

# MERK® | RESEARCH

## U.S. Business Cycle Report

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## What Central Banks are Saying

Central banks, with their access to data and well staffed research departments, provide valued global economic perspective that tends to be objective and clearly articulated in policy statements and other communications. Some key excerpts from the past month below:

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*"While the outlook for the global economy remains reasonable, the risks are tilted to the downside. The US-China trade and technology disputes continue to affect international trade flows and investment as businesses scale back spending plans because of the uncertainty." – Reserve Bank of Australia (11/5/19)*

*"In China, the authorities have taken steps to support the economy... a number of central banks have eased monetary policy in response to the persistent downside risks and subdued inflation... financial market sentiment has improved" – Reserve Bank of Australia (11/5/19)*

*"Looking through Brexit-related volatility, underlying UK GDP growth has slowed materially this year... That slowdown reflects weaker global growth, driven by trade protectionism, and the domestic impact of Brexit-related uncertainties." –Bank of England (11/7/19)*

*"The UK and EU agreed a Withdrawal Agreement and a flexible extension of Article 50... the perceived likelihood of a no-deal Brexit has fallen... [this is] expected to remove some of the uncertainty facing businesses and households" -Bank of England (11/7/19)*

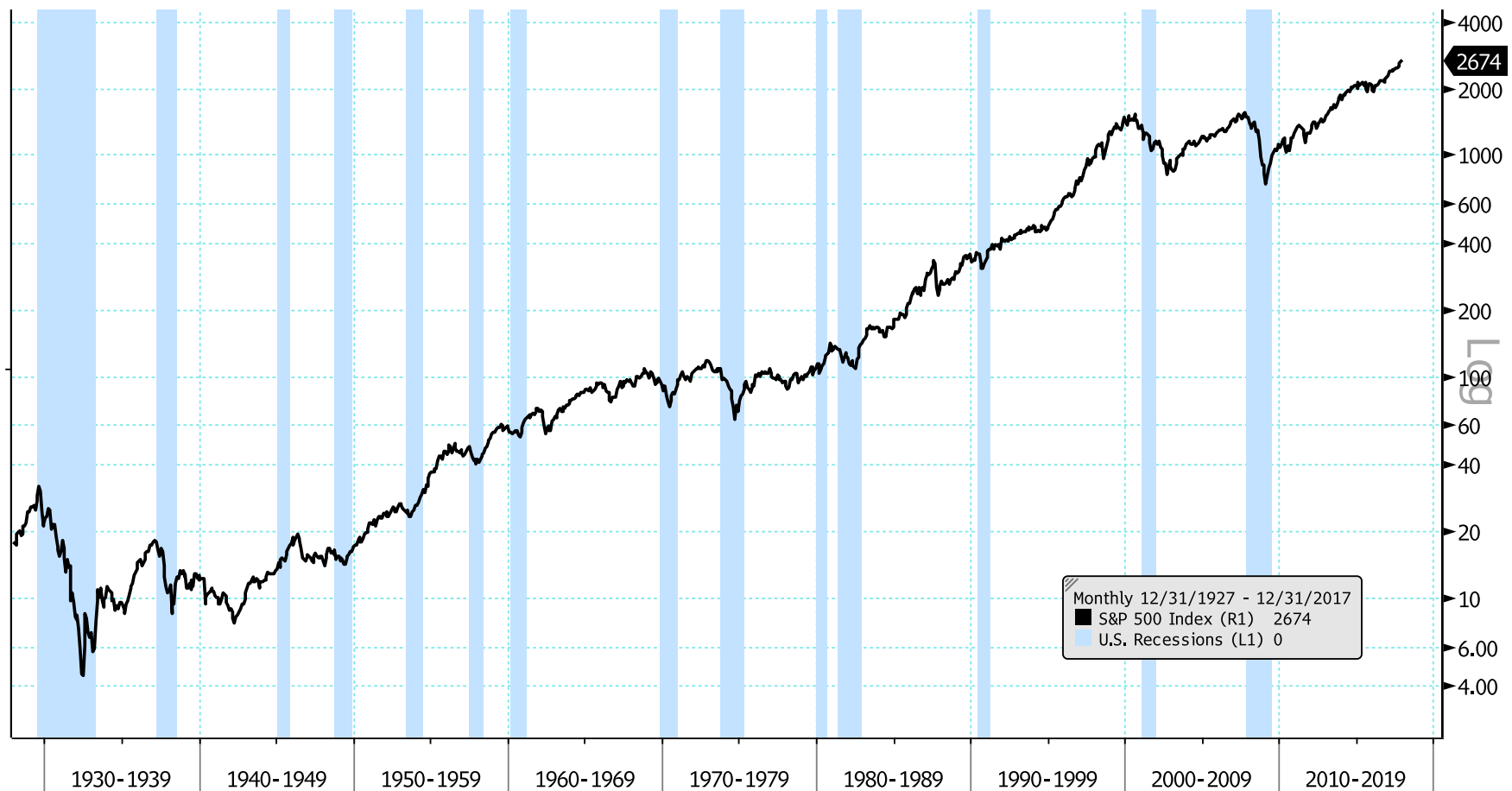
*"Trading-partner growth has also slowed. Growth in global trade and manufacturing is weak and uncertainty remains high, dampening global business investment." – Reserve Bank of New Zealand (11/13/19)*

*"There is nascent evidence that the global economy is stabilizing, with growth still expected to edge higher over the next couple of years. Financial markets have been supported by central bank actions and waning recession concerns." – Bank of Canada (12/04/19)*

*"Ongoing trade conflicts and related uncertainty are still weighing on global economic activity, and remain the biggest source of risk to the outlook." – Bank of Canada (12/04/19)*

