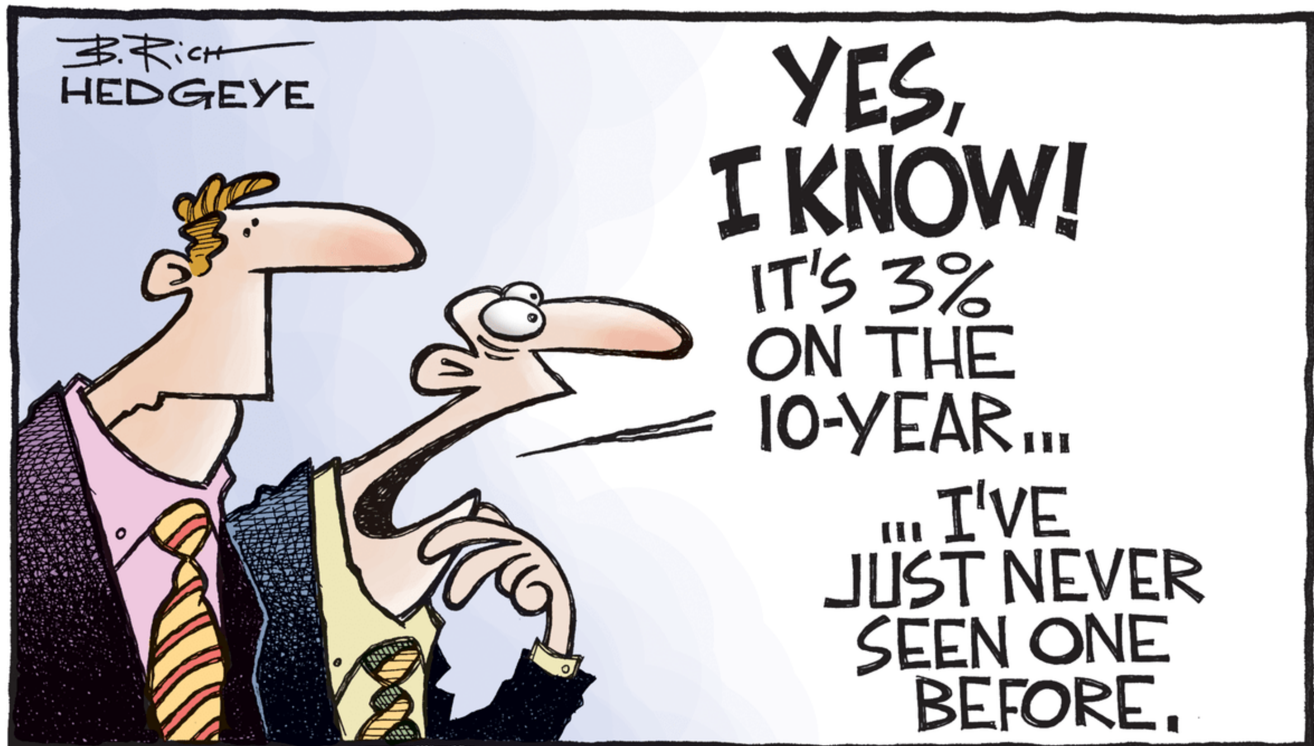
May 2018: The Bonds are Back in Town

Bonds yields are back – kind of. For the first time in five years, U.S. 10-Year Treasuries yield over 3%.[1] This is quite remarkable, as yields on the 10-Year were as low as 2.03% in September of last year.[2] In percentage change terms, the rally in rates over the last ten months has been the sharpest since the 1980s.[3] Government and corporate bonds are offering their most attractive returns to income-oriented investors in many years, including on an after-inflation basis.



Following the Financial Crisis, global central banks cut interest rates and embarked on a massive quantitative easing program (buying up trillions of dollars in government and corporate debt) in an attempt to save the global economy. Now, global central banks are slowly beginning to unwind their bond purchases and raise interest rates in an attempt to "normalize" monetary conditions. The Federal Reserve, for instance, is widely expected to raise interest at least two more times this year, which would set the Fed Funds rate between 2.25% - 2.50% by the end of the year. In anticipation of interest rate hikes, U.S. 2-Year Treasuries now are yielding 2.60% - this is not only higher than the yield on the 10-Year Treasury at the beginning of the year, but it is now also higher than the dividend yield on the S&P 500 (which is currently 1.9%).[4]

Karmin Capital
600 Central Ave, Suite 365
Highland Park, IL 60035
(847) 559-9700
www.karmincapital.com

