MERK® | RESEARCH

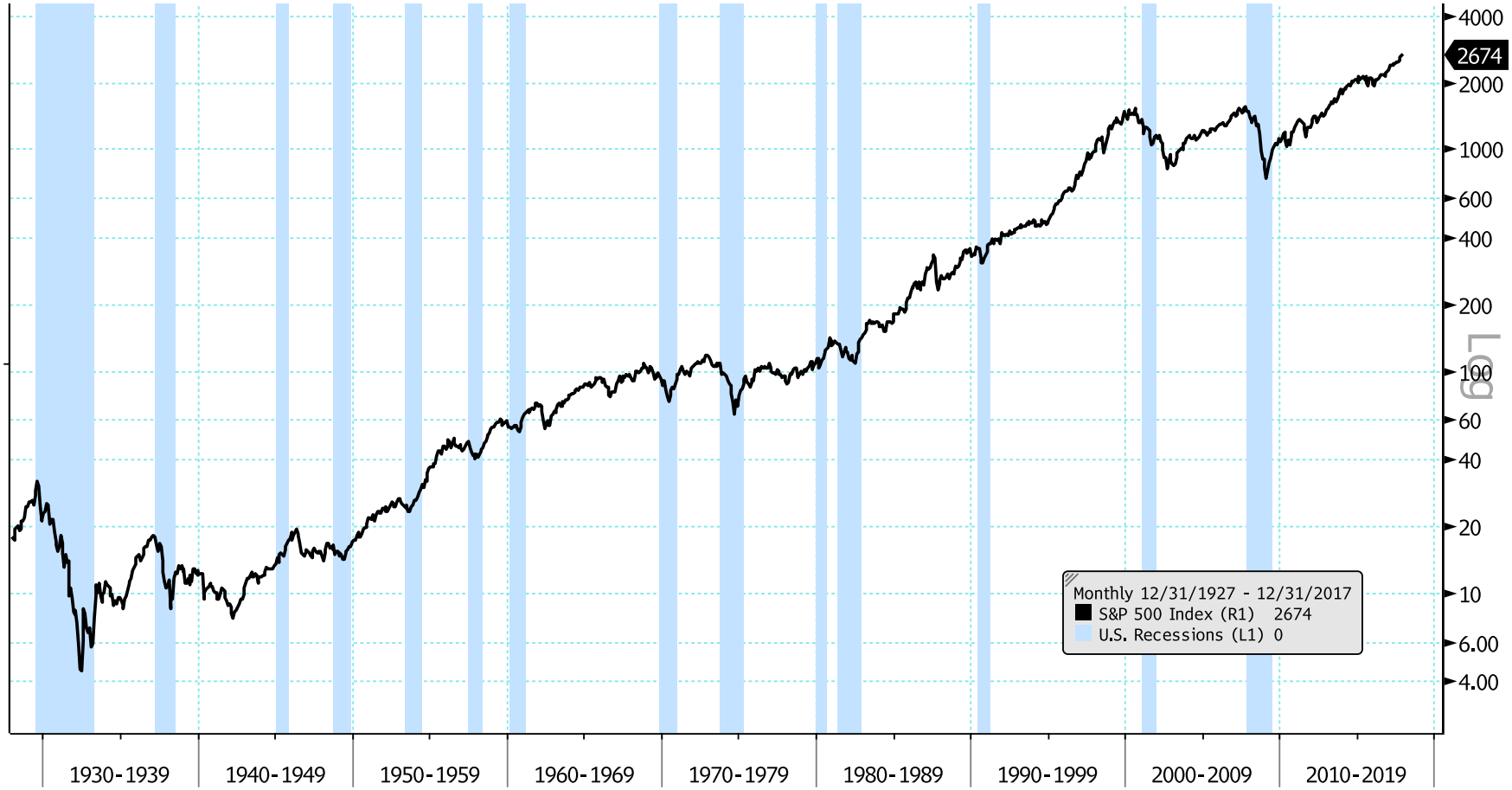
U.S. Business Cycle Report

March 2019

Nick Reece, CFA
Senior Financial Analyst, Merk Investments LLC

Why is the Business Cycle Important?

S&P 500 (log scale) and official National Bureau of Economic Research (NBER) U.S. Recessions

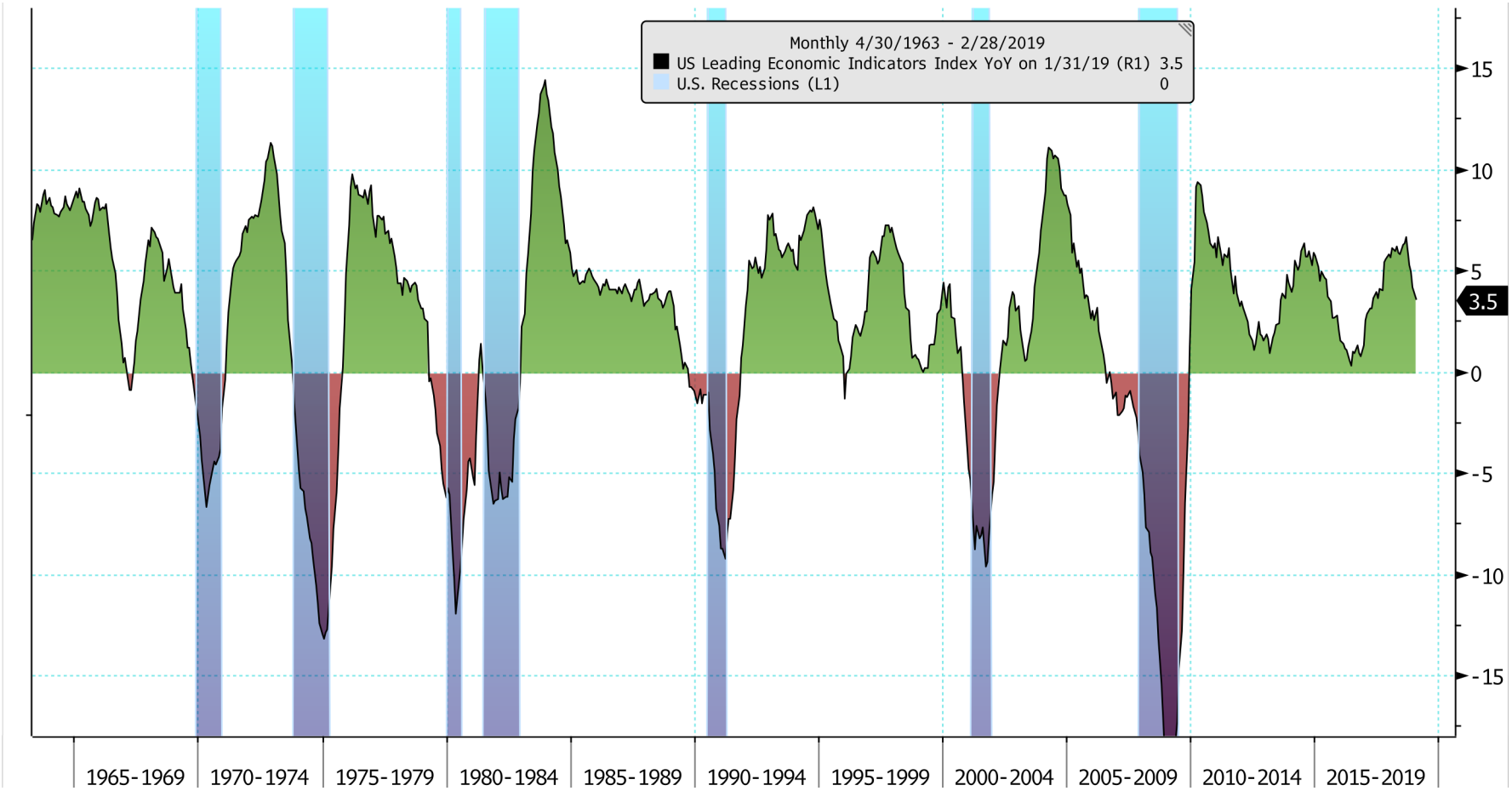


Source: Bloomberg, © Merk Investments LLC

*Analysis: Over the 90 years between 1927 and 2017, the average S&P 500 monthly return during expansions was +0.89% (889 months), compared to an average S&P 500 monthly return during recessions of -0.71% (191 months). In terms of proportions of time: expansion months account for about 80% and recession months about 20%. The business cycle also has important implications for Fed policy. *Note that recessions are not announced by the NBER until well after their start dates**

Leading Economic Indicators (LEIs) Index

YoY rate of change of the Conference Board's LEI Index

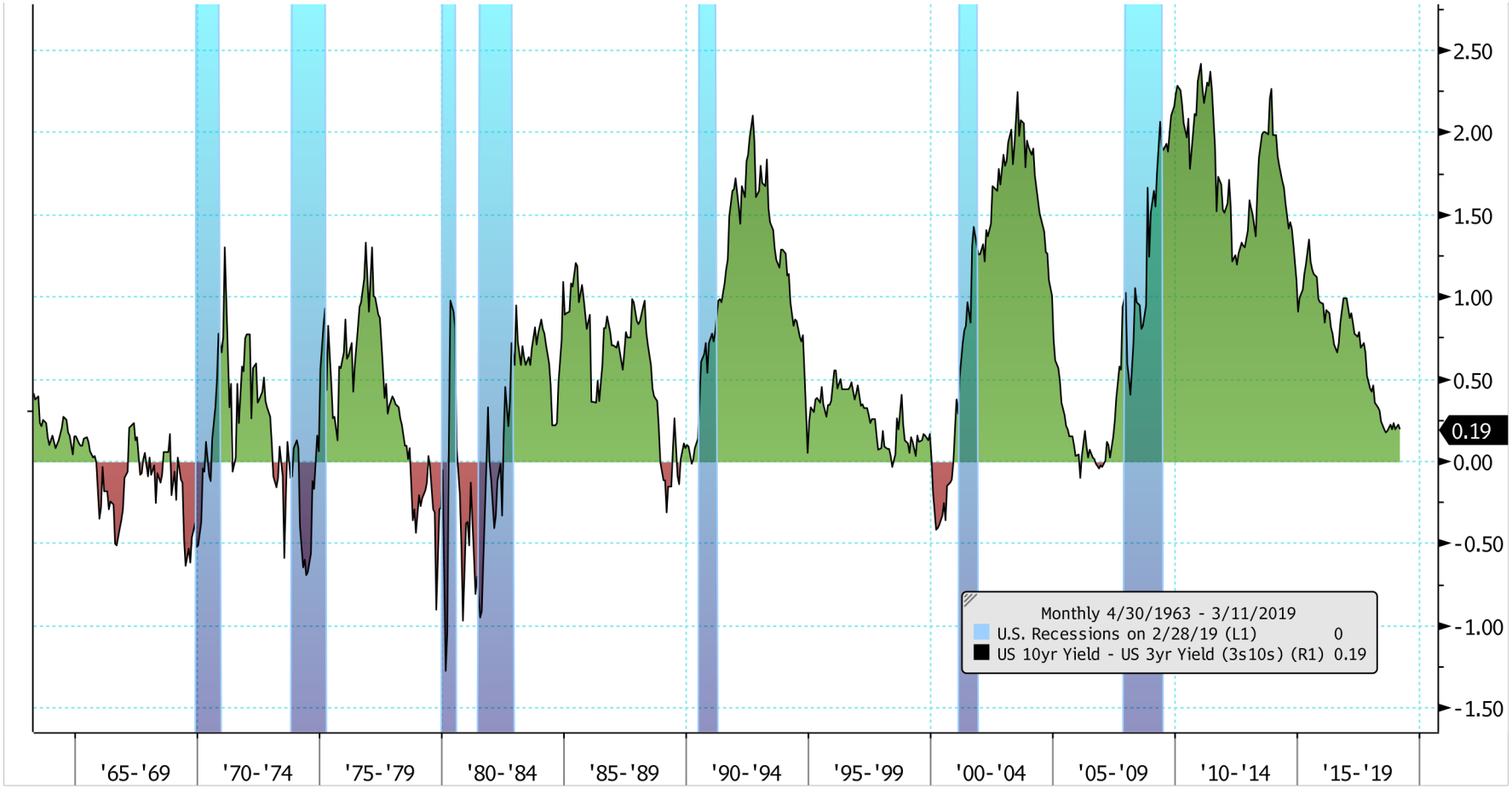


Source: Bloomberg, © Merk Investments LLC

Analysis: Since last month's report the LEI YoY rate of change decreased: from +4.3 to +3.5. The momentum has clearly slowed, but given that the YoY rate of change remains positive, history suggests a recession is unlikely to start within the next six months. Chart Framework: I'd get incrementally negative on the business cycle outlook if the LEI YoY went negative.

U.S. Yield Curve Steepness

(10yr yield – 3yr yield)

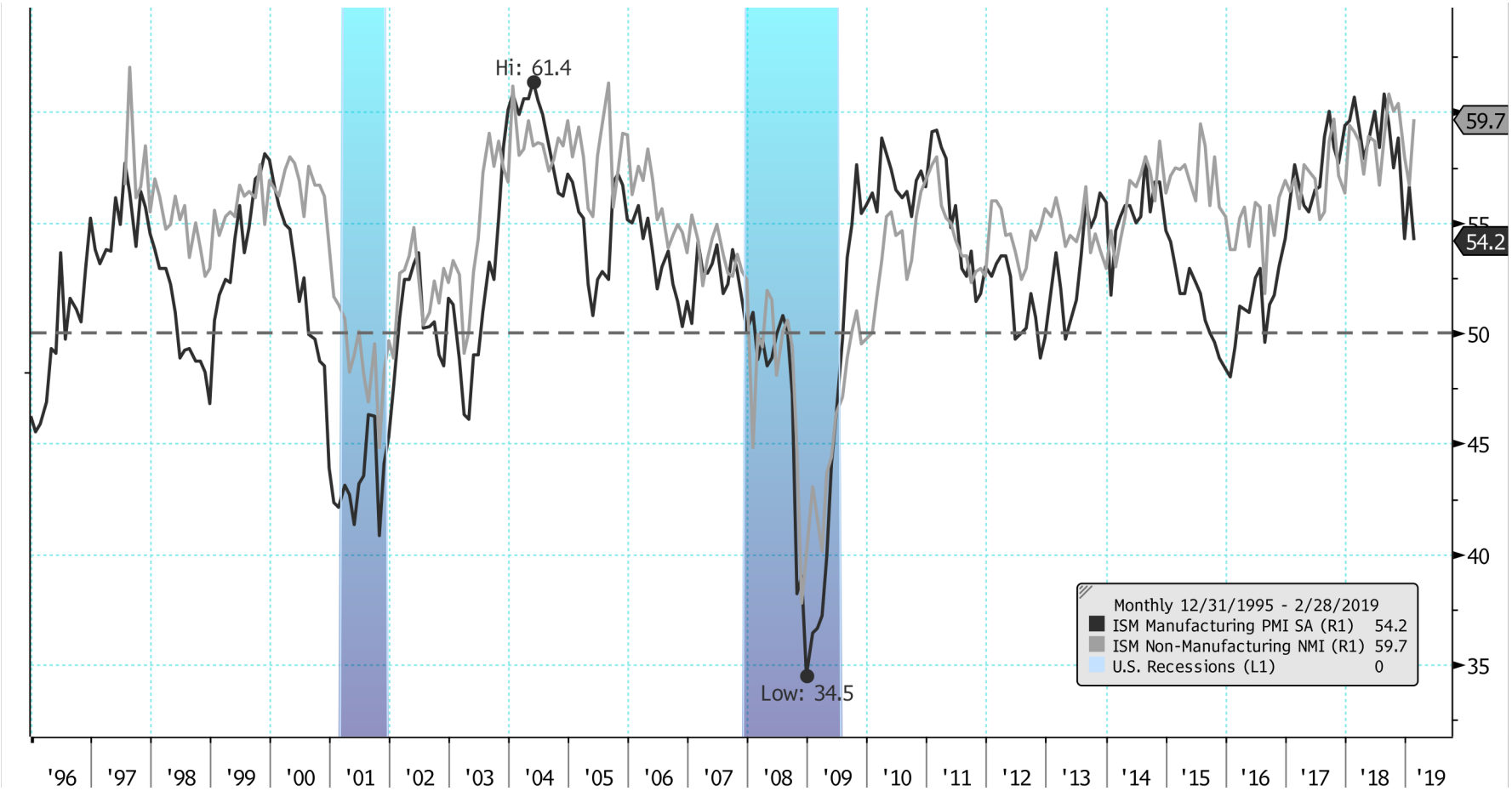


Source: Bloomberg, © Merk Investments LLC

Analysis: The yield curve is still positively sloped, meaning the 10yr yield is higher than the 3yr yield. The yield curve steepness is little changed since last month's report, but in general the flattening trend continues and the curve may invert in the coming months. Chart Framework: I'd get incrementally negative on the medium term business cycle outlook if the yield curve inverted (i.e., 3yr yield > 10yr yield).

