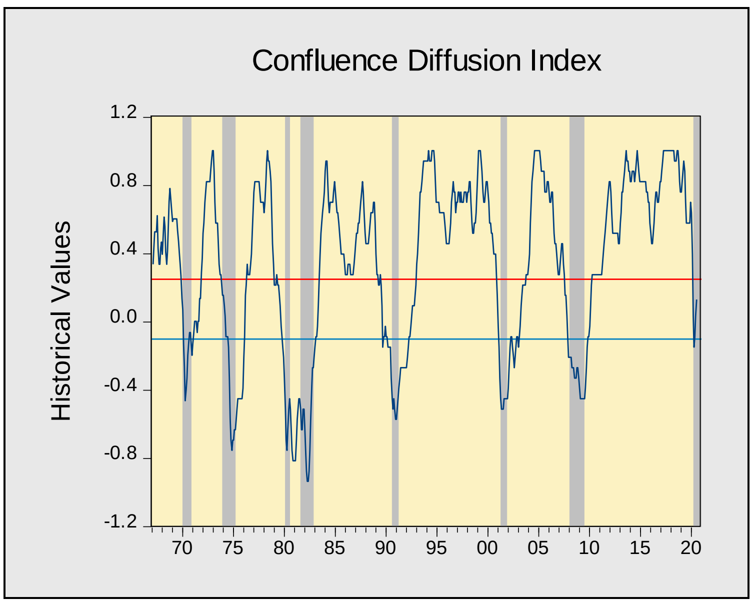
Business Cycle Report

By Thomas Wash

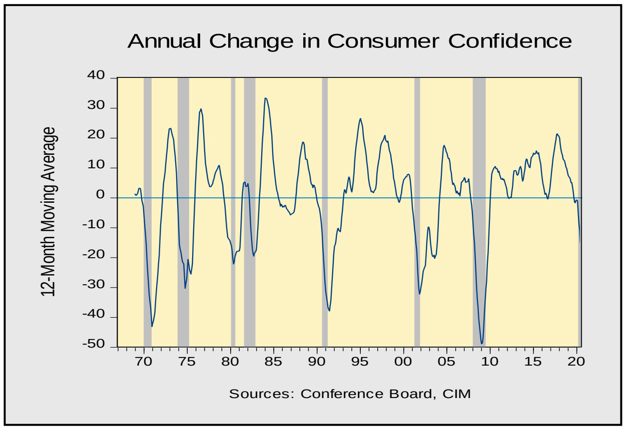
The business cycle has a major impact on financial markets; recessions usually accompany bear markets in equities. The intention of this report is to keep our readers apprised of the potential for recession, updated on a monthly basis. Although it isn't the final word on our views about recession, it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

In August, the diffusion index rose further above contraction territory, signaling that the economy remains on track to expand in Q3. Financial markets were sending positive signals as equities surged, while the yield curve steepened. Meanwhile, the labor market continues to show signs of improvement as hires continue to surpass the pre-pandemic high. Markets responded positively to news regarding the stage of development of various vaccines. 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, five out of the 11 indicators are in contraction territory. The reading for August rose from 0.0303 to 0.0909, above the recovery signal of -0.100.



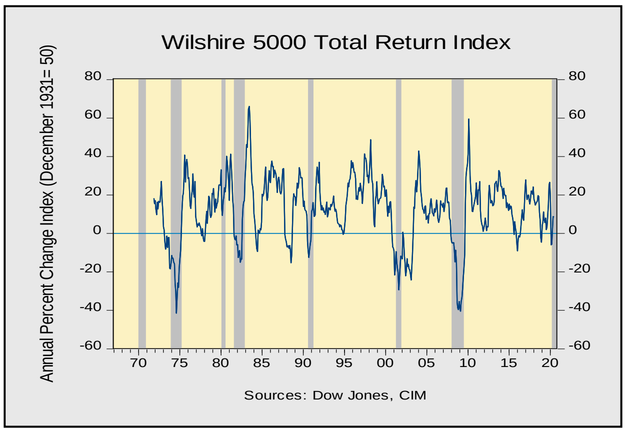
The chart above shows the Confluence Diffusion Index. It uses a three-month moving average of 11 leading indicators to track the state of the business cycle. The red line signals when the business cycle is headed toward a contraction, while the blue line signals when the business cycle is headed toward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



