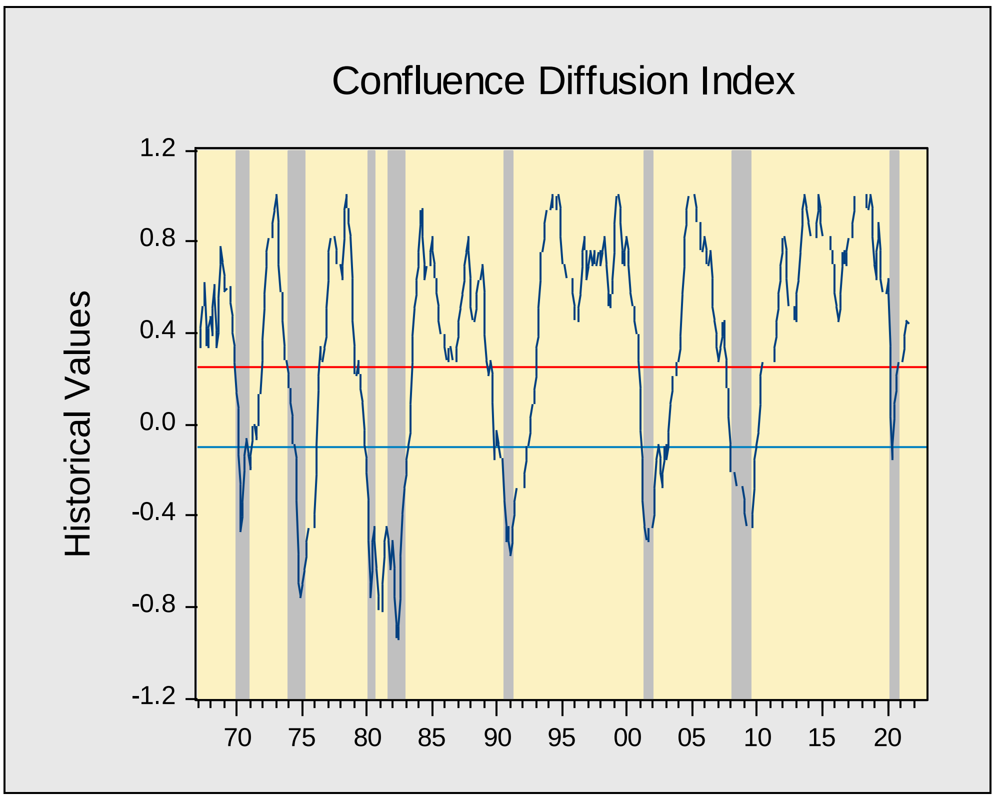
Business Cycle Report

By Thomas Wash

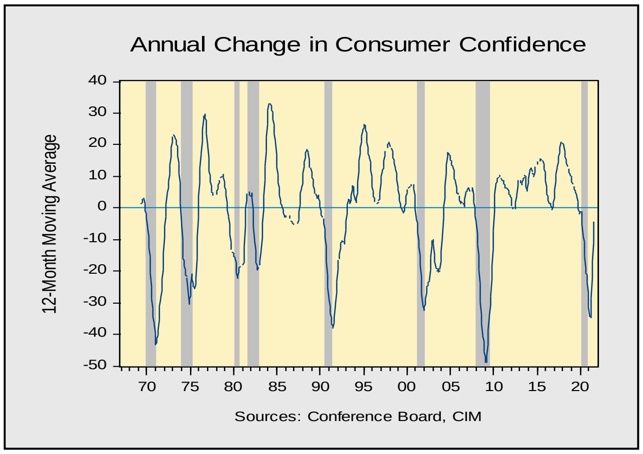
The business cycle has a major impact on financial markets; recessions usually accompany bear markets in equities. The intention of this report is to keep our readers apprised of the potential for recession, updated on a monthly basis. Although it isn't the final word on our views about recession, it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

In August, the diffusion index rose further above the recession indicator, signaling that the recovery continues. In the financial markets, a sharp rise in COVID-19 cases led to a modest sell-off in equities throughout the month. Meanwhile, construction and manufacturing activity improved due to stable levels of demand. Lastly, a huge miss in employment payrolls led to doubts about the strength of the recovery. As a result, eight out of the 11 indicators are in expansion territory. The diffusion index rose from +0.4545 to +0.4697, remaining well above the recession signal of +0.2500.



