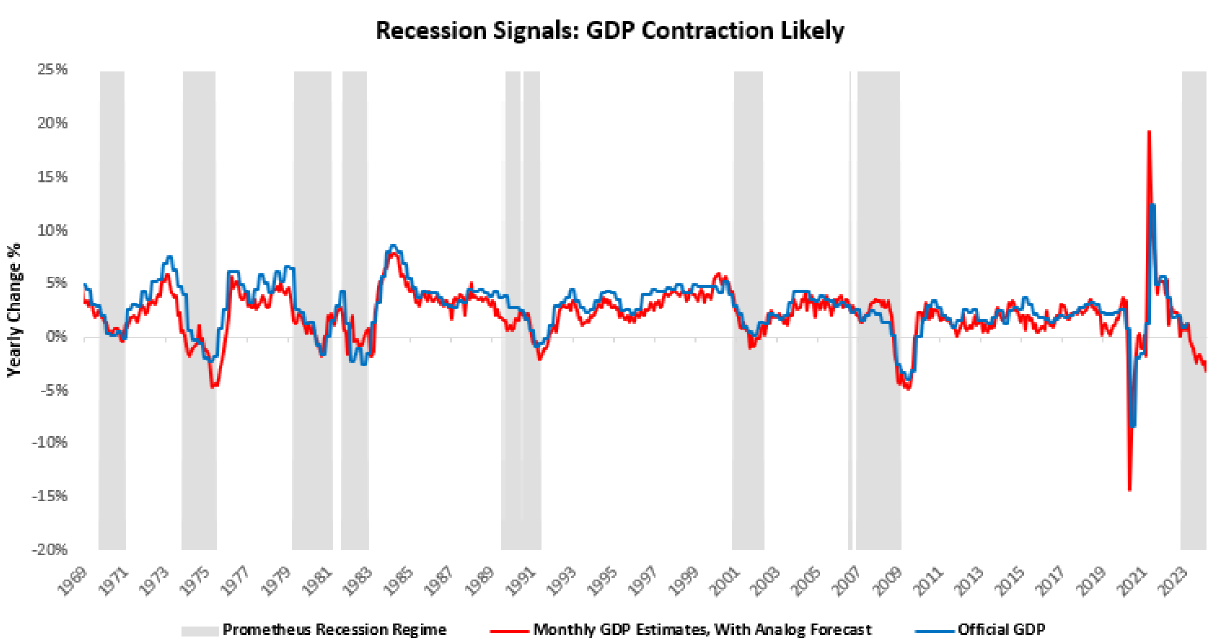
Month In Macro

This report is part of our ongoing effort to provide economic and market guidance to our subscribers during a period of historic levels of uncertainty. This note aims to share our research team's internal checkpoint process in evaluating the current state of the economy as it pertains to markets. The pages that follow will have familiar content for those who follow our work, but with the added benefit of our connecting the dots across all the economic and financial data our systems use to make portfolio decisions. Our primary takeaways are as follows:

- ***Nominal activity has decelerated, with real growth contracting and inflation decelerating. These moves aligned with our expectations and reflected the slowing of the labor impulse to broader activity.***
- ***Alongside this contraction in real activity, we saw significant stress in the banking system as the cumulative impact of tightening policy liquidity flowed through to financial intermediaries. We are now moving into the part of the cycle where public and private sector liquidity are likely to contract in unison. This path bodes ill for future nominal activity.***
- ***Our systems have now confirmed recessionary conditions. We see equity markets as particularly exposed to this risk, which our cycle strategies will look to exploit.***

In this issue, we will begin to weave in our systematic expectations for markets as part of our Month In Macro offering. In this edition, we will be mainly focused on the real growth outlook. Additionally, this edition will be relatively concise relative to our typical publications- the team has just returned from a much-needed break and will return to regular publishing this month. Now, let's dive in.

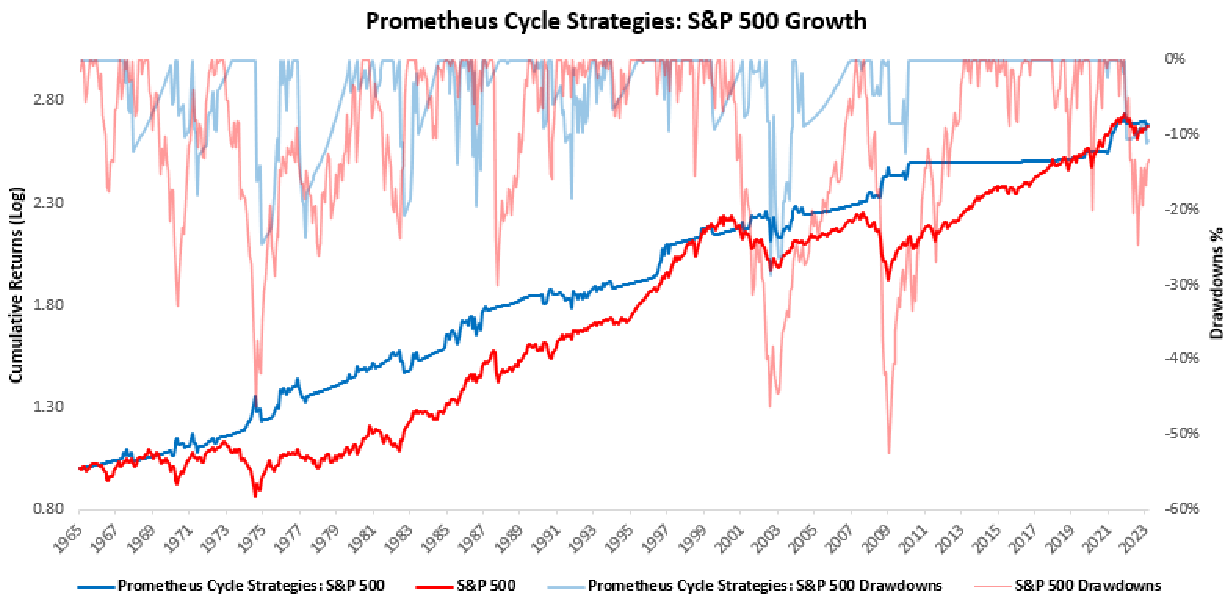
As noted in our headline takeaways, our systems now place the economy in a recessionary regime:



Based on our estimates, GDP will enter a contraction in H2 of this year, creating an opportunity for our Prometheus Cycle Strategies in equity markets.

Prometheus Cycle Strategies: Real Growth

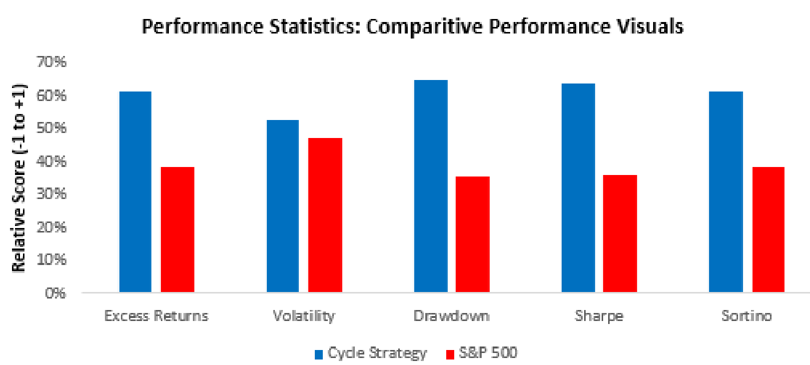
Our Month In Macro report aims to offer a granular and comprehensive understanding of current economic conditions and how they will likely evolve- to help investors navigate markets through the economic cycle. To augment the research and analysis, we have developed Prometheus Cycle Strategies- which use our cyclical expectations to trade markets. These Cycle Strategies reflect the understanding that particular points in the economic cycle offer an asymmetrically positive return on risk, either long or short assets. Using our systematic process, we attempt to forecast these points to harvest these attractive return-to-risk characteristics. Below, we show the first of the Prometheus Cycle Strategies- which trades the equity market based on our real growth forecasts:



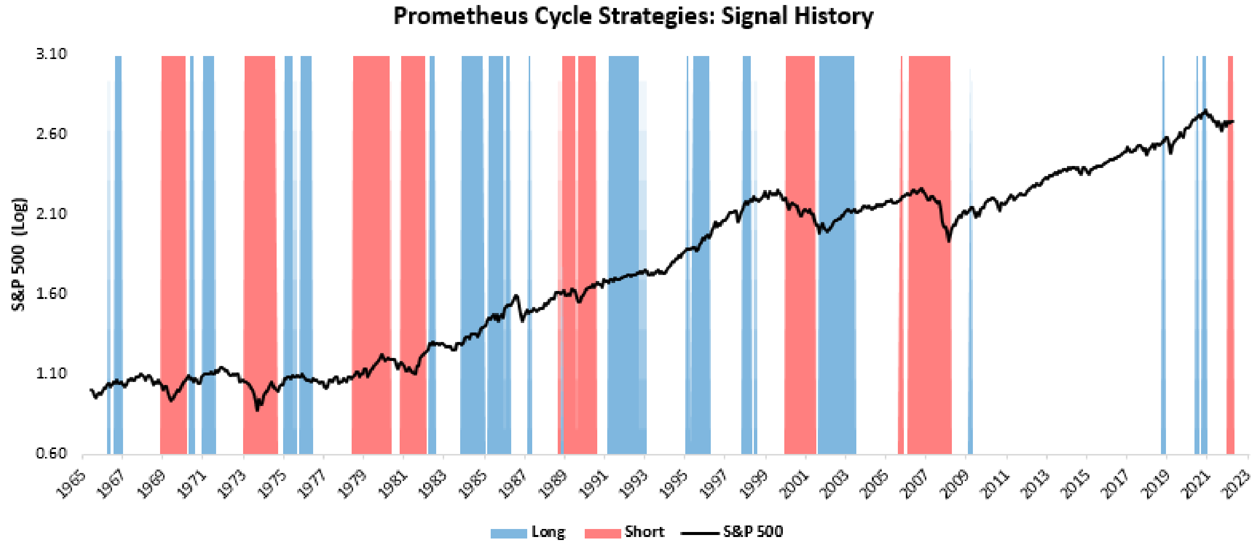
The strategy above seeks to short equity markets as we head into an impending recession and go 2X leveraged long equity markets during recoveries; otherwise, it remains in cash, with monthly turnover. As shown above, the system performs well, outpacing equity returns with smaller drawdowns. Importantly, it does so with minimal market exposure- with a beta of 0.1. Said differently, this strategy outperforms the equity market while exposed to market risk less than a third of the time. This performance reflects our understanding that there are particular points in the economic cycle where an asset offers a significantly higher return on risk than during other periods. Harvesting these returns can lead to significant outperformance. Below, we show some summary statistics:

Summary Statistics

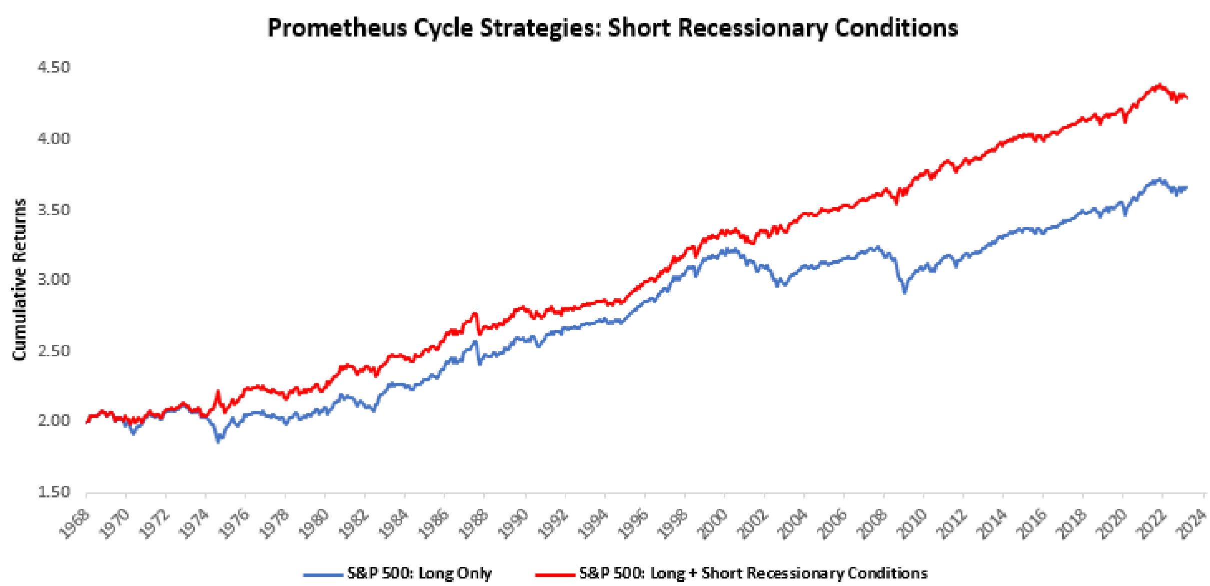
	Cycle Strategy	S&P 500
Excess Returns	4.6%	2.9%
Volatility	13.8%	15.2%
Drawdown	-28.7%	-52.6%
Sharpe	0.34	0.19
Sortino	0.43	0.27



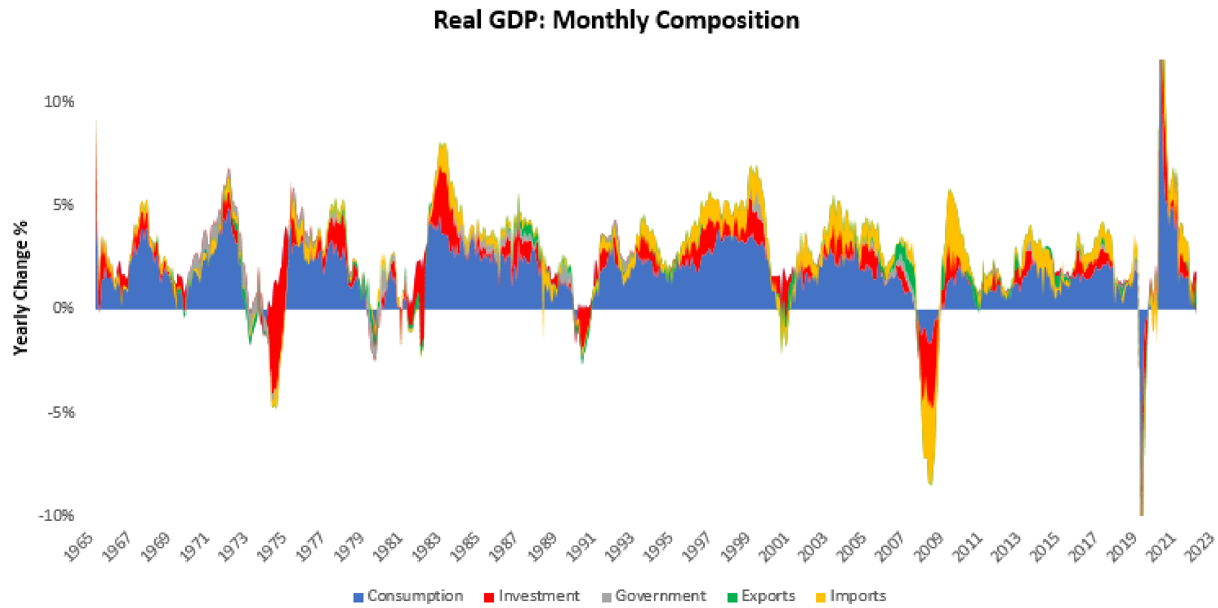
In the case of equities, this pay-off profile can be obtained by shorting stocks as we move into a recessionary environment and buying them as we emerge and move into an economic recovery. These turning points in the economic cycle offer some of the most substantial return-on-risk opportunities, both long and short. Below, we show the signal history of the strategy:



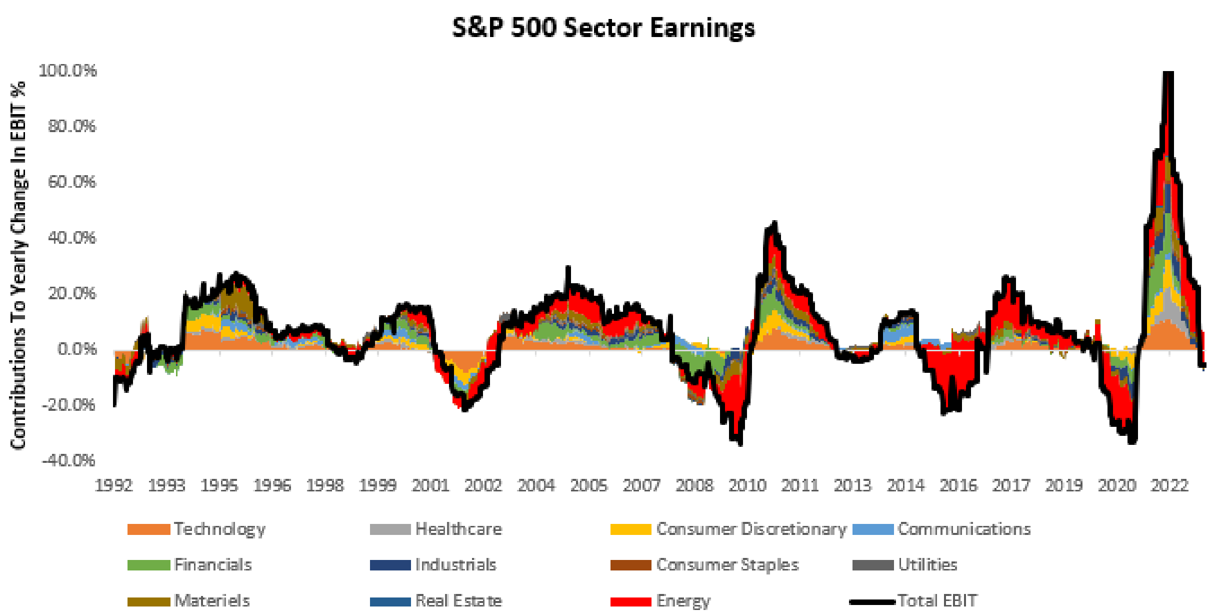
Above, we note two features. First, the strategy has no directional bias, i.e., no hidden beta. Second, the strategy did not trigger for nearly a decade as cyclical conditions did not warrant a recession or a recovery. Nonetheless, gains made from prior cycles allowed the Cycle Strategy to remain ahead of equities. This Prometheus Cycle Strategy has turned bearish on the S&P 500 as our systems now expect a recession. Even if we do not achieve a recession, we find it highly likely that we will achieve a further profit contraction. This weakening of cashflows will likely mean more equity weakness ahead as markets have priced neutral growth outcomes in 2023. We think it is important to take heed of this message, even if maintaining beta exposure is the objective. Below, we show how only taking the short signal in addition to long S&P 500 exposure has been highly additive to performance:



Therefore, even if you are a long-only investor, the bearish outlook of our systems implies that the forward-looking returns on equities will be weak at best and significantly negative at worst. The strategy is in a bearish regime but positioned flat. To protect our edge in markets, we do not share our signal construction; however, we share the logic driving our systems' expectations over the pages that follow. To contextualize our expectations, we begin by showing the composition of our GDP Nowcast below:



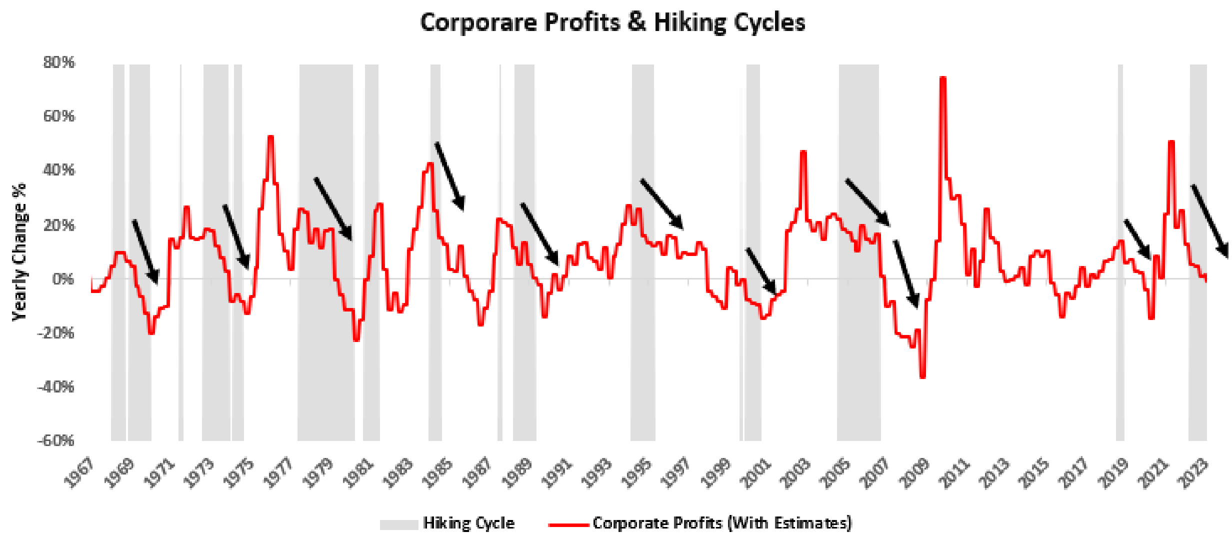
The latest data showed that GDP contracted in February by 0.60%, with softening likely in March as well. This weakness came from a reversal in consumption & export strength and a continuation of weakness in investment activity. The composition of this growth was a pressure on profitability as well. Public corporation profits have now confirmed our expectations of a profit contraction:



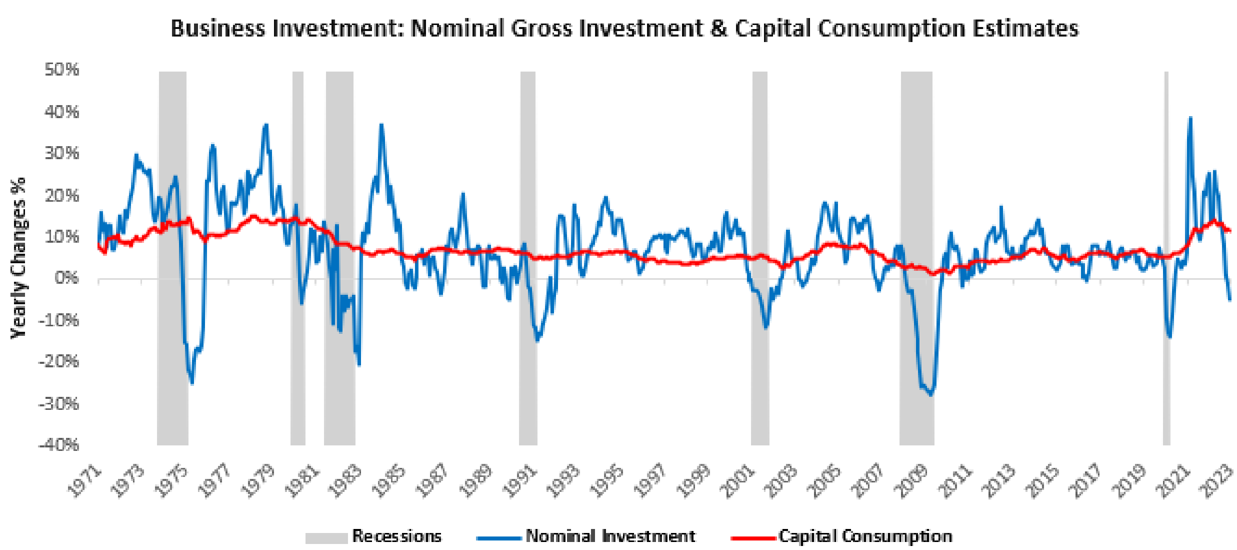
The cumulative impact of these developments places us within range of a recession, and we explain the drivers we expect to take us there in the next section.

Pressures On Business Activity Will Drive Activity Lower

Economic cycles generally follow cause-and-effect templates, and this cycle has been true to the archetype. Late in the economic cycle, as nominal activity rises, these nominal gains flow to companies, benefiting from higher revenues and potentially improved margins. As this nominal activity has a large inflation component, policymakers step in to try and tap the brakes on the economy. This usually takes the form of a hiking cycle in interest rates. Over time, this increase in interest rates leads to pressure on the economy, which results in a contraction in profits. These profit pressures eventually lead to lay-offs, which precipitate a recession. Below, we show the big-picture view of how hiking cycles have typically preceded profit contractions:

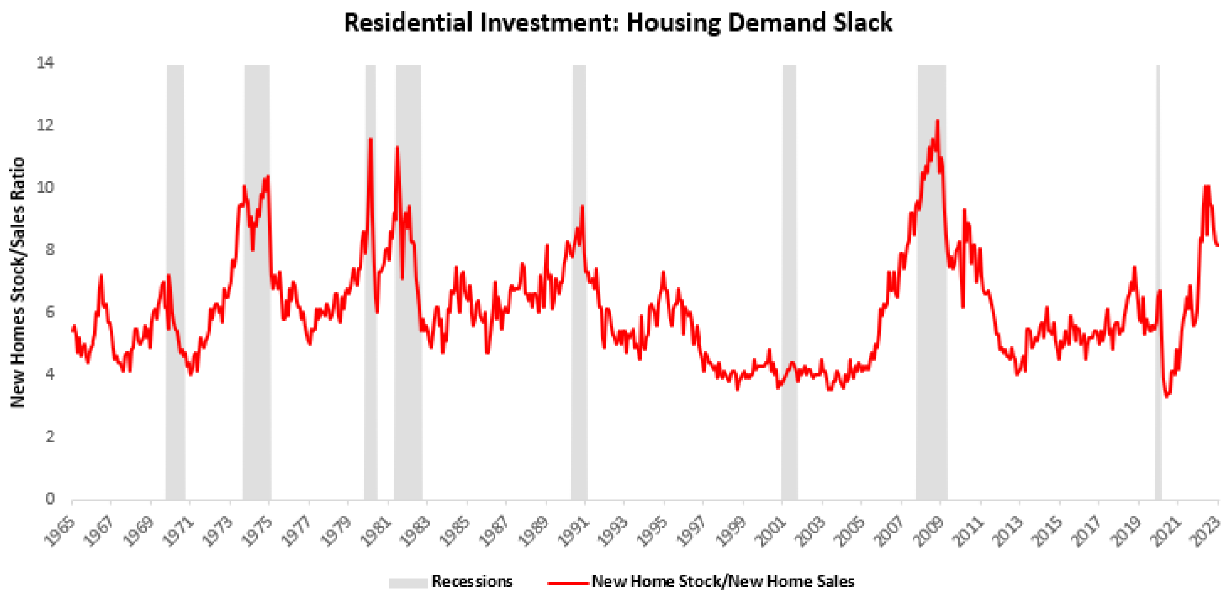


Hiking cycles typically initiate profit contractions. Part of this relationship is contextual, and part of it is mechanical. Mechanically, inflation flows through to profits immediately as companies benefit from higher prices; however, inflation also flows through the company's income statements with a lag as higher inflation induces higher interest rates and increased depreciation expenses. Contextually, lagged costs matter relative to the current and likely trajectory of business investment. Today, inflation has resulted in increased capital consumption costs, with nominal investment contracting:

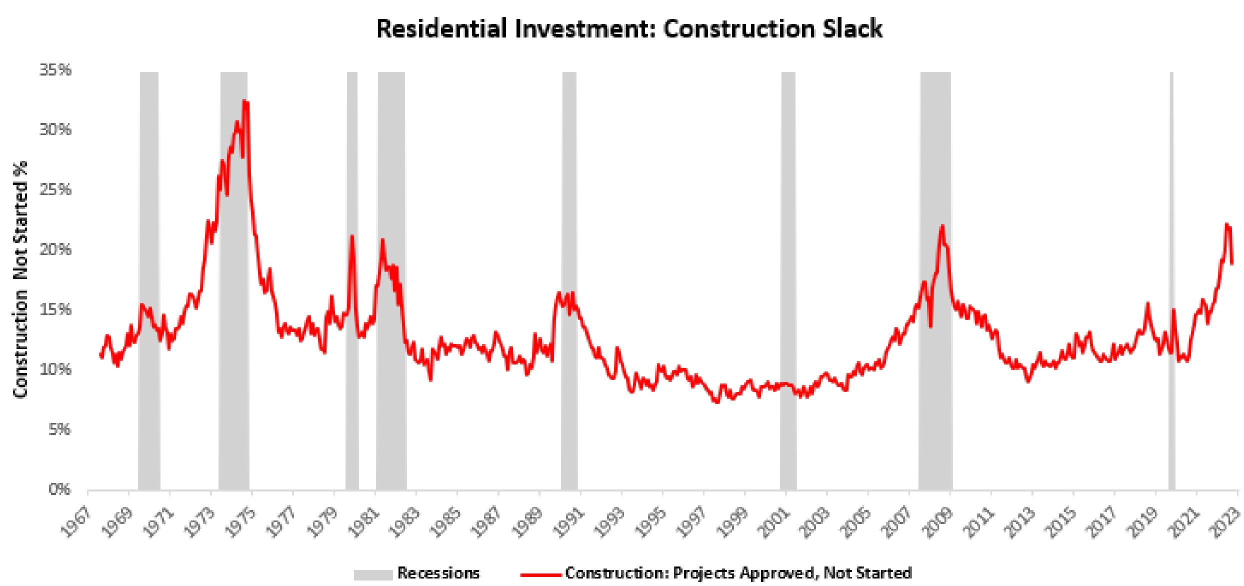


Based on our estimates, business investment activity will likely worsen, further dragging profitability. We expect construction activity, inventories, and equipment investment to weaken.

Within construction, we continue to see current conditions in the residential sector imply an increasing amount of slack in the industry. Housing demand has begun to show slack, with the stock of new homes rising relative to the volume of homes sold:

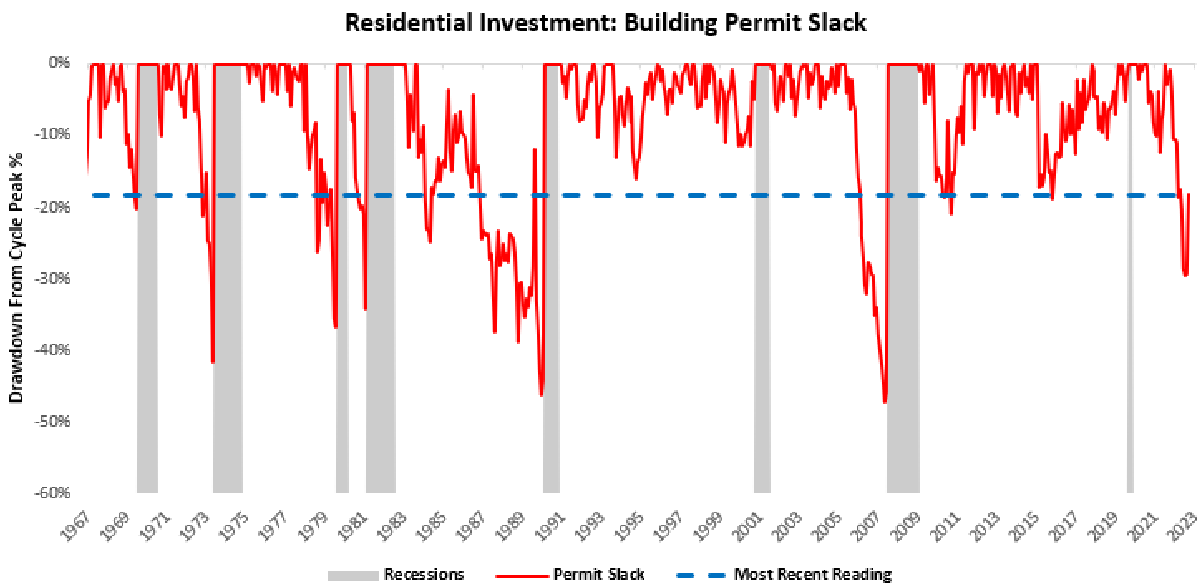


Coinciding with this slowing in sales is a slowdown in construction activity. We see this in the form of construction projects that have been approved but not yet started:

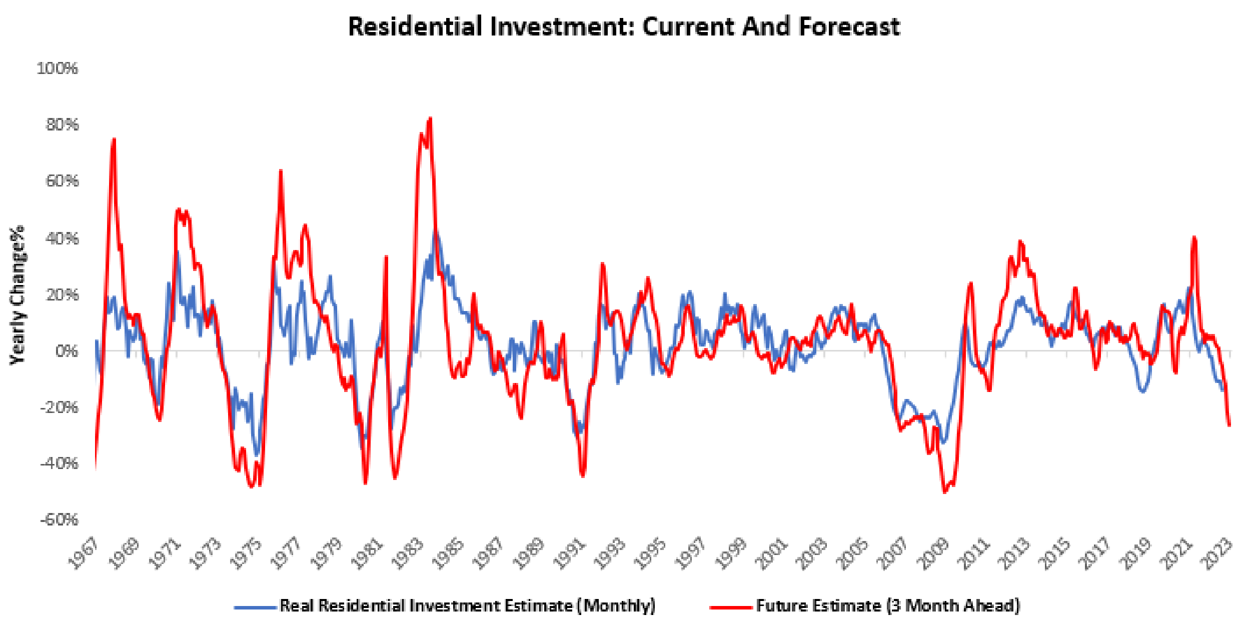


The combination of these factors suggests a softening in demand for housing relative to previous expectations. We see further evidence of this slowdown in housing activity in the form of declining residential building permits.

Below is the building permit drawdown relative to their economic cycle highs. As we can see, current conditions, much like those in housing demand and construction, imply conditions consistent with recessions:



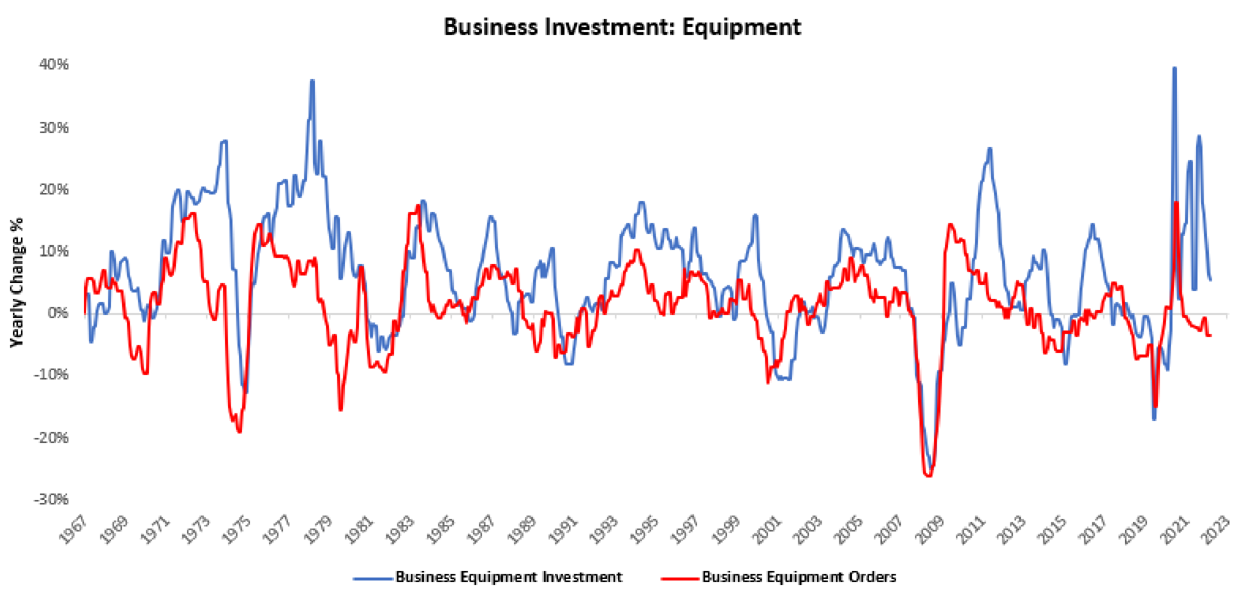
The combination of these factors leads us to think that real residential investment is likely to end up weaker. We show our estimates of future real residential investment below:



As we can see above, our expectation is for real residential investment to continue on its downward trajectory, which will weigh on total real investment in the economy. Additionally, we expect other components of gross investment to continue to soften. We will discuss these next.

