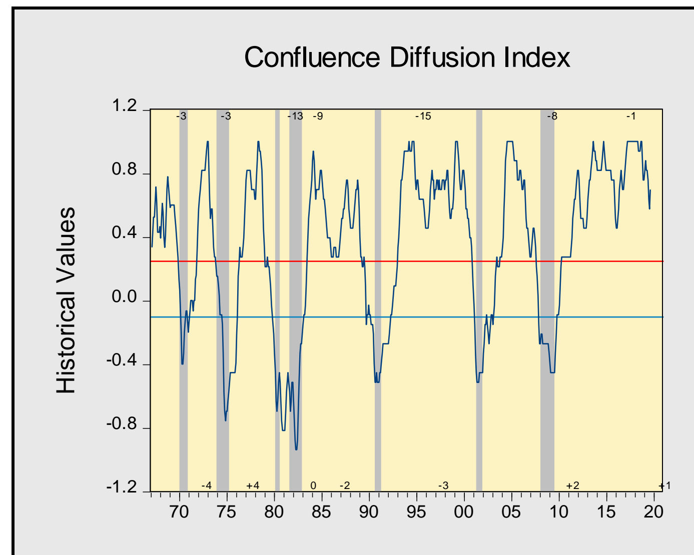
Business Cycle Report

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 August suggests the economy is still 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 has fallen from +0.636 to +0.575.[1]

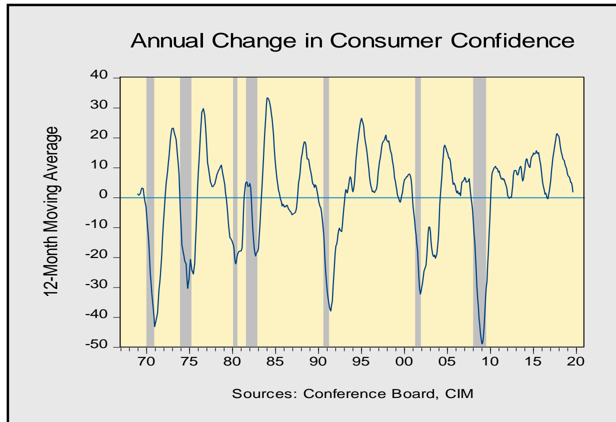


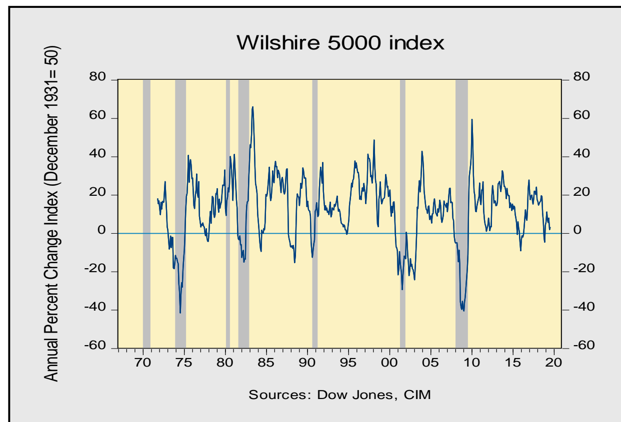
The chart above shows the Confluence Diffusion Index. It uses a three-month moving average of 11 leading indicators to track the state of the business cycle. The red line signals when the business cycle is headed toward a contraction, while the blue line signals when the business cycle is headed toward a recovery. On average, the diffusion index is currently providing about seven months of lead time for a contraction and three months of lead time for a recovery. Continue reading for a more in-depth understanding of how the indicators are performing.

