MERK® | RESEARCH

U.S. Business Cycle Report

January 2020

Nick Reece, CFA
Senior Analyst & Portfolio Manager, Merk Investments LLC

Quote

Quotes or book excerpts that I find particularly insightful…

"According to the latest data, people are living longer and becoming healthier, better fed, richer, smarter, safer, more connected–and, at the same time, ever gloomier about the state of the world… This disconnect originates in the nature of news.

News is about what happens, not what doesn't happen, so it features sudden and upsetting events like fires, plant closings, rampage shootings and shark attacks. Most positive developments are not camera-friendly, and they aren't built in a day. You never see a headline about a country that is not at war, or a city that has not been attacked by terrorists–or the fact that since yesterday, 180,000 people have escaped extreme poverty.

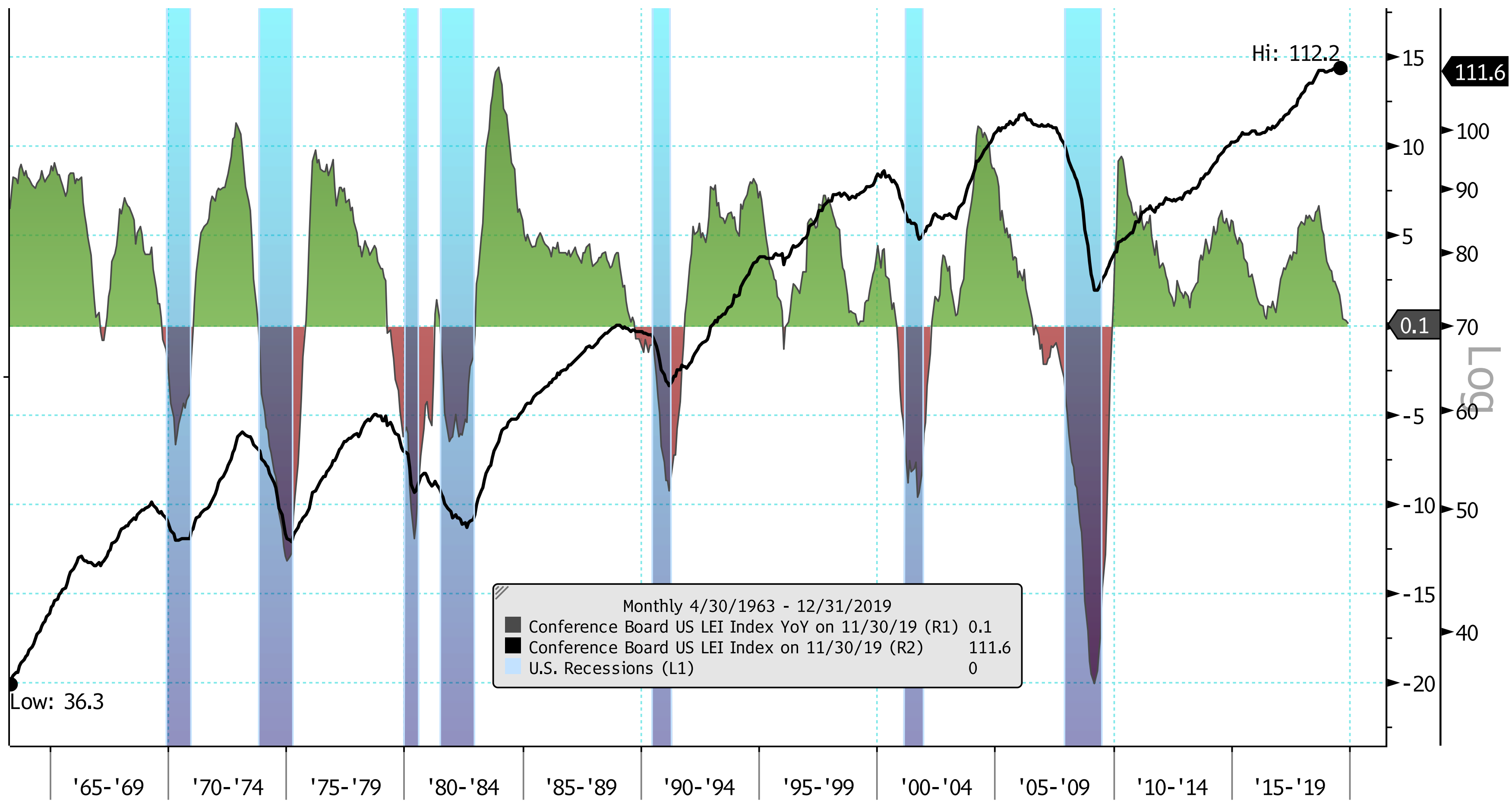
The bad habits of media in turn bring out the worst in human cognition. Our intuitions about risk are driven not by statistics but by images and stories… It's easy to see how this cognitive bias–stoked by the news policy "If it bleeds, it leads"–could make people conclude the worst about where the world is heading.

Irrational pessimism is also driven by a morbid interest in what can go wrong–and there are always more ways for things to go wrong than to go right. This creates a market for experts to remind us of things that can go wrong that we may have overlooked. Biblical prophets, oped pundits, social critics, dystopian filmmakers and tabloid psychics know they can achieve instant gravitas by warning of an imminent doomsday. Those who point out that the world is getting better–even hardheaded analysts who are just reading out the data–may be dismissed as starry-eyed naifs."

-Steven Pinker

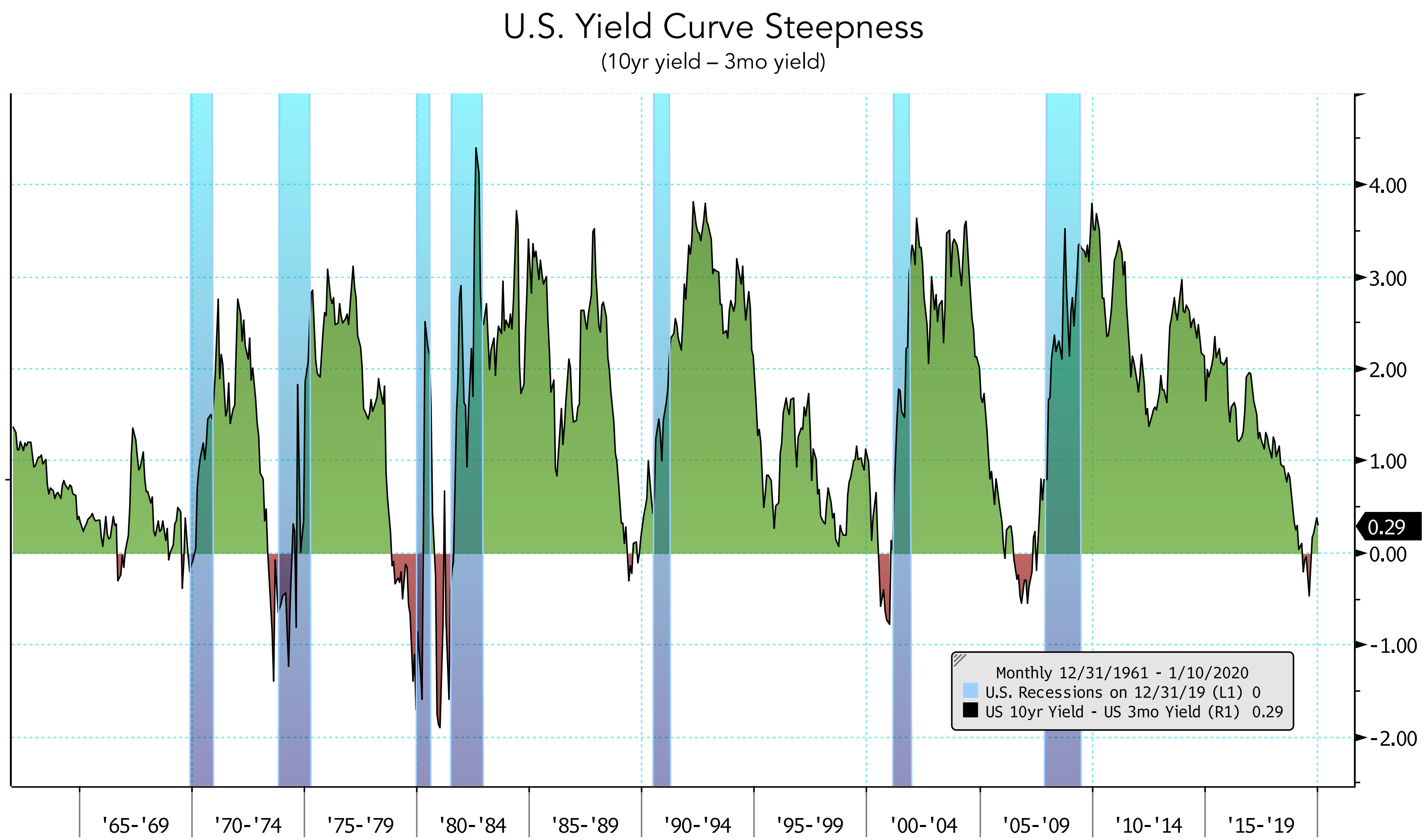
U.S. Leading Economic Indicators (LEIs) Index

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 fell to 0.1%. And the index level remains slightly below its cycle high. Over the past several months positive momentum has slowed. But given the YoY rate of change remains positive, history suggests a recession is unlikely to start within the next six months. Also, base-effects should be favorable to the YoY change over the next two 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.