U.S. PMIs

Manufacturing and Non-manufacturing (aka Services) PMIs (Purchasing Managers Index)

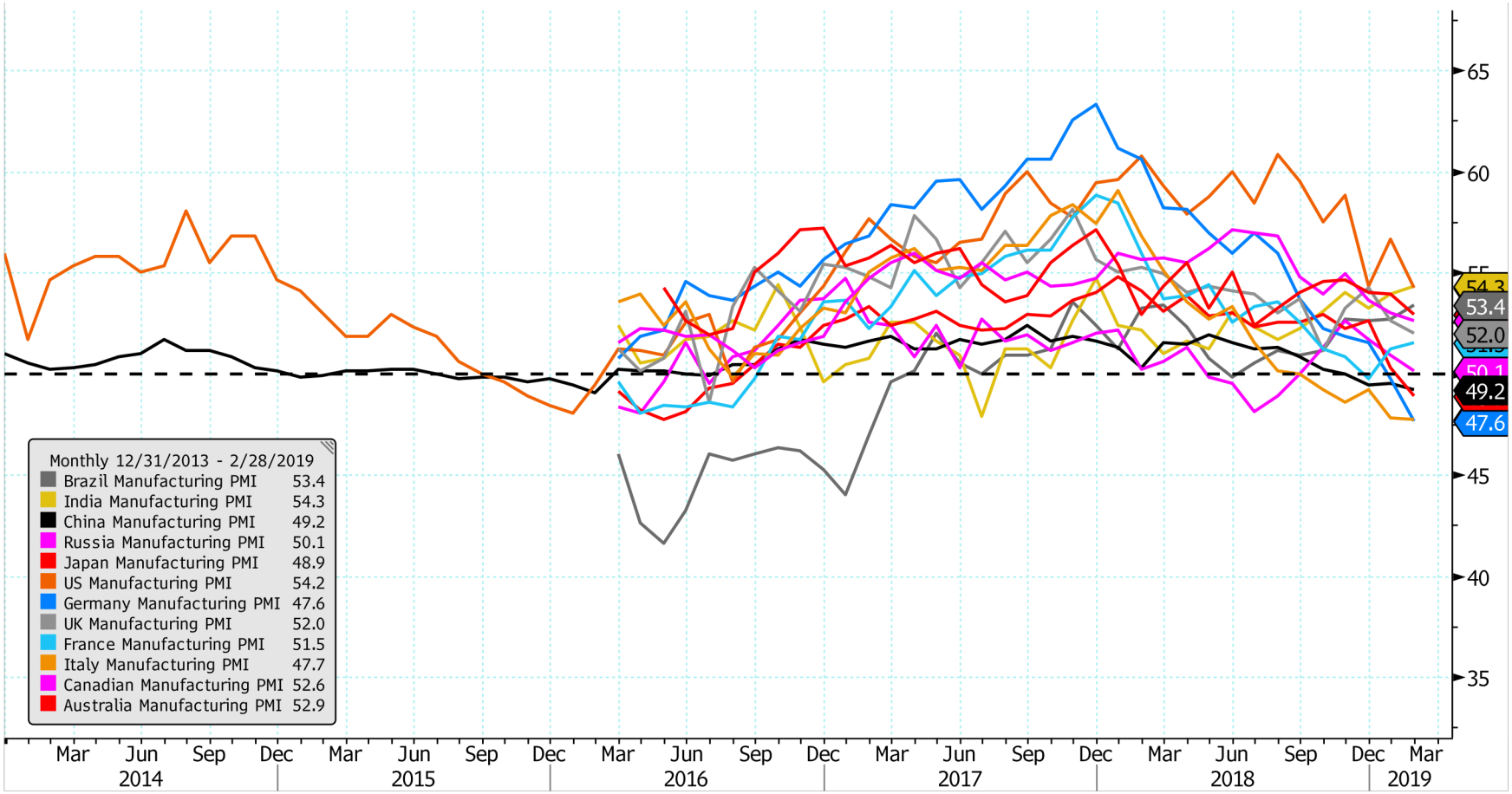


Source: Bloomberg, © Merk Investments LLC

Analysis: Since last month's report manufacturing PMI ticked down, from 56.6 to 54.2, but is still generally at a level consistent with a strong economy. Chart Framework: I'd get incrementally negative on the business cycle outlook if manufacturing PMIs fell below 50.

Global PMIs

Largest global economies' Manufacturing PMIs (Purchasing Managers Index)

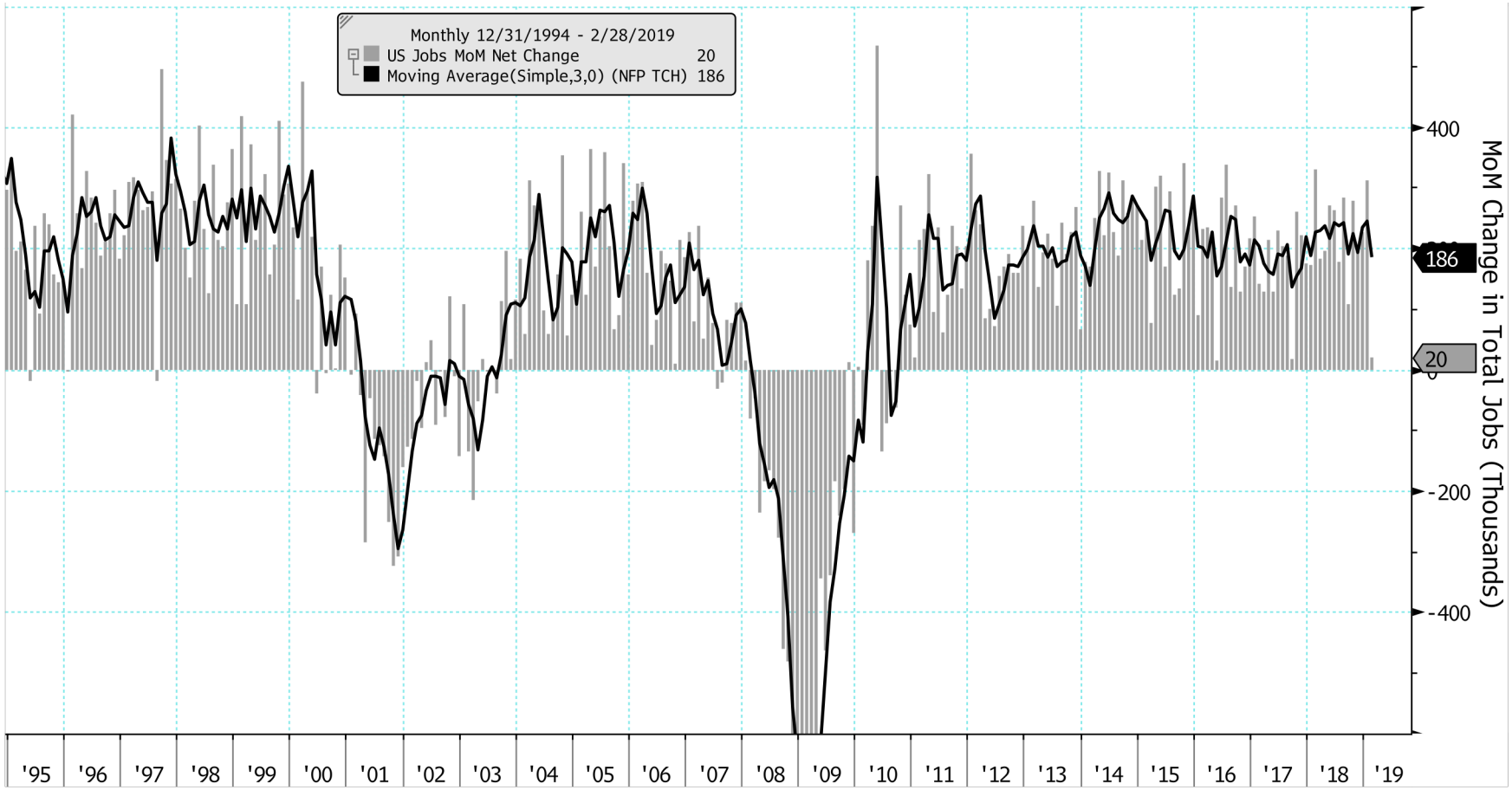


Source: Bloomberg, © Merk Investments LLC

Analysis: Global economic momentum was mostly weaker over the past month. China, Germany, and Italy remain below 50. Given my framework I'm negative on this picture. Chart Framework: To get positive on this picture all PMIs would have to be above 50.

Job Gains

The Net Monthly Change in Non-farm Payrolls (grey) with 3-month Moving Average (black)

