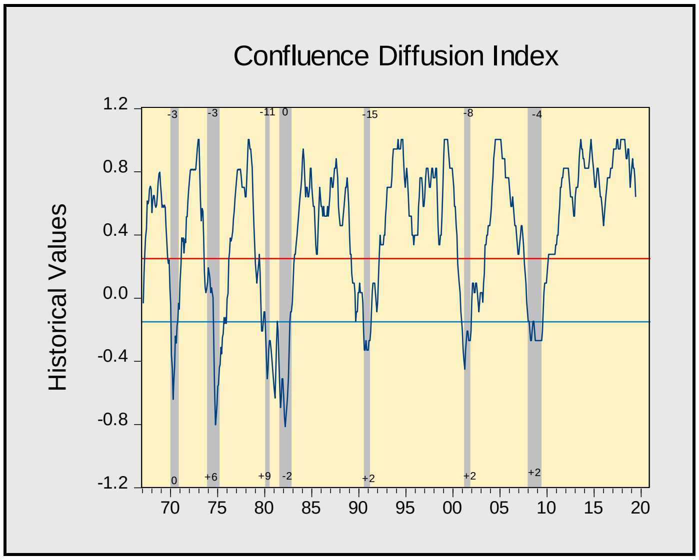
Business Cycle Report

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.

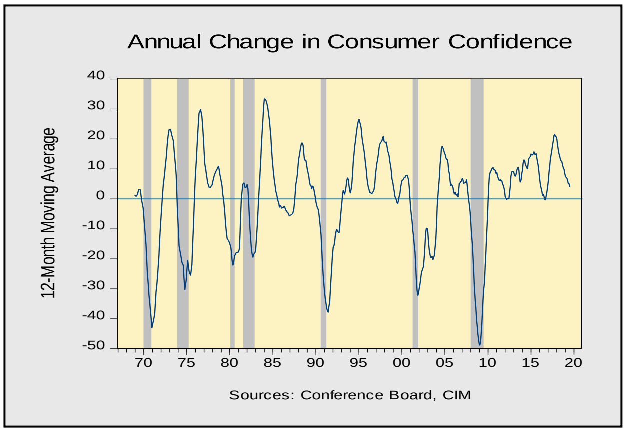
Data released for July suggests the economy is strong, but a slowdown in manufacturing and signals of financial weakness have been a drag on the index. Currently, our diffusion index shows that eight out of 11 indicators are in expansion territory, with several indicators approaching warning territory. The index has fallen from +0.757 to +0.636.[1]



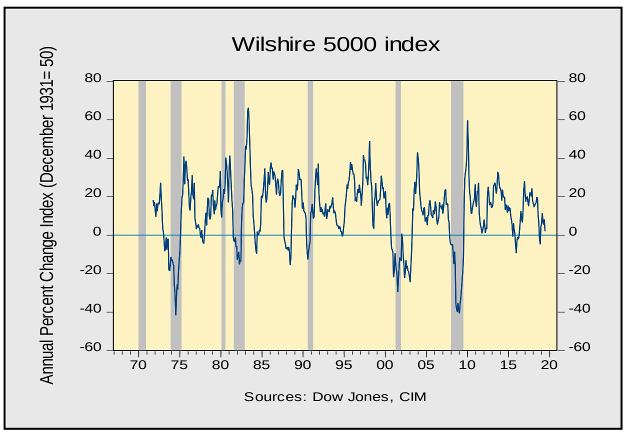
The chart above shows the Confluence Diffusion Index. It uses a three-month moving average of 11 leading indicators to track the state of the business cycle. The red line signals when the business cycle is headed toward a contraction, while the blue line signals when the business cycle is headed toward 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 Second Month
Manufacturers New Orders Nondefense Capital Goods ex Airplanes	Third month in negative territory
36- Moving Average Change for Housing Permits	Fell back into negative territory