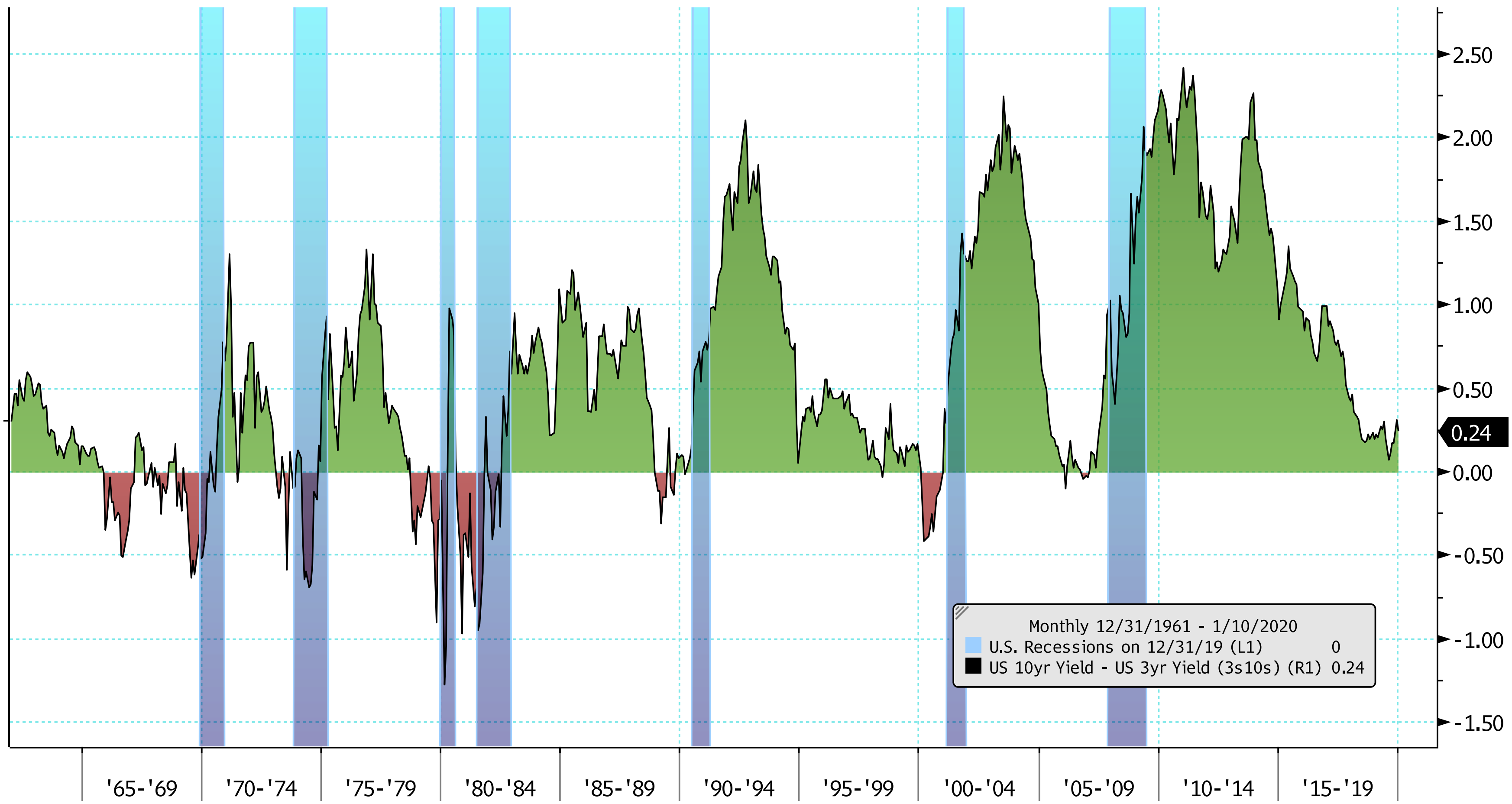


Source: © Merk Investments, Bloomberg

*Analysis: The 10yr-3m yield curve was inverted from May to October (meaning the 3-month yield was higher than the 10-year yield) . 10yr-3m inversion has historically been a strong recession indicator (with recessions historically starting 6-18 months after initial inversion). I'm currently neutral/negative on this picture. Chart Framework: I'd get incrementally positive on this picture if the yield curve steepened 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)

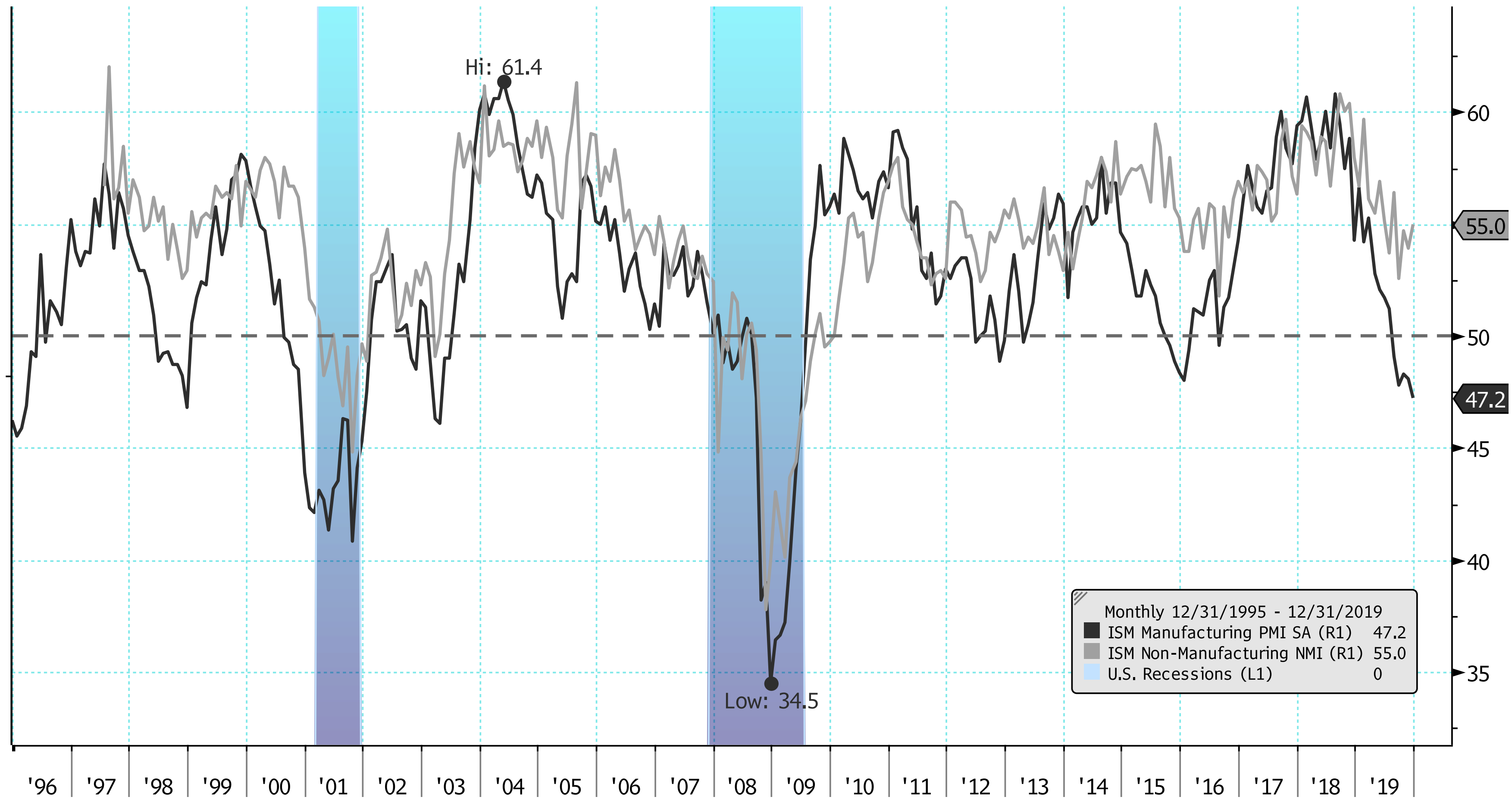


Source: © Merk Investments, Bloomberg

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 slightly steeper since last month's report, but the bigger picture flattening trend continues. The 10yr-3yr curve may invert in the coming quarters. 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)

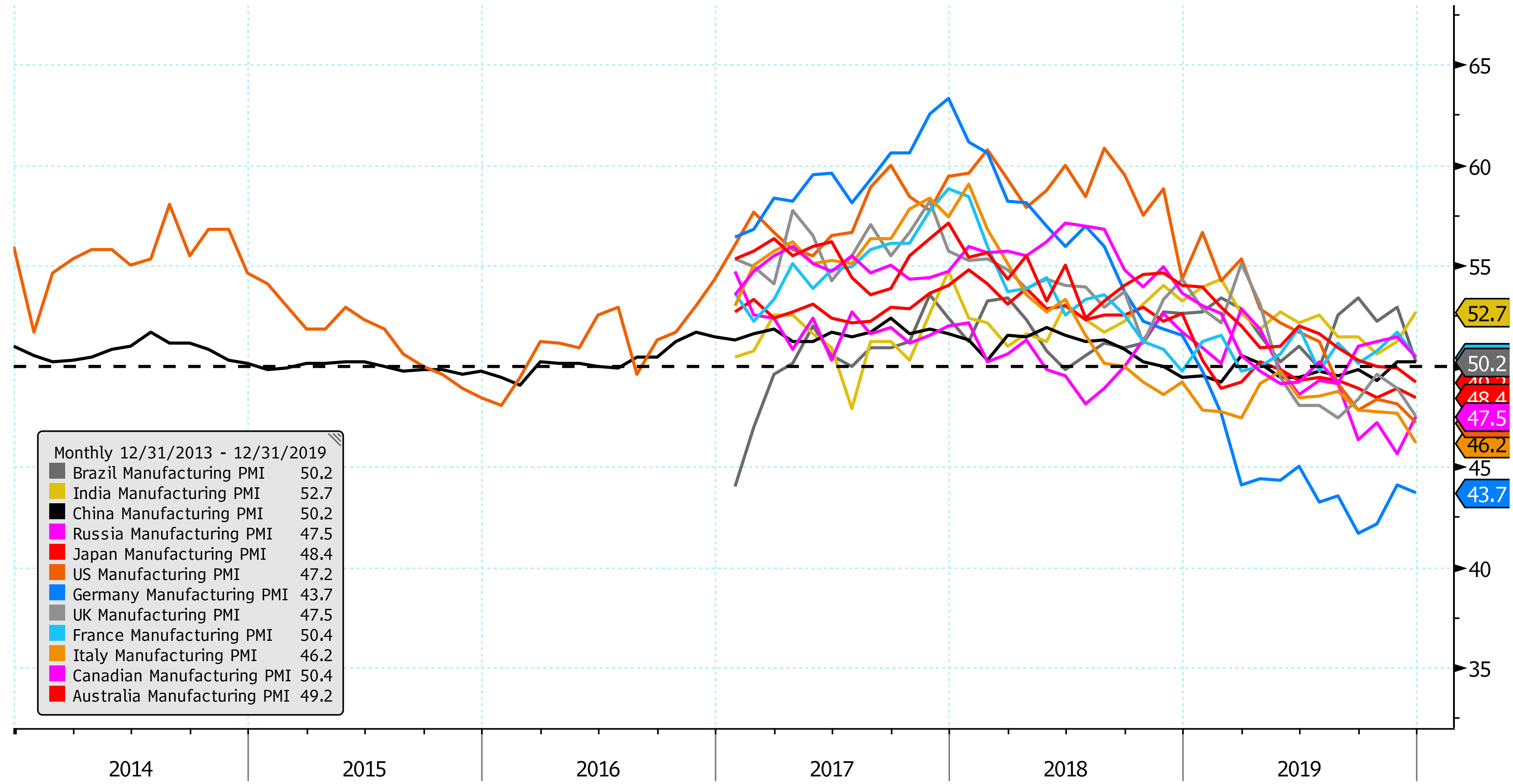


Source: © Merk Investments, Bloomberg

Analysis: Manufacturing PMI ticked down slightly over the past month, from 48.1 to 47.2, remaining below 50 and suggesting economic contraction. I'm currently negative on this picture. Chart Framework: I'd get incrementally positive on the business cycle outlook if the manufacturing PMI rose above 50.

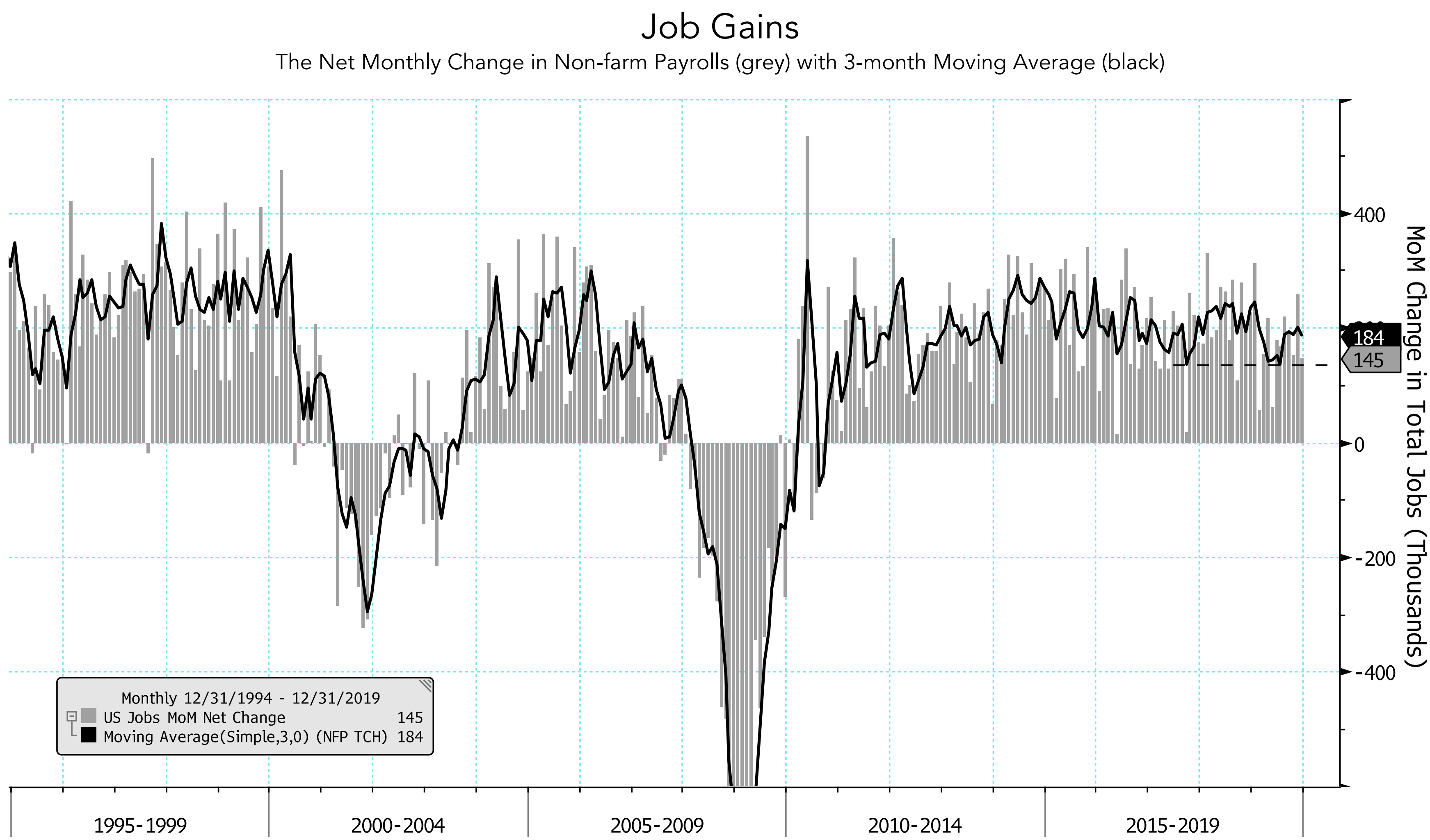
Global Manufacturing PMIs

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



Source: © Merk Investments, Bloomberg

Analysis: Global economic momentum as measured by manufacturing PMIs was mixed over the past month. seven out of the twelve readings remain below 50, i.e., in contractionary territory. Given my framework I'm negative on this picture.
Chart Framework: I'd get positive on this picture if the majority of Mfg PMIs were above 50.