## Why is the Business Cycle Important?

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

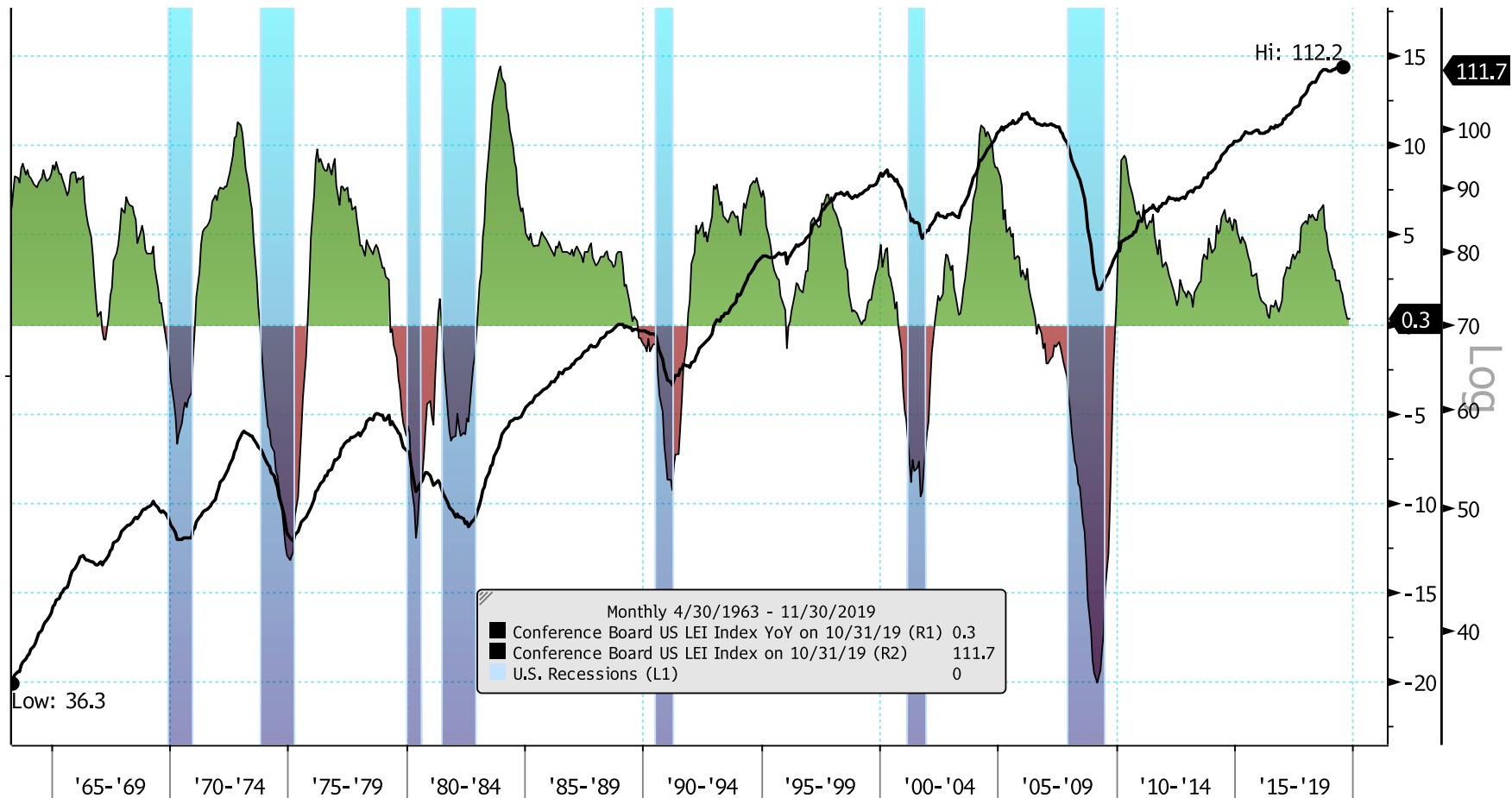


Source: © Merk Investments, Bloomberg

*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\**

# U.S. Leading Economic Indicators (LEIs) Index

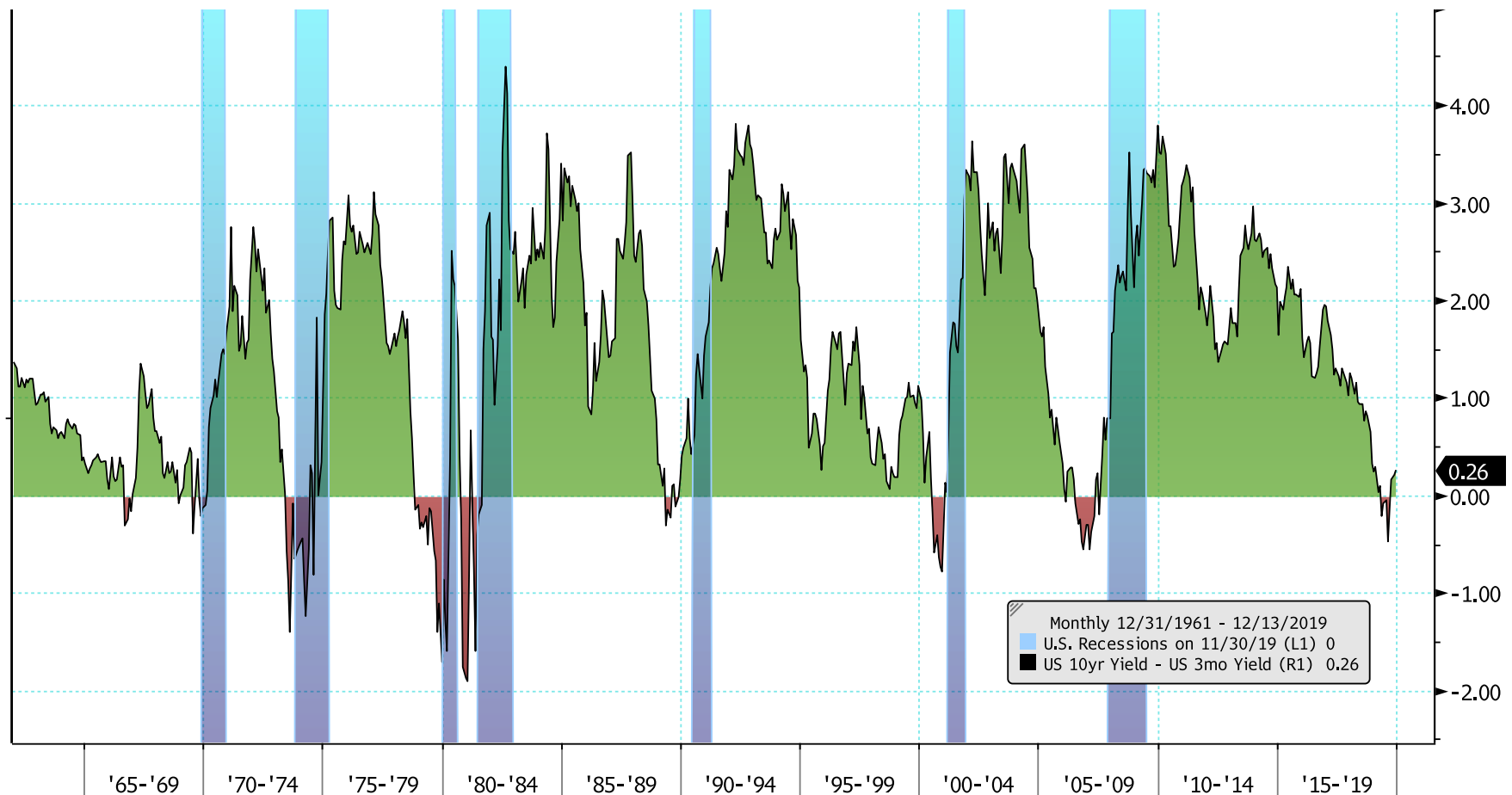
Conference Board's LEI Index and YoY Rate of Change



Source: © Merk Investments, Bloomberg

*Analysis: Since last month's report, the LEI YoY rate of change fell to 0.3%. 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. 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.*

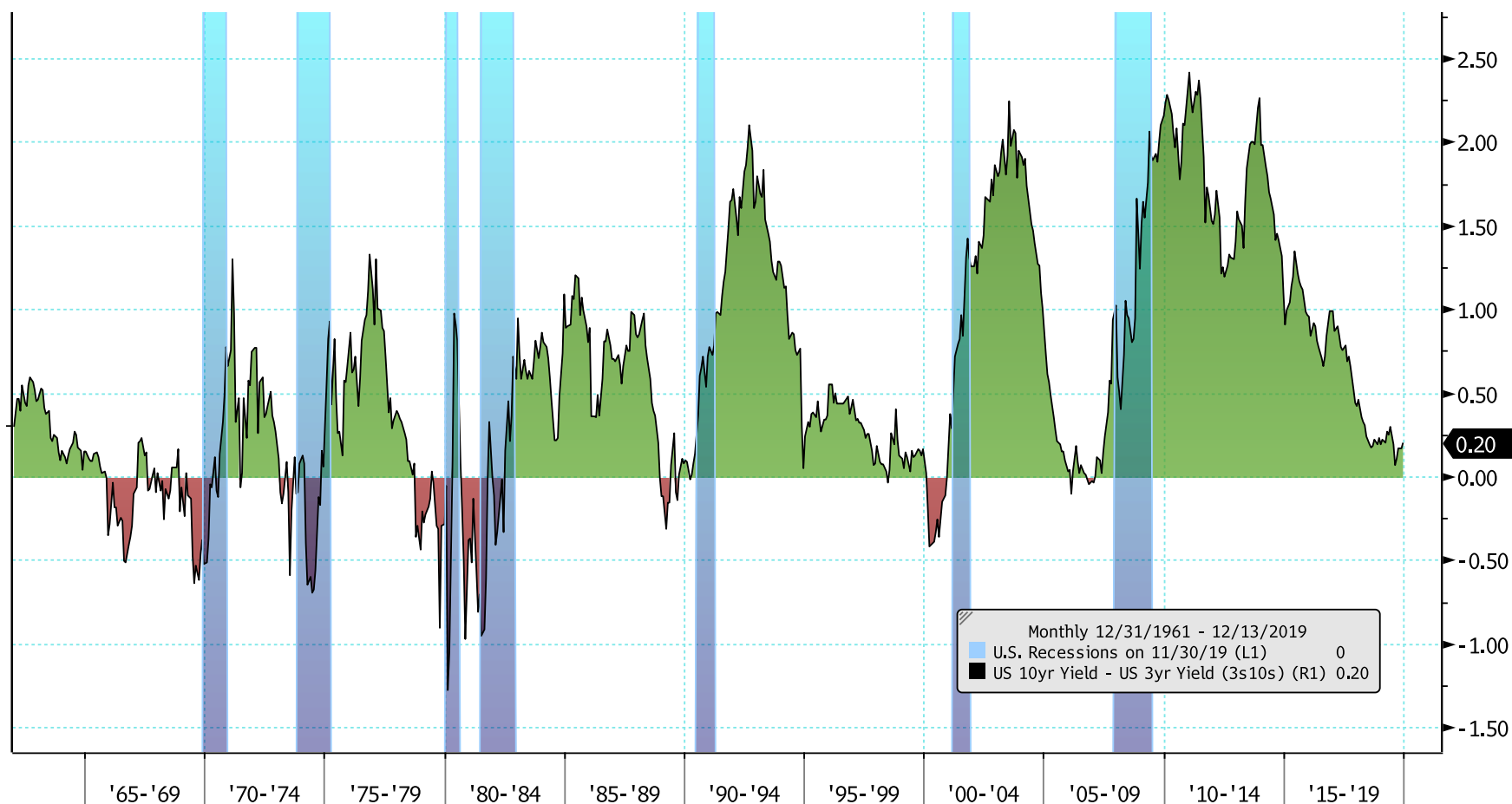
## U.S. Yield Curve Steepness (10yr yield – 3mo yield)



Source: © Merk Investments, Bloomberg

*Analysis: The 10yr-3m yield curve was inverted 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)

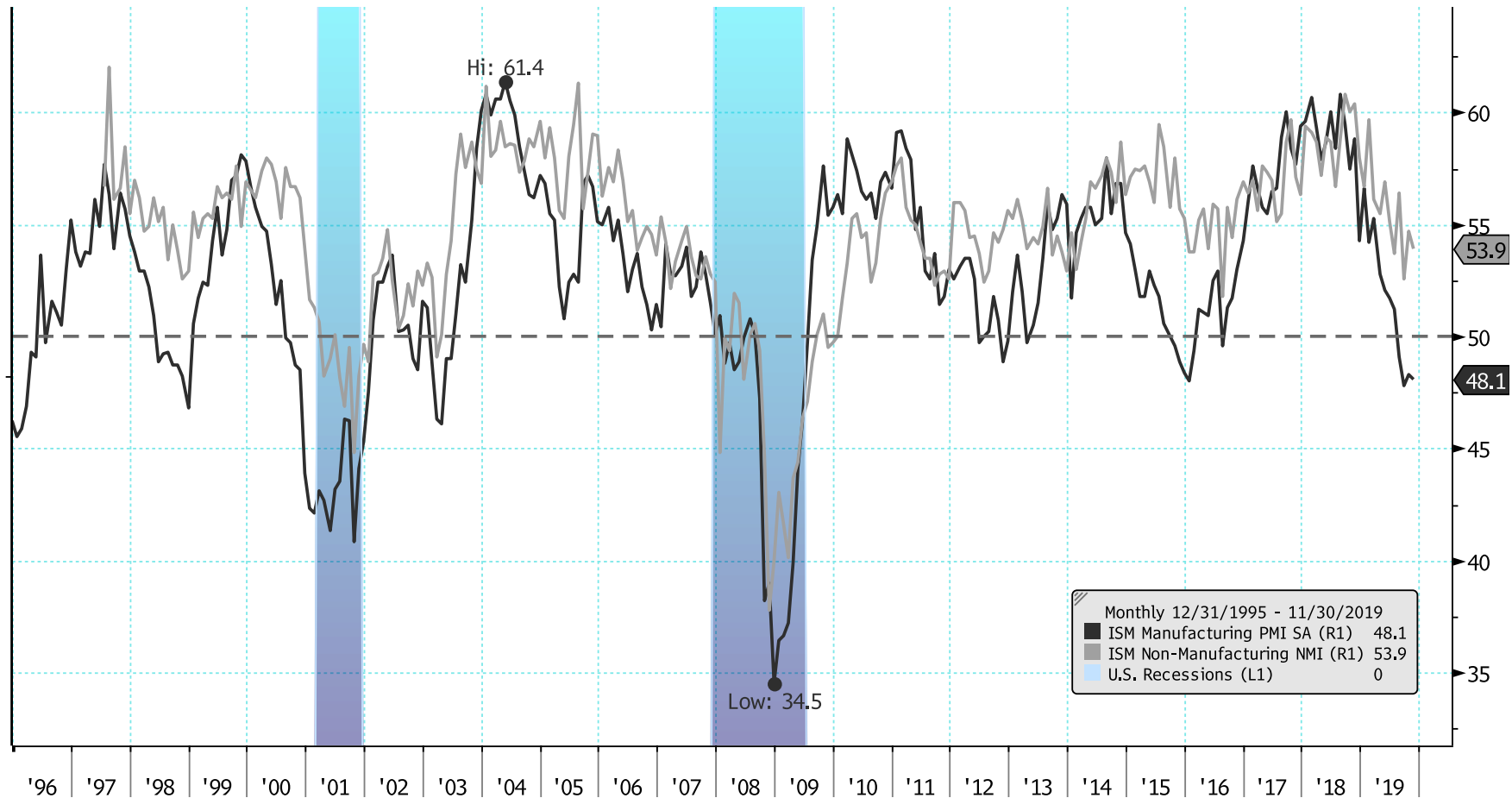


Source: © Merk Investments, Bloomberg

*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)

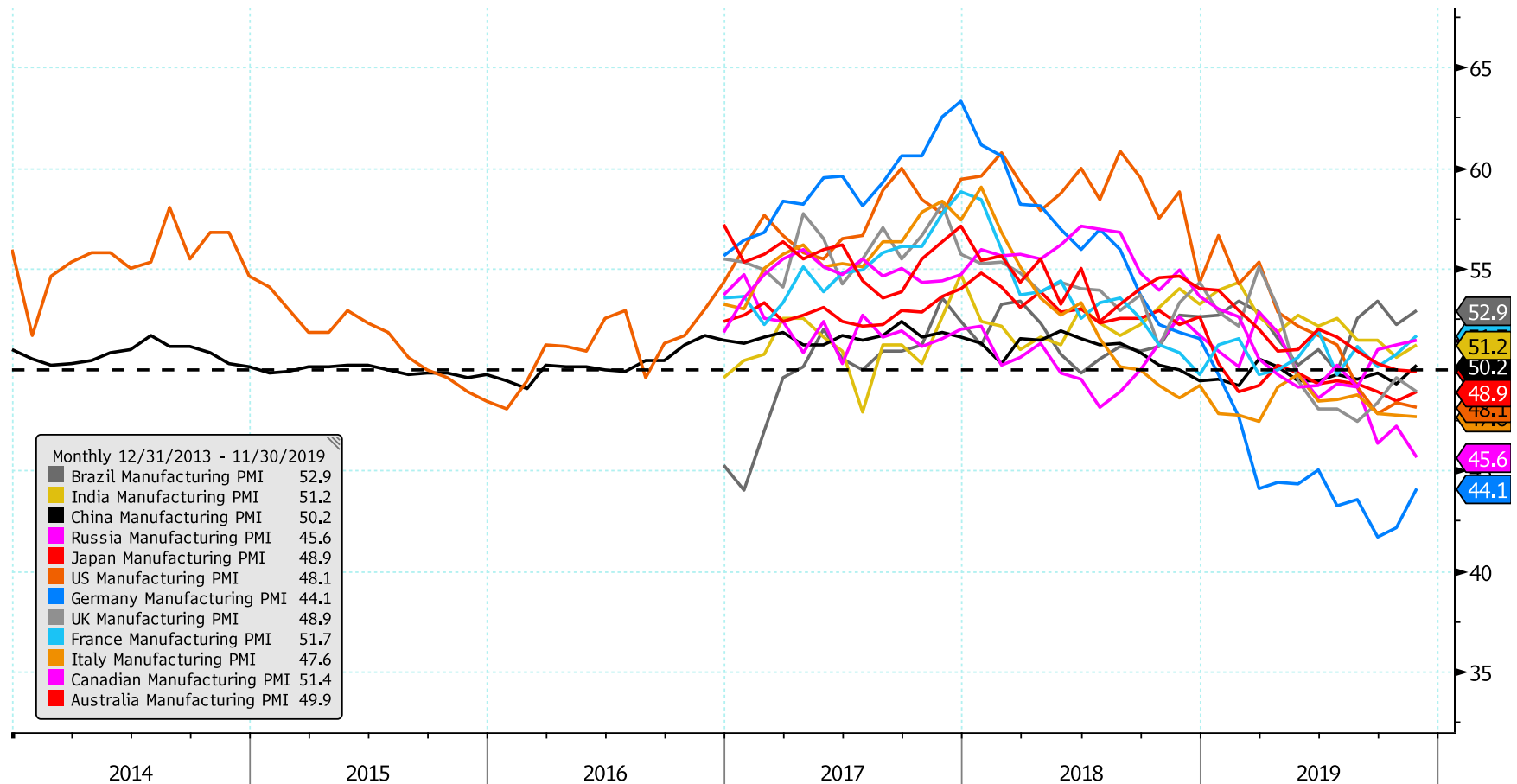


Source: © Merk Investments, Bloomberg

*Analysis: Manufacturing PMI ticked down slightly over the past month, from 48.3 to 48.1, 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)



