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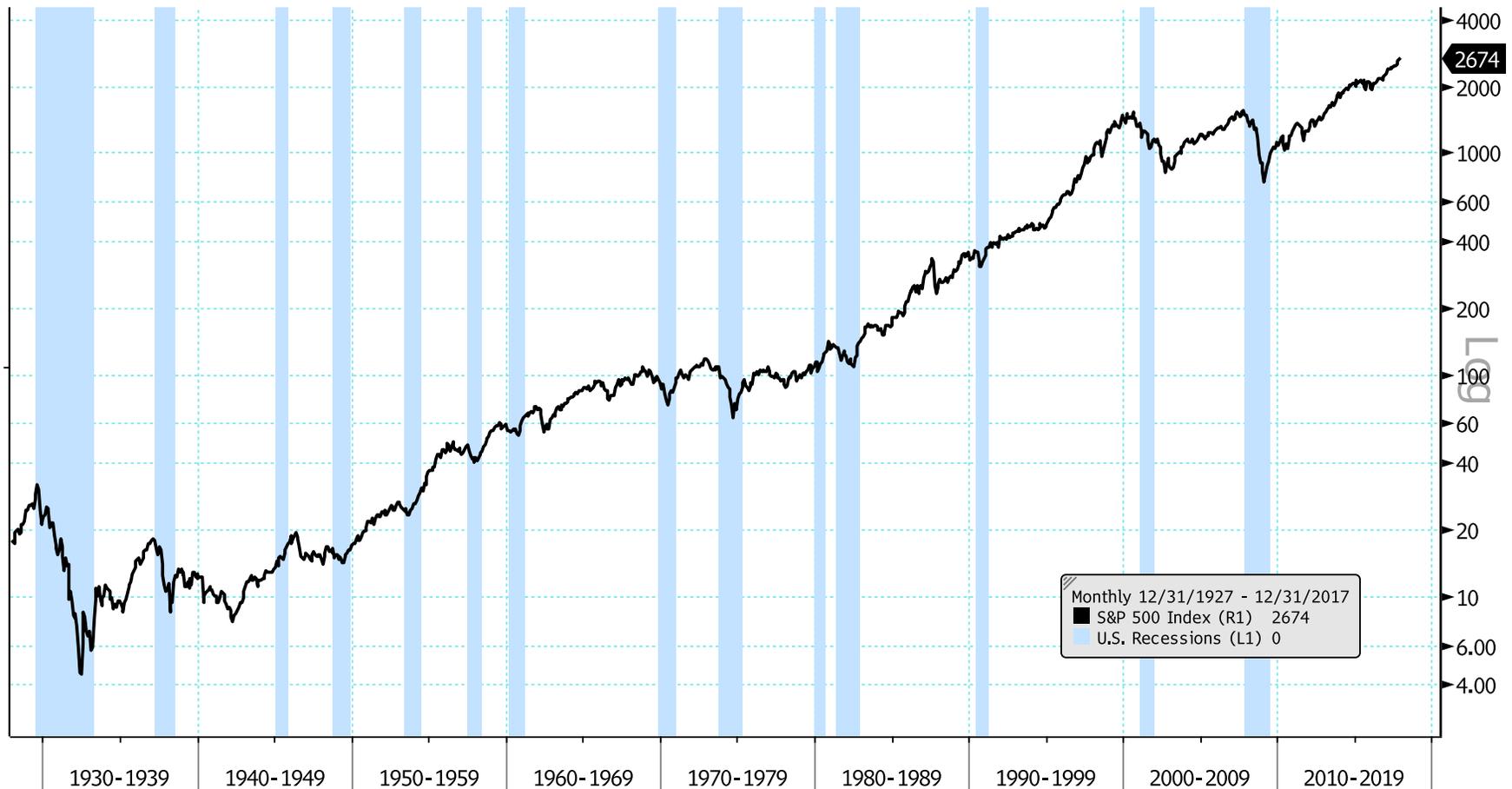
U.S. Business Cycle Report

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Why is the Business Cycle Important?

