MARKET COMMENTARY

INSIGHTS FROM THRIVENT ASSET MANAGEMENT

Things That Matter and Things That Don't

By Russell Swansen, Chief Investment Officer

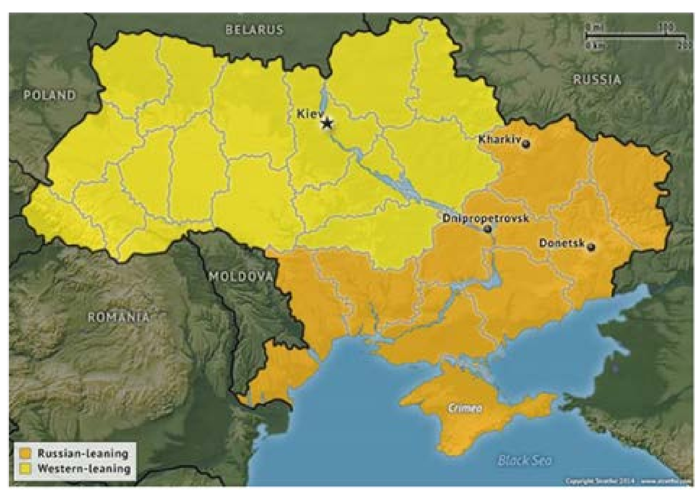
One of the challenges for investors is deciding which developments are important to the financial markets and which are not. Let us take a closer look at three issues in the news lately — the crisis in the Ukraine, U.S. monetary policy, and leading economic indicators — to see which really matter to the investment outlook and why.

Russia and the West

I wrote last month that the Russian-engineered conflict in Ukraine was of little economic or market importance. That continues to be my view. Nevertheless, I thought I might add a little more insight, and note where Russia's obstruction of Western interests actually could be significant.

Russia's leaders view the collapse of the Soviet Union as a catastrophe for which the West, and particularly the United States, is to blame. In economic terms the collapse really was devastating for the Soviet Union, as Russia and the former Soviet states suffered severe economic decline for a decade afterward. It is only in recent years that they have begun to make progress in rebuilding their economies.

Eastern Ukraine Leans Russian

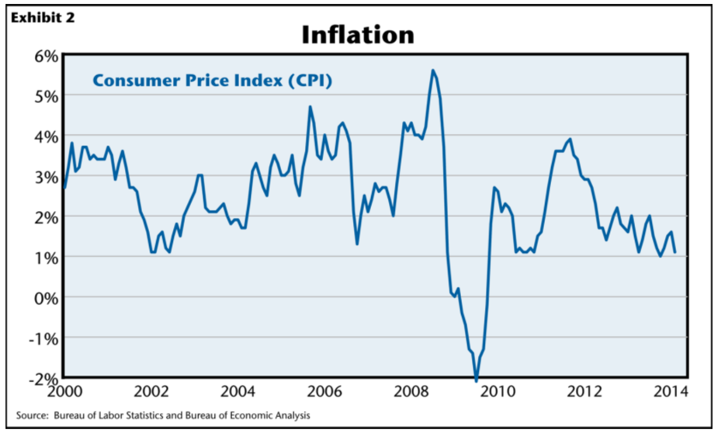


In geopolitical terms, Russia views itself as a counterbalance to the U.S., and believes that it has "privileged interests" in areas of the former Soviet Union. This explains its behavior toward Ukraine, whose Eastern half is home to a heavy concentration of Russian speakers who wish to maintain economic ties to Russia. The western half of the country leans toward joining the European Union, however, which suggests that civil unrest within Ukraine is likely to continue.

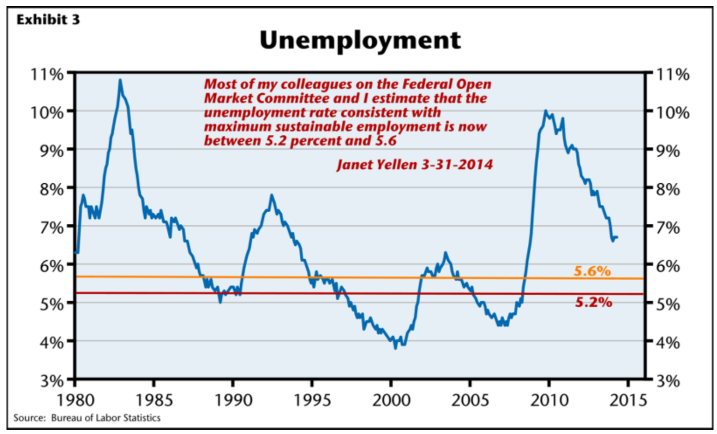
While Ukraine has little economic significance, there are areas and issues where Russia could, and perhaps likely will, obstruct Western interests. The most significant in the near-term is Iran and its nuclear program. Iran is important not only because of the threat of nuclear proliferation, but also because of its potential to block the Strait of Hormuz, through which about half of OPEC oil passes. If Iran, with tacit Russian support, were to block that body of water, the resulting energy shocks could affect global economics and markets.

U.S. Monetary Policy

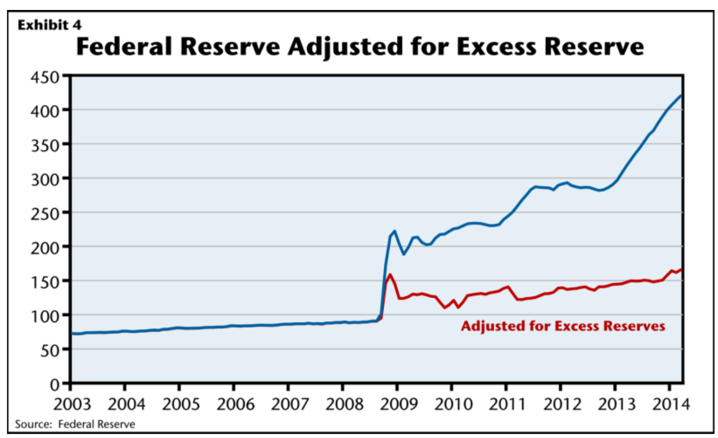
Back in the U.S., investors have been carefully watching for any sign of change in Federal Reserve monetary policy since February, when Janet Yellen took over for Ben Bernanke as Fed chair. Fed policy matters immensely to the economy and the financial markets. So far it has remained on the track forged by Bernanke as economic fundamentals have unfolded about as expected. Although the *unemployment rate has continued to trend lower* — it stood at 6.7% in March — the labor market remains weaker than that number would suggest. Meanwhile, inflation has remained below the Fed's target of 2%. All this has tempered concerns that the Fed may need to raise interest rates anytime soon.



Yellen did provide one new policy insight recently when she revealed in a speech that most members of the Fed's Federal Open Market Committee believed that the full-employment rate of unemployment — essentially, an acceptable rate of unemployment at which those who are not working are just temporarily between jobs — is now between 5.2% and 5.6%. You may recall Bernanke had previously targeted 6.5% as a full-employment milepost. If unemployment continues on the downward trend line established over the last few years it will reach 5.6% in late 2015. Against this backdrop, data released by the FOMC show that its members do not expect it will be appropriate to increase short-term interest rates this year. Their median expectation is for short-term rates of 1% in 2015 and 2% in 2016, levels that are just a smidge higher than their median expectations when polled last November. There is no change to their expectation of 4% short-term rates in the longer run.



