PROMETHEUS

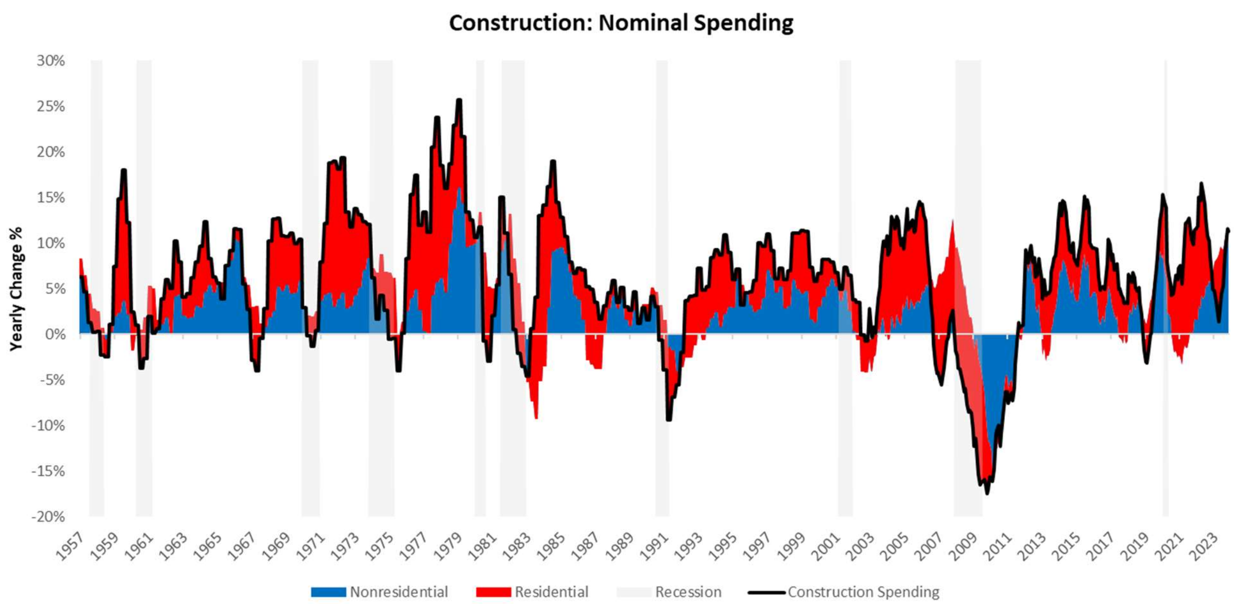
The Observatory

Welcome to The Observatory. The Observatory is how we at Prometheus monitor the evolution of the economy and financial markets in real-time. The insights provided here are slivers of our research process that are integrated algorithmically into our systems to create rules-based portfolios.

Our primary takeaways are as follows:

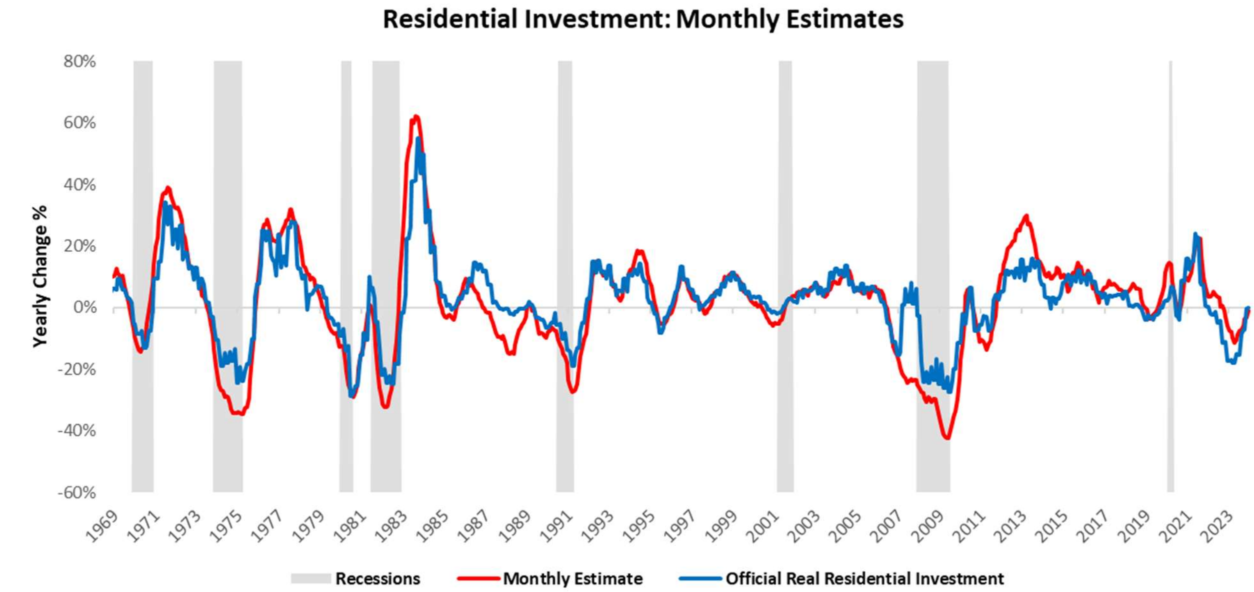
- ***Conditions in residential spending drive cyclical accelerations and declarations, often serving as a harbinger of recessionary pressures. Given the tightening of interest rates by the Federal Reserve, we would expect the impacts of tightening to be most prevalent in the residential construction market.***
- ***However, a broad-based assessment of conditions in the residential market continues to suggest a robust, and accelerating environment in residential construction driven by backlogs.***
- ***Markets have front run this expectation significantly, with homebuilder equities showing significant returns. While these gains have started to look stretched, we see little by way of fundamental dynamics in the construction sector that can slow this down. Much like the broader equity market, this remains a trend not to fight.***

Overall, conditions continue to look positive and improving in the housing market, and while equity conditions may be stretched relative fundamentals, there are little catalysts that a reversal of conditions. As markets extend themselves, staying close to the data will be essential to knowing when to exit. Until then, this continues to be trend not to be fought. We dive into our tracking of conditions, beginning with nominal construction spending:

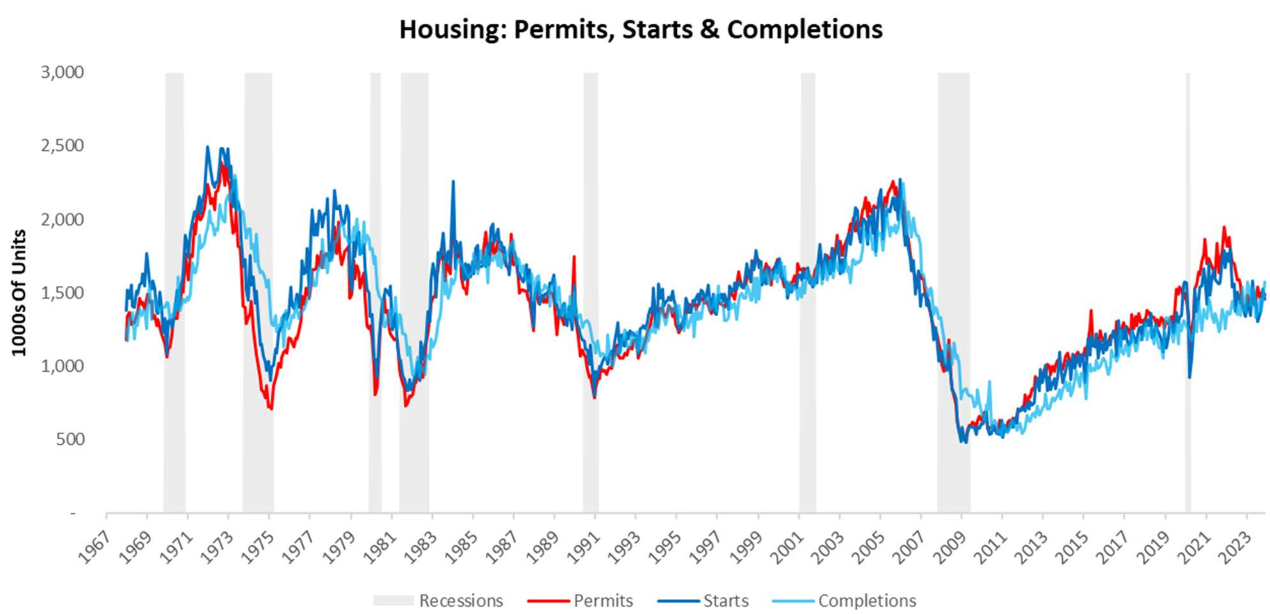


As we can see above, nominal construction spending remains strong, driven by a combination of extremely strong nonresidential spending, and recovering residential spending.

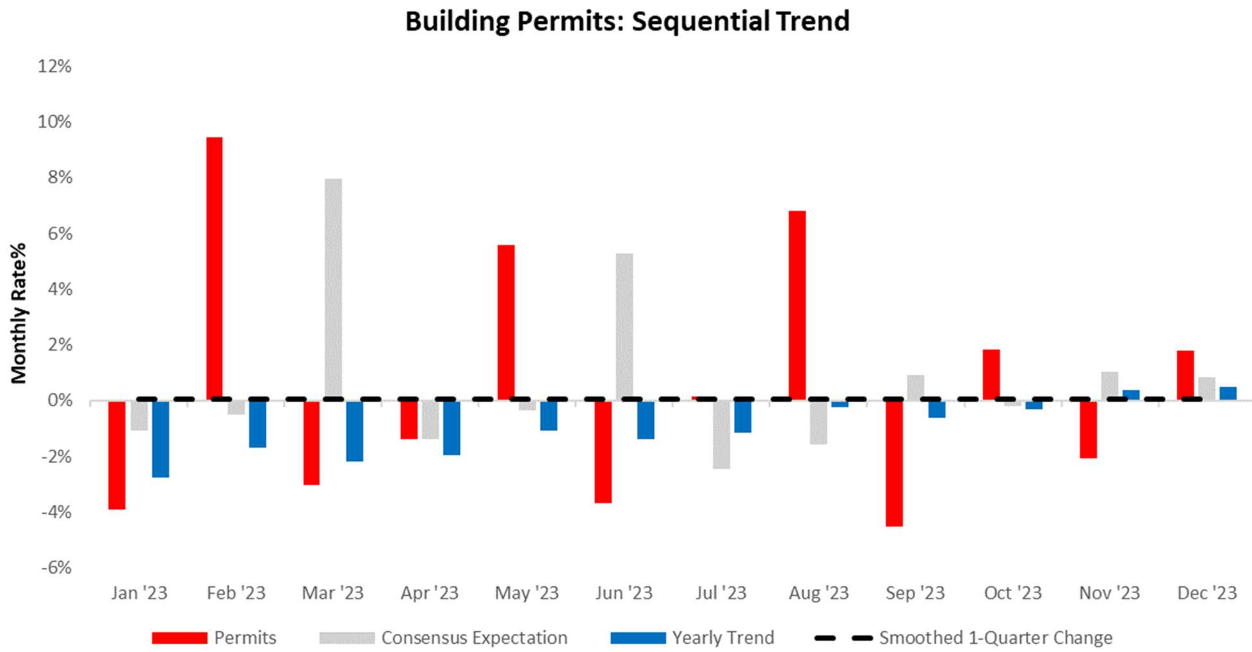
We zoom in on the real residential spending component of this nominal spend. Our latest monthly estimate place real residential investment at -1% versus one year ago.



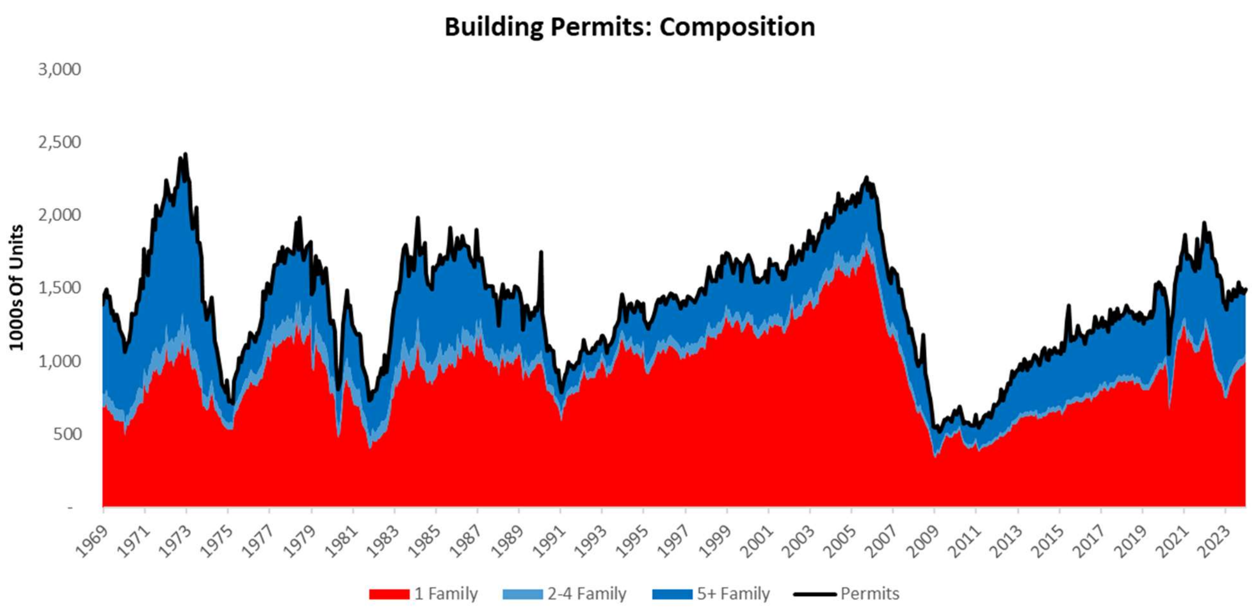
Zooming into the data further, leading measures of housing activity continue to suggest stabilization after a period of decline. The latest data for December showed housing permits increased by 1.77%, housing starts decreased by -4.26%, and housing completions increased by 8.7%. Below, we show the current levels for the same:



Zooming into the data, housing permits increased by 1.77%, surprising consensus expectations of 0.82%. Below, we show the sequential evolution of the data, along with the smoothed one-quarter change in the most recent data. We provide the smoothed version as monthly housing data contains significant noise:

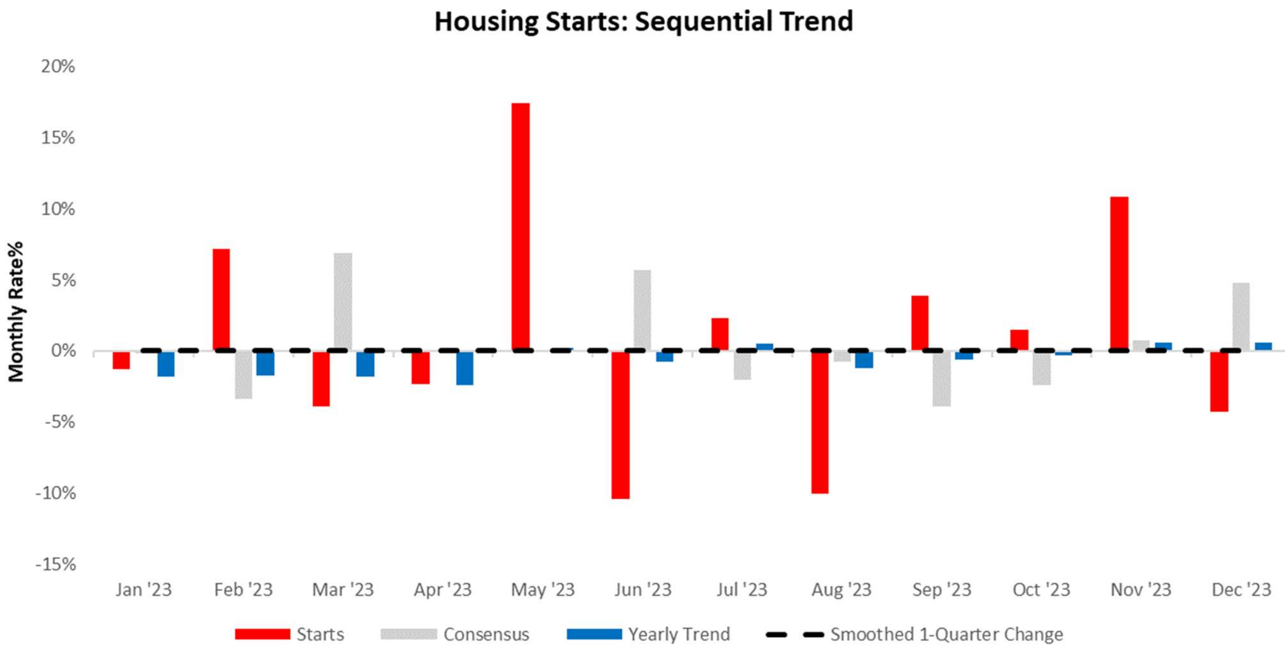


For further context, we zoom out to show the contributions from single-family homes (251), two-family homes (0), and multi-family homes (-167) to the rise (84) in total permits over the last year:

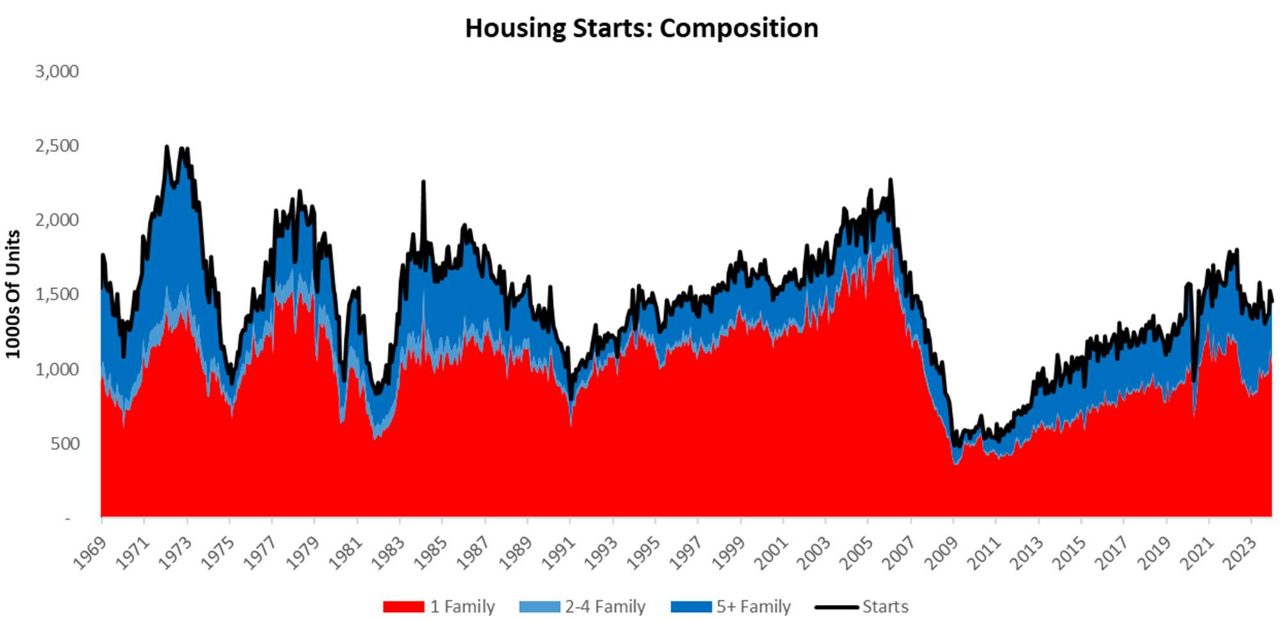


In contrast to the permits data, housing starts data showed starts decreased by -4.26%, disappointing consensus expectations of 4.78%. Below, we show the sequential evolution of the data, along with the smoothed one-quarter change in the most recent data.

We provide the smoothed version as monthly housing data contain significant noise.

