MARKET COMMENTARY

INSIGHTS FROM THRIVENT ASSET MANAGEMENT

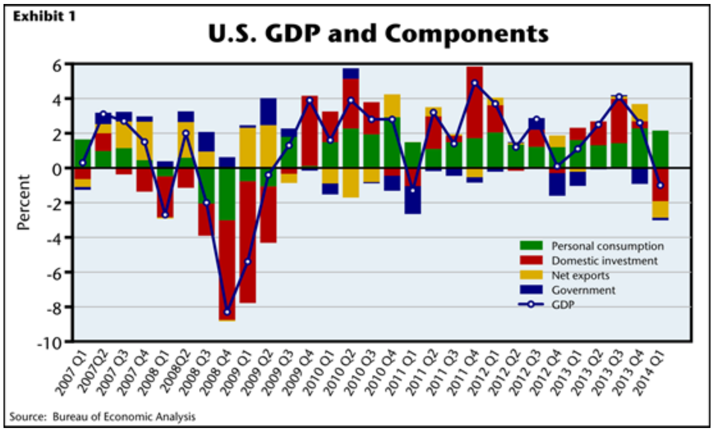
The European Central Bank Experiments with Negative Interest Rates, and other News
By Russell Swansen, Chief Investment Officer

Six years have passed since the 2008 credit crisis, yet much of the world is still grappling with the fallout.

In Europe, whose economy has been recovering even slower than ours, the European Central Bank last week took the unusual step of establishing a negative rate of interest for banks depositing money with ECB. Its goal is to encourage banks to make business loans rather than deposit their reserves, but it will be interesting to see how the situation plays out. Banks could merely pass the cost on to their depositors or hold onto their cash. In the end, I expect the move will be more helpful to financial assets, such as stocks, than to the general economy.

Economic Growth
Europe is not alone in struggling to regain its economic footing. In the U.S., the Bureau of Economic Analysis reported last month that U.S. gross domestic product did not grow at an annual rate of 0.1% in the first quarter as originally estimated, but actually contracted at a rate of 1.0%. To its credit, the stock market did not skip a beat. The entire change in GDP could be attributed to a decline in inventories, which can be volatile from one period to the next. Still, if consumption is strong — it makes up about 70% of the economy — inventories will later follow. The BEA said consumption rose at a 3.1% rate in the first quarter, up slightly from its original estimate. Given that, I would argue that the economy was stronger in the first quarter than the headline number suggested, and that the positive market reaction was not surprising.

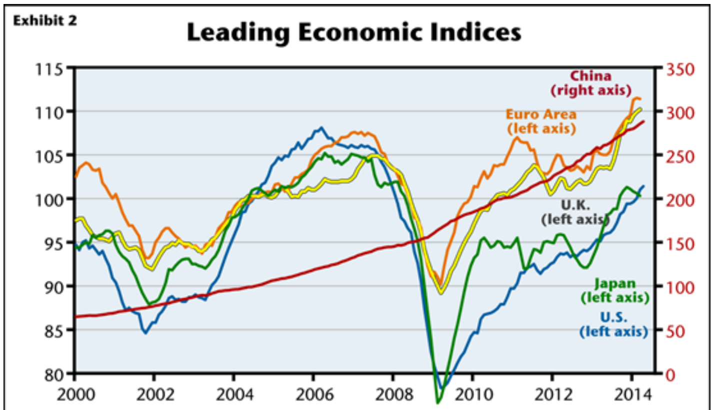
Exhibit 1



Source: Bureau of Economic Analysis

Leading Economic Indices
The Leading Economic Indices for the U.S., the U.K., and China continue to improve, according to the latest reports from The Conference Board, while Europe's index has weakened slightly and Japan's index has fallen for four straight months.

Exhibit 2



Source: The Conference Board

Conference Board economists said the numbers for the U.S. suggest our economy will continue to expand and may even accelerate through the second half of this year. "Despite a brutal winter which brought the economy to a halt, the overall trend in the leading economic index has remained positive," the economists said. "If consumers continue to spend, and businesses pick up the pace of investment, the industrial core of the economy will benefit and GDP growth could move closer towards the 3% range." I am a shade less sanguine. Our models suggest the U.S. economy will grow at a 2% to 3% rate near-term, roughly in line with what we have averaged over the past few years.

Meanwhile, I expect the U.K. to grow at about a 2% rate over the next several months, consistent with what Conference Board economists anticipate. I expect roughly the same from Europe's economy, despite the observation from Conference Board economists that "April's slight decline in the Leading Economic Index suggests that a considerable acceleration in the recovery of the Euro Area economy is unlikely in the months ahead."

