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U.S. Business Cycle Report

March 2020

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Quote

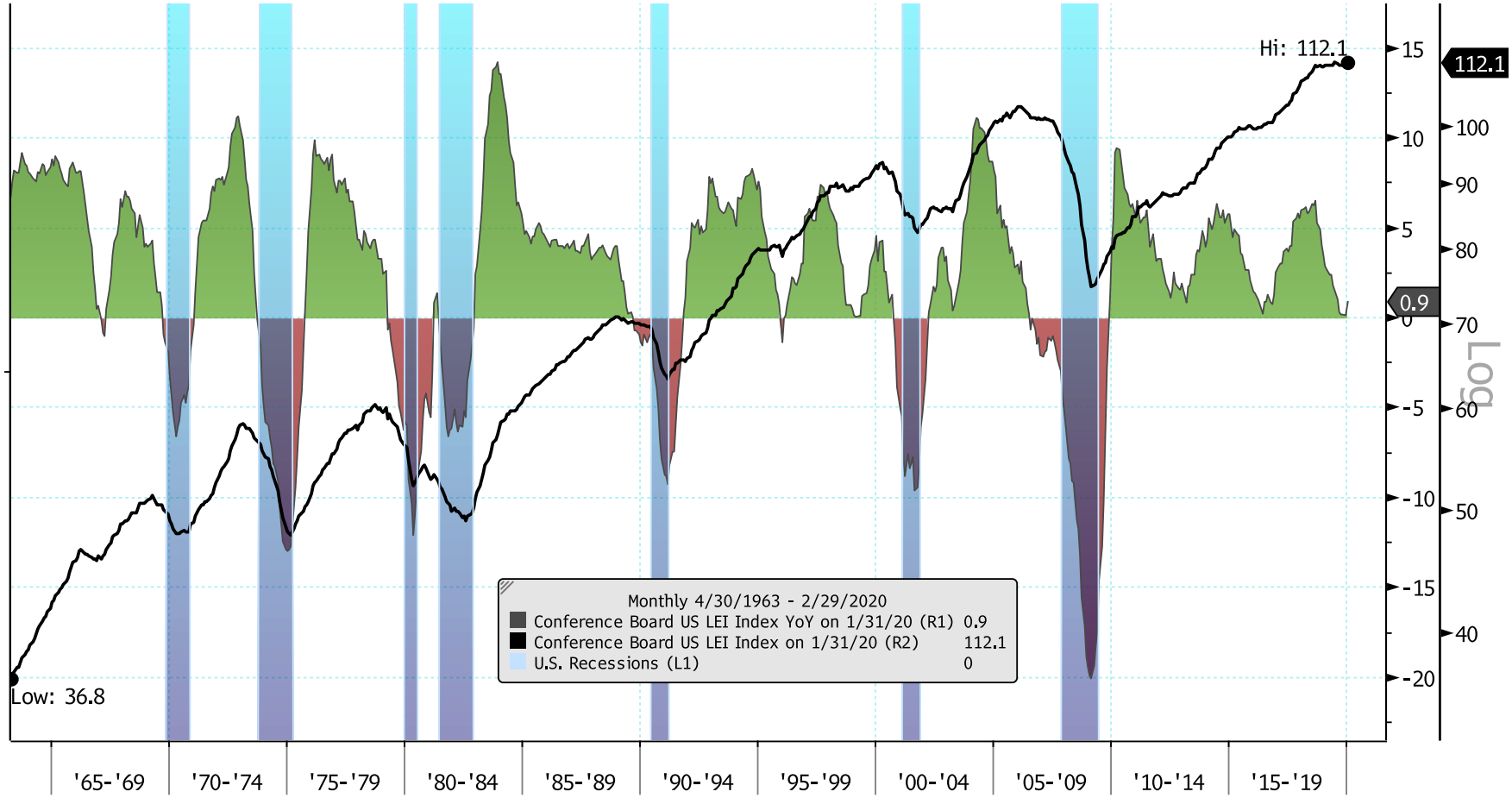
Quotes or book excerpts that I find particularly insightful…

"[My] studies draw inferences from past [data]. There is, of course, no certainty the future [will follow] similar patterns. In all cases, however, the underlying assumption is that past patterns are indicative of the more likely patterns for the future. Readers should bear in mind that since the conclusions are based on empirical studies, they should be viewed as indications rather than absolute truths. Still, it seems more reasonable to invest in accordance with the empirical evidence than in opposition to it."

-Jack Schwager, in *Market Sense and Nonsense*

U.S. Leading Economic Indicators (LEIs) Index

Conference Board's LEI Index and YoY Rate of Change

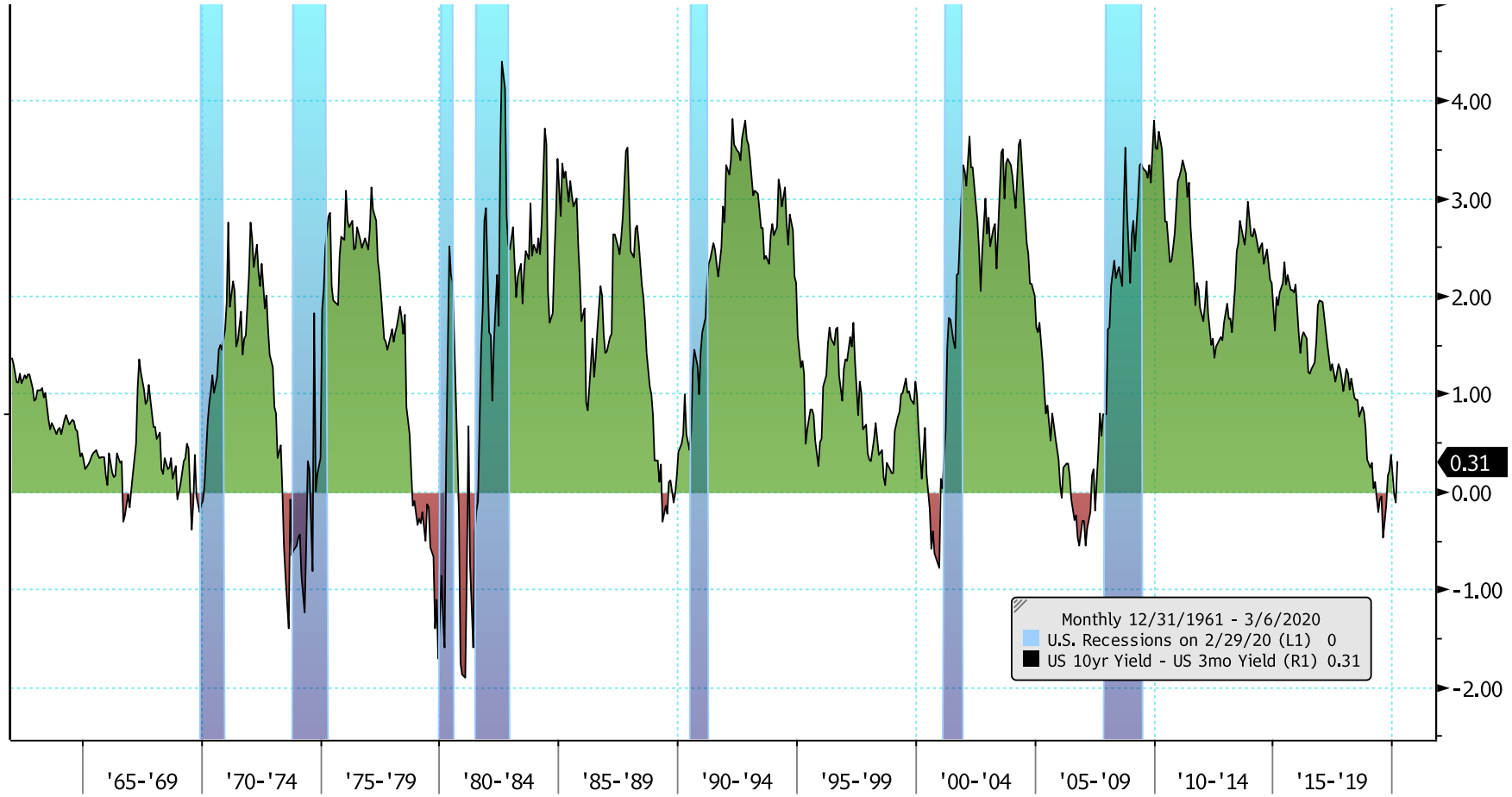


Source: © Merk Investments, Bloomberg

Analysis: Since last month's report, the LEI YoY rate of change accelerated to 0.9%. And the index level reached a new cycle high. Given the YoY rate of change remains positive, history suggests a recession is unlikely to start within the next six months. This picture keeps me generally positive on the outlook for the U.S. economy. 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 – 3mo yield)

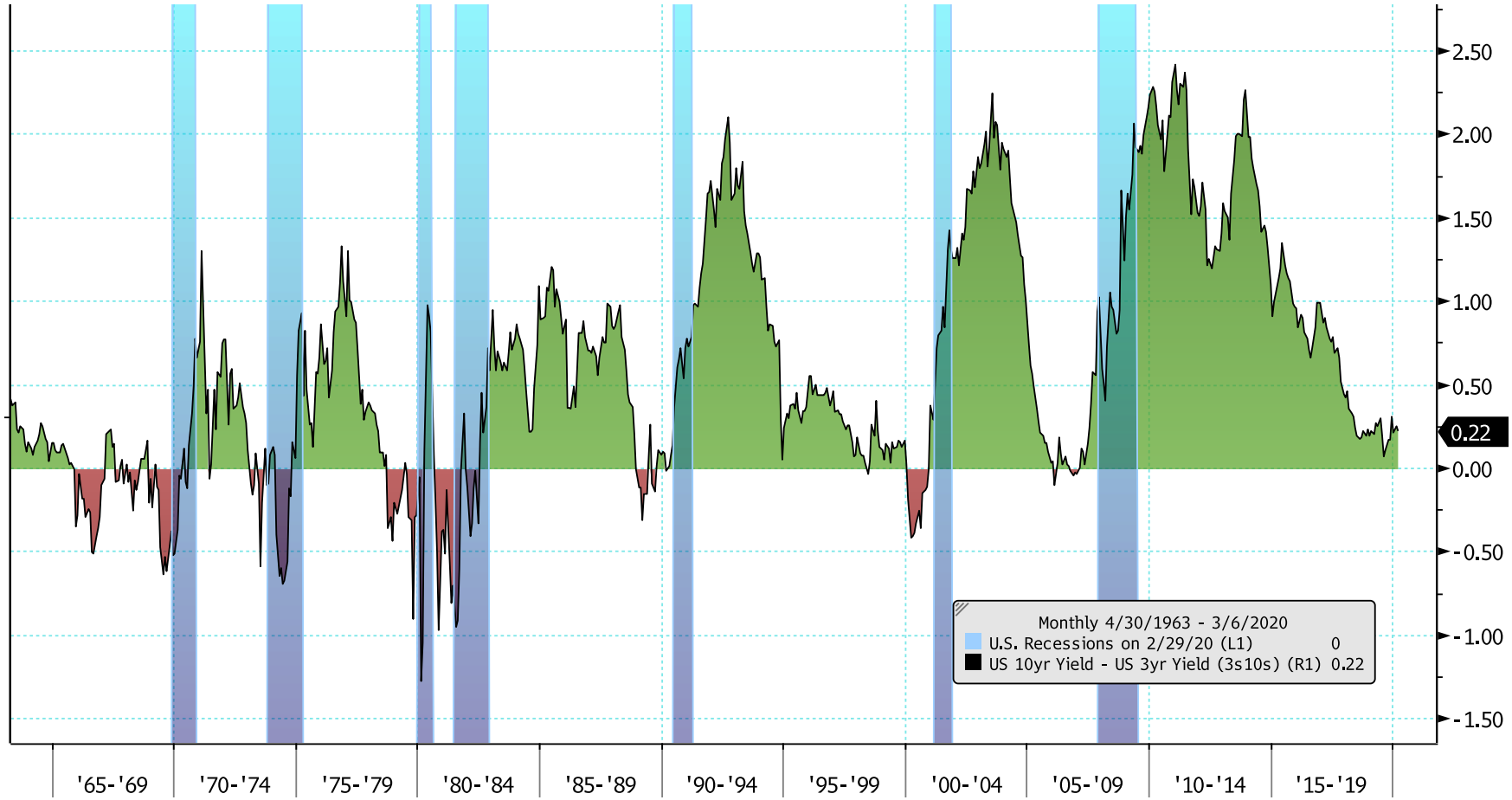


Source: © Merk Investments, Bloomberg

*Analysis: The 10yr-3m yield curve was inverted (meaning the 3-month yield was higher than the 10-year yield) from May to October 2019 and again in Q1 2020. 10yr-3m inversion has historically been a strong recession indicator (with recessions historically starting 6-18 months after initial inversion). I'm currently negative on this picture. Chart Framework: I'd get incrementally positive on this picture if the yield curve bear steepened (meaning long end rates rising) while other macroeconomic data (e.g., U.S. Mfg PMI) also improved. *It may be worth noting that the 10yr-3yr (shown on the next page) has always inverted prior to recessions and still has not (yet) inverted.**

U.S. Yield Curve Steepness

(10yr yield – 3yr yield)

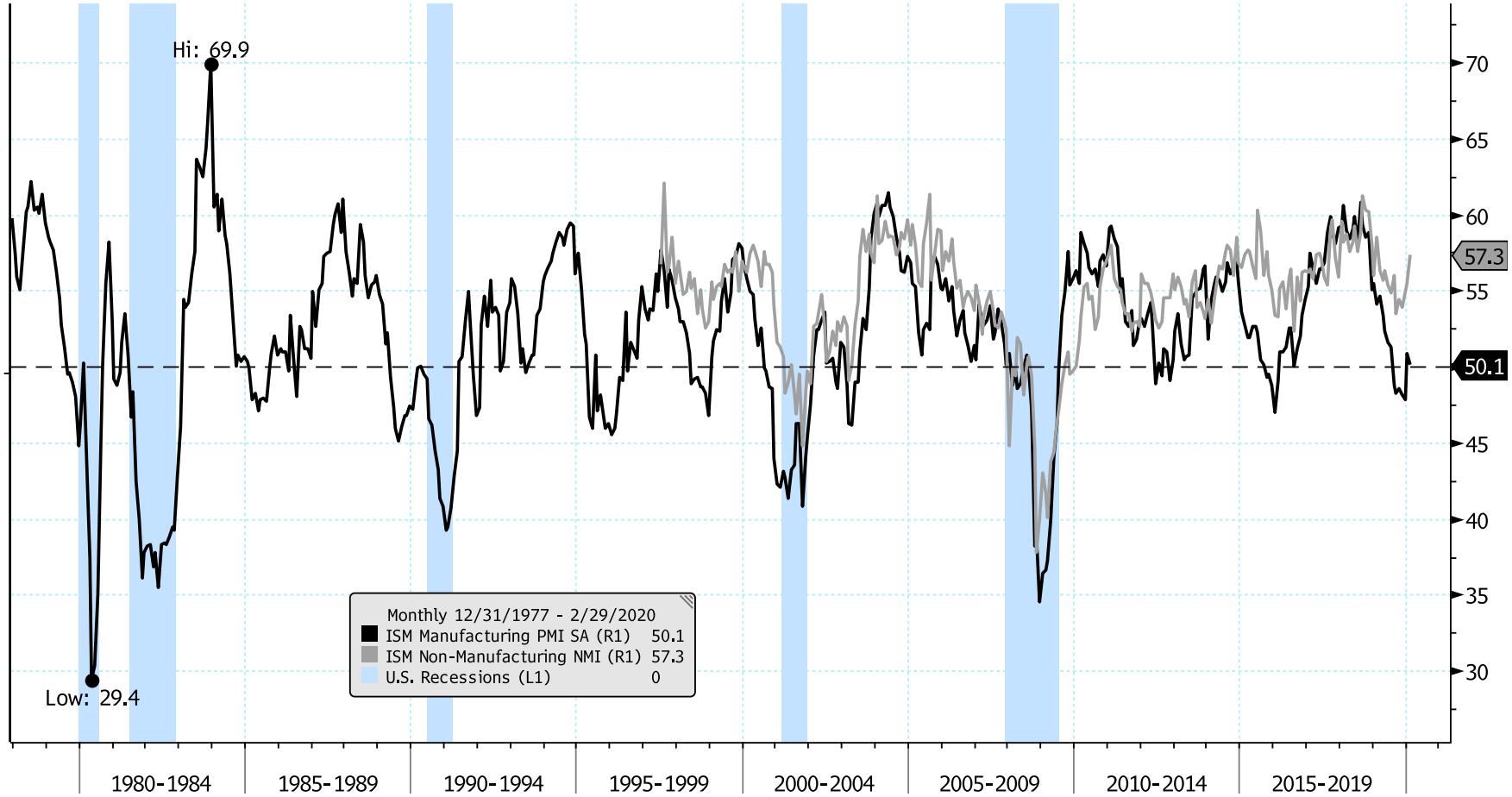


Source: © Merk Investments, Bloomberg

Analysis: A cross reference to the 10yr-3yr shows a yield curve that has remained positively sloped (meaning the 10yr yield is higher than the 3yr yield). The yield curve is little changed since last month's report. 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)

