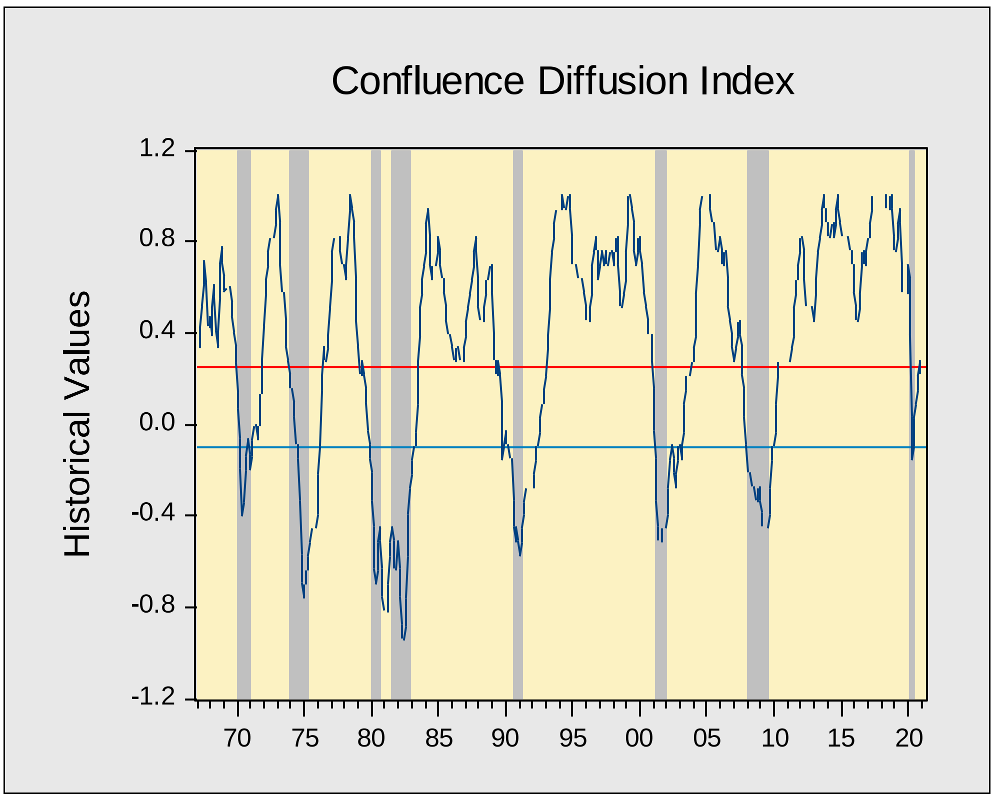
Business Cycle Report

By Thomas Wash

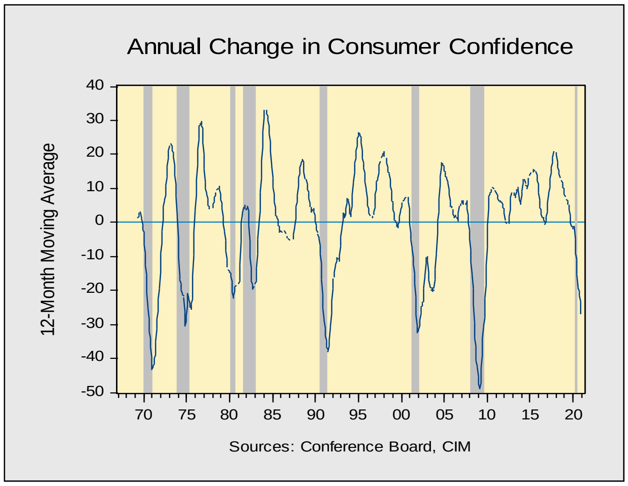
The business cycle has a major impact on financial markets; recessions usually accompany bear markets in equities. The intention of this report is to keep our readers apprised of the potential for recession, updated on a monthly basis. Although it isn't the final word on our views about recession, it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

In December, the diffusion index rose further, signaling that the economy remains on track to continue its recovery. Financial markets were mixed; equities strengthened, while the yield curve steepened as vaccine production boosted growth expectations and lifted inflation expectations. Meanwhile, the labor market had a setback as a rise in COVID-19 cases led to new lockdown restrictions. Manufacturing remains strong as a weaker dollar promoted more exports abroad. As a result, four out of the 11 indicators are in contraction territory, unchanged from last month. The reading for December remained unchanged from the previous month at +0.2727, above the recession signal of +0.250.