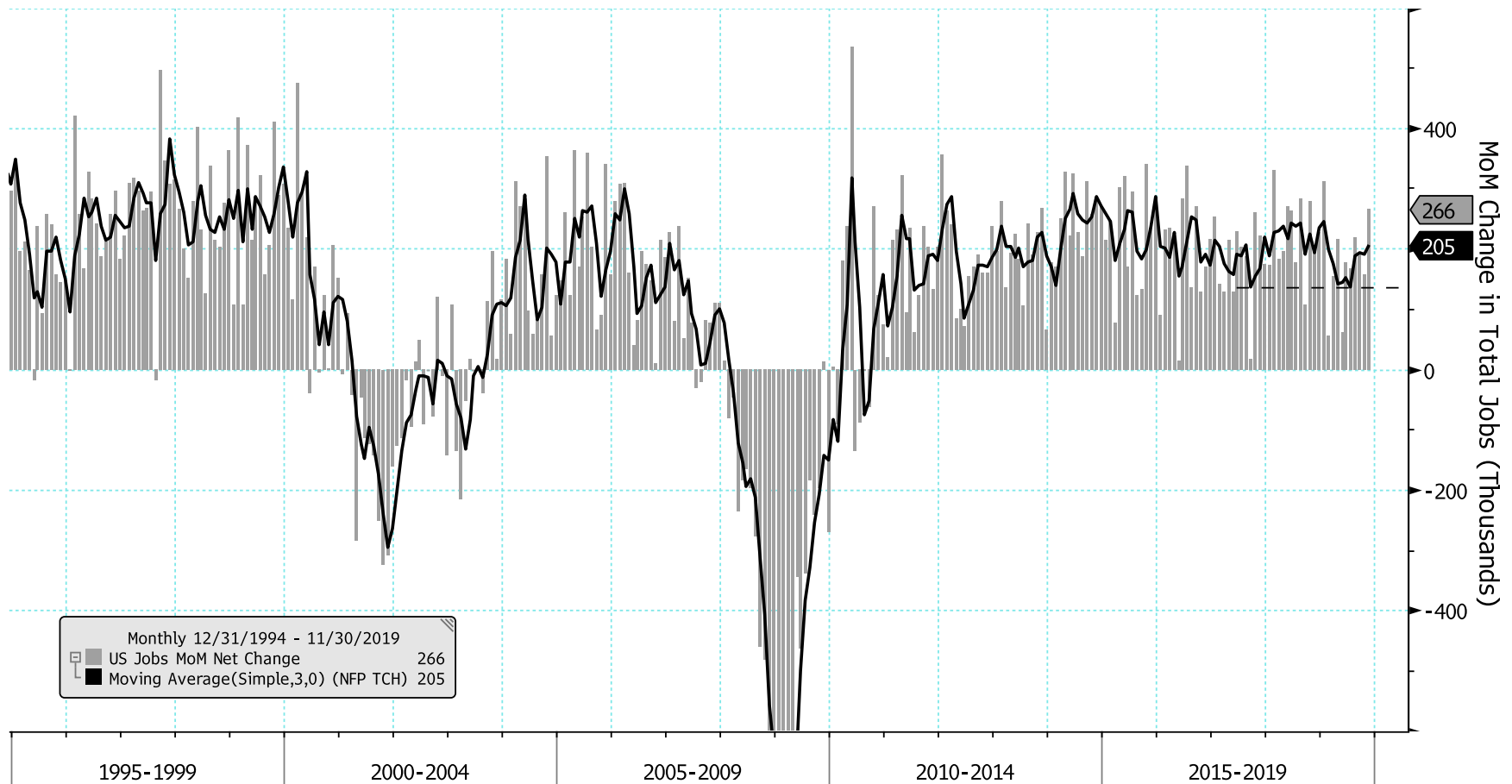
Source: © Merk Investments, Bloomberg

*Analysis: Global economic momentum as measured by manufacturing PMIs was generally positive over the past month. But 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.*

## Job Gains

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

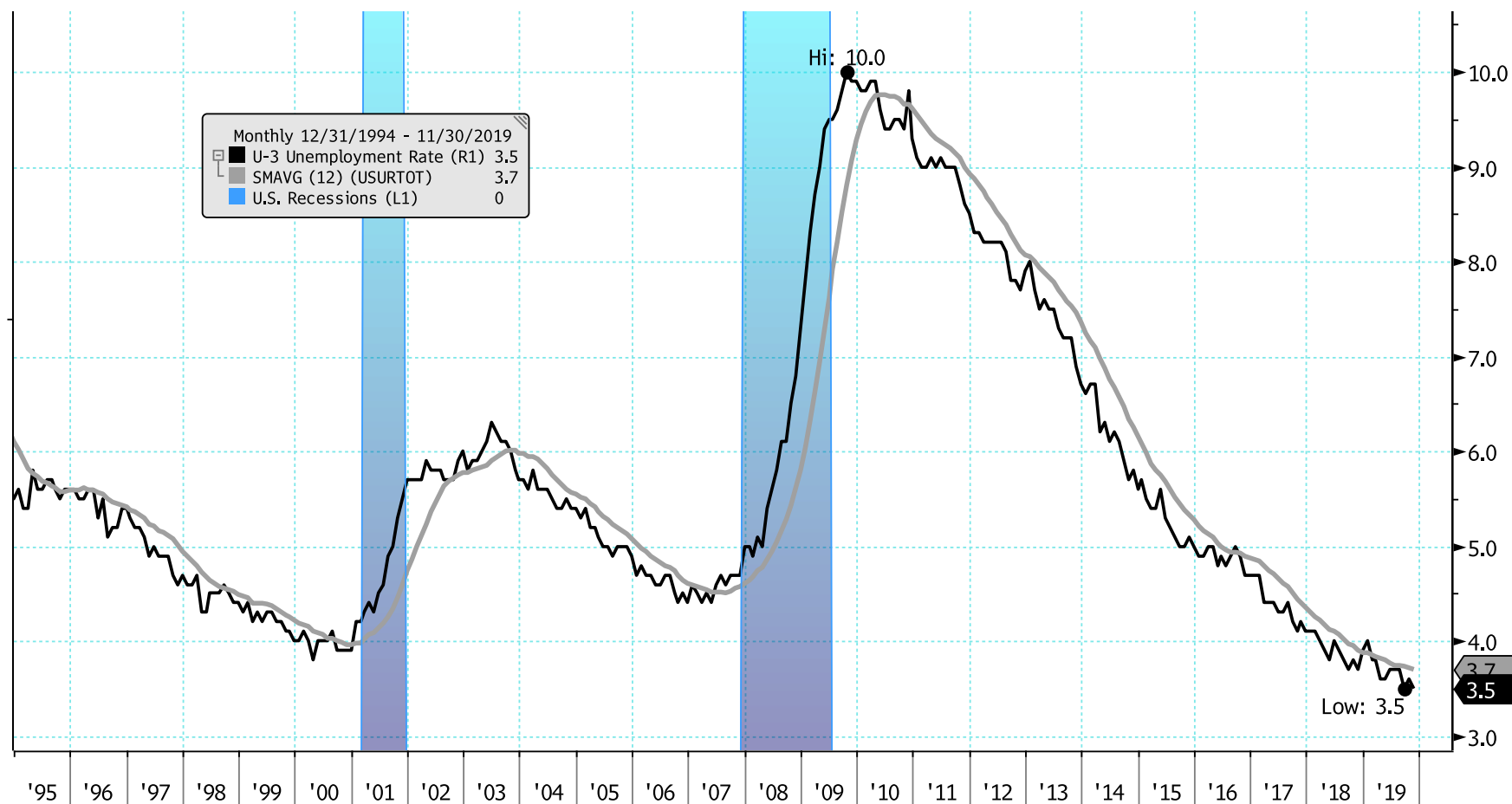


Source: Bloomberg, © Merk Investments LLC

*Analysis: The 3-month moving average of job gains is 205k, 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