Notable Indicators	
Data Series	Commentary
10-Year Constant Minus Feds Funds	Remains inverted for the third consecutive month
36-Moving Average Change for Housing Permits	Returned to positive territory
12-Month Moving Sum Nonfarm Payrolls	Fell to its level since January 2018 but remains in positve territory

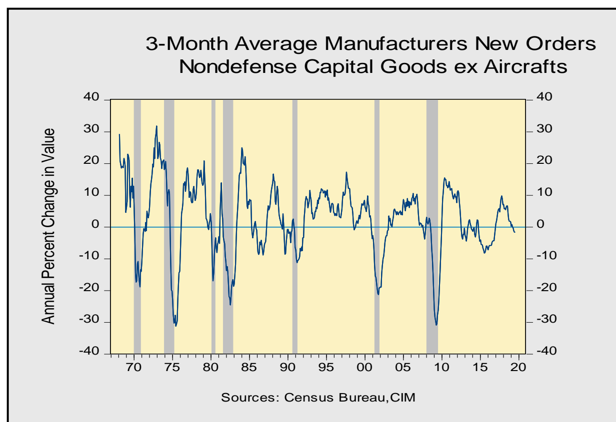
[1] The diffusion index looks slightly different from last month due to adjustments we made to the formula and revisions in certain data sets.

The 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. The chart on the left shows the 12-month moving average of the annual change of the index. The 12-month average has risen 2.53% from the prior year. Last month's report remains unchanged, which contributed to the slowdown in the rise in consumer confidence. There was a sharp rise in the present state of consumer confidence, but it was outweighed by a drop in consumer expectations. It appears the strong job market continues to buoy consumer confidence, while the ongoing trade war is adding to fears of a possible recession.

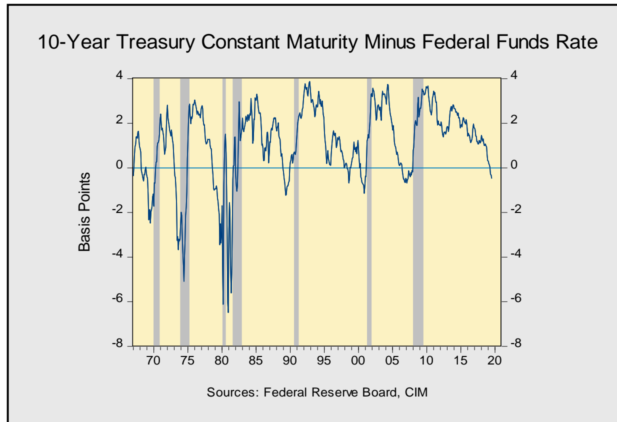




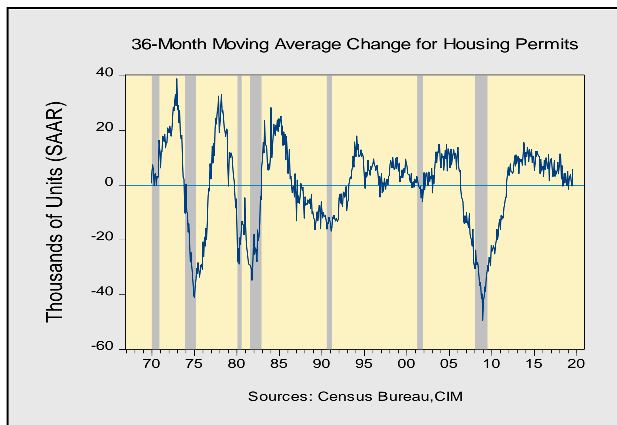
This chart shows the annual change in the Wilshire 5000 Index, which is the broadest U.S. equity index. The index contains 3,500 stocks and is designed to track overall performance of the U.S. stock market. It is an important indicator because steep equity pullbacks have often coincided with economic contractions. The latest reading shows an annual change of 2.94%. Lower interest rates continue to harm profit margins of financial institutions, while also making it easier for growth firms to grow through borrowing. It appears corporations are choosing to take advantage of lower interest rates by issuing longer duration corporate bonds. These additional funds, along with private savings, which are near all-time highs, suggest that firms will be able to fund future expansion projects.



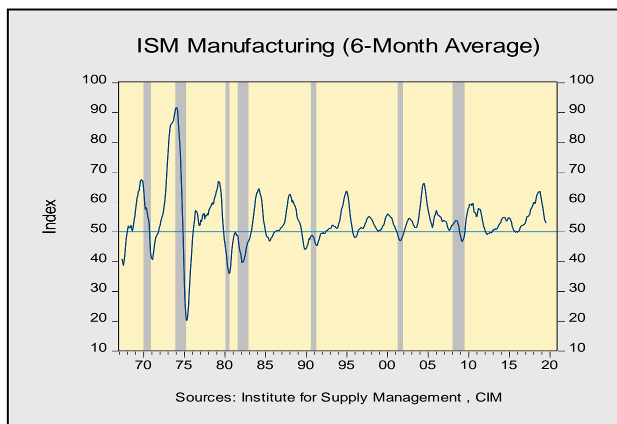
This chart shows the annual change in the value of core capital goods orders. This indicator gives insight into the amount of business investment spending. A positive report suggests that manufacturers are optimistic about future demand. The current reading is negative as the moving average fell 1.81% from the prior year. Despite strong consumer demand, it appears business owners are becoming less willing to expand production, while the U.S. and China continue their tit-for-tat trade war.



