MARKET COMMENTARY

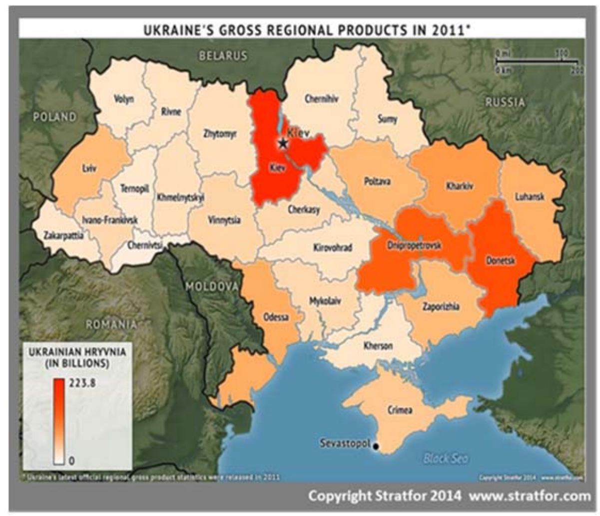
INSIGHTS FROM THRIVENT ASSET MANAGEMENT

Shadows of the Cold War and other Distractions

By Russell Swansen, Chief Investment Officer

There are plenty of distractions in the headlines these days. Don't let them overshadow developments that have more immediate consequences for investors.

The first case in point is Crimea, a smallish (population 2 million) autonomous republic of Ukraine that Russia seems intent on annexing. The financial markets dislike violent geopolitical conflict, and the prospect of violence in Crimea sparked a brief drop in stock prices in late February and early March. But neither Crimea nor Ukraine are economically significant enough, by themselves, to matter much to the markets over the long run. Furthermore, the issue in Crimea is not as black and white as news reports and political rhetoric suggest. During the Soviet era, Russia and Ukraine were very close, and in 1954 Russia gave Crimea to Ukraine. Most of Crimea's citizens remain Russian speakers. Not only is this not a terribly significant conflict from a market perspective, it also is but one of many recently between Russia and the Western democracies. Others have included Georgia, Syria, Edward Snowden, and Russia's support of Iran and North Korea.



The real story here, which is not new, is the ongoing conflict between Russia and the West, which is unlikely to be resolved soon despite Russia's limited bargaining position. It is difficult to appreciate how far Russia has fallen since it enjoyed superpower status during the Cold War era. Russia is now considered an emerging market, among the likes of Brazil, India, and China. It has serious economic challenges, including a below-replacement rate of births and severe chemical-dependency problems among its population. Some analysts project that Russia will soon be challenged to field an adequate military, which may explain some of its behavior.

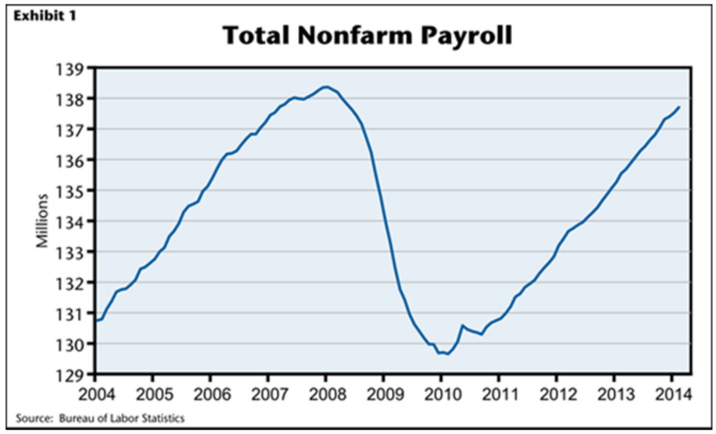
Also of little consequence to the financial markets right now is the president's 2015 budget, released by the White House last week. In years past I have analyzed the president's budget as a relevant part of the budget debates, but budgeting is dominated by Congress, which reached a two-year spending agreement last year. That makes the recent White House document essentially irrelevant except as a political statement.

Of much more importance are recent economic reports which indicate that for all the noise that's being generated overseas and in Washington, the U.S. economy may have come through a surprisingly harsh winter better than it seemed just a few weeks ago.

Labor Report

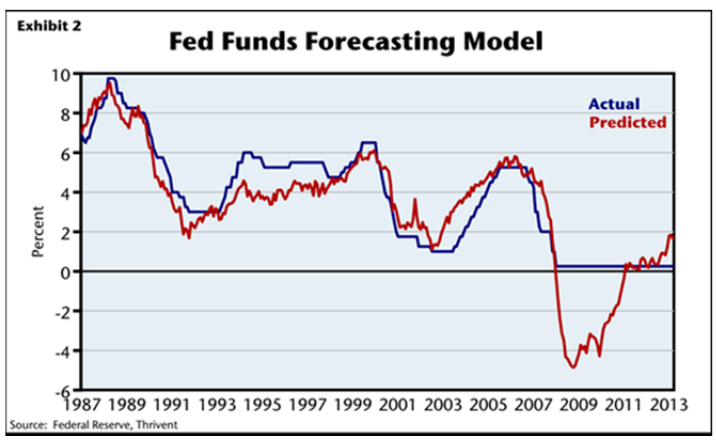
There is a mini housing boom going on in my neighborhood. From my front yard I can see four houses being built, and I drive by a fifth a few blocks away before getting on the highway for my morning commute. These projects illustrate the effect that weather can have on economic activity. When the weather is good, construction crews are on the job site as I leave for work. But this has been an especially cold winter in Minnesota, with more than 50 days of below-zero temperatures. You have to go back 36 years to find a winter that cold, and back to the 1880s to find a colder one. Many days I did not see anyone on the job sites, and a neighbor who is one of the general contractors told me it had been so cold that nail guns and other equipment stopped working.

That is not weather conducive to economic growth. Many other parts of the country have endured colder-than-normal temperatures this winter, too, often accompanied by above-average snowfall. In light of how bad the weather has been, the latest jobs report from the Bureau of Labor Statistics was better than expected. It showed that nonfarm payrolls grew by 175,000 in February, compared to the relatively anemic rates of 84,000 and 129,000 in December and January. By comparison, job growth averaged 204,000 per month for the first eleven months of 2013.

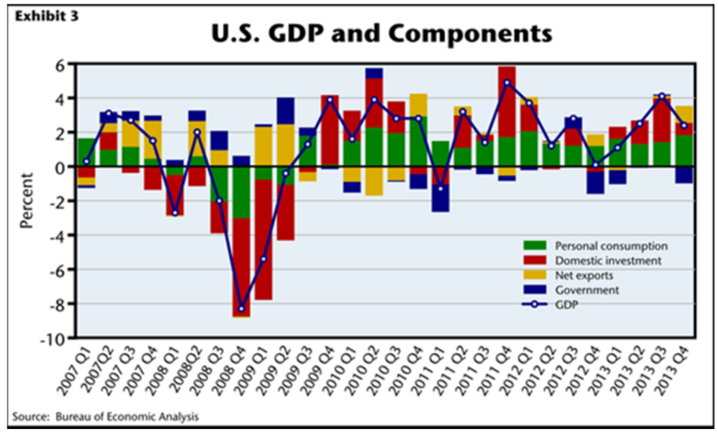


The unemployment rate ticked up to 6.7% from 6.6% in February, almost entirely due to people entering the workforce. While it is not encouraging to see the unemployment rate go up, bringing more people into the workforce is ultimately a good development. Remember, too, that all of these labor statistics are estimates with wide margins of error.

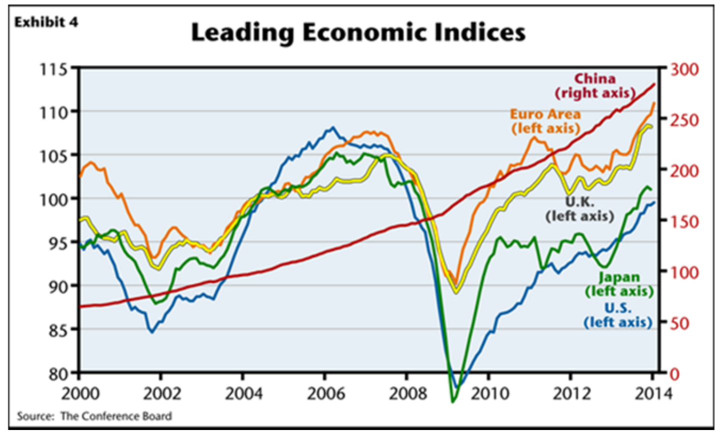
There was nothing in the labor report that would suggest the Federal Reserve will change the course of monetary policy. I expect the Fed to continue trimming its program of making monthly bond purchases—commonly called quantitative easing or QE—and have it wrapped up by the end of the year. While QE seeks to keep a lid on long-term interest rates, the Fed also has been holding short-term interest rates at extraordinarily low levels. It has done this by keeping its target for the federal funds rate—the rate at which banks borrow from each other overnight—near 0% for more than five years. An interesting debate is now starting to develop over when the Fed might begin to raise short-term rates. Our model of Fed behavior suggests that the Fed would normally be targeting a fed funds rate of 2% when inflation and unemployment are at their current levels. (See exhibit 2). Nevertheless, we do not expect the Fed to push short-term rates higher soon.



Real Gross Domestic Product (Real GDP)
At the end of January, the Bureau of Economic Analysis estimated that GDP had grown 3.2% in the fourth quarter. That seemed strong compared to the economy's average quarterly growth rate of 2.2% over the prior three years. As I noted at the time, these statistics are regularly revised, and at the end of February the fourth-quarter estimate was revised down to 2.4%.



Leading Indicators
The Leading Economic Indices reported by the Conference Board for the U.S., Europe, and China continued to rise in the latest reports, while the indices for Japan and the U.K. ticked down. A Conference Board economist observed that, "The U.S. Leading Economic Index continues to fluctuate on a monthly basis, but the six-month average growth rate has been relatively stable in recent months, which suggests that the economy will remain resilient in the first half of 2014 and underlying economic conditions should continue to improve. . ."



Notwithstanding the Conference Board's opinion, my expectations for growth in the U.S. have moderated slightly. I had previously reported that our forecasting model suggested GDP would grow at a 2 percent to 3 percent annual rate over the next several months. I now expect it to be closer to 2%, or about equal to the average of the last few years.

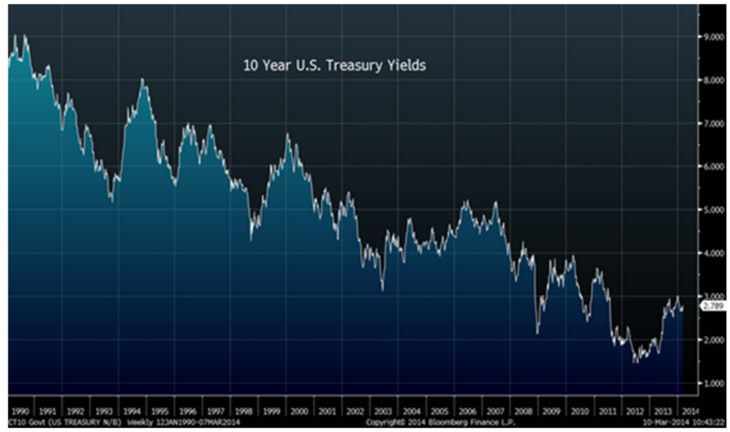
We also expect growth in Europe and the U.K. to continue to improve to a 1% to 2% rate, following the shallow but extended recession in Europe and barely more than 0% growth in the U.K. over the last couple of years.

Japan's economy also has struggled in recent years, and that country is now trying to stimulate its economy through an aggressive mix of monetary and fiscal policies frequently referred to as Abenomics, after Prime Minister Shinzo Abe. While indicators suggest modest economic growth in the near term, I remain very skeptical of Japan's outlook due to extreme demographic headwinds and massive government debt.

Data from China are always suspect, but what we have indicates a steady growth rate of around 7% in the world's second-largest economy.

The Bottom Line

Almost nothing has changed in the outlook for monetary policy and economic growth. We expect the Fed to continue to slowly wind down its quantitative easing program amid modest economic growth in the U.S. and most other significant economies.



While that is generally encouraging, it is increasingly difficult to find any asset classes that seem like bargains. In the bond market, for example, it is hard to get excited about 10-year Treasury notes yielding 2.8% when inflation expectations are 2% and the Fed is pulling back from its extraordinary monetary policy. Meanwhile, stocks in the S&P 500 index are trading on average at about 17 times their per-share earnings, a price-to-earnings ratio that is not extreme but does lean to the full side. Corporate earnings will have to continue growing to justify current valuations, and so far they have been doing just that—but on modest sales increases. With nearly all the companies in the S&P 500 reporting fourth-quarter results, earnings were up 8.4% collectively while sales rose less than 1%. If financial companies, which are arguably distorting the statistics, are excluded, earnings grew a more modest 5% on sales growth of 2%.

We continue to prefer large-company stocks with global businesses over stocks of small and mid-sized companies and large European stocks over domestic stocks. Small and mid-sized domestic stocks have outperformed their larger counterparts over the last couple of years, but their valuations now seem high relative to the valuations of large companies. We expect large European companies to perform relatively well as Europe recovers from its recent shallow but prolonged recession. The higher dividend yields available on European stocks will provide a small tailwind to performance. The dividend yield on the Euro Stoxx 50 index is 3.48%, for example, compared to 1.93% for the S&P 500.

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