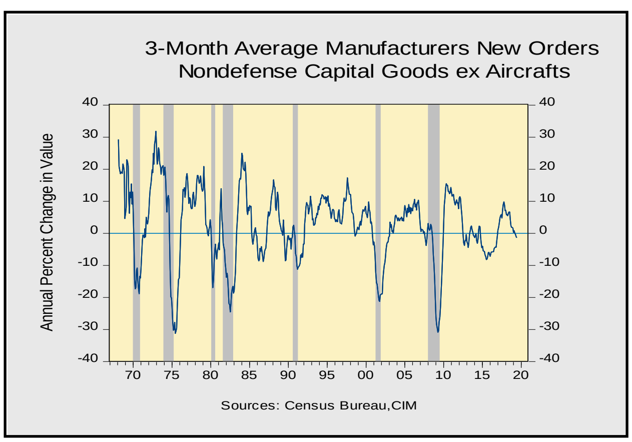
[1] The diffusion index looks slightly different from last month due to adjustments we made to the formula and revisions in certain data sets.



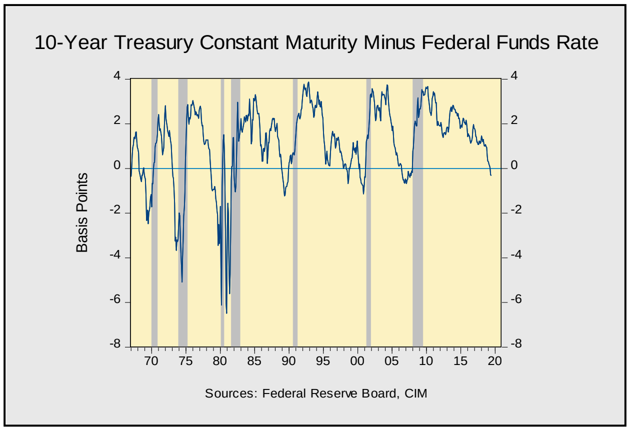
The Consumer Confidence Index is an economic indicator that measures the level of consumer optimism about the overall state of the economy and consumers' personal financial situations. The chart on the left shows the 12-month moving average of the annual change of the index. The 12-month average has risen 3.82% from the prior year. Although last month the reading was strong, it did little to slow the momentum of the decline. That being said, strong consumer confidence suggests consumption, which is the largest component of our economy, will resume.



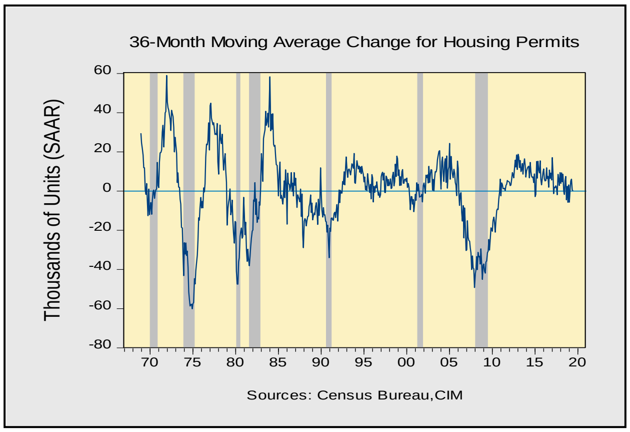
This chart shows the annual change in the Wilshire 5000 Index, which is the broadest U.S. equity index. The index contains 3,500 stocks and is designed to track overall performance of the U.S. stock market. It is an important indicator because steep equity pullbacks have often coincided with economic contractions. The latest reading shows an annual change of 1.84%. Expectations of a Fed rate cut led to a modest rise in equities for July. However, the Fed's reluctance to provide assurances of future rate cuts prevented the index from rising higher.



