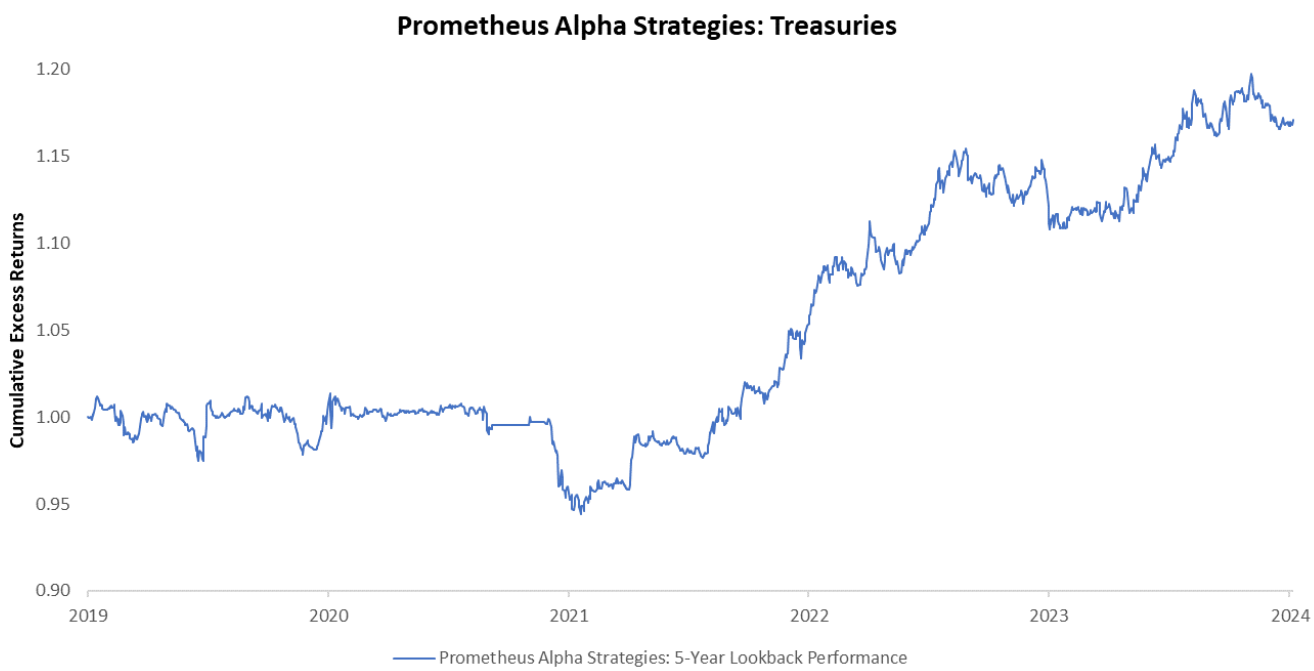
The Observatory

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:

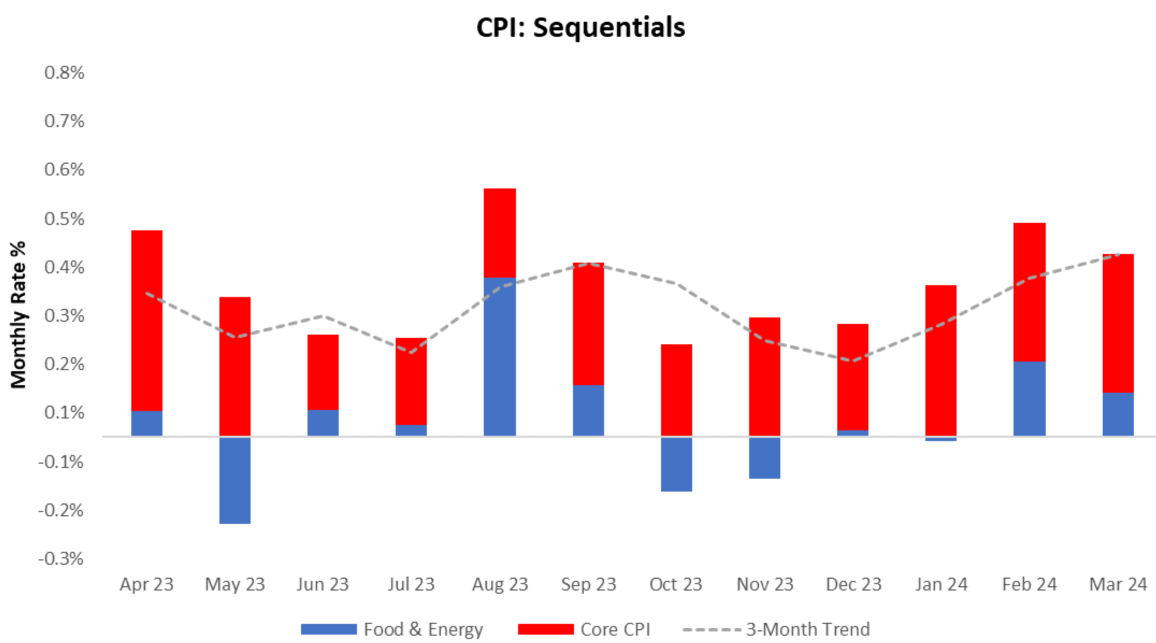
- ***The latest CPI data points to inflationary pressures largely inconsistent with the Fed's achieving dynamics consistent with its 2% objective.***
- ***Services prices remain well-supported, while goods prices will likely face some pressures. We see the net impact of these forces as an inflation rate that stays modestly above the Feds target.***
- ***Relative to these expectations, treasury markets are pricing outcomes consistent with a recession, resulting in a return to the Fed's 2% inflation objective. At the same time, term premia remain depressed relative to government asset supply.***
- ***Our Alpha Strategies favor exposure consistent with a steepening of the yield curve. At the same time, we also find a modest signal to be short bonds. Bond beta remains unattractive for asset allocators.***

We begin by showing the recent context for our Alpha Strategies for US Treasuries:

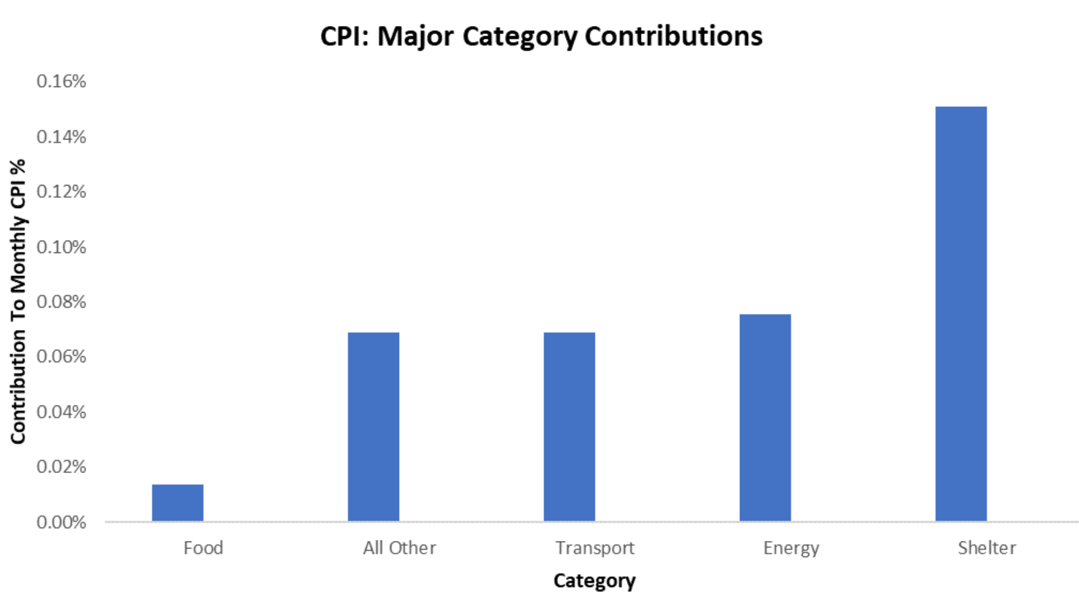


Thus far in 2024, we have yet to see a durable steepening of the yield curve; however, we continue to see fundamental dynamics evolve to support these moves. We dive into the data driving this assessment.