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

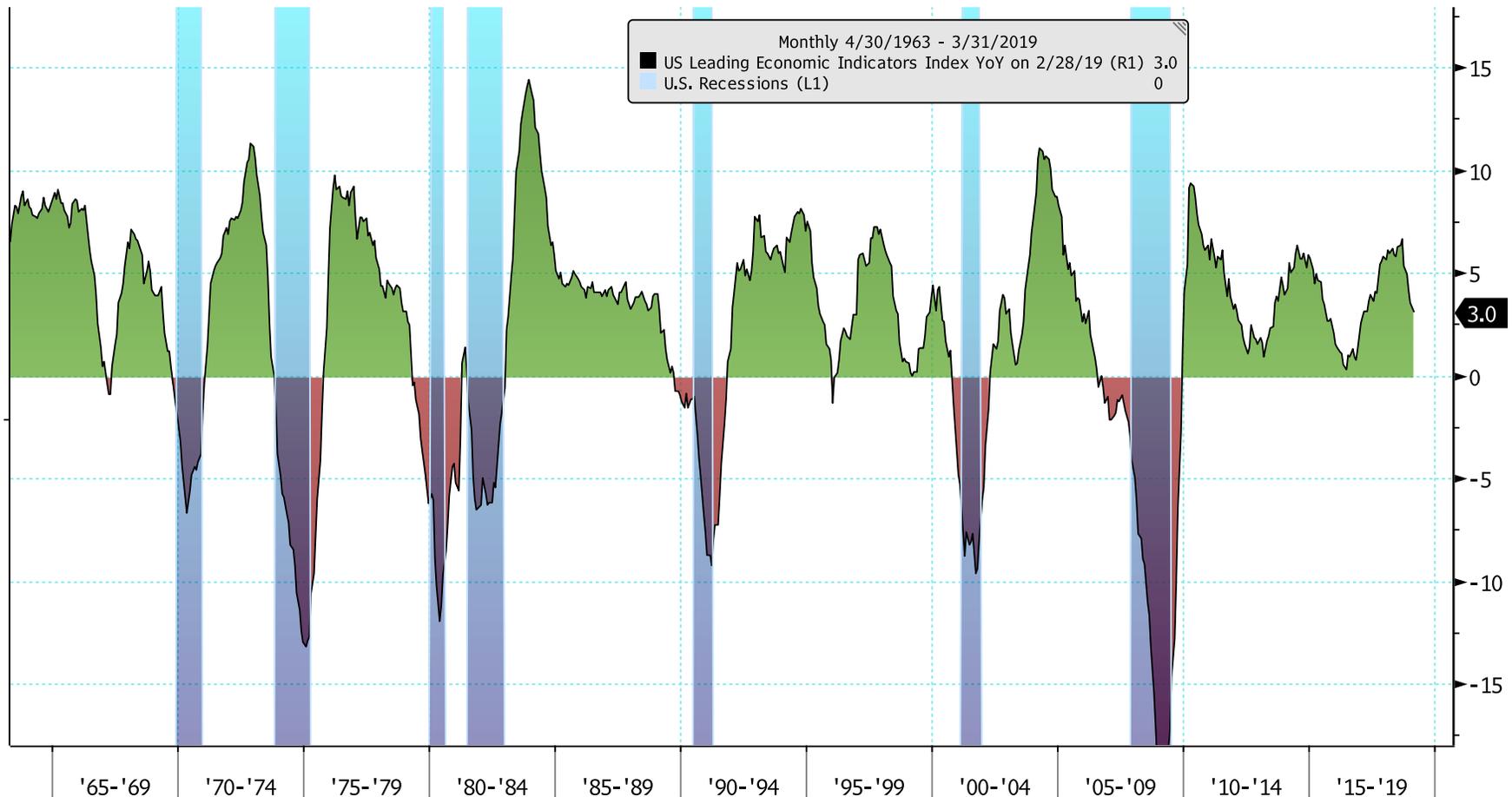


Source: Bloomberg, © Merk Investments LLC

*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

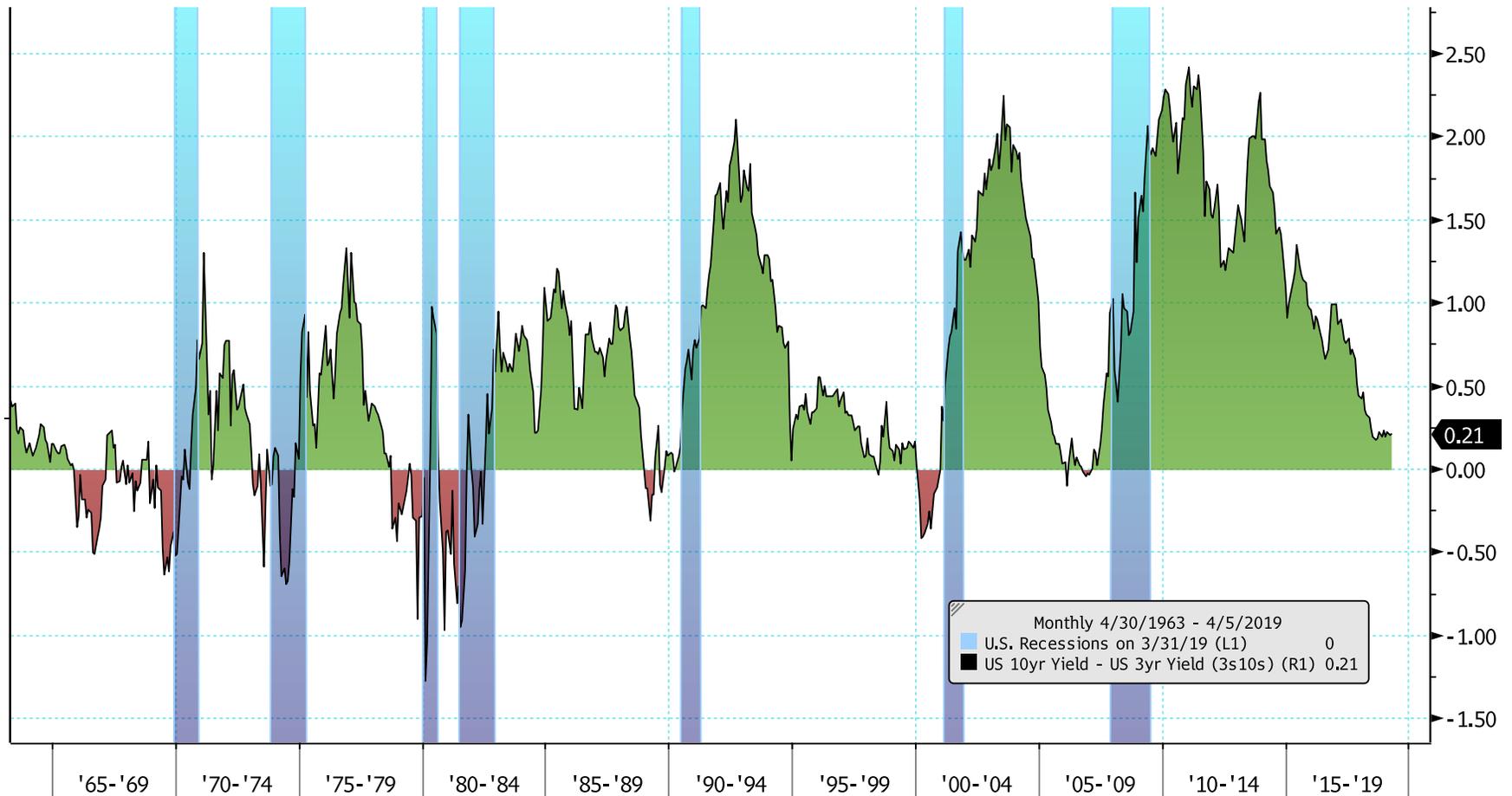
YoY rate of change of the Conference Board's LEI Index



Source: Bloomberg, © Merk Investments LLC

Analysis: Since last month's report the LEI YoY rate of change decreased: from +3.5 to +3.0. 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)

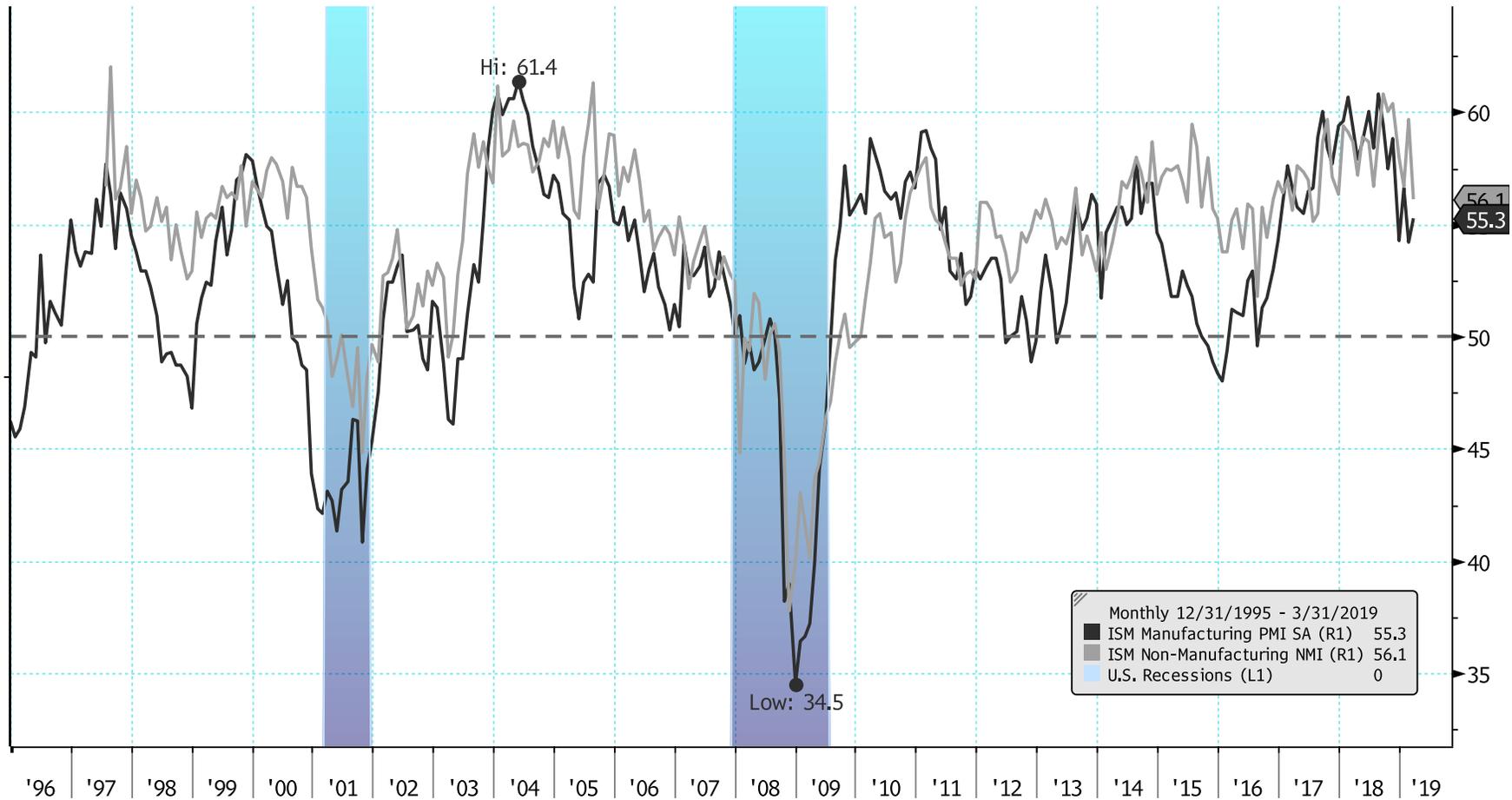


Source: Bloomberg, © Merk Investments LLC

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 3s10s 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)

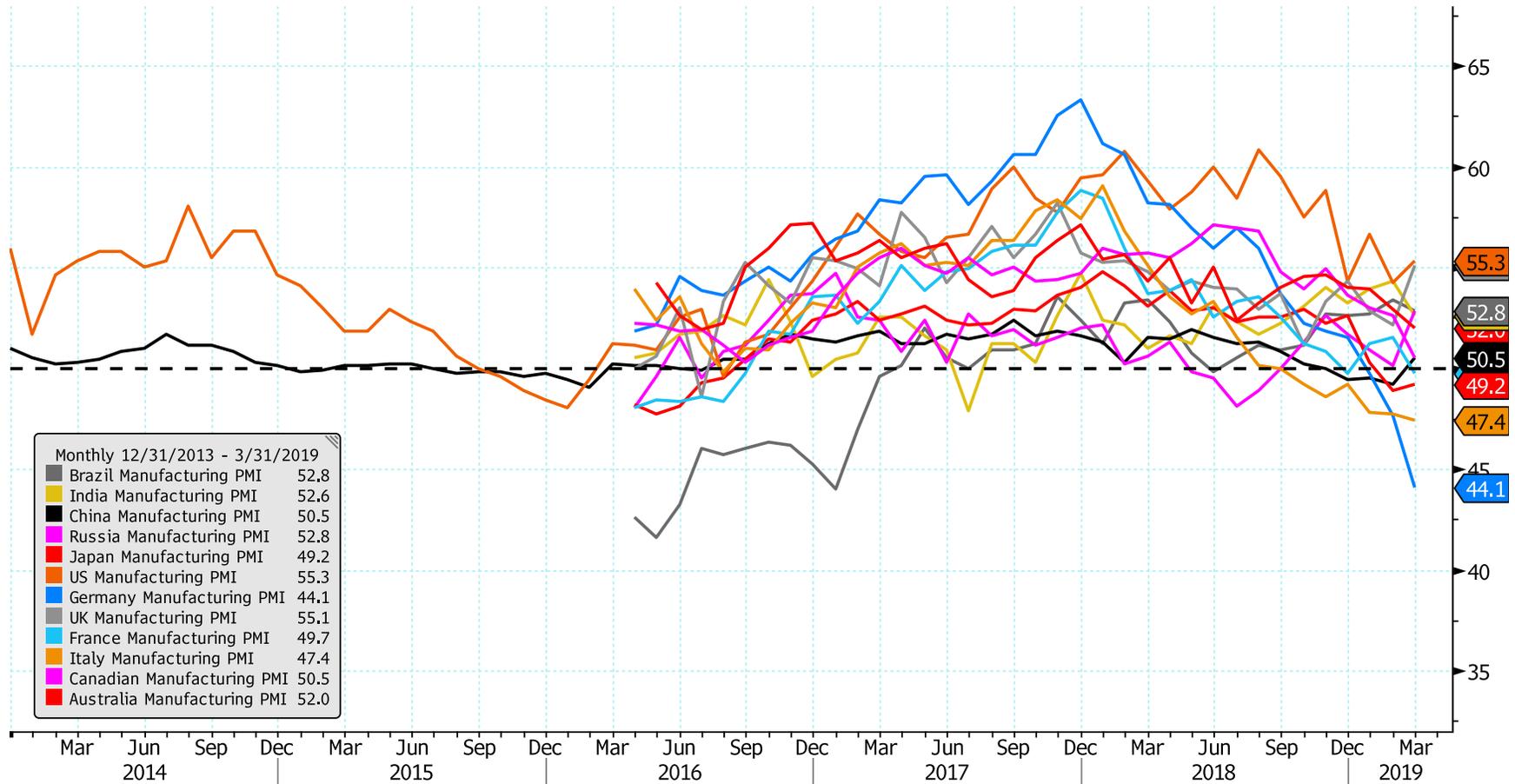


Source: Bloomberg, © Merk Investments LLC

Analysis: Since last month's report manufacturing PMI ticked up, from 54.2 to 55.3 and 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)

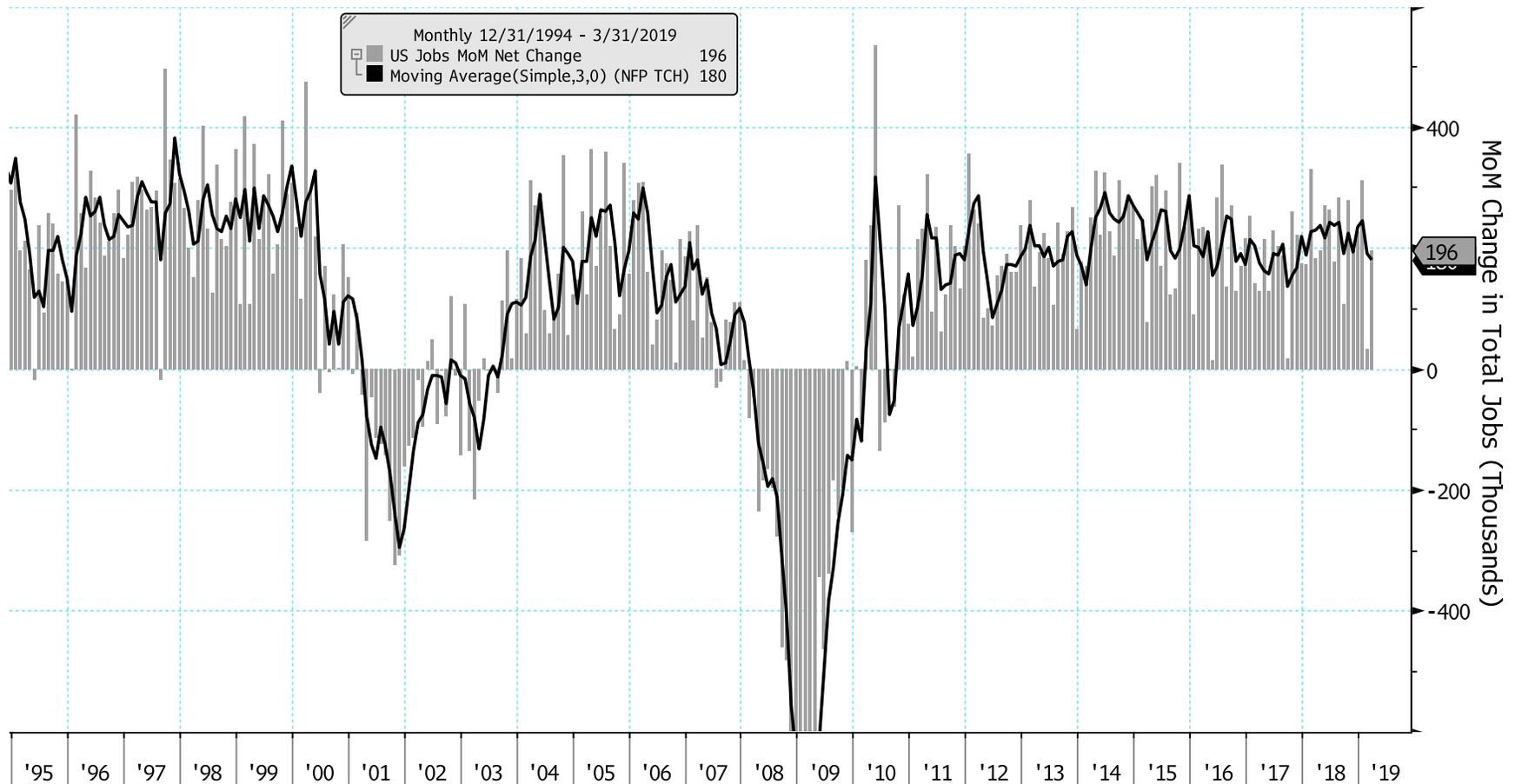


Source: Bloomberg, © Merk Investments LLC

Analysis: Global economic momentum was mixed over the past month. Notably China's manufacturing PMI moved back above 50. Germany fell to the low 40s, which is concerning- and Italy and Japan 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)

