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U.S. Business Cycle Report

July 2020

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

What Policy Makers are Saying

“The Federal Reserve is strongly committed to using our tools to do whatever we can for as long as it takes to provide some relief and stability to ensure that the recovery will be as strong as possible and to limit lasting damage to the economy… The Fed will continue to use these powers forcefully, proactively, and aggressively until we're confident that the nation is solidly on the road to recovery.”

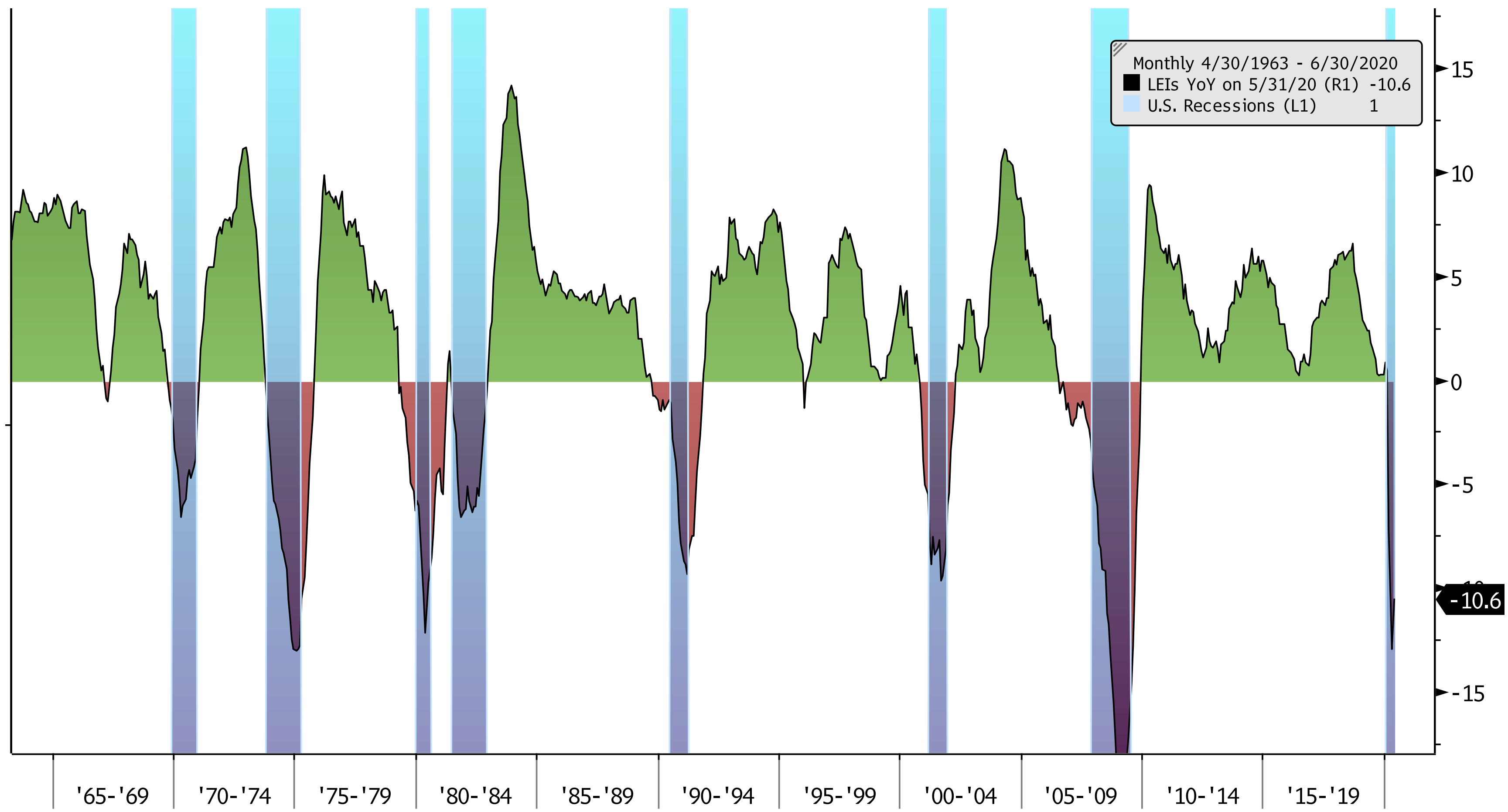
– Fed Chair Powell (Congressional Testimony on 6/30/20)

“The PPP is keeping tens of millions of employees connected to their jobs. Economic impact payments are also helping millions of families and workers through these challenging months… we're beginning to have conversations about supplemental relief legislation, we look forward to working with Congress on a bipartisan basis in July on any other further legislation that will be necessary. Treasury has already been entrusted with a tremendous amount of funding to inject into the economy. We are closely monitoring these results and seeing conditions improve. We would anticipate that any additional relief would be targeted to certain industries that have been especially hard hit by the pandemic, with a focus on jobs and putting all Americans back to work who have lost their jobs through no fault of their own.”

- Treasury Secretary Mnuchin (Congressional Testimony on 6/30/20)

U.S. Leading Economic Indicators (LEIs) Index

Conference Board's LEI Index and YoY Rate of Change



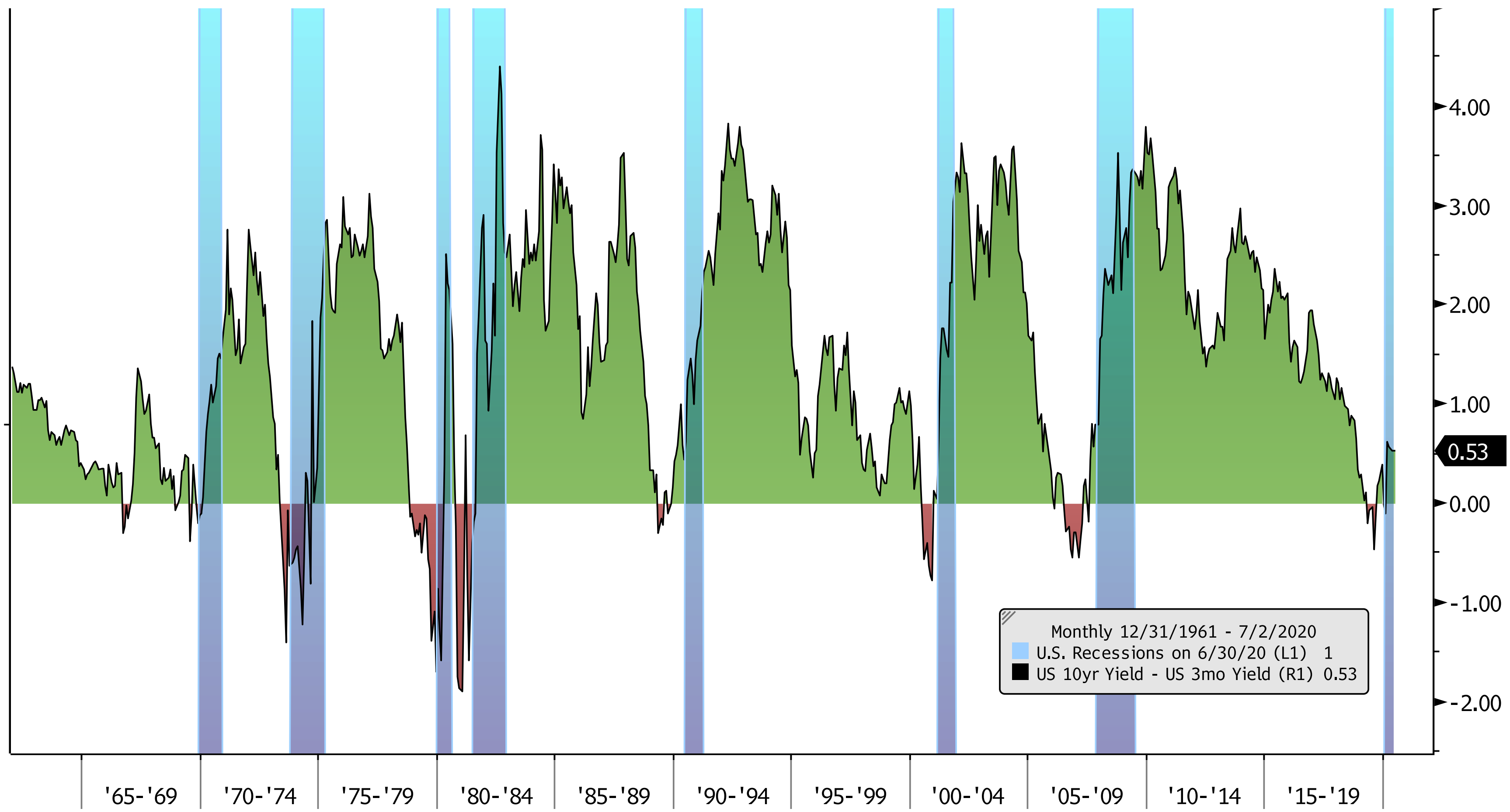
Source: © Merk Investments, Bloomberg

Analysis: The LEI index bounced back in May. And given the bounce I'm positive on this picture. It's also confirmed by a move higher in the OECD U.S. leading index for May. As I noted previously, this will likely be the first time the LEIs failed to signal an imminent recession (given the positive picture for the Feb LEIs). That speaks to the sudden exogenous shock nature of the current Covid19 pandemic/shutdown. Framework: I'd get negative if the YoY rate of change moved lower again.