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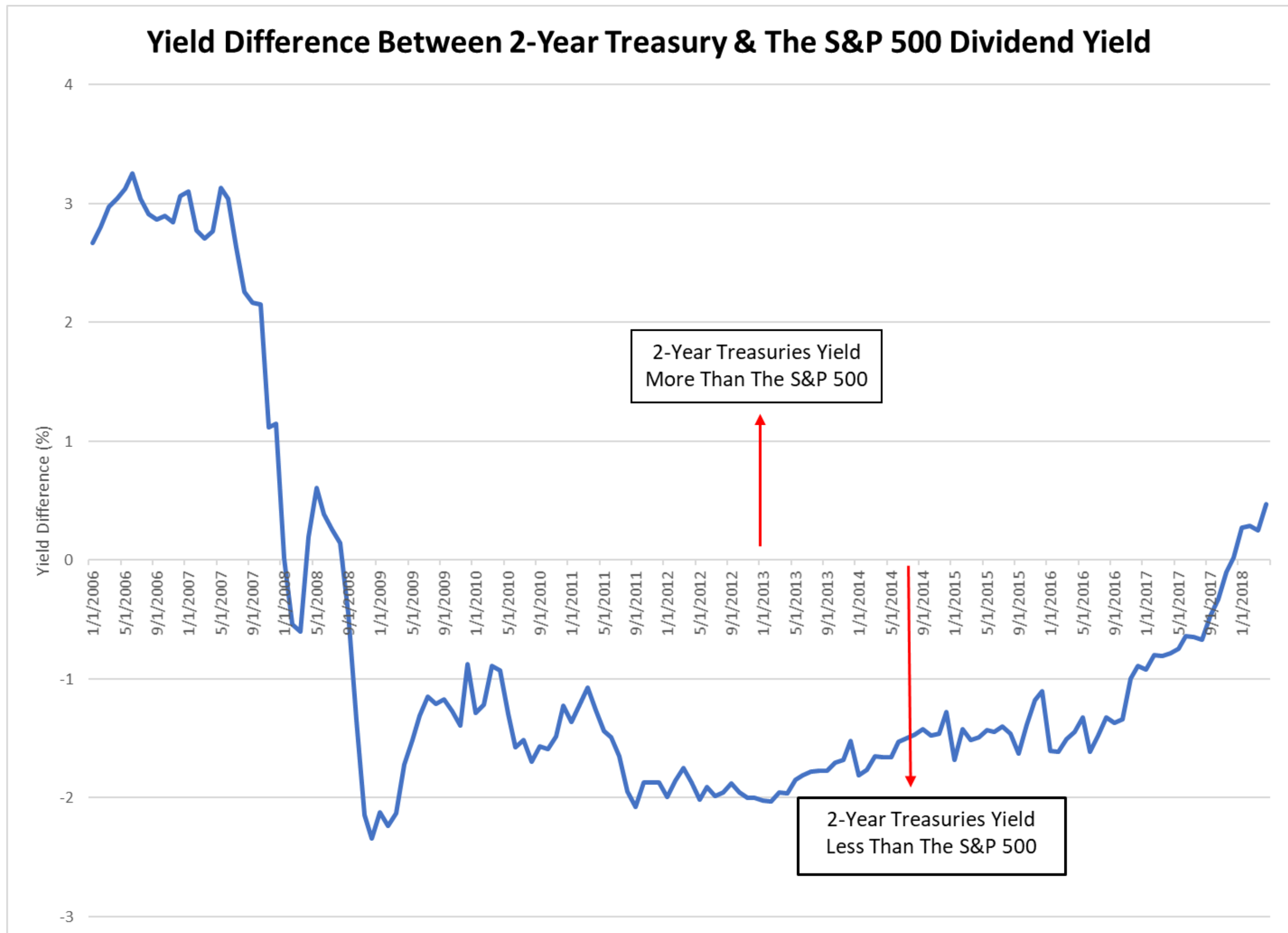

As bond yields cratered in the aftermath of the Financial Crisis and the extreme monetary policy measures implemented by global central banks, yield focused investors had to migrate into equities in order to receive any meaningful income. The massive inflow of fixed income investors from bonds into dividend paying stocks had a number of effects. For one, it arguably distorted valuations for "dividend aristocrats," or stocks with long histories of stable and rising dividend payments. At one point in 2016, reliable dividend paying companies like Colgate and Procter and Gamble, which were growing earnings and sales less than 5% annually, traded at materially more expensive valuations than tech companies like Facebook and Alphabet/Google which were growing sales and earnings over 20% annually (this was discussed in our September 2016 newsletter). This made no sense, except for the fact that investors placed a premium value on stable dividend payments. Another effect of the shift from bonds to stocks was that investors who may have had conservative risk profiles felt compelled to take on substantially more risk through owning stocks in order to receive any meaningful income. Now that yields are rising, valuations of dividend aristocrats are correcting as income-oriented investors begin to rotate out of stocks and back into bonds.