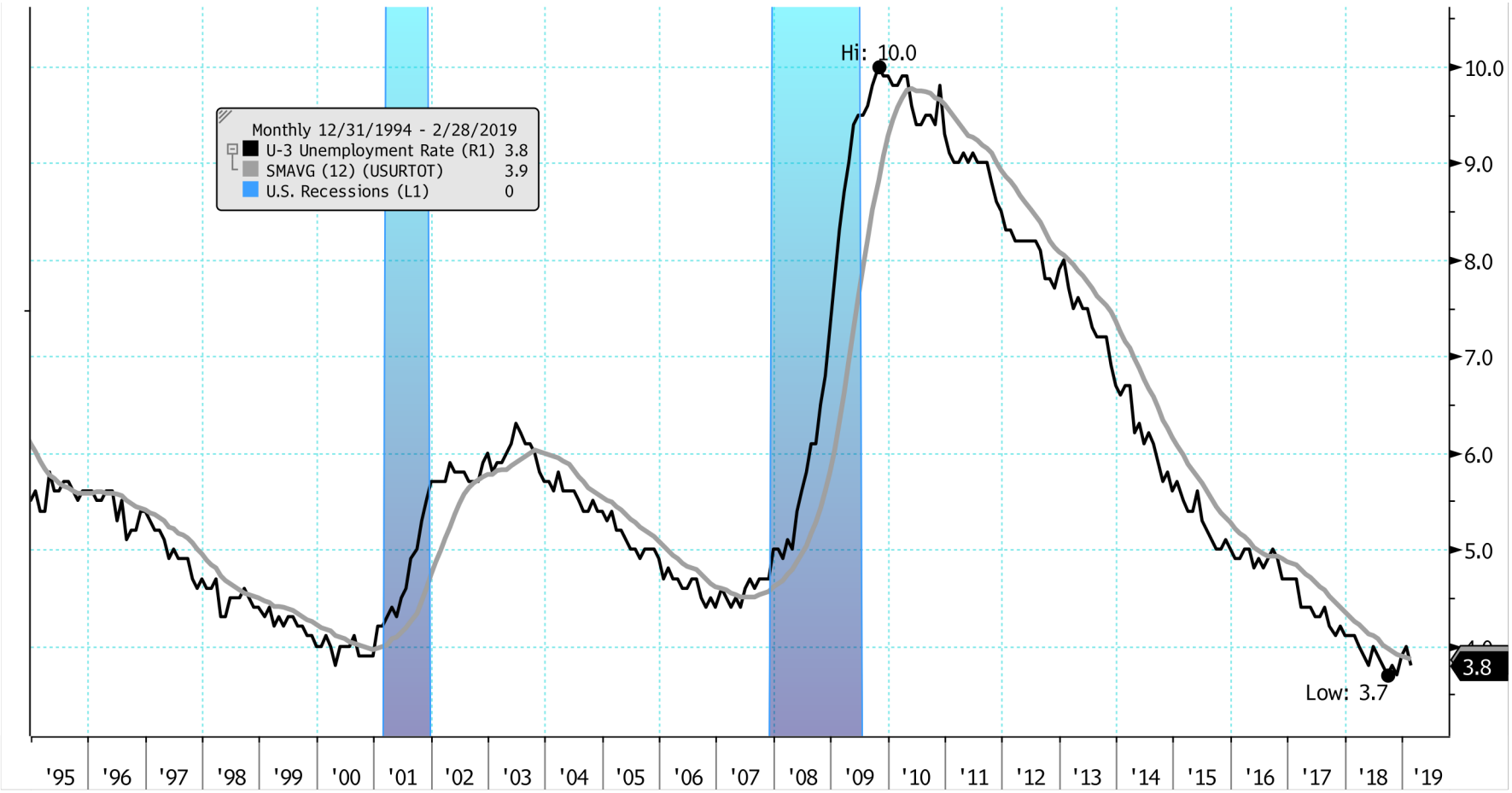


Source: Bloomberg, © Merk Investments LLC

Analysis: The 3-month moving average of the change in non-farm payrolls is 186k, likely above the pace needed to provide jobs to new entrants into the labor force. This picture currently suggests strength in the U.S. labor market. Framework: I'd get incrementally negative on this picture if the 3-month average for job gains fell below 135k.

U.S. Unemployment Momentum

U-3 Rate and U-3 12 month Moving Average

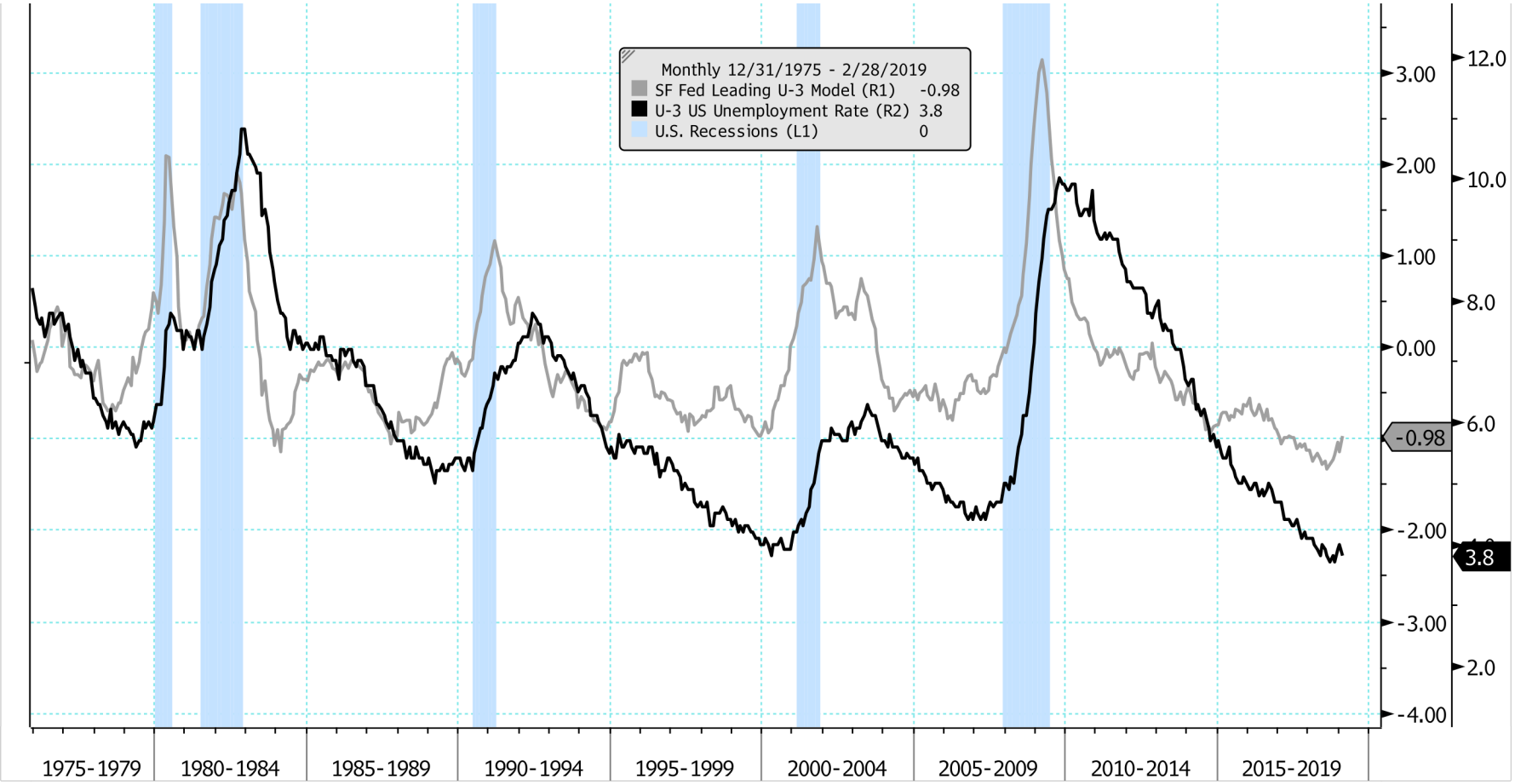


Source: Bloomberg, © Merk Investments LLC

Analysis: The unemployment rate ticked down from 4.0% to 3.8%, which is slightly below the 12-month moving average (labor force participation rate remained stable– not shown). Chart Framework: I'd get incrementally negative on the business cycle outlook if the unemployment rate moved above its 12m MA while the labor force participation rate trended lower.

SF Fed Leading Unemployment Rate (U-3) Model

Replica of San Francisco Fed Model (grey) and U-3 Unemployment Rate (black)