Alongside a weakening in construction activity, we expect a reduction in business inventories driven by a decrease in nominal business sales.*** One business's sales are another business's inventories, and as sales increase and decrease, the stock of inventories increases and decreases. Nominal business sales have decelerated this cycle meaningfully, resulting in sustained pressures on inventories. Current business sales growth suggests that this pressure will persist:

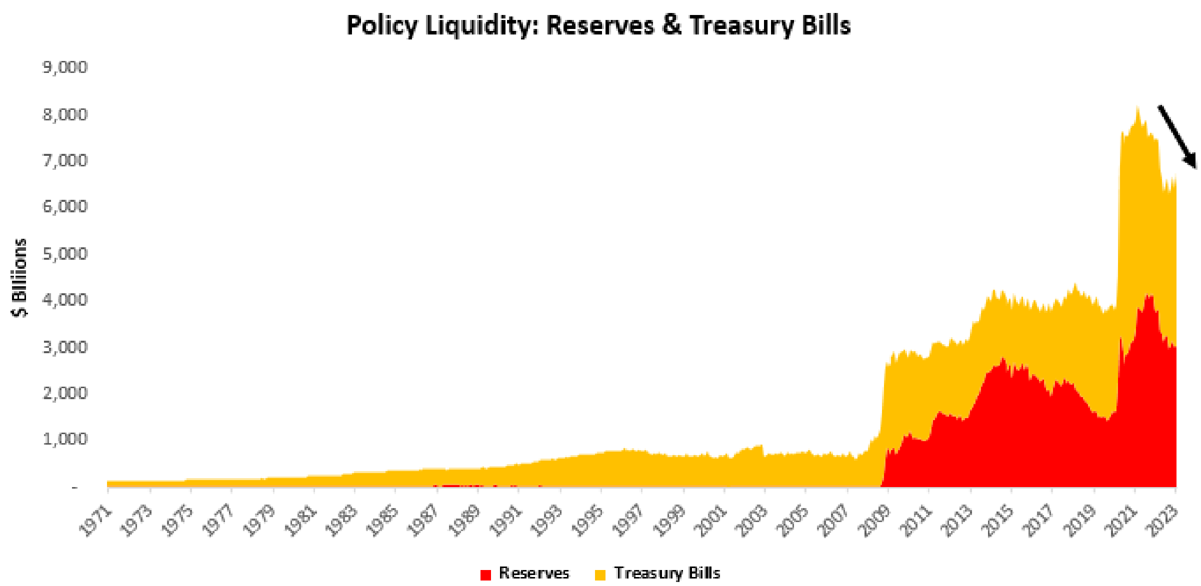
Coincident with these declining business inventories, we are also likely to see a slowdown in business equipment investment coming from a slowdown in business equipment orders to manufacturers:



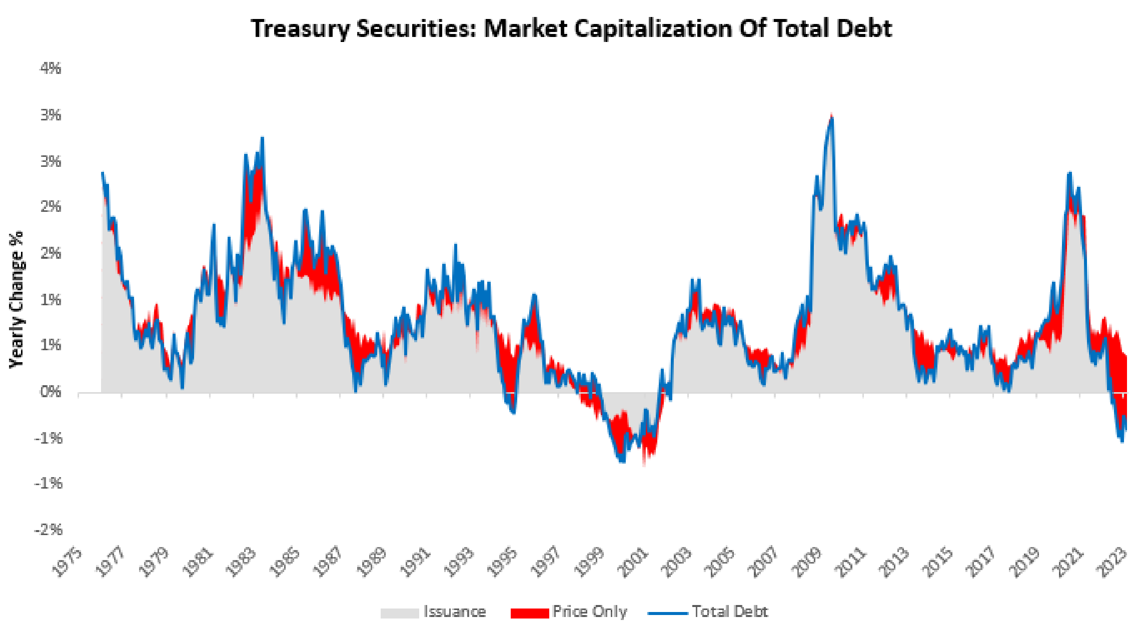
Therefore, looking through the existing pressures on construction, inventories, and equipment, we expect that future economic investment activity will continue to contract, which will remain a pressure on profitability. Furthermore, this comes alongside a weakening in private sector liquidity conditions, wich we discuss next.

Liquidity Conditions Will Get Worse, Not Better

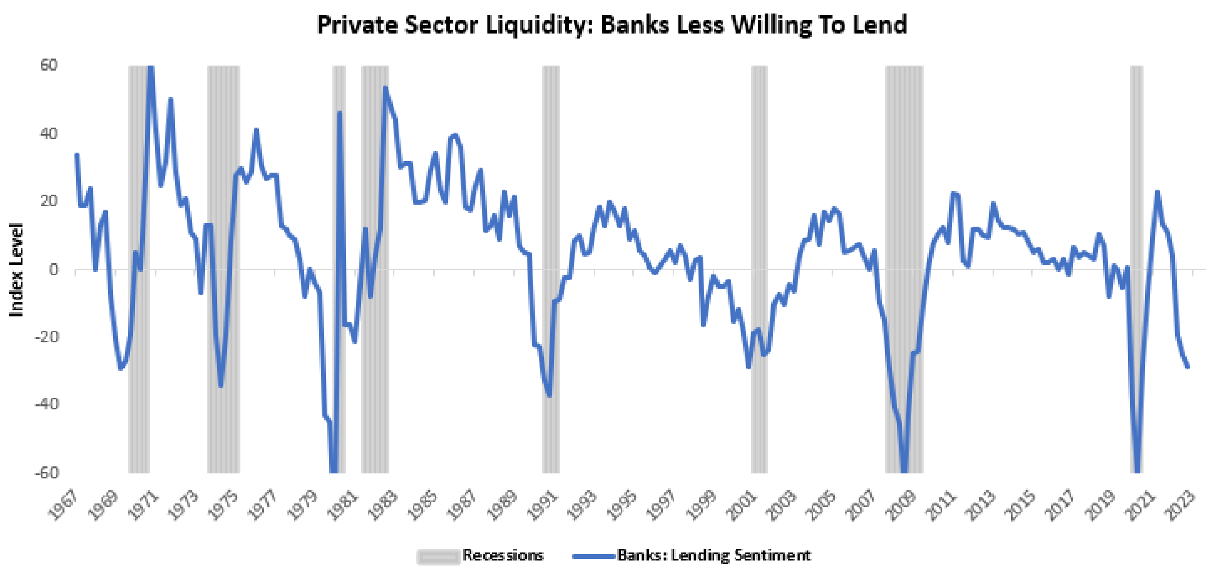
So far, during this cycle, we have primarily seen declines in policy liquidity, i.e., interest rates have risen, quantitative tightening has commenced, and Treasury bill issuance has slowed significantly. ***However, we think that declines in private-sector liquidity are likely ahead of us.*** Before we discuss private sector liquidity, we show the drag on policy liquidity coming from the decline in reserve balances at the Federal Reserve (through quantitative tightening) and the decline in Treasury bills outstanding (net of intragovernmental impacts):