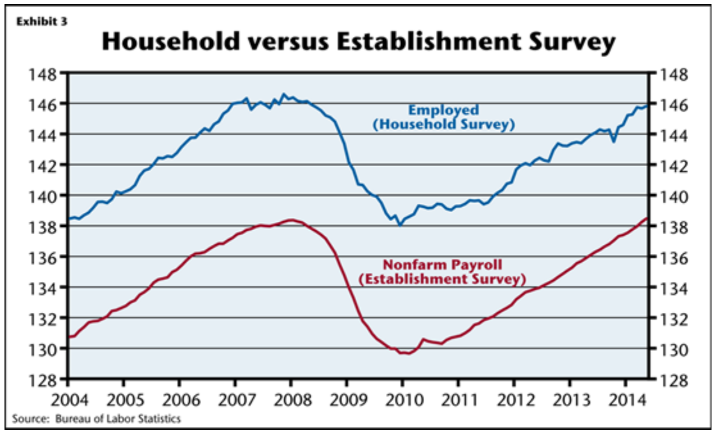
While the LEI for China rose in April, The Conference Board was tempered in its response to that improvement, too, calling the rise "subdued." With industrial activity and retail sales running at their lowest levels since 2004, Conference Board economists said, the slower trend of economic growth in China will likely continue at least into the third quarter. Near-term, I expect China to grow at about a 7% rate. While that may seem high compared to what western economies are doing it is low for China, which grew at about a 10% rate in 2004 and continued to expand at a double-digit pace for the next few years. Even at the bottom of the 2008/2009 economic downturn, China's growth rate only fell to 6%.

Japan has adopted a monetary policy that is extraordinarily aggressive compared to what even the U.S. is doing. Still, it continues to have modest economic prospects. Our models suggest Japan will grow at about a 2% pace in the near term. However, the country's excessive government debt and aging workforce leave me more pessimistic about the longer-term outlook. Sales of adult diapers reportedly surpassed sales of baby diapers in Japan this year.

Labor Report

Back in the U.S., labor news continues to be mixed despite years of economic recovery. The Bureau of Labor Statistics reported that nonfarm payrolls grew by 217,000 in May, finally pushing the total number of jobs in the country above pre-recession levels. That may sound impressive—and it does mark a milestone—but the luster of the achievement pales when you consider that it has been five years since the recession started, and that over that period our population grew 6.5%. Also, at least one other measure of employment—the "Employed" figure taken from a separate BLS survey—has yet to regain its pre-recession peak. (Employed is similar to but more comprehensive than the more widely reported nonfarm payroll measure, in part because the Employed include the self-employed. As you can see in Exhibit 3, the two measures do tend to move together over time.) Yet another employment measure — the number of people working part-time who would like to work full-time — also indicates that the labor market remains soft.

Exhibit 3



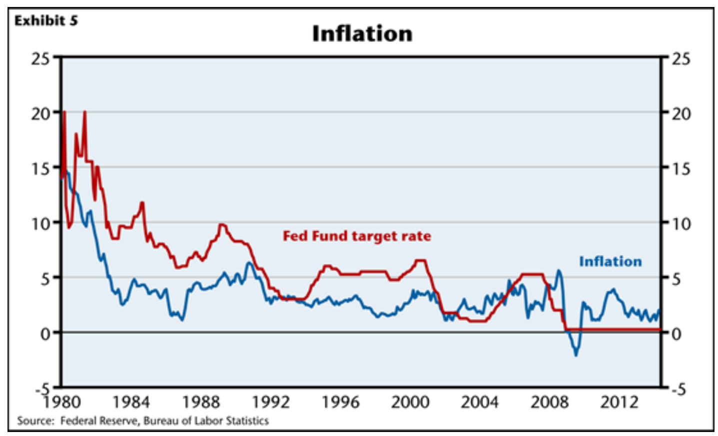
Source: Bureau of Labor Statistics

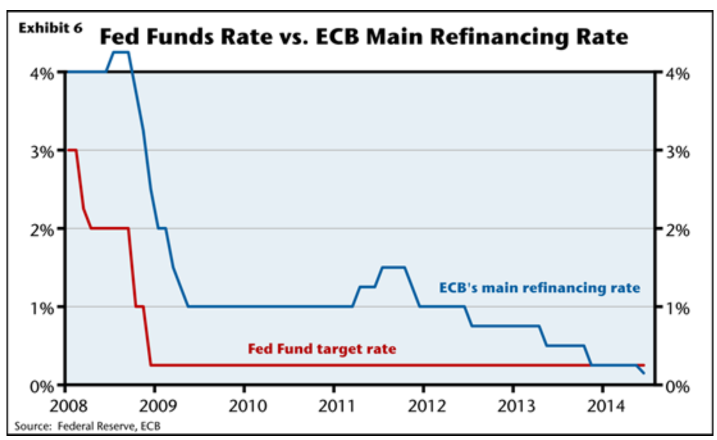
The unemployment rate held steady at 6.3% in April despite the creation of 217,000 new jobs, as the number of people entering the workforce roughly matched the number that found jobs. Although it has a negative effect on the unemployment rate, having people enter the workforce is a good sign for the economy.

Monetary Policy

An interesting debate has begun among officials at the U.S. Federal Reserve, which is charged with the dual mandate of achieving full employment (that means low, