PROMETHEUS

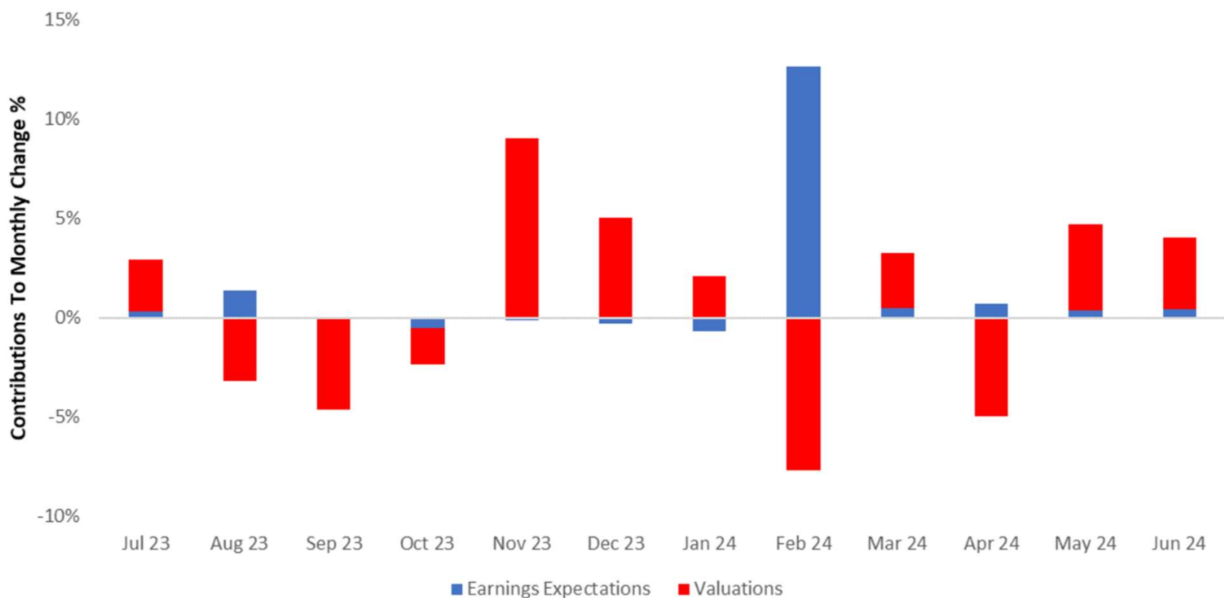
The Observatory

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:

- ***The S&P 500 rose 4.05% in June, primarily driven by an improvement in valuations. On a macroeconomic basis, growth and liquidity have supported equities over the last year.***
- ***Treasury markets also witnessed sequential gains across all tenors, primarily driven by discount rate expectations. Currently, markets are pricing in approximately five cuts over the next eighteen months.***
- ***Overall, pricing in equities remains largely consistent with the underlying macroeconomic conditions. On the other hand, market expectations of five rate cuts remain inconsistent with the current backdrop of resilient nominal growth conditions.***
- ***Our strategies remain long equities and modestly long bonds. Our bond positions remain limited in size due to market pricing.***

When we examine equity markets, we can decompose their total returns into those coming from changes in earnings expectations and valuations. Over June, the S&P 500 rose 4.05%, primarily driven by valuations. Earnings expectations and valuations contributed 0.46% & 3.59% to the 4.05% rise in markets. Below, we show the sequential evolution of market prices, along with our decomposition of returns:



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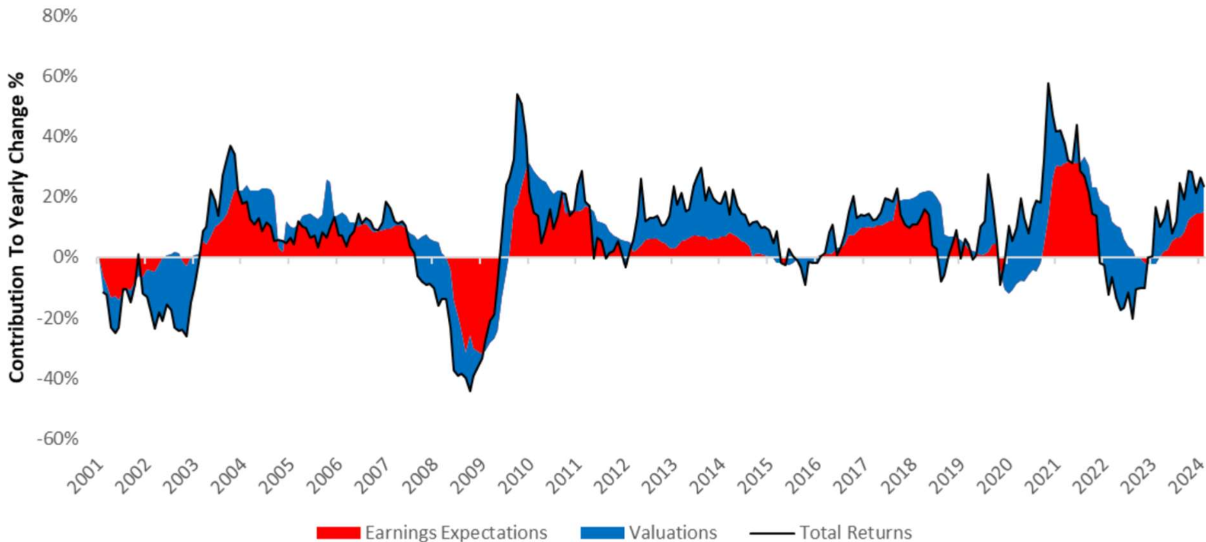
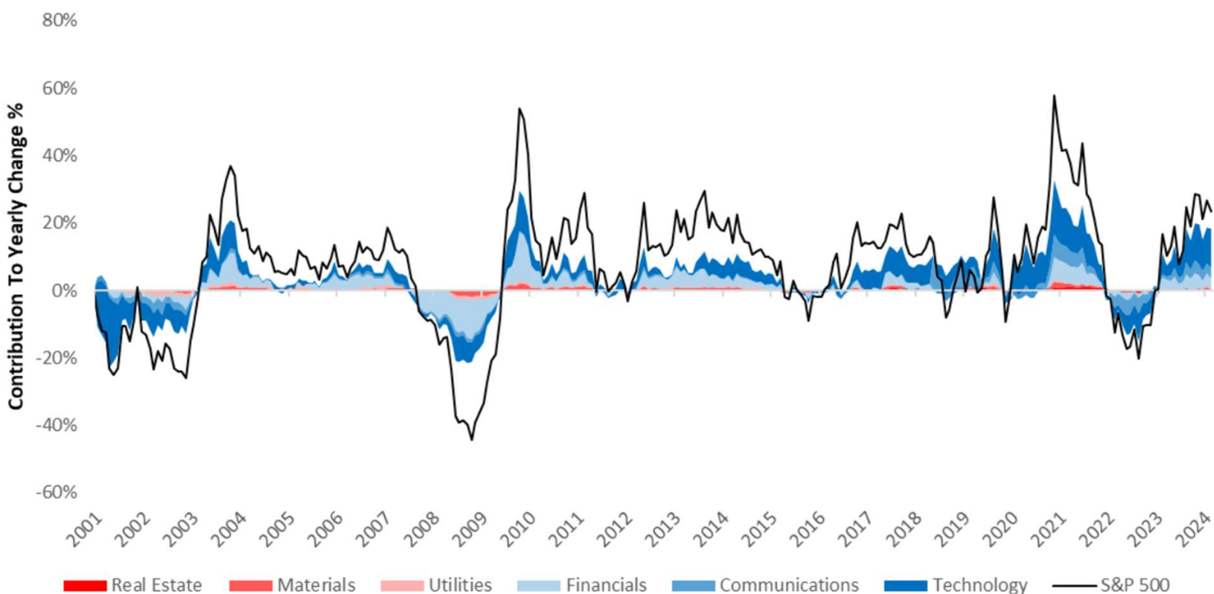
Over the last year, the S&P 500 has been dominantly driven by earnings expectations, with total returns rising by 23.35%. We show cumulative returns on the S&P 500 over the last year, decomposed into earnings expectations (15.21%) and valuations (6.01%):



We further decompose these yearly returns into their sector contributions. We begin by showing the primary drivers of the S&P 500. We show the top three drivers in blue (Technology, Communications, Financials) and the bottom three in red (Real Estate, Materials, Utilities):



We drill down into these total returns by isolating the changes in earnings expectations. We show the top three drivers in blue (Technology, Communications, Consumer Discretionary) and the bottom three in red (Materials, Real Estate, Utilities):