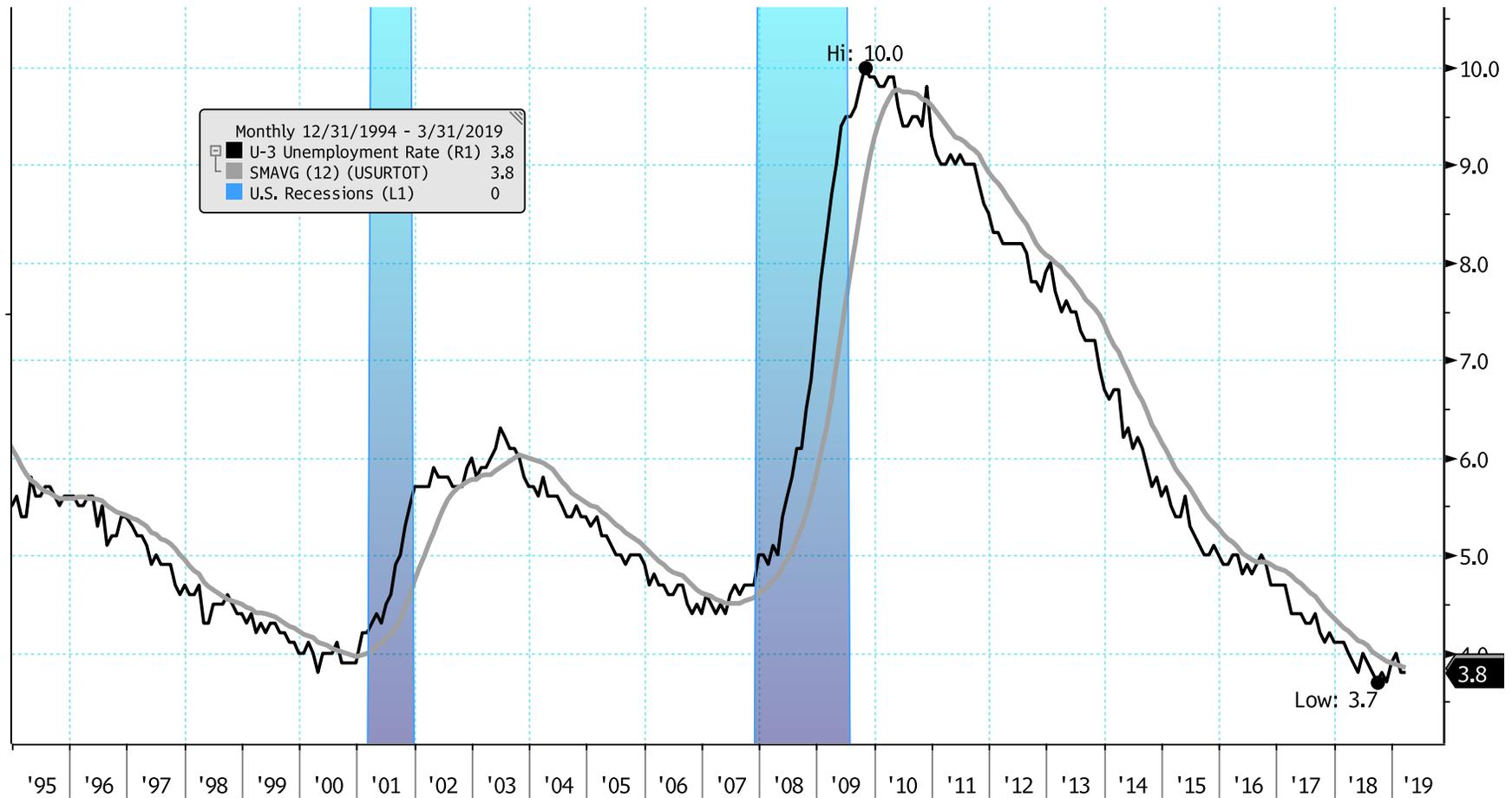


Source: Bloomberg, © Merk Investments LLC

Analysis: The 3-month moving average of the change in non-farm payrolls is 180k, 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

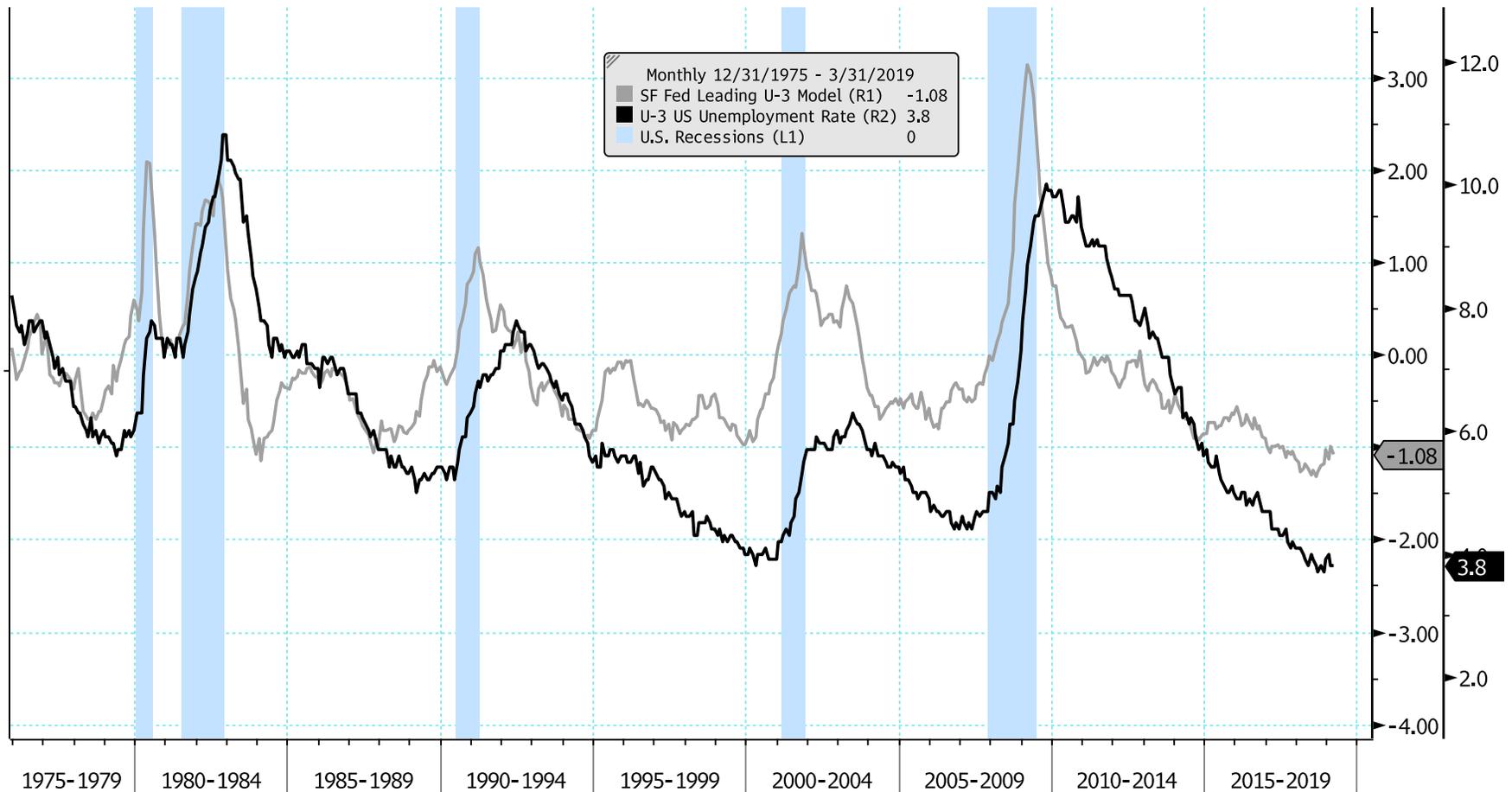
U-3 Rate and U-3 12 month Moving Average



Source: Bloomberg, © Merk Investments LLC

Analysis: The unemployment rate remained stable at 3.8%, which is slightly below the 12-month moving average (labor force participation rate ticked down– 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)