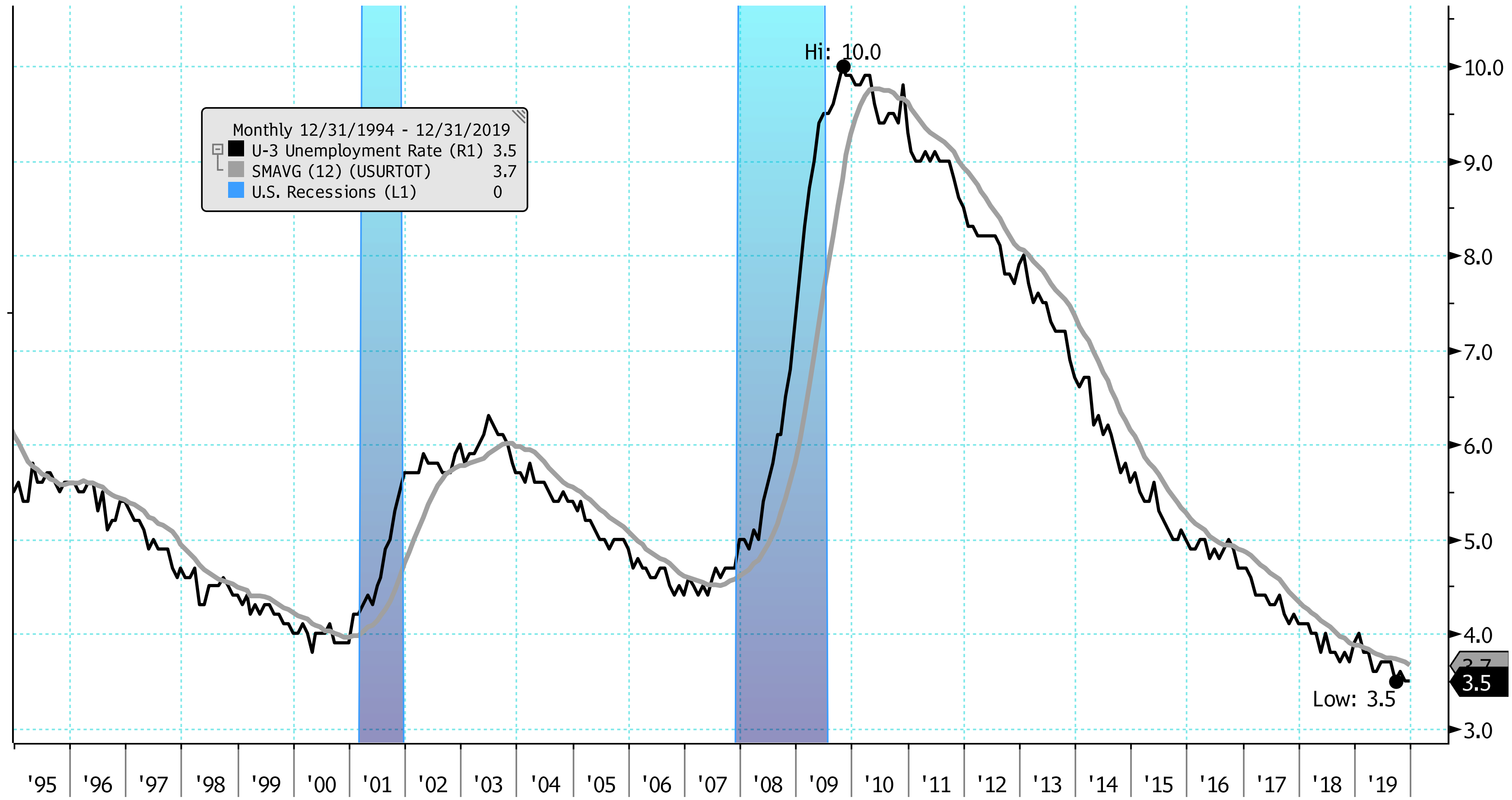


Source: Bloomberg, © Merk Investments LLC

Analysis: The 3-month moving average of job gains is 184k, still a relatively strong level.
Framework: I'd get incrementally negative on this picture if the 3-month average for job gains fell below 135k.

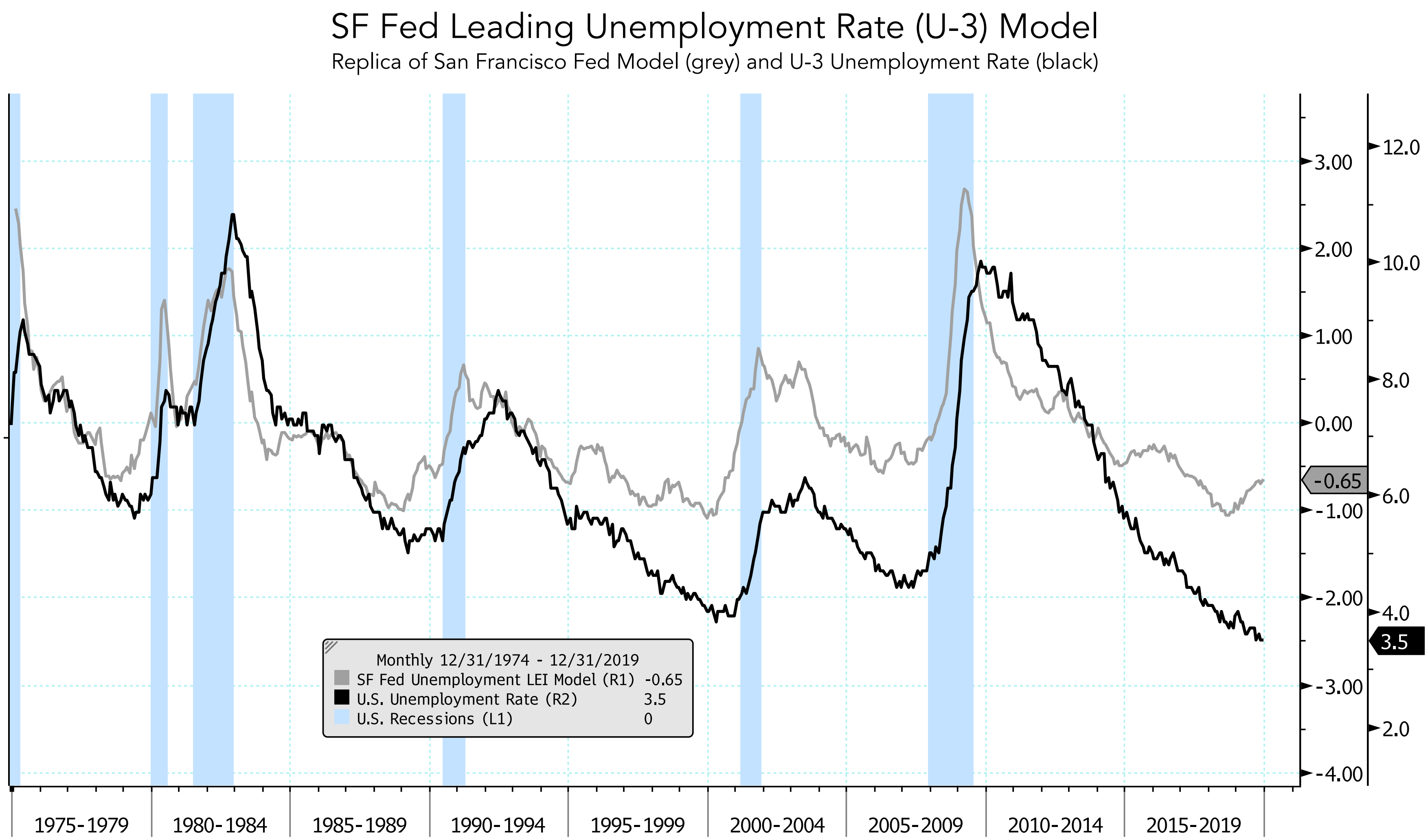
U.S. Unemployment Momentum

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



Source: © Merk Investments, Bloomberg

Analysis: The unemployment rate remained stable at 3.5%. And remains below its 12-month moving average (the labor force participation rate remains near a multi-year high– 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.