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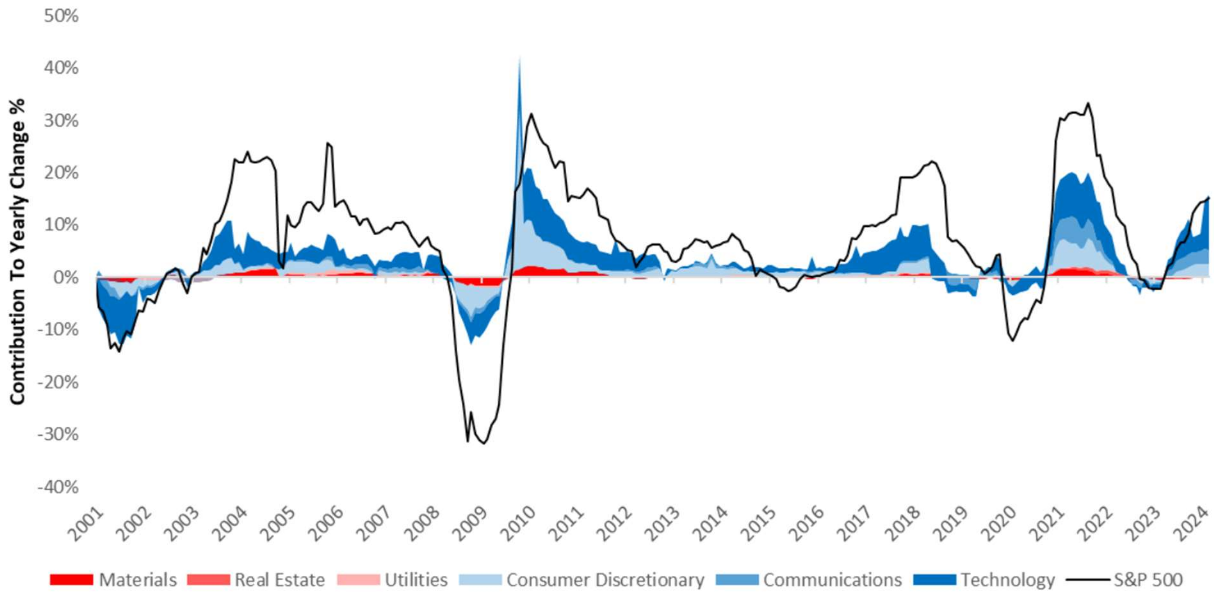
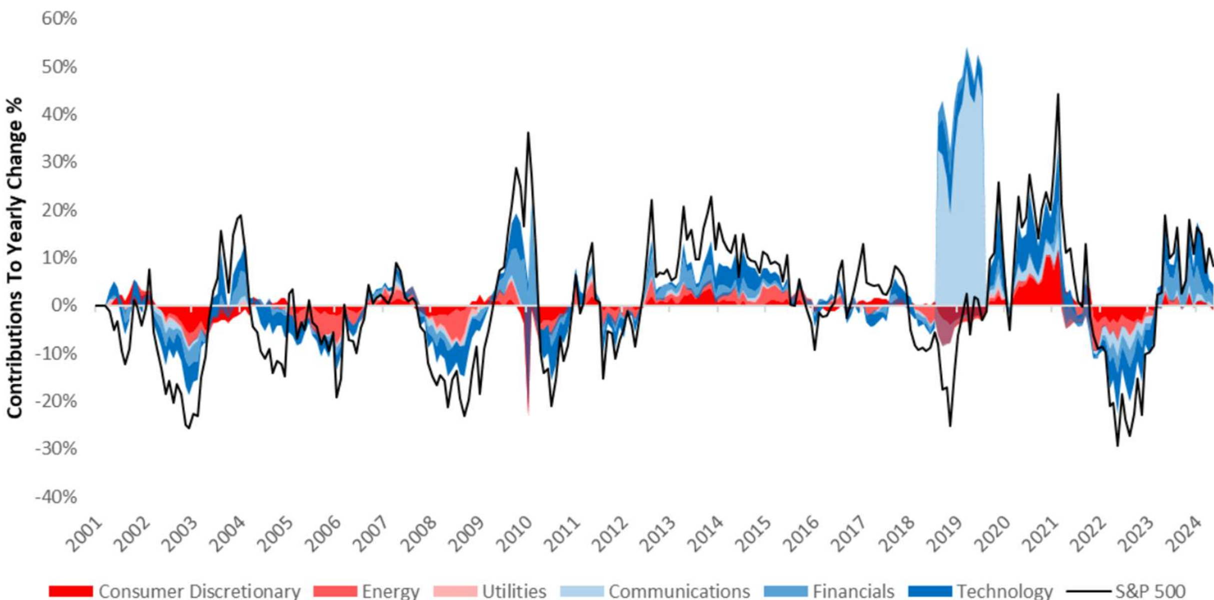


Finally, we examine the contributions of sectors to valuation changes. We show the top three drivers in blue (Technology, Financials, Communications) and the bottom three in red (Consumer Discretionary, Energy, Utilities):



Zooming back into the most recent month, we show the composition of the most recent strength in equity markets. We show the sector-wise composition of the most recent months' returns, changes in earnings expectations, and changes in valuations below:

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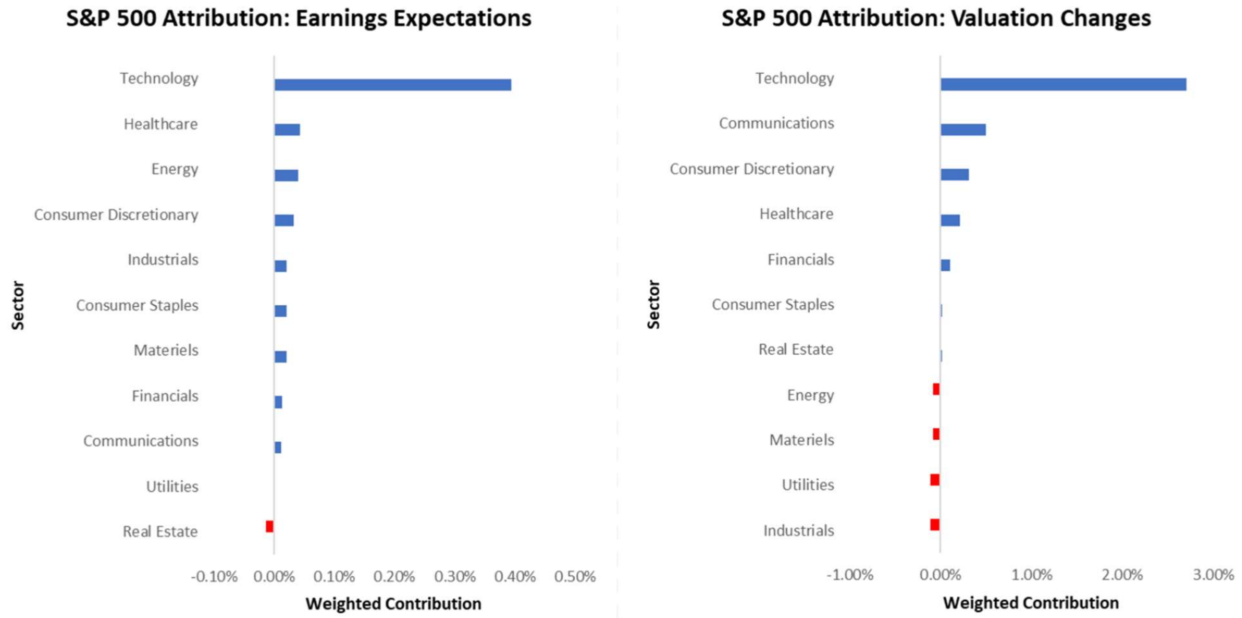
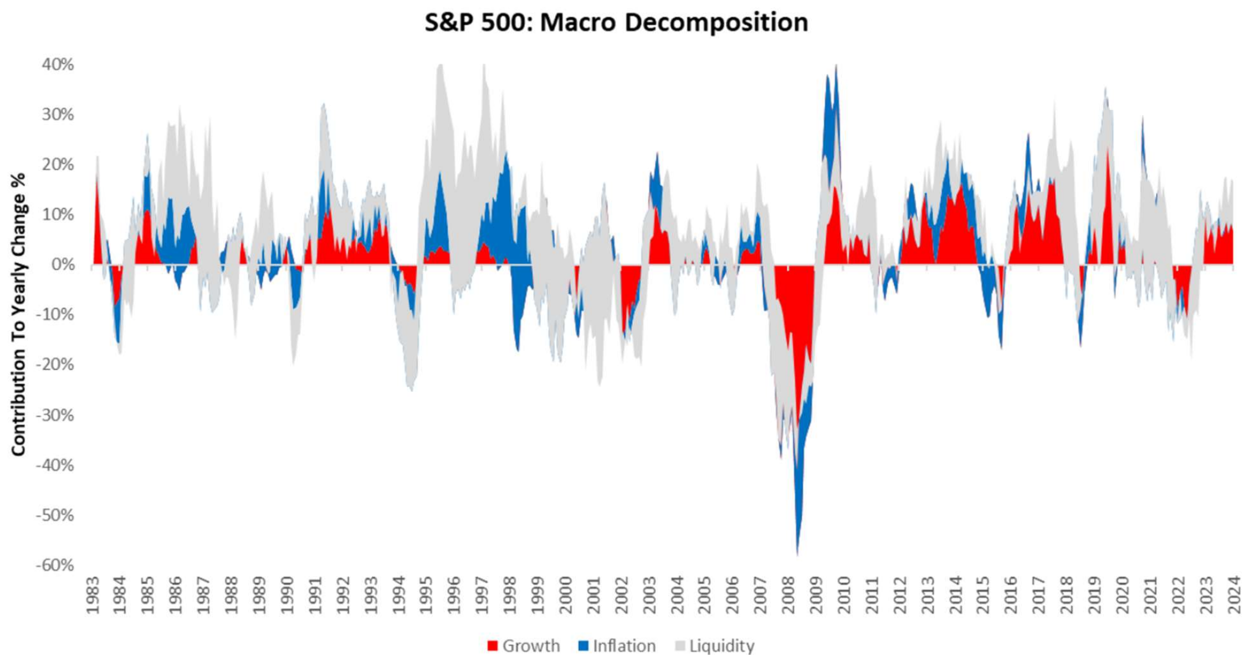


At a macroeconomic level, we can decompose equity returns into their constituent drivers of growth, inflation, liquidity, and discount rates using our proprietary measures. Over the last year, equities have been primarily driven by Liquidity, with Inflation dragging on returns:



For further contextualization of these returns, we show the cumulative returns attributable to our growth, inflation, liquidity, and discount rate factors. In the most recent month, growth, inflation, and liquidity have contributed 0.42%, 1.82%, & 1.45%, respectively. We show the cumulative contributions to total returns over the last year below:

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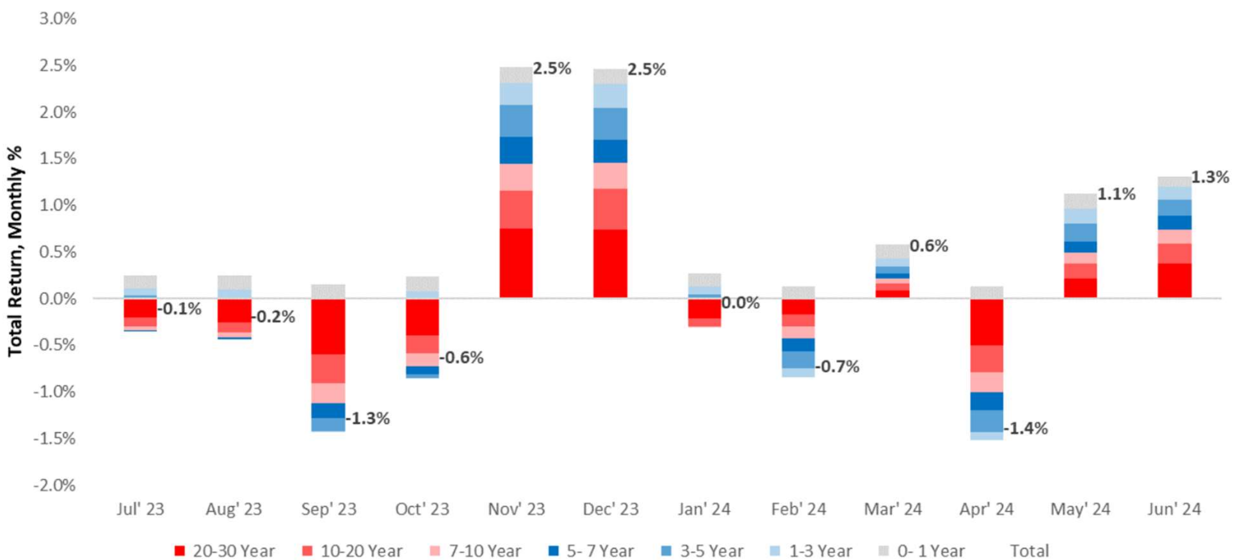
Over June, treasury markets rose by 1.31%. Over the last year, our aggregate treasury markets have returned 3.27%. Below, we show the sequential evolution of returns:



For a more granular understanding of the most recent months' returns, we perform an attribution of total returns coming from various maturities of nominal treasuries across the yield curve. Over June, treasury markets were positive across the board, with 20-30-year treasuries contributing the most to strength, while 0- 1-year treasuries contributed the most to weakness. We show this below:

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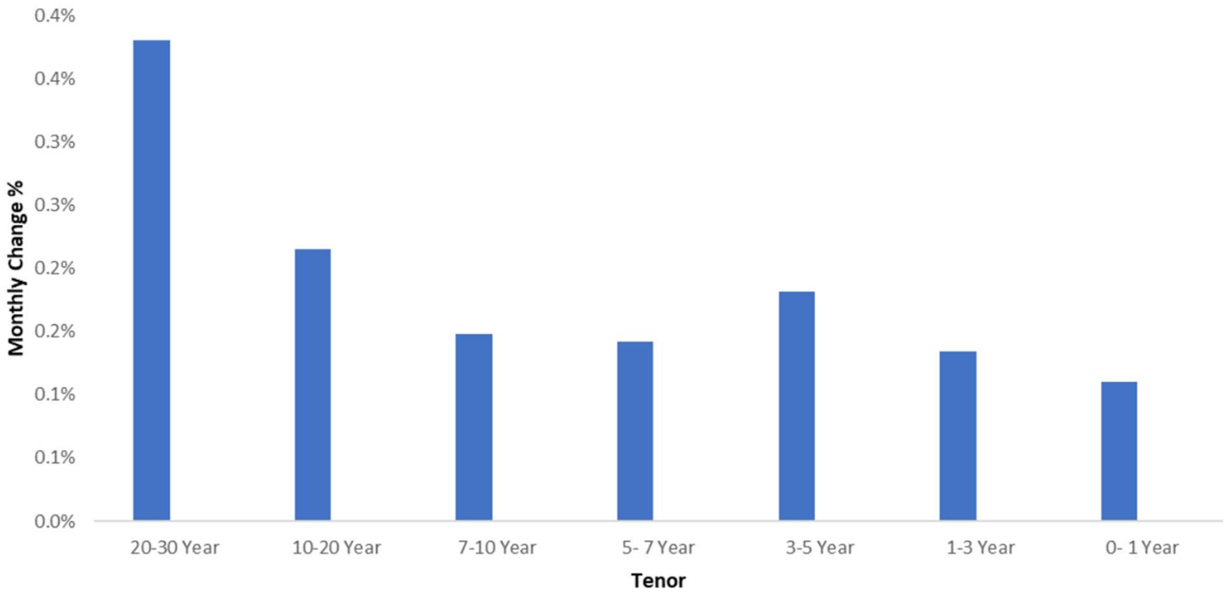
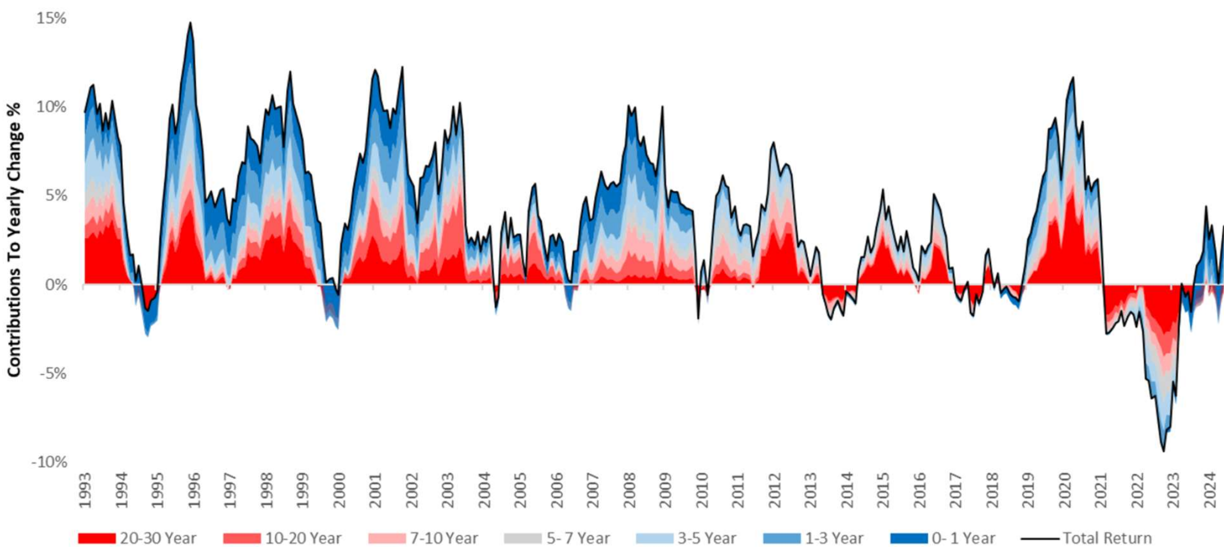


