despite a drop in the headline housing starts, single-family construction has increased for the fourth consecutive month and appears to be in response to lower interest rates. At the same time, rising labor and material costs have cast doubt as to whether construction will be able to continue at a steady pace going forward.



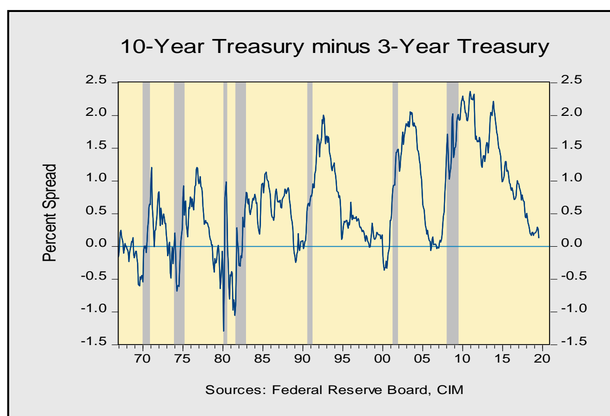

The ISM Manufacturing Index monitors employment, production, inventories, new orders and supplier deliveries. The current reading of 52.2 suggests manufacturing activity is quickly losing momentum. Out of the 10 components measured in the survey, supplier delivery is the only one in expansion territory. Even though the diffusion index focuses on supplier delivery, we feel that other components provide insights as to the possible causes of manufacturing slowdown. Based on the report, new export orders appear to be the biggest drag on manufacturing activity, which suggests that much of the slowdown is due to a reduction in global trade.




The latest reading is 2.147 mm, which is well above the recession indicator of 1.800 mm and is a slight reversal from last month's 2.119 mm.[2] Payrolls for September came in at 136k, below the cycle average of 200k and below the model's estimate of 150k needed to sustain the expansion.[3] The weakness in payrolls signals that businesses are becoming more reluctant to hire as rising materials and labor costs are becoming a drag on productivity. Assuming there is no revision to this report, there will need to be at least 277k jobs added in October to prevent this indicator from weakening further. However, if job losses do not exceed 70k, the indicator will continue to positively contribute to the index.




The current Real M1 Money Stock measure is 3.62%, which is above the recession indicator. In September, a combination of large corporate tax payments and Treasury issuance led to a big cash shortage in the repo market. In addition, a repatriation by Saudi Arabia to support the rebuilding of oil refineries also drained the repo market. This resulted in a larger demand for cash than banks were willing to lend. The Fed addressed the issues by purchasing the Treasuries, therefore boosting monetary supply. The cause of the liquidity crisis has been attributed to cash hoarding by the five largest banks, which hold 90% of the supply of total reserves, due to regulation concerns. As a result of this hoarding, the Fed has made it abundantly clear that it is willing to intervene in the repo market until the problem is resolved. Hence, it is highly likely this indicator will continue to contribute positively to the index.



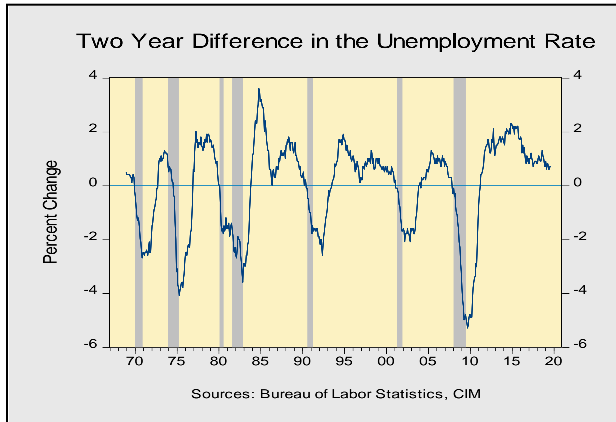

The spread between the 10-year and three-year Treasury gauges investor sentiment. The latest reading is +0.11, which indicates waning optimism among investors. Despite inversions in various segments of the yield curve, the spread remains steady. As a result, it offers a relatively optimistic outlook on the economy compared to other spreads. In September, all Treasury notes with durations below two years had higher interest rates than the 10-year Treasury. In other words, despite inversions in the yield curve financial markets are still relatively stable. Because this version of the yield curve is so conservative, we have been reluctant to say that a recession is unavoidable. However, if this yield curve does invert, we would view the chances that the Fed will be able to navigate a soft landing to be low.

---

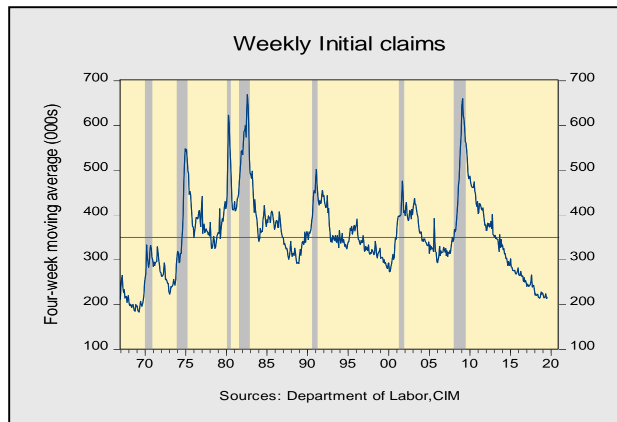
[2] Payroll revisions added 45k to the previous report.

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

This chart measures slack in the labor market. The reading of +0.7 suggests the labor market remains tight.




The September unemployment rate came in at a cycle low of 3.5% as workers who make up the short-term unemployed, those who have been looking for less than five weeks, were able to find jobs easily. This indicates many of these workers have left jobs in favor of higher wages. The number of short-term unemployed fell by 15.4% for the month, the sharpest drop in four years. As a result, we suspect the low unemployment rate may be temporary. Nevertheless, the spread appears to be narrowing as it becomes increasingly difficult to lower the unemployment rate due to the length of the expansion.




This chart shows the four-week moving average of initial jobless claims. The latest reading of 213k indicates the labor market remains strong. The low initial claims number suggests the slowdown in economic activity, particularly in manufacturing, has not resulted in job losses. In addition, the General Motors (GM, $36.31) strike does not appear to have had much of an impact on the initial claims report. Although autoworkers are not entitled to receive unemployment benefits, the spillover effects from part suppliers and related industries due to plant inactivity were minimal. That being said, although businesses have not begun to lay off workers, the JOLTS report for August suggests that business owners have begun cutting back on the number of job openings.

Thomas Wash
October 24, 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.

**3-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 Permits:** 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 permits are strong it implies that builders are optimistic about future demand.

**ISM Manufacturing (6-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 3-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.