Conference Board LEI release: https://conference-board.org/pdf_free/press/US%20LEI%20PRESS%20RELEASE%20-%20JUNE%202020.pdf

U.S. Yield Curve Steepness

(10yr yield – 3mo yield)

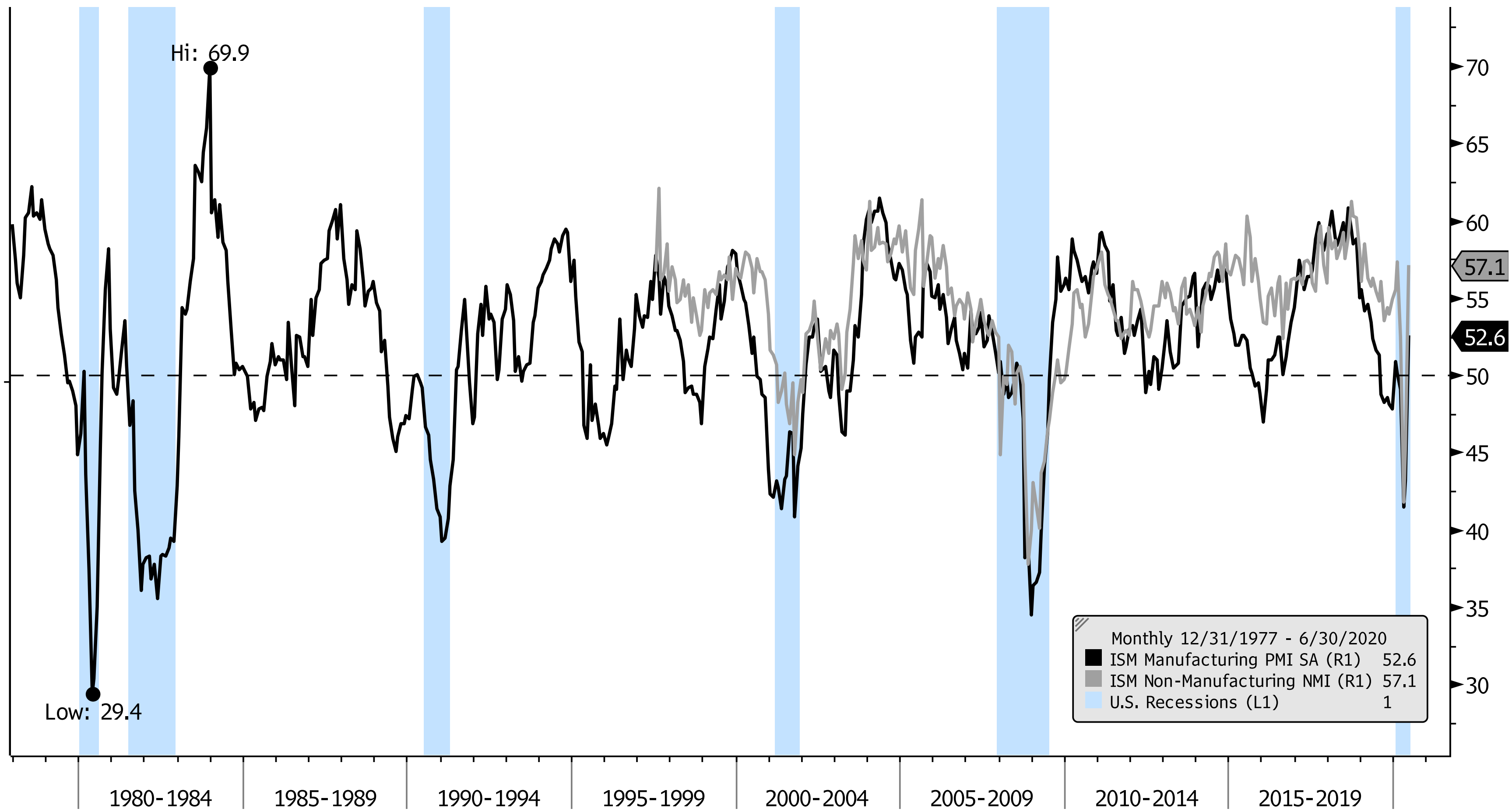


Source: © Merk Investments, Bloomberg

Analysis: The yield curve flattened from 73bps to 53bps over the past month. The 10-year yield declined from 90bps to 67bps since last month's report, while the 3-month yield remained stable, falling only 1bp (from 15bps to 14bps). The 10yr-3m yield curve had 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). In hindsight, this may be one of the only leading indicators that "predicted" the current recession. Chart Framework: I'd get incrementally negative on this picture if the yield curve flattens again, likely meaning lower long end rates. The short-end is likely to remain near zero for some time as the Fed as committed to keeping rates low.

