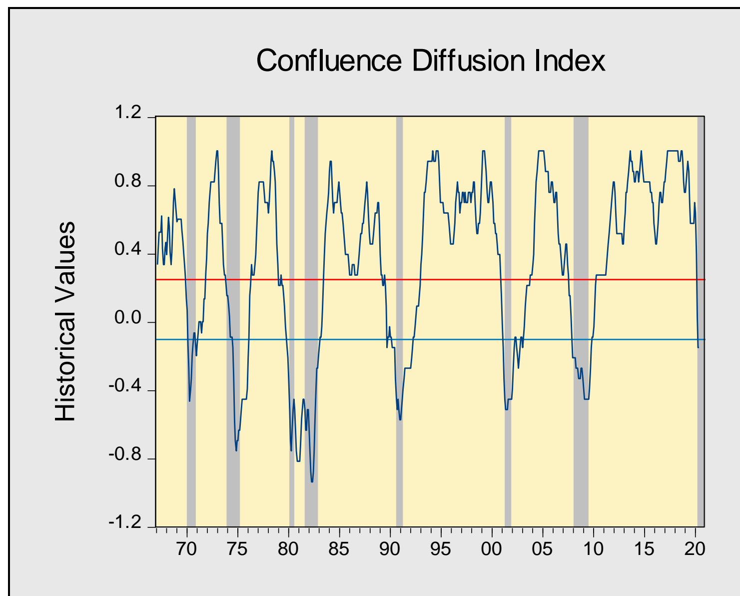
Business Cycle Report

By Thomas Wash

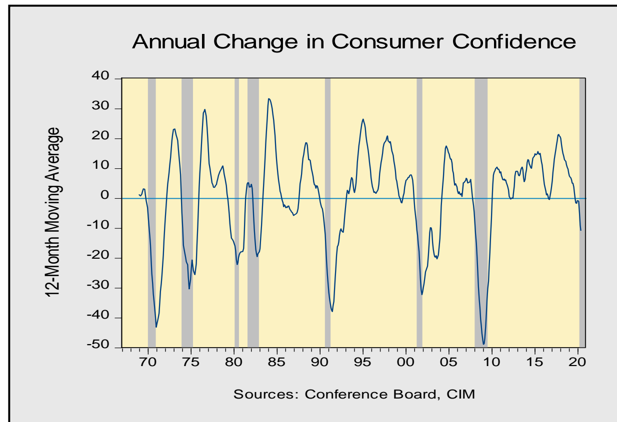
The business cycle has a major impact on financial markets; recessions usually accompany bear markets in equities. The intention of this report is to keep our readers apprised of the potential for recession, updated on a monthly basis. Although it isn't the final word on our views about recession, it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

In June, the diffusion index stayed in recession territory as improvements in several indicators could not outweigh the negative impact of the previous three months. That being said, it does appear that the worst is now behind us. Financial markets continued to show signs of improvement as Fed Chair Jerome Powell testified before Congress that the Fed will not remove stimulus prematurely. Additionally, fiscal stimulus and monetary easing led to a sharp rise in equities. Meanwhile, the labor market showed signs of improvement as an increase in consumption, following the reduction in lockdown restrictions, allowed firms to hire workers in record numbers. However, economic uncertainty has weighed on consumer and investor confidence as a rise in virus cases toward the end of the month has hindered efforts to further ease restrictions. As a result, six out of the 11 indicators are in contraction territory. The reading for June remains unchanged from the previous month, at -0.1515, well below the recession signal of +0.250.