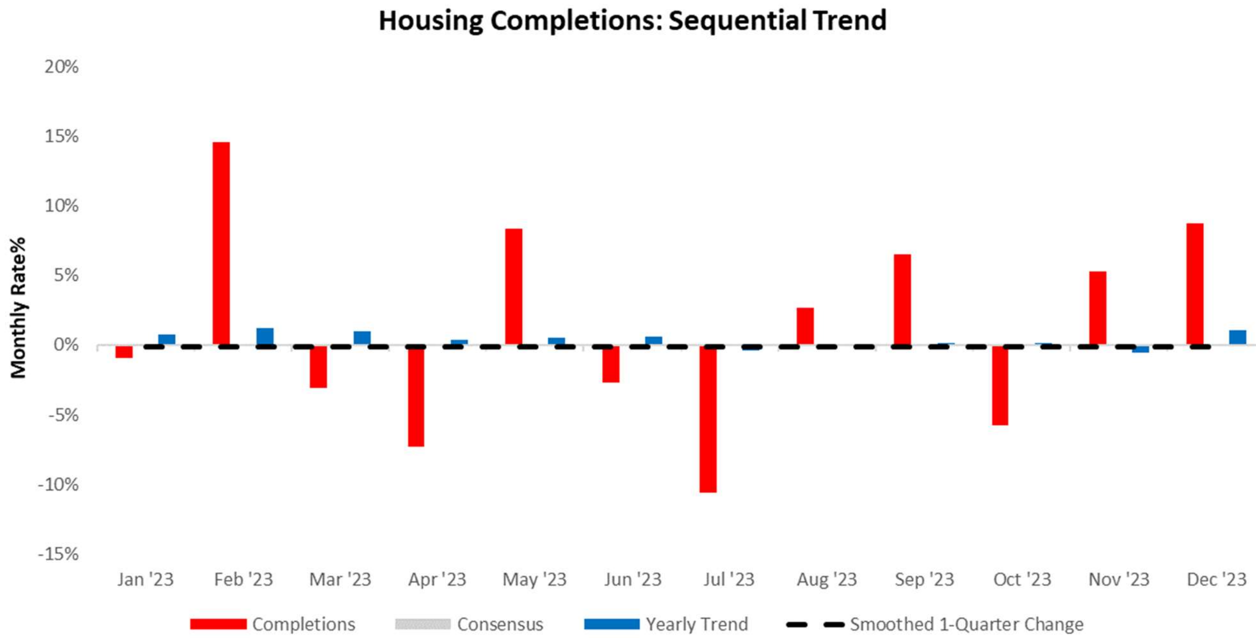


To illustrate the bigger picture, we show the contributions from single-family homes (-97), two-family homes (7), and multi-family homes (-44) to the rise (103) in total starts over the last year:

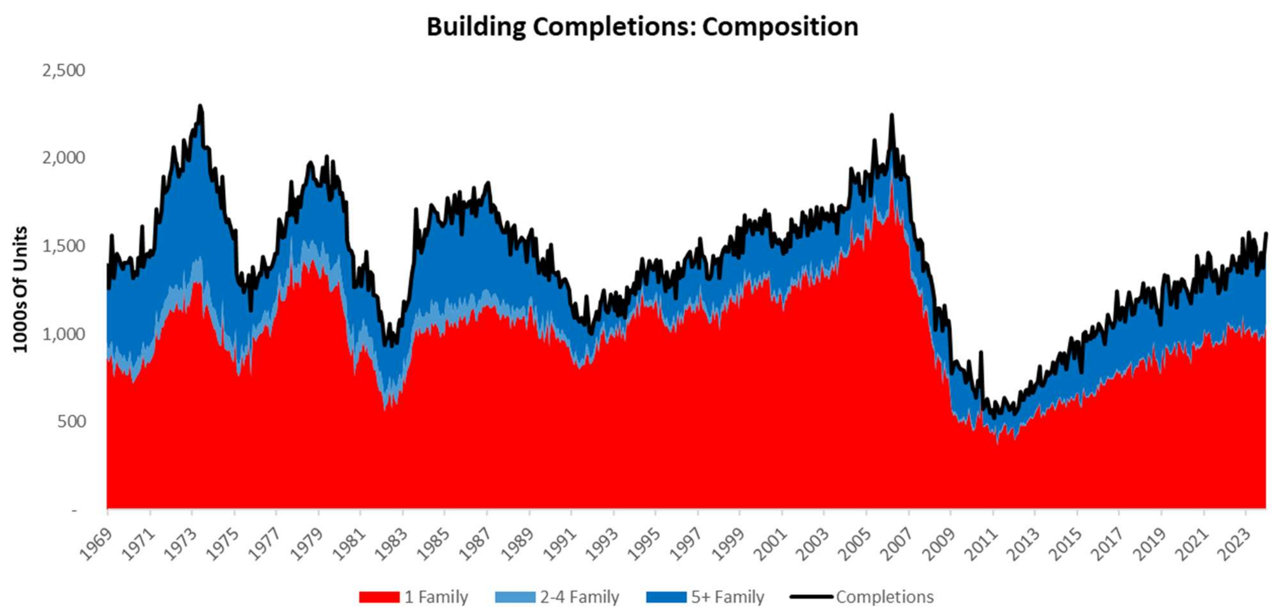


Last, in our sequential analysis, we turn to housing completions data, which showed completions increase by 8.7%. Below, we show the sequential evolution of the data, along with the smoothed one-quarter change in the most recent data.

Again, we provide the smoothed version as monthly housing data contain significant noise.