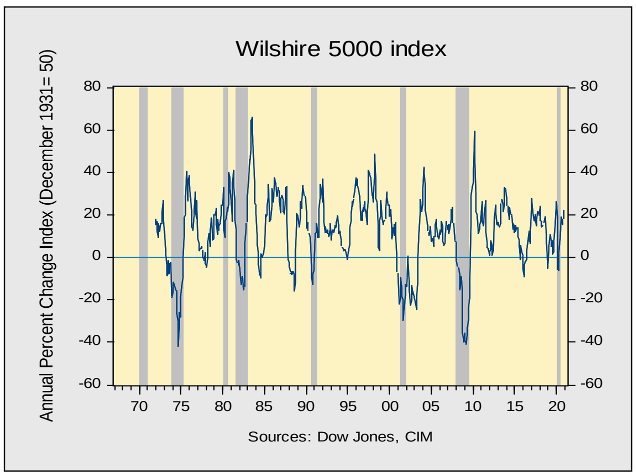
The chart above shows the Confluence Diffusion Index. It uses a three-month moving average of 11 leading indicators to track the state of the business cycle. The red line signals when the business cycle is headed toward a contraction, while the blue line signals when the business cycle is headed toward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



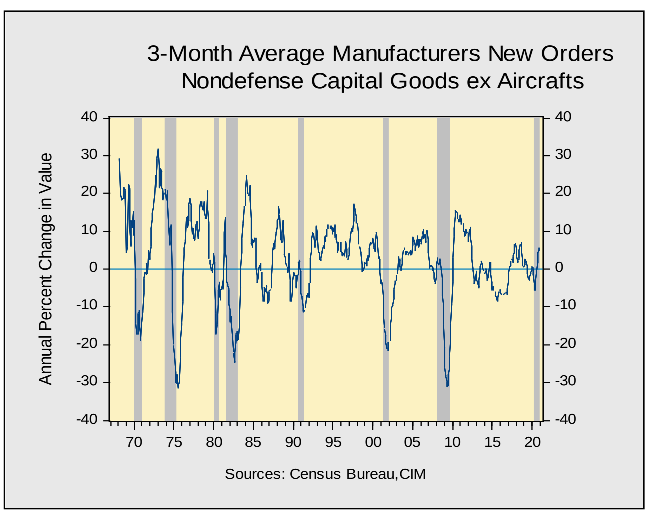
A rise in COVID-19 cases led to a drop in consumer optimism in December. Last month, the index fell by 4.3 points from 92.9 to 88.6. This reading is much lower than the previous year's reading of 130.4. As a result, the 12-month moving average of the annual change fell from -23.7 to -27.1. The drop in the index is primarily due to consumers being less confident about their present situation. Consumer current sentiment fell 15.6 points from the prior year, from 105.9 to 90.3. However, vaccine news may have boosted future expectations. The index for consumer expectations rose 3.2 points from 84.3 to 87.5, well below last year's level of 100.0.