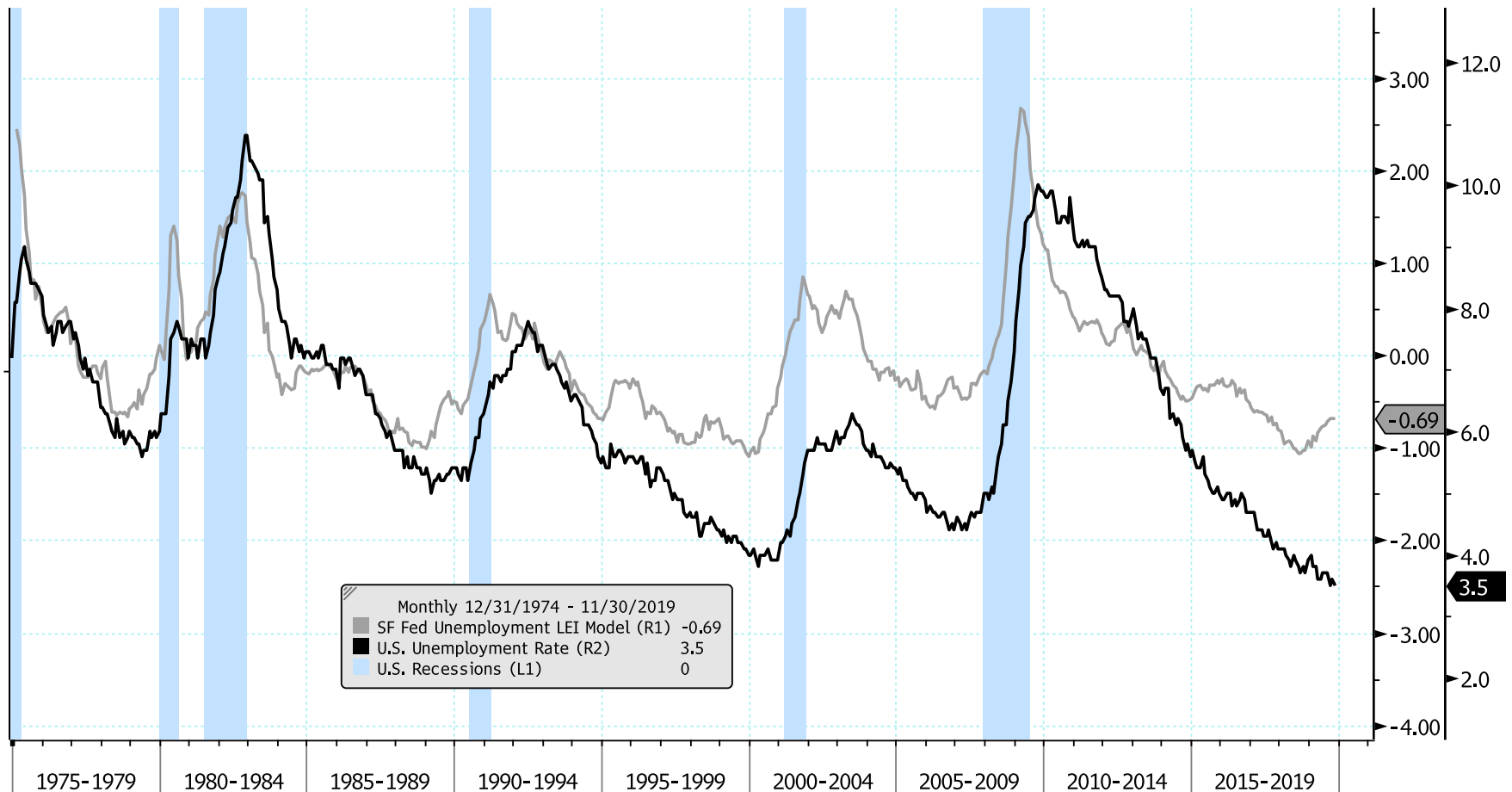


Source: © Merk Investments, Bloomberg

*Analysis: The unemployment rate ticked back down to 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.*

## SF Fed Leading Unemployment Rate (U-3) Model

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

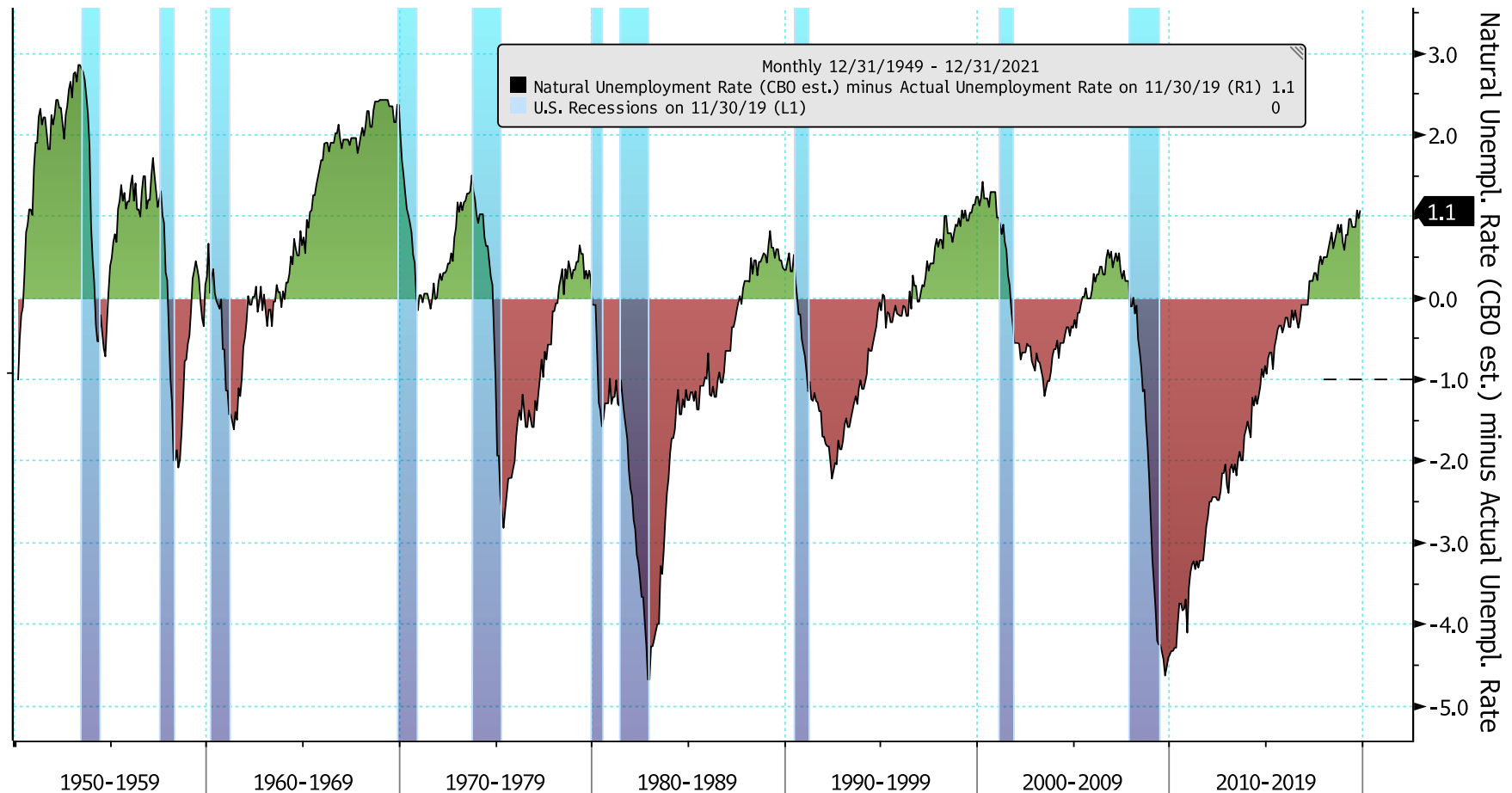


Source: © Merk Investments, Bloomberg

*Analysis: The SF Fed unemployment rate model (grey line) has 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