U.S. PMIs

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



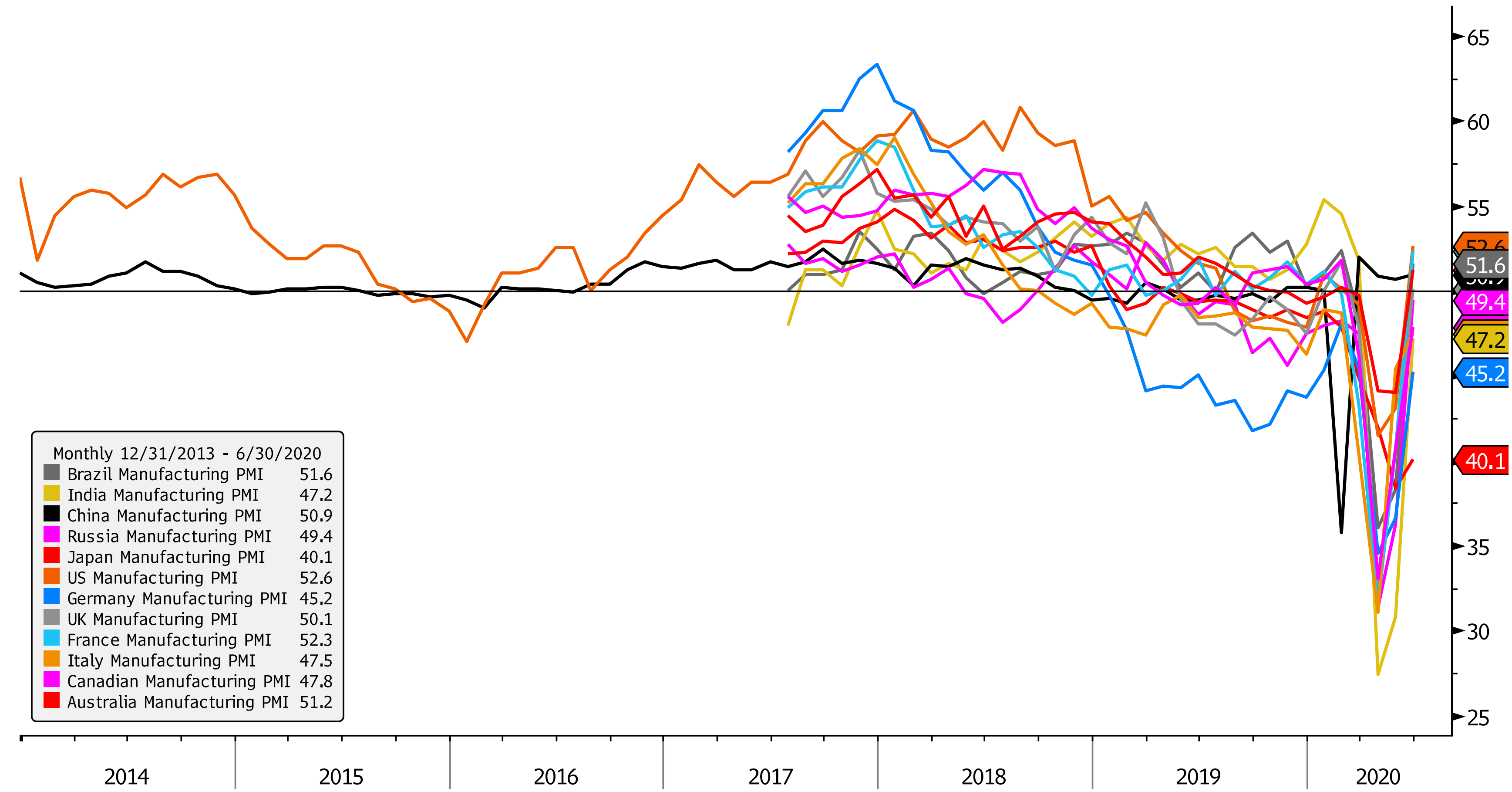
Source: © Merk Investments, Bloomberg

Analysis: U.S. Manufacturing PMI moved back above 50. And so did the Services PMI. For background, the Mfg PMI is a diffusion index. A diffusion index is a cross-sectional way to analyze incremental changes among various time-series. It aggregates multiple indicators by examining whether they are getting better or worse relative to the prior month but ignores the magnitude of the change. Chart Framework: I'd get incrementally negative on the business cycle outlook if the manufacturing PMI moved back below 50.

ISM Report: https://www.instituteforsupplymanagement.org/ISMReport/MfgROB.cfm?SSO=1

Global Manufacturing PMIs

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

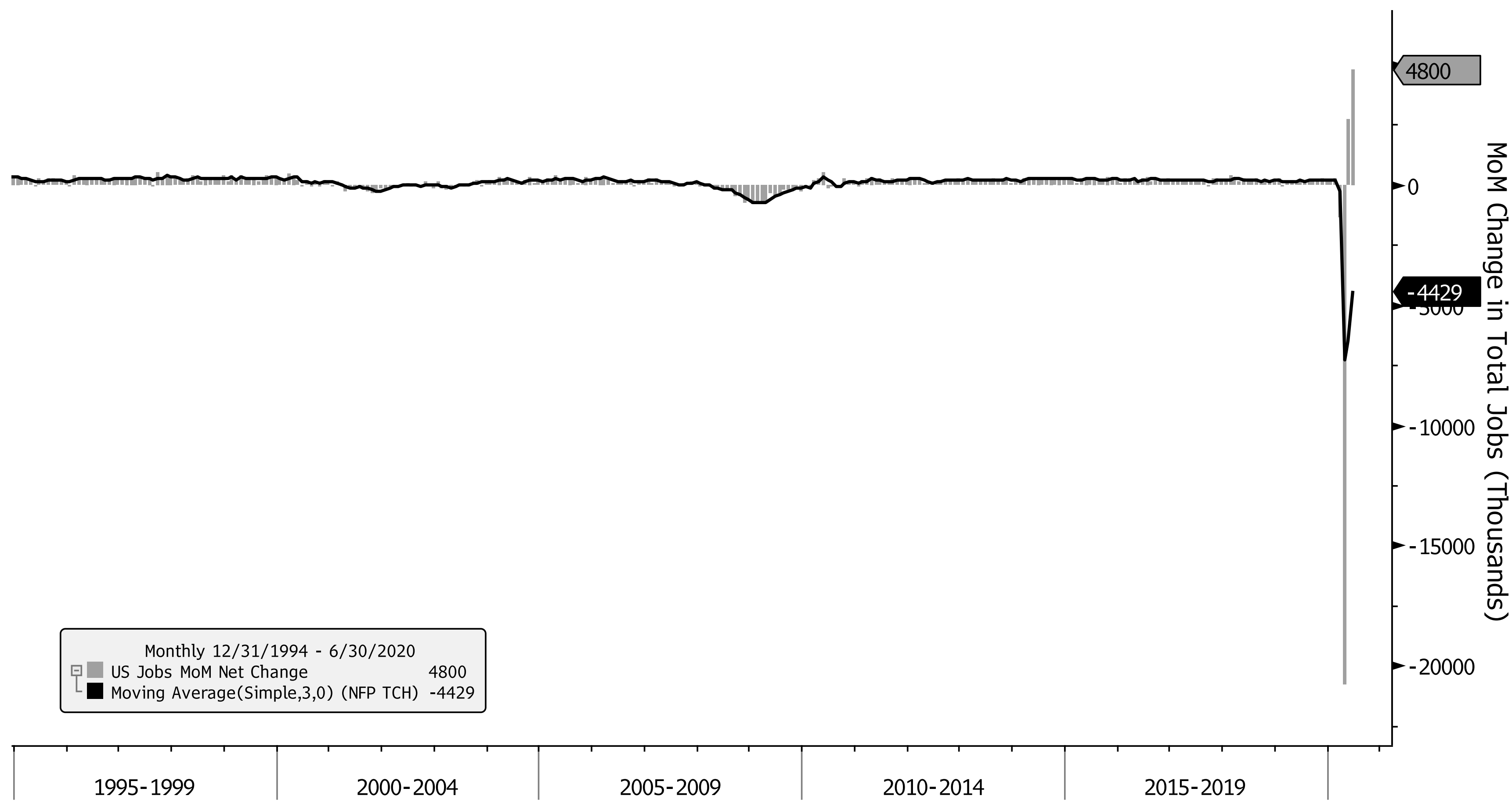


Source: © Merk Investments, Bloomberg

Analysis: Global economic momentum as measured by manufacturing PMIs was positive over the past month. Now six of the twelve readings are above 50 (with an average of 48.8, up from an average of 40.4 last month). Given my framework I'm currently negative on this picture, but the picture is improving. Chart Framework: I'd get positive on this picture if a majority of Mfg PMIs move above 50.

