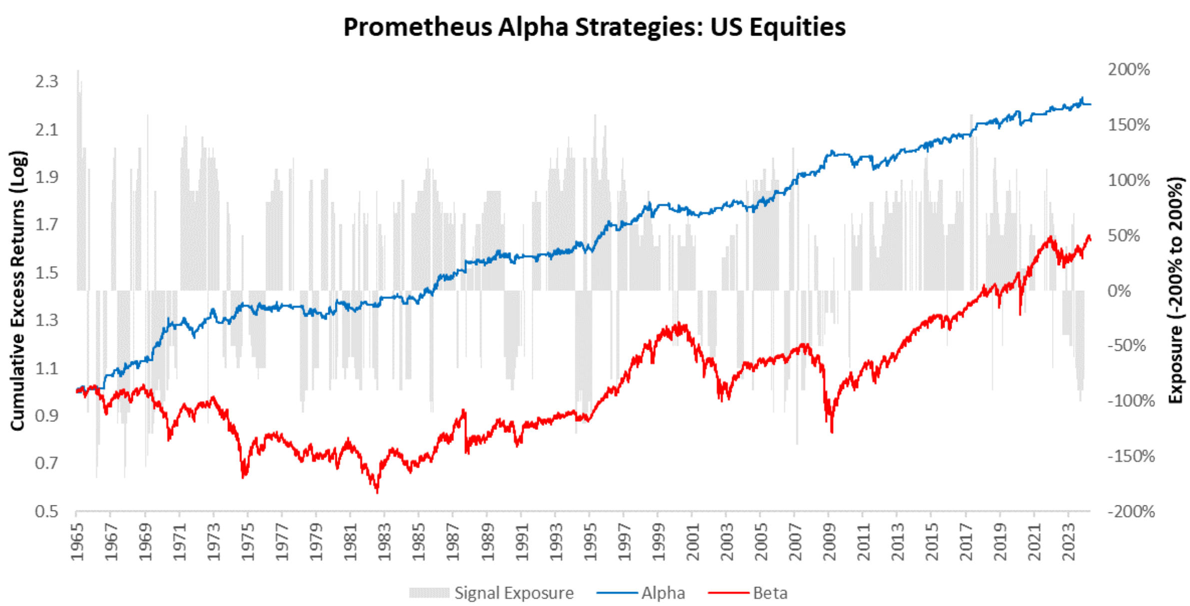
The Observatory

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:

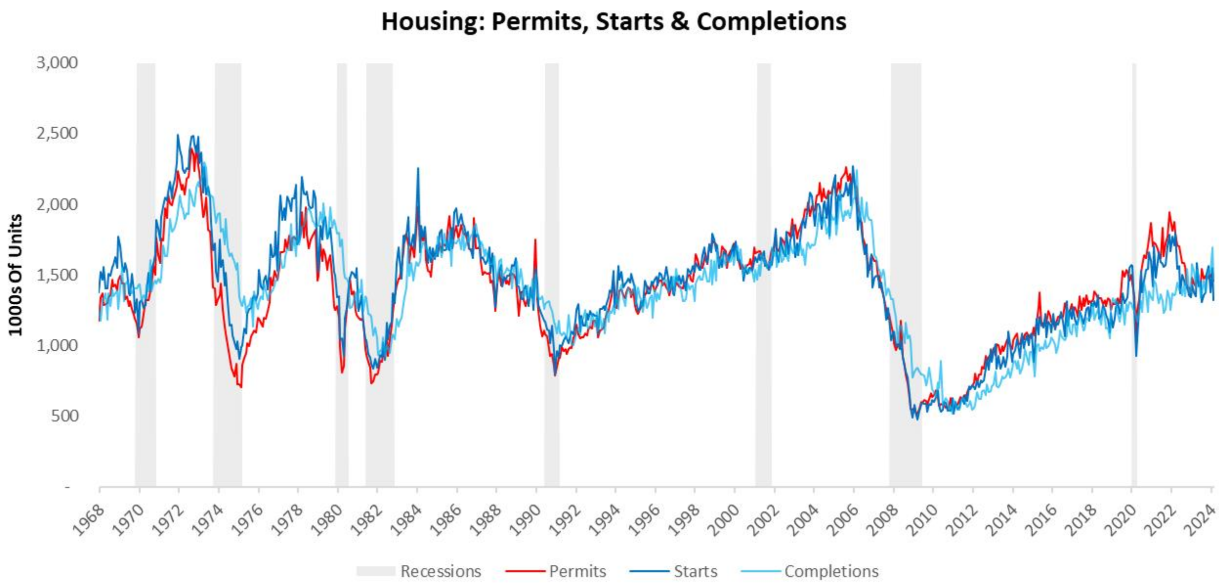
- ***The trend in housing data remains consistent with a cyclically stable economy, with building permits, starts, and completions maintaining their levels.***
- ***Without a downshift in housing, housing employment or nominal investment is unlikely to enter a self-reinforcing downturn. The latest trends continue to signal the opposite, i.e., improving residential investment.***
- ***Relative to these expectations, equity markets have moved to price in improving earnings expectations in a manner that now exceeds the fundamental macro impulse.***
- ***Our Alpha Strategies find equities modestly ahead of the ongoing fundamental impulse and are modestly short. Our asset allocation strategies continue to view risk-controlled exposure to equities as appropriate.***

This short exposure from our Alpha Strategies does not reflect a bet on recessionary conditions but on modest macro mispricing. These signals are modest in magnitude and have the potential to be resolved quickly. Thus, while our strategies are modestly short equities at this junction, cyclical dynamics remain largely inconsistent with a recession. As such, our asset allocation strategies continue to view the economic backdrop as one suitable for beta-capture for equities. Most recent housing data are consistent with these signals. We dive into the data driving this assessment. We begin by showing the recent context for our Alpha Strategies for Equities:

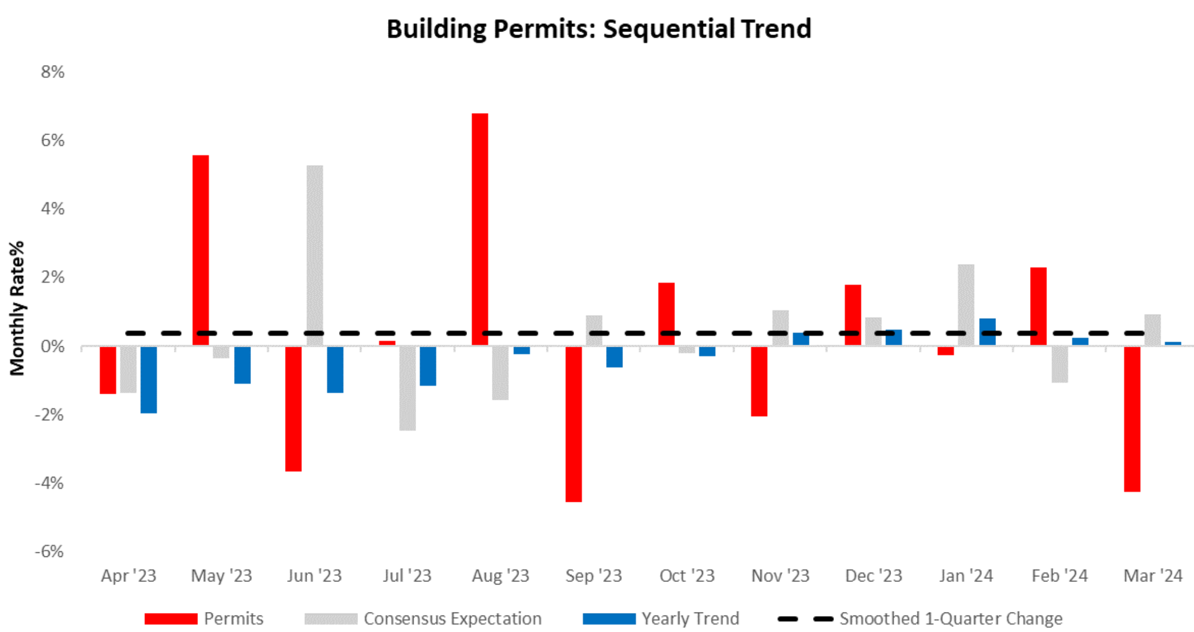


Let's dive into the latest housing data.

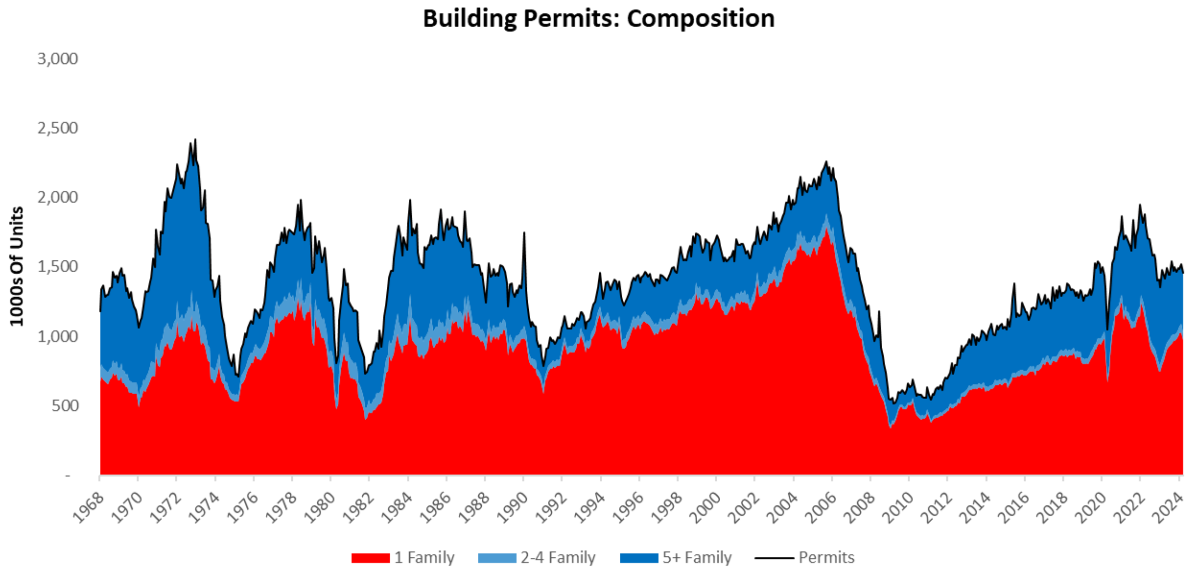
The latest data for March showed housing permits decreased by -4.27%, housing starts decreased by -14.72%, and housing completions decreased by -13.49%. Below, we show the current levels for the same:



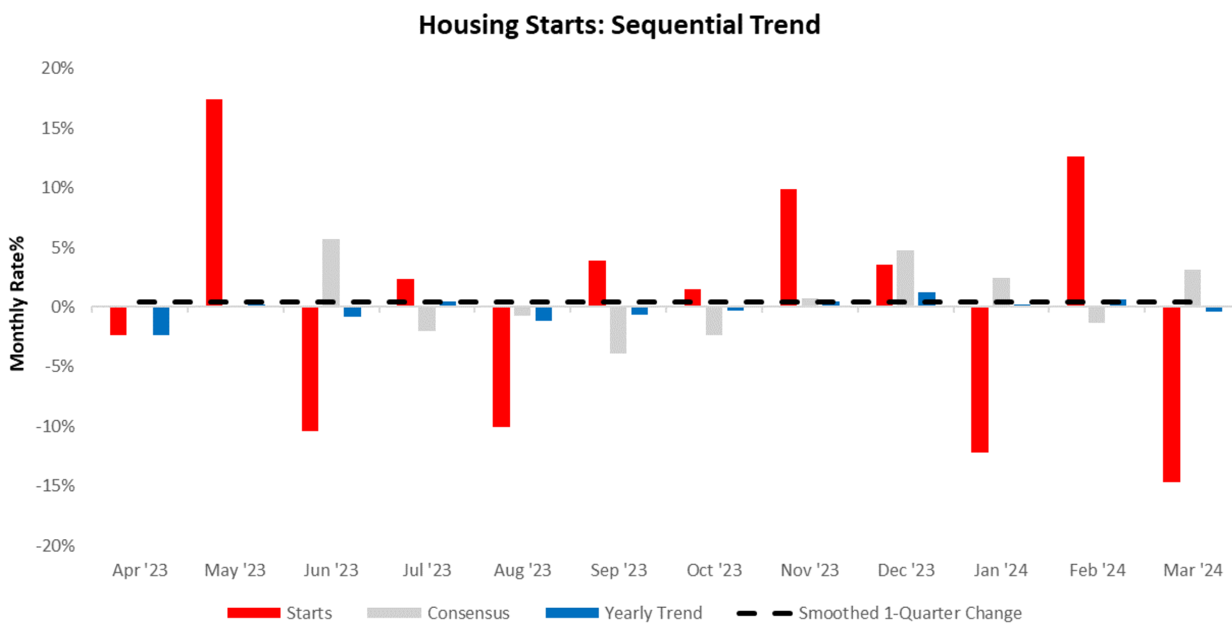
The data shows that housing permits decreased by 4.27%, with disappointing consensus expectations of 0.94%. Below, we show the sequential evolution of the data, along with the smoothed one-quarter change in the most recent data. We provide the smoothed version as monthly housing data contains significant noise.



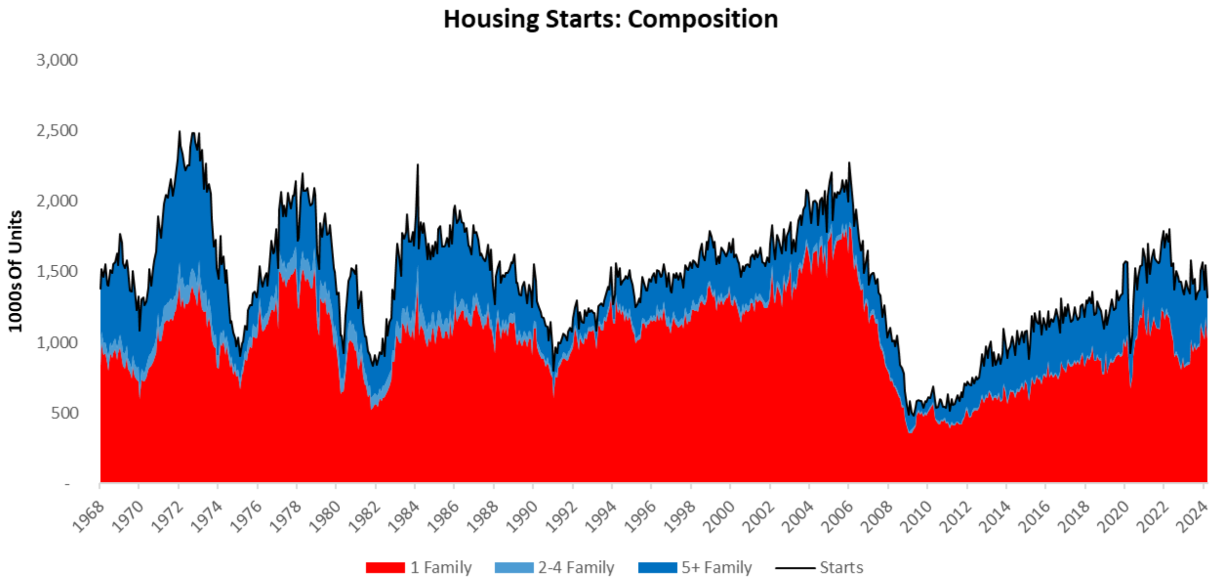
For further context, we zoom out to show the contributions from single-family homes (144), two-family homes (0), and multi-family homes (-123) to the rise (21) in total permits over the last year:



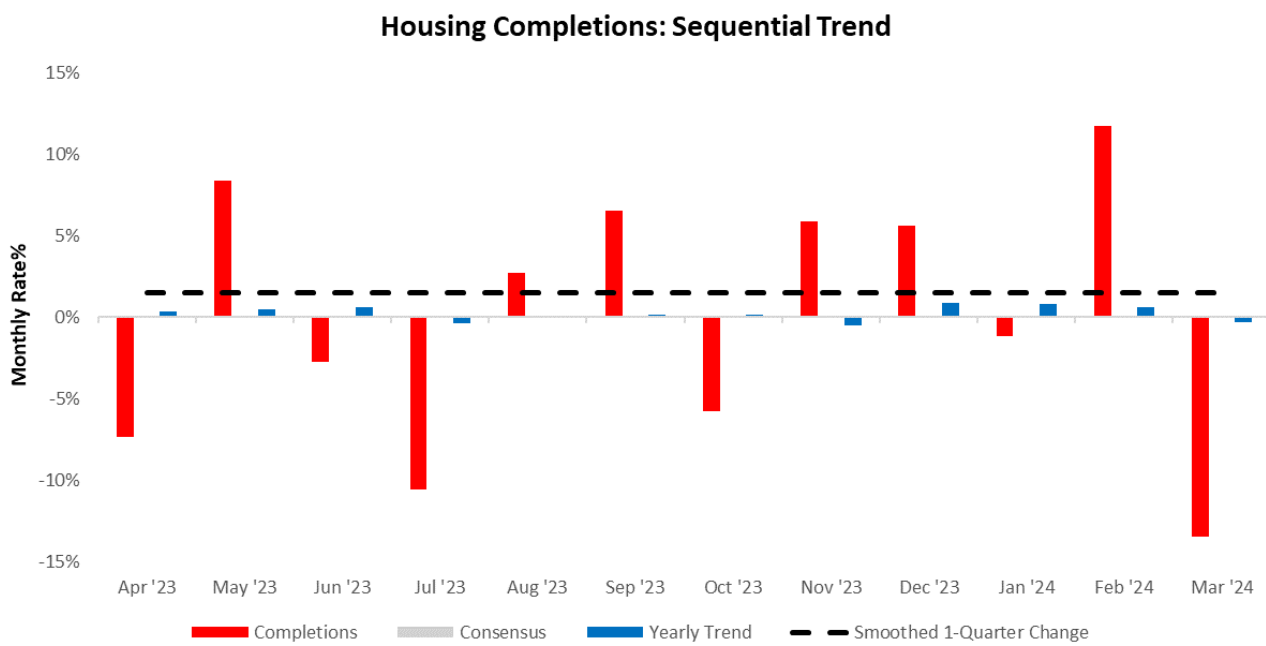
Consistent with the permits data, housing starts data showed starts decreased by -14.72%, disappointing consensus expectations of 3.13%. Below, we show the sequential evolution of the data, along with the smoothed one-quarter change in the most recent data. We provide the smoothed version as monthly housing data contain significant noise.



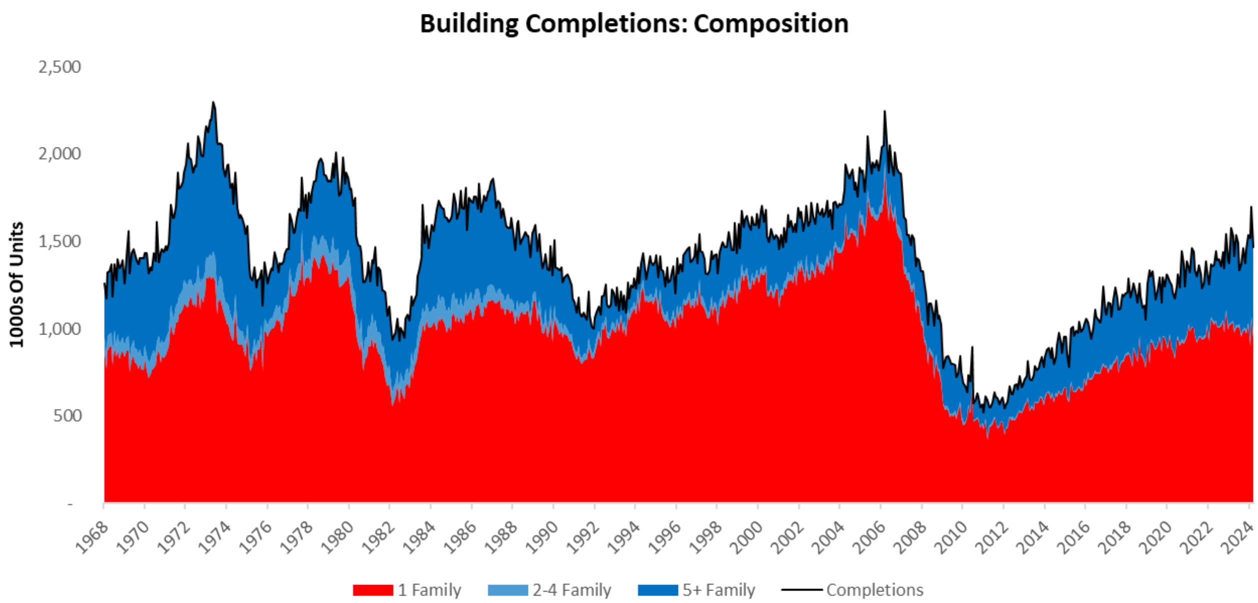
To illustrate the bigger picture, we show the contributions from single-family homes (-145), two-family homes (-13), and multi-family homes (-225) to the fall (-59) in total starts over the last year:



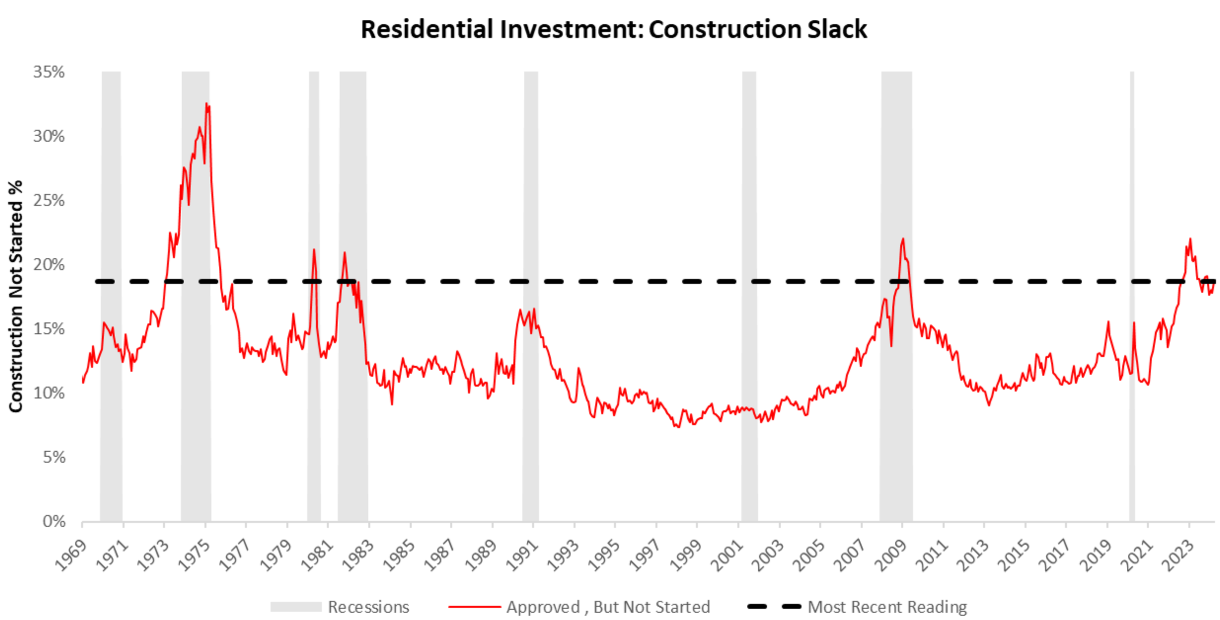
Last, in our sequential analysis, we turned to housing completion data, which showed that completions decreased by 13.49%. Below, we show the sequential evolution of the data, along with the smoothed one-quarter change in the most recent data. We provide the smoothed version as monthly housing data contain significant noise.



We show the contributions from single-family homes (-111), two-family homes (7), and multi-family homes (22) to the fall (-59) in total completions over the last year:

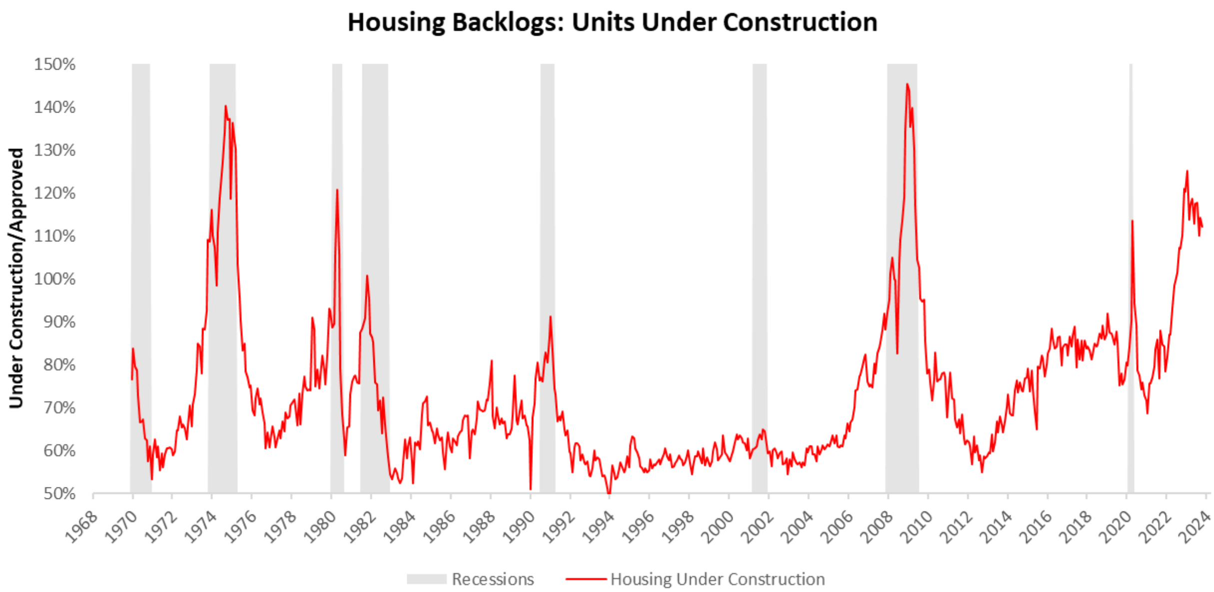


To get a better sense of where we are in the housing cycle, we examine how many construction projects have been approved but not yet started. According to the latest data, 19% of projects are yet to begin construction. Looking through history, housing-led recessions usually begin when this measure of construction slack is around 15%, suggesting that we are within the ballpark of a recession.