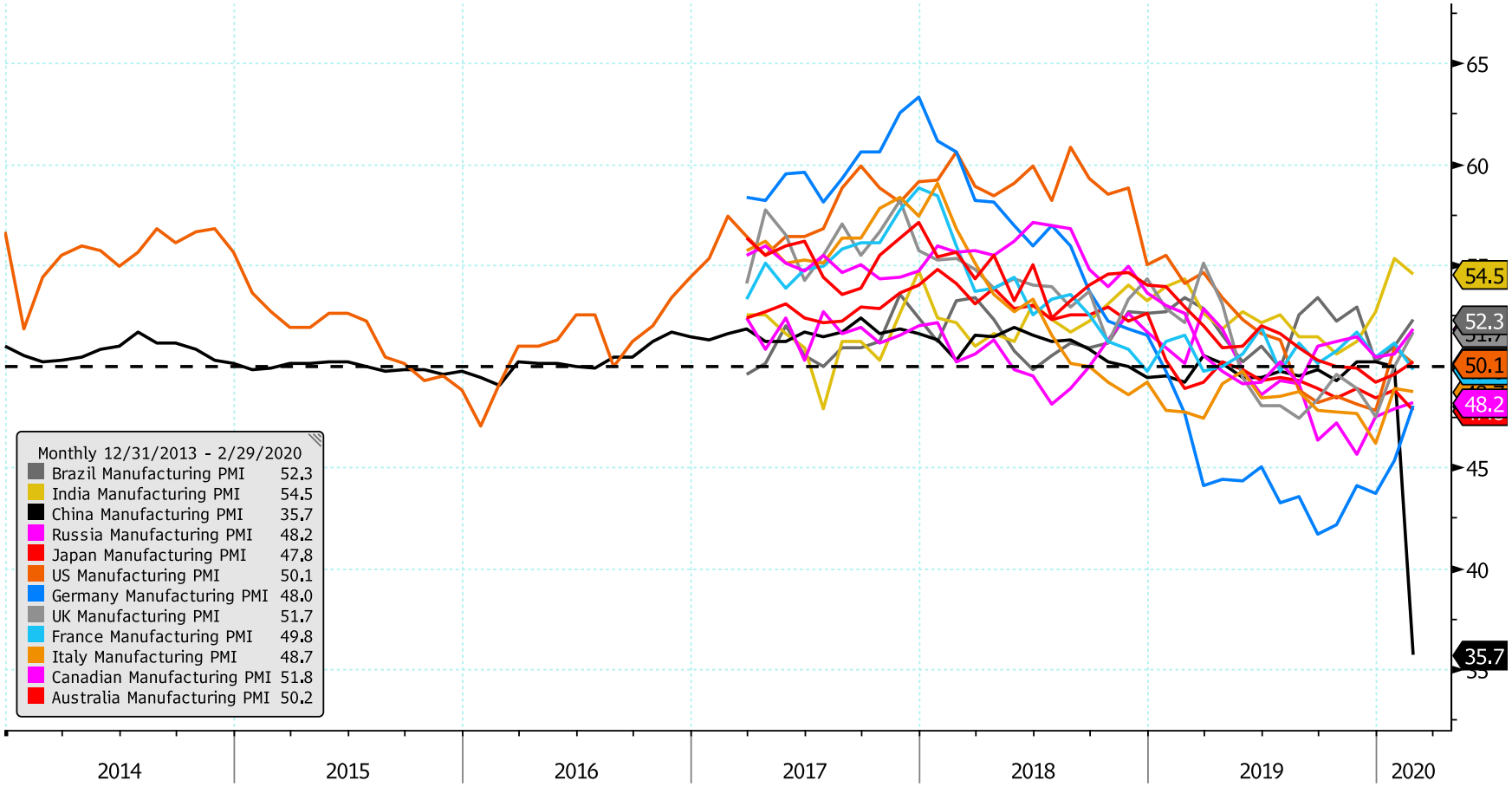


Source: © Merk Investments, Bloomberg

Analysis: Manufacturing PMI moved down over the past month, from 50.9 to 50.1, but remained above 50 and suggested economic expansion. The Feb data was generally positive in terms of the level, but that will almost certainty deteriorate below 50 for March. Chart Framework: I'd get incrementally negative on the business cycle outlook if the manufacturing PMI fell below 50.

Global Manufacturing PMIs

Largest twelve global economies' Manufacturing PMIs (Purchasing Managers Index)

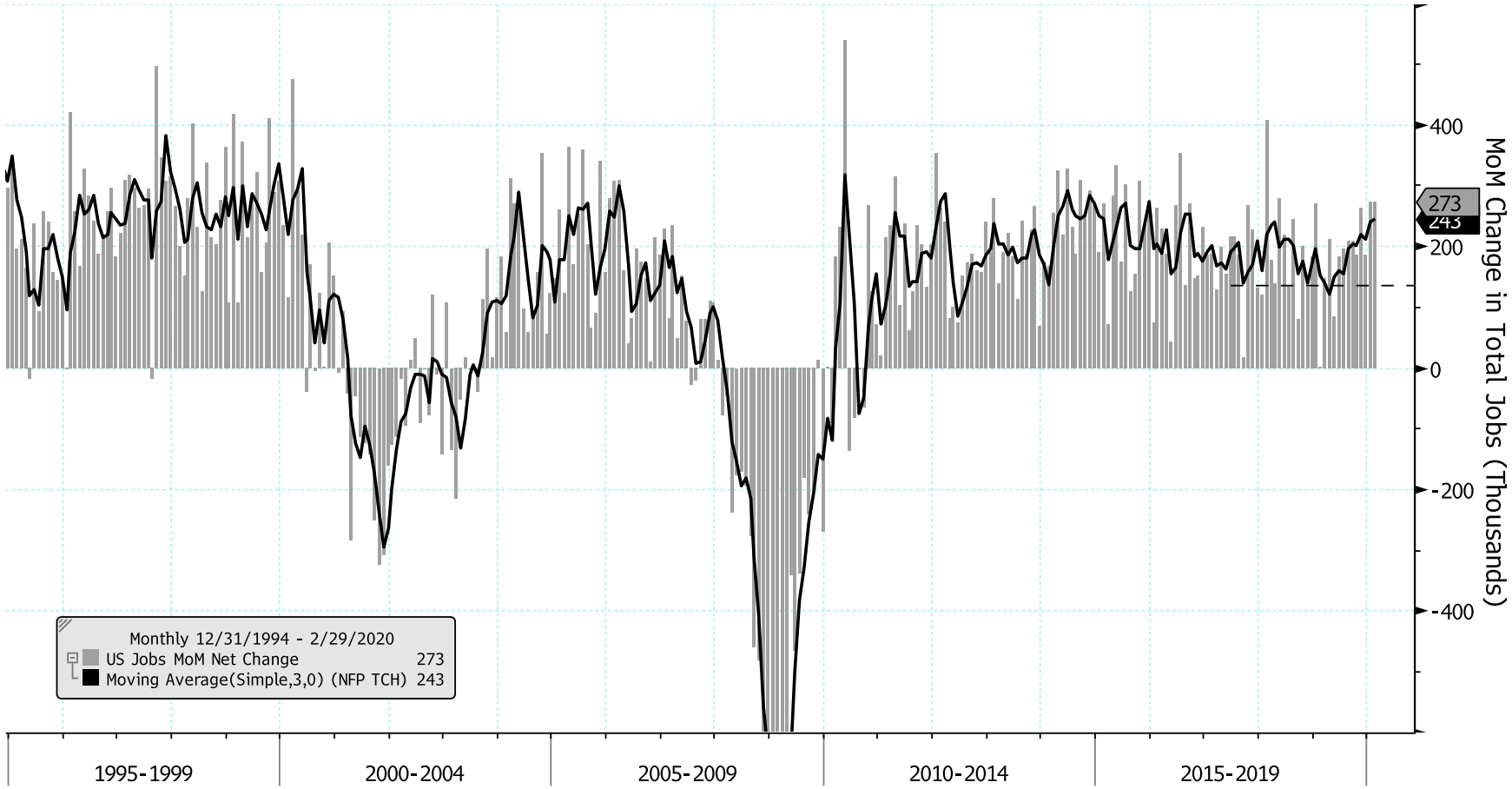


Source: © Merk Investments, Bloomberg

Analysis: Global economic momentum as measured by manufacturing PMIs was negative over the past month. Six out of the twelve readings are below 50 with an average of 49.1. China is an outlier to the downside given the virus-driven slowdown. That slowdown might be observed more broadly in next month's data. Given my framework I'm currently negative on this picture.
Chart Framework: I'd get positive on this picture if a majority of Mfg PMIs are above 50.