Job Gains

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



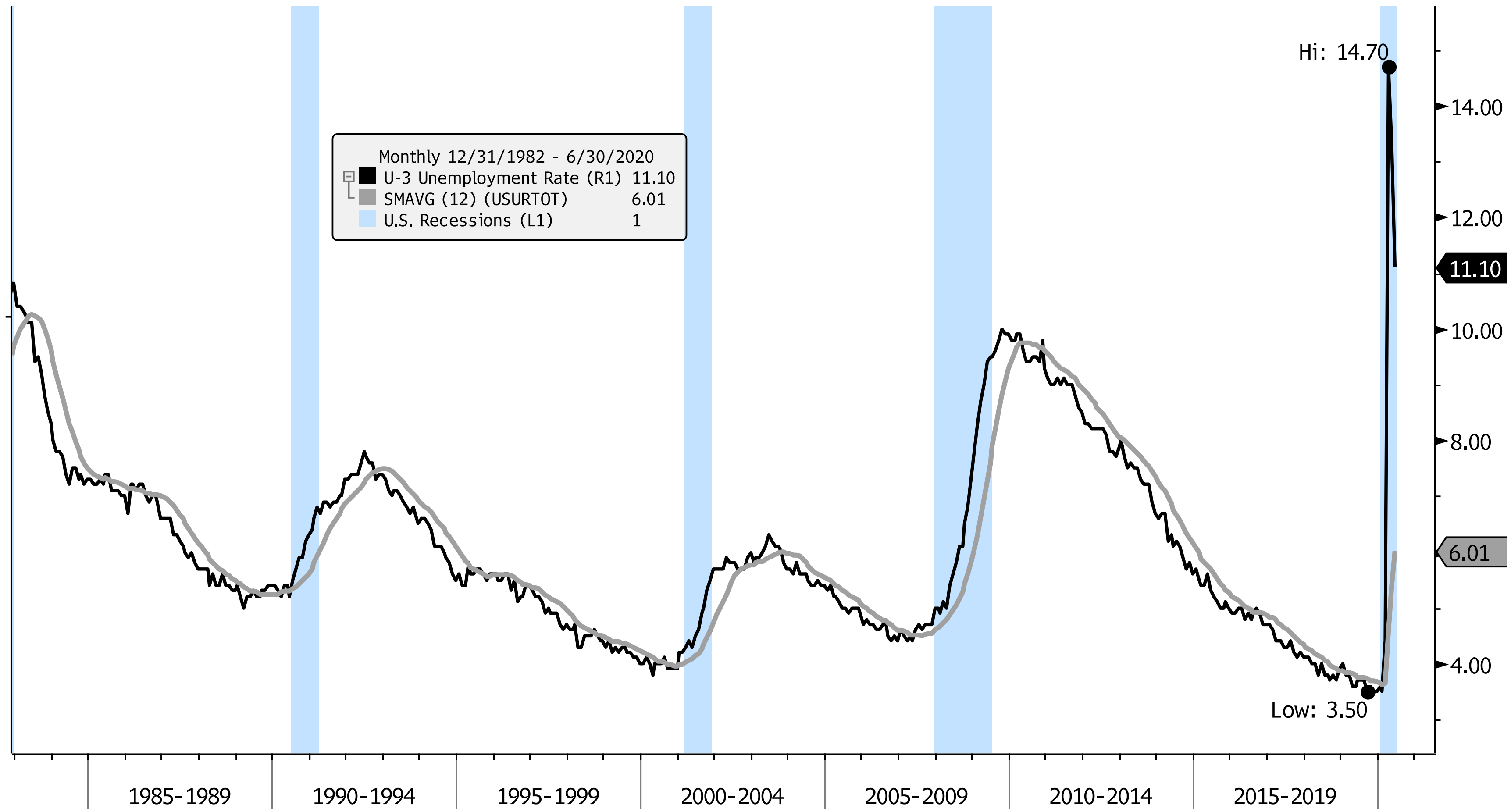
Source: © Merk Investments, Bloomberg

Analysis: The June jobs reports showed net job gains of 4.8 million, the second month of growth. Notably, this was supported by data from the ADP report. The 3-month moving average of net job gains continues to move higher. Framework: I'd get incrementally negative on this picture if the 3-month average for job gains inflected lower.

June Jobs Report: https://www.bls.gov/news.release/pdf/empsit.pdf

U.S. Unemployment Momentum

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

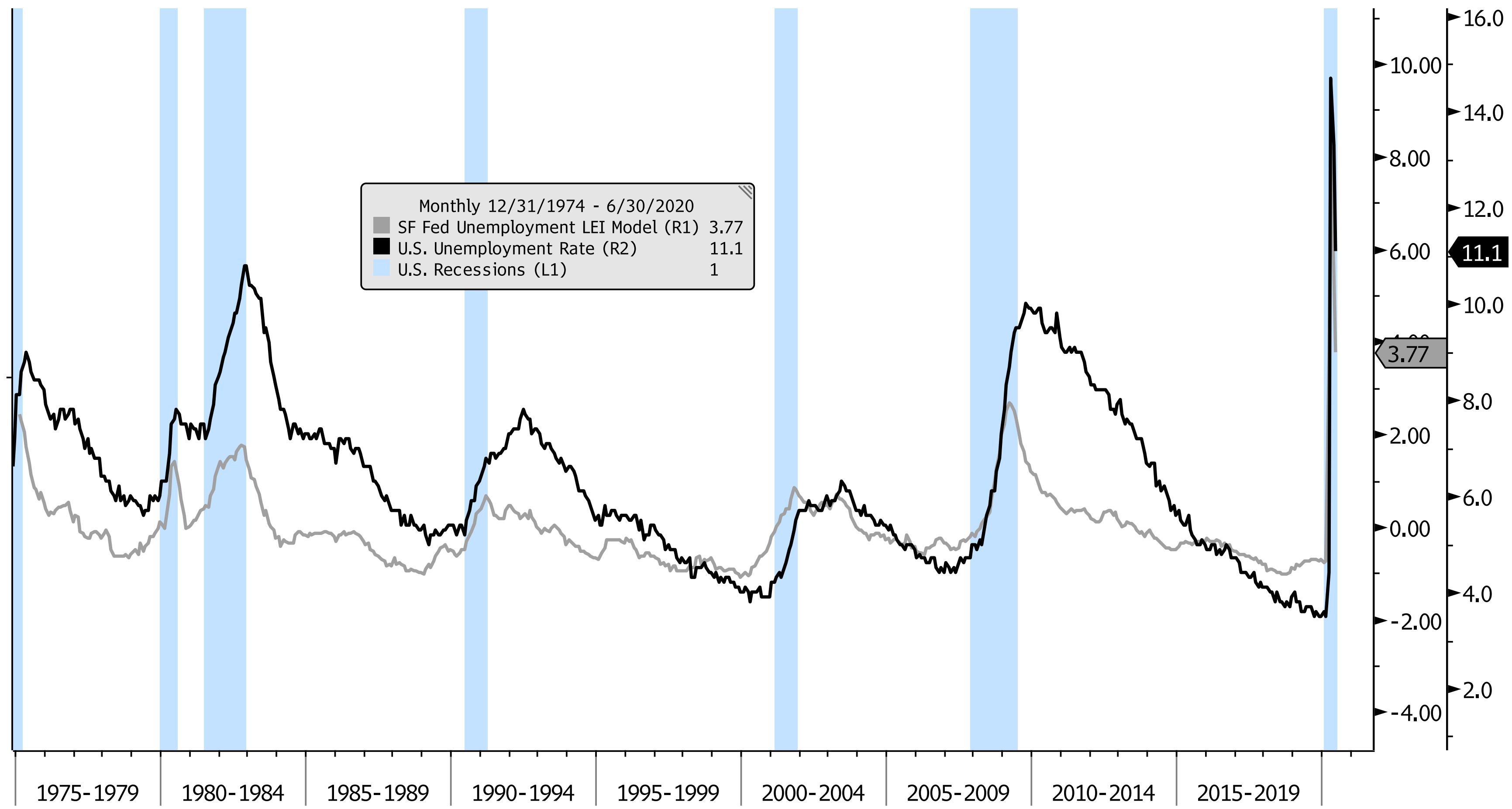


Source: © Merk Investments, Bloomberg

Analysis: The unemployment rate fell further: from 13.3% to 11.1%. The spread between the unemployment rate (black) and its 12-month moving average (grey) has continued to narrow (see additional charts section). Chart Framework: I'd get incrementally negative if the spread between the unemployment rate and its 12m MA widened.

SF Fed Leading Unemployment Rate (U-3) Model

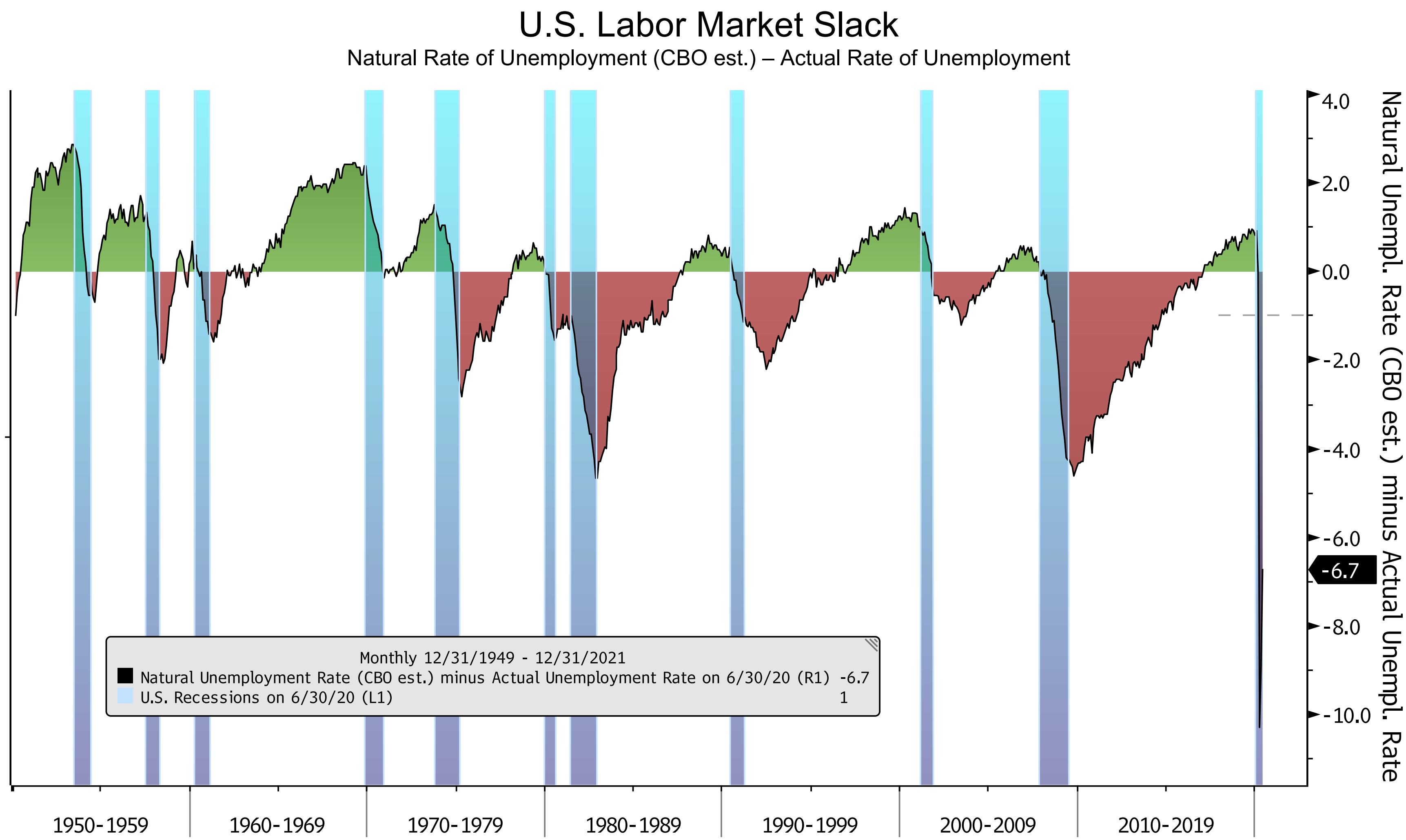
Replica of San Francisco Fed Model* (grey) and U-3 Unemployment Rate (black)