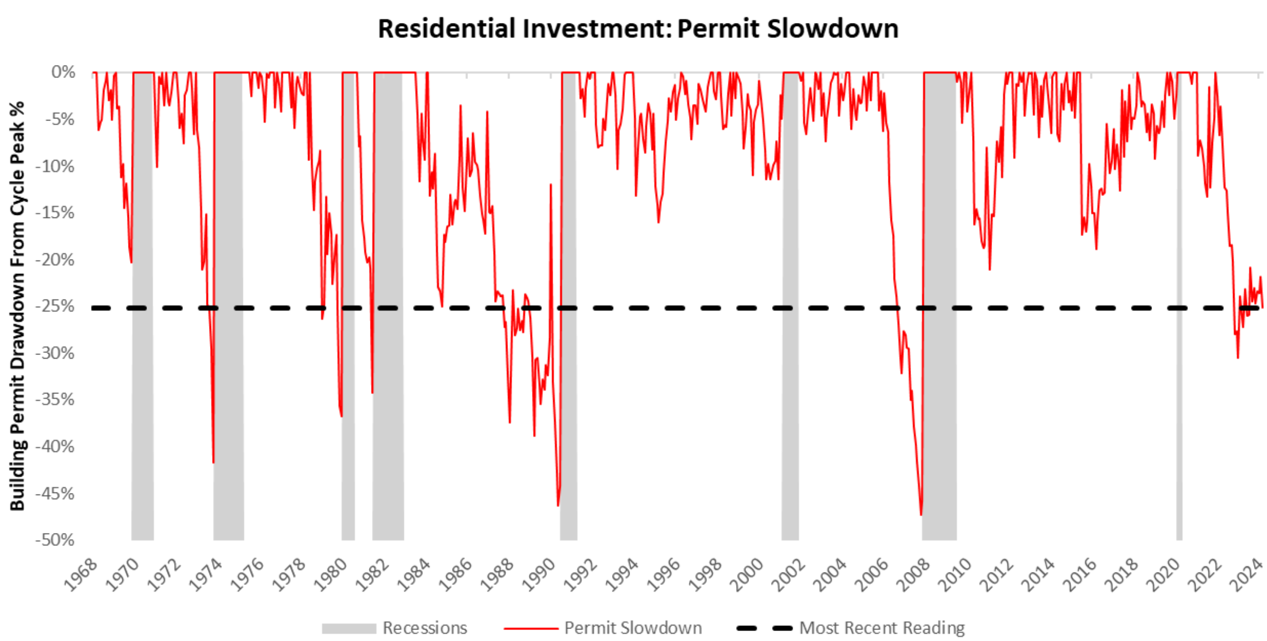


As we can see above, we are seeing a significant number of construction projects that have been approved but not started.

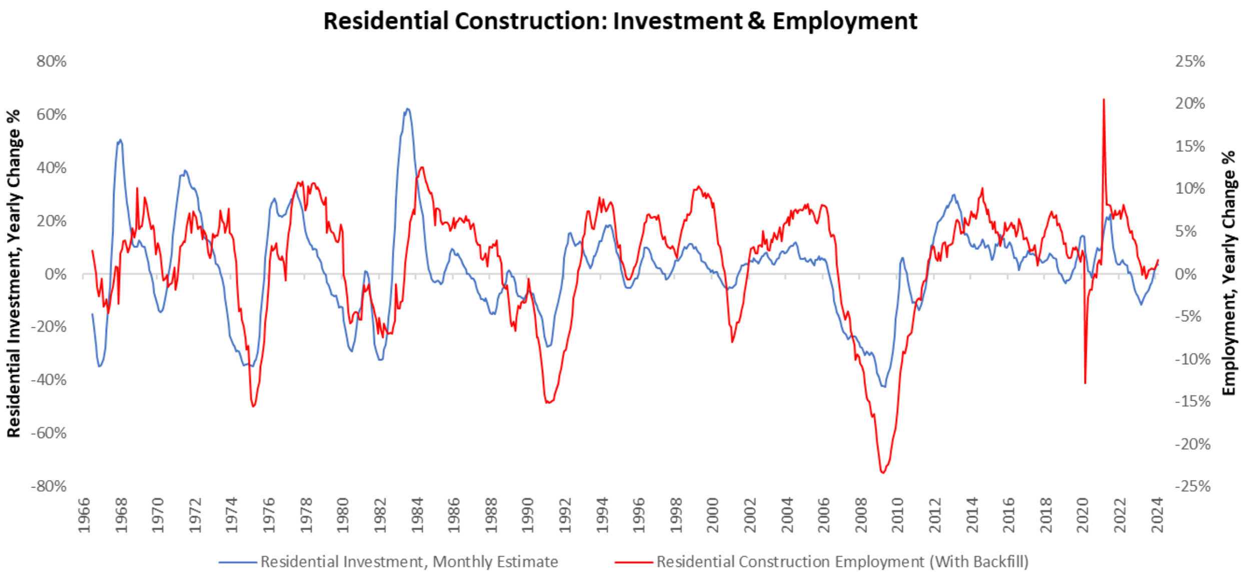
Now, while this rise in unstarted projects can often be a sign of weakness in perceived end demand, it can also be due to existing backlogs in construction. Below, we show a measure of these backlogs, which show the number of homes under construction relative to those under construction:



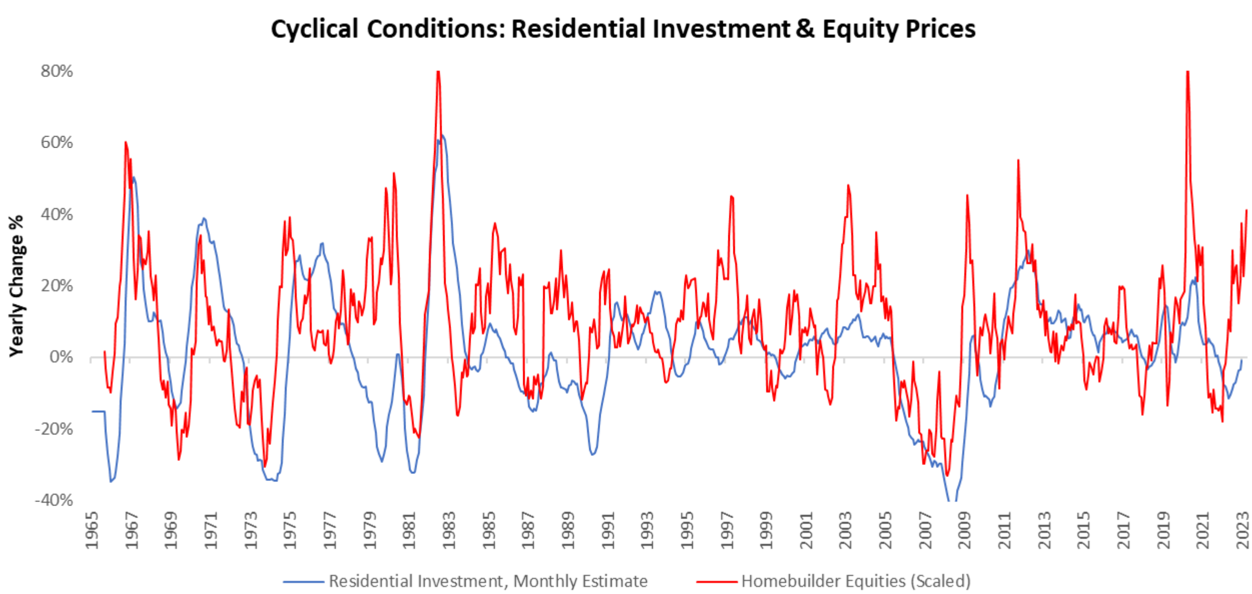
We conclude by examining another measure of housing weakness, i.e., permit slowdowns- which measures how much building permits have fallen from their cycle highs. Large drops in permits bode ill for the broader residential investment complex & GDP. The latest data shows that building permits are off their cycle highs by -25.15%. Housing-led recessions usually begin when this measure of cyclical weakness is around -29%, suggesting that we are within the ballpark of a recession.