Wilshire 5000 Index



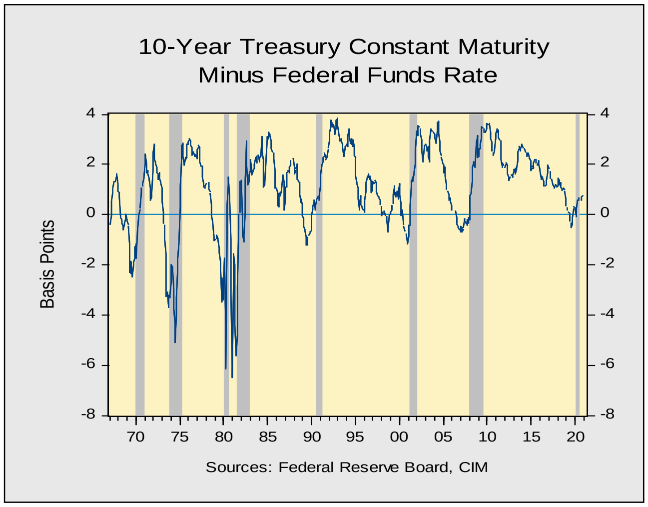
An increase in fiscal stimulus as well as positive vaccine news lifted equities in December. Last month, the index rose from 178.85 to 186.76, which is 22.3% higher than the previous year. Developments in COVID-19 vaccines and fiscal stimulus likely boosted optimism that the recovery will continue to gain momentum going into 2021. The three top-performing sectors in the index were Financials, Information Technology, and Energy. The bottom-performing sectors were Industrials, Consumer Staples, and Utilities. We expect equities to remain bullish throughout the year as credit conditions will likely remain favorable for the foreseeable future.

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



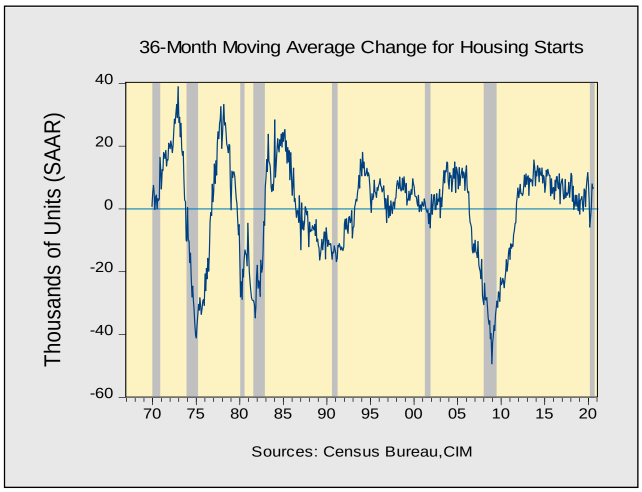
According to the Conference Board LEI, the value for new orders of durable goods fell in the final month of the year. In December, new orders for nondefense capital goods came in at $39.376B in 1982-chained dollars, 0.2% lower than the previous month. The three-month moving average came in at $39.393B, up from the previous year's value of $37.366B. The indicator, which tracks the annual change in the three-month moving average for new orders, came in at 5.80, higher than the previous month's reading of 5.35. The decline in orders was the result of COVID-19 cases making companies less optimistic about future demand. We expect the recent developments in vaccine methods will likely reverse this trend.

10-Year Treasury Constant Maturity Minus Federal Funds Rate



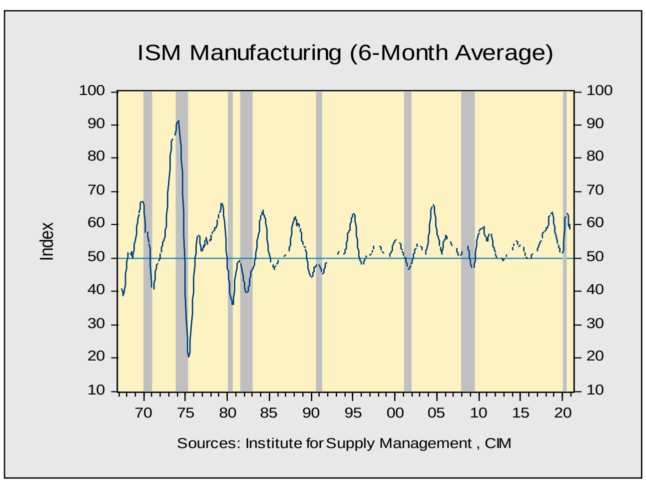
The financial spread, also known as the 10-year Treasury minus the federal funds rate, remained in expansion territory in December. The spread rose from +0.78 to +0.84. The yield curve steepened due to fears that fiscal stimulus could lead to higher inflation. As a result, there was a sell-off in 10-year Treasuries. Last month, the fed funds rate remained unchanged from the previous month at 0.09%. Meanwhile, the 10-year Treasury rose 6 bps from 0.87% to 0.93%.