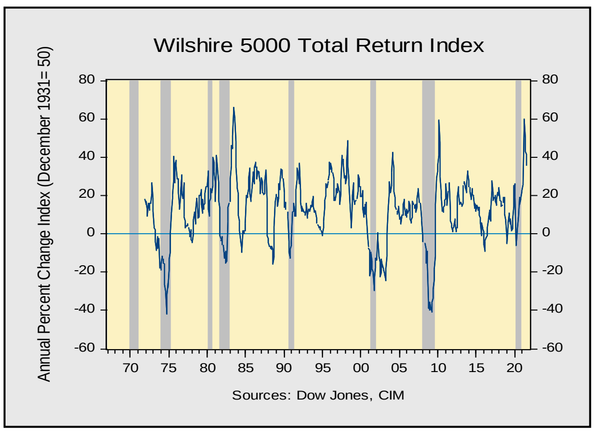
The chart above shows the Confluence Diffusion Index. It uses a three-month moving average of 11 leading indicators to track the state of the business cycle. The red line signals when the business cycle is headed toward a contraction, while the blue line signals when the business cycle is headed toward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



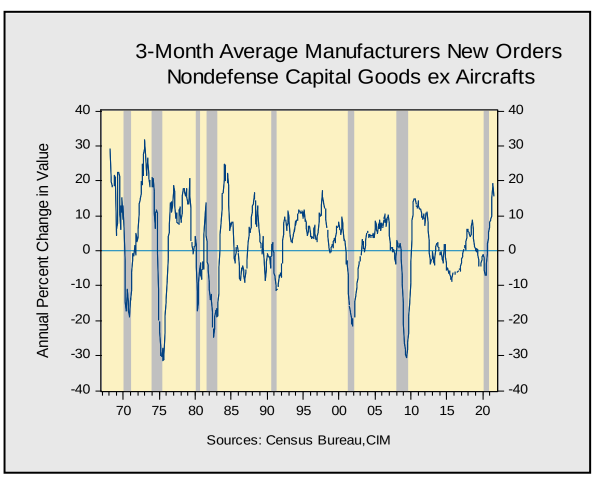
In August, the Consumer Confidence Index fell to its lowest level since February but remains well above last year's level. Last month, the Present Situation Index and Consumer Expectations Index took a dip as respondents expressed concerns over rising COVID-19 cases and inflation. The latest reading for the Consumer Confidence Index stands at 113.8, down from 125.1 in the previous month. This reading is well above last year's level of 86.3. The 12-month moving average of the annual change in the index rose from -10.3 to -4.33 as seen on the chart to the left. The recent rise in COVID-19 cases has not had the same negative impact on the economy as previous outbreaks, but consumers are still worried that the recovery could stagnate. As a result, the Present Situation Index fell from 157.2 to 147.3. Meanwhile, the index for consumers' six-month outlook fell from 103.8 to 91.4.