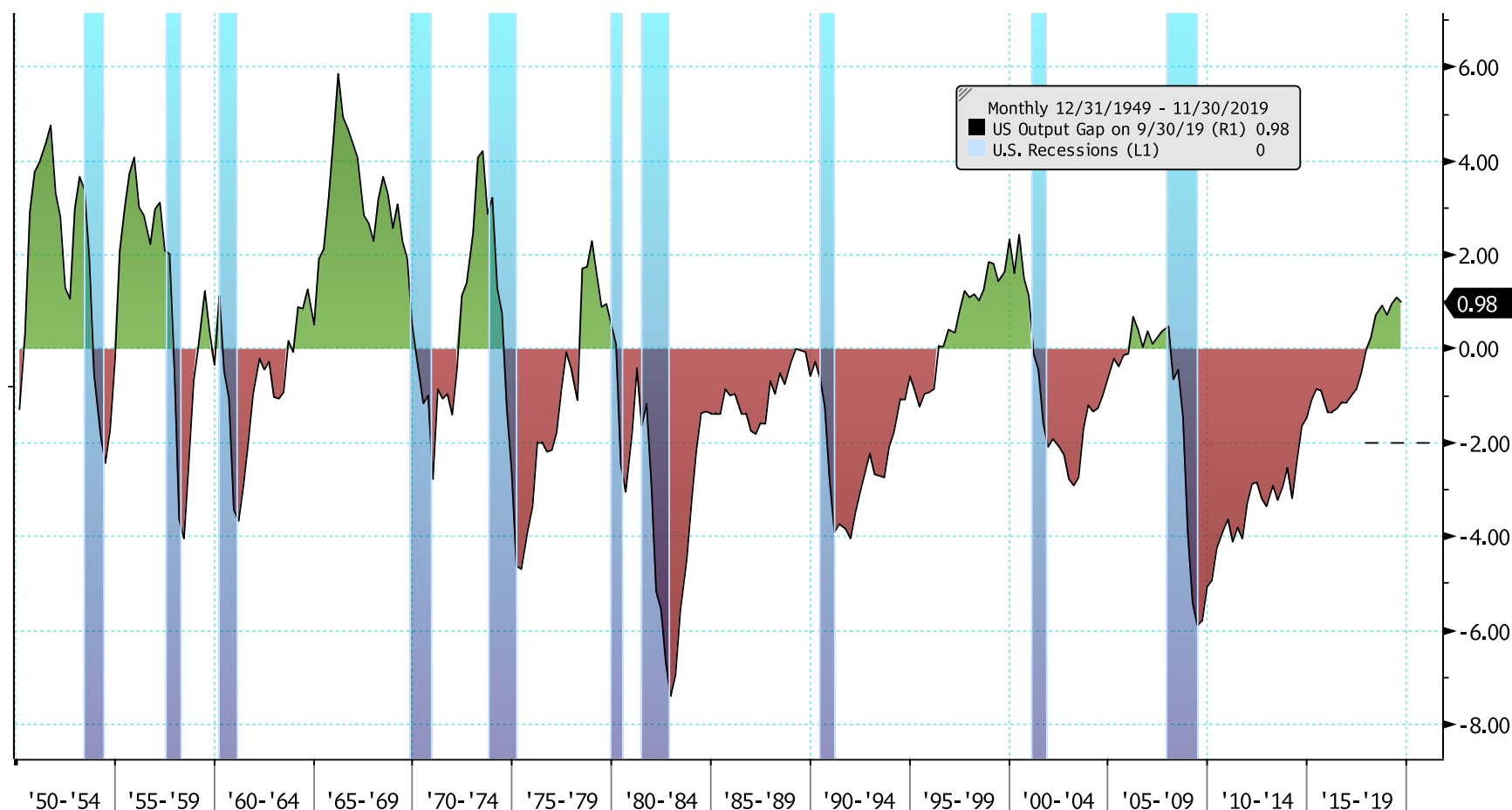


Source: © Merk Investments, Bloomberg

*Analysis: The estimated natural rate of unemployment is higher than the current unemployment rate (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.)

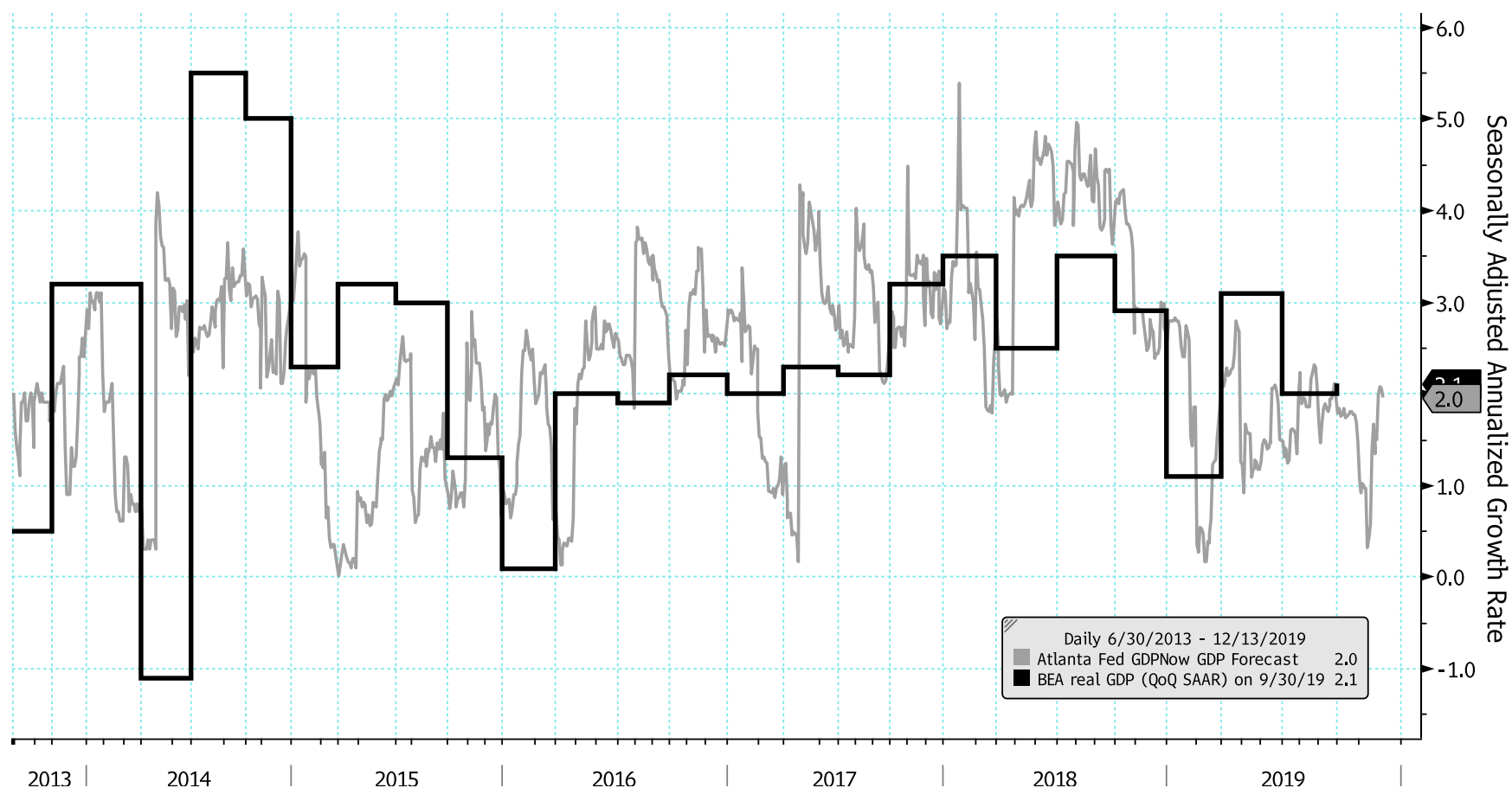


Source: © Merk Investments, Bloomberg

*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

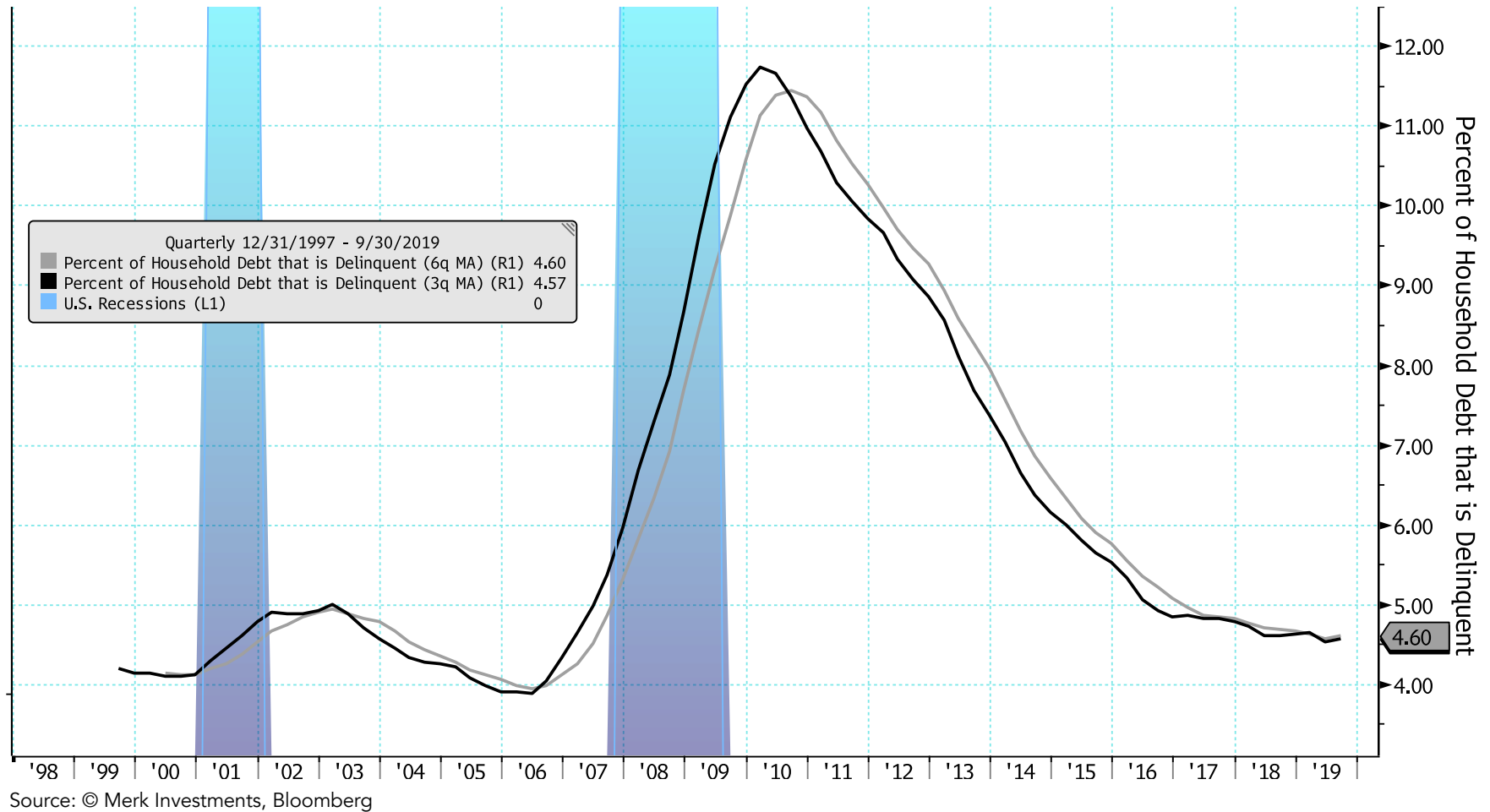


Source: © Merk Investments, Bloomberg

*Analysis: The Q3 2019 GDP second 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