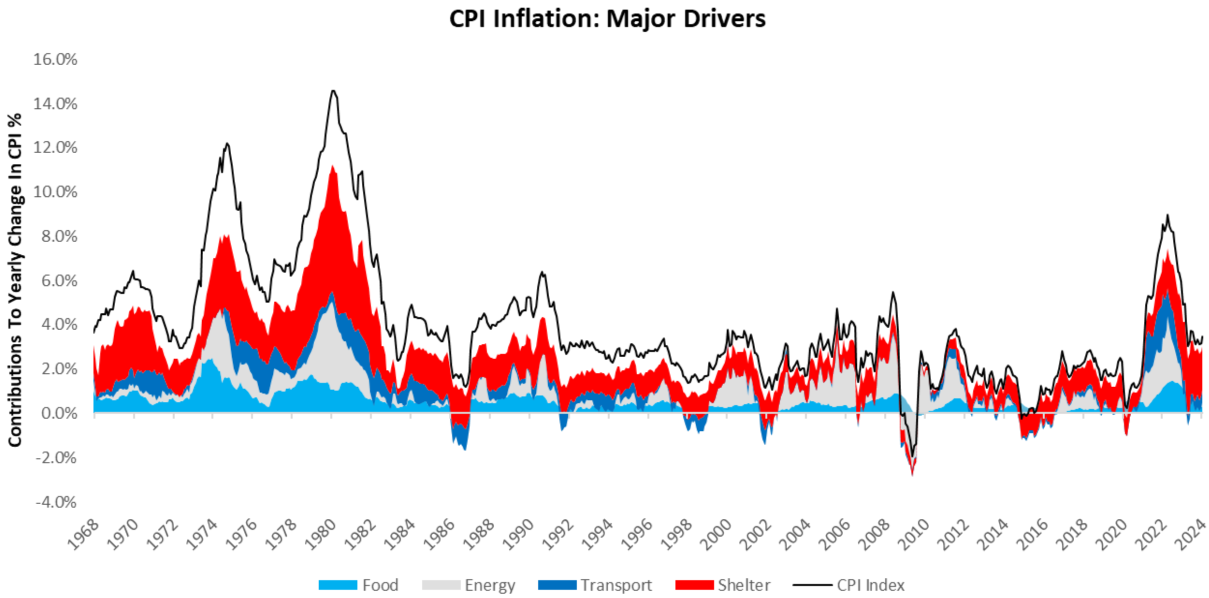
We begin with the most recent CPI data. In March, headline CPI came in at 0.38%, surprising consensus expectations of 0.3%. Core CPI contributed 0.29% to this point, with food & energy contributing the remaining 0.09%. This print drove an acceleration in the three-month trend. Below, we display the sequential evolution of the data:



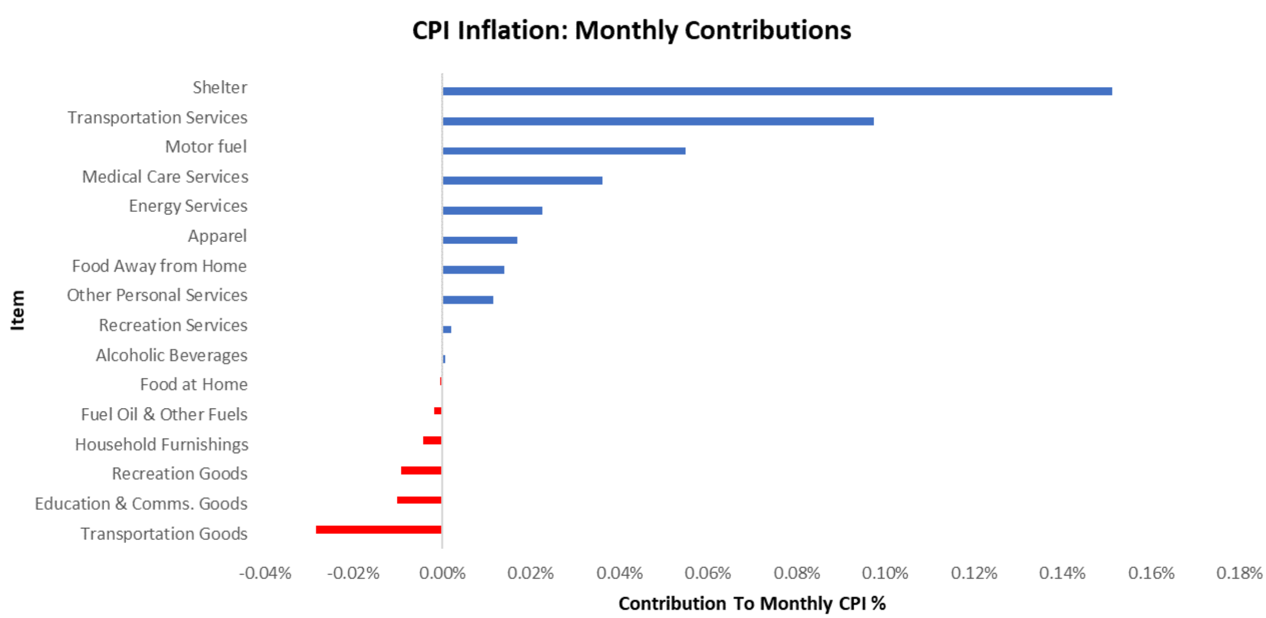
The primary drivers of CPI inflation are food, energy, transport, and Shelter. These components have contributed 0.01% (Food), 0.08% (Energy), 0.07% (Transport), and 0.15% (Shelter), respectively. We display these contributions to the 0.38% change in CPI below:



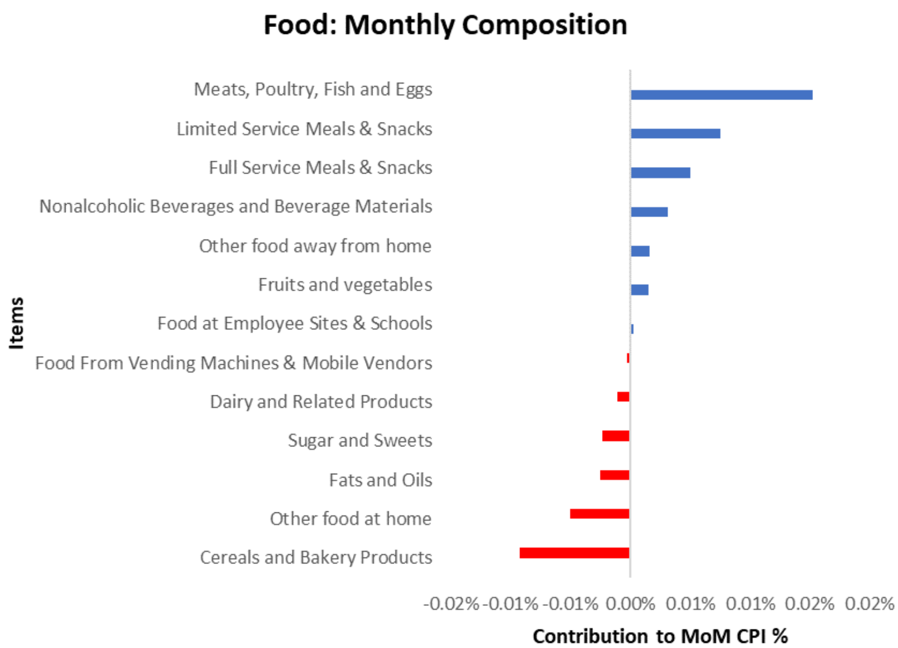
For further perspective, we show how these areas have accounted for the majority of variation in inflation both economically and statistically. Over the last year, food, energy, transport, and housing have contributed 0.3% (Food), 0.19% (Energy), 0.6% (Transport), and 1.96% (Shelter), respectively, to the change in inflation. We display these principal drivers of inflation over time below:



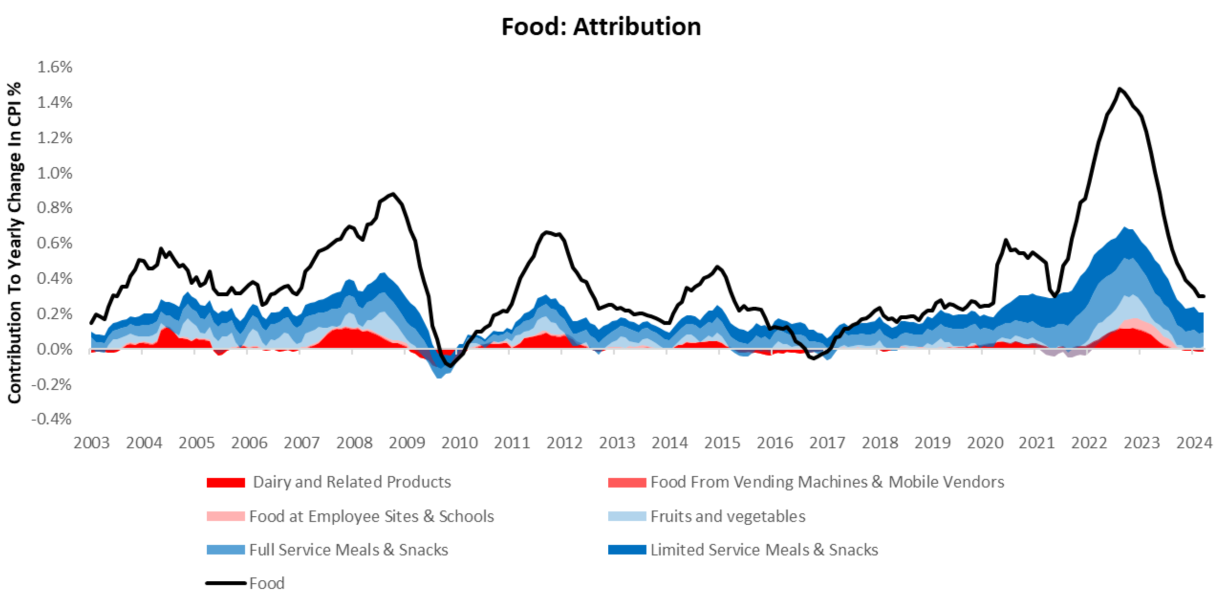
We now zoom back into the most recent print. Inflation was largely positive, with Shelter contributing most positively and Transportation Goods contributing most to weakness. We display the largest movers to the upside and downside below:



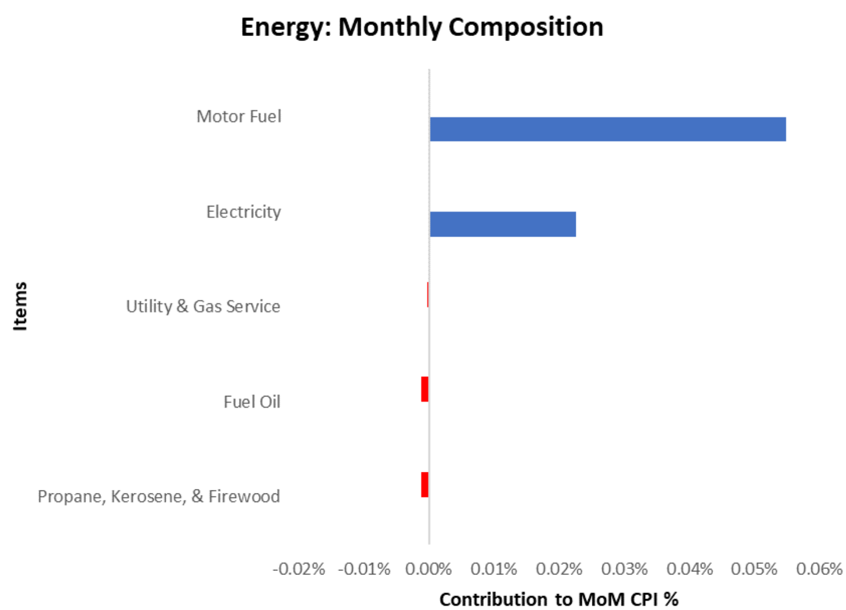
We now zoom into our major food, energy, transport, and Shelter categories. We begin with food. The most recent data showed that food inflation was somewhat mixed, with meats, poultry, fish, and eggs showing the most relative strength and cereals and bakery products showing the most weakness.