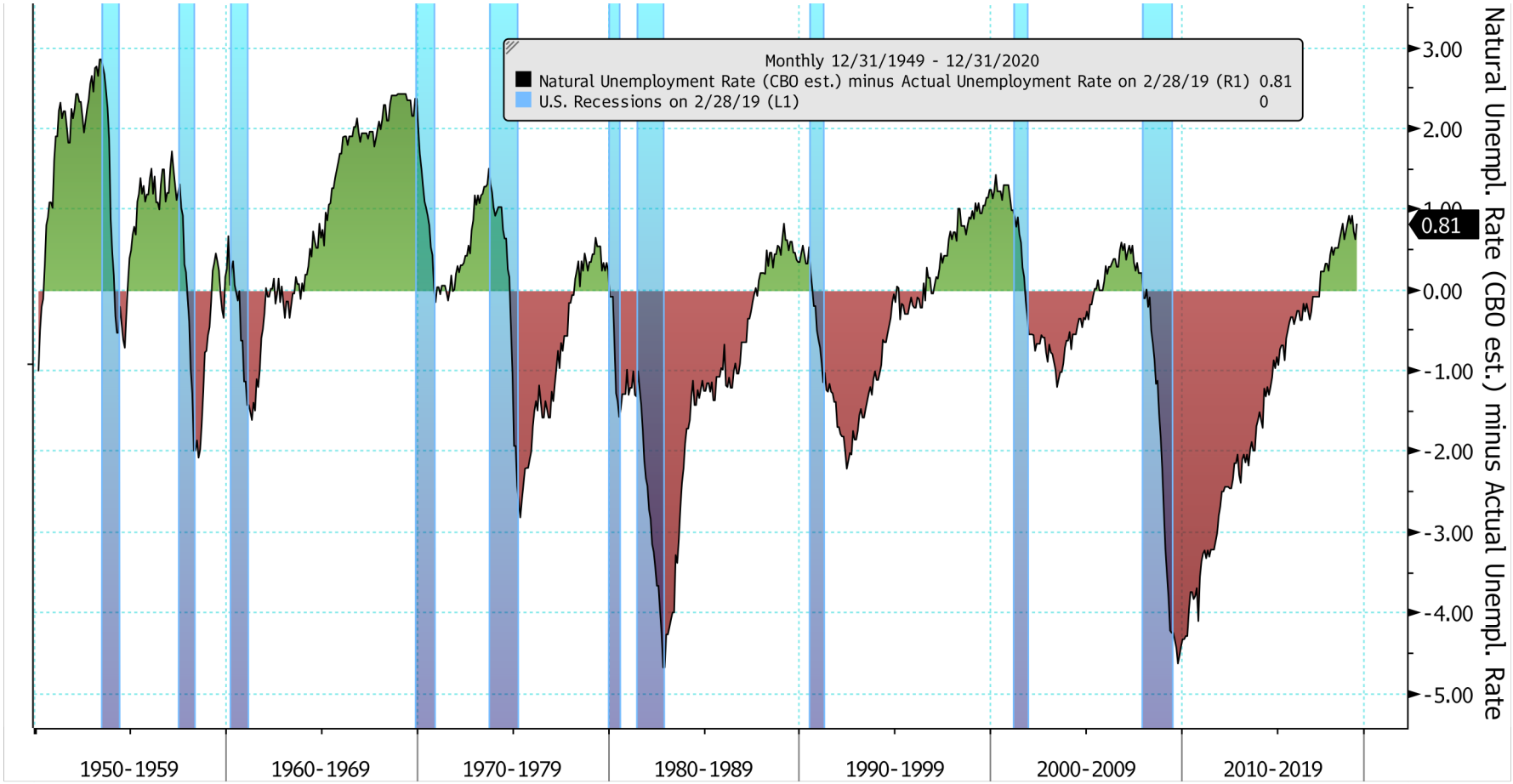


Source: Bloomberg, © Merk Investments LLC

Analysis: The SF Fed unemployment rate model (grey line) has moved higher in recent months, which warrants caution as it might signal a cyclical turning point in the labor market. Given the chart framework I'm currently negative on this picture. Chart Framework: I'd get incrementally negative on the business cycle outlook if the SF Fed model line trends higher on a YoY basis.

U.S. Labor Market Capacity Utilization

Natural Rate of Unemployment (CBO est.) – Actual Rate of Unemployment

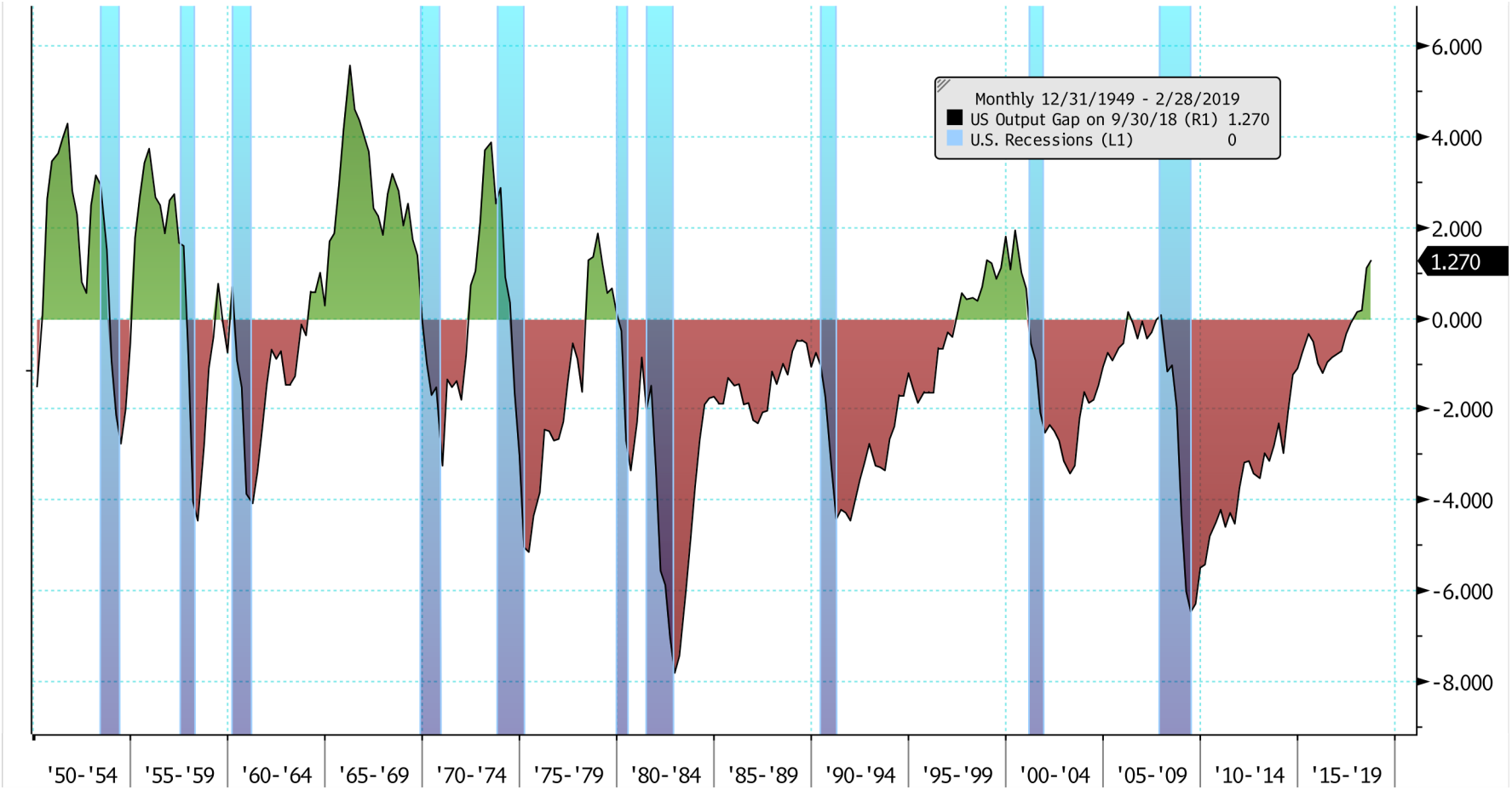


Source: Bloomberg, © Merk Investments LLC

Analysis: The estimated natural unemployment rate is higher than the current unemployment rate (4.61% – 3.8%), meaning the U.S. economy is potentially running above capacity, which likely increases the risk of a recession roughly 1-5 years out. Chart Framework: I'm currently incrementally negative on the business cycle outlook medium/longer term based on this picture, I'd get incrementally positive medium/longer term around -1.00 on the chart, which would likely only be during or after a recession.

U.S. GDP Output Gap

Actual GDP minus Potential GDP (CBO est.)