Job Gains

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

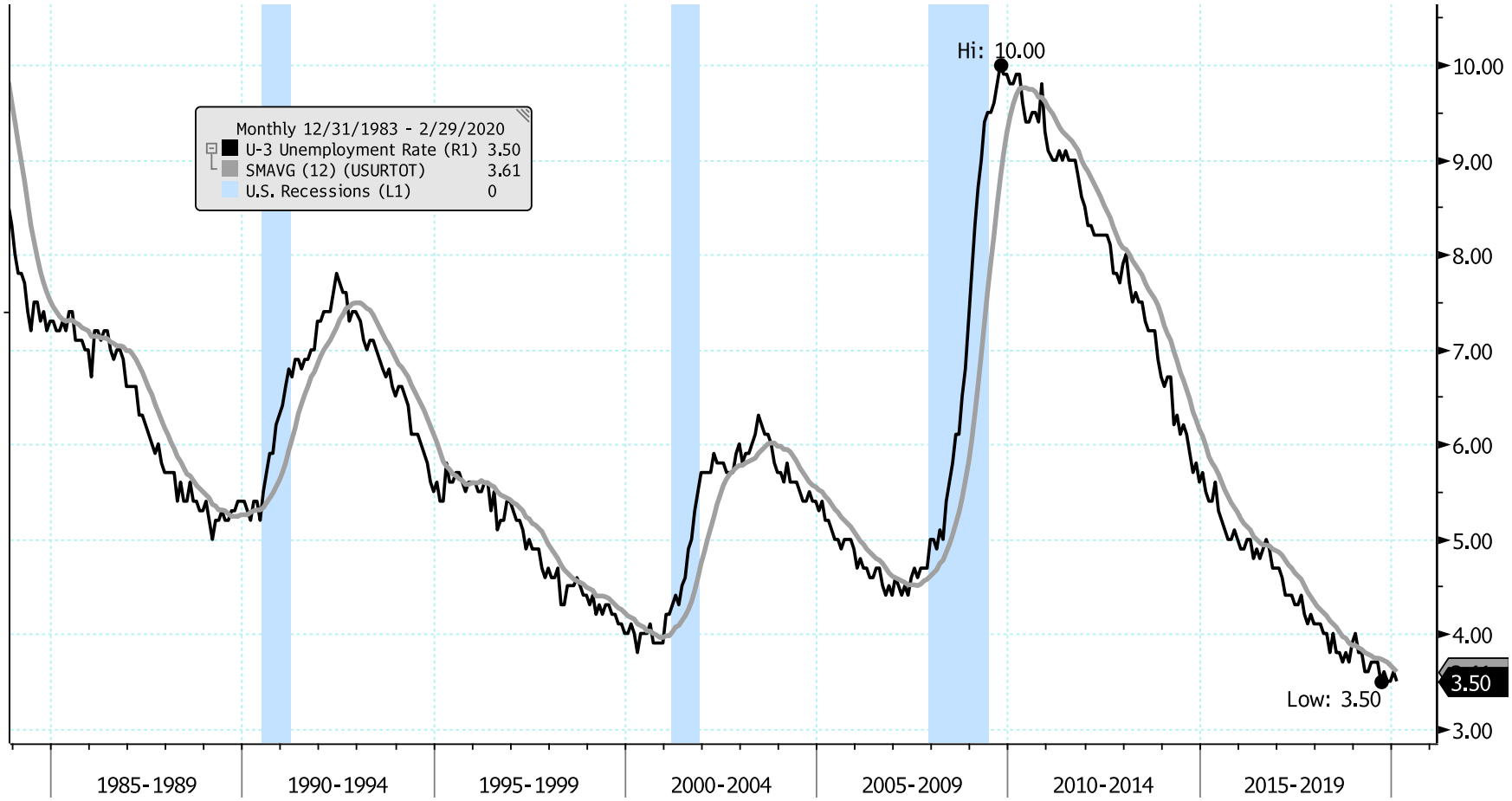


Source: © Merk Investments, Bloomberg

Analysis: The 3-month moving average of job gains is 243k, overall a strong level.
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

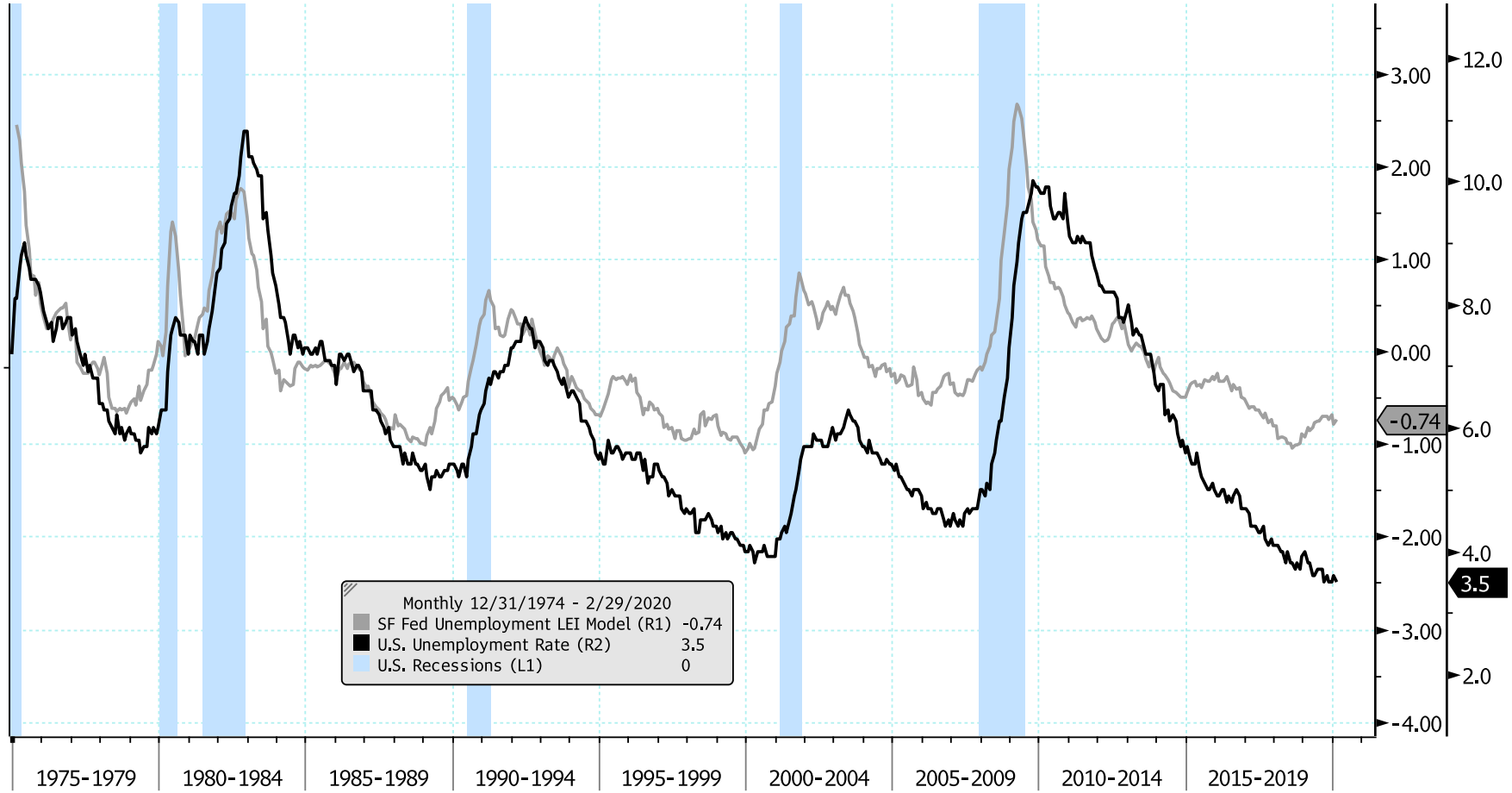


Source: © Merk Investments, Bloomberg

Analysis: The unemployment rate ticked down to 3.5%, the cycle low. Labor force remained at a 7-year high. Unemployment remains below its 12-month moving average. I'm currently positive on this picture. 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)