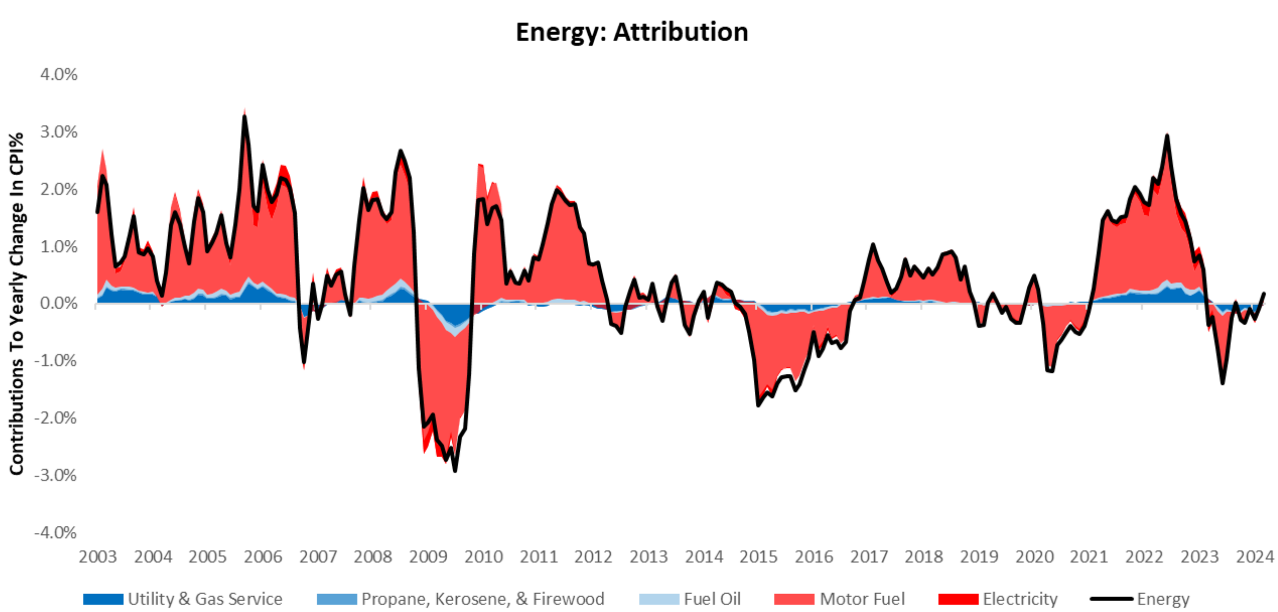
For further perspective, we also show the evolution of food inflation over the last year, with the strongest contributors in shades of blue (Limited Service Meals & Snacks, Full Service Meals & Snacks, Fruits and vegetables) and the weakest in shades of red (Dairy and Related Products, Food From Vending Machines & Mobile Vendors, Food at Employee Sites & Schools):



Next, we turn to energy. The most recent data showed energy inflation was largely negative, with Motor Fuel showing the most relative strength and Propane, Kerosene, & Firewood showing the most weakness.

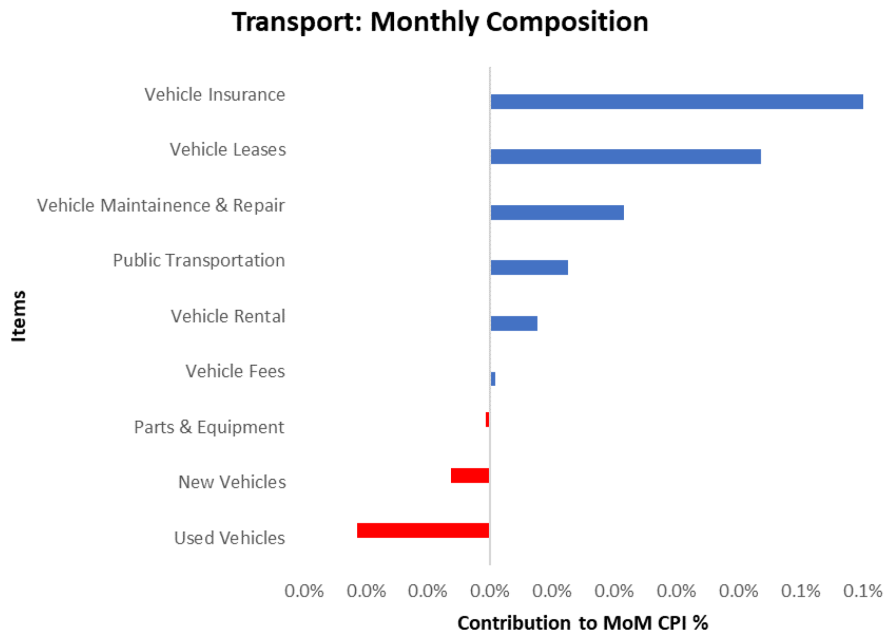


We also show the contributions of these items to total energy inflation over the last year with historical context:

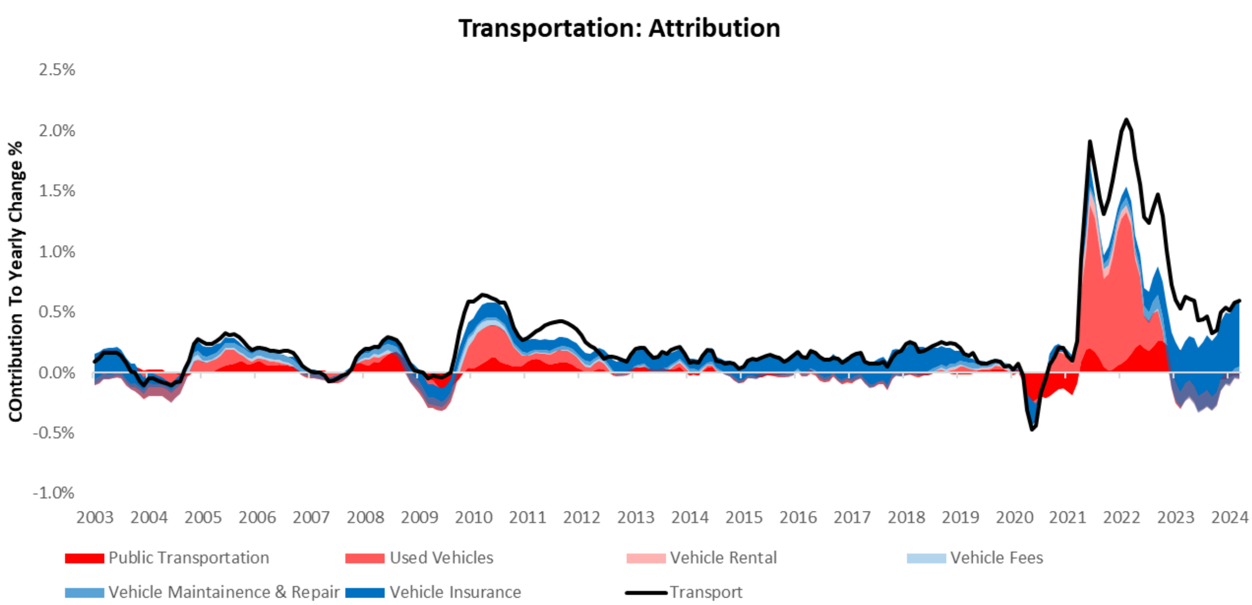


We note that energy inflation has risen again, which is consistent with recent commodity prices. This change removes a significant damper on inflation.