While we take some signal from this decline in permits, the backlogs from construction continue to flow through to construction employment and residential investment.

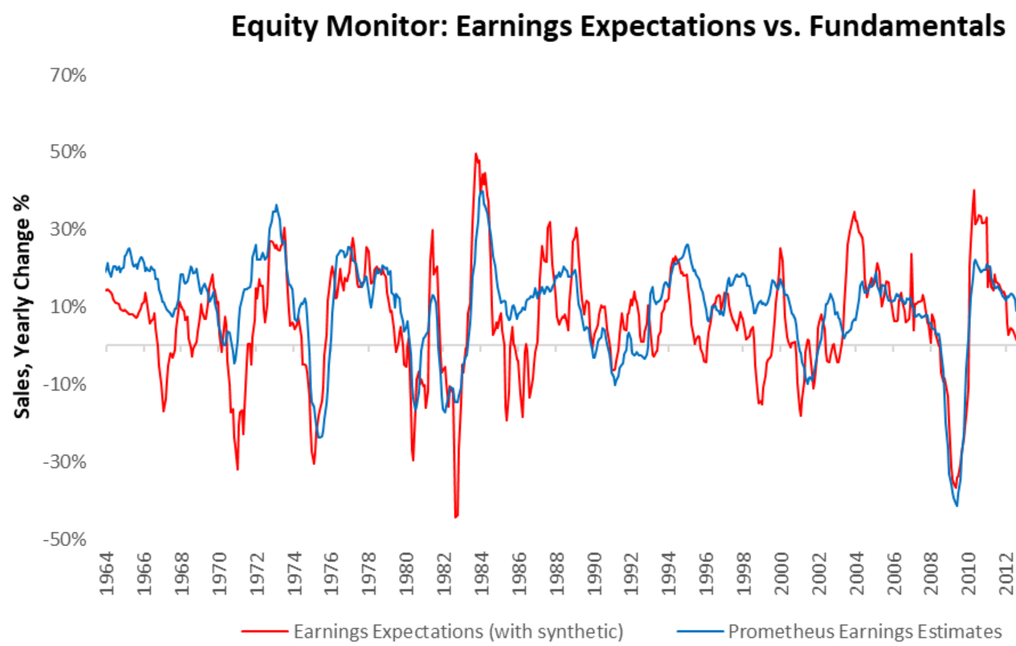


As we can see above, residential employment and investment remain inconsistent with recessionary activity. These dynamics are mirrored in homebuilder equities:

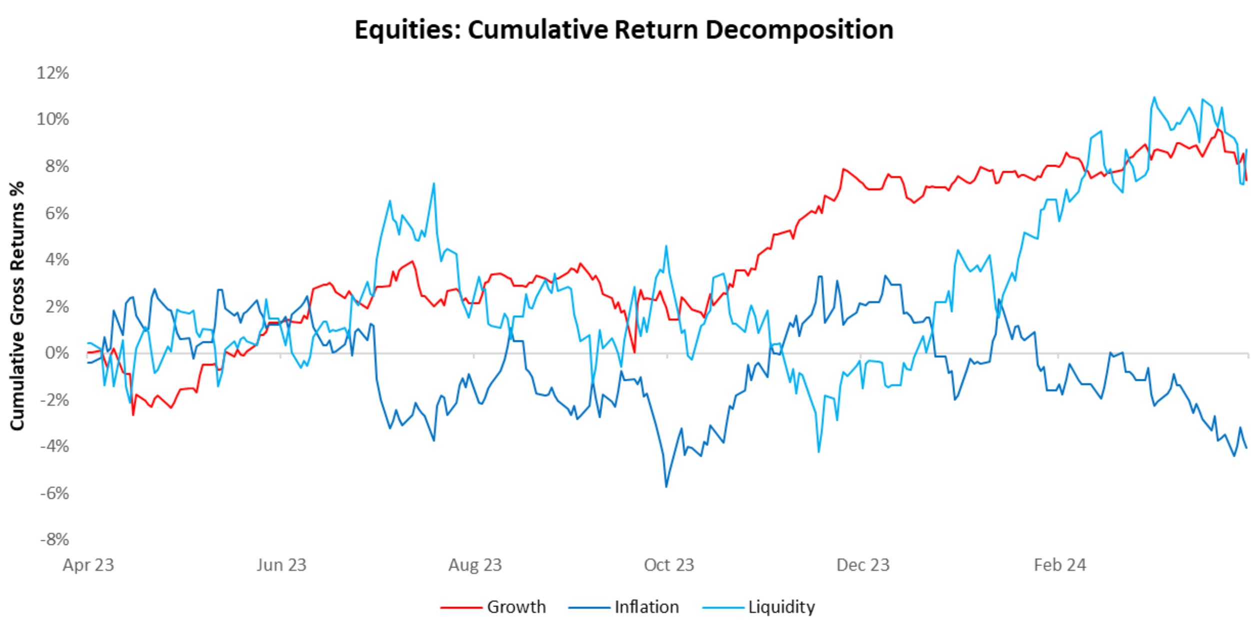


While we do not see broad signs that will contribute to a pullback in housing conditions, equity market pricing has now moved ahead of fundamentals. This is true not just at the residential sector level but at the broader equity market level.

