Martone Capital Management: Weekly Investment Commentary (6/4/2014)

Broadly speaking, both stocks and bonds are looking expensive. But at current levels, traditional bonds in particular offer little value. We don't expect a big selloff in bonds, causing rates to sharply climb back up, but overall, we continue to favor equities over bonds, even as stocks continue to move toward new highs.

Bond markets continue to defy expectations and investor appetite for bonds remains undiminished, despite media reports to the contrary. Indeed, last week saw another $6.3 billion flow into U.S. bond funds, with $1.2 billion into fixed income exchange traded products.

Although economic data continues to be mixed - for example, last week revealed the U.S. economy actually contracted by 1% in the first quarter versus an initial estimate of 0.5% growth - the demand for bonds and subsequent drop in yields appears to be driven by technical factors, rather than any serious re-evaluation of the economy.

Perhaps most importantly, institutional buying of bonds appears to be particularly strong, as many U.S. pension plans look to "de-risk" (sell stocks and buy bonds). In addition, U.S. commercial banks are increasing their bond holdings. In the first quarter of the year, the collective holdings of U.S. Treasury securities by banks increased by 23%, the biggest shift since the financial crisis.

We still expect interest rates to rise modestly in the second half of the year, although we don't foresee a dramatic "melt-up" in rates. But even a small rate rise puts bond holders at risk, and at these prices, we don't think traditional taxable bonds, notably Treasuries, offer enough value to compensate investors for those risks.

In short, in a world of few bargains, investors need to tread carefully and look for relative value.