Wilshire 5000 Index



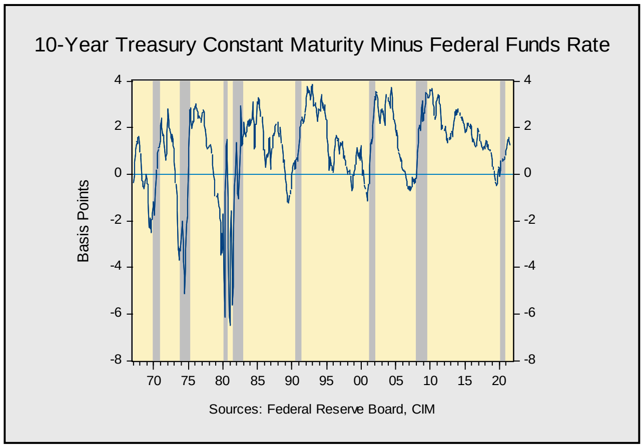
The annual change in the Wilshire 5000 Total Return Index slowed for the third consecutive month. In August, the index rose 35.3% from the prior year, lower than the annual rise of 41.0% recorded in the previous month. The slowdown can be attributed to higher than expected inflation, supply chain constraints, labor shortages, and rising COVID-19 cases. However, Fed reassurance of accommodative policy has kept investors optimistic. 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



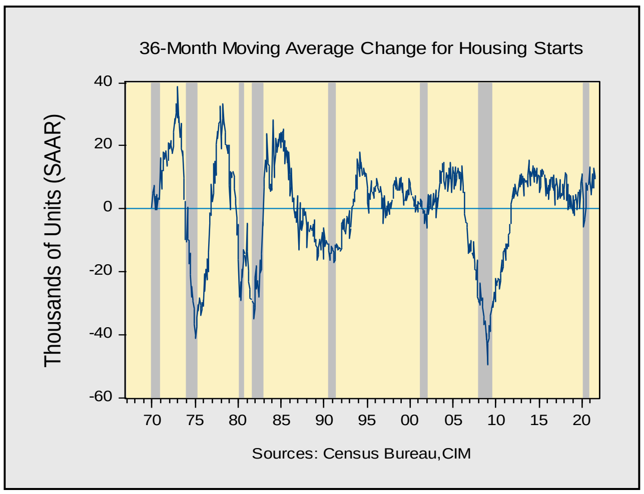
New orders for durable goods, a proxy for business investment, remained strong in August. According to the Conference Board LEI, the value for new orders of durable goods adjusted for inflation rose 0.56% from the previous month. The latest report showed that new orders for nondefense capital goods came in at $41.211B in 1982-chained dollars, which is 9.2% higher than the previous year. New orders for the previous month were revised lower, from $41.283B to $40.980B. The three-month moving average came in at $41.149B, up from the previous year's value of $36.681B. The indicator, which tracks the annual change in the three-month moving average for new orders, came in at 11.68, higher than the previous month's reading of 15.36.

10-Year Treasury Constant Maturity Minus Federal Funds Rate



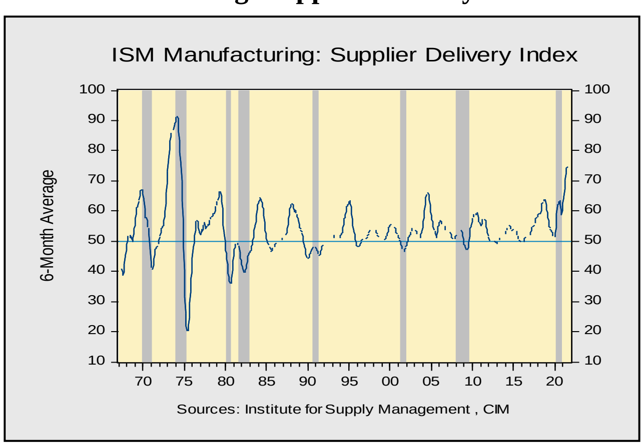
A growing preference for safe haven assets as well as steady monetary policy compressed yield spreads in August. That being said, the 10-year Treasury yield minus the effective federal funds rate, also known as the financial spread, contributed positively to the diffusion index. Last month, the spread declined from +1.22 to +1.19, above the recession indicator of 0. In August, Federal Reserve officials reassured investors that they will maintain low rates. This policy shift likely influenced bond investors' preference for longer-duration Treasuries. As a result, the 10-year Treasury rate fell from 1.52% to 1.32%, while the fed funds rate increased from 0.08% to 0.10%.