For those of you who felt like it did not pay to own bonds over the last five-plus years or who purchased dividend stocks solely for income, it may be time to revisit bonds again. As the rise in long-term bond yields has

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not been as severe as the rise in short-term bond yields, we recommend considering both government and corporate bonds with shorter maturities. The yield spread or difference between the 10-Year Treasury and 2-Year Treasury has narrowed from over 250 basis points five years ago to just 55 basis points today.[5] Thus, shorter-term bonds are yielding close to longer-term bonds, with significantly less long-term risk of price erosion as they are only two-year instruments. Investors also may want to reconsider holding cash as an alternative. While government money market funds are paying far from the 5%-plus of ten years ago, they now pay close to 1.5% – a notable improvement from 0%.[6] As the Federal Reserve continues increasing rates, the yield on money market funds will rise as well. While such payments may not meet the needs of all income-oriented investors, the below table shows various yields for bonds and related fixed-income products:[7]

	Sample Investment Yields					
	6-Months	**1 Year**	**2 Years**	**5 Years**	**10 Years**	**30 Years**
CDs	2.05%	2.35%	2.83%	3.33%	3.65%	4.13%
Treasuries	2.09%	2.34%	2.60%	2.91%	3.09%	3.21%
AAA Corporates	2.15%	2.42%	2.71%	3.26%	3.59%	4.12%
A Corporates	2.35%	2.75%	3.39%	4.09%	5.25%	5.10%
AAA Municipals	1.69%	1.78%	2.11%	2.83%	3.21%	3.85%

Despite the recent increase in interest rates, there are still a number of investors who remain nonplussed by current levels of rates. Using the Rule of 72, at a 3% yield, it will take 24 years to double the value of one's investment. At a 5% yield, it will take approximately 14.4 years.

On a related note, the mid-stream Master Limited Partnerships (MLPs) have been a staple of our portfolios for years. The past week saw a number of general partners offer to buy out their limited partners (or the MLPs) including Enbridge Energy Partners, LP. While partnership/corporate simplification has been a growing trend over the past year, we do not anticipate our largest holding, Enterprise Products Partners (EPD), will seek to undergo a partnership to corporate conversion. Management continues to express confidence in the benefits of the partnership structure for EPD. The two MLPs we own that may potentially consider such a transaction in the future are Plains All American (PAA) and Energy Transfer Partners (ETP). To date, the management of these firms have not indicated that they are considering such transactions.

On an administrative note, those of you who have had to recently wire funds have noticed that is becoming a "bigger pain" as we and others are on high alert for fraudulent requests. If you ask us to wire money or any other disbursement, we will always call you at a phone number we know (this is referred to as a "trusted phone number") to verify the request and to hear you tell us that the instructions are correct. We have been told stories where an

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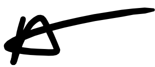
email account is hacked, and a request is then made to wire funds to an account that has the alleged account holder's name on it. That account is not in the account holder's name but in the hacker's name. So please do not be annoyed when any of us (generally Lisa and Donna) call to verify your request including the account number. While this is an inconvenience for all involved, it is in everyone's best interests.

Finally, for those clients who are 70.5 years and older and like to donate to charity, we would like to highlight the advantage of giving from one's IRA. Rather than taking the required minimum distribution (RMD), individuals can transfer up to $100,000 annually from one's IRA to non-profits. This charitable contribution counts against your required annual minimum distribution, but unlike the normal RMDs you are not taxed on the contributions and they are not added to your adjusted gross income. There is an economic savings by giving directly from your IRA rather than taking the RMD and then giving from your personal account. But please remember: You cannot take a charitable write-off for the IRA distribution.

Please let us know if you would like to discuss potential fixed income investments or discuss your portfolio, generally. Many thanks.

Sincerely,



Peter Karmin
Managing Member

Stuart Loren
Director

Citations and Disclosures

[1] Bloomberg (as of May 17, 2018).
[2] Bloomberg.
[3] Bloomberg.
[4] Bloomberg (as of May 17, 2018).
[5] Bloomberg (as of May 17, 2018).
[6] Bloomberg (as of May 17, 2018).
[7] Source https://www.bonddesk.com/bdi/owa/pkg_static.home?p_custom=BASEAs (of May 22, 2018).

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