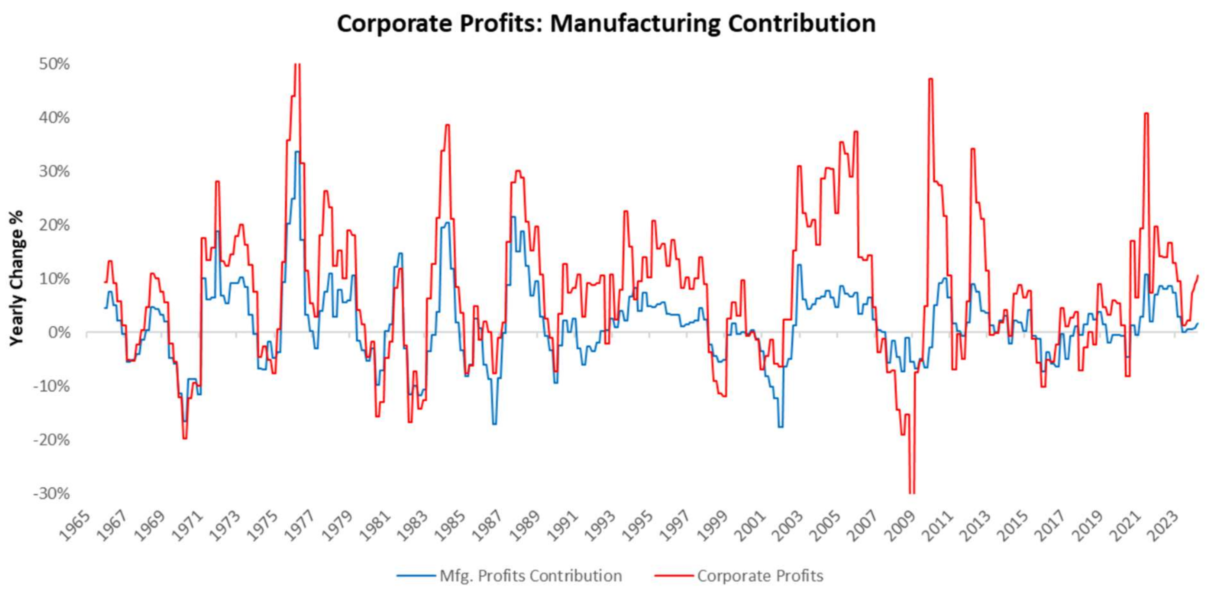
The Observatory

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.

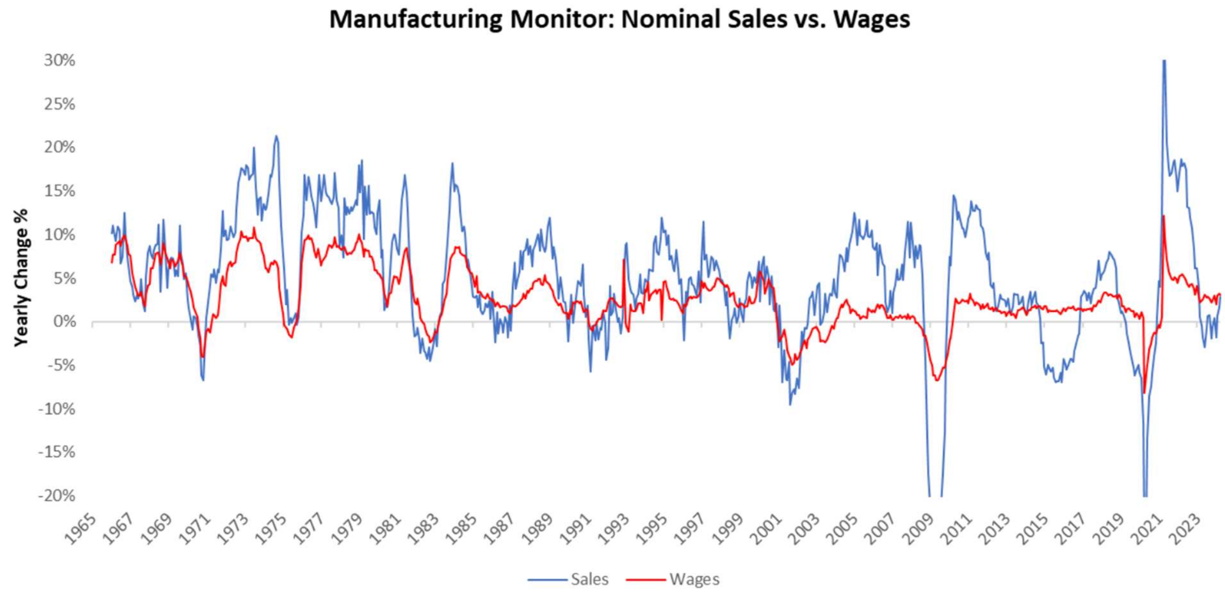
Our primary takeaways are as follows:

- ***Cyclical conditions have improved in the economy, with manufacturing measures showing sequential gains in line with cyclical conditions. However, the magnitude of these gains remains muted, weighing on overall corporate profitability.***
- ***Zooming in, factors such as a weakness in sales, low levels of production, and high labor cost pressures continue to pose significant headwinds for manufacturing profits.***
- ***Relative to these pressures, commodities continue to price in highly favourable conditions, creating the potential for a mispricing.***
- ***However, the divergence is not large enough to create commodity shorts. Therefore, our strategies continue to hold modest exposures to long commodities.***

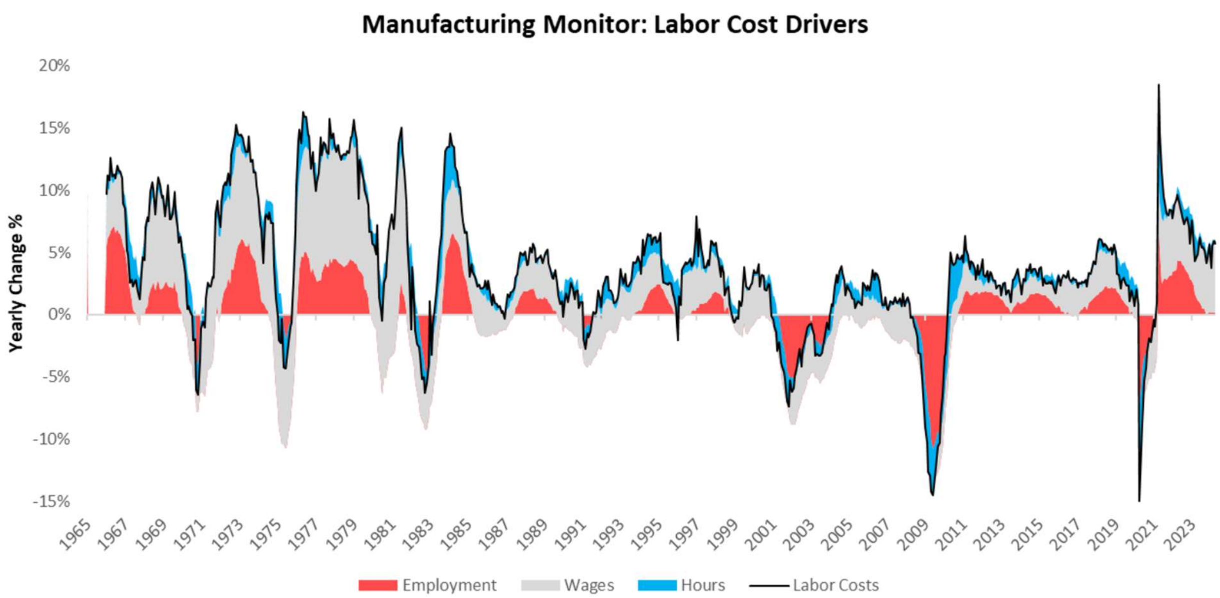
Manufacturing is an integral part of the cyclical economy. While manufacturing now commands a smaller portion of the GDP, it continues to be a primary driver of the variation in profitability. We visualize this importance below, by showing the contribution of manufacturing sector profits to aggregate corporate profits. As shown, manufacturing plays a strong role in setting the trend for overall profitability. Though not negative, manufacturing profits continue to weigh on overall corporate profitability.