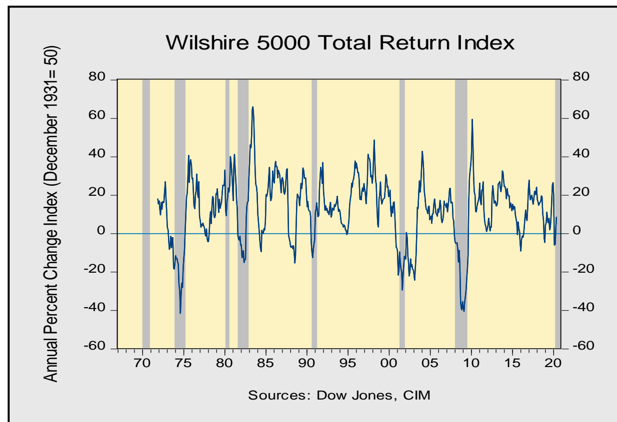
The chart above shows the Confluence Diffusion Index. It uses a three-month moving average of 11 leading indicators to track the state of the business cycle. The red line signals when the business cycle is headed toward a contraction, while the blue line signals when the business cycle is headed toward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



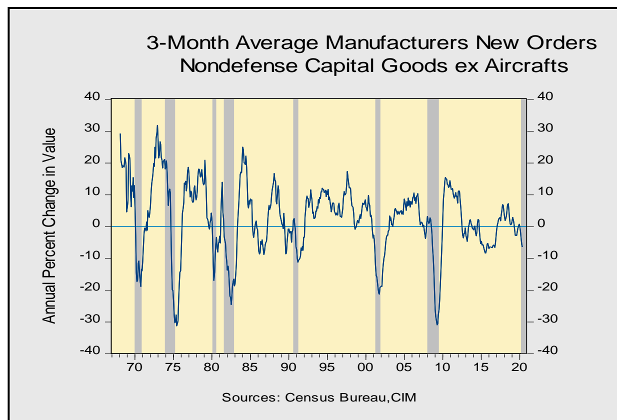
In June, the consumer confidence index contributed negatively to the diffusion index as the moving average fell further below the recession indicator. Last month, consumer confidence rose by 11.5 points from 85.9 to 98.1. This reading is much lower than the previous year's reading of 124.3. As a result, the 12-month moving average of the annual change fell from -9.1 to -11.0. Despite a drop in consumer confidence, the consumer six-month outlook rose 8.4 points from the prior year, from 97.6 to 106.0. However, the reading of consumer sentiment about their present situation, at 86.2, remains well below last year's level of 164.3.

Wilshire 5000 Index



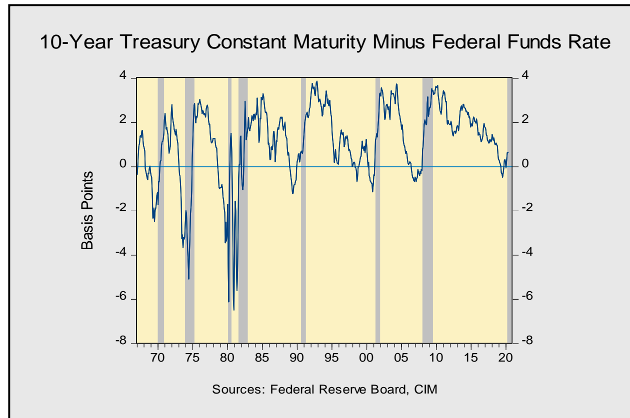
In June, the Wilshire 5000 Total Return Index gained for the second consecutive month, rising 8.56% from the prior year, thus the indicator contributed positively to the diffusion index. The improvement in equities can be attributed to the economic data beating market expectations and government stimulus leading to an increase in consumption. As a result, investors became more optimistic that the economy was improving. The three top-performing sectors in the index were Information Technology, Consumer Discretionary, and Real Estate. The three bottom-performing sectors were Energy, Health Care, and Utilities.

