5T Wealth, LLC

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Ellumination Newsletter

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The antidote to Wall Street."

What about bonds for 2023?

January 3, 2023

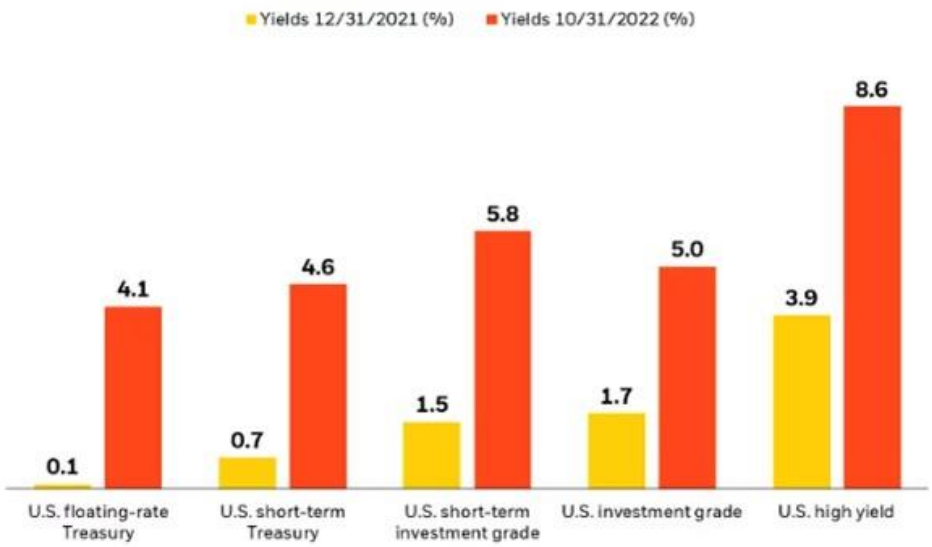
If you owned bond funds (ETF's or mutual funds) that held fixed rate bonds at the beginning of 2022, and held them all year, you lost money. If they held very short maturities you didn't lose much. If they held only longer-term maturities you lost a lot.

ETFs or mutual funds that held floating rate bonds through 2022 made out much better. Most returns weren't spectacular, but in a year when many other bonds, and almost all stocks lost at least -15%, even a 1% return looked great in comparison.

Fixed rates bond ETFs and mutual funds suffered as rates rose and the net asset value of their shares dropped all year. Floating rates buoyed values of funds that owned them.

2023 should turn out to be very different for bond owners. The U.S. short-term Treasury (1-3 years) was yielding about 0.7% at the beginning of 2022. Almost all bonds were offering yields below 2%. High yield (junk) was the exception at about 3.9%. (See graph below)

A significant change in yield resets the investment landscape



Source: BlackRock, Bloomberg, chart by iShares Investment Strategy. As of November 1, 2022. US Floating Treasury refers to the Bloomberg U.S. Treasury Floating Rate Index. US Short-Term Treasury refers to the ICE U.S. Treasury 1-3 Year Index. US Short-term Inv. Grade refers to the ICE BofA 1-5 Year U.S. Corporate Index. US Agg Bond refers to the Bloomberg U.S. Aggregate Bond Index. US High-Yield refers to the Markit iBoxx USD Liquid High Yield Index. **Index performance is for illustrative purposes only. Index performance does not reflect any management fees, transaction costs or expenses. Indexes are unmanaged and it is not possible to invest directly in an index. Past performance does not guarantee future results.**

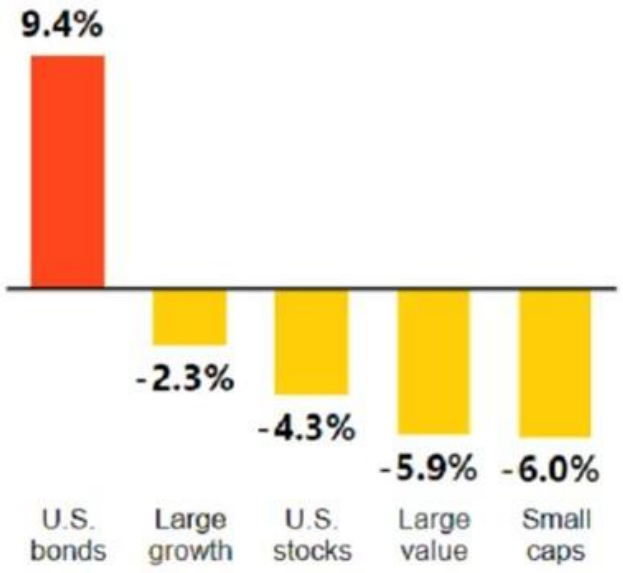
Yields have skyrocketed in 2023. Short-term Treasuries now yield over 4.6%. High yield (junk) is over 8%. Whether 4.6% or 8%, those yields look pretty darned good in a world full of uncertainty, and in which most stock indexes are finishing 2022 down anywhere from -15% to -30%.

What makes them even more attractive is all the uncertainty about other asset classes as we move into 2023. Opinion among the pundits is almost unanimous that recession has either already arrived or will do so in 2023. It is widely anticipated that stock prices will fall. For our perspective on stock prices see our 2023 Outlook letter on our website at https://5twealth.com/current-newsletter. Stocks are the other pillar of most traditional asset allocation models. 2023 may be the year when the bonds in your portfolio outperform the stocks.