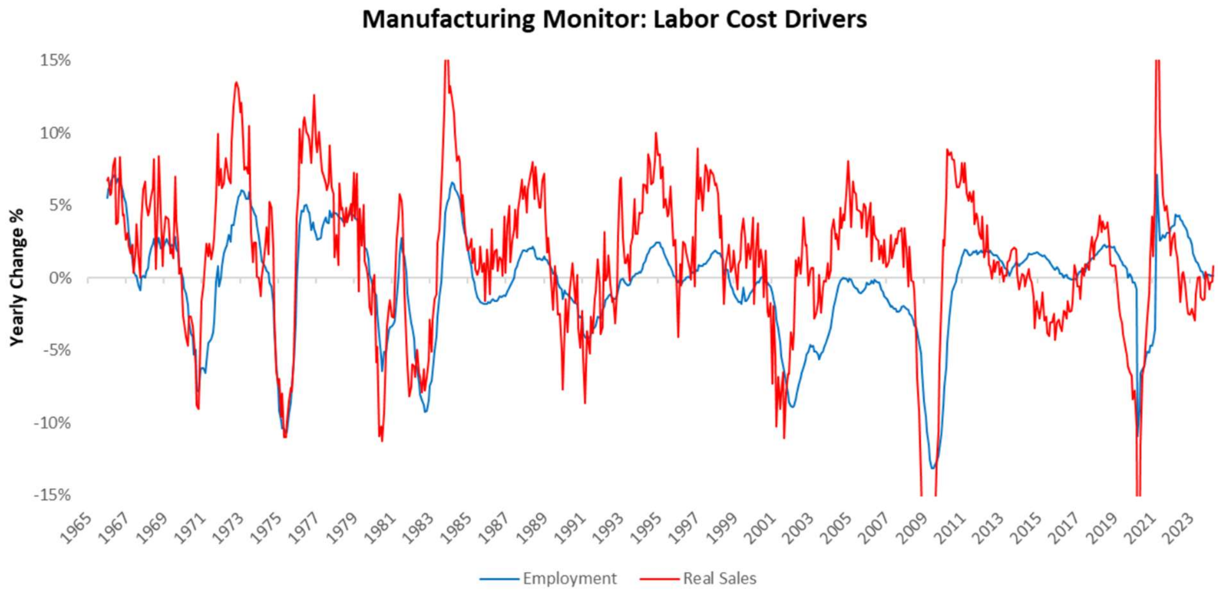
Given the importance of manufacturing profits to the cyclical direction of the economy, we perform an in-depth assessment of the drivers of manufacturing profitability. Like any business, profits are a function of the sales generated relative to the costs incurred. At the macro level, the primary driver of these costs tends to be labor costs in the form of wages. Below, we visualize these principal drivers of profitability for manufacturing.