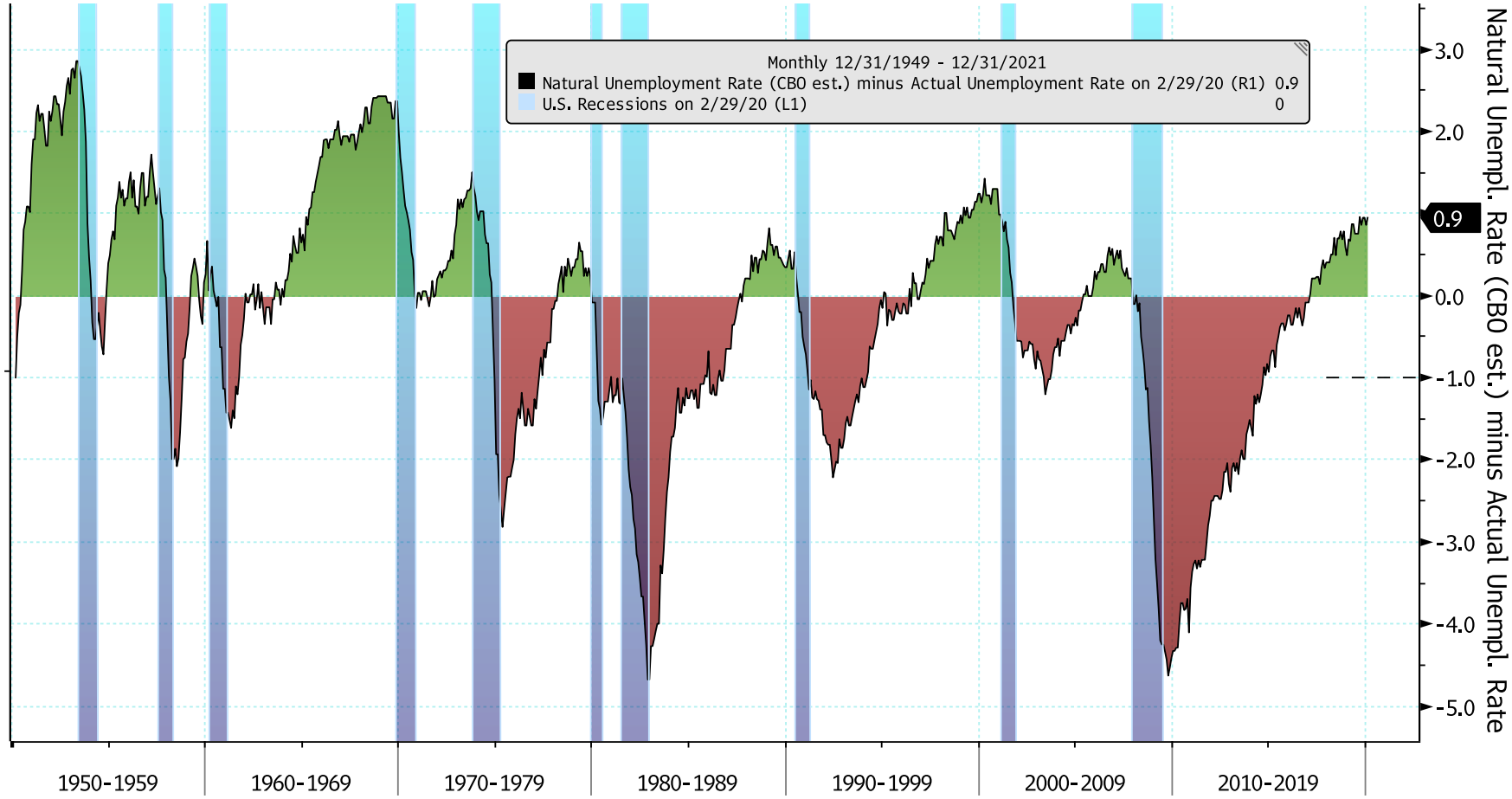


Source: © Merk Investments, Bloomberg

Analysis: The SF Fed unemployment rate model (grey line) has turned down again in recent months, but is still trending higher YoY. 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. For reference: the San Francisco Fed Paper

U.S. Labor Market Capacity Utilization

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

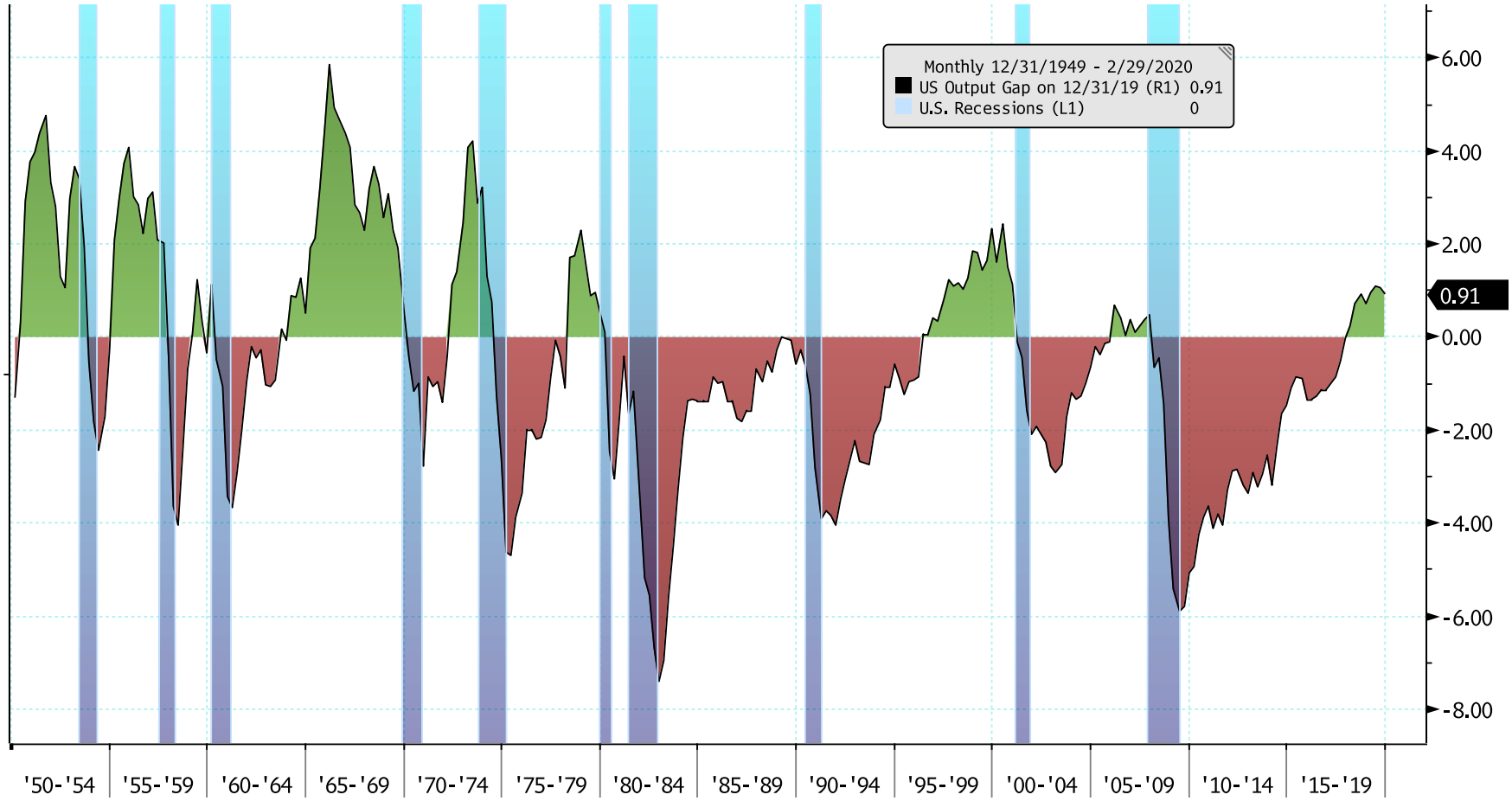


Source: © Merk Investments, Bloomberg

Analysis: The estimated natural rate of unemployment is higher than the current unemployment rate by 0.9% (4.4% estimate – 3.5% current reading), meaning the U.S. economy is potentially running above capacity, which likely increases the risk of a recession roughly 1-5 years out. It is worth noting that the estimate of the natural rate of unemployment is debated, and some think it is lower than the 4.4% estimated by the CBO. 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. It's worth noting that despite the current picture above many other metrics seem to indicate that some slack remains in the labor market.

U.S. GDP Output Gap

Actual GDP minus Potential GDP (CBO est.)