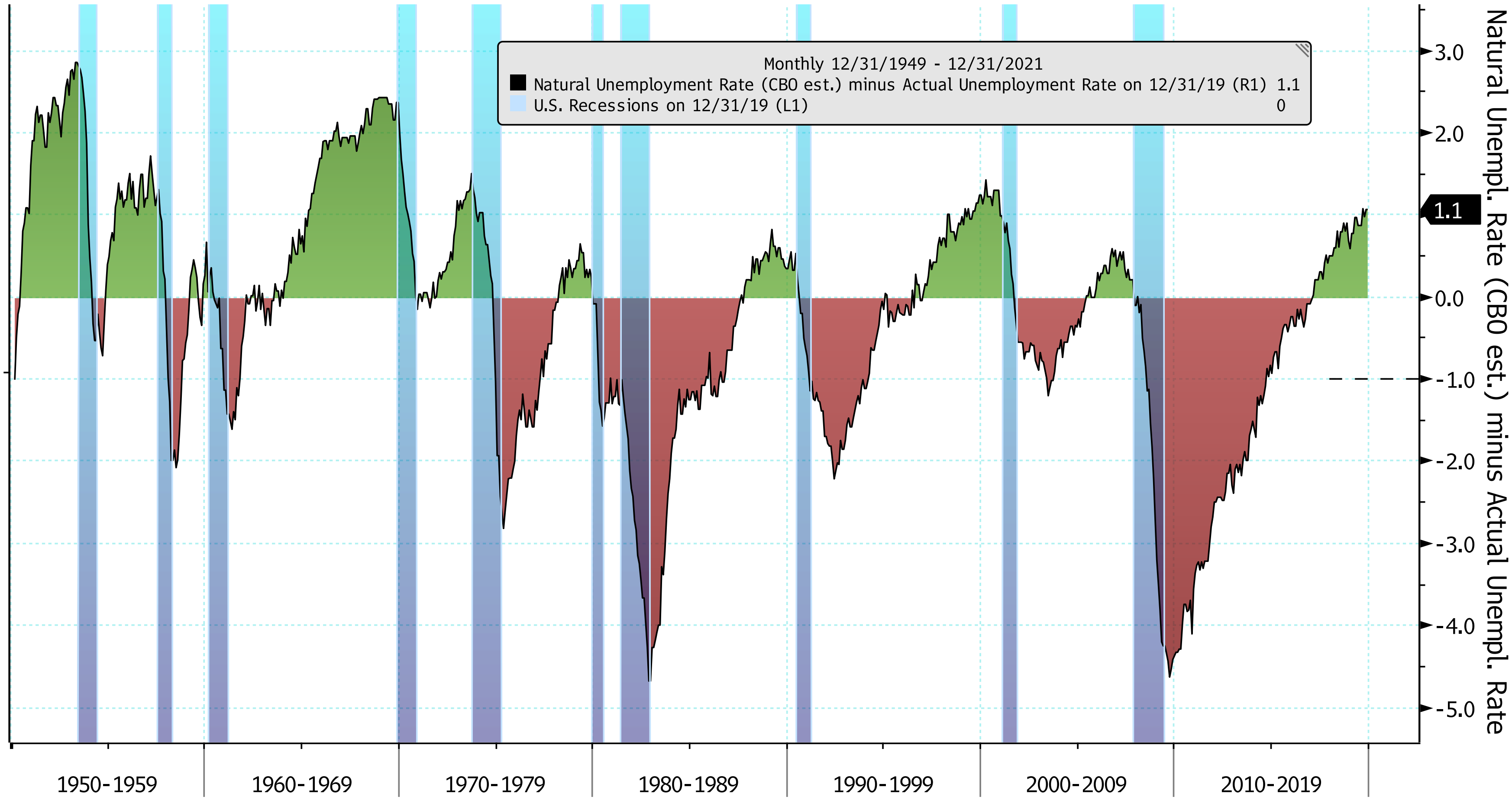


Source: © Merk Investments, Bloomberg

Analysis: The SF Fed unemployment rate model (grey line) has trended 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. For reference: the San Francisco Fed Paper

U.S. Labor Market Capacity Utilization

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

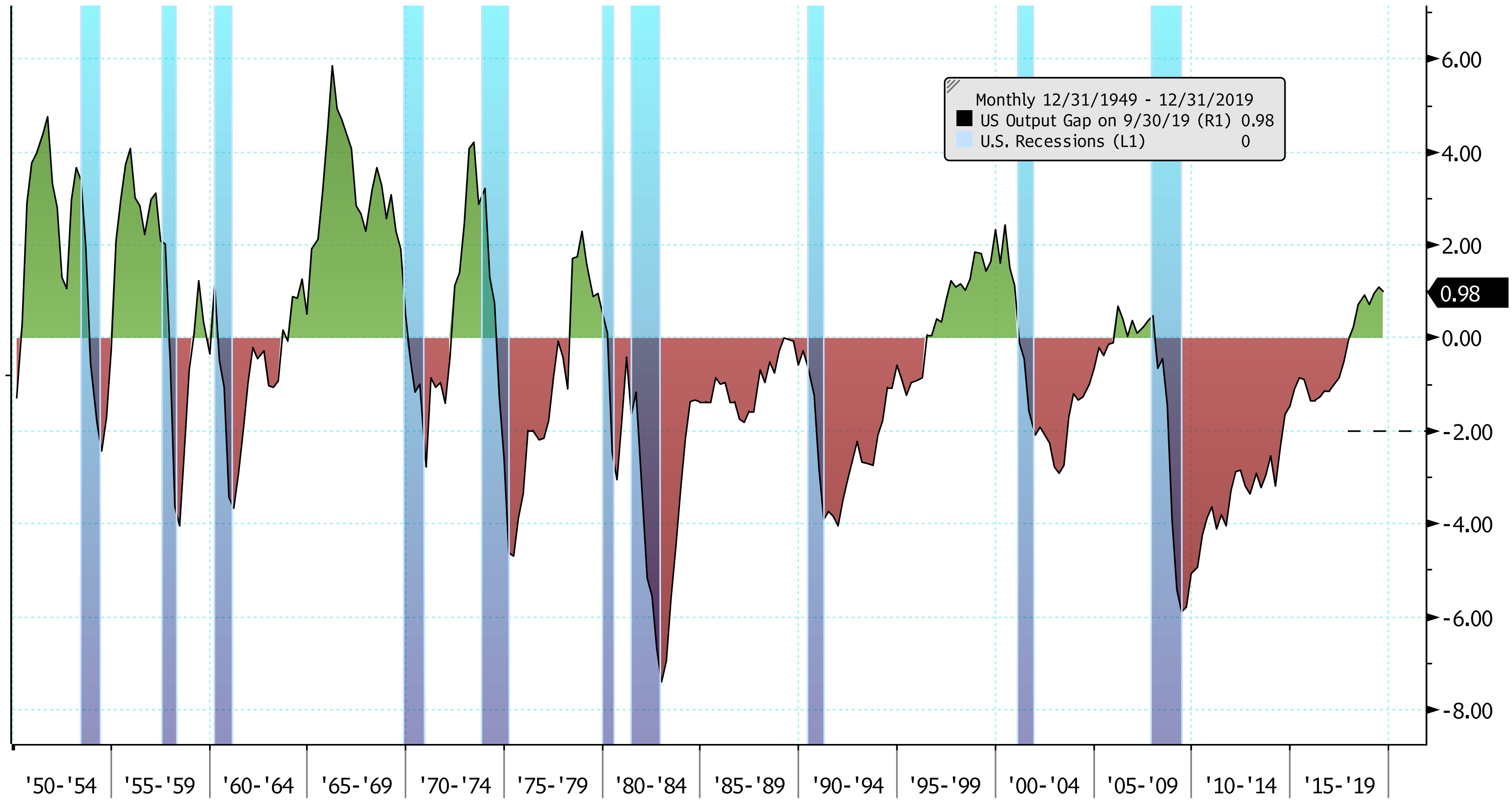


Source: © Merk Investments, Bloomberg

Analysis: The estimated natural rate of unemployment is higher than the current unemployment rate by 1.1% (4.6% 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 4.6% 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.)

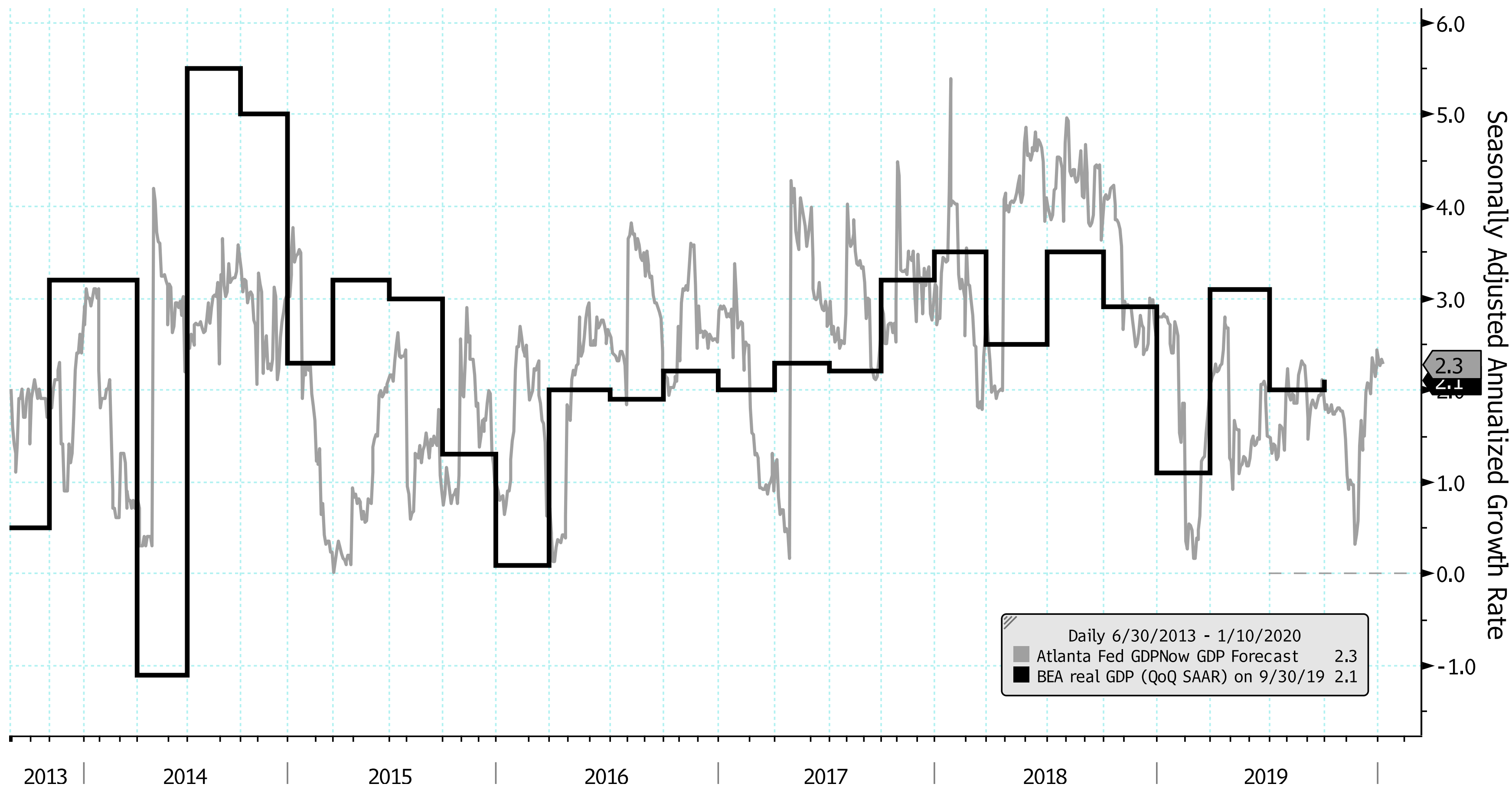


Source: © Merk Investments, Bloomberg

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

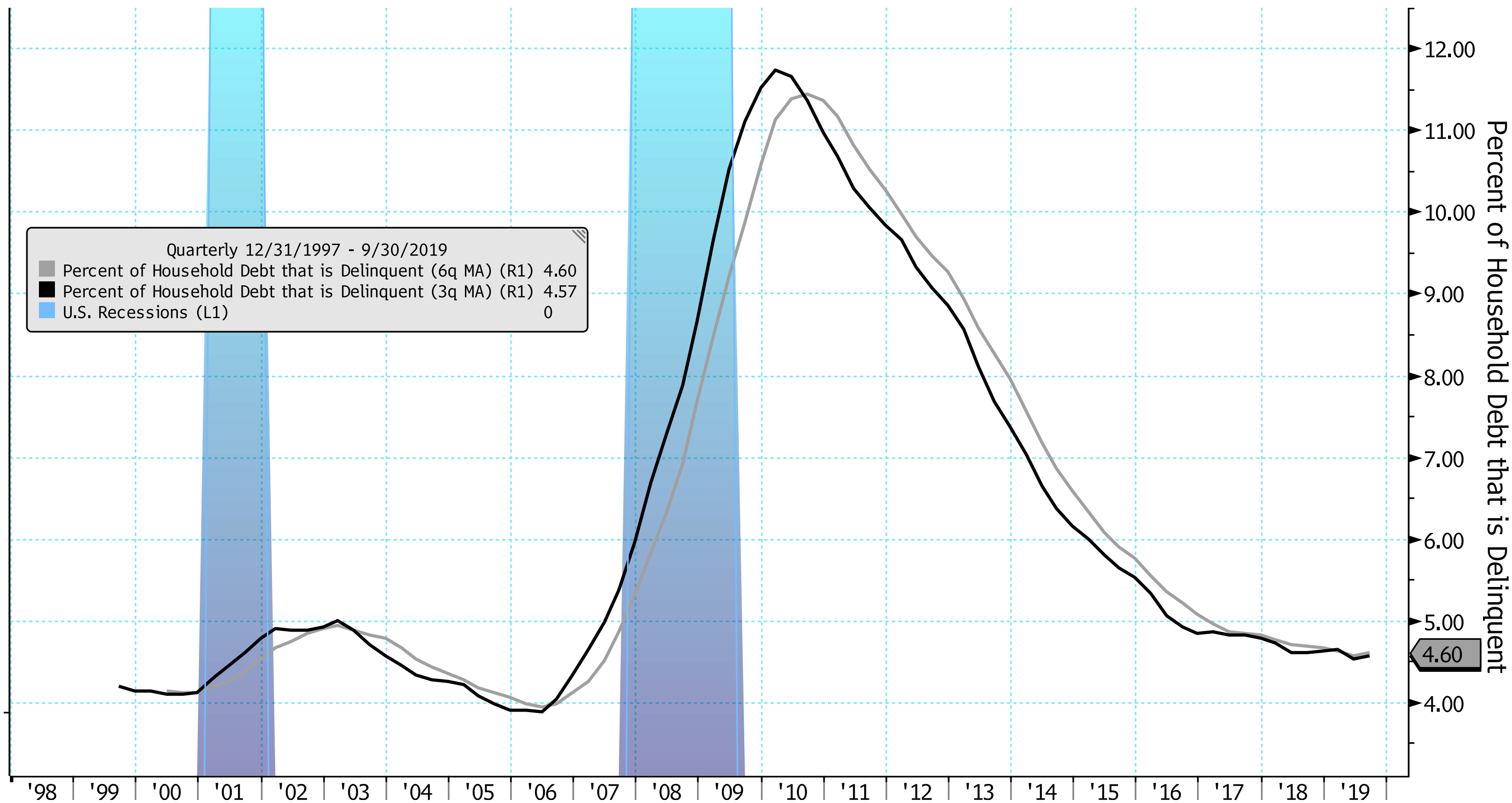


Source: © Merk Investments, Bloomberg

Analysis: The Q3 2019 GDP final reading (black line) came in at 2.1%. The current forecast for Q4 2019 GDP is around 2.0%. 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)