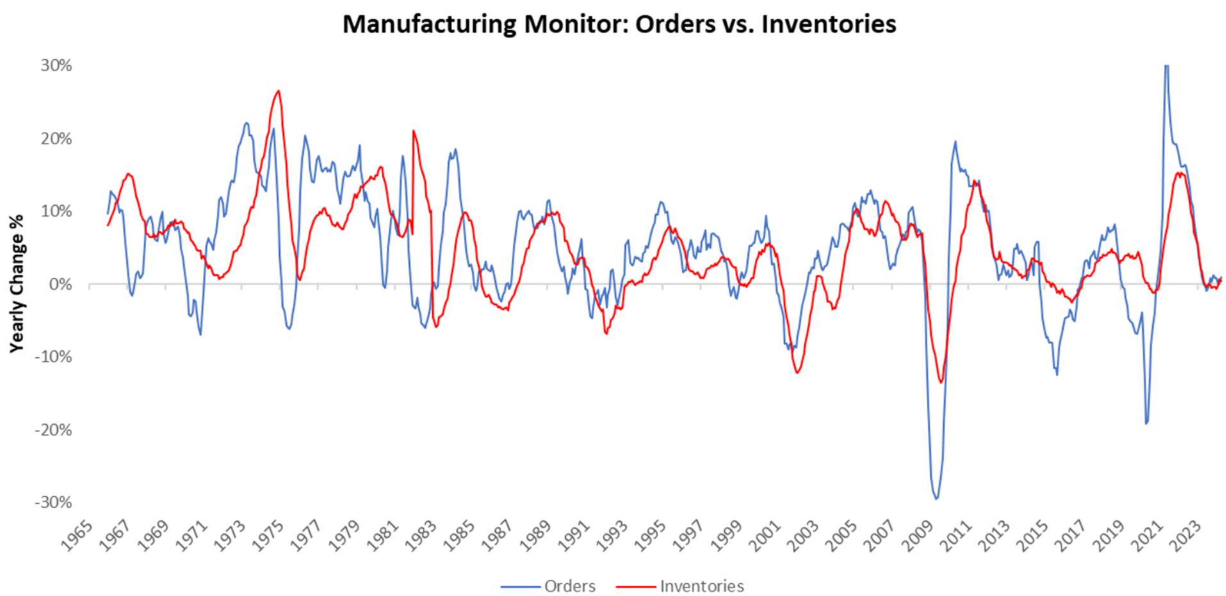
To better understand the macro drivers of these wage trends, we decompose total labor costs into their constituent drivers- changes in employment, hours worked, and hourly wages. We visualize their contributions to total labor costs below. Over the last year, wages have been the primary driver of the changes in labor costs.



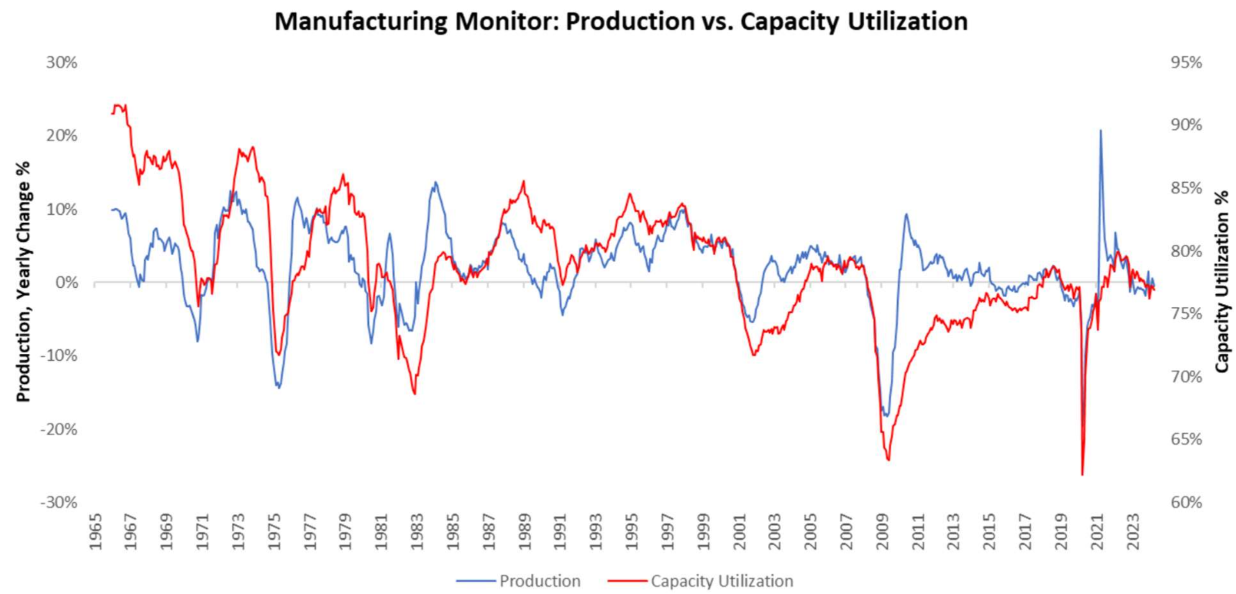
We now zoom in on employment growth to highlight a fundamental condition, i.e., the purpose of employment growth is output growth. As such, output (real sales) and employment generally rise and fall together. Currently, the trend in both of these series remains neutral.