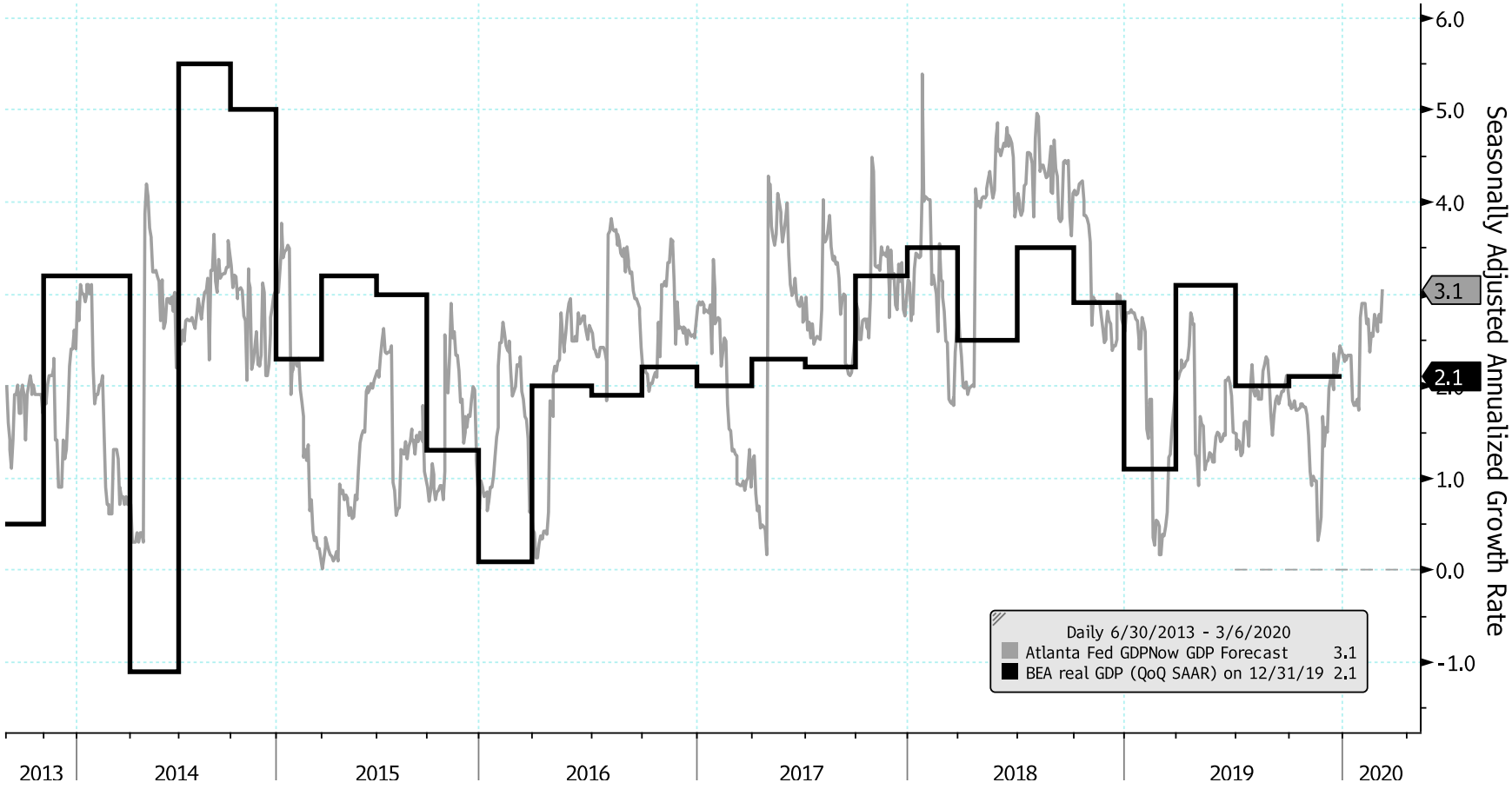


Source: © Merk Investments, Bloomberg

Analysis: Actual GDP is more than potential GDP (as estimated by the CBO), which suggests the expansion may be in its late stages. As with the unemployment rate on the previous page, there is debate about what potential GDP should be. 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

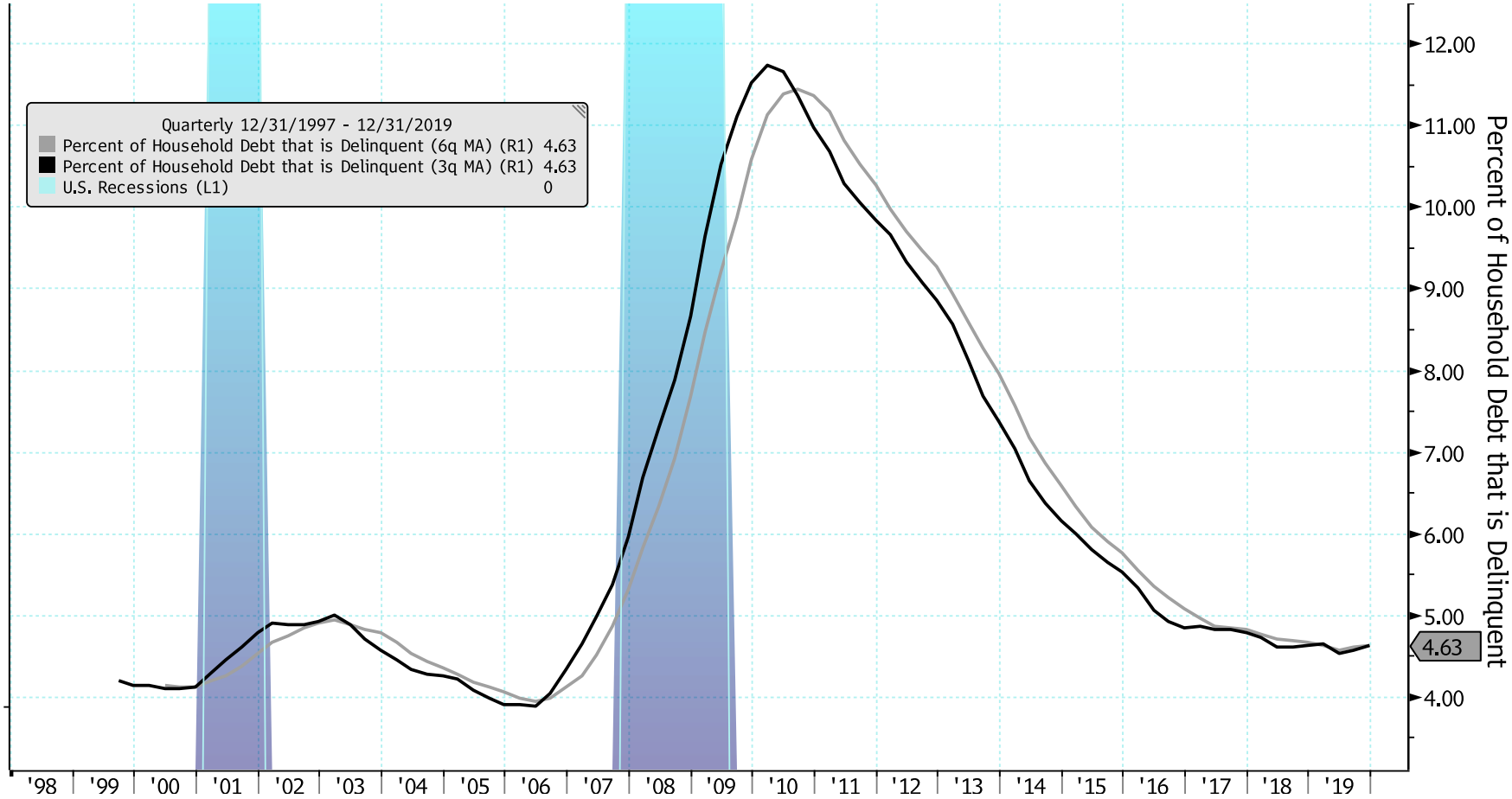


Source: © Merk Investments, Bloomberg

Analysis: The Q4 2019 GDP final reading (black line) came in at 2.1%. The current forecast for Q1 2020 GDP is around 3%. 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)