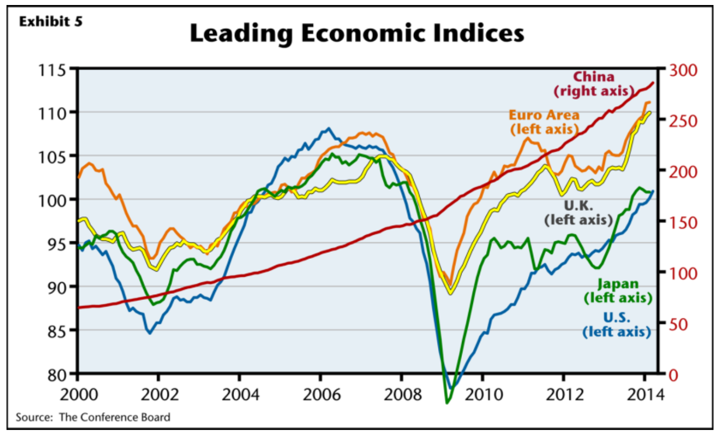
A key concern for Fed watchers is how the Fed's so-called "tapering" program will play out, and whether the Fed will accelerate or decelerate that process. Tapering refers to the Fed's phasing out of its securities-purchase or "quantitative easing" program, which it has been using to inject liquidity, or money, into the financial system and hence promote economic growth. I expect the Fed will continue to wind it down, completing the process by year-end. The bigger question is when and how it will unwind the massive holdings it has accumulated. Although the Fed has pumped huge amounts of money into the financial system through its security purchases, a very large percentage of that money has been deposited right back with the Fed, where it now counts as excess reserves on the Fed's balance sheet. The risk is that if banks reclaim those reserves to boost their lending activities too quickly, the rush of reserves back into the financial system could ignite inflation. Exhibit 4 shows the growth in the Fed's balance sheet since 2008 and how much smaller it would be without those excess reserves.



Some investors also are concerned that the Fed will drive up intermediate- and long-term interest rates if, in its bid to withdraw liquidity from the financial system, it sells off its securities portfolio too quickly. The Fed actually has a variety of ways to drain liquidity while minimizing the impact on longer-term rates. One is by using the repurchase agreement or "repo" market, a large and well-developed part of the short-term money market that is used primarily by money market funds and other institutional investors. A "repo" is basically a short-term investment collateralized with securities; it allows institutional investors to invest their cash for short periods of time with little risk. The Fed is prepared to take the other side of those trades, using its securities as collateral to borrow money which it will just hold. That will take liquidity out of the short end of the credit markets rather than the intermediate or long sectors.

Leading Indicators

The Leading Economic Indices reported by The Conference Board are important indicators of economic health around the globe. In the U.S., the U.K., Europe and China they have been rising. In Japan they have shown some weakness.



In the U.S., the LEI rose sharply in March for a second consecutive month, marking the third consecutive monthly gain overall. "After a winter pause, the leading indicators are gaining momentum and economic growth is gaining traction," Conference Board economists reported. "And, for the first time in many months, the consumer outlook is much less negative. The March increase in the LEI suggests accelerated growth for the remainder of the spring and the summer."

My views on economic growth have not changed. I continue to expect growth in the U.S. to be near 2% this year, about equal to the average of the last few years. I expect growth in Europe and the U.K. to continue to improve to 1% to 2%, following the shallow but extended recession in Europe and barely more than 0% growth in the U.K. over the last couple of years. I remain very skeptical of Japan's future economic growth, despite that country's newly aggressive monetary and fiscal policies, due to extreme demographic headwinds and massive government debt.

China is harder to peg. While data from China are always suspect, what we have indicates an improving outlook. Near-term growth appears to have risen to an 8.5% annual pace from 7% just a month or so ago. Still, we must take all economic information about China with a grain of salt.

The Bottom Line

As I wrote last month, almost nothing has changed in the outlook for monetary policy or economic growth. We expect the Fed to continue the slow winding down of its securities purchases. We anticipate modest economic growth in the U.S. and most other significant economies.

In the financial markets, it is increasingly difficult to find any asset classes that seem like bargains, as valuations seem pretty full. The price/earnings ratio on the S&P 500 stock index remains about 17x, for example, which while not extreme does lean to the full side. Still, corporate earnings have continued to advance even as sales increases have been modest. With about half of earnings reports in, profits for the S&P 500 companies were up 6.1% in the first quarter on sales growth of 3.9%. Excluding financial companies, earnings were up 6.4% on sales growth of 5.0%.

We continue to prefer stocks of large companies with global businesses over shares of small and mid-sized companies, and stocks of large European companies over their domestic counterparts. Shares of small and mid-sized domestic companies have outperformed shares of large companies over the last couple of years, but their valuations now seem high relative to those of large-company shares. We expect stocks of large European companies to perform relatively well as Europe recovers from its recent shallow but prolonged recession, with higher dividend rates on European stocks acting as a small tailwind to performance. The dividend on the Euro Stoxx 50 index is 3.37%, compared to 1.95% for the S&P 500.

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