To offer a bigger-picture view, we zoom out to show how aggregate treasury market returns have evolved over the last year and through history. As we can see below, over the last year, our aggregate treasury markets have returned 3.27%. The strongest component of the treasury market has been the 0-1 Year tenors, and the weakest component has been the 20-30 Year treasuries.



To help better understand these moves in treasury markets, we decompose these returns into their constituent macroeconomic drivers. Our estimate of the weighted average maturity of outstanding treasuries is 6 years, making the 5-year note the best proxy to assess the impact of macroeconomic forces on the treasury market. Over the last year, growth, inflation, and liquidity have contributed 0.49%, -0.63%, and -2% to total treasury returns.

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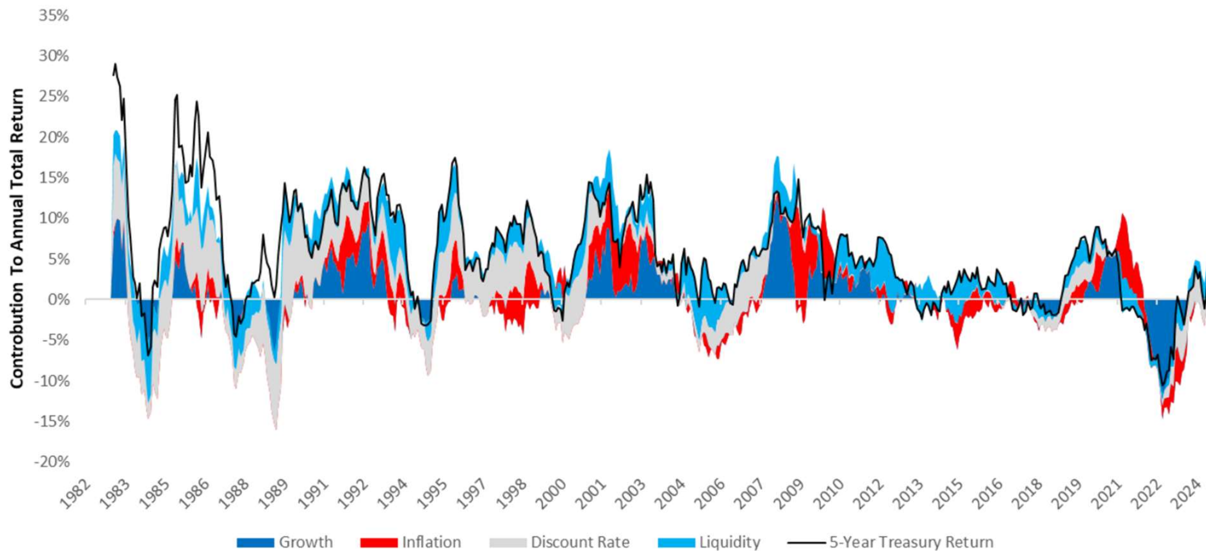
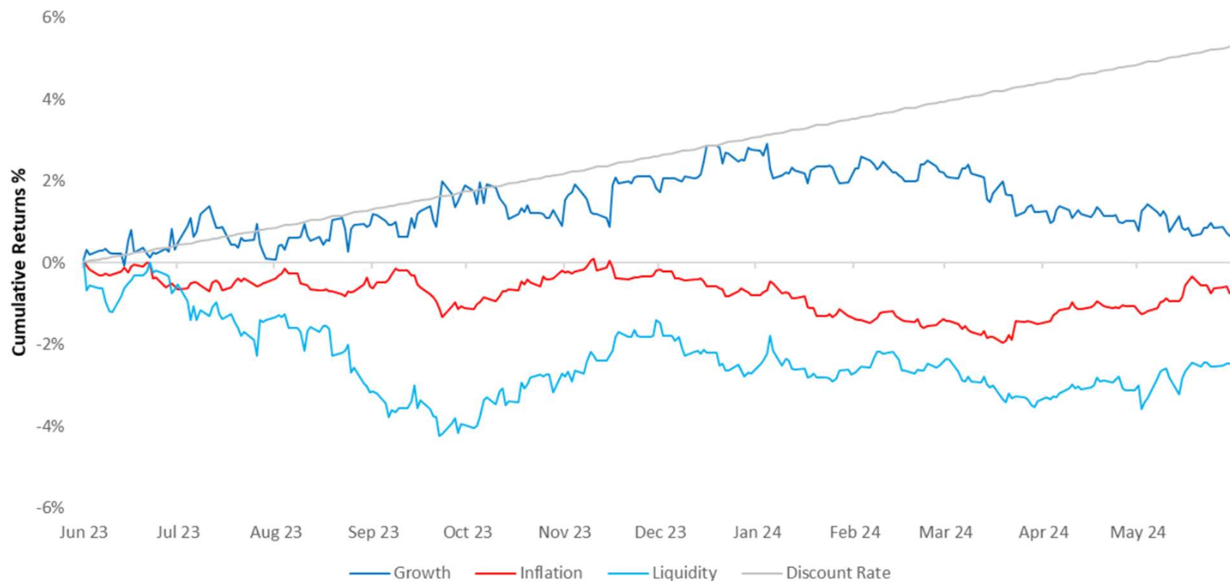