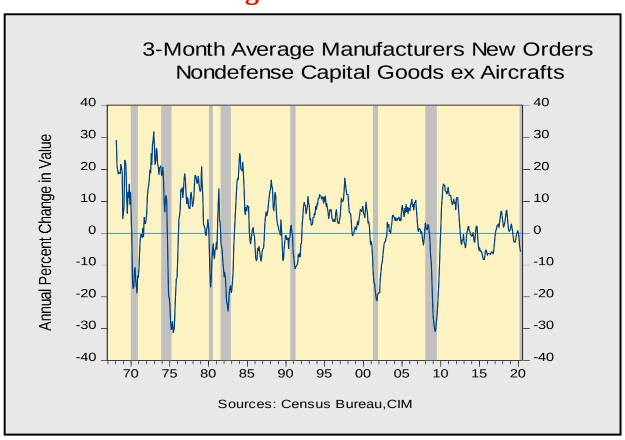
The Consumer Confidence Index contributed negatively to the diffusion index in August as the moving average fell further below the recession indicator. Last month, the index fell by 6.9 points from 91.7 to 84.8. This reading is much lower than the previous year's reading of 134.2. As a result, the 12-month moving average of the annual change fell from -15.3 to -19.4. The consumer six-month outlook fell 21.2 points from the prior year, from 106.4 to 85.2. Additionally, the reading of consumer sentiment about the present situation sits at 84.2, well below last year's level of 176.0. The drop in confidence may be partially attributed to Congress's lack of progress to pass the next round of fiscal stimulus. Additionally, fears of the reemergence of the virus may also have weighed on consumer optimism.

Wilshire 5000 Index



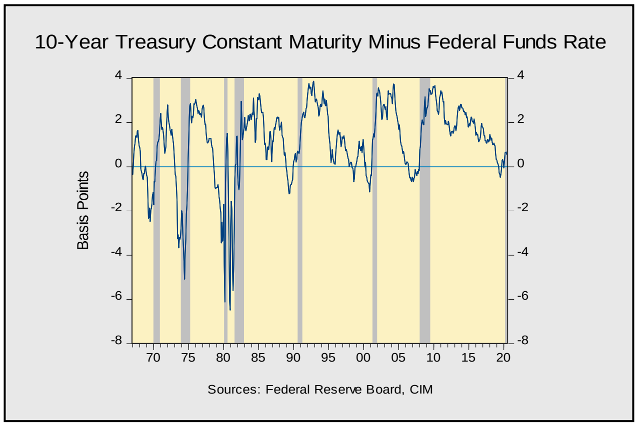
In August, the Wilshire 5000 Total Return Index showed gains for the fourth consecutive month, rising 19.04% from the prior year, thus the indicator contributed positively to the diffusion index. The improvement in equities can be attributed to corporate earnings beating market expectations and stronger-than-expected economic data. The three top-performing sectors in the index were Consumer Discretionary, Information Technology, and Communication Services. The bottom-performing sectors were Real Estate, Energy, and Utilities. We expect equities to remain bullish throughout the year as credit conditions will likely remain favorable for the foreseeable future. However a contested election could cause a pullback in November.

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



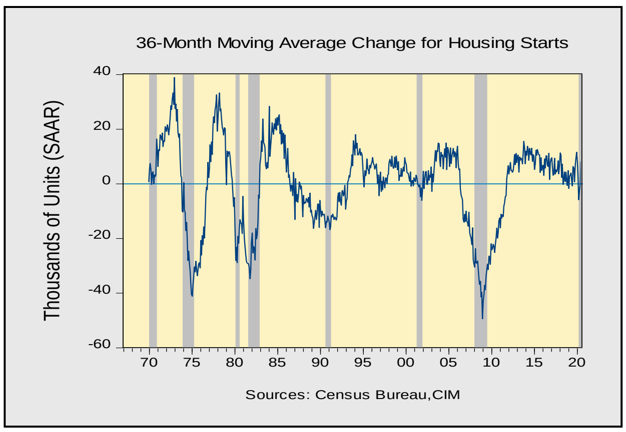
New durable goods orders fell in August, according to the Conference Board LEI. The drop is likely the result of weaker global consumption weighing on the manufacturing sector. As a result, the annual change in the three-month moving average for new orders came in at -2.12, lower than the previous month's reading of -3.26. The value of new orders for nondefense capital goods came in at $36.364B in 1982-chained dollars, which is 1.9% lower than the previous year. New orders for July were revised upward from $35.391B to $36.852B. The three-month moving average came in at $36.481B, down from the previous year's value of $37.275B. The decline in orders suggests that companies are still waiting for the economy to recover before deciding to invest. Although we do expect orders to pick up soon, the growth really depends on vaccine progress.