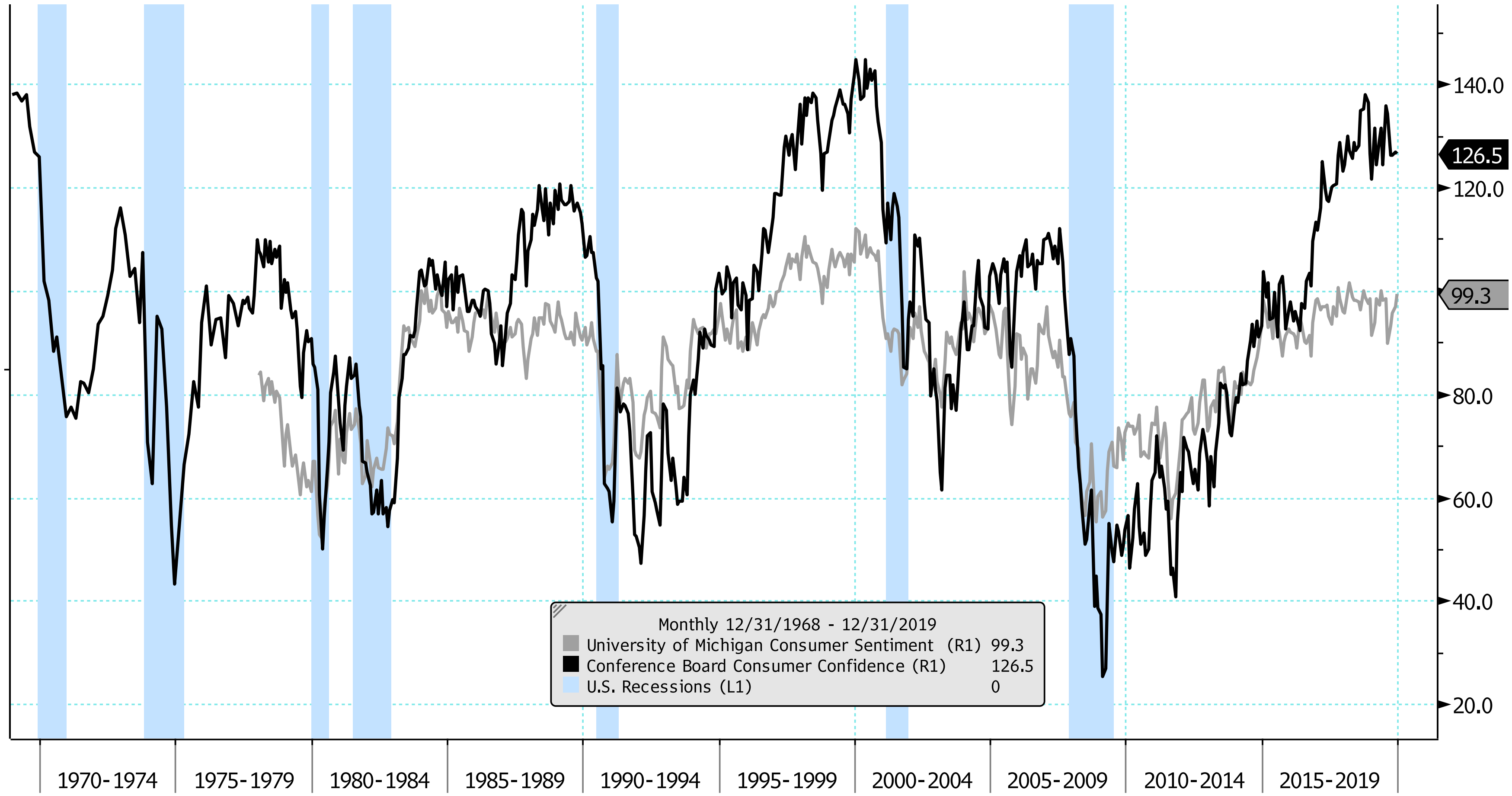


Source: © Merk Investments, Bloomberg

Analysis: The Q3 2019 data showed a notable uptick in the household delinquency rate (generally a negative sign for the economy). But the 3-quarter moving average (black) remains below the 6-quarter moving average (grey). Given my chart framework I'm currently positive on this picture. Chart Framework: I'd get incrementally negative if the 3q MA rose above the 6q MA. The Q4 2019 data comes out in late February.

U.S. Consumer Confidence

Michigan Consumer Sentiment and Conference Board Consumer Confidence

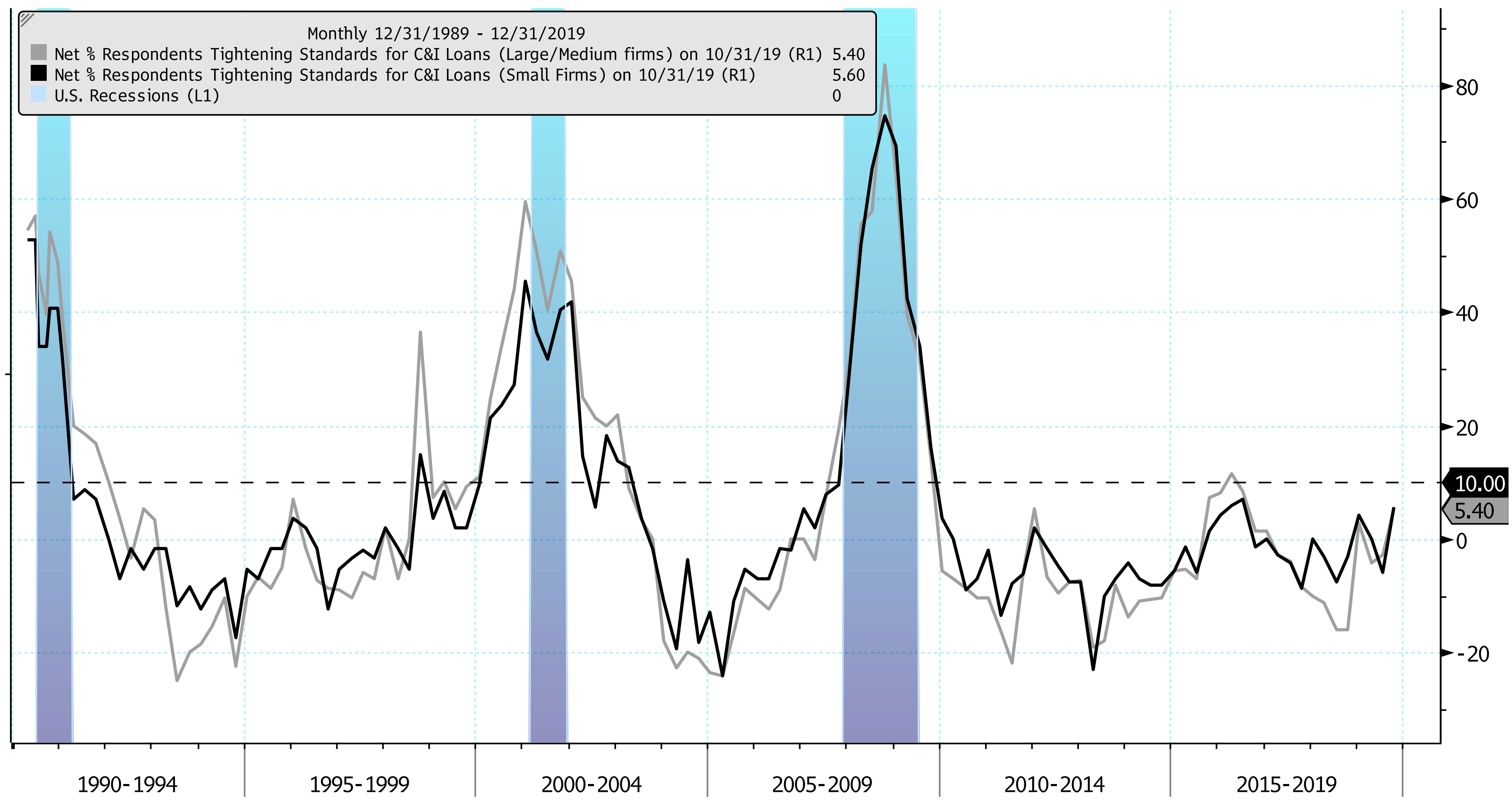


Source: © Merk Investments, Bloomberg

Analysis: The consumer confidence indexes are generally trending sideways to higher (at elevated levels). Given my framework, I'm currently positive on this picture. 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