36-Month Moving Average Change for Housing Starts



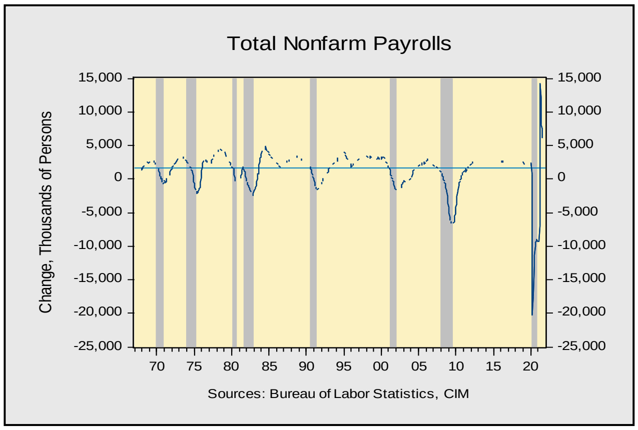
Lower lumber costs and strong demand for homes have led to an acceleration in housing starts in August. Last month, annualized housing starts expanded at an annualized pace of 1,615K, lower than the previous month's report of 1,554K. The latest NAHB report showed that the Housing Market Index rose for the first time in three months. The increase in homebuilder confidence may have contributed to the rise in building permits for single-family homes. The 36-month moving average for the change of housing starts fell from 10.03 to 9.08, well above the recession signal of 0.

ISM Manufacturing: Supplier Delivery Index



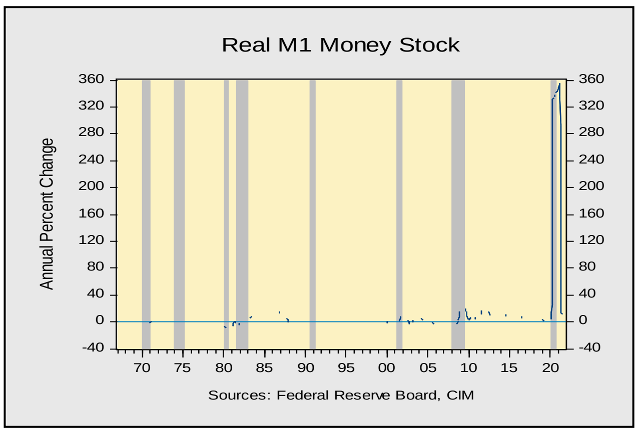
Strong demand for goods has led to an overall improvement in the ISM Manufacturing Index. However, the Supplier Delivery Index fell from the previous month due to expanding production capacity. In general, the index views faster shipments as a negative due to the assumption that it reflects weakening demand. Although in this case the index is wrong, its overall impact on the indicator is limited by the moving average. As a result, the ISM Supplier Delivery Index came in at 69.5 in August, below the previous month's reading of 72.5, while the six-month moving average fell slightly from 75.0 to 74.6.

Total Nonfarm Payrolls



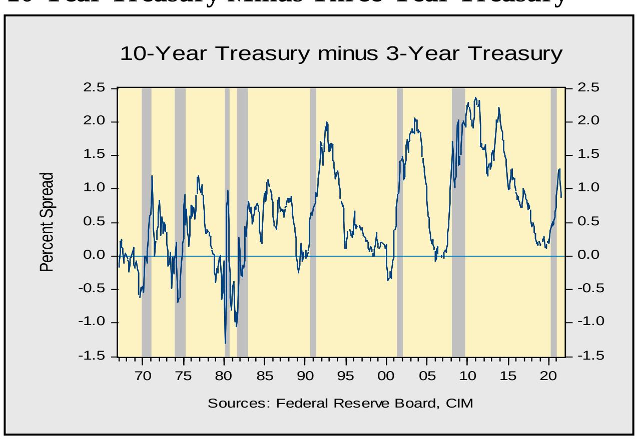
A slowdown in the amount of jobs added in *Leisure & Hospitality* led to suppressed nonfarm payrolls. The country gained 235K jobs for a 12-month moving sum of 6.041MM in August. Most of the new jobs came from the private services-providing sector, primarily in *Professional & Business Services*, which added 74K. In total, the services-providing sector accounted for 203K new jobs. The government sector lost 8K, while the goods-producing sector added 40K. Currently, the indicator is significantly above the recession signal of 1.600MM. Given the transitory nature of this indicator, the moving sum will likely decline sharply over the next few months but should remain in expansionary territory.