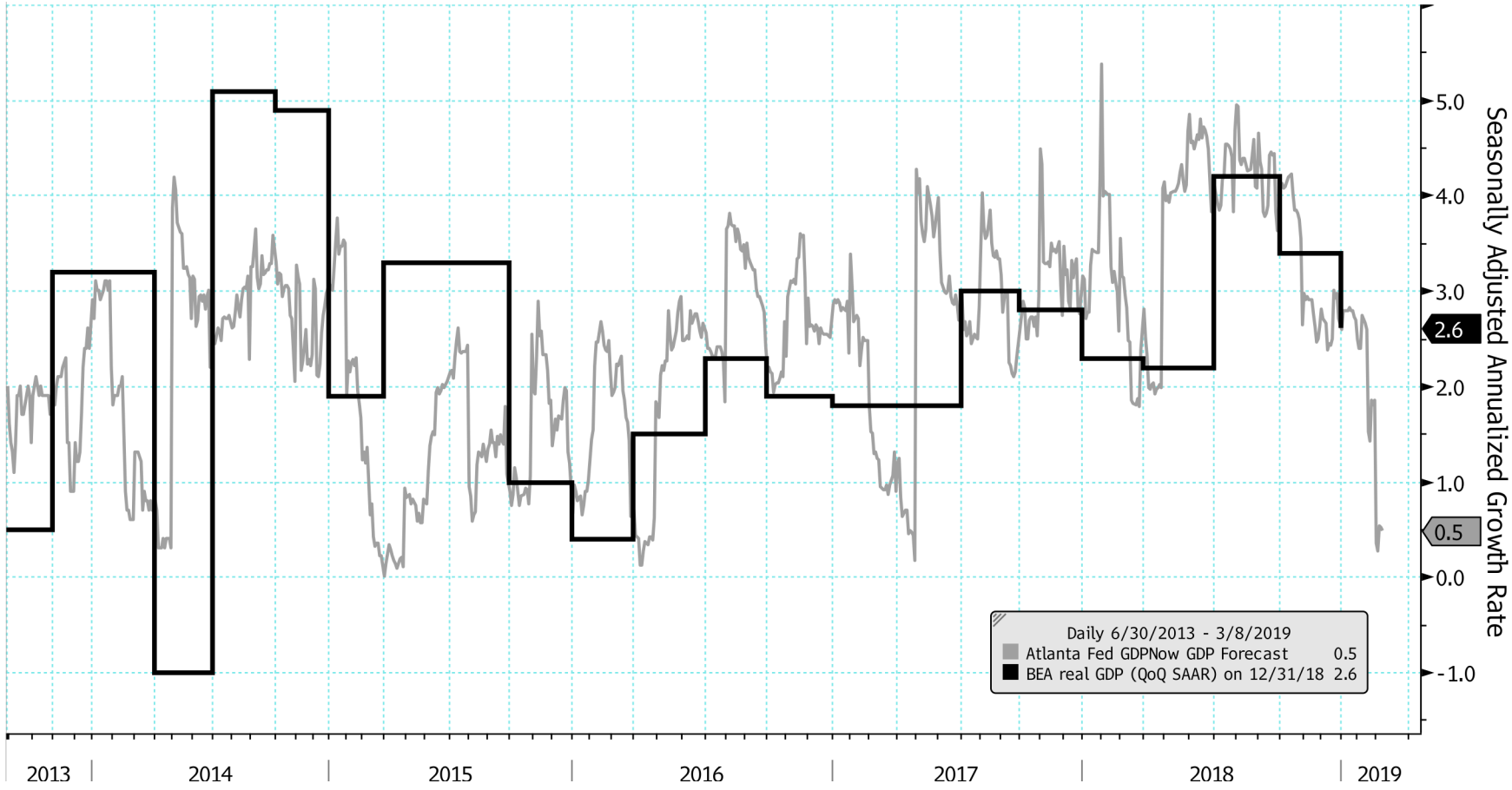


Source: Bloomberg, © Merk Investments LLC

Analysis: Actual GDP is more than potential GDP (as estimated by the CBO), which suggests the expansion may be in its final stages. I'm currently incrementally negative on the business cycle outlook medium/longer term based on this picture. Chart Framework: I'd get incrementally positive medium/longer term around -2.0 on the chart, which would likely only be during or after a recession.

Atlanta Fed GDPNow GDP Forecast

GDPNow Forecast and the official QoQ SAAR from BEA

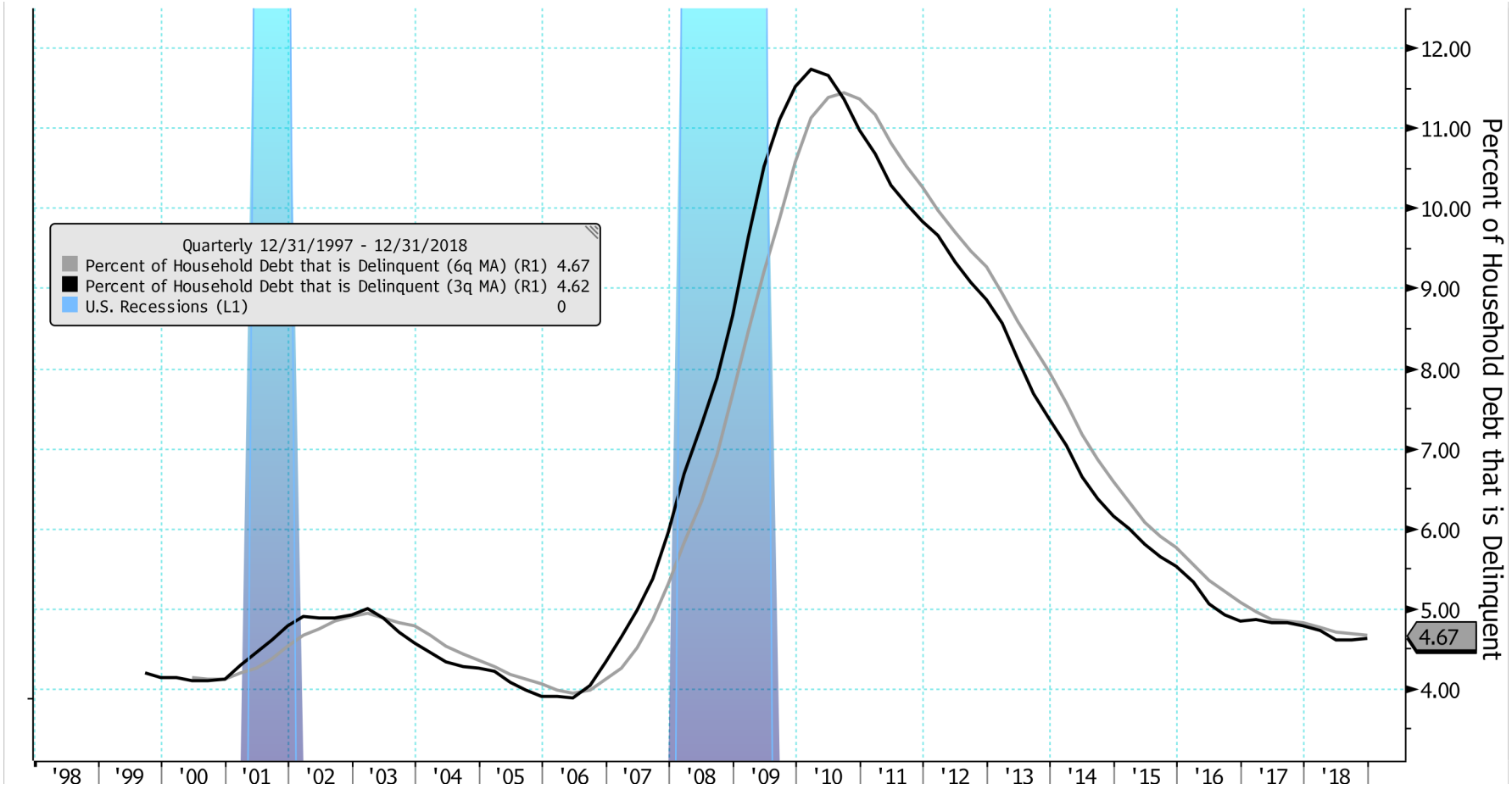


Source: Bloomberg, © Merk Investments LLC

Analysis: The initial Q4 GDP reading (black line) came in at 2.6%, the current forecast for Q1 GDP is around 0.5%.
Chart Framework: I'd get incrementally negative on the business cycle outlook if the Atlanta Fed GDP indicator fell below zero.

U.S. Household Credit Cycle

Percent of Household Debt that is Delinquent (3 quarter and 6 quarter moving averages)