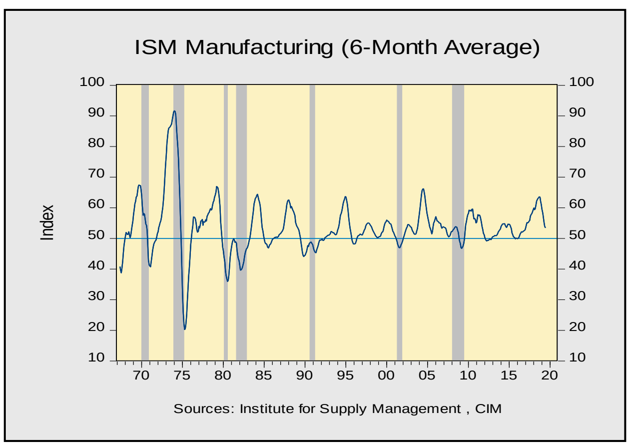
This chart shows the annual change in the value of core capital goods orders. This indicator gives insight into the amount of business investment spending. A positive report suggests that manufacturers are optimistic about future demand. The current reading is negative as the moving average fell 1.52% from the prior year. As global growth slows, we expect manufacturing to continue to weigh on growth.



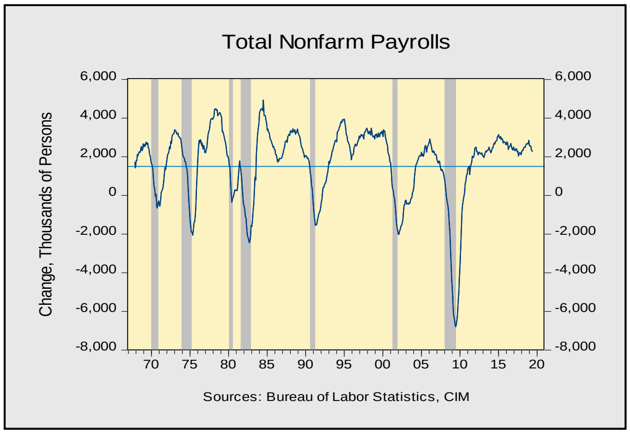
This chart shows the spread between the 10-year maturity and the Fed funds rate. It reflects market sentiment of the future state of the economy. Generally speaking, a negative spread suggests a contraction is likely to occur within 24 months. The current reading is -0.34, which is below the recession indicator. The inversion of the yield curve was caused by fears of a global slowdown, leading to flight-to-safety in 10-year Treasuries.



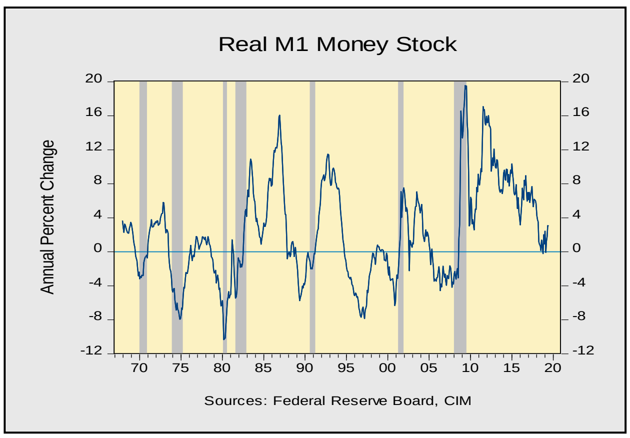
This chart shows the 36-month moving average of the annual change in housing permits. This is an important indicator because it provides a gauge of future construction activity. If housing permits are strong it implies that builders are optimistic about future demand. The current reading of -0.2 is below the recession indicator. This index is very volatile; therefore, we would not be surprised if this index is back in expansion territory next month.