We now turn to transportation. The most recent data showed transport inflation was largely positive, with Vehicle Insurance showing the most relative strength:

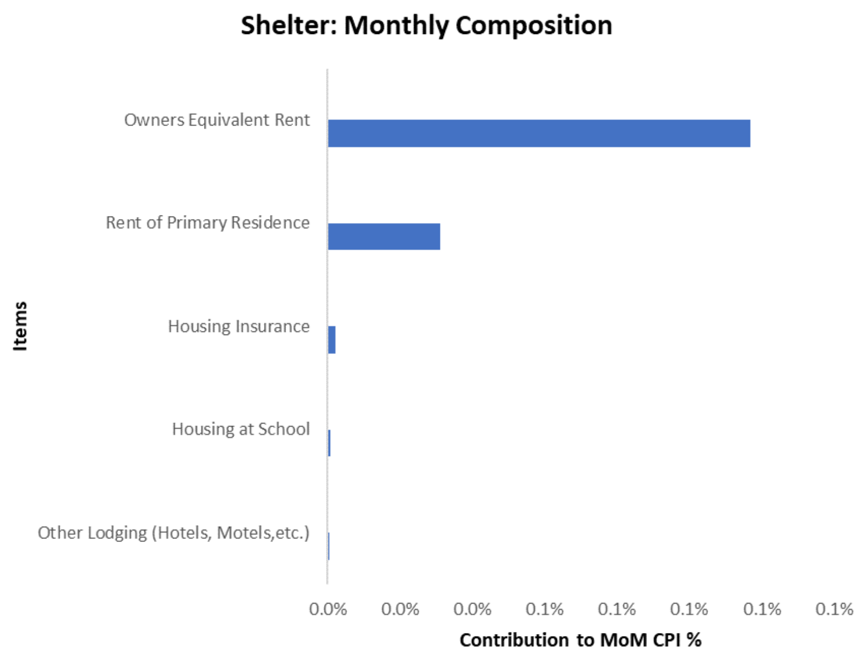


For further perspective, we also show the evolution of transportation inflation over the last year, with the strongest contributors in shades of blue (Vehicle Insurance, Vehicle Maintenance & Repair, Vehicle Fees) and the weakest in shades of red (Public Transportation, Used Vehicles, Vehicle Rental):

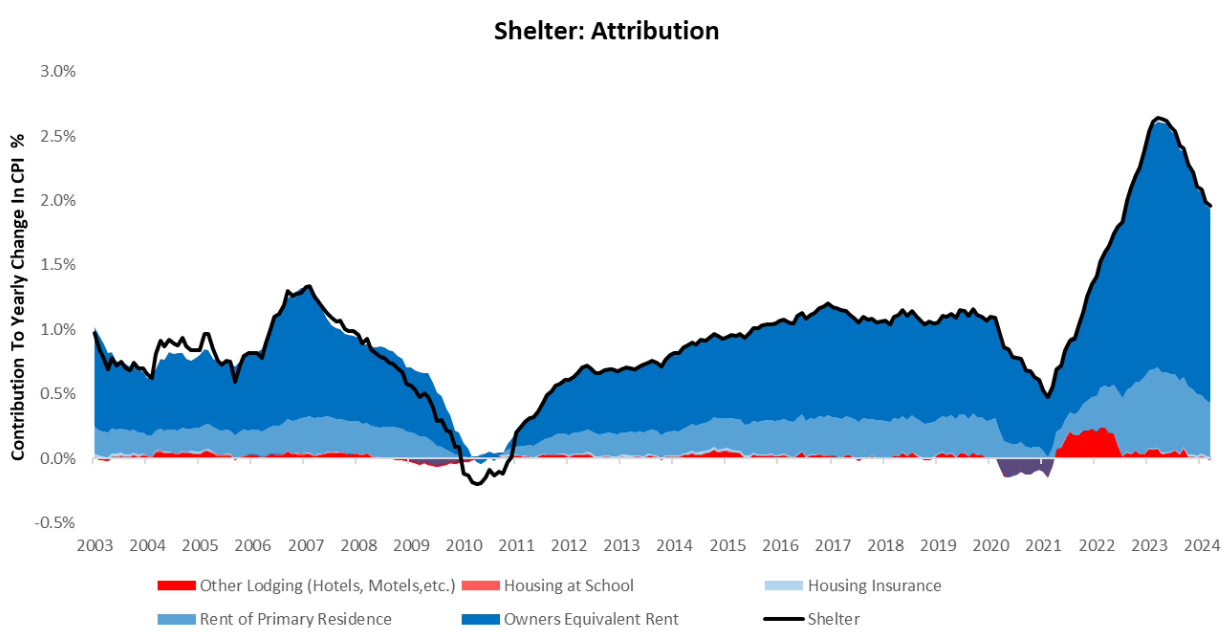


Transportation dynamics continue to show resilience as automobile dealers work through significant backlogs.

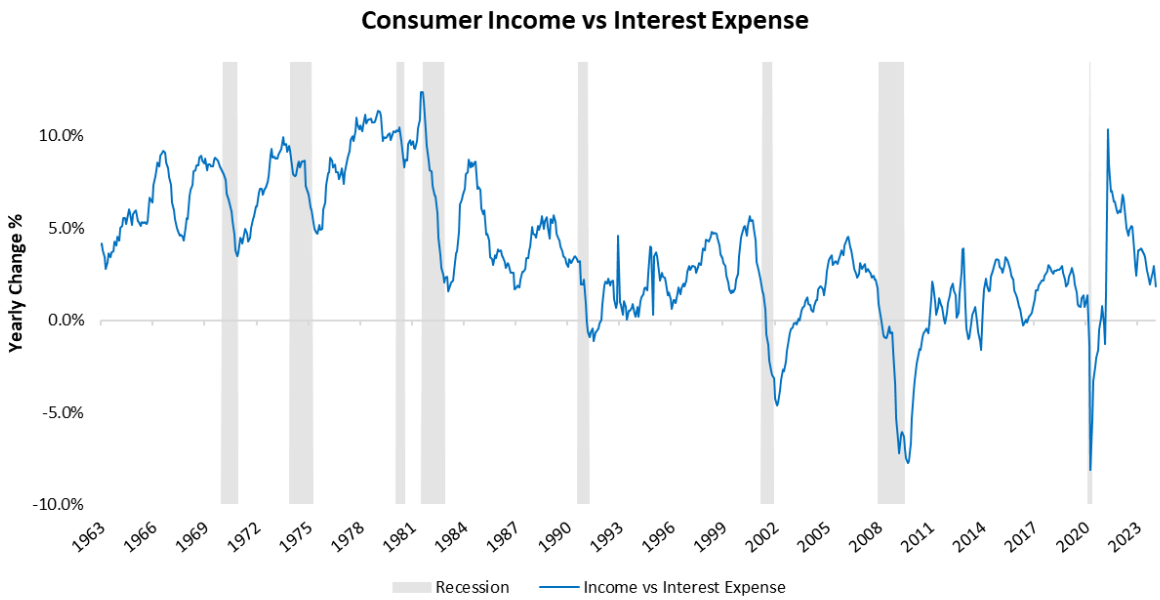
Finally, we examine Shelter, the economy's most significant driver of consumer inflation. The most recent data showed shelter inflation was positive across the board, with Owners Equivalent Rent showing the most relative strength and Other Lodging (Hotels, Motels, etc.) showing the most weakness.