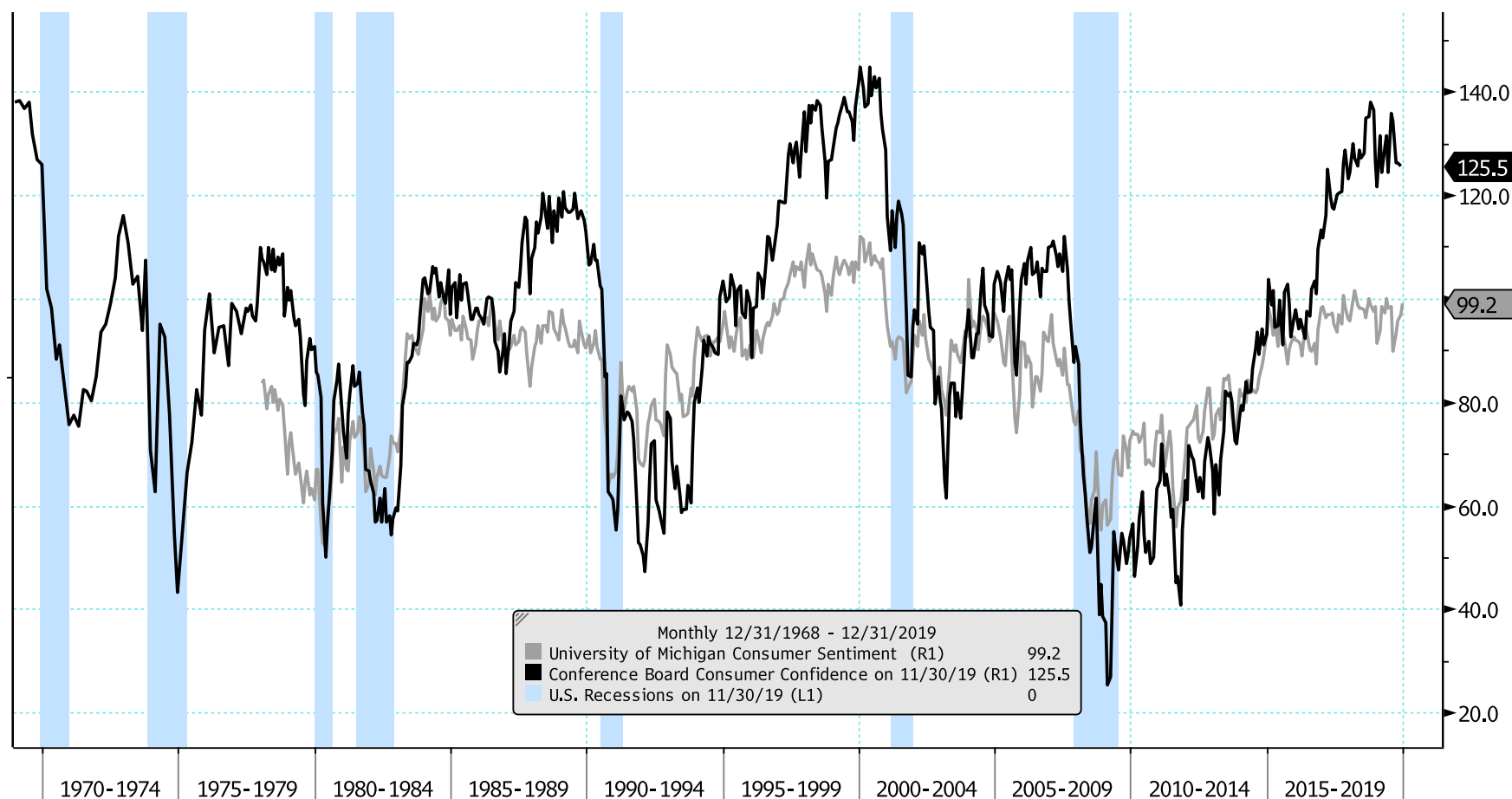
Percent of Household Debt that is Delinquent (3 quarter and 6 quarter moving averages)



*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

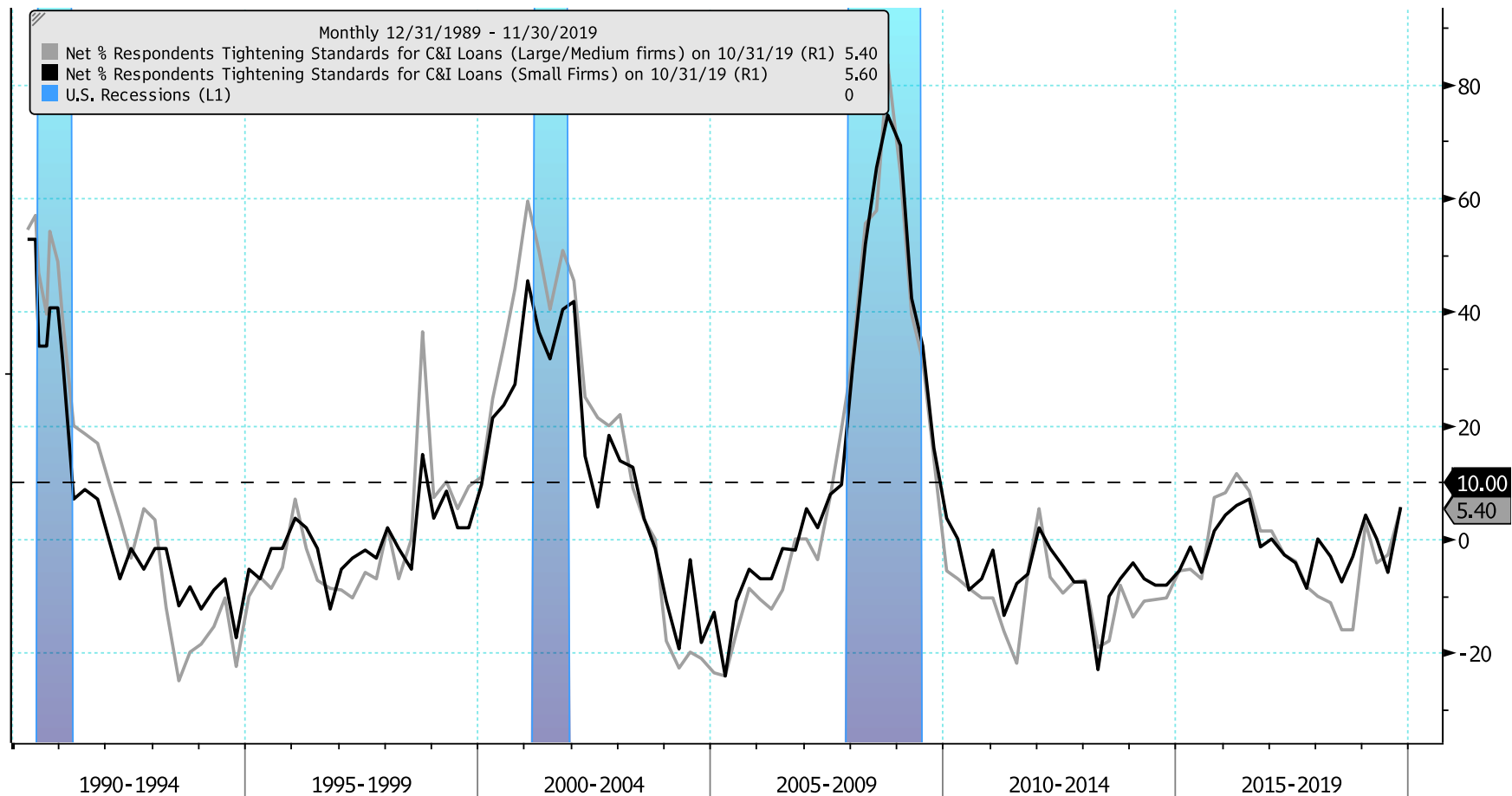


Source: © Merk Investments, Bloomberg

*Analysis: The consumer confidence indexes are generally trending sideways (at elevated levels). Given my framework, I'm currently neutral on this picture. Chart Framework: I'd get incrementally positive if one or both measures are trending higher on a YoY basis.*