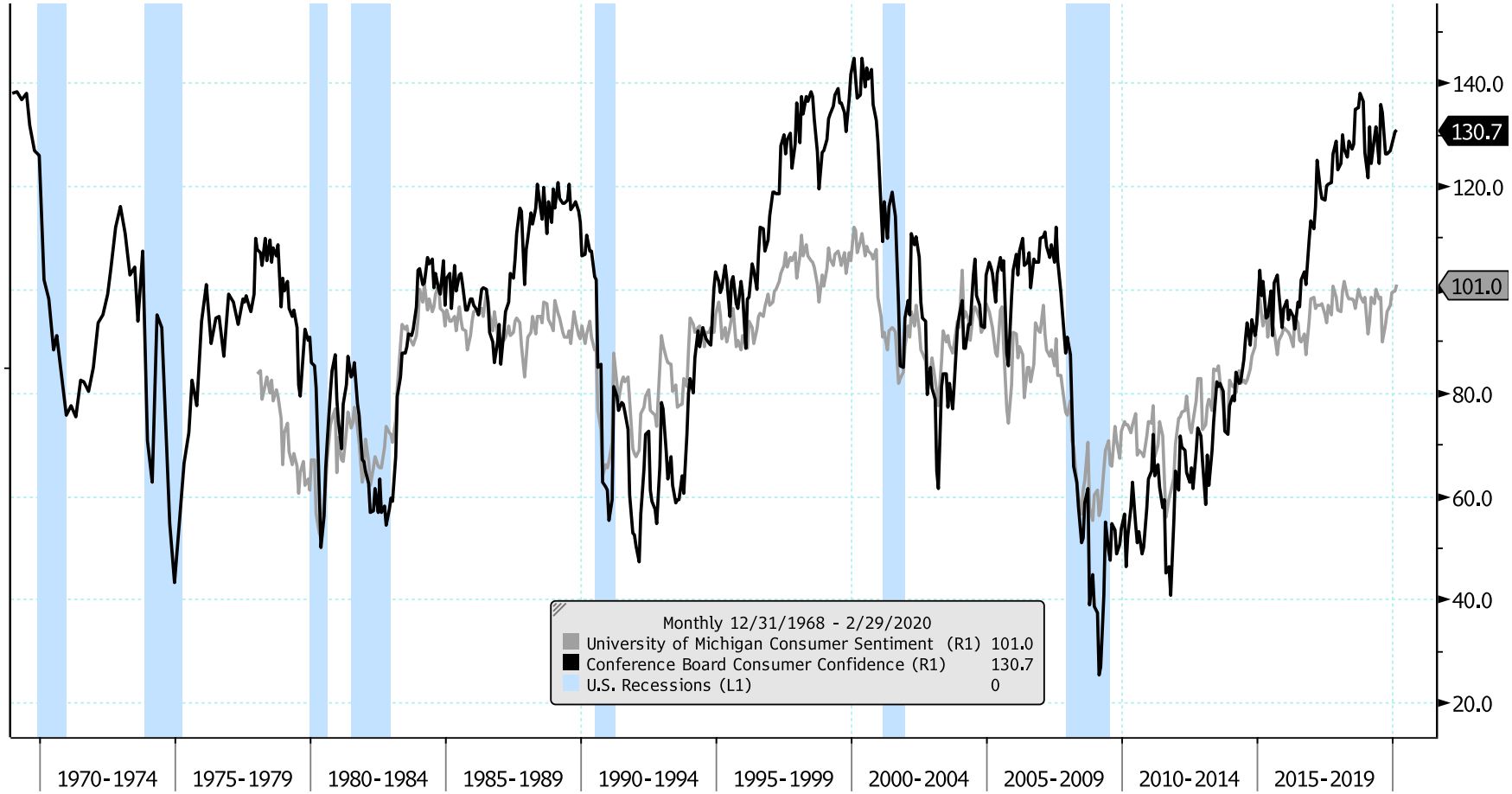


Source: © Merk Investments, Bloomberg

Analysis: The Q4 2019 data showed a downtick in the household delinquency rate (generally a positive sign for the economy). But the 3-quarter moving average (black) now matches the 6-quarter moving average (grey). Given my chart framework I'm currently neutral on this picture. Chart Framework: I'd get incrementally positive if the 3q MA falls back below the 6q MA. Conversely, I'd get negative if thee 3q MA rises above the 6q MA. The Q1 2020 data comes out in late May.

U.S. Consumer Confidence

Michigan Consumer Sentiment and Conference Board Consumer Confidence

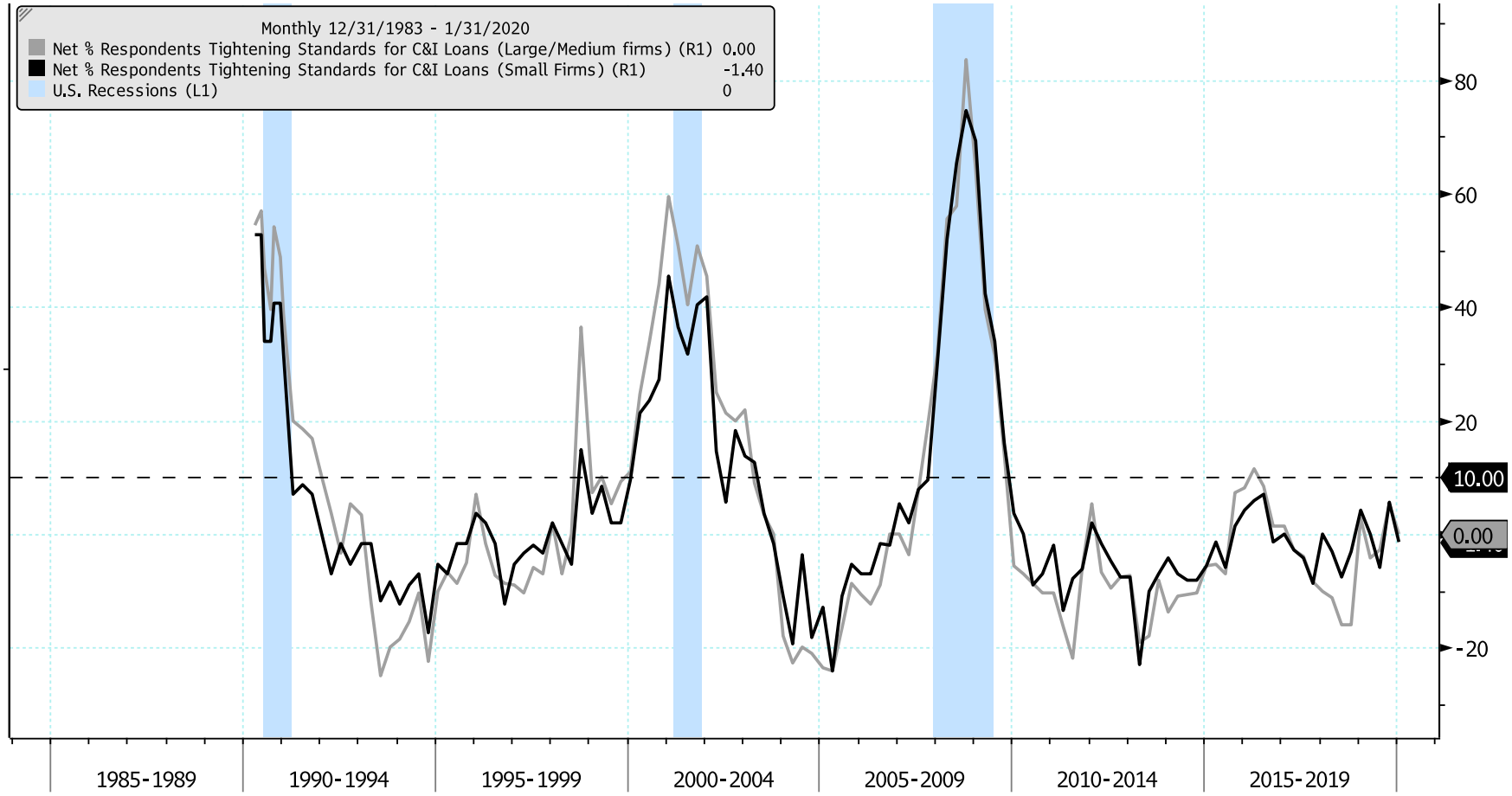


Source: © Merk Investments, Bloomberg

Analysis: The consumer confidence indexes are generally trending sideways to higher (at elevated levels). Given my framework, I'm currently neutral/positive on this picture. But at elevated levels these indicators are likely a medium-term contrarian indicator. Chart Framework: I'd get incrementally negative if both measures trended lower 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

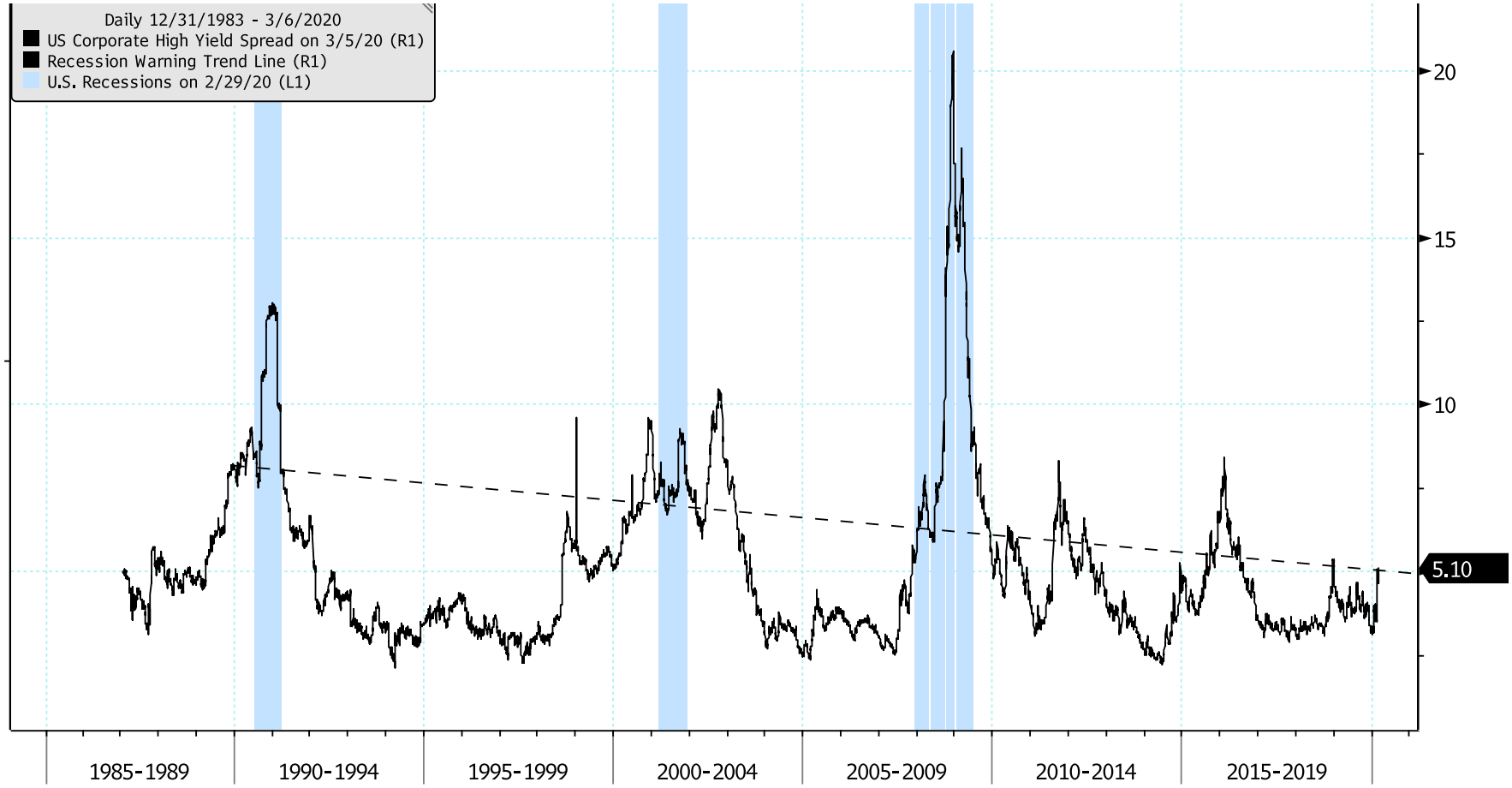


Source: © Merk Investments, Bloomberg

Analysis: Data from the Fed's Senior Loan Officer Opinion Survey suggest bank lending standards generally continue to be supportive of economic activity, loosening as of Jan 2020. Chart Framework: I'd get incrementally negative on the business cycle outlook if 10% of respondents report tightening lending standards. It's worth noting that this data only comes out quarterly.