36-Month Moving Average Change for Housing Starts



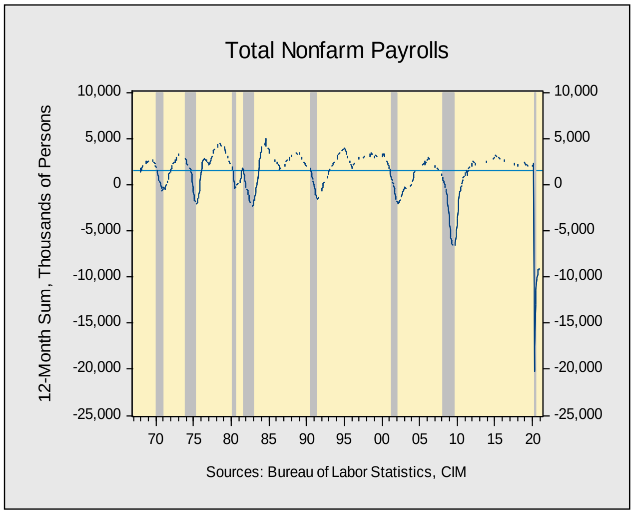
In December, housing starts surged as homebuilders prioritized single-family over multi-family homes. The preference for single-family homes can be partially attributed to homebuilders becoming more optimistic about demand for homes in the suburbs. Home prices have soared lately as record-low mortgage rates have attracted young adults into a housing market that is low on supply. As a result, homebuilders have begun construction to meet the new demand. In December, annualized housing starts rose from 1,578K in November to 1,669K in the following month. The 36-month moving average change of housing starts rose 13.06K from the prior month.

ISM Manufacturing: Supplier Delivery Index



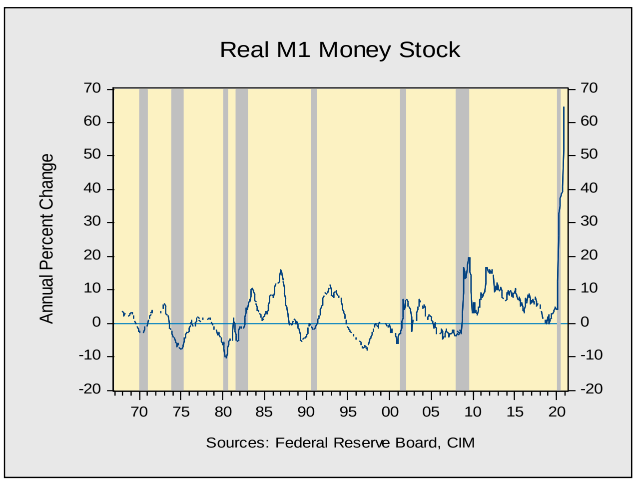
The ISM Supplier Delivery Index rose from 61.7 in November to 67.6 in December. The rise in the index was due to a sharp increase in firms reporting shorter delivery times. As a result, the moving average rose from 58.6 to 60.5. The rise in the indicator is a reflection of the increase in manufacturing activity since lockdown restrictions have eased. Unlike services, manufacturing has been able to rebound quicker than most anticipated as demand for goods has soared. In fact, activity has been so robust that many consumers, myself included, have complained about not getting their deliveries on time.

Total Nonfarm Payrolls



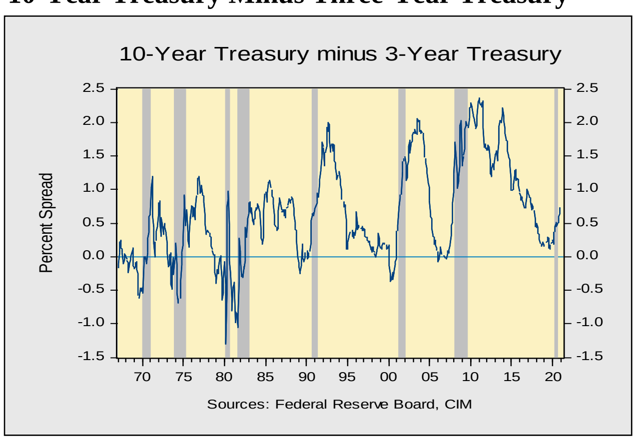
In December, the country lost 140K jobs for a 12-month moving sum of -9.374MM. Most of the job losses came from the services-providing sector. In total, the services-providing sector lost 188K jobs. The government sector lost 45K jobs. Local and state governments saw the least job losses at 32K and 19K, respectively, while the federal government added 6K. Meanwhile, the goods-producing sector contributed 93K, primarily in construction which added 51K. 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