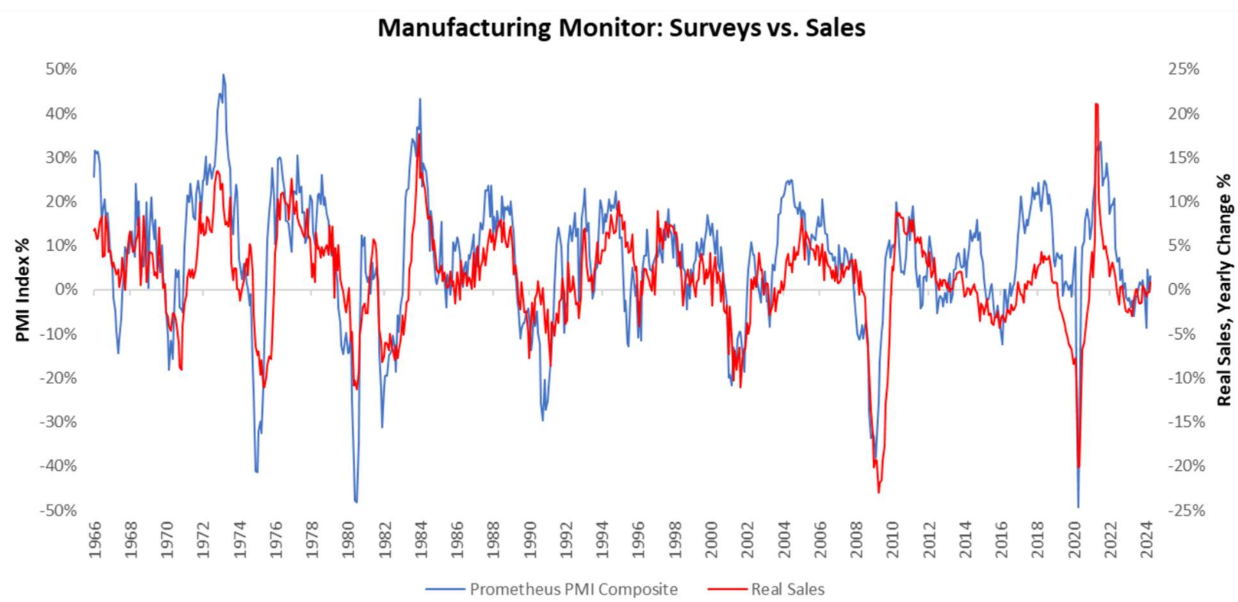
Now that we have examined the high-level determinants of profits, we turn to underlying measures of demand conditions. Particularly, we look at the growth of new orders and inventories. New orders drive sales, and sustained growth in new orders increases inventories. Excessively large gaps between these two variables are unsustainable and likely to be resolved in favor of new orders. We visualize these dynamics below. Both, order growth and inventory growth remain suppressed.