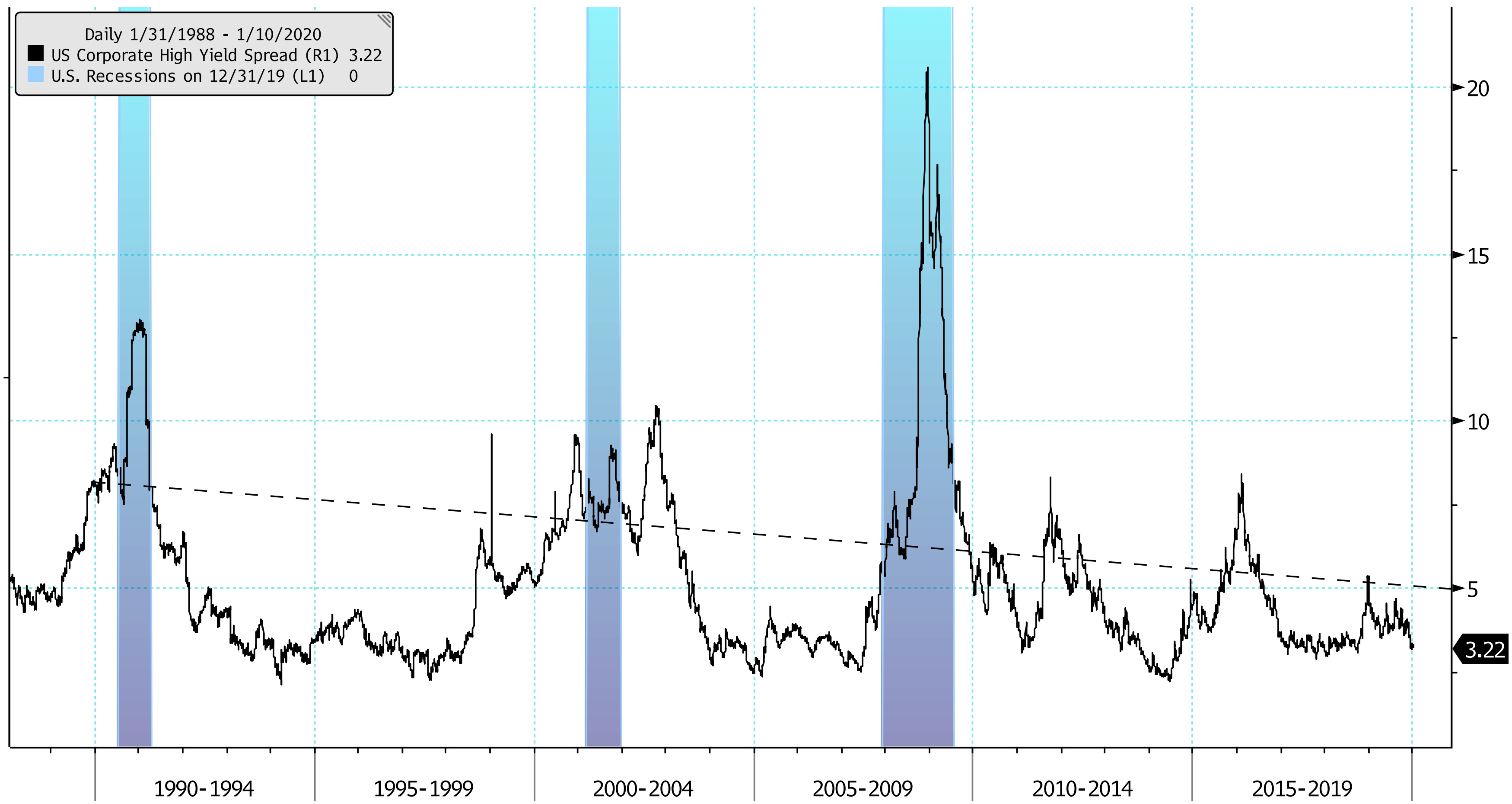


Source: © Merk Investments, Bloomberg

Analysis: Data from the Fed's Senior Loan Officer Opinion Survey suggest bank lending standards generally continue to be supportive of economic activity. 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

US High Yield Spread with Trend Line

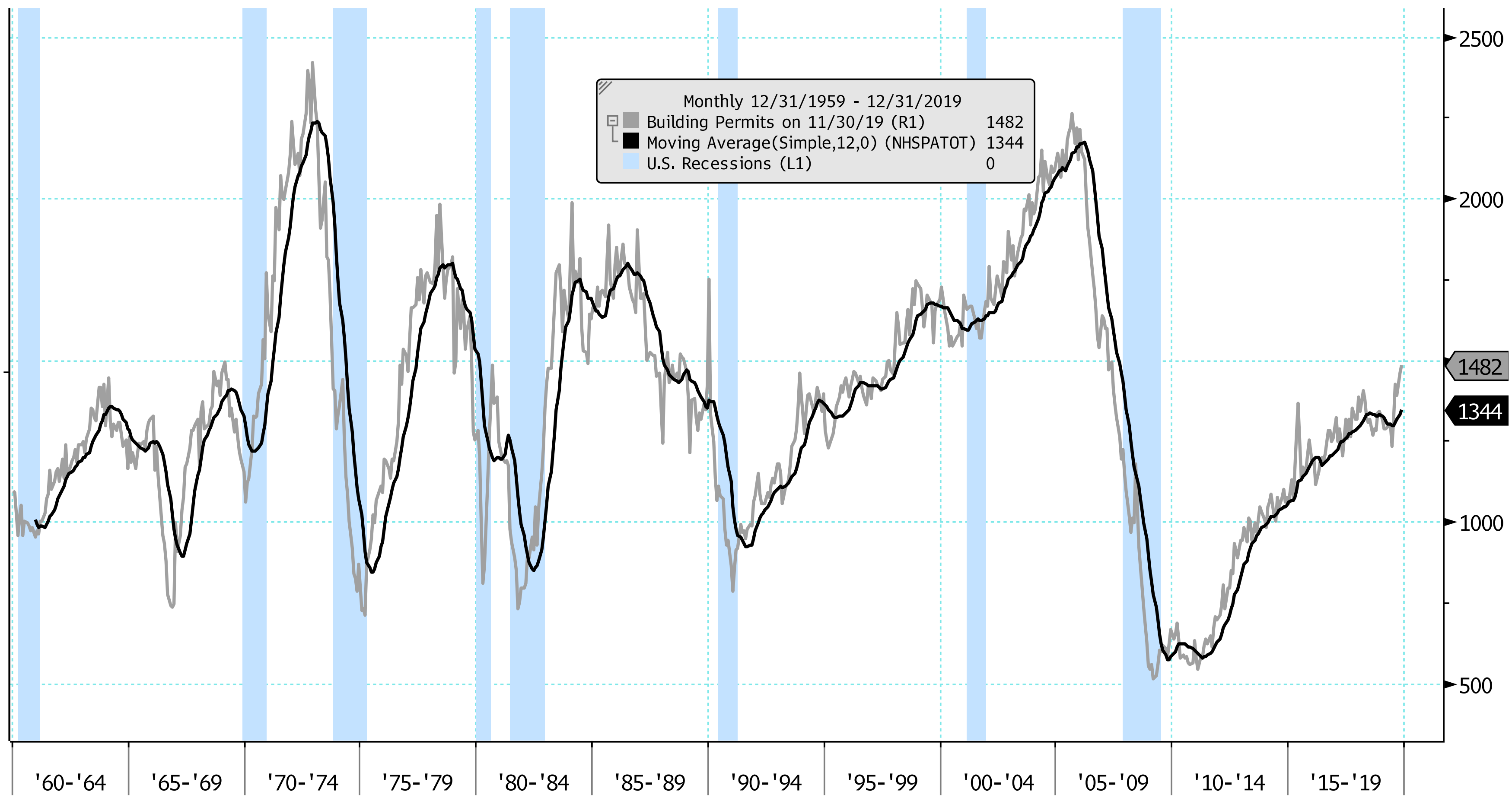


Source: © Merk Investments, Bloomberg

Analysis: The high yield credit spread has continued to come down and remains below what I consider the warning level. 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: © Merk Investments, Bloomberg

Analysis: Building permits, historically a long leading indicator, are at cycle highs. 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	Negative
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/Positive
U.S. Consumer Confidence	Short/Medium Term	Positive
Lending Standards	Medium Term	Positive
High Yield Spread	Short/Medium Term	Positive
U.S. Building Permits	Medium/Longer Term	Positive
	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

My view continues to be economic expansion until further notice, but recession risk remains. I'd currently estimate recession probability over the next six months to be around 10-25%. While a few pictures still look concerning, there are enough recession disconfirmations to make me more positive than negative. My base-case view is that we are in the process of coming out of a mid-cycle (or perhaps late-cycle) slowdown, and that we will see further evidence of cycle extension. But uncertainty around the outlook remains elevated and recession probability may fluctuate notably—either higher or lower—in the quarters ahead.

The LEI index YoY remains positive (if only barely). The U.S. 10yr yield continues to trend slightly higher, suggesting the yield curve inversion last year may have been a false signal. The Services PMI has not followed the Manufacturing PMI lower. Building permits are at a cycle high, typically a long leading indicator. Both the unemployment rate trend and job gains suggest continued labor market health. Consumer sentiment improved overall since last month's report. And GDP growth seems to continue to be around the 2.0% average of this expansion. Also, several international leading economic indicators have turned up.

Global trade policy uncertainty appears to be declining, although risks remain. EU/US trade disputes may escalate in the coming months. On the positive side, a Brexit deal is likely by the end of the month. Also, tension in Hong Kong appears to be subsiding. Stress that flared up last summer in USD.HKD exchange rate options pricing is coming down.

Of concern the ISM Manufacturing PMI fell to a new cycle low. But Services PMI remains strong. It will be important to see ISM Manufacturing move higher in the coming months, along with the LEI index. While we've seen some stabilization and recovery in global manufacturing PMIs, questions remain around the German manufacturing sector.

Based on my checklist approach, the U.S. business cycle picture near-term is overall more positive than negative. On balance, based on the data and frameworks presented (which inevitably may not capture all possible risk factors in real-time), it seems more likely than not that the expansion continues in the coming several months. The longer-term outlook remains neutral/negative as we are likely in the later part of this cycle. All the presented charts and concepts are somewhat inter-related, as is the economy in general. The idea is to have some different data points to cross-reference. No one indicator should be looked at in isolation.

-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

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. Some believe predicting recessions is either impossible or very difficult. 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