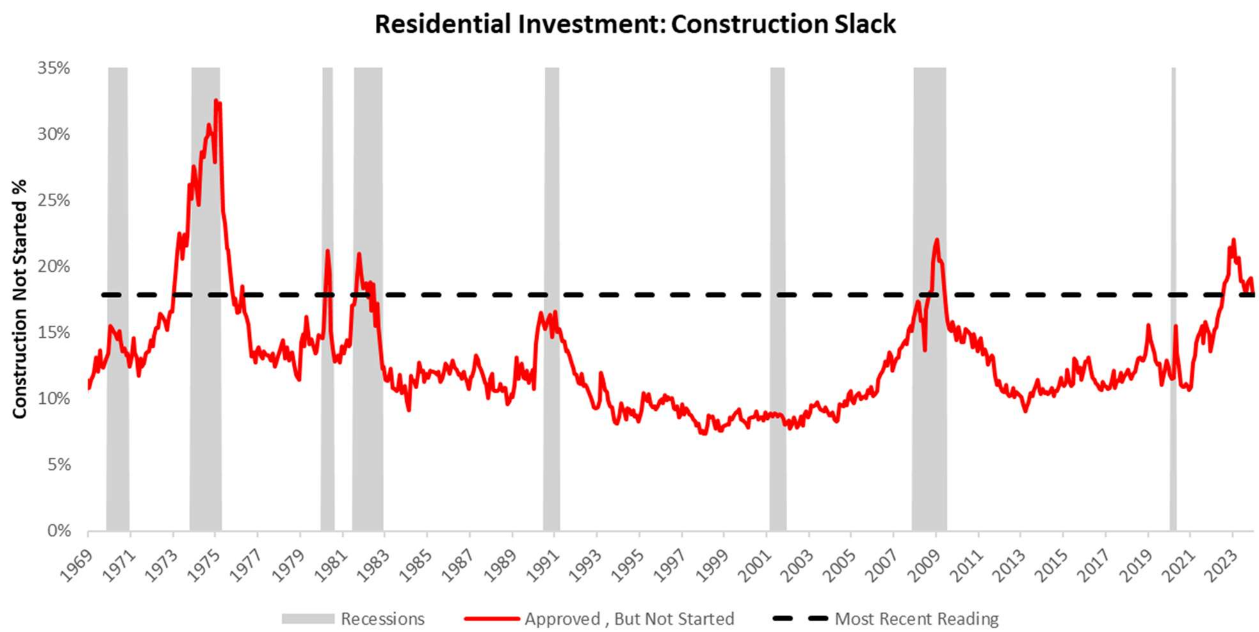


We show the contributions from single-family homes (82), two-family homes (-5), and multi-family homes (128) to the rise (184) in total completions over the last year:

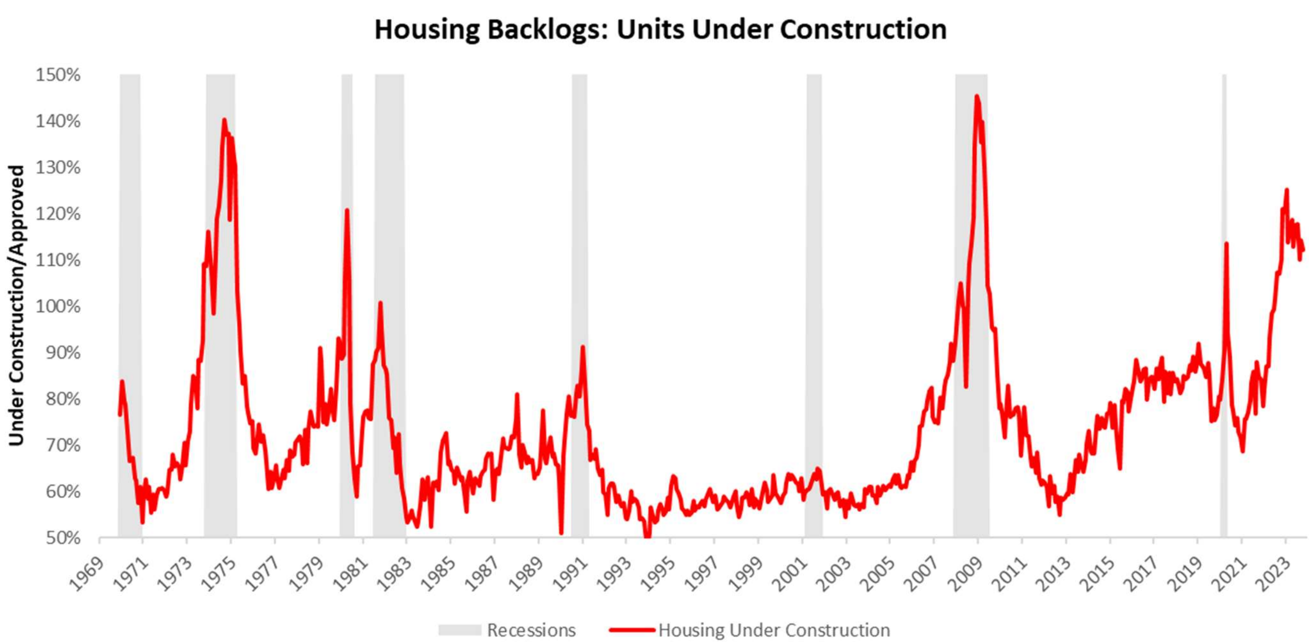


As we can see, these high-frequency measures of housing construction point to a stabilization of housing conditions. These measures largely point to a neutral environment, which is consistent with what we see from aggregate residential construction data.

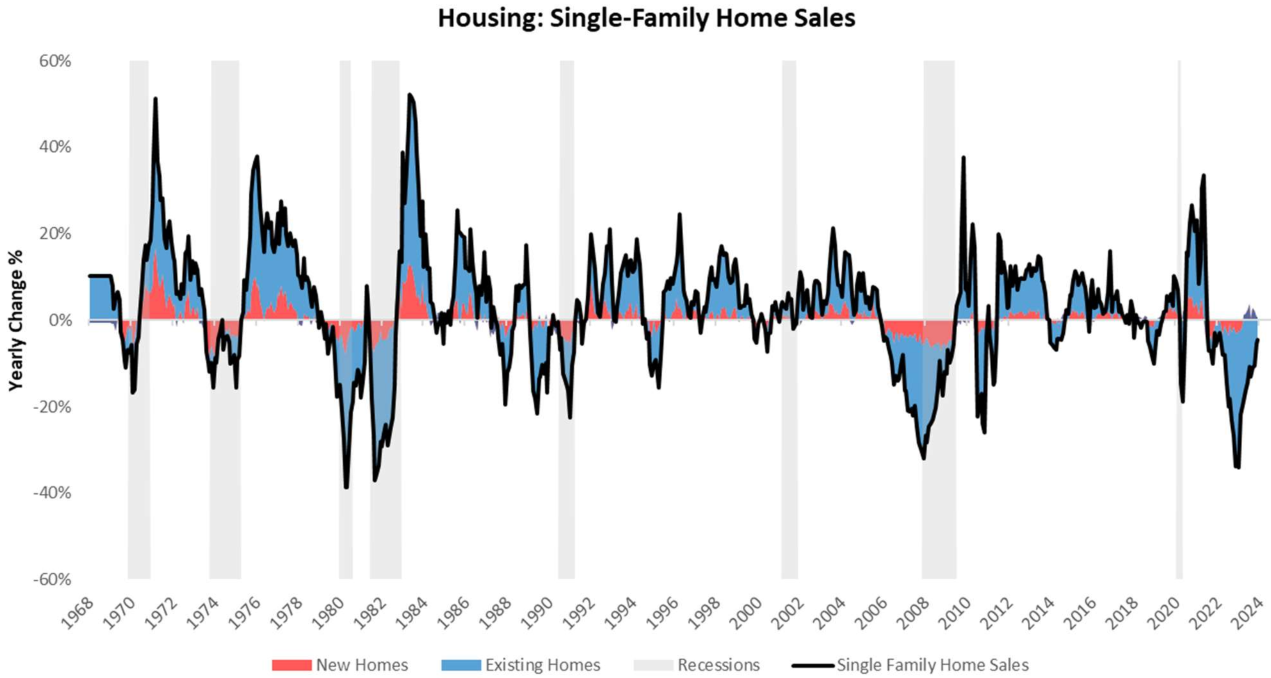
While measures of activity allow us to understand the sequential path, we now examine measures of tightness and slack to understand the health of construction data. We begin with measures of construction slack. According to the latest data, 18% of projects are yet to begin construction. Looking through history, housing-led recessions usually begin when this measure of construction slack is around 15% suggesting that we are within the ballpark of a recession.