Source: © Merk Investments, Bloomberg

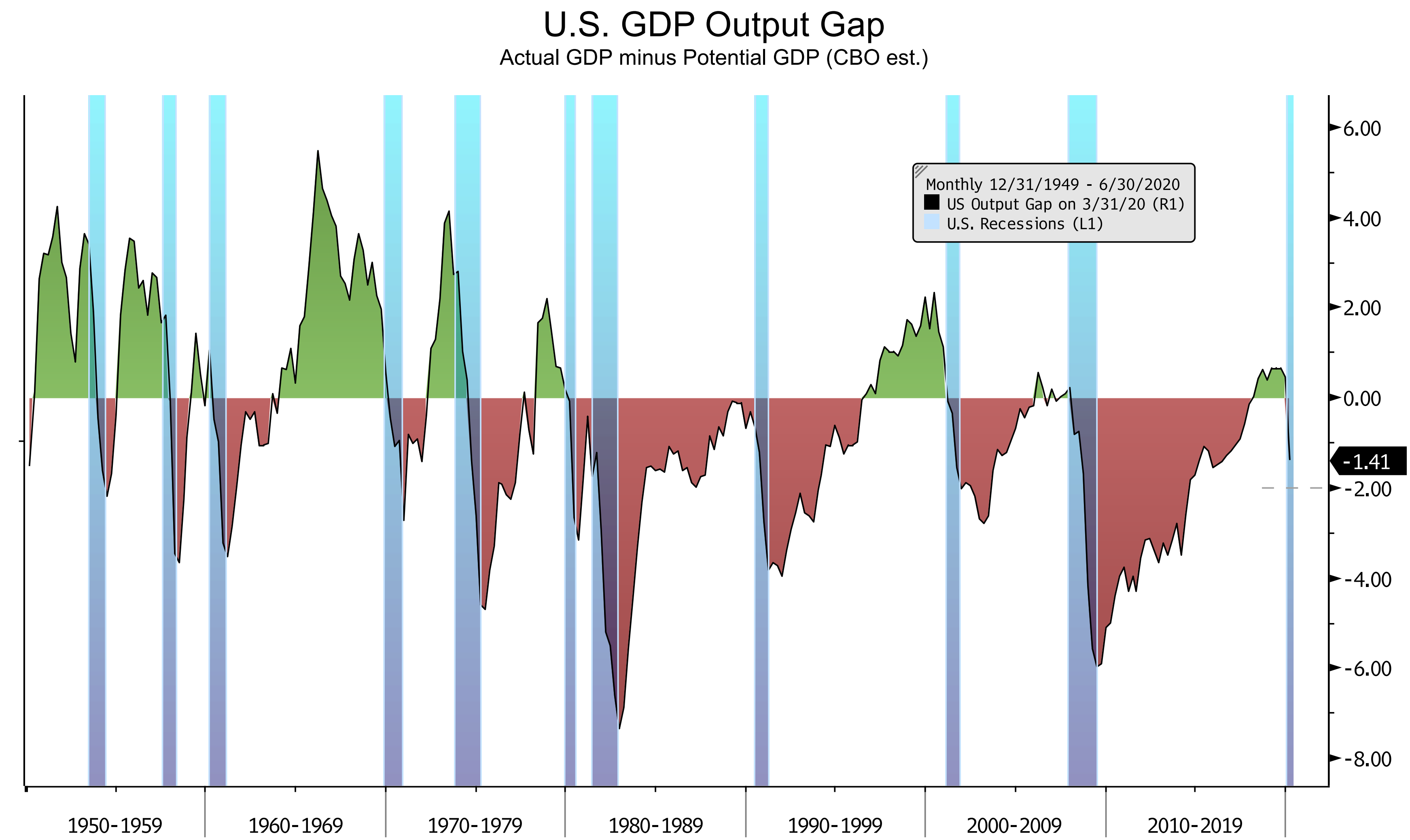
Analysis: The SF Fed unemployment rate model (grey line) continues to support the recent decline in the U-3 unemployment from the official jobs report. Chart Framework: I'd get incrementally negative on the business cycle outlook if the SF Fed model line inflected back up.

*The SF Fed identified six indicators they believe are predictors of future developments in the unemployment rate: insured unemployment rate, initial claims, capacity utilization, the jobs gap, the ISM manufacturing index, and private payroll employment growth. The model creates an average Z-score of these six indicators. For reference see the San Francisco Fed Paper



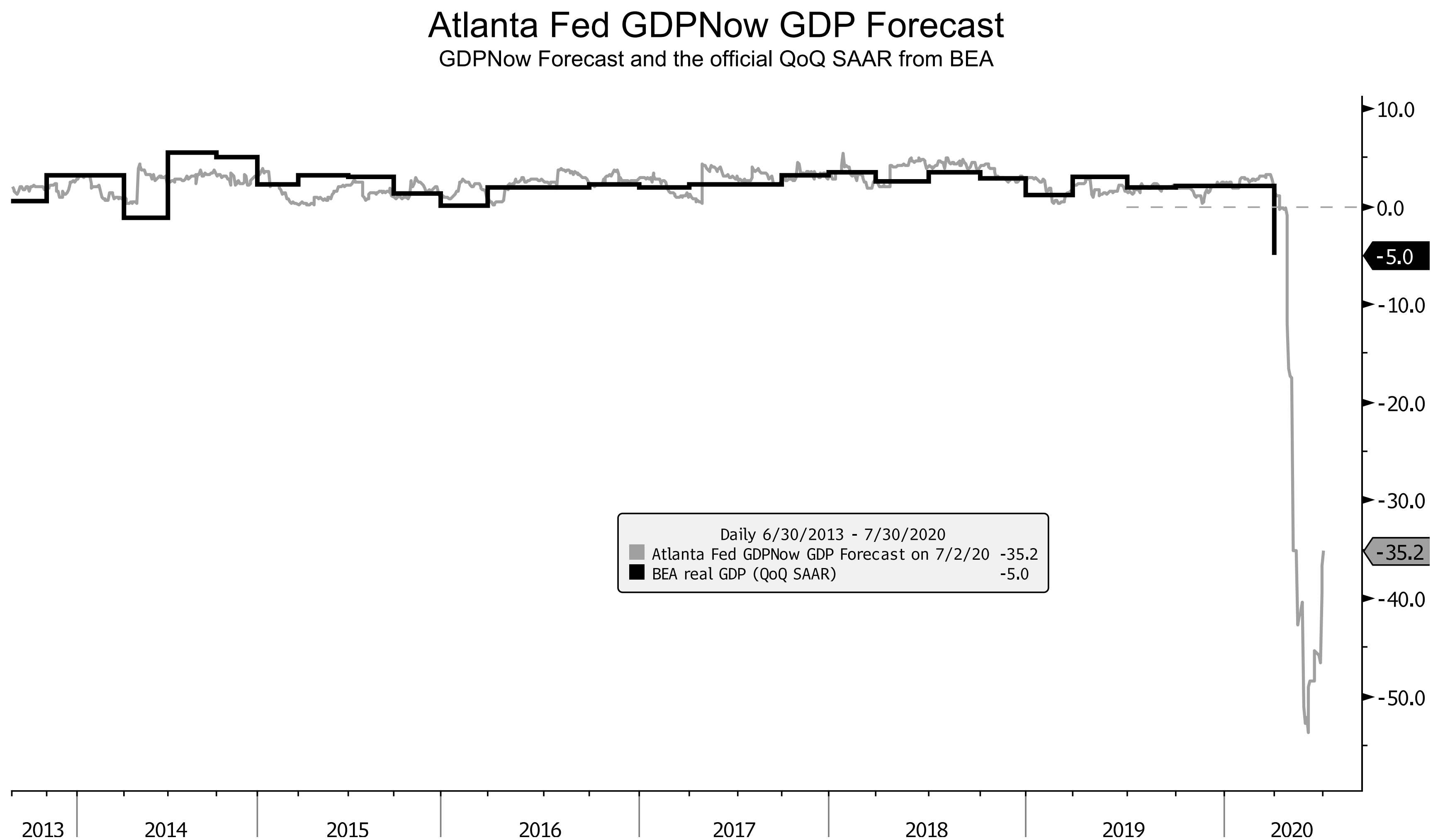
Source: © Merk Investments, Bloomberg

Analysis: The estimated natural rate of unemployment is well below the current unemployment rate (4.4% estimate – 11.1% current reading), indicating a large amount of labor market slack. I'm currently positive on this chart. Chart Framework: I'd get incrementally negative medium/longer term above zero.