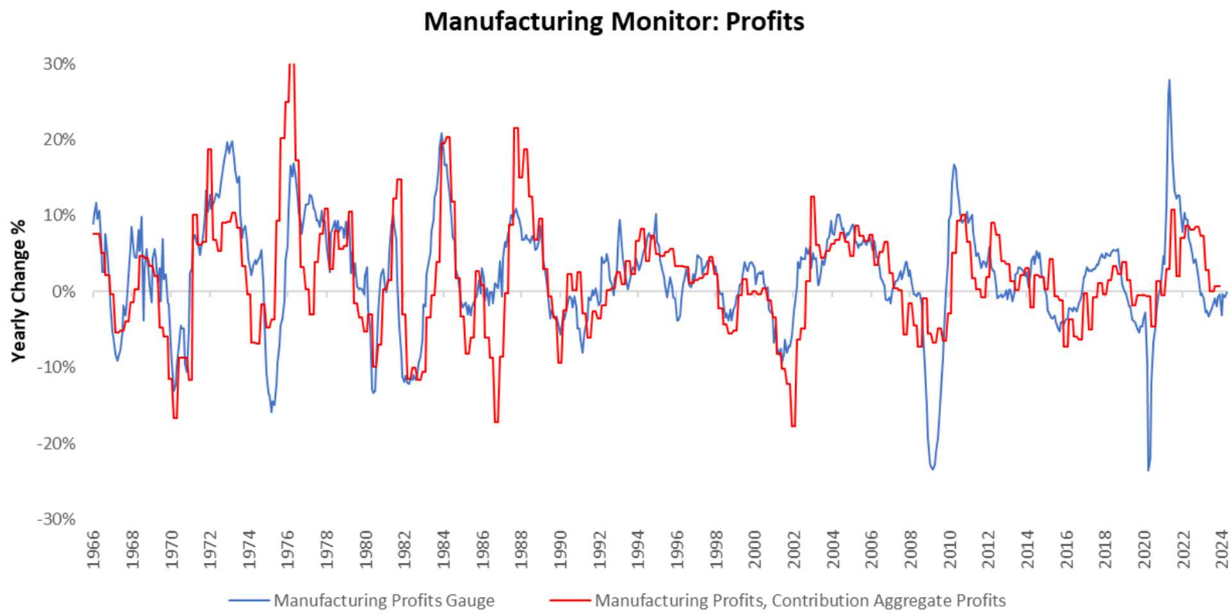
For a further understanding of demand conditions, we now turn to production and capacity utilization measures. Production is the primary engine for the growth of the manufacturing sector over time. While expanding production is a positive for topline, existing capacity constraints limit the degree of expansion we can see in the manufacturing sector. Strong moves in production without an increase in total productive capacity are typically unsustainable. We visualize the trend in manufacturing production along with the current degree of capacity utilization below. Once again, we observe neutral dynamics at play.



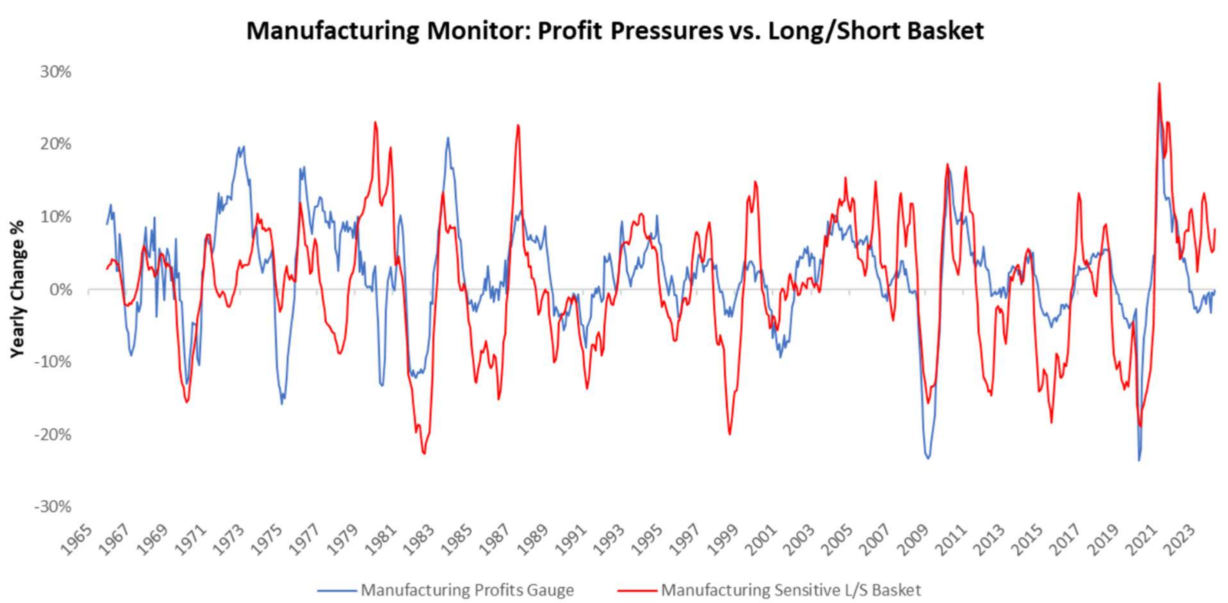
While hard data offers significant insights into the mechanical drivers of manufacturing, survey-based measures (PMIs) can provide insight into where we are in the manufacturing cycle. These PMIs have intrinsic value as purchasing managers sit at the intersection of demand and supply, and their perception of conditions reflects conditions in the manufacturing cycle. Below, we show our PMI composite, which aggregates data across PMI measures, and how our composite offers timely insights into the real manufacturing sales cycle.