For a closer look at the current dynamic, we show the contributions to cumulative returns over the last year coming from our macroeconomic factors. Please note the sum of the various factors equals the total return on the 5-year note:



While our macroeconomic perspective is essential for us to understand what's going on under the surface, mathematically, the single biggest factor that impacts nominal bonds are changes in discount rate expectations. Over the last month, short-term interest rate markets have remained unchanged. Over the last year, these markets have moved to price less interest rate cuts. We show the evolution of these expectations below:

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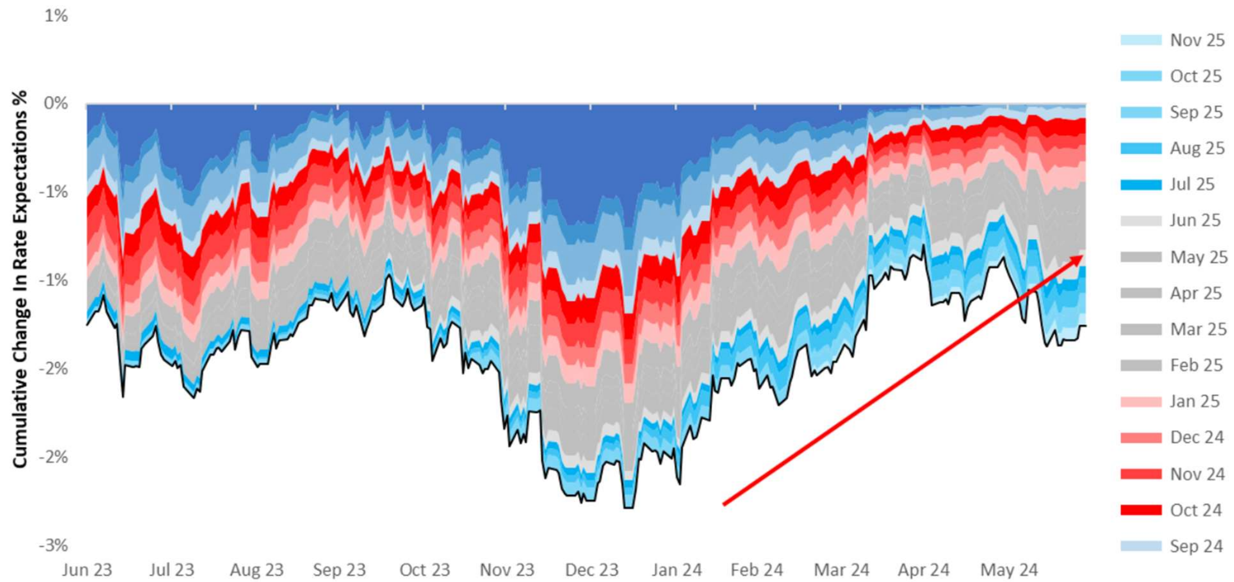
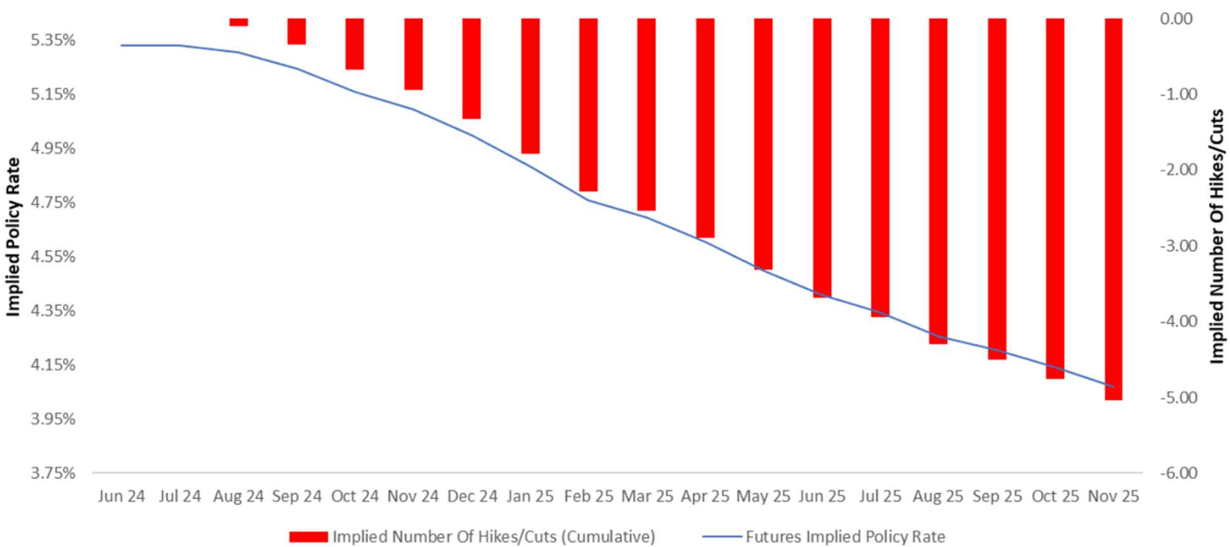