Source: © Merk Investments, Bloomberg

Analysis: This chart is updated with Q1 GDP but is still stale. GDP for Q2 will show the output gap materially wider (the first reading for Q2 GDP will come out on July 30th). That will set the stage for the economic recovery back to full potential.



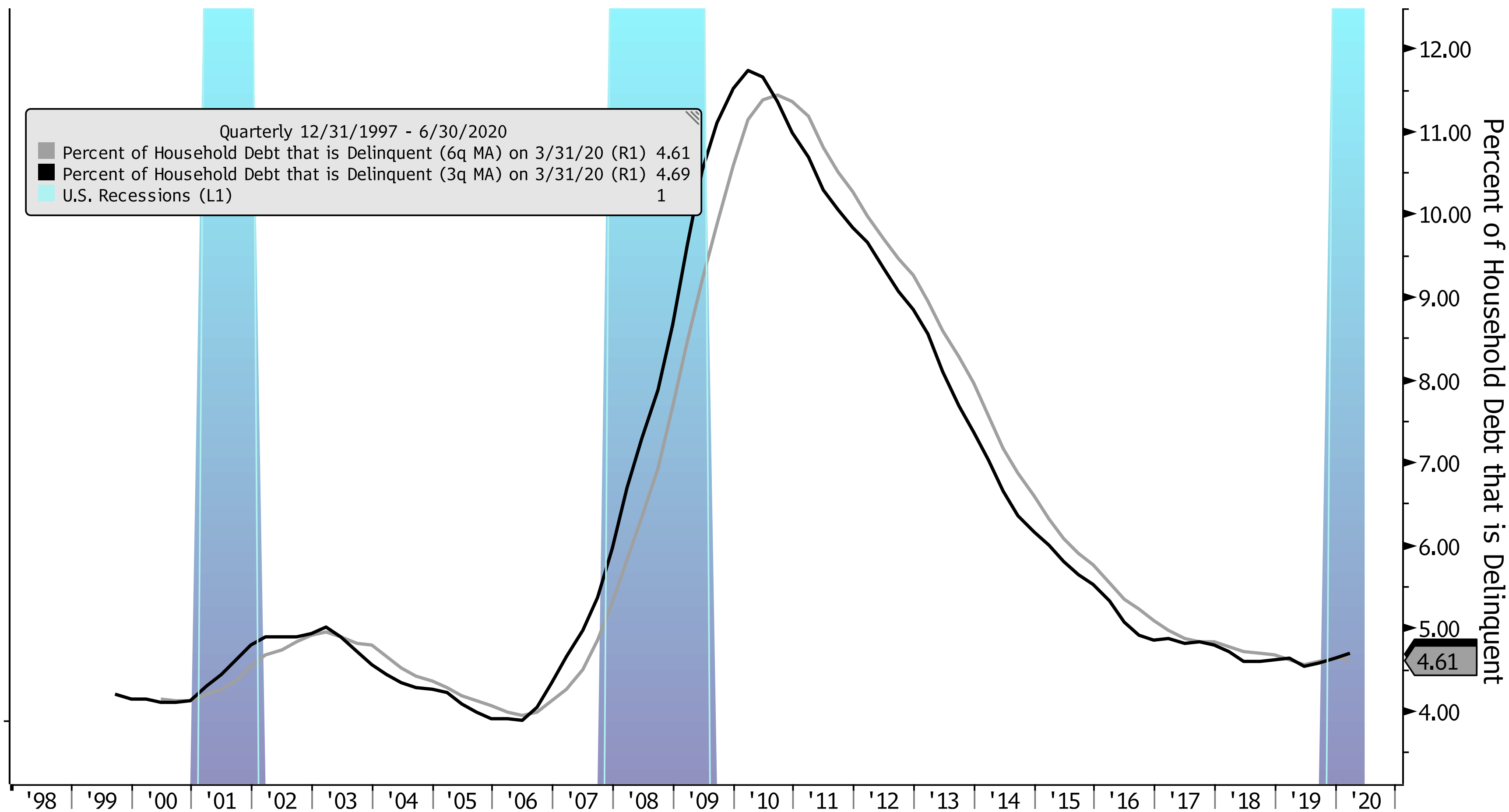
Source: © Merk Investments, Bloomberg

Analysis: The Atlanta Fed GDP model currently projects a Q2 reading of -35.2%. Keep in mind that's on an annualized basis (i.e., roughly multiplies the QoQ reading by 4). The Q1 2020 GDP was revised lower to -5.0% (from 4.8% initial reading) (again, that's an annualized number). Historically, the Atlanta Fed GDPNow indicator has been accurate near the end of the quarter and so the official Q2 number that comes out at the end of July might be near -35%.

Atlanta Fed GDPNow report: https://www.frbatlanta.org/-/media/documents/cqer/researchcq/gdpnow/RealGDPTrackingSlides.pdf