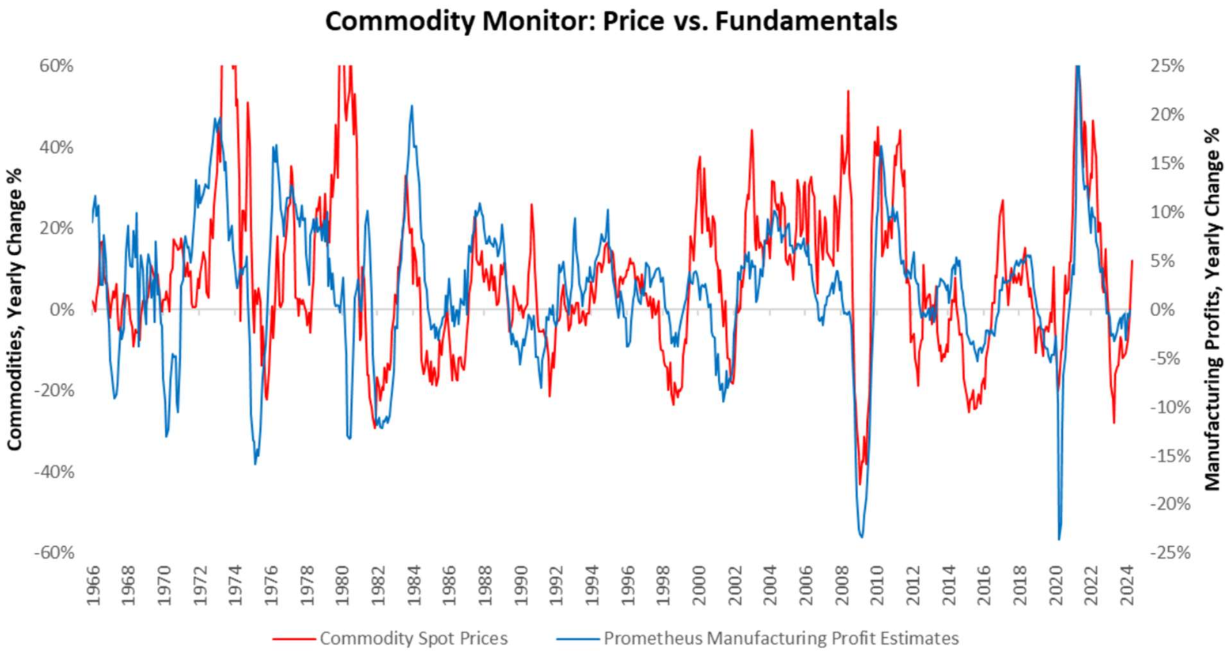
We now aggregate and net all of the cross-current from these various drivers of manufacturing into a single metric to gauge manufacturing profit pressures. Below, we show how this measure has been a good guide for manufacturing's contribution to aggregate profits. As we can see below, both of these measures continue to hover around the contractionary space. Therefore, a significant deceleration from this point onwards could pose a significant challenge for the manufacturing complex and therefore nominal activity.



Finally, we visualize market pricing relative to these evolving fundamental trends. Below, we show our manufacturing profits gauge and our long/short basket of manufacturing sensitive vs. insensitive sectors. As we can see below, trends in this basket are capped by the degree to which profits move. Said differently, manufacturing outperformance usually requires an accelerating profit cycle. As it stands, these measures remain at a significant divergence:



Additionally, commodity markets also now look ahead of our estimates of fundamental conditions. We show this divergence below:



Overall, the manufacturing economy continues to face headwinds, but market pricing has moved in a manner inconsistent with these headwinds. Therefore, a macro mispricing continues to build. Consequently, our strategies are modestly exposed to long commodities. Until tomorrow.

PROMETHEUS

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