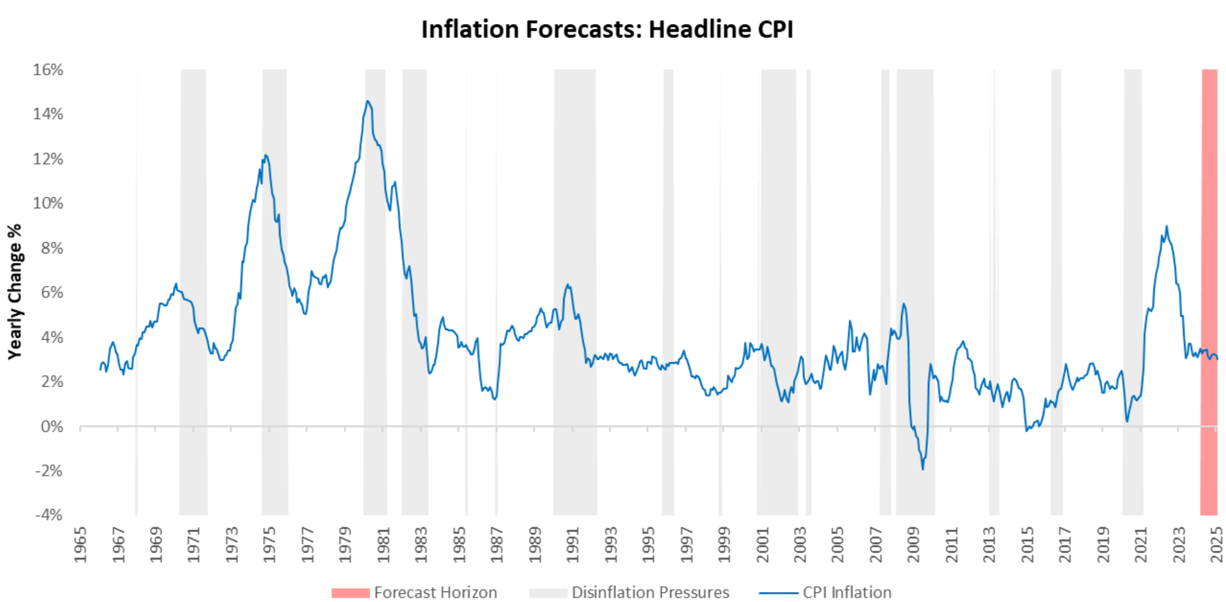
We also show the contributions of these items to total shelter inflation over the last year with historical context:



Shelter inflation continues to be a dominant driver of CPI inflation, yet another area showing resilience relative to expectations. This resilience of inflation is primarily driven by household incomes, which remain highly elevated relative to interest burdens:



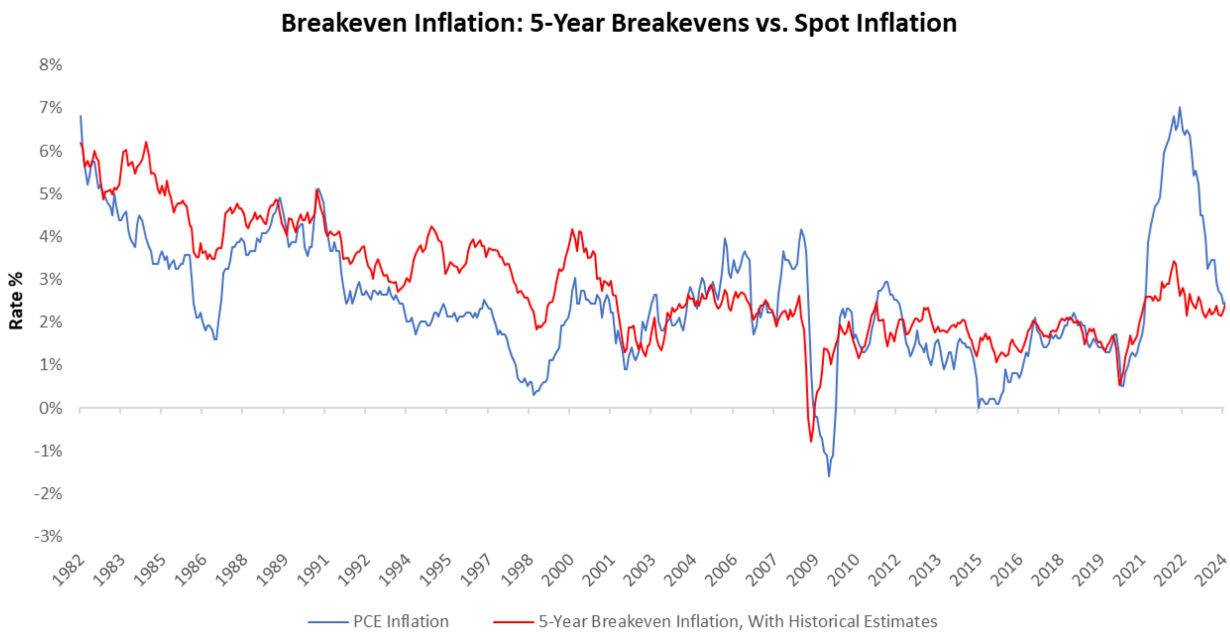
Without significant pressure on household incomes, the need to pull back on nominal spending remains muted, likely to keep inflationary potential elevated. This dynamic is reflected in our systematic forecasts for CPI inflation:



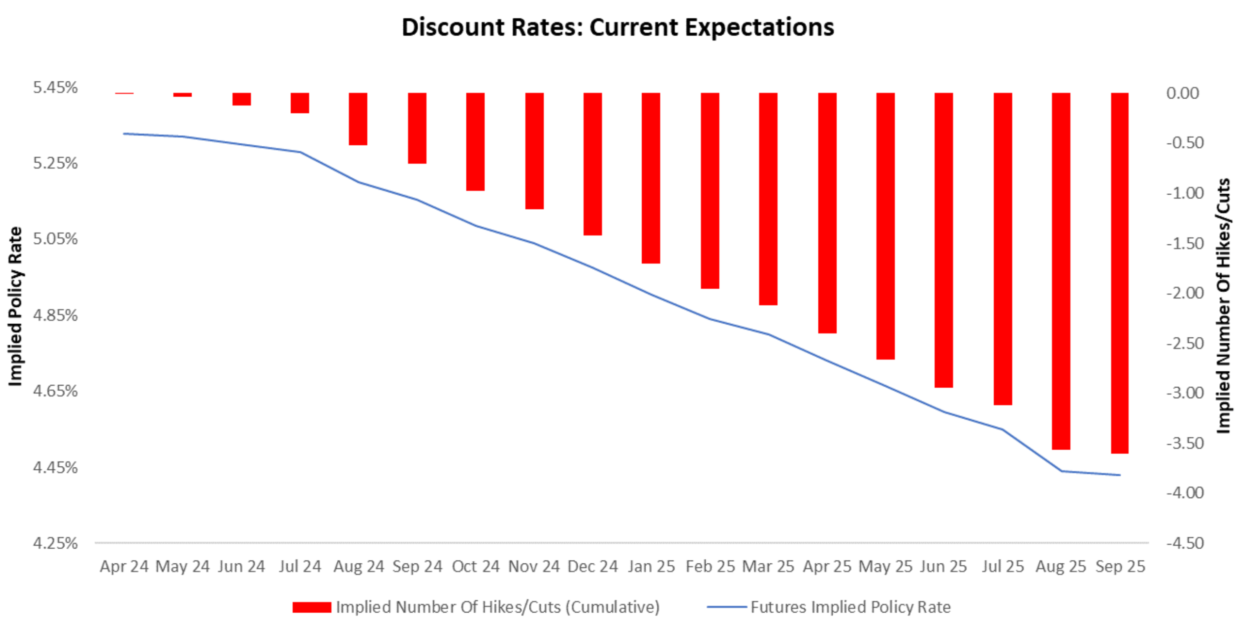
Therefore, we see an environment where inflation doesn't accelerate significantly but doesn't decelerate very quickly, either.