Real M1 Money Stock



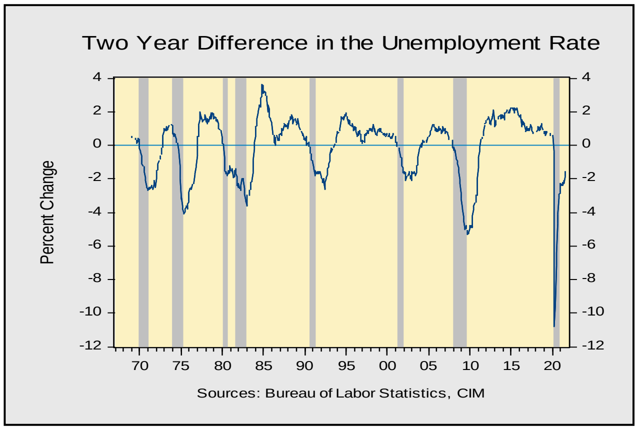
An increase in demand deposits helped offset the rise in inflation leading to an increase in Real M1. In August, Real M1 Money Stock, which is M1 minus inflation, rose 11.23% from the prior year, up from the previous month's reading of 10.27%. The slump in the indicator was heavily influenced by a change 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



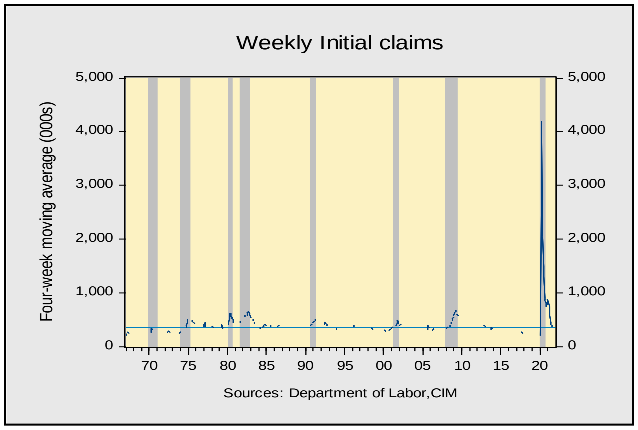
In August, the spread narrowed between the 10-year and three-year Treasury. Long-duration demand remains strong after the spread of the delta variant increased the attractiveness of safe haven assets. As a result, the spread between the 10-year and three-year Treasury narrowed by 6 bps from +0.92 in the previous month to +0.86. Last month, the 10-year Treasury yield declined by 4 bps from +1.32 to +1.28, while the three-year Treasury rose by 2 bps from +0.40 to +0.42.

Two-Year Difference in the Unemployment Rate



In August, the two-year spread in the unemployment rate narrowed from -1.8 to -1.5, contributing negatively to the diffusion index. Last month, the unemployment rate fell from 5.4% to 5.2%, well above its level of 3.7% two years prior. The fall in the unemployment rate was largely due to workers finding employment. The number of workers employed rose 0.3% from the prior month, while the civilian labor force rose by 0.12%. Meanwhile, the number of unemployed workers declined by 3.65% from the prior month. Nevertheless, we do not expect this indicator to contribute positively to the diffusion index for the foreseeable future. Labor market recoveries generally take longer than economic recoveries. As a result, it is unlikely that the unemployment rate will dip below the historic lows we saw in 2019 any time soon.

Weekly Initial Claims



In August, average weekly initial claims remained unchanged from the prior month, coming in at 352K. The drop in initial claims can be attributed to general improvement in the economy.

Thomas Wash
September 30, 2021

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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.