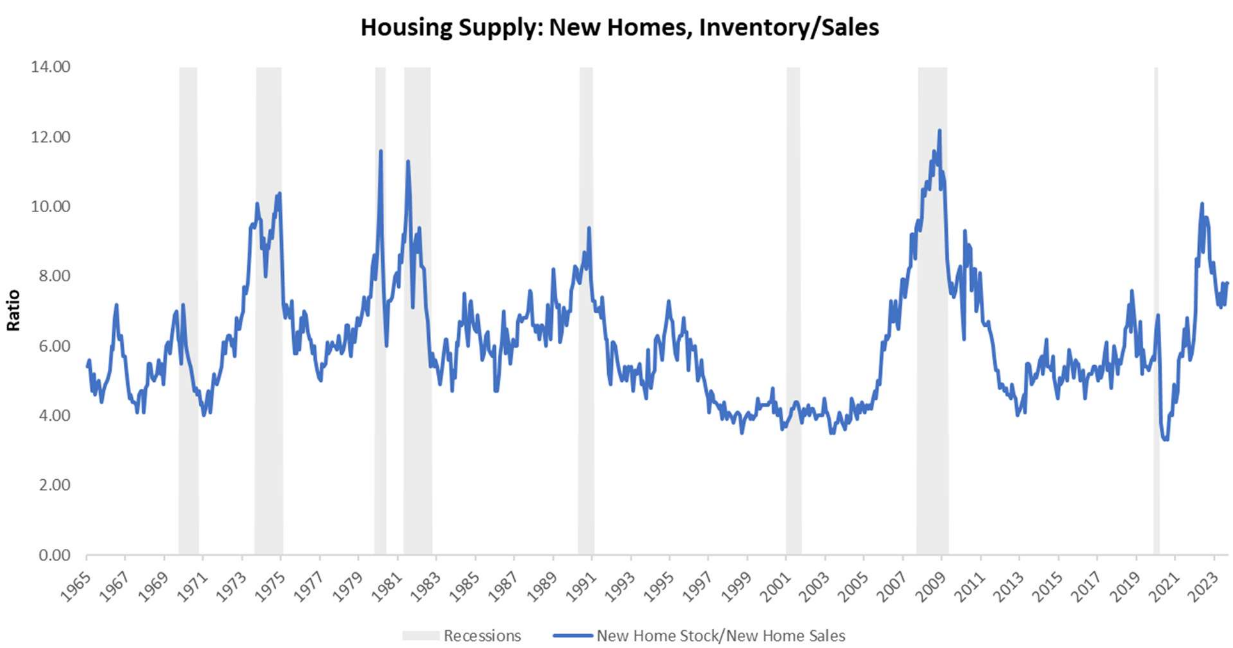
Now, while this rise in unstated projects can often be a sign of weakness in perceived end demand, it can also be due to existing backlogs in construction. Below, we show a measure of these backlogs, which show the number of homes under construction relative to those under construction:



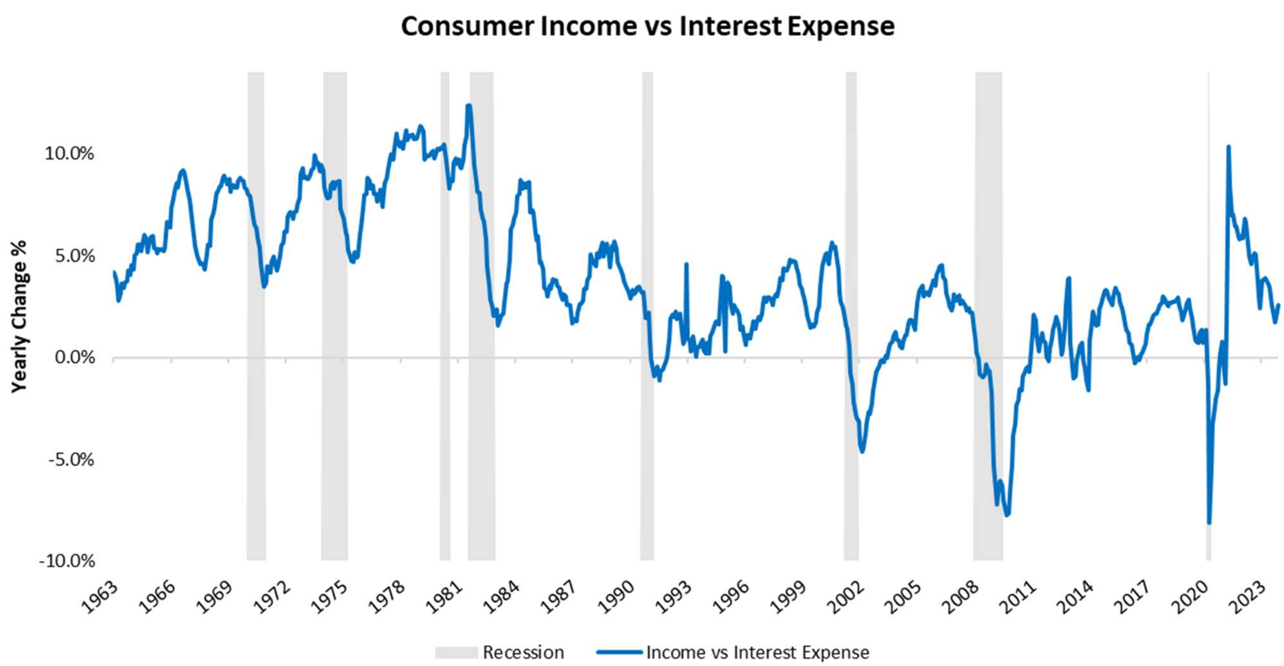
As we can see, the construction market continues to show significant backlogs, with a significant portion of approved housing units remaining either unstated of under construction. While these dynamics are extremely supportive of construction markets, they have been less supportive to housing sales.



