Socha Financial Group, LLC

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2023 First Quarter Commentary

The first quarter began with better-than-expected economic conditions and healthy returns in the stock and bond markets. This economic strength then turned from a positive attribute for the market to a negative as the bond market began pricing in more interest rate hikes, putting pressure on equities. When the Federal Reserve (FED) raises rates as aggressively as they have in the past year, the risk of something "breaking" is elevated. On March 10th Silicon Valley Bank collapsed. This reverberated through the banking sector and subsequent fall of Signature Bank and Credit Suisse, resorting to a $54 billion loan from the Swiss National Bank to keep it afloat until UBS agreed to take over the bank for $3.2 billion. This caused Treasury yields to collapse with the yield on the two-year Treasury falling the most in one week than it had in the past 30+ years. The equity market was shaky at first but once it became clear the crisis was likely contained, stocks moved higher on the back of lower interest rates and the prospect of less FED rate hikes in the future.

The global economy slowed late last year but reaccelerated this year, as global GDP estimates for Q1 continue to rise. Estimates for US growth have been revised up with the Atlanta FED GDPNow forecasting 2.2% and J.P. Morgan Global Economics forecasting 3.3%. We do expect the economy to slow as the effects of tighter monetary policy, significant fiscal drag, tighter lending standards, and a dramatic decline in M2 money supply growth are felt. Consumer spending slowed in Q4, picked up in Q1, and will likely slow again, but we do not think it will collapse. The personal savings rate this year was 4.5%, roughly half its 60-year average. Revolving consumer credit fell significantly during COVID but is back to an all time high as consumers used their credit cards to maintain the lifestyle they came to enjoy because of record fiscal stimulus. Business spending is at risk as capital expenditures (Capex) tends to follow operating Earnings Per Share (EPS) growth with a three-quarter lag and operating EPS growth has come down over the past year. Global Purchasing Managers' Index (PMIs) show manufacturing is slowing generally while services are accelerating. Single-family housing starts have come under pressure from higher interest rates and have slowed and are below the 65-year average, although not dramatically so. Multi-family housing starts, however, have increased and remain above the 65-year average. The commercial real estate market appears to be the most at risk, primarily driven by offices, as financing costs have skyrocketed, and average occupancy of offices is less than half the March 2020 levels. Overall, the economy looks relatively healthy at the moment, but risks lie ahead. Should the US go into a recession, we think the most likely scenario will be that of a rolling nature, affecting different areas of the economy at different times. Consensus estimates expect zero economic growth for the next nine months with growth resuming in 2024.

Inflation has been the underlying issue that caused the FED, and Central Banks globally, to act in such an aggressive manner over the past eighteen months. Inflation peaked in June 2022 and has been trending lower since. Headline inflation for March moderated and came in at 5% Year-Over-Year (YoY) versus 6% for February. Headline CPI tends to track the ISM Service Prices Index with a three-month lag. The ISM Service Price Index peaked in April 2022 and has fallen precipitously since, now approaching 2% on a YoY basis. Core CPI tracks the ISM Service Price Index with a six-month lag, so we expect Core CPI to follow the ISM Service Price Index lower in the coming months. Additionally, wage inflation is also coming down. Average Hourly Earnings also broadly follow the ISM Service Price Index, although with more volatility and a three-month lag, suggesting wage inflation should also fall in the months ahead. These factors seem to be taking pressure off overall inflation, which is a good thing. Finally, inflation expectations, a metric watched closely by the FED, are falling rapidly. The Federal Reserve Bank of New York Survey of Consumer expectations show the median one-year ahead expected inflation at 4% and the three-year ahead expected inflation at 2.5%, and both measures are significantly lower than they were a year ago. If the inflation picture continues to improve, this should take pressure off the FED and allow them to pause their rate hikes and begin to cut rates, most likely starting in 2024.

There has been some encouraging news out recently with regards to the labor market. Labor demand has continued to moderate with JOLTS job openings falling by 632,000 in February and by ~2 million from their peak, the largest decline in history outside of a recession. This has occurred while employment increased by 2.6 million, differing from the historical pattern that many thought would be impossible. The labor supply has also fully recovered as the labor force participation rate is now back in line with its pre-pandemic demographic trend. Finally, as discussed above, wage growth has continued to soften, which should take some pressure off inflation. These developments in the labor market improve the prospects for a soft landing.

In March, we saw what can happen when interest rates are raised aggressively. This was the most aggressive rate hiking cycle since the early 1980's. On March 8th, Silvergate Capital, a California based cryptocurrency-focused bank, announced it would liquidate its assets after a run on the bank and Silicon Valley Bank (SVB) was forced to sell a bond portfolio at a $1.8 billion loss to shore up its balance sheet, which began a wave of customer withdrawals. On March 9th, SVB bank stock plummeted 60% as panic spread on social media suggesting the bank could fail. On March 10th, SVB failed after a run-on deposits. Regulators took over the bank and the FDIC was named the receiver. On March 12th, regulators seized Signature Bank to prevent contagion in the banking system. The FDIC invoked a "systemic risk exception," which allows the government to pay back uninsured depositors to prevent financial instability, and the FED announced it would set up an emergency lending program. On March 16th, First Republic received $30 billion in deposits from the largest US banks and Credit Suisse announced it would borrow $54 billion from the Swiss National Bank. UBS ultimately bought Credit Suisse for $3.2 Billion. SVB was the 16th largest bank in the Nation and was the largest bank to fail since the great financial crisis. It was in a unique situation as it primarily served the start-up and venture capital community, resulting in 86% of its deposits being above the $250,000 FDIC insurance limit. Nevertheless, it had a contagion effect and the government and regulators had to step in to contain it.

This "mini" banking crisis appears to have been contained but will likely have a lasting effect on the markets. Treasury yields plummeted in the aftermath of the SVB failure. The FED stated at its March FOMC meeting that they see the tightening in financial conditions due to the banking crisis equivalent to ~1% of rate increases. This suggests that their terminal rate can be lower and thus an end to the tightening cycle may be closer than we expected otherwise. The credit markets have become tighter as 45% of banks are tightening their lending standards, reducing the availability of credit in the system, and thus having a slowing effect on the economy.

In 2022, all financial asset classes posted negative returns with the exception of cash. In that type of environment, the benefits we seek from diversification break down. While we had some positions that performed well last year, most suffered along with the rest of the financial markets. In the first quarter, all financial asset classes had positive returns and our portfolio also reaped the benefits. In many cases, we took advantage of the increase in interest rates and purchased a US Treasury Bond and a two-year and three-year CD, which allowed us to lock in a 4.9% - 5.25% annualized return assuming they are held to maturity. We reduced our real estate exposure after several years of strong performance. We use real estate primarily as an alternative to the low risk (bond) asset class and over the past three years it outperformed the US Aggregate Bond index by about 37%. In the alternatives asset class, the Invenomic fund provided strong diversification benefits as it was up 49.5% last year and was up an additional 11.4% in the first quarter. On the equity side of the portfolio, we have tried to keep roughly equally weighted to value and growth but have gone up in quality over the past 18 months.

We are excited to be presenting to you this quarterly report that was generated using our new portfolio accounting system. We designed your report so the data being displayed matches the reports you are used to, but the formatting is a bit different. Eventually, all our technology systems will be integrated into this one platform, which should increase efficiency and help elevate the client experience. We know change can be challenging, so we ask for your cooperation and patience as we fully integrate the software into our business.

Please know we are here to help during this time of uncertainty and are available to answer any questions or concerns you may have.

All our best,

Michael, Michelle Jolie, Nina

The Management Team

Michael, Michelle, Jolie and Nina

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