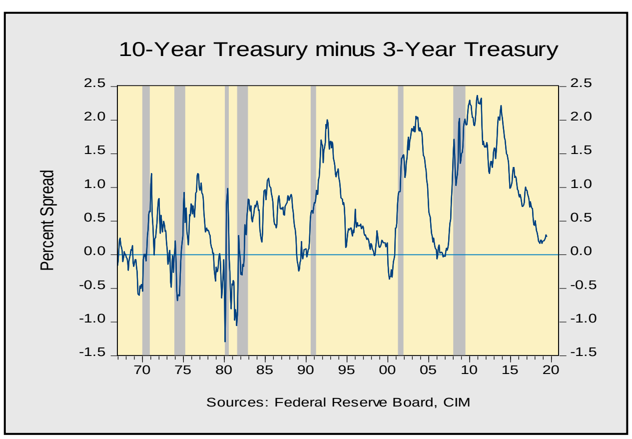
The ISM Manufacturing Index is a report that monitors employment, production, inventories, new orders and supplier deliveries. This index shows a six-month moving average and is used to gauge the level of manufacturing activity. A reading above 50 signals that manufacturing activity is expanding, while a reading below 50 signals that manufacturing activity is contracting. The current reading of 53.3 suggests that manufacturing activity remains robust but is slowing.



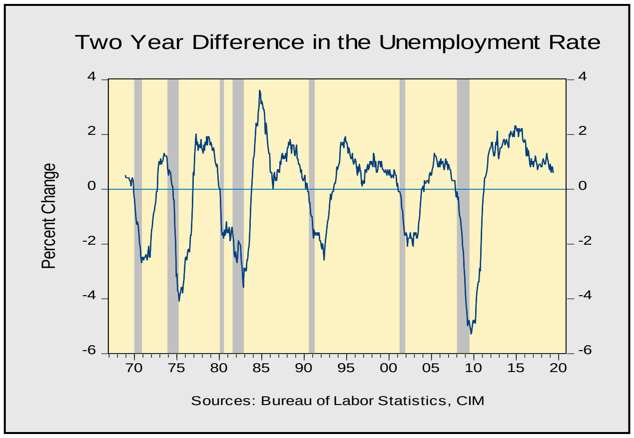
This chart shows the 12-month moving sum of total nonfarm payrolls. This report represents the total number of workers added to the workforce excluding proprietors, private household employees, unpaid volunteers, farm employees and incorporated self-employed. It is a significant indicator of the strength of the labor market. A moving sum that exceeds 1,800 suggests the demand for labor is strong. The latest reading of 2,246 indicates that the labor market remains tight but may be slowing.



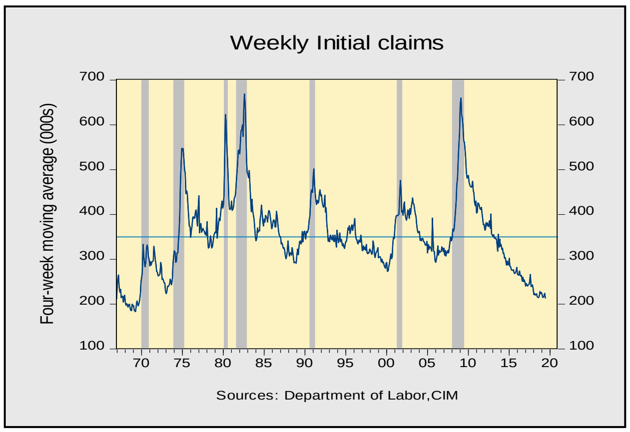
The Real M1 Money Stock report measures the annual change in the money supply minus inflation. M1 is the measure of currency in circulation and represents the amount of money being held for transaction purposes, therefore it can act as a proxy for economic activity. The latest reading is 2.96%, which is above the recession indicator. The rise in real M1 was due to an increase in demand deposits. It is possible that rising trade tensions may have resulted in some portfolio liquidation, thus increasing the supply of money.



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 +0.26, which indicates waning optimism among investors. Despite inversions in certain sections of the yield curve, the spread remains steady.



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 +0.6 suggests the labor market remains tight. Nevertheless, the gap appears to be narrowing as more people continue to rejoin the workforce to take advantage of higher wages.



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 212k indicates that business sentiment is still strong.

Thomas Wash
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