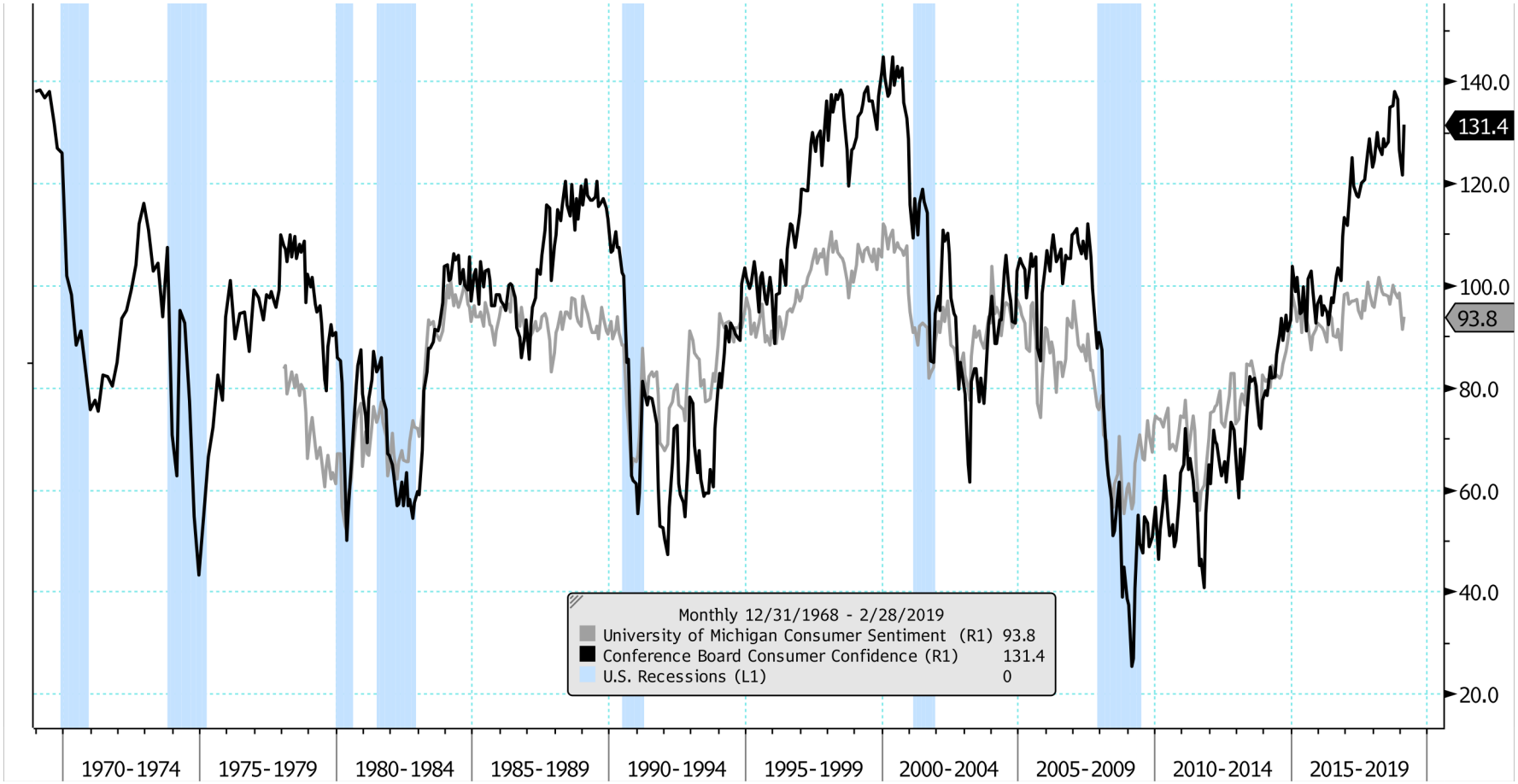


Source: Bloomberg, © Merk Investments LLC

Analysis: The Q4 2018 data showed a downtick in the household delinquency rate, which suggests the household credit cycle is still going: 3-quarter moving average (black) is below the 6-quarter moving average (grey). Chart Framework: I'd get incrementally negative on the business cycle outlook if the 3q MA crossed above the 6q MA. The Q1 2019 data comes out in late May.

U.S. Consumer Confidence

Michigan Consumer Sentiment and Conference Board Consumer Confidence

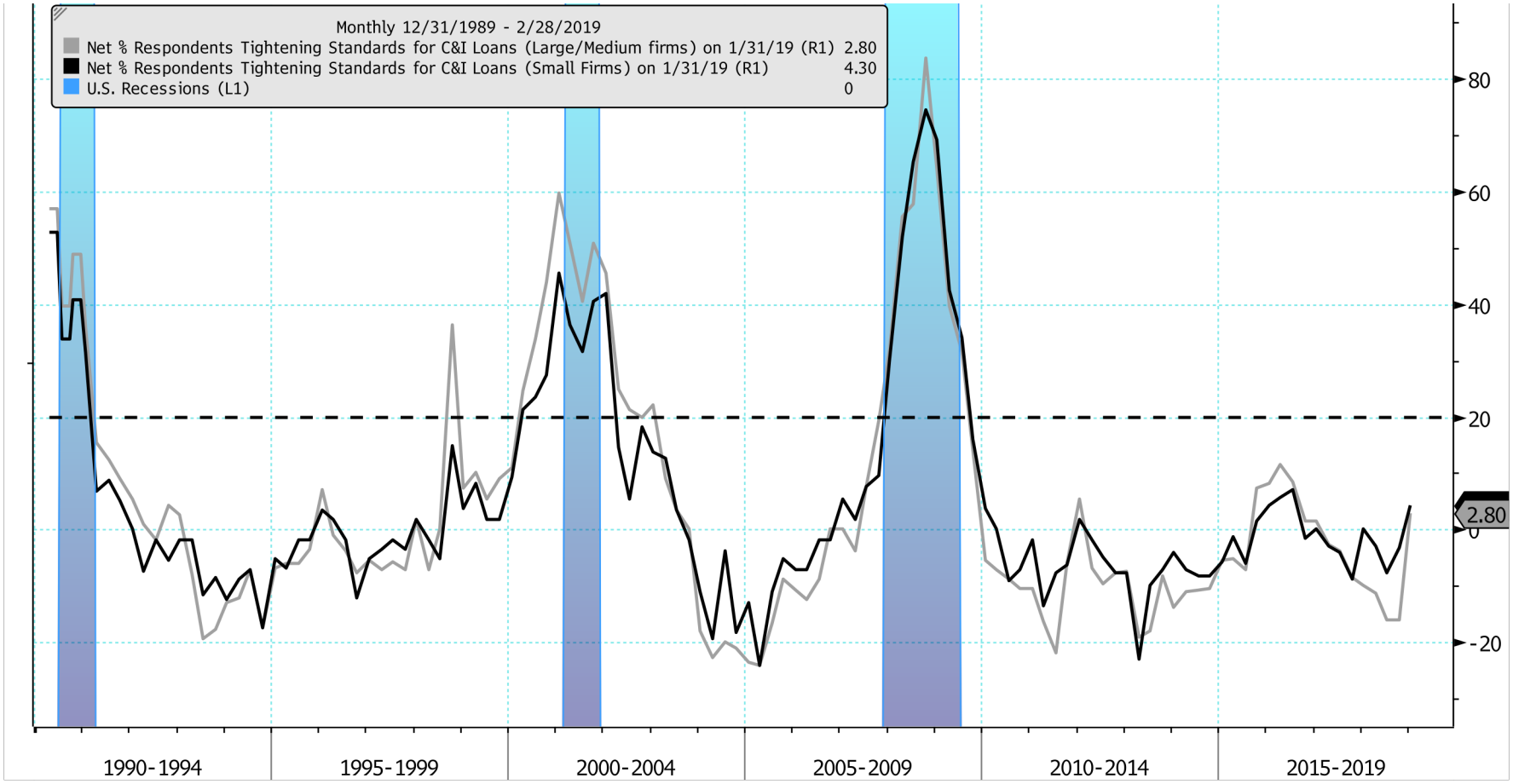


Source: Bloomberg, © Merk Investments LLC

Analysis: Both measures of consumer confidence have rebounded somewhat. Given my framework, I'm currently neutral on this picture. Chart Framework: I'd get incrementally negative on the business cycle outlook if both measures started trending lower on a YoY basis. I'd get incrementally positive if both measures are trending higher on a YoY basis.

Bank Lending Standards

Senior Loan Officer Opinion Survey (SLOOS): Net % of Respondents that are Tightening Lending Standards for Commercial and Industrial (C&I) Loans

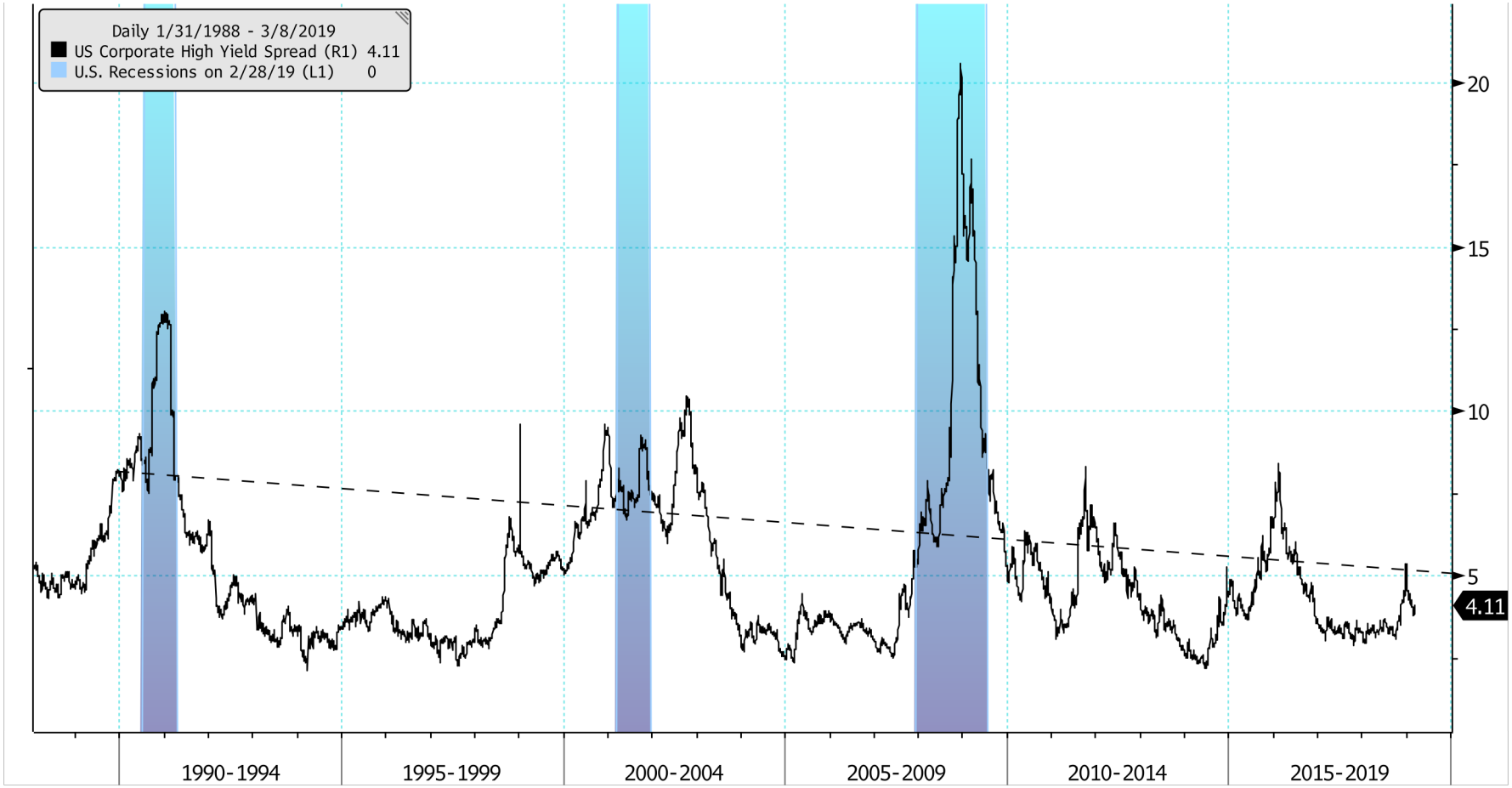


Source: Bloomberg, © Merk Investments LLC

Analysis: Data from the Fed's Senior Loan Officer Opinion Survey suggest bank lending standards generally continue to be supportive of economic activity. Chart Framework: I'd get incrementally negative on the business cycle outlook if 20% of respondents report tightening lending standards.