That could be especially true if recession does materialize. (See graph below)

Bonds have historically performed well during recessions

Performance during recessions since 1972



Source: Morningstar and BlackRock as of 9/30/22. U.S. stocks represented by the Ibbotson SBBI U.S. Large Cap TR Index and the S&P 500 Index, U.S. bonds by the IA SBBI U.S. IT Bond Index and the Bloomberg U.S. Agg Bond Index, Large growth by the Russell 1000 Growth Index and the Fama French Large Growth Index, Large value by the Russell 1000 Value Index and the Fama French Large Value Index, Small cap by Fama French Small Cap Stock Index. Index performance is for illustrative purposes only. Past performance does not guarantee or indicate future results. Indexes are unmanaged and it is not possible to invest directly in an index.

Bonds have always outperformed stocks during recessions. The deeper the recession the larger the outperformance tends to be.

Our Global Select strategy is being rebalanced during the first week of January 2023 to increase its allocation to bonds to 50%. It will hold a combination of short-term and long-term U.S. Treasuries, convertible bonds, mortgage-backed securities, and corporate bonds, all in ETFs.

Our 80/60 strategy is currently 40% allocated to bonds. The bond holdings will be similar to those in Global Select, all in ETF's.

We will be offering a strategy that is 100% allocated to bonds during 2023. This will be the first time we've done so since 2015.

Mendocino currently has an allocation of only 10% to short term Treasuries, and 40% to Cash (money market). As of December 30, 2022, the yield on the money market account is 3.85%. In January 2023 we will likely double the allocation to Treasuries. We are also considering adding high quality corporate bonds to raise the average yield on the bond allocation.

We are also pairing Global Select, 80/60 and Mendocino with private credit and equity offerings for qualified investors. We'll be commenting on these private offerings in a future newsletter.

How high will interest rates go in 2023?

The Fed has been signaling that the Fed Funds rate could reach 5% to 5.25% in early 2023, which would be a 17 year high. That would be up from the current level of 4.25% to 4.5%.

Some members of the Fed are projecting 5.5% to 5.75%, which would be the highest rate since 2001. Even if the Fed's highest forecasts come to fruition, it shows that, at most, only 1.25 percentage points of rate hikes are on the table for 2023. That's nowhere near the 4.25 percentage points of tightening Fed officials approved in 2022 alone.

All other rates are pegged to this key rate that is set by the Fed. The higher it goes, the higher other rates go, including mortgages, auto loans, credit cards, etc.

We all know that the Fed has been raising rates to fight inflation. The biggest fear in markets right now is that the Fed will push rates too high and push us into recession. This is a reasonable fear since historically this is exactly what's happened when the Fed is in inflation-fighting mode.

The bond market is signaling this fear with the 10-year Treasury yield trading at only 3.88% and the 30-year Treasury yield at 3.92%. (yields as of December 30, 2022) Both are well below the yields of 1- and 2-year Treasury yields, a sign that the bond market is preparing for recession.

What is one to do?

1. Keep a long-term mindset. Recessions can be painful, but they are transitory and set up buying opportunities. It might be better to enter 2023 with a larger allocation to bonds. It might be better to exit 2023 with a larger allocation to stocks.

2. Recession-proof your finances. Live within your means. Increase savings and make investments when prices are down!

3. If you have any debt, it might be smart to pay it down, especially credit card debt. Review your mortgage obligations.

4. Review long term plans to make sure that after 2022, and facing recession in 2023, you are still on track to meet your original goals.

5. Talk to us. Let's make sure your portfolio is suitable for your risk tolerance and compatible with your long-term goals.

All the best to you,

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Disclosure and Disclaimer - Updated last on December 11, 2019 by Paul Krsek:

All return calculations for the S&P 500 were done using https://dqydj.com/sp-500-return-calculator/unless otherwise noted.

All charts used in this newsletter are from Stockcharts.com and annotated by 5T Wealth, LLC

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5T WEALTH,LLC manages accounts with various histories and investment objectives. Various accounts may be managed differently from time to time.

Krsek makes frequent reference to strategies called Mendocino, Dividend Diamonds, Global Select and 5T Wealth Partners, LP. Each of these investment strategies have different suitability standards, investment objectives, potential volatility, and minimum investments. It is important to understand each strategy in detail before investing.

From time to time 5T WEALTH, LLC receives requests from clients to purchase securities that are not included in our investment strategies. Effective May 24, 2006, 5T WEALTH, LLC has encouraged clients to hold such securities in a separate account for the client. Because 5T WEALTH, LLC is a "fee only" registered investment advisor" it charges its normal management fee for monitoring such securities in the separate accounts in which they are held.

The investment objectives of various strategies may be substantially different from one another. Therefore topics or investments mentioned in ELLUMINATION may or may not apply to specific managed accounts and/or model strategies.

Trades or adjustments to accounts mentioned in ELLUMINATION may or may not happen in every account managed by portfolio managers at 5T WEALTH,LLC.

If you are not satisfied with the investment results in your account it is your responsibility to inform Krsek to discuss possible changes that can be made to the account to accommodate and satisfy your needs.

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The portfolio managers at 5T WEALTH, LLC do not guarantee results.

Past performance should not be considered an indicator of potential future performance. If you do not consider yourself suitable, either emotionally or financially, to experience volatility and/or losses in financial markets, you should not invest.

From time to time Krsek lists the simple annual returns of the strategies mentioned in this newsletter. These results are from accounts that are "models" and do not represent the actual results accruing to each clients individual accounts. Simple annual return does not represent "time weighted return" as reported individually to clients in their investment performance reports which are prepared using data and calculations from Orion Advisors.

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