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



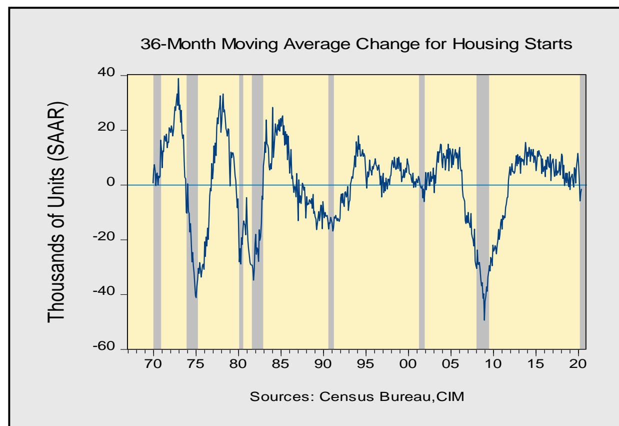
In June, new durable goods orders fell, according to the Conference Board LEI. The drop is likely the result of weaker global consumption weighing on the manufacturing sector. As a result, the annual change in the three-month moving average for new orders came in at -6.56, lower than the previous month's reading of -5.75. The value of new orders for nondefense capital goods came in at $35.125 billion in 1982 chained dollars, which is 6.3% higher than the previous year. New orders for May were revised down from $35.699 billion to $34.787 billion. The decrease led to a drop in the three-month average from $37.181 billion in the previous year to $34.738 billion. The decline in orders suggests the pandemic has had an adverse impact on investment intentions. Although we do expect orders to pick up soon, the reemergence of the virus could further depress investment activity.

10-Year Treasury Constant Maturity Minus Federal Funds Rate



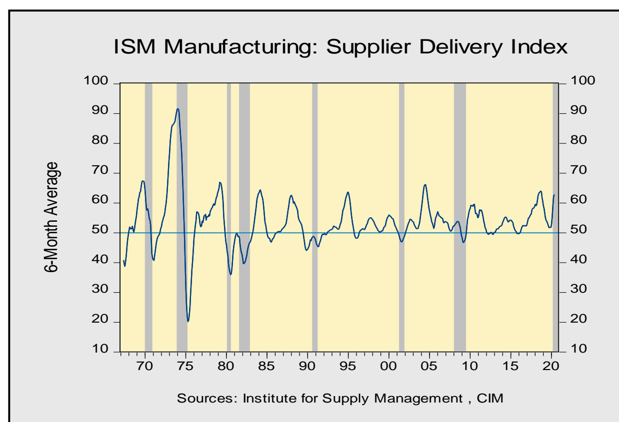
The financial spread, also known as the 10-year Treasury minus the federal funds rate, remained in expansion territory in June. The spread widened slightly from +0.62 to +0.65. According to the FOMC minutes, the Fed foresees highly accommodative policy until the economy improves. There was a slight uptick in the fed funds rate as it rose 3 bps in June from 0.05% to 0.08%. Meanwhile, the 10-year Treasury rose 6 bps from 0.67% to 0.73%.

36-Month Moving Average Change for Housing Starts



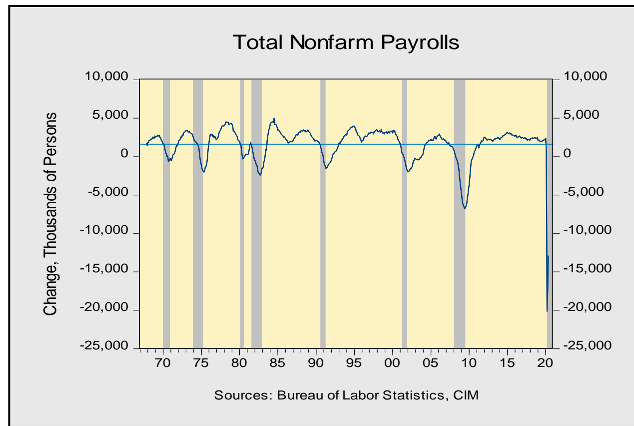
In June, housing starts were relatively low as homebuilders prioritized single-family over multi-family homes. The preference for single-family homes can be partially attributed to potential sellers holding out for favorable market conditions. Hence, the construction of new homes may be the result of a lack of inventory. As a result, annualized housing starts rose from 1,011k in May to 1,186k in the following month. Despite the rise in starts, the 36-month moving average change declined 1.58 from the prior month, suggesting that housing construction is still relatively soft. The overall weakness in housing construction can be attributed to economic uncertainty. Although there has been a sharp rise in construction activity, homebuilding hasn't returned to pre-pandemic levels.