To better contextualize these recent changes in policy expectations, we show the latest discount rate path priced over the next eighteen months. Short-term interest rate markets are expecting a peak in policy rates on Jun 24Jul 24 at 5.33%, followed by a trough on Nov 25 at 4.07%. This implies approximately 5 interest rate cuts cumulatively over the next eighteen months. We show this path below:



For further insight into what markets are pricing for the expected policy path, we show market expectations for discount rates priced across the yield curve. Currently, 10-year notes are pricing 4 cuts, 5-year notes are pricing 4 cuts, and 2-year notes are pricing 4 cuts.

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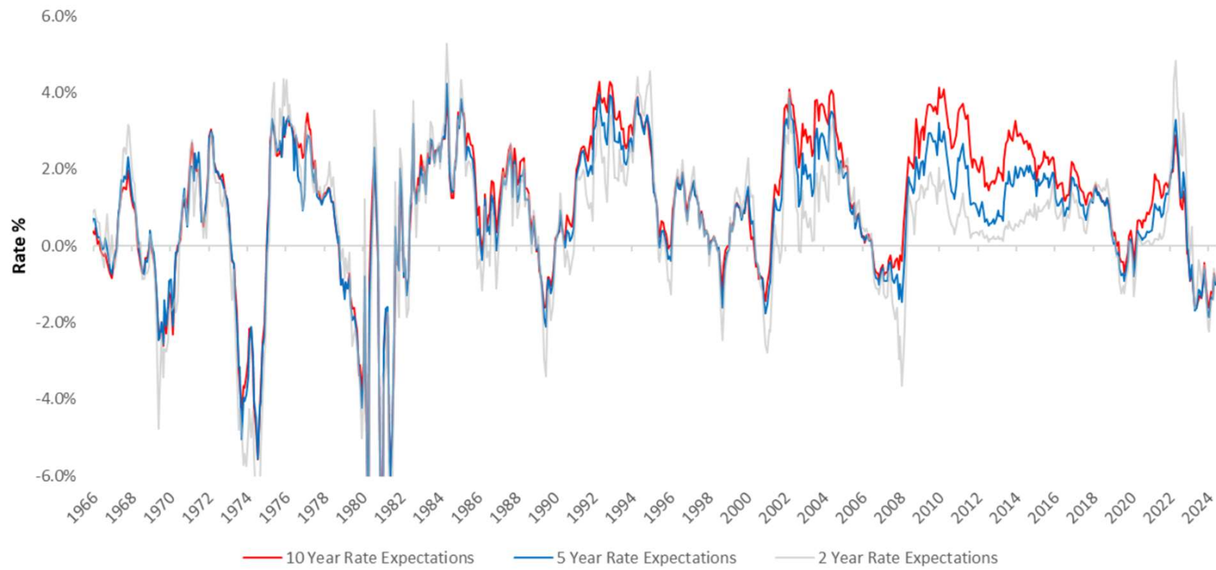

Overall, pricing in equities remains largely consistent with the underlying macroeconomic conditions. On the other hand, market expectations of five rate cuts remain inconsistent with the current backdrop of resilient nominal growth conditions. Our strategies remain long equities and modestly long bonds. Our bond positions remain limited in size due to market pricing. Until next time.

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