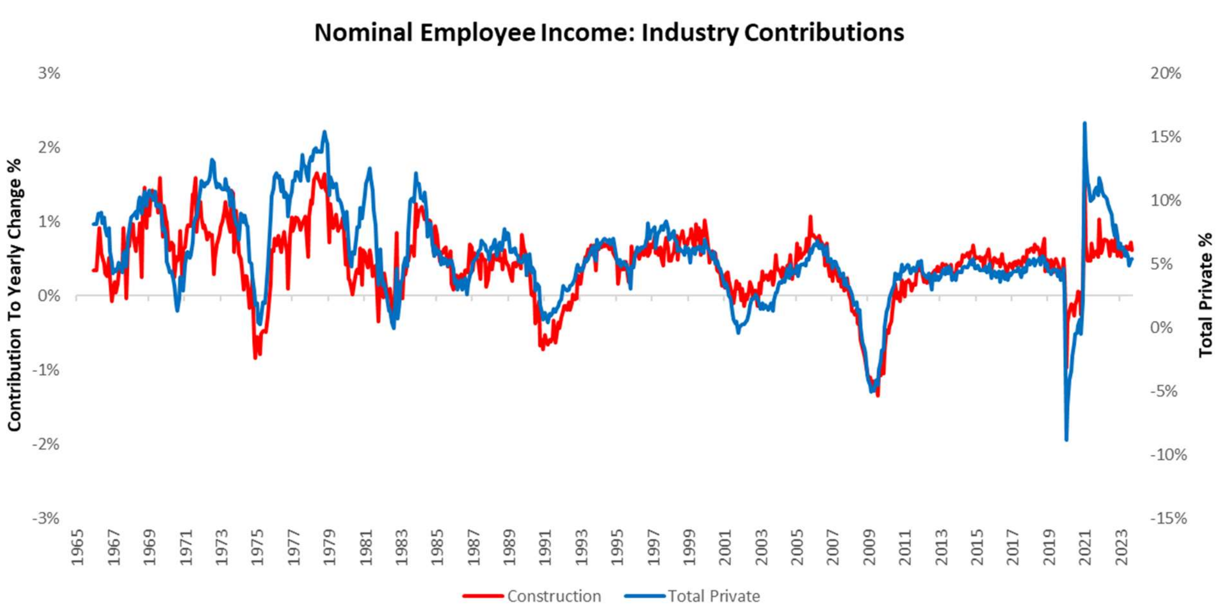
We see this in the fact that new home stock continues to stagnate relative to sales, i.e. housing inventories continue to increase:



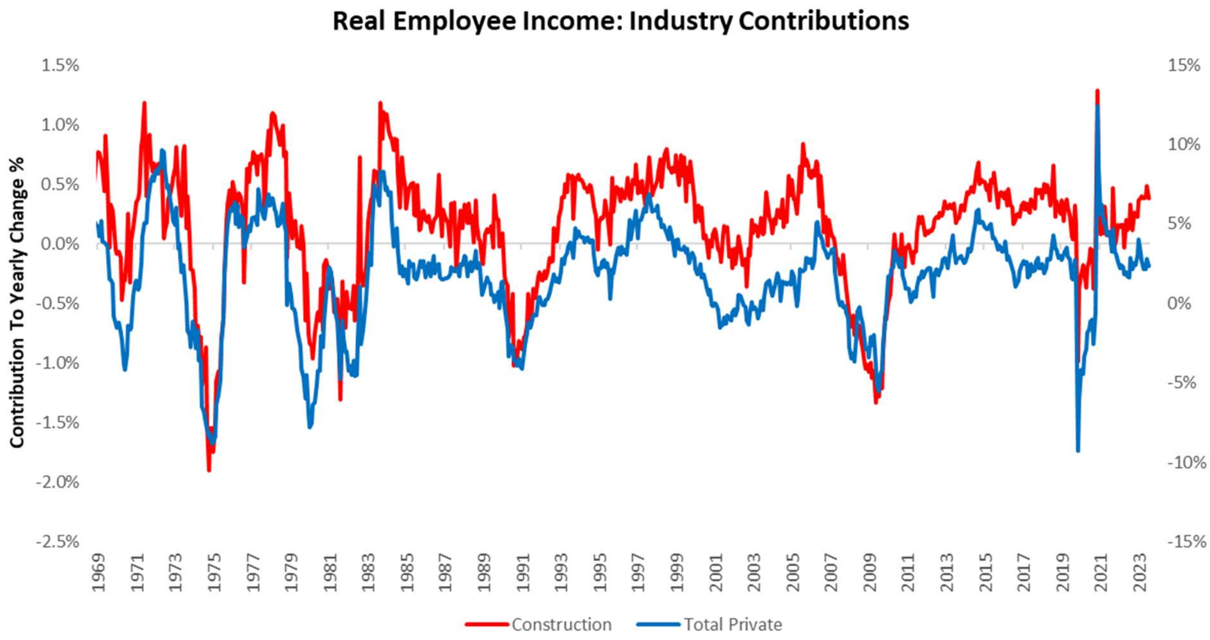
Aggregating these dynamics, housing construction remains a healthy component of economic activity as we continue to work through backlogs. However, we see the pass-through to sales as limited, suggesting weaker consumer demand. We see this pressure emerging as nominal income begins to decelerate relative to rising interest expense. We visualize this below:



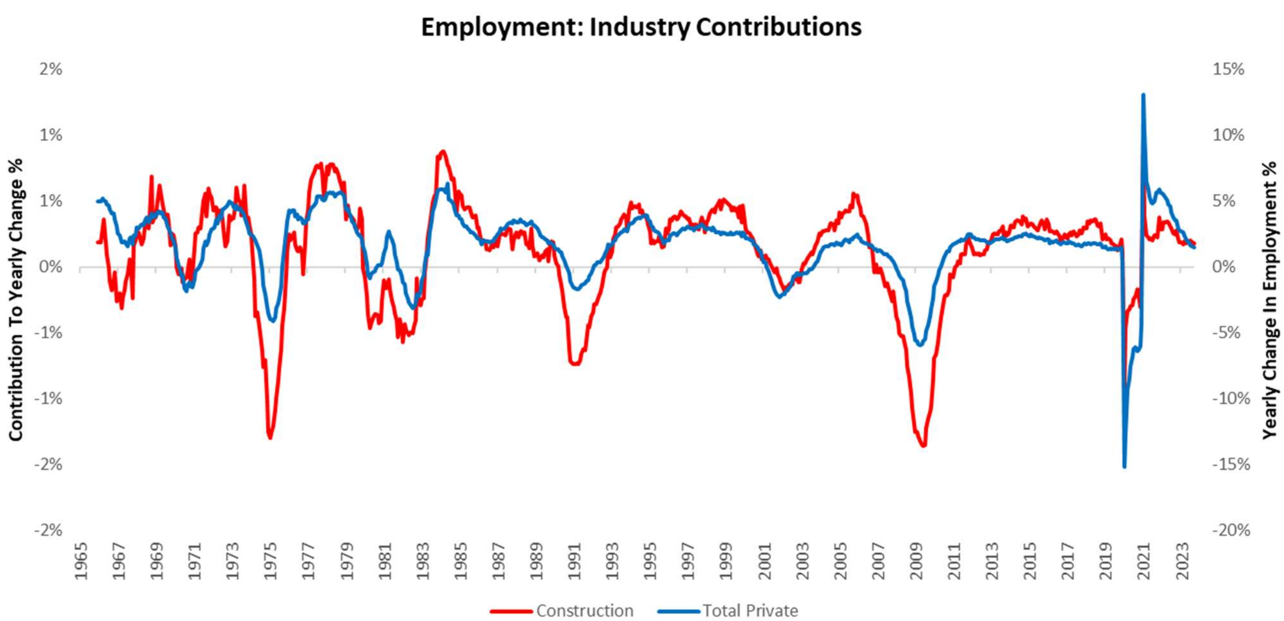
Now, while these conditions may speak to weak consumer demand, we think it is important to recognize that output, spending, and employment are largely dependent upon construction rather than sales. While this is evident in real residential investment, it is also evident in nominal construction employe incomes:



We zoom in on the real income component of this nominal spending, which shows real construction incomes expanding:

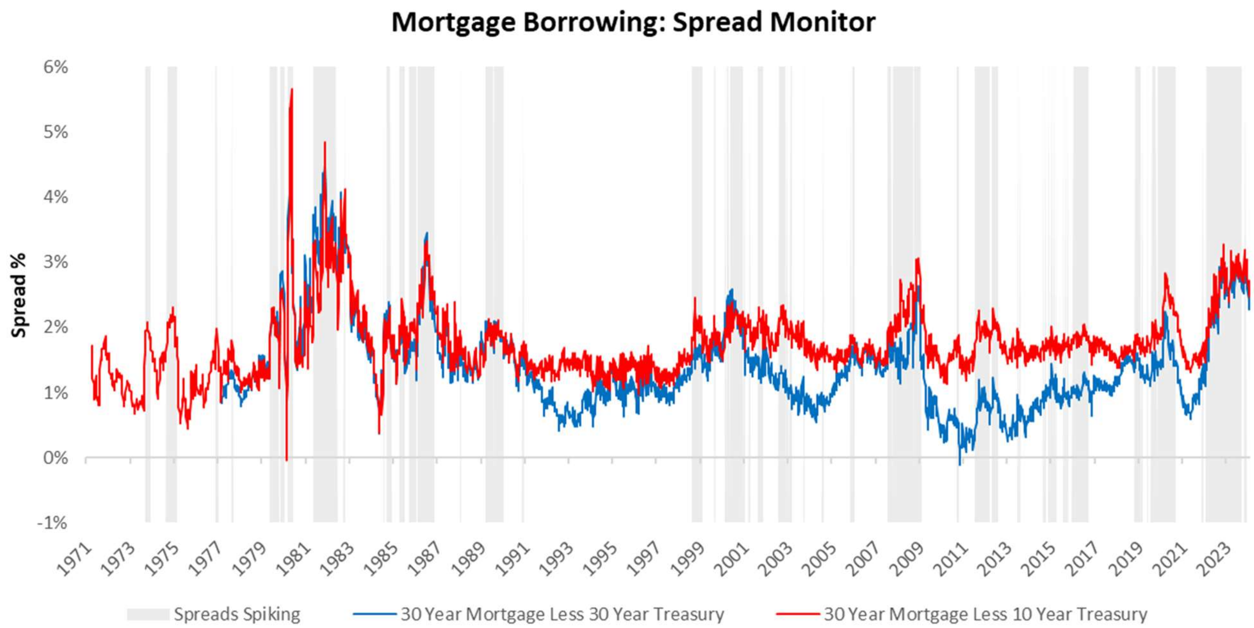


Additionally, construction employment continues to grow:

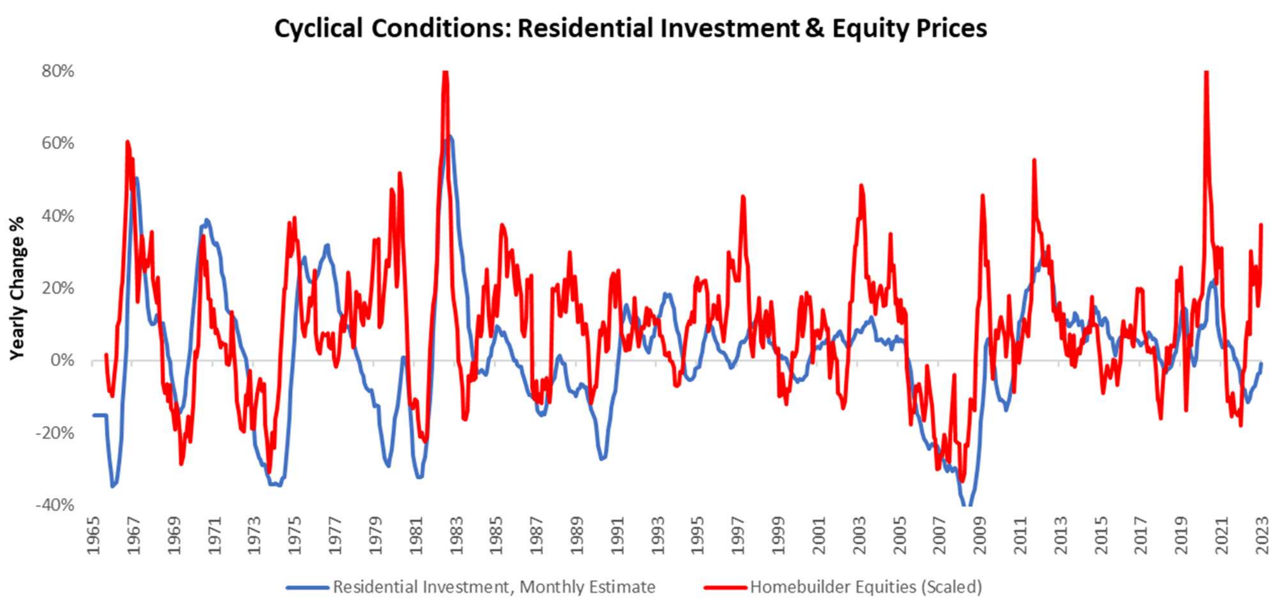


Therefore, while home sales continue to look weak, construction backlogs continue to push construction spending, output, and incomes forward. These dynamics remain significantly at odds with pre-recessionary activity. Furthermore, real-time market-based measures of this sector continue to suggest further improvement.

Below, we show how mortgage spreads have now begun to compress. According to our measures, mortgage spreads remain contained. Spreads have remained contained since January 2024. Since then, the 30-year mortgage yield relative to 10-year Treasury yields has compressed minimally. Below, we present the 30-Year Mortgages relative to 10 & 30-Year Treasuries:



While mortgage applications and mortgage spreads are an important barometer of housing demand conditions, we now turn to market-based measures of the health of the supply side, i.e., the performance of homebuilder stocks relative to broader equities. Homebuilder equities continue to significant strength, suggest market expectations for a strong environment for construction:



With mortgage rates at relatively wide levels, and a broad-based assessment of construction dynamics suggesting that residential spending continues to be in an expansion, we think the risk-reward of being short homebuilders or the broader real estate markets is likely to be limited. While these gains have started to look stretched, we see little by way of fundamental dynamics in the construction sector that can slow this down. Much like the broader equity market, this remains a trend not to fight. Until next time.

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