Below, we show equity market earnings expectations relative to our fundamental macro estimates:

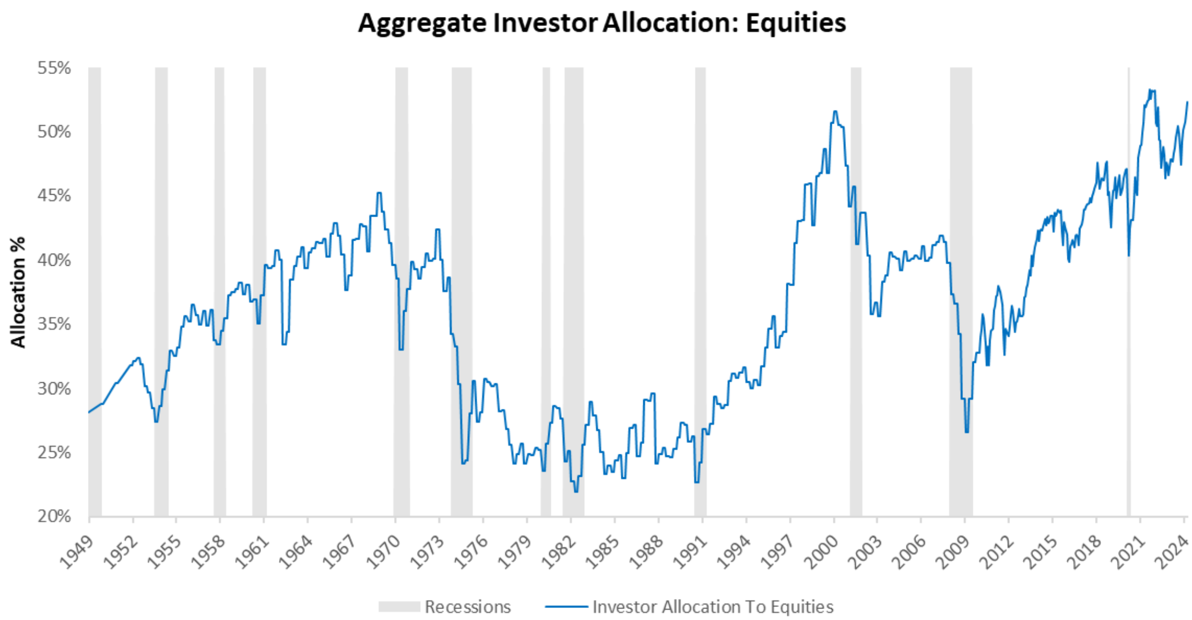


As we can see above, growth expectations have now exceeded the improvement in our estimates of fundamental macro conditions. At the same time, liquidity conditions have driven a significant part of the recent bid in equity markets. We show our macro decomposition below:

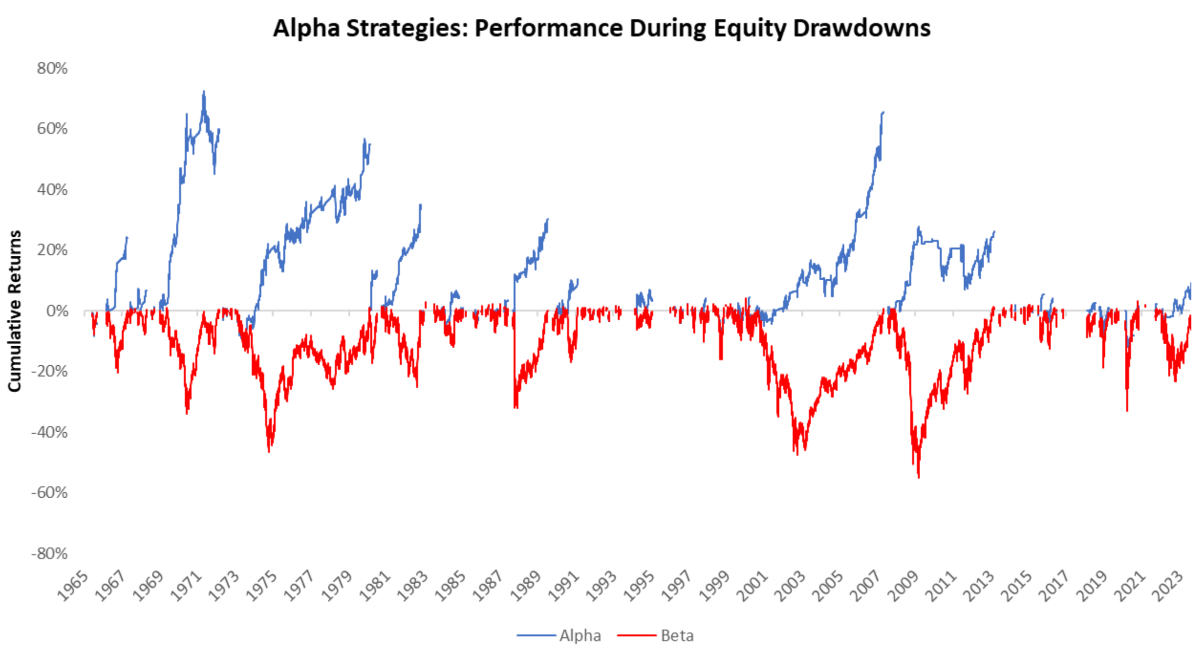


As we can see above, growth and liquidity have been the primary drivers of equity market returns.

This return composition comes at a time when investor allocations to equities are at all-time highs:



Given these dynamics, while broad macro conditions remain largely inconsistent with a recession, recent equity returns have pulled forward future returns, creating the potential for a sell-off. Our Alpha Strategies were designed to capitalize on equity downside from their initial onset, which is reflected in our modest tactical shorts. Significantly more signal is required to exit equities for asset allocators.



Until tomorrow.

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