U.S. Household Credit Cycle

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



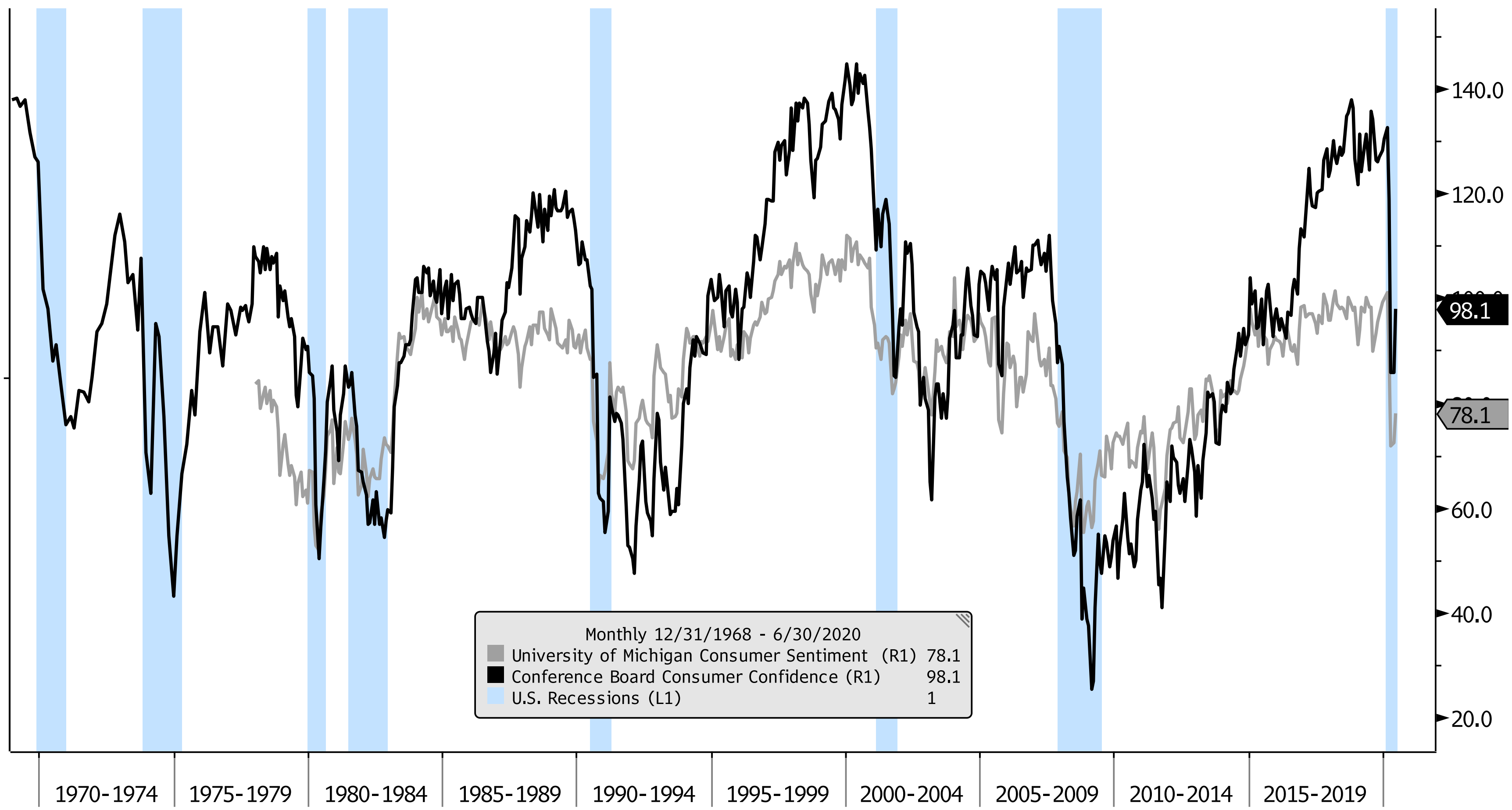
Source: © Merk Investments, Bloomberg

Analysis: The Q1 2020 data showed a *decline* in delinquency rate. For intellectual consistency I'm still showing the 3q vs 6q MA chart, which shows the 3q MA above the 6q MA (a mathematical quirk of base effects). The last two quarters have shown declines in the delinquency rate (see additional charts section). Q1 data (which is as of 3/31/2020) wouldn't yet show delinquencies related to Covid19 shutdown/job loss. Q2 data will come out in late August.

NY Fed Report: https://www.newyorkfed.org/medialibrary/interactives/householdcredit/data/pdf/HHDC_2020Q1.pdf

U.S. Consumer Confidence

Michigan Consumer Sentiment and Conference Board Consumer Confidence



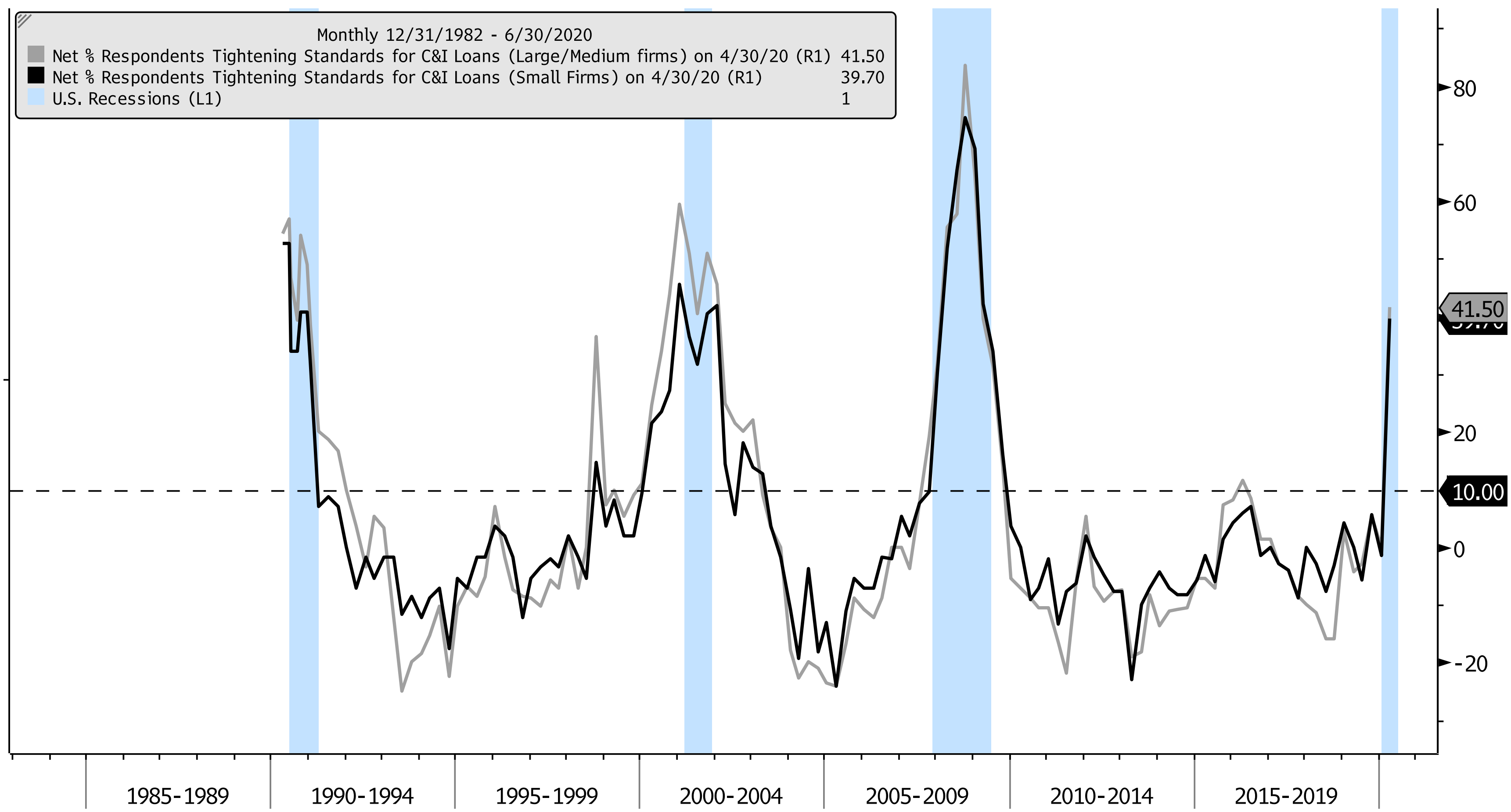
Source: © Merk Investments, Bloomberg

Analysis: Both readings have now moved higher—an encouraging sign. But both measures are trending lower YoY. Chart Framework: I'd get incrementally positive if both measures start trending higher on a YoY basis.

Conference Board: https://www.conference-board.org/data/consumerconfidence.cfm
U Mich: http://www.sca.isr.umich.edu