Relative to this expected path, the Treasury markets are pricing in inflation expectations that are roughly consistent with inflation stabilizing around these levels, a monetary policy path consistent with recession, and a term premium inconsistent with the ongoing pace of government asset supply.

We currently view the picture for breakevens as largely fair. We visualize this below:

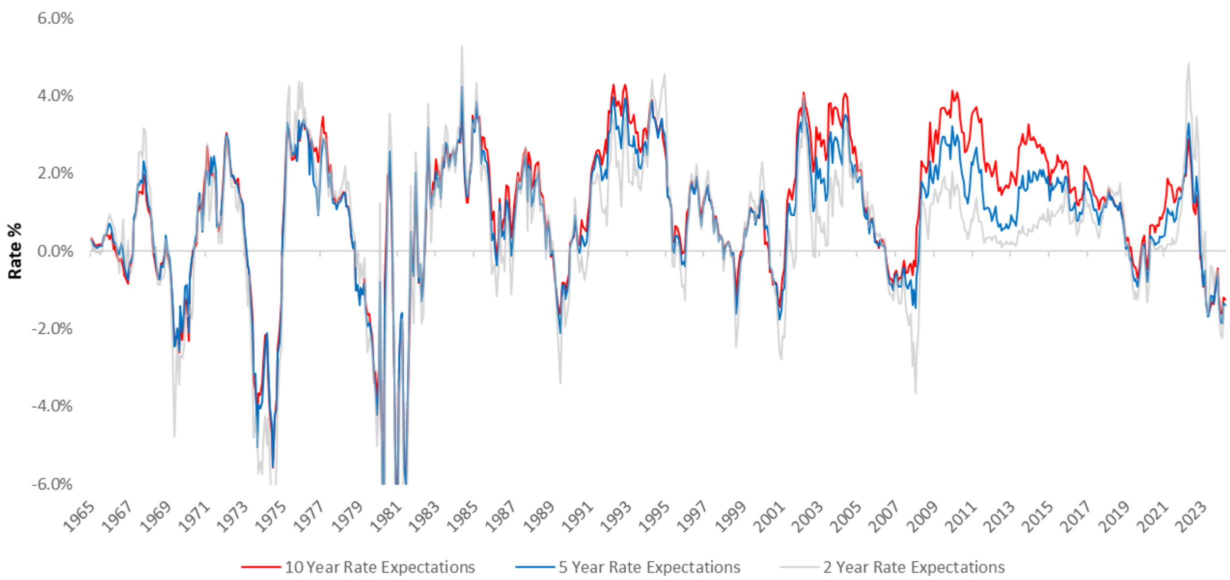


However, we see the current pricing of rate cut expectations largely unwarranted. Below, we show the latest discount rate path priced over the next eighteen months:



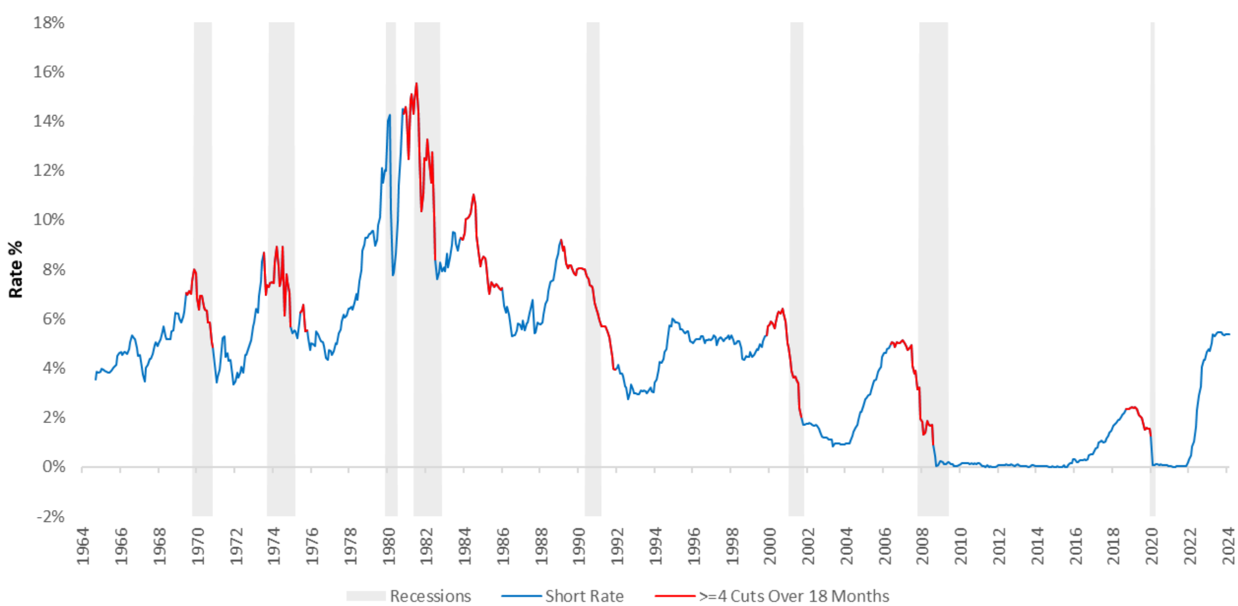
Short-term interest rate markets expect a peak in policy rates on May 24 at 5.33%, followed by a trough on Sep 25 at 4.43%. This pricing implies approximately four interest rate cuts cumulatively over the next eighteen months. This pricing echoes through the yield curve:

Treasury Yields: Change In Policy Rates Expectations



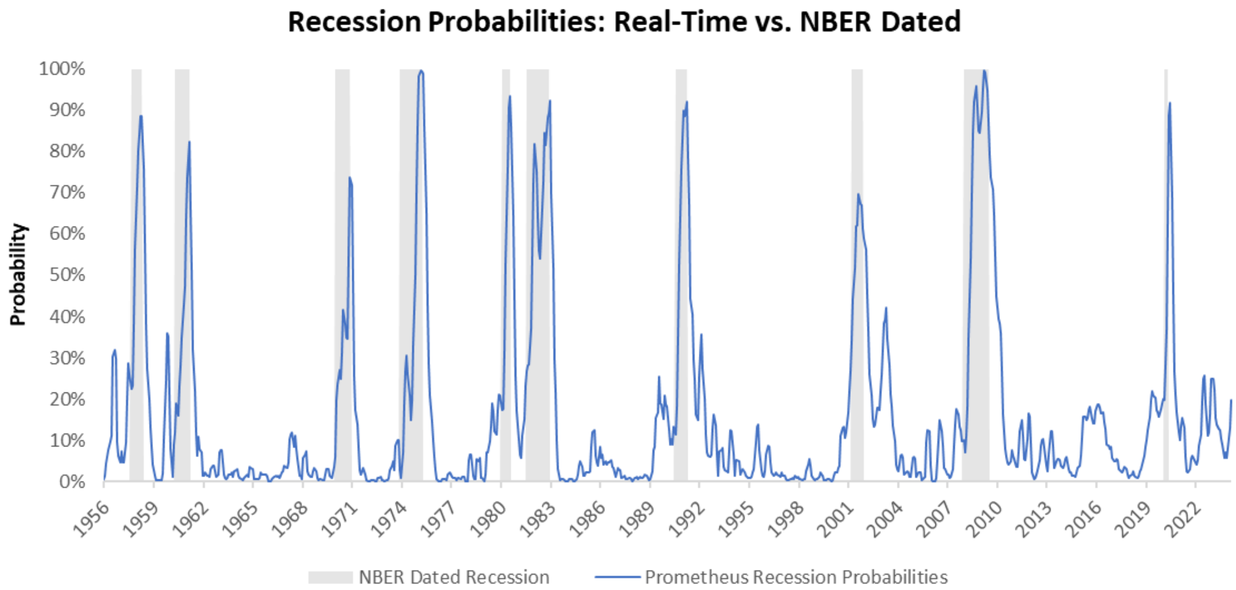
Currently, 10-year notes are pricing five cuts, 5-year notes are pricing six cuts, and 2-year notes are pricing six. This degree of cuts remains consistent with recessionary territory:

Cutting Cycle Analogs: 4 Cuts Or More Typically Coincide With A Recession

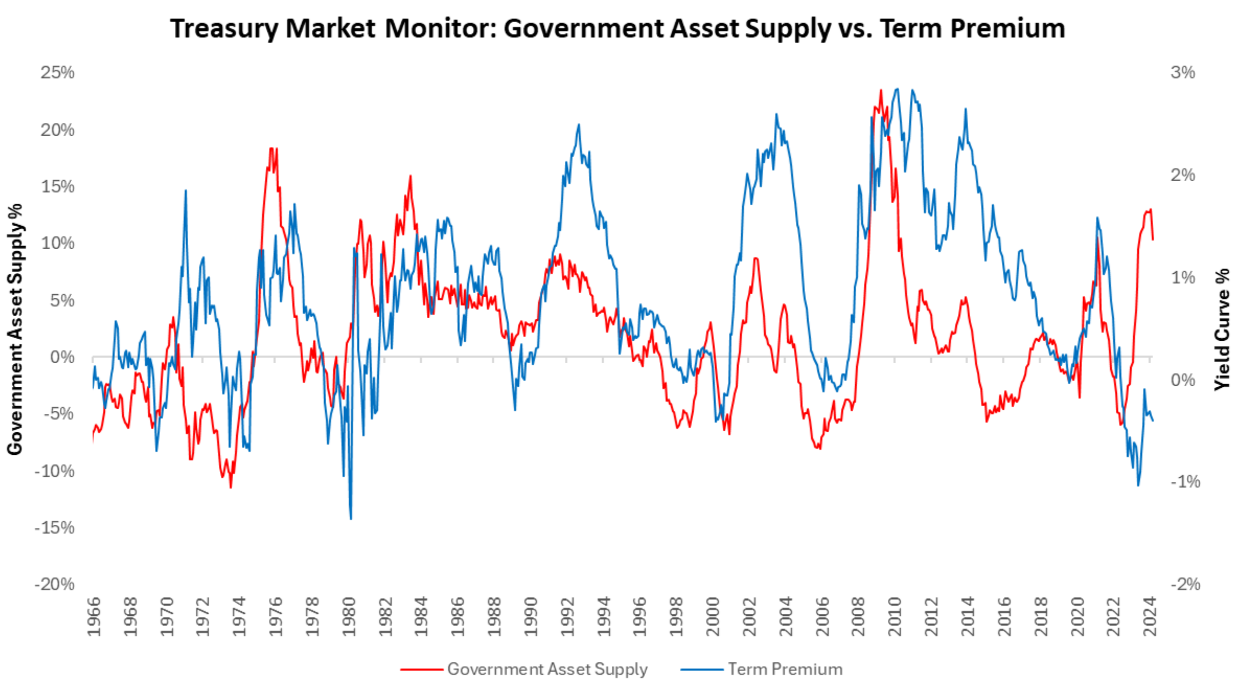


As we can see above, four or more cuts over 18 months largely occur only during a recession.

However, conditions remain far from recessionary:



Our recessionary probability monitor suggests that we are well-removed from recessionary conditions. As such, current short-rate expectations look inconsistent with macroeconomic fundamentals. Further, treasury curves remain depressed relative to the ongoing pace of government asset supply:



Above, we show our internal estimates of effective government asset supply. This gauge has a useful barometer of yield curve regimes and suggests significant pressure on curves to steepen.

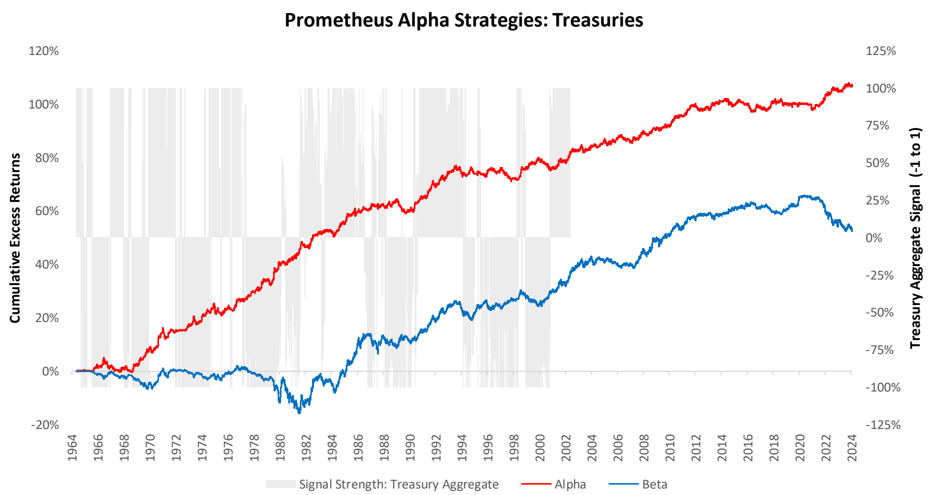
The nuances of term premia and how it relates to government asset supply are beyond the scope of this note, but you can find ample explanation in previous notes and our recent webinar. In short, the supply of treasuries puts upward pressure on yields depending on the ability of the private sector to absorb the new supply.

Overall, inflationary pressures persist as nominal spending persists. This nominal spending and inflation are largely inconsistent with what is priced into the short-term interest rate markets and across the curve. Term premia available in long-term securities relative to short-term securities continue looking unattractive enough to generate a significant bid for treasury bonds. We show the systematization of these principles outlined in this note in the form of the full sample backtest for our Alpha Strategies for Treasuries.

Prometheus Alpha Strategies: Comparative Returns vs. Beta

Summary Statistics

	Alpha	Beta
Total Return	9.0%	6.7%
Excess Return	4.2%	2.2%
Volatility	4.9%	6.0%
Semi-Variance	3.6%	4.4%
Max DD	-8.5%	-22%
Sharpe	0.86	0.37
Sortino	1.19	0.50
Calmar	0.50	0.10
Hit Rate	53%	50%
DD Duration (Years)	2.40	3.71



Bonds continue to face headwinds, and we expect the yield curve to steepen. Bond beta remains unattractive for asset allocation purposes. Until next time.

Finally, the net issuance of bonds remains a headwind for Treasuries and is likely to push term premia higher.

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