High Yield Spread

US High Yield Spread with Trend Line

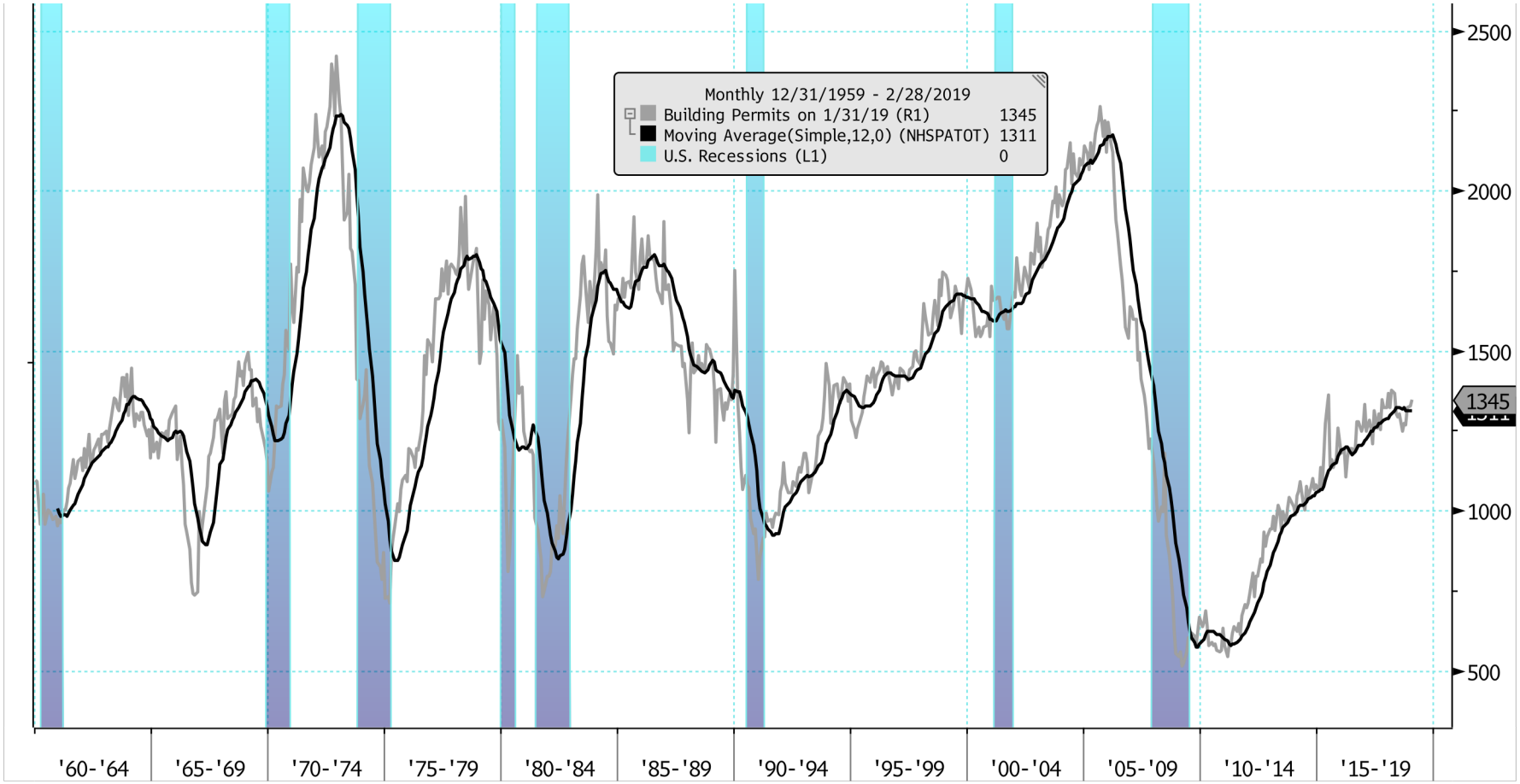


Source: Bloomberg, © Merk Investments LLC

Analysis: The high yield credit spread has come down since last month's report, but remains above its earlier multi-year range (from 2.90 to 3.75). Chart Framework: I'd get incrementally negative on the business cycle outlook if the spread moves above 5.

U.S. Building Permits

U.S. Building Permits and 12-month Moving Average



Source: Bloomberg, © Merk Investments LLC

Analysis: Building permits, historically a long leading indicator, are starting to look like they might be topping for the cycle- another potential late cycle indictor if they begin to trend lower in earnest. Higher mortgage rates have likely contributed to the slowing demand for housing. Framework: I would get negative if the 12-month moving average is trending down for several consecutive months.

Checklist

Page	Chart	Time Horizon	Per Framework Outlook on Business Cycle
3	LEIs	Short/Medium Term	Positive
4	Yield Curve	Medium Term	Positive
5	U.S. PMIs	Short/Medium Term	Positive
6	Global PMIs	Short/Medium Term	Negative
7	Job Gains	Medium Term	Positive
8	U-3 v 12m MA	Medium Term	Neutral/Positive
9	SF Fed U-3	Medium Term	Neutral/Negative
10	Labor Force Capacity Util.	Medium/Longer Term	Negative
11	Output Gap	Medium/Longer Term	Negative
12	GDP Forecast	Short Term	Neutral/Positive
13	Household Credit	Medium Term	Neutral/Positive
14	U.S. Consumer	Short/Medium Term	Neutral
15	Lending Standards	Medium Term	Positive
16	High Yield Spread	Short/Medium Term	Neutral/Positive
17	U.S. Building Permits	Medium/Longer Term	Neutral
		Time Horizon	Overall Outlook on Business Cycle
		Short Term (<6 months)	Neutral/Positive with high uncertainty
		Medium/Longer Term (6m - 5 years)	Neutral/Negative with high uncertainty

Conclusion/Thoughts

While some business cycle indicators continue to turn more negative, my base-case view remains that the U.S. economic expansion will likely continue over the next few months, and in general until further notice.

There are two key indicators that are helping to keep me positive on the economy: the LEI Index still looks reasonably strong, and the yield curve still has not yet inverted. It's worth keeping in mind that yield curve inversion is historically a medium term indicator (6-24 months) with respect to the beginning of a subsequent recession.

In terms of negatives: I'm primarily concerned about the weakness in the global economy, China and Germany specifically, where the manufacturing PMIs are below 50. Also, recession risk over roughly the 1-5 year period is likely elevated- with measures suggesting the economy is potentially operating above capacity, specifically with respect to the output gap and labor force capacity utilization.

Even given some of the late cycle indications, some slack seems to remain in the labor market, which suggests that the economic cycle can continue for a little while longer. Specifically, the labor force participation rate continues to trend higher and people continue to come off of the disability rolls. Encouragingly, the U-6 underemployment rate hit a new cycle low with last Friday's jobs report.

To reiterate, taken together I think the U.S. business cycle picture is still positive, although there is greater uncertainty and we have clearly seen a slowdown in growth momentum. On balance, based on the charts and frameworks presented (which inevitably may not capture all possible risk factors in real-time), it seems more likely than not that the U.S. economic expansion continues. All of the presented charts and concepts are somewhat inter-related, as is the economy in general, so the idea is to have some different data points to cross-reference- in my view no one indicator can be looked at in isolation.

-Nick Reece, CFA

To discuss investment advisory services click here.

Disclosure

This report was prepared by Merk Investments LLC, and reflects the current opinion of the authors. It is based upon sources and data believed to be accurate and reliable. Merk Investments LLC makes no representation regarding the advisability of investing in the products herein. Opinions and forward-looking statements expressed are subject to change without notice. This information does not constitute investment advice and is not intended as an endorsement of any specific investment. The information contained herein is general in nature and is provided solely for educational and informational purposes. The information provided does not constitute legal, financial or tax advice. You should obtain advice specific to your circumstances from your own legal, financial and tax advisors. Past performance is no guarantee of future results.

* * *

Published by Merk Investments LLC