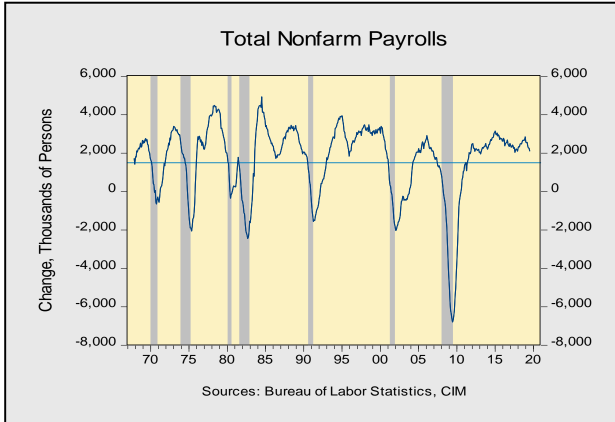
This chart shows the spread between the 10-year maturity and the fed funds rate. It reflects market sentiment of the future state of the economy. Generally speaking, a negative spread suggests a contraction is likely to occur within 24 months. The current reading is -0.50, which is below the recession indicator. The decline in the spread suggests there is some financial distress, specifically on the near-end of the yield curve. That being said, the negative spread will likely recede and contribute positively to the diffusion index as long as the Fed continues to lower rates. However, a return back to positive territory is not necessarily a positive sign as the curve usually steepens when policy is eased; therefore, a positive reading should be viewed with caution.



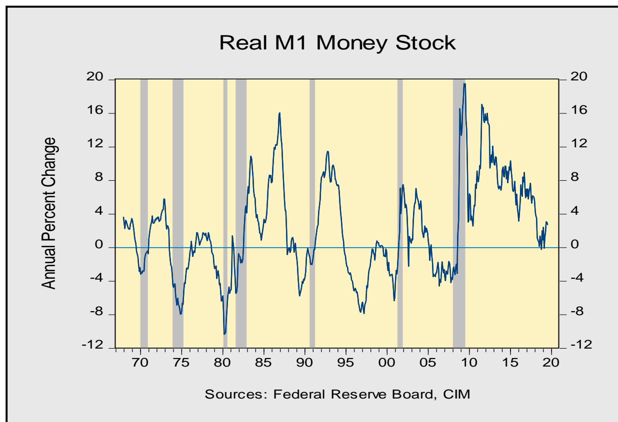
This chart shows the 36-month moving average of the annual change in housing starts. This is an important indicator because it provides a gauge of future construction activity. If housing permits are strong it implies that builders are optimistic about future demand. The current reading of +5.7 is above the recession indicator. Housing starts rebounded in August due to a boost in apartment construction. The rise is likely due to the Fed's decision to lower rates in July, which made financing cheaper for home buyers. At the same time, we still expect a lot of turbulence in the indicator as rising labor costs and material costs will likely weigh on future profits. As a result, we are not confident that the rebound in housing starts will be extended.