10-Year Treasury Constant Maturity Minus Federal Funds Rate



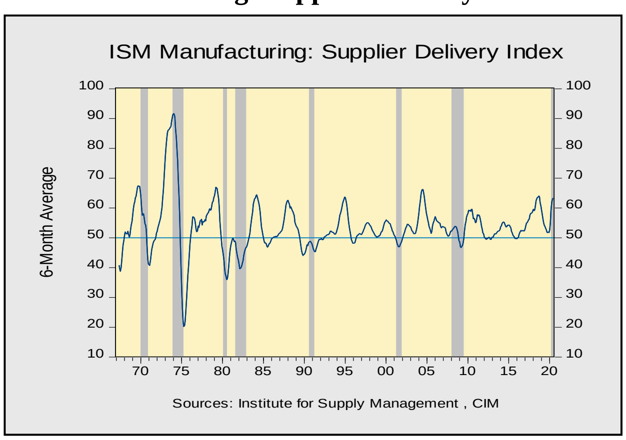
The financial spread, also known as the 10-year Treasury minus the federal funds rate, remained in expansion territory in August. The spread rose slightly from +0.53 to +0.55. In August, Federal Reserve Chair Powell stated that the Fed will allow inflation to rise above its 2% target to prevent inflation expectations from being anchored. Although there was no indication as to how long the Fed will allow rates to stay above 2%, Powell's comments suggest the Fed may be moving away from an inflation target altogether. There was a slight uptick in the fed funds rate as it rose 1 bp in July from 0.09% to 0.10%. Meanwhile, the 10-year Treasury rose 3 bps from 0.62% to 0.65%.

36-Month Moving Average Change for Housing Starts



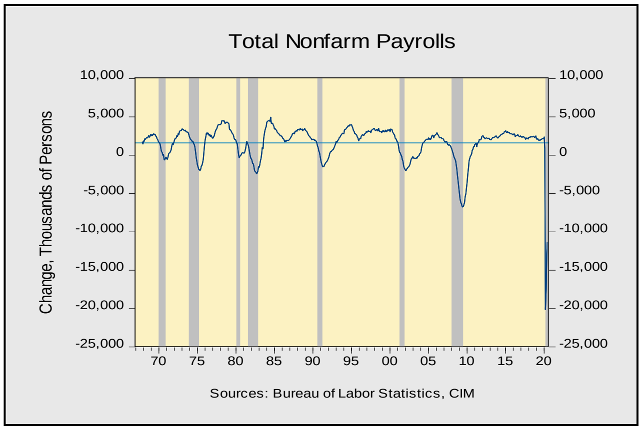
In August, housing starts surged as homebuilders prioritized single-family over multi-family homes. The preference for single-family homes can be partially attributed to homebuilders becoming more optimistic about demand for homes in the suburbs. This could be the result of record-low mortgage rates attracting young adults into the housing market. However, annualized housing starts fell from 1,492K in July to 1,416K in the following month. The 36-month moving average change of housing starts rose 7.03K from the prior month, suggesting that housing construction is still recovering.

ISM Manufacturing: Supplier Delivery Index



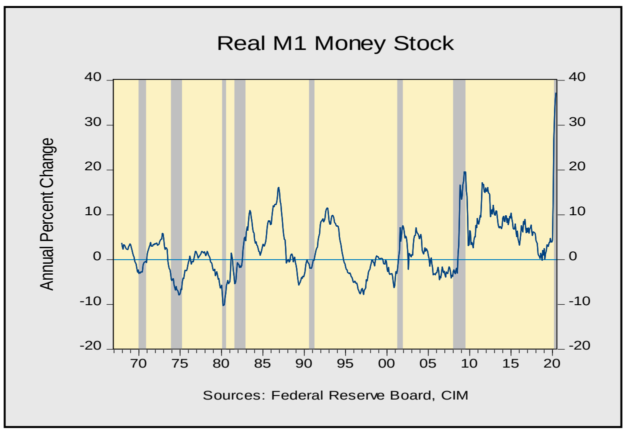
In August, the ISM Supplier Delivery Index rose from 55.2 in July to 58.5 in the following month. The rise was due to fewer firms reporting faster deliveries. As a result, the moving average rose from 63.2 to 63.3. The shift in the time period prevented the moving average from being higher. Consequently, the transition from February to March, which saw an unprecedented drop in the index due to the pandemic, may have distorted this month's reading. That being said, the gains in the index still support the consensus belief that the global economy is recovering.

Total Nonfarm Payrolls



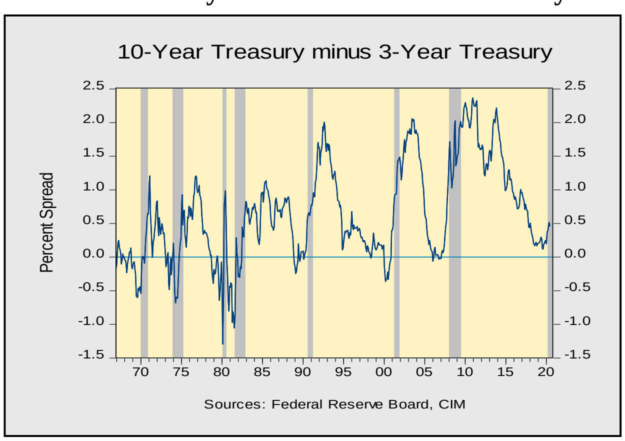
In August, the country gained 1.371MM jobs for a 12-month moving sum of -10.246MM. Most of the jobs added came from the services-providing sector. In total, the services-producing sector accounted for 1.027MM added jobs. Meanwhile, the goods-producing sector contributed 43K, primarily in manufacturing, which added 29K. The government sector added 344K jobs. Federal government saw the most job gains at 251K and local governments added 95K, while state governments lost 2K. 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



