Martone Capital Management: Weekly Investment Commentary (12/3/2015)

U.S. stocks were essentially flat in a holiday-shortened week, while long-term bond yields slipped.

Both stocks and bonds are feeling the brunt of mixed economic data, which has inhibited earnings gains for stocks and is also one of the factors keeping long-term yields contained. The latter is somewhat surprising given the growing likelihood that the Federal Reserve (Fed) will start to nudge short-term rates higher in December. We believe long-term yields are likely to remain low for some time, and within our bond portfolio prefer Treasury Inflation Protected Securities (TIPS). These offer some hedge against what we view as unrealistically low inflation expectations.

With the third-quarter earnings season coming to an end, it is now clear that company earnings are not strong enough to push stocks substantially higher. Quarterly earnings growth was down 3.3% year-over-year, while revenue growth contracted by 4.4%. Part of the problem: After years of levitating at record-high levels, profit margins are coming under pressure.

In fixed income markets, the story in the U.S. is eerily similar to equities in that bonds, although volatile, have not moved much this year. Ten-year U.S. Treasury yields are within five basis points (0.05%) of where they started the year, thanks in part to the muted nature of the economic recovery.

Our base case scenario calls for an only modest rise in long-term yields in 2016. Moreover, several factors unrelated to economic growth should keep rates from rising above the 3% threshold: an aging population, a dearth of supply of bonds and persistent institutional demand for fixed income instruments. All of these either increase demand or reduce supply, which supports prices and, therefore, keep yields low.

Thank you for your continued confidence in Martone Capital Management.

We welcome your comments and questions.