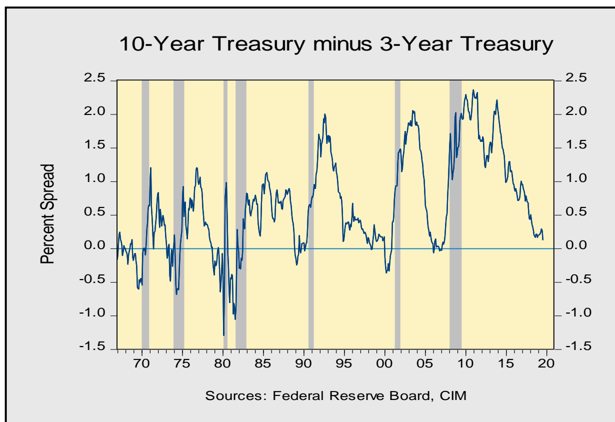
The ISM Manufacturing Index is a report that monitors employment, production, inventories, new orders and supplier deliveries. This index specifically focuses on the six-month moving average of supplier deliveries in ISM, which we believe is a good gauge of future levels of manufacturing activity. A reading above 50 signals that manufacturing activity is expected to expand, while a reading below 50 signals that manufacturing activity is expected to contract. The current reading of 52.7 suggests that manufacturing activity has slowed considerably but still remains in expansion territory. For the month of August, supplier deliveries remained in expansion territory, while the overall index fell slightly into contraction territory.



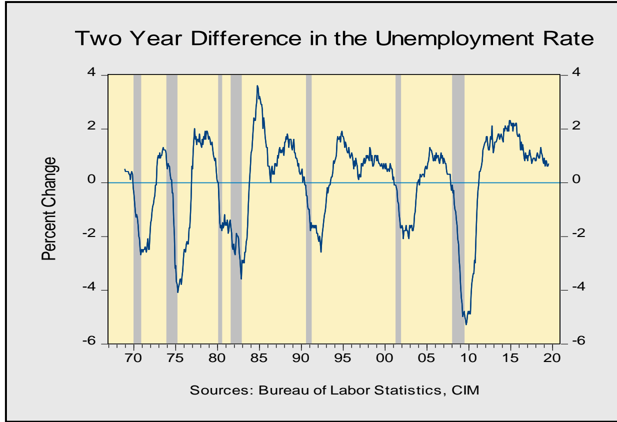
This chart shows the 12-month moving sum of total nonfarm payrolls. This report represents the total number of workers added to the workforce excluding proprietors, private household employees, unpaid volunteers, farm employees and incorporated self-employed. It is a significant indicator of the strength of the labor market. A moving sum that exceeds 1,800 suggests the demand for labor is strong. The latest reading fell to its lowest level since January 2018 at 2,074. The slowdown in payrolls is likely due to rising labor costs as employers are being forced to raise wages in order to attract more workers.



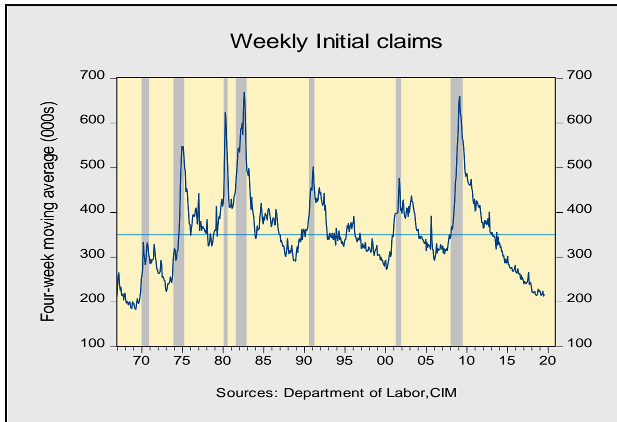
The Real M1 Money Stock report measures the annual change in the money supply minus inflation. M1 is the measure of currency in circulation and represents the amount of money being held for transaction purposes, therefore it can act as a proxy for economic activity. The latest reading is 2.63%, which is above the recession indicator. The rise in real M1 was due to an increase in demand deposits and other checkable deposits. It is possible that rising trade tensions may have resulted in some portfolio liquidation, thus increasing the supply of money. Easier monetary policy also tends to lift the money supply.



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. The latest reading is +0.12, which indicates waning optimism among investors. Despite inversions in certain sections of the yield curve, the spread remains steady. This spread remains the most optimistic as all Treasury notes below two years have higher interest rates than the 10-year Treasury. In other words, despite inversions at various points of the yield curve, financial markets are still relatively stable.



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. The latest reading of +0.7 suggests the labor market remains tight. Nevertheless, the gap 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. 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 that the economy may be headed toward a contraction. The latest reading of 216k indicates that business sentiment is still strong. Initial claims suggest that businesses haven't seen a slowdown in sales.

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September 25, 2019

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