Bank Lending Standards

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



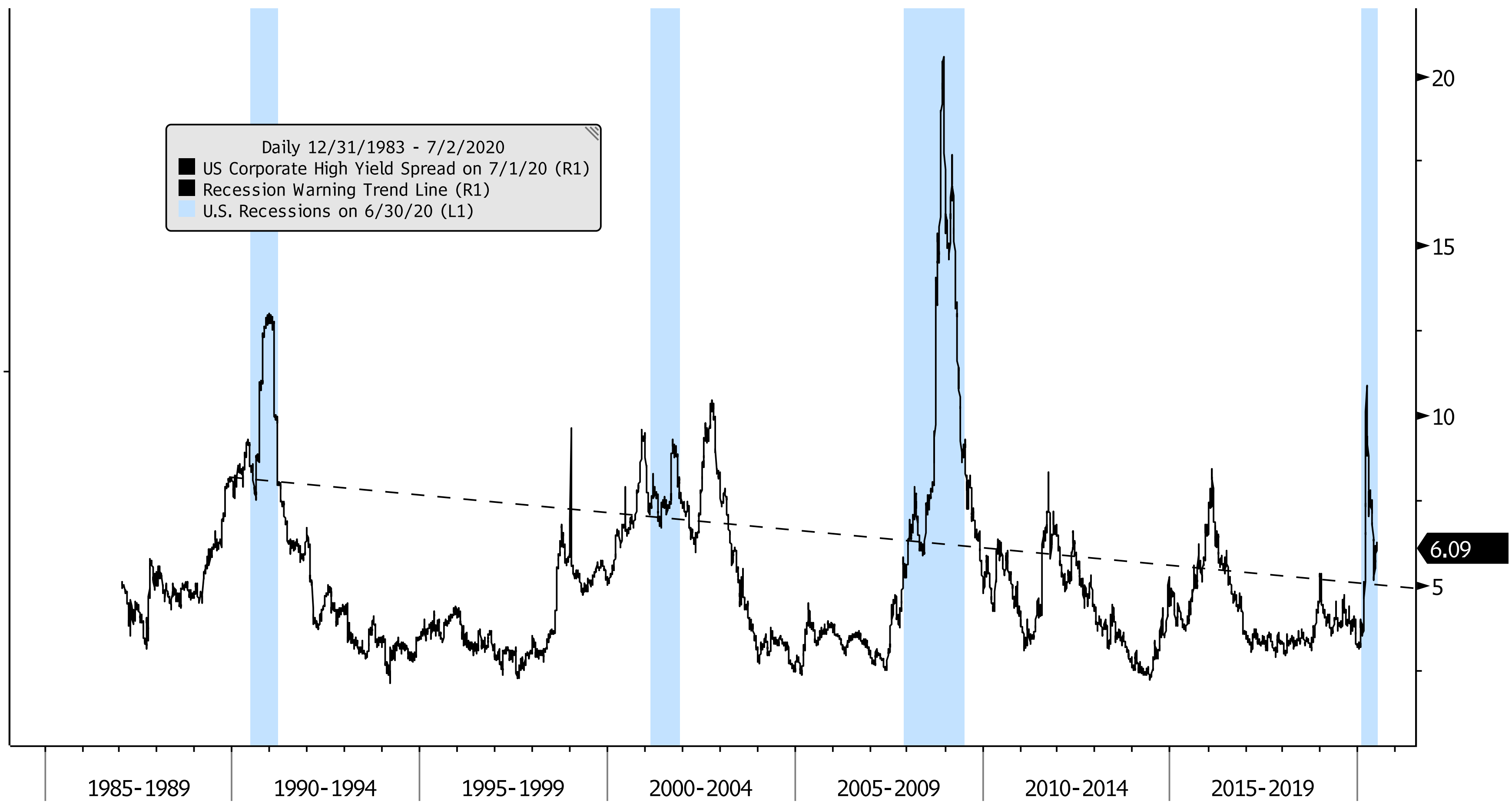
Source: © Merk Investments, Bloomberg

Analysis: Data from the Fed's Senior Loan Officer Opinion Survey suggest bank lending standards tightened materially by the end of April. Since the onset of the pandemic, the Fed has created several programs to encourage banks to continue providing credit to businesses and households, but banks are tightening anyway. The current picture is negative. Chart Framework: I'd get incrementally positive on the business cycle outlook if the percent of respondents reporting tightening lending standards starts declining. It's worth noting that this data only comes out quarterly.

Fed SLOOS: https://www.federalreserve.gov/data/documents/sloos-042020-fullreport.pdf

High Yield Spread

U.S. High Yield Spread with Trend Line

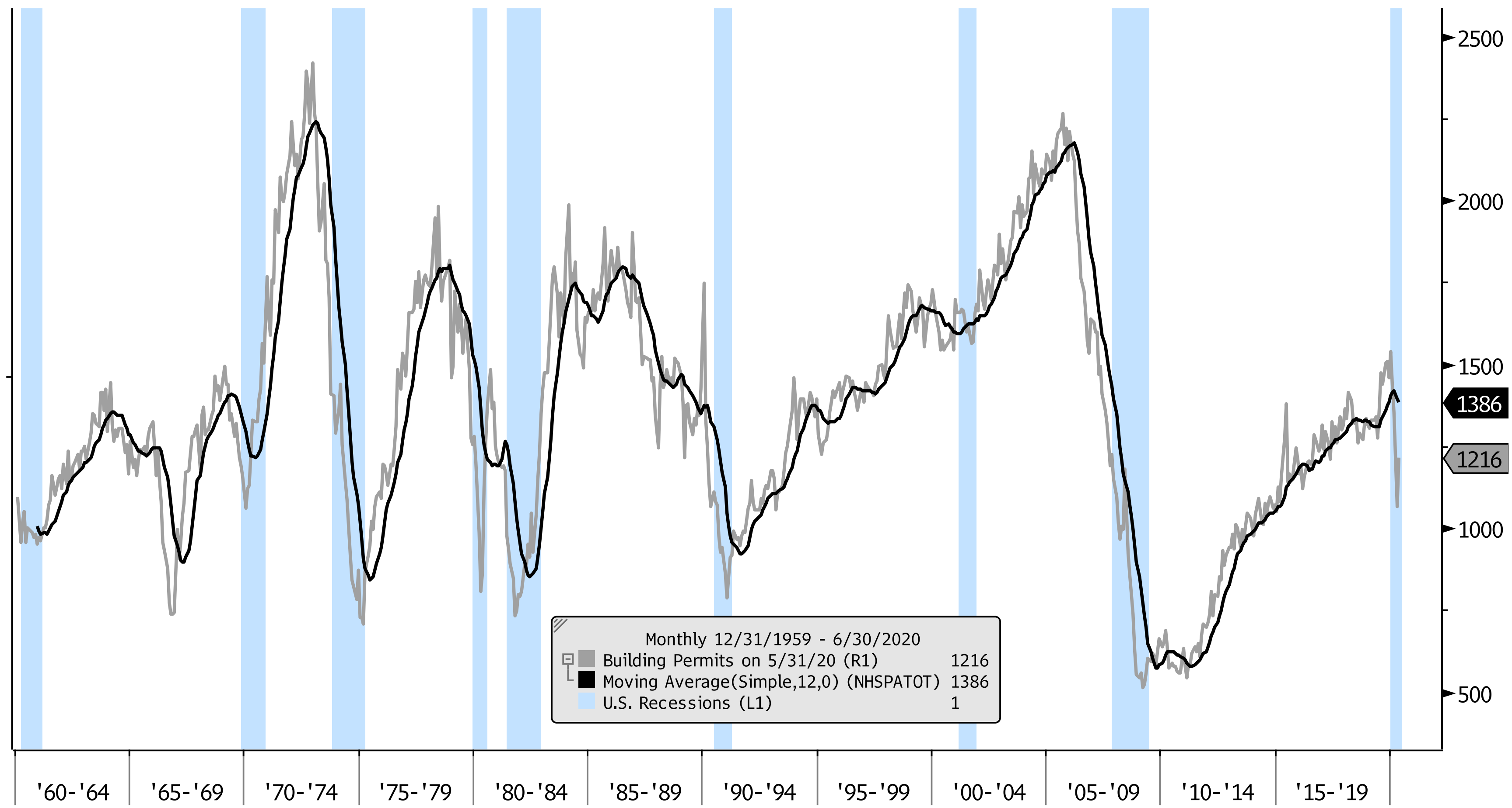


Source: © Merk Investments, Bloomberg

Analysis: The high yield credit spread has generally declined since its local peak on March 23rd at 10.88. It's come down in large part due to various Fed programs aimed at backstopping credit markets. The spread has remained below its recent high and continues to decline. Chart Framework: I'd get incrementally negative on the business cycle outlook if the spread moved above its recent high of 10.88.

U.S. Building Permits

U.S. Building Permits and 12-month Moving Average (thousands)



Source: © Merk Investments, Bloomberg

Analysis: Building permits bounced back in May, to 1.2 million. Counterintuitively, or maybe intuitively, housing demand may surge due to Covid. For now, I'm still cautious to negative on this picture. Framework: I would get positive if building permits moved back above their 12-month moving average.

Checklist

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

Conclusion/Thoughts

Incoming data continues to suggest the U.S. economy has bottomed and is coming out of recession The LEIs have turned up and the manufacturing PMI is back above 50. Consumer confidence has started to recover on both the University of Michigan and Conference Board surveys. And the labor market data is improving. Also, the German IFO survey continues to suggest Europe's largest economy is also coming out of recession.

The biggest risk to the outlook is the virus and reopening rollbacks. Covid data shows daily deaths still falling, but it's hard to know if that will last. Also, the Economic Cycles Research Institute's U.S. weekly leading index ticked down for the first time since it started moving higher on March 27th. And in terms of market-based growth indicators, while copper and oil continued trending higher, the U.S. 10-year yield has fallen back down to around 0.70%.

The next round of fiscal relief is expected by the end of the month. So far, fiscal and monetary policy support have been aggressive. I expect that to continue. While there will be partisan disagreements over the composition, there is strong bi-partisan agreement on doing another round of relief measures.

Like in 2009, there are skeptics about the recovery. My view is that we are coming out of recession, but the road out will be bumpy. The riskiest time is probably from here until a vaccine is distributed, i.e., until we get to the point where the virus stops spreading without social distancing measures. Dr. Fauci and the former FDA commissioner, Scott Gottlieb, remain optimistic that a vaccine, or multiple, will be ready the end of the year or early 2021.

In summary, further fiscal relief measures and therapeutics/vaccine development will likely be key drivers for the next six months.

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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