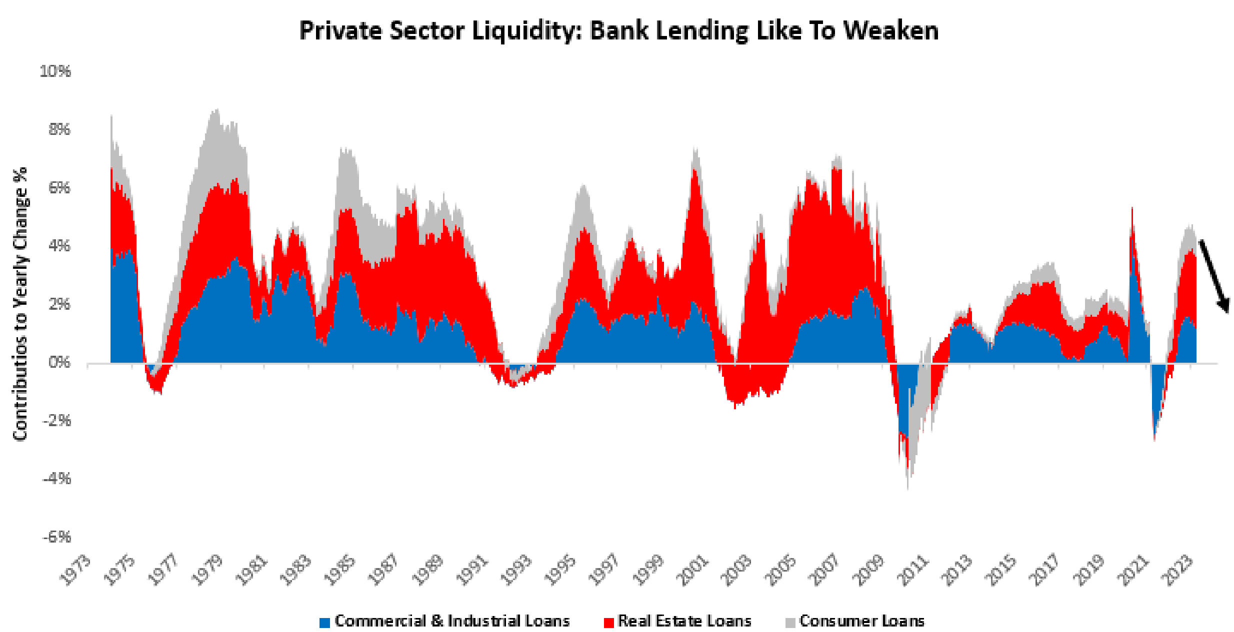
This contraction in Reserves & Treasury Bills has negatively affected the liquidity ecosystem by creating a shortage of safe asset growth relative to activity. Furthermore, increases in interest rates have led to declines in longer-duration assets ranging from government securities to riskier credits. Below, we show the losses on outstanding US government securities coming from changes in interest rates:



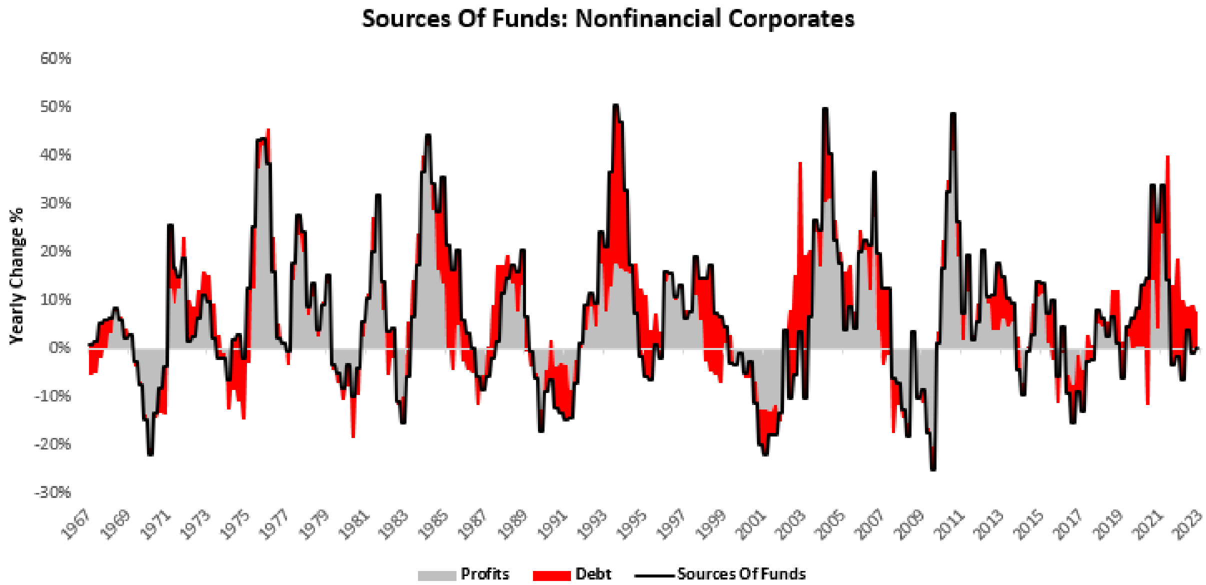
These dynamics are the root cause of the banking stress we have seen over the last month. We are not experts in single-name securities, but we believe that the stress is seen in individual companies (Silicon Valley Bank, etc.) is just a concentration of industry-wide risks driven by macroeconomic liquidity factors***. Moreover, we expect liquidity conditions to worsen as private-sector-procyclical liquidity begins to contract while public-sector liquidity remains in contraction.*** Recent stress in the banking system will likely result in further hesitancy to lend, exacerbating current weakness in lending sentiment:



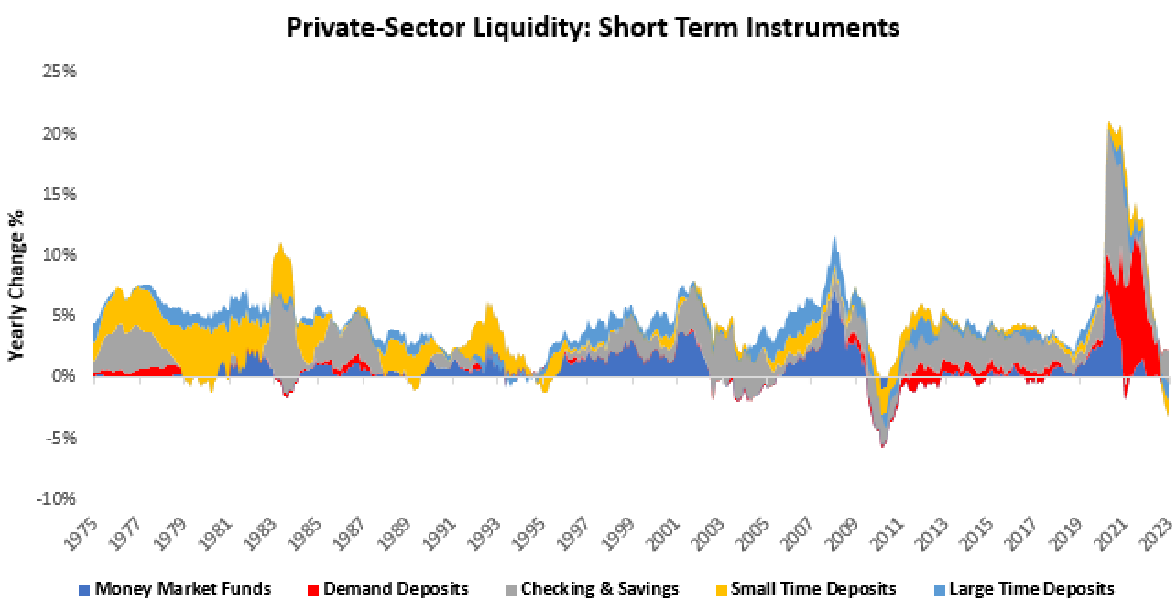
Additionally, new borrowers are now experiencing weaker nominal incomes and higher borrowing costs, likely weighing on loan growth. Below, we show the loans growth has begun to decelerate but not yet decline:



Profits and debt are the primary sources of private sector funds, which finance business expenses and investments. As detailed in this note, profits are already in contraction, and businesses borrowing to finance investment and expenditures have also declined significantly. We show this decline in nonfinancial corporate sources of funds below:

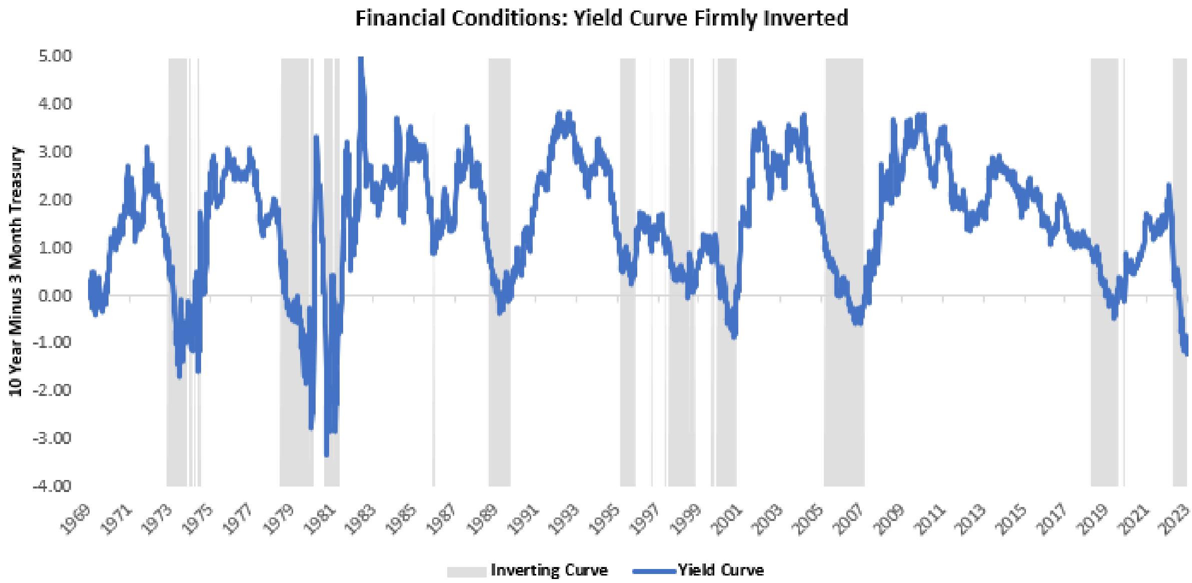


This decline in business sources of funds is a drag on businesses' uses of funds, i.e., spending on labor and investment. This decline in spending will likely drive a decrease in incomes, which will further drag on already softening bank deposits and money market funds inflows:

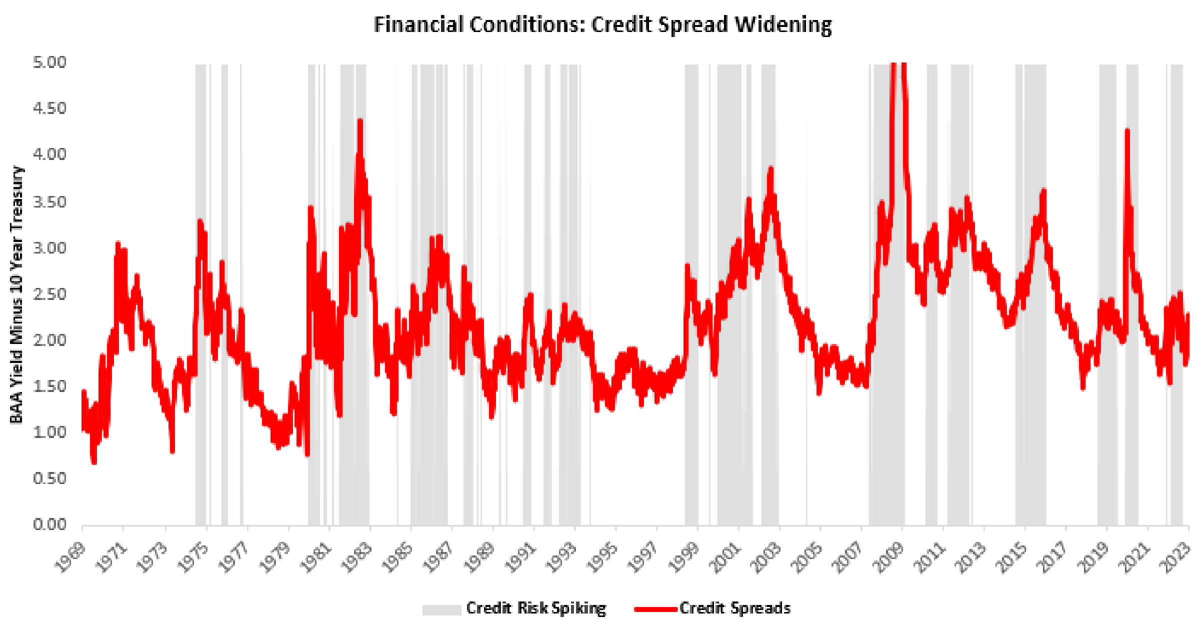


As we can see above, short-term liquidity store holds have already begun to contract (primarily from QT), and we expect this picture to worsen as bank balance sheets contract.

Consistent with the cumulative contraction in policy liquidity, yield curves remain inverted:



However, as we move into the next phase of the liquidity cycle, i.e., when private sector liquidity begins to contract, we are likely to see a widening of credit spreads:



Therefore, while we have already seen a significant deterioration in the liquidity ecosystem during this hiking cycle, we expect conditions to worsen as private-sector liquidity follows public-sector liquidity into contraction. In this environment, credit spreads will likely continue on their path toward widening. The wheels are in motion for liquidity to contract meaningfully. Unless the Federal Reserve reverses course swiftly, we will probably see a worsening in market conditions in the next six months.

Conclusions:

To reiterate the views laid out at the onset of this note:

- ***Nominal activity has decelerated, with real growth contracting and inflation decelerating. These moves aligned with our expectations and reflected the slowing of the labor impulse to broader activity.***
- ***Alongside this contraction in real activity, we saw significant stress in the banking system as the cumulative impact of tightening policy liquidity flowed through to financial intermediaries. We are now moving into the part of the cycle where public and private sector liquidity are likely to contract in unison. This path bodes ill for future nominal activity.***
- ***Our systems have now confirmed recessionary conditions. We see equity markets as particularly exposed to this risk, which our cycle strategies will look to exploit.***

Overall we expect that profit pressures will weigh on broader GDP, alongside a weakening in private sector liquidity. The wheels are now in motion for a meaningful slowdown in economic activity, with the reward-to-risk favoring equity shorts. Our Prometheus Cycle Strategies now place us within a bearish regime for the S&P 500 but remain neutral for April. Whether you choose to short the market or not, we think it is imperative to recognize that over the next 6 to 18 months, the returns on equities are likely to be weak at best and significantly negative at worst. Navigating this part of the cycle remains challenging, but we remain well-prepared. Until next month.

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