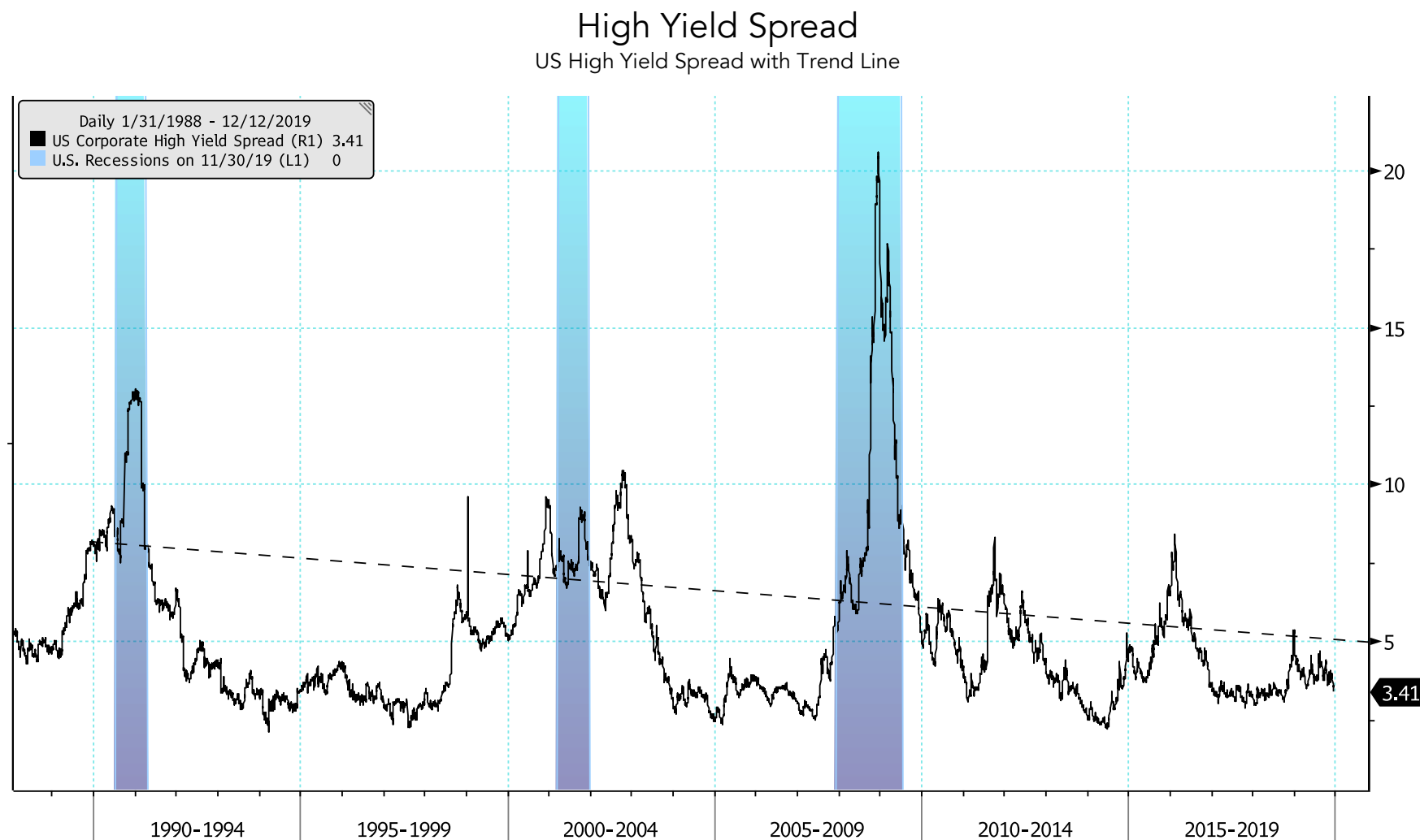
# Bank Lending Standards

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



Source: © 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.*

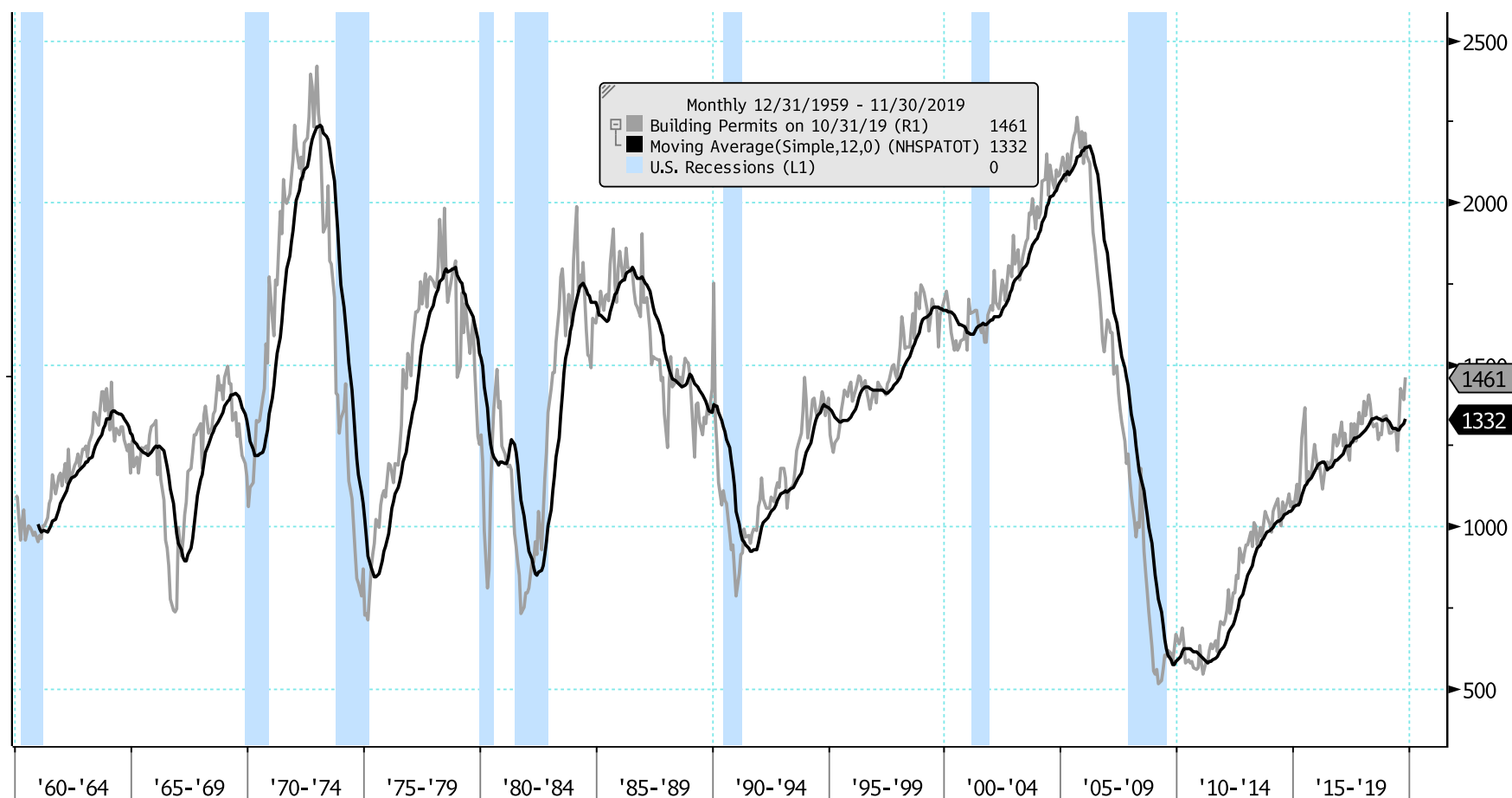


Source: © Merk Investments, Bloomberg

*Analysis: The high yield credit spread has 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                 | Neutral                                  |
| 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 medium uncertainty |
|                            | Medium/Longer Term (6m - 5 years) | Neutral/Negative with high uncertainty   |

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## Conclusion/Thoughts

Serious investors think probabilistically. Based on incoming data, recession risk has declined. I'd estimate the probability of a recession starting in the coming six months to be around 15-30%. My view remains that the expansion continues over the next several months, and in general until further notice.

The jobs report was strong. Both the unemployment rate trend and job gains suggest continued labor market health. The U.S. 10yr yield continues to rise, which suggests the yield curve steeping is a positive sign, rather than the kind you see right before recessions. Slack remains, both in the labor market and capacity utilization. People continue to come off disability rolls. Historically, business cycles have ended with an "overheating" and an overshoot of inflation. The U.S. economy has not (yet) "overheated" and there seems to be an absence of obvious excesses.

Global trade policy uncertainty appears to be declining, although risks remain. The re-election of Boris Johnson in the UK reduces Brexit uncertainty. A Brexit deal is now likely in the next month or two. There are some signs that the global auto market might be starting to recover. Domestically, the U.S. housing market is showing signs of strength. And credit spreads continue to narrow. In the coming months it will be important to see a reacceleration higher in the Conference Board's LEI index, and a recovery in the ISM Manufacturing PMI.

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**

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