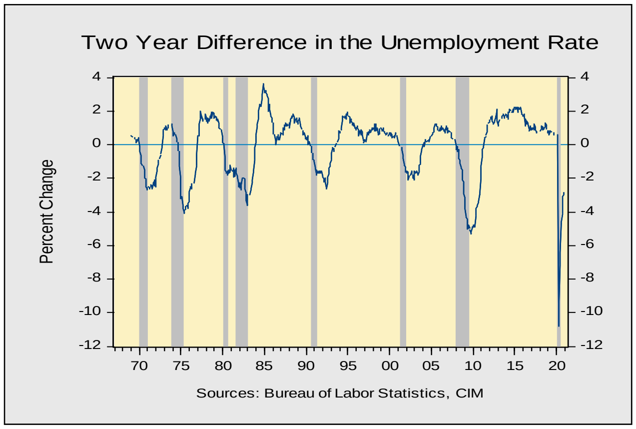
In December, Real M1 rose to its highest level ever. Last month, the Real M1 Money Stock, which is M1 minus inflation, rose 65.05% from the prior year, higher than the previous month's reading of 52.00%. The unprecedented rise in the indicator was heavily influenced by a surge in demand deposits, which rose 105.89% from the prior year. Additionally, a slowdown in airfare and energy prices led to a deep deceleration in headline inflation. As a result, M1, which rose 66.45% from the prior year, outweighed the rise in CPI, which rose 1.40% from the prior year.

10-Year Treasury Minus Three-Year Treasury



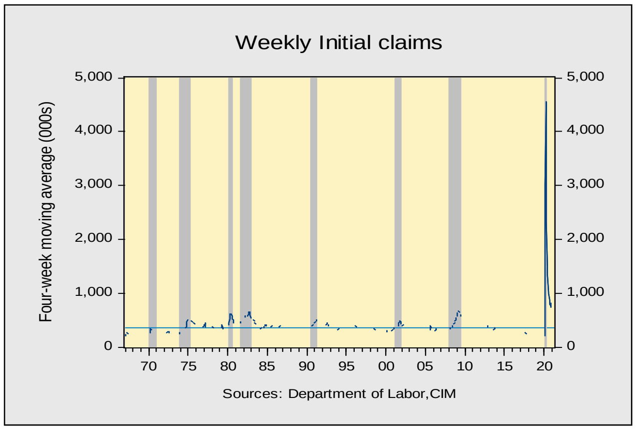
In December, a reflation trade resulted in a rise in long-duration bond yields and a reduction in short-duration note yields. The spread between the 10-year and three-year Treasury widened from +0.65 to +0.74. The widening of the spread was due to an increase in interest rates for the 10-year Treasury and a decrease in the three-year Treasury rate. Last month, the 10-year Treasury rose by 6 bps from +0.87 to +0.93. The three-year Treasury fell from +0.22 to +0.19. We expect that as vaccines become more widely available the yield curve will steepen further.

Two-Year Difference in the Unemployment Rate



In December, the two-year spread in the unemployment rate narrowed from -2.9 to -2.8, contributing negatively to the diffusion index. Last month, the unemployment rate remained unchanged from the prior month and still remains well above its level of 3.9% from two years ago. Last month, the labor market stalled as new lockdown restrictions made it harder for businesses to stay open. As a result, the number of workers employed and entering the labor force remained relatively unchanged from the prior month. Meanwhile, the number of unemployed workers fell 0.1% from the prior month.

Weekly Initial Claims



In December, average weekly initial claims rose for the first time in seven months, coming in at 825K, up from the 746K recorded in the previous month. Last month, a rise in cases forced many businesses to reduce hours or temporarily close. As a result, initial claims began to rise across the country, with the Midwest seeing the most claims.

Thomas Wash
January 28, 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.