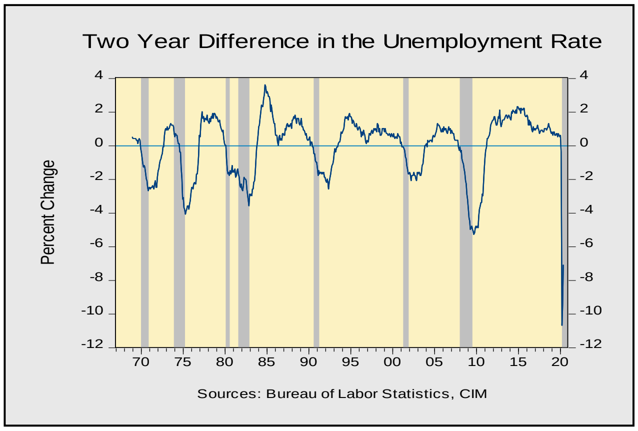
In August, Real M1 rose to its highest level ever for the fourth consecutive month. Last month, the Real M1 Money Stock, which is M1 minus inflation, rose 38.71% from the prior year, higher than the previous month's reading of 35.33%. The unprecedented rise in the indicator was heavily influenced by a surge in demand deposits, a direct result of accommodative monetary policy. Additionally, a slowdown in airfare and energy prices led to a deep deceleration in headline inflation. As a result, M1, which rose 40.01% from the prior year, outweighed the rise in CPI, which rose 1.30% from the prior year.

10-Year Treasury Minus Three-Year Treasury



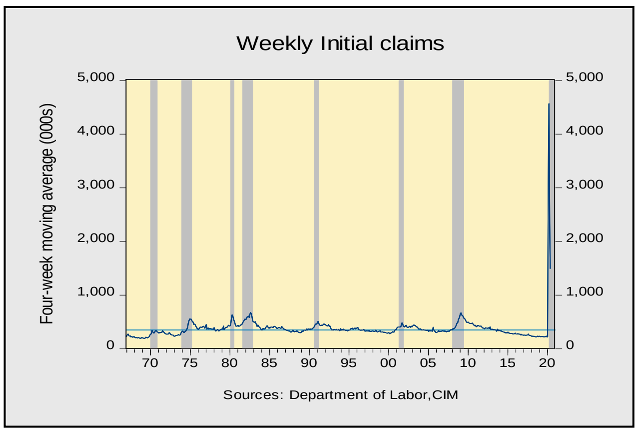
In August, the yield curve steepened as the global economy continues to show signs of recovery. Easy monetary policy and fiscal stimulus from countries around the world likely boosted investor optimism. Consequently, this may have led to a sell-off of safe haven assets such as U.S. Treasuries. As a result, the spread between the 10-year and three-year Treasury widened from +0.45 to +0.49. The widening of the spread was due to an increase in interest rates for 10-year Treasuries and a decrease in rates for three-year Treasuries. Last month, the 10-year Treasury fell by 9 bps, while the three-year Treasury fell by 3 bps. As a result, the 10-year rose from +0.62 to +0.65 and the three-year fell from +0.17 to +0.16. The steepening of the curve should continue as long as countries remain effective in containing and treating the virus.

Two-Year Difference in the Unemployment Rate



In August, the two-year spread in the unemployment rate narrowed from -6.4 to -4.6, therefore contributing negatively to the index. Despite the drop in the unemployment rate from 10.2% to 8.4%, it still remains well above its level from two years ago of 3.8%. Last month, the labor market tightened as workers continued to return back into the workforce following the easing of lockdown restrictions. The number of workers employed rose 2.6% from the prior month, while the civilian labor force rose 0.6%. Meanwhile, the number of unemployed workers fell 17.1% from the prior month. Despite the drop in the unemployment rate, there is still a large portion of the population that has not returned to the labor force. As a result, we do not expect this indicator to contribute positively to the diffusion index over the coming months.

Weekly Initial Claims



In August, average weekly initial claims fell for the third consecutive month, coming in at 0.987MM, down from the 1.335MM recorded in the previous month. A bulk of the layoffs came from the "leisure and hospitality" and manufacturing sectors as pandemic fears have hurt travel and shipments. For the most part, individual state reports have begun leveling out. That being said, claims will likely remain elevated until the economy returns to normal.

Thomas Wash
September 24, 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.