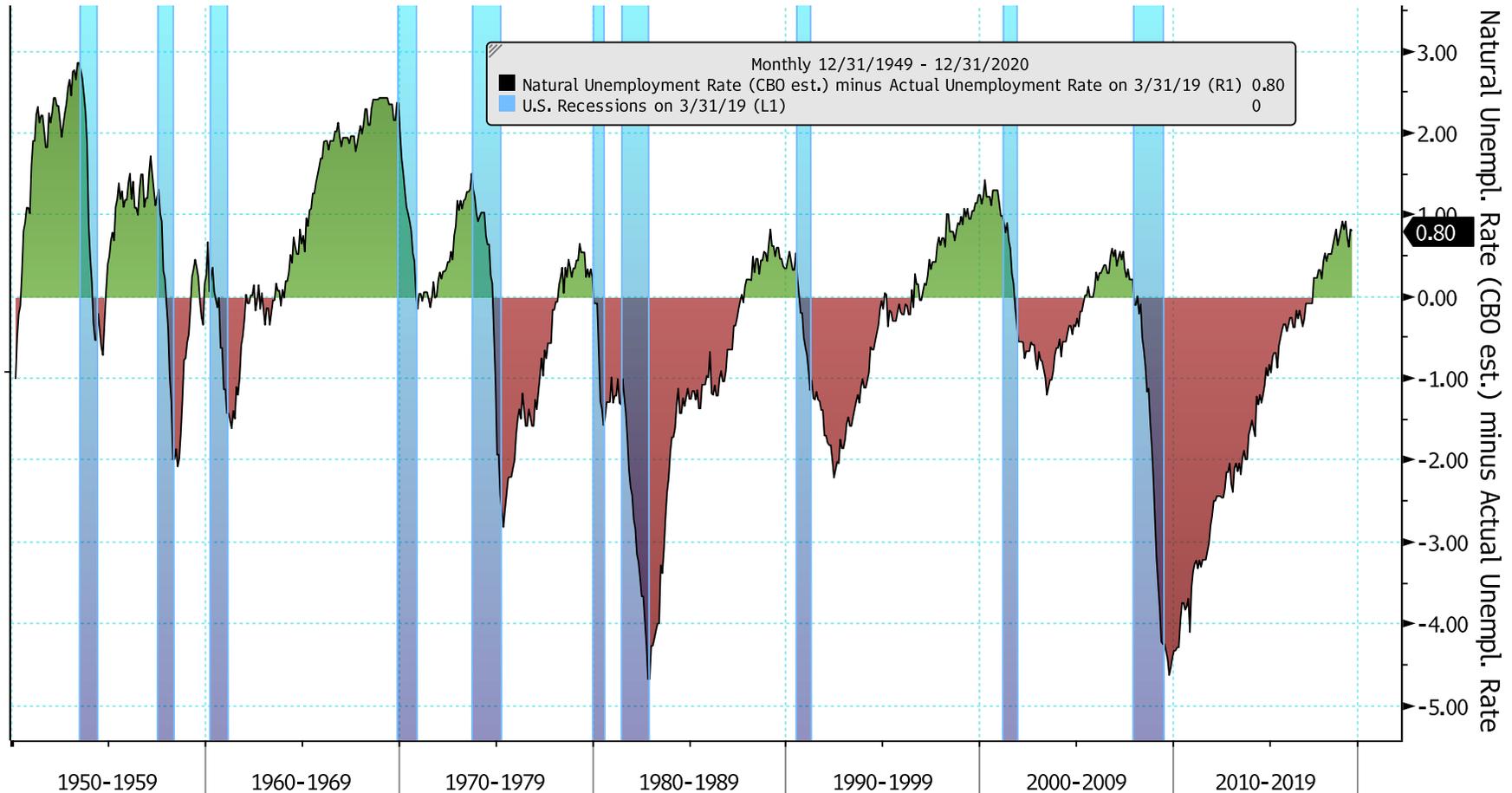


Source: Bloomberg, © Merk Investments LLC

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 my chart framework I'm currently negative on this picture. Chart Framework: I'd get incrementally positive on the business cycle outlook if the SF Fed model line started trending lower again on a YoY basis.

U.S. Labor Market Capacity Utilization

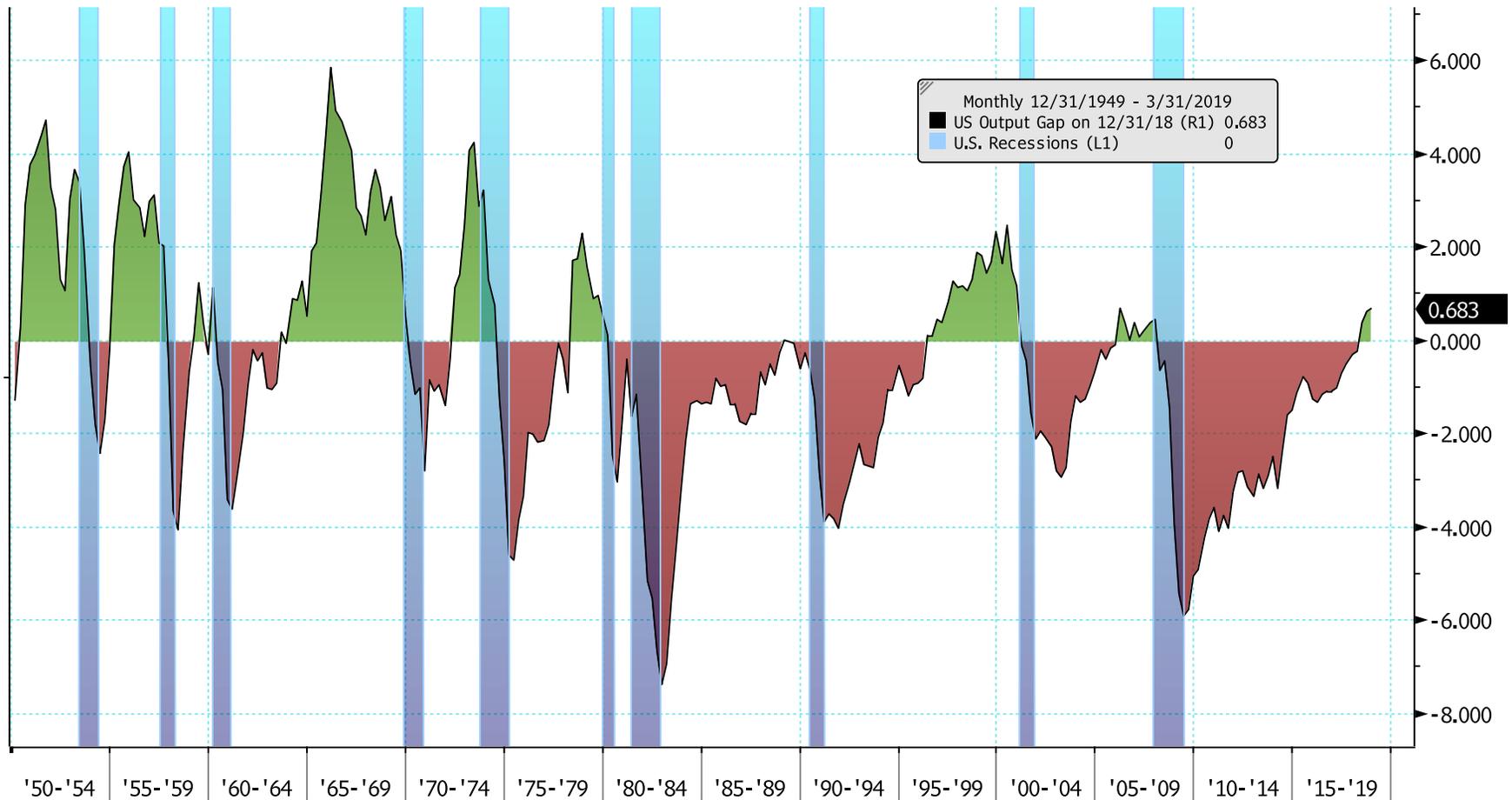
Natural Rate of Unemployment (CBO est.) – Actual Rate of Unemployment



Source: Bloomberg, © Merk Investments LLC

Analysis: The estimated natural rate of unemployment is higher than the current unemployment rate (4.6% – 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.

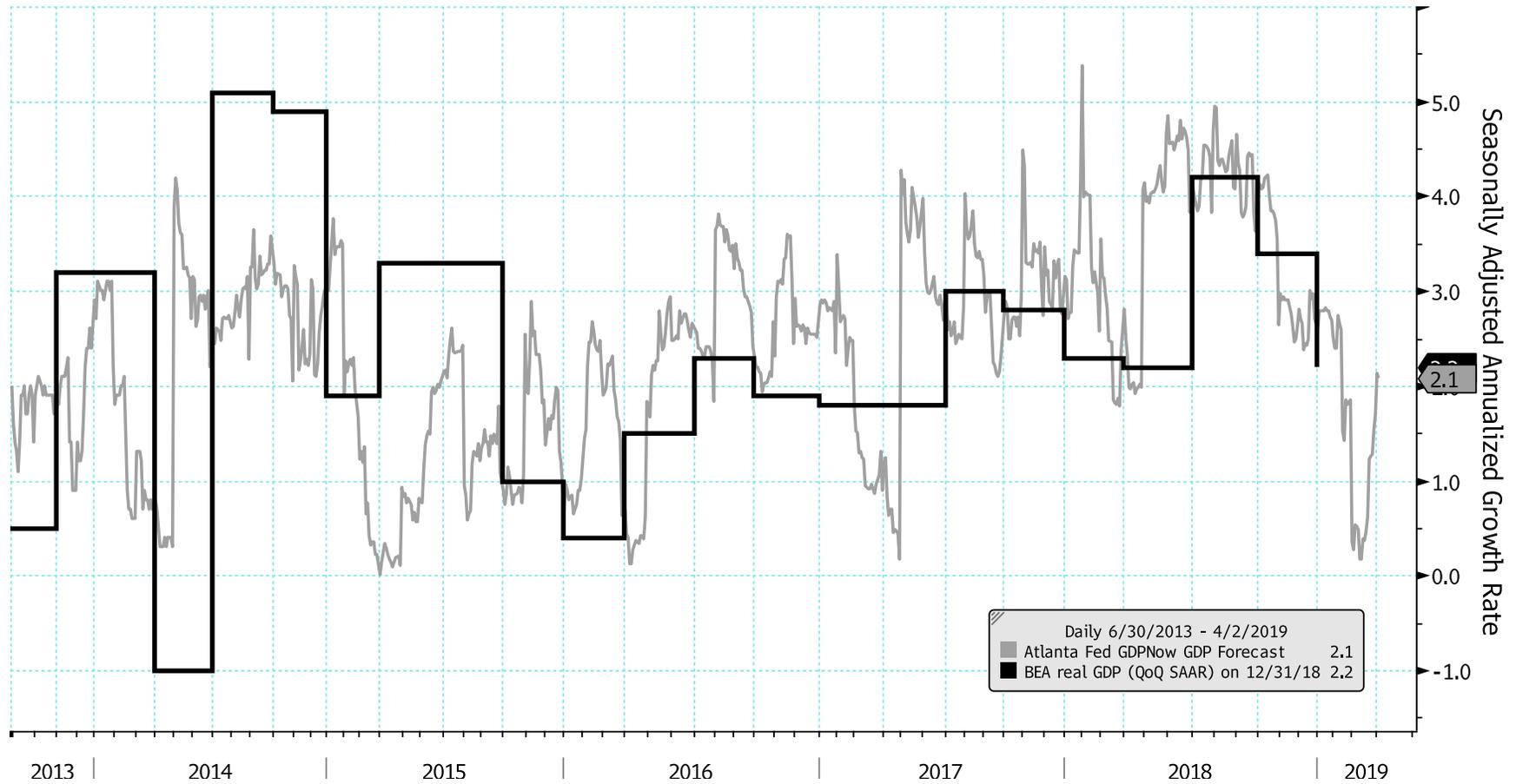
U.S. GDP Output Gap Actual GDP minus Potential GDP (CBO est.)



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

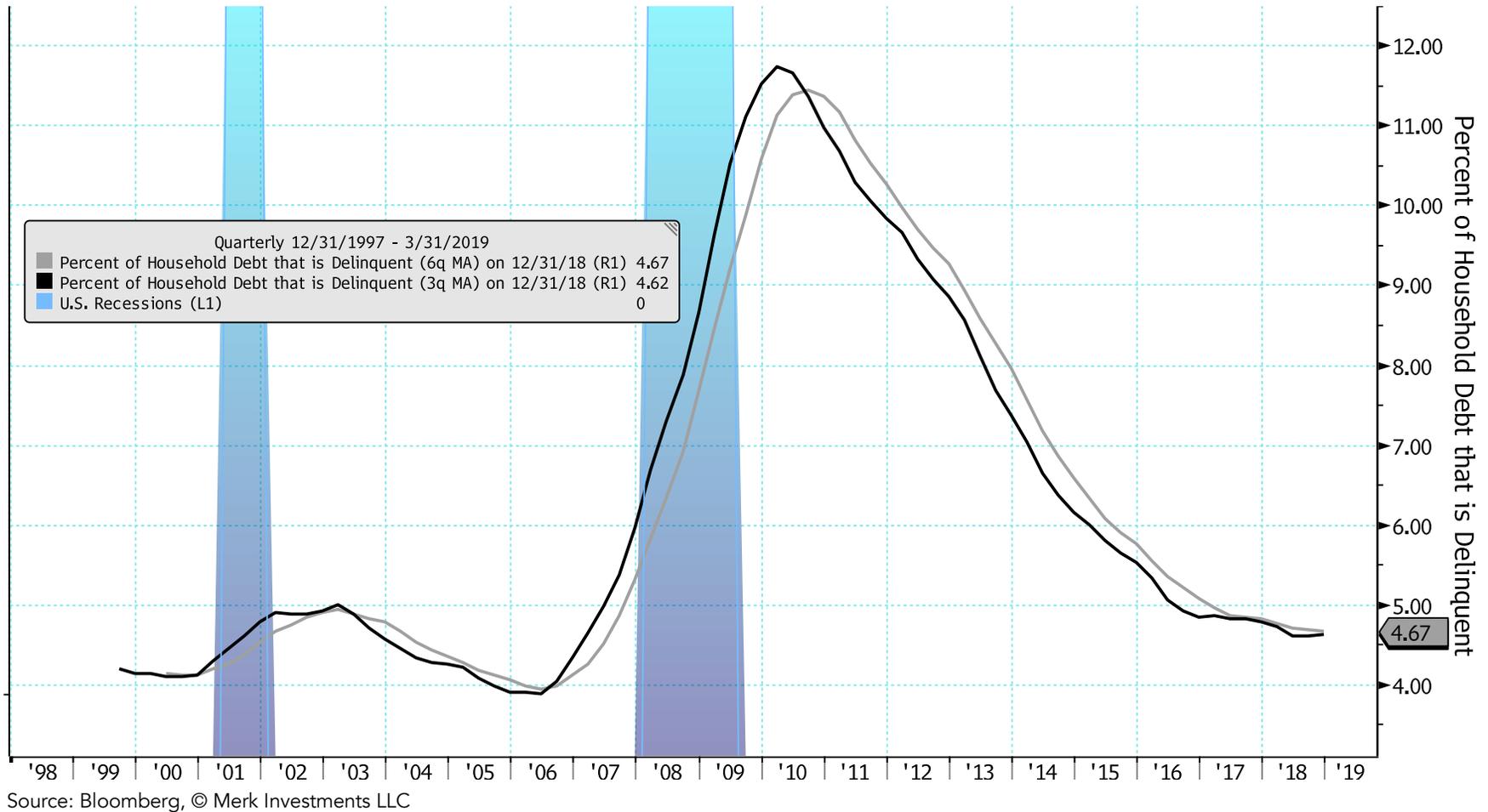


Source: Bloomberg, © Merk Investments LLC

*Analysis: The final Q4 2018 GDP reading (black line) came in at 2.2%, the current forecast for Q1 2019 GDP is around 2.1%.
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

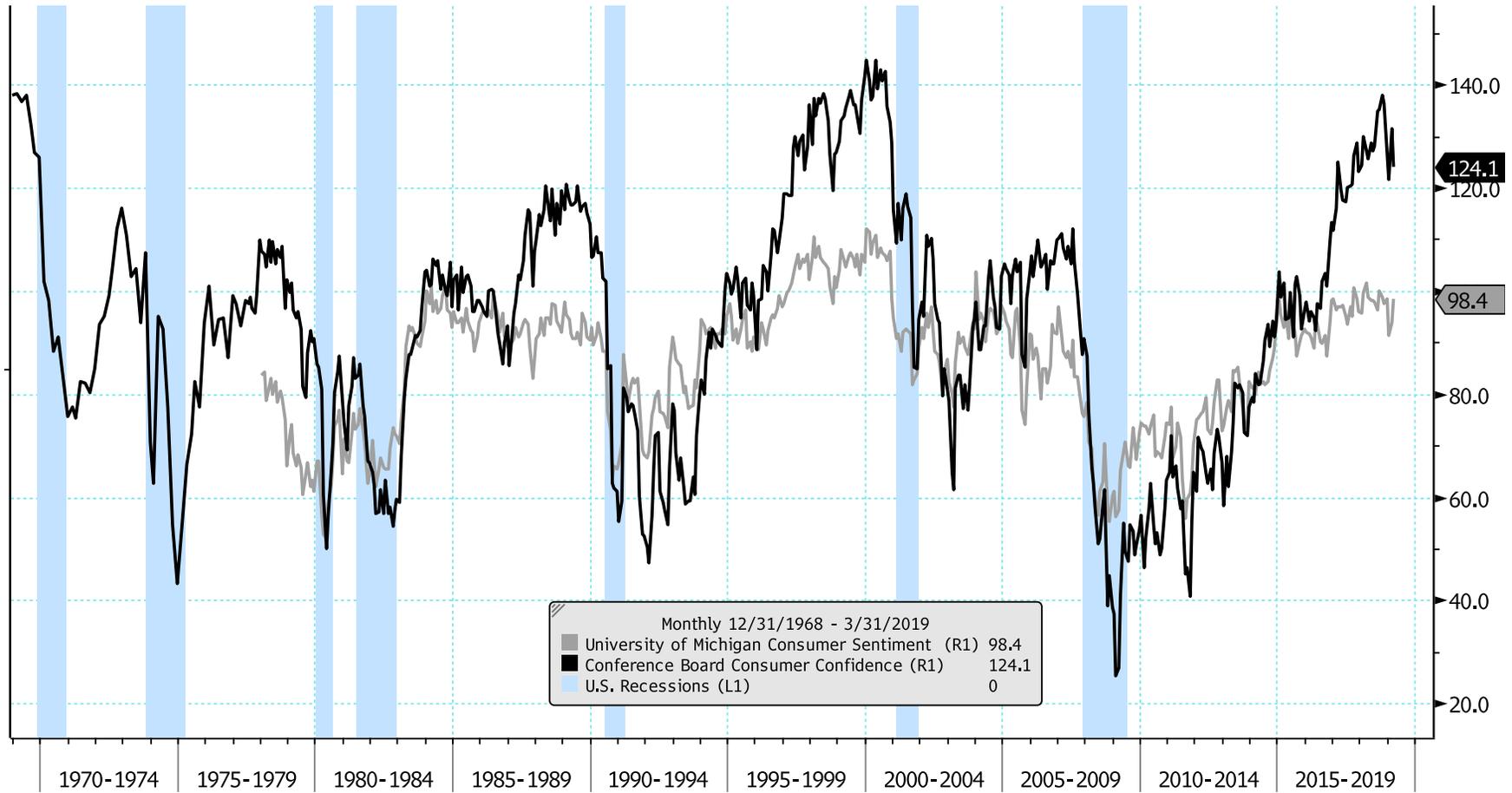
Percent of Household Debt that is Delinquent (3 quarter and 6 quarter moving averages)



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

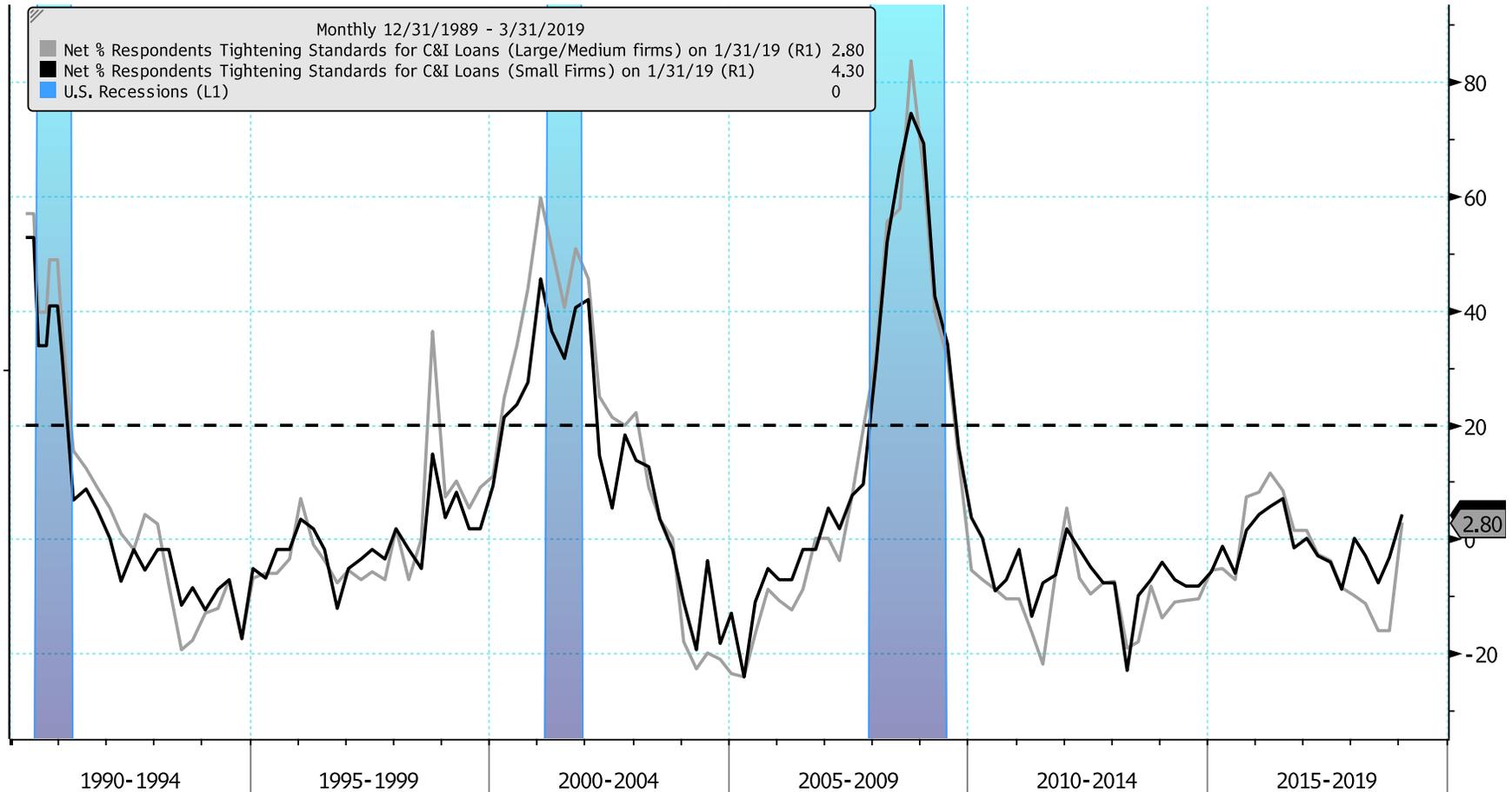


Source: Bloomberg, © Merk Investments LLC

*Analysis: Both measures of consumer confidence are trending sideways to down. Given my framework, I'm currently negative on this picture.
 Chart Framework: I'd get incrementally positive if both measures are trending higher on a YoY basis.*

Bank Lending Standards

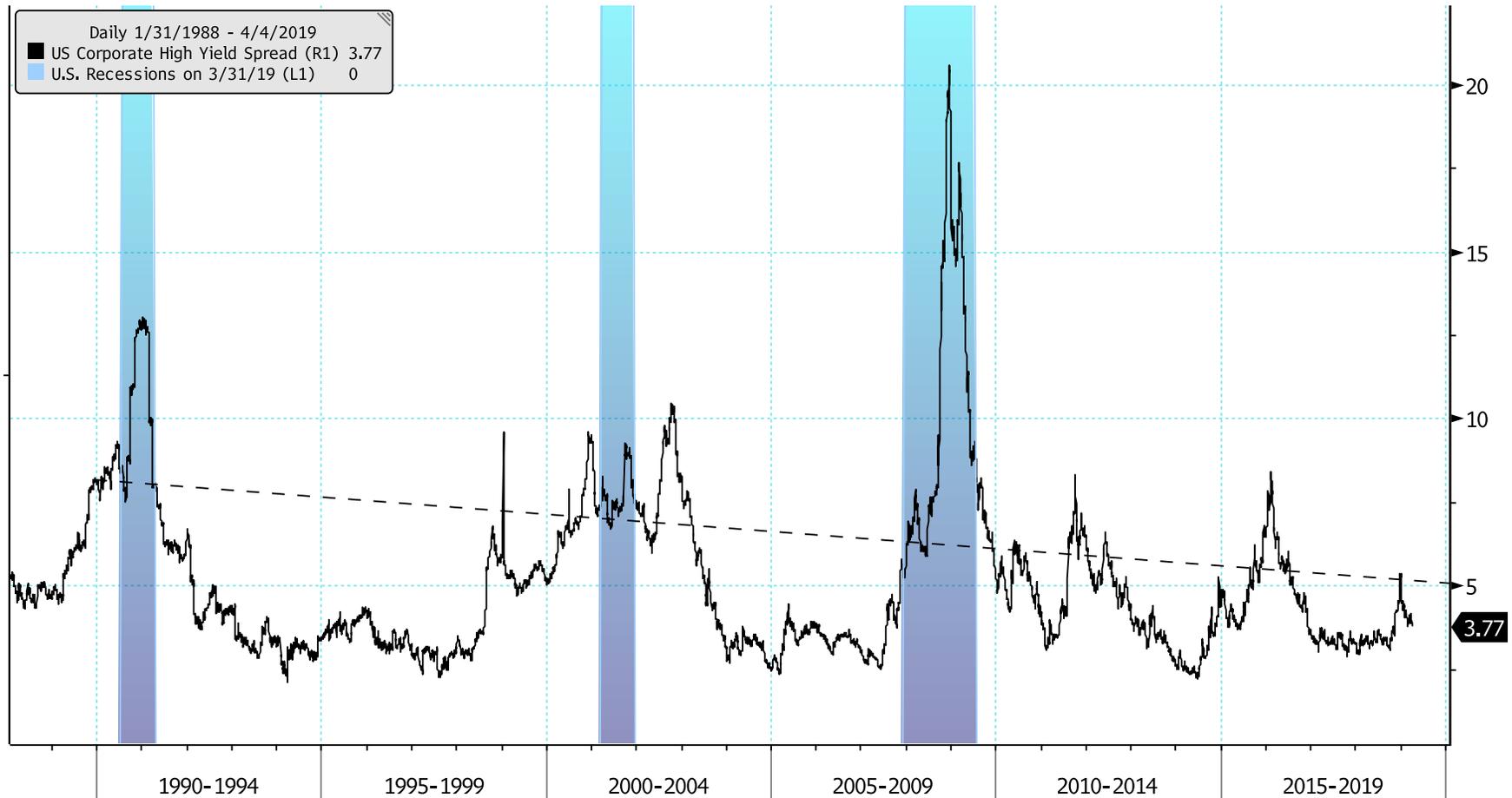
Senior Loan Officer Opinion Survey (SLOOS): Net % of Respondents that are Tightening Lending Standards for Commercial and Industrial (C&I) Loans



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

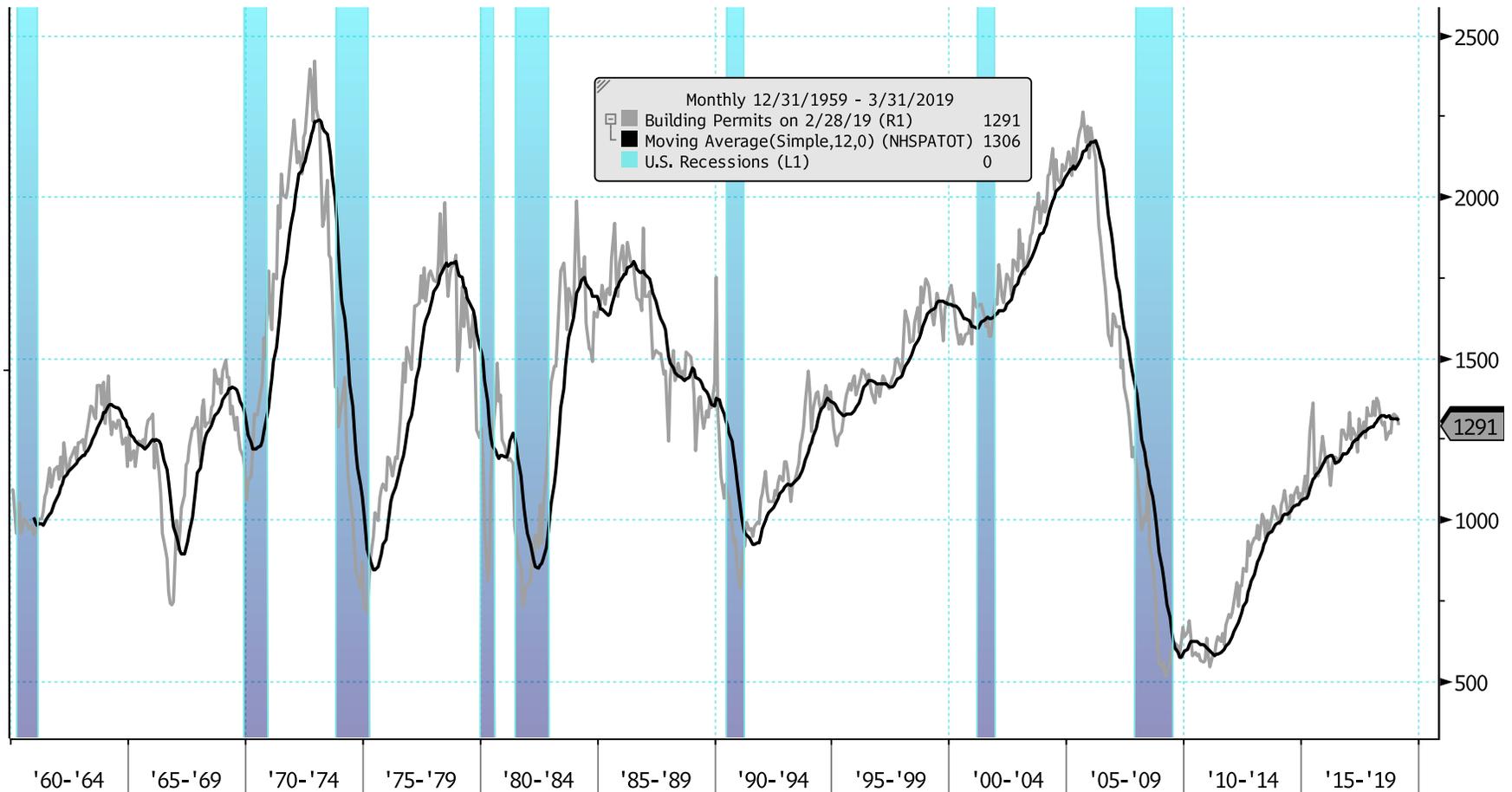


Source: Bloomberg, © Merk Investments LLC

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 indicator if they begin to trend lower in earnest. 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	Neutral/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	Positive
13	Household Credit	Medium Term	Neutral/Positive
14	U.S. Consumer	Short/Medium Term	Negative
15	Lending Standards	Medium Term	Positive
16	High Yield Spread	Short/Medium Term	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

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Conclusion/Thoughts

There are some positive signs of marginal improvement on indicators that had been softening recently. 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.

While some segments of the yield curve have started to invert, we still have not yet had yield curve inversion on 3s10s, and leading economic indicators are still positive year-over-year. It's worth keeping in mind that yield curve inversion is historically a medium term indicator (6 to 24 months) with respect to the beginning of a subsequent recession.

In terms of negatives: my primary concern remains weakness in the global economy, however, China's manufacturing PMI is back above 50. Also, recession risk remains elevated over roughly the 1-5 year period, 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 while longer. Specifically, the labor force participation rate continues to trend higher and people continue to come off of the disability rolls.

To reiterate, based on my checklist approach I think the U.S. business cycle picture is still overall mostly positive near term, although there is greater uncertainty and we have 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 in the coming several months. The longer term outlook remains more negative as we are clearly in the late part of this economic expansion.

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

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Disclosure

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