High Yield Spread

U.S. High Yield Spread with Trend Line

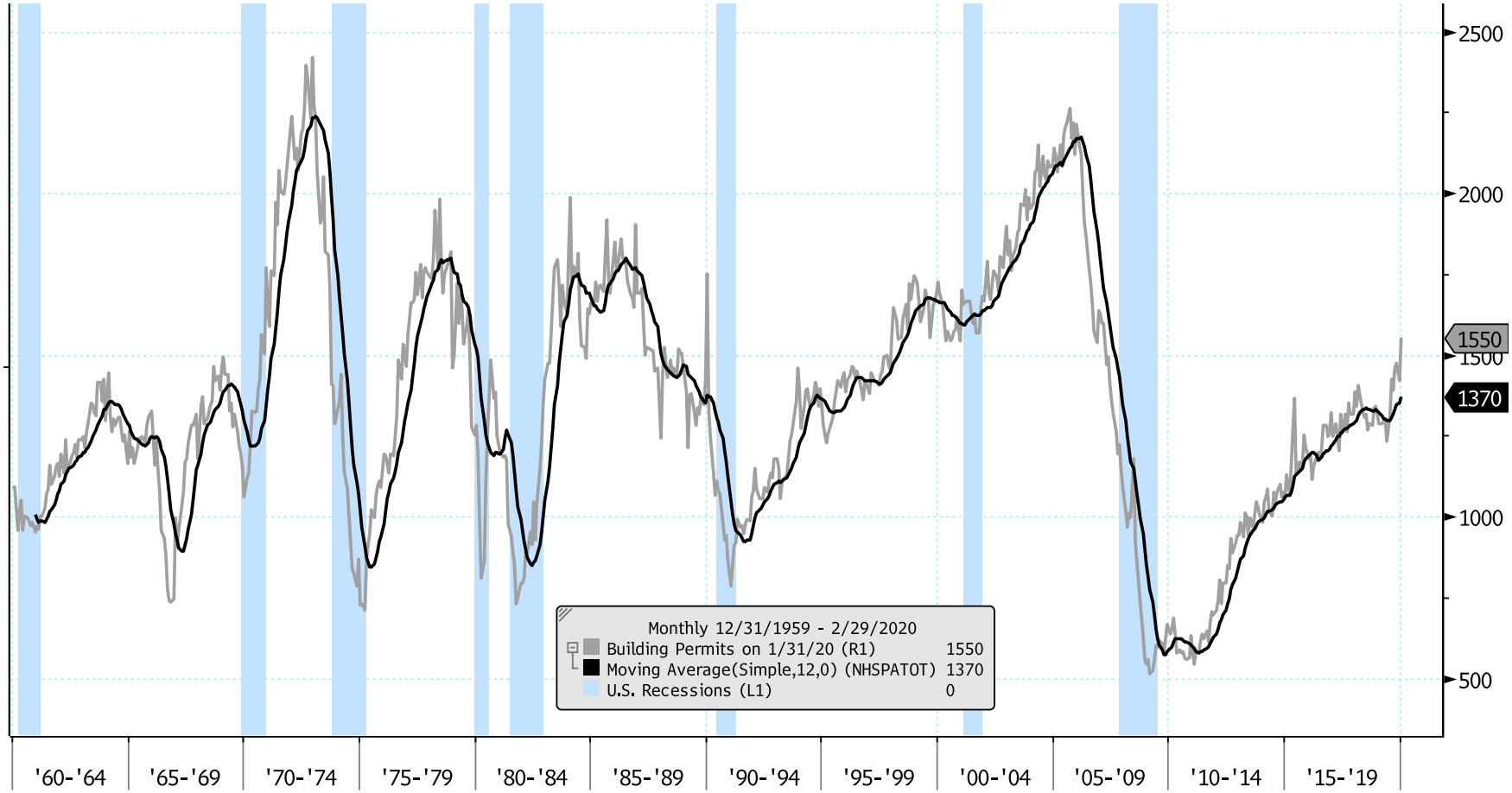


Source: © Merk Investments, Bloomberg

Analysis: The high yield credit spread has risen and is now above what I consider the warning level. Chart Framework: I'd get incrementally positive on the business cycle outlook if the spread moves back below 5.

U.S. Building Permits

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



Source: © Merk Investments, Bloomberg

Analysis: Building permits, historically a long leading indicator, are at a new cycle high. I'm currently positive on this picture. Framework: I would get negative if the 12-month moving average started trending lower again.

Checklist

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

Conclusion/Thoughts

If you want attention, fear monger. We live in a media era of extreme negativity. That goes for the mainstream media, and doubly so for the Twittersphere and cottage industry of doom-and-gloom punditry. My tendency has been to push back against calls for "the beginning of World War Three" and the like, and to focus on the data.

The rise of excessive fear mongering of course doesn't negate the fact that genuine risks exist. Coronavirus, and precautions taken, will clearly have a negative impact on economic activity. At this point it is hard to know how big and for how long. We're currently in a fog of uncertainty with questionable information. The picture will likely become clearer in the days and weeks ahead. As I always write, my data and frameworks inevitably may not capture all possible risk factors in real-time.

The economy was in the process of re-accelerating coming into this negative shock. The Conference Board's Leading Economic Indicators (LEI) Index had just reached a new cycle high. Historically, the average time between the LEI cycle peak and the start of the subsequent recession is 13 months (the shortest amount of time was 9 months). So if the U.S. goes into imminent recession (i.e., within 6 months) it would be a historical anomaly, which is of course possible. In other words, negative exogenous shocks usually do not unilaterally cause recessions. Some economists say 9/11 caused the early 2000s recession, but the economy was already in recession for 6 months (starting in March 2001). So that event exacerbated the existing downturn rather than caused it. Also, historically business cycles typically end with an exhaustion of slack and buildup of inflation, which we haven't yet had.

Expansion is the normal state of the economy. And expansions don't die of old age. While we've been late cycle, there were still several disconfirmations of an imminent downturn as of Feb 2020. For example: LEIs YoY positive and re-accelerating higher, lack of inversion of the 10yr-3yr yield curve (which historically always inverted prior to previous recessions), PMIs above 50, accommodative lending standards, building permits at a cycle high, and initial unemployment claims trending lower.

Nevertheless, the recent sharp drop in Treasury yields suggests a massive slowdown in growth ahead, particularly over the near-term. That may turn out to be right. That seems to be further confirmed by the decline in oil prices, and the emergency rate cuts from the Fed. Notably, the strong jobs report last Friday was completely ignored by the markets—suggesting the February data is irrelevant.

The weekly initial unemployment claims (out every Thursday morning) will likely be one of the first places we observe the effects of the virus-driven slowdown in the macro data. And I'll be monitoring Google search interest in "coronavirus" to watch for a possible inflection point (interest continues to make new highs as of writing and that seems likely to continue for a while). Also, I'll be monitoring the South Korea data, where the testing has been abundant and the case fatality rate so far has been under 1% (still about 10x more fatal than the common flu). Generally, the U.S. public health situation appears certain to get worse before it gets better. And judging from last week's data, sentiment and positioning coming into this week clearly had room to get worse.

-Nick Reece, CFA

About the Author

Nick Reece, CFA: Nick is a Senior Analyst & Portfolio Manager at Merk Investments. He focuses on macroeconomic research and private wealth management, regularly publishing reports on the U.S. business cycle and equity market. Prior to joining Merk in 2012, Nick gained experience working on capital markets deals with Paul Hastings in Hong Kong, and with Atlantis Investment Management. Mr. Reece holds a B.A. in Economics from Trinity College and is a Chartered Financial Analyst (CFA) charterholder. Nick lives in New York City. Outside of work, he is an avid reader and volunteer high school math tutor. You can follow Nick on Twitter @nicholastreece.

Disclosure

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