ISM Manufacturing: Supplier Delivery Index



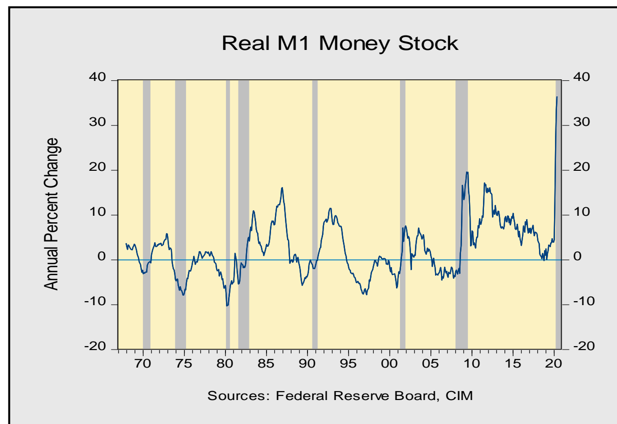
In June, the supplier delivery index fell drastically as reopenings made it easier for firms to distribute shipments. As a result, last month's reading fell from 68.0 to 56.9. This drop is due to fewer firms reporting slower deliveries. Despite the decline in the index, the moving average rose from 61.9 to 62.8. The rise in the moving average was due to a shift in the time period. In other words, the moving average rose because the June reading was higher than the December reading, the month that was dropped from the average. Although the indicator suggested that supplier deliveries were improving, this is misleading. The supplier delivery index tracks delivery time. Slow delivery times are considered positive as the model, in this case erroneously, assumes that slow delivery times are a signal of increased volume, while faster delivery signals the opposite. Therefore, the lockdown contributed positively to the index even though volume was decreasing.

Total Nonfarm Payrolls



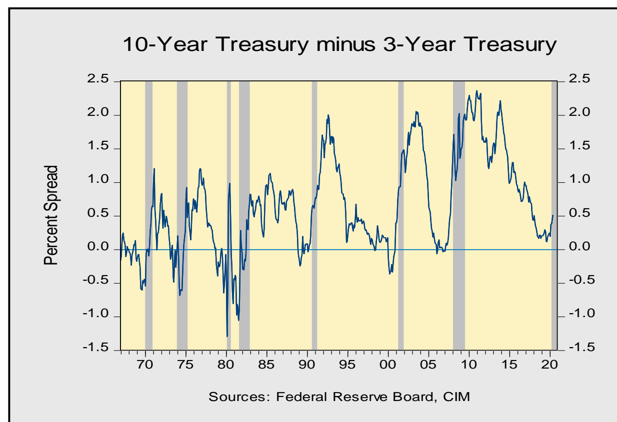
In June, the country gained a record 4.800 million jobs for a 12-month moving sum of -12.957 million. Most of the jobs added came from the private service-providing sectors, especially "leisure and hospitality," which gained 2.088 million. In total, the services-producing sector accounted for 4.263 million added jobs. Meanwhile, the goods-producing sector contributed 504,000, primarily in manufacturing, which added 356,000. The government sector added 33,000 jobs. Local government had the most job gains at 57,000, and the federal government added 1,000, while state governments lost 10,000. Currently, the indicator is significantly below the recession signal of 1.600 million. At this rate, this indicator will likely be signaling recession for the foreseeable future.

Real M1 Money Stock



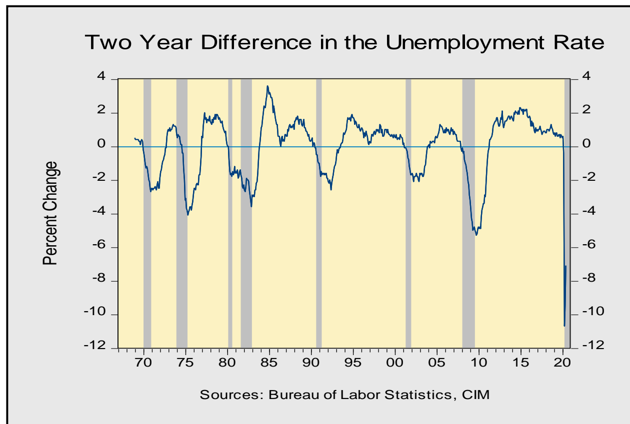
In June, Real M1 rose to its highest level ever for a second consecutive month due to a steep rise in M1 and a slowdown in inflation. Last month, the Real M1 Money Stock, which is M1 minus inflation, rose 36.40% from the prior year, higher than the previous month's reading of 33.40%. The unprecedented rise in the indicator was heavily influenced by a surge in demand deposits and other checkable deposits at commercial banks, 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 36.97% from the prior year, outweighed the rise in CPI, which rose 0.65% from the prior year.

10-Year Treasury Minus Three-Year Treasury



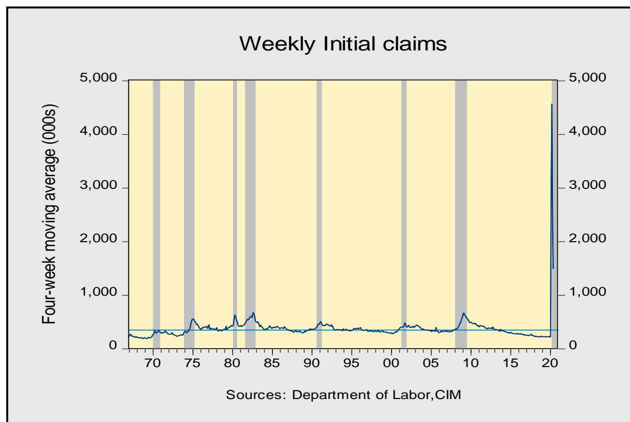
In June, the yield curve steepened as improvements in the global economy resulted in weaker demand for long-duration bonds. Additionally, Fed reassurances that it will not change from its current monetary path likely weighed on short-duration bonds. As a result, the spread between the 10-year and three-year Treasury widened slightly from +0.45 to +0.51. The steepening of the curve will likely continue as strong economic data continues to signal that the economy is in recovery. Last month, the 10-year Treasury rose slightly, by 6 bps, while the three-year Treasury remained unchanged. As a result, the 10-year rose from +0.67 to +0.73 and the three-year held steady at +0.22.

Two-Year Difference in the Unemployment Rate



In June, the two-year spread narrowed slightly as the unemployment rate unexpectedly fell from 13.3% to 11.1%. As a result, the two-year difference narrowed from -9.5 to -7.1. Last month, workers began returning to work which resulted in some labor market tightening. The number of workers employed and in the civilian labor force rose 3.6% and 1.1% from the prior month, respectively. Meanwhile, the number of unemployed workers fell 15.4% from the prior month. Despite the sharp drop in the unemployment rate, there is still a large portion of the population that has not returned to the labor force. That being said, if this downward trend in the unemployment rate continues it will likely lead to a faster than expected recovery.

Weekly Initial Claims



In June, average weekly initial claims fell for the second consecutive month, coming in at 1.483 million, down from the 2.331 million recorded in the previous month. A bulk of the layoffs came from the "leisure and hospitality" sector as consumers have been reluctant to travel during the pandemic. Texas and Colorado were the only two states that saw a rise in initial claims. Although claims will likely remain high for the time being, a slowdown does show that the economy is slowly returning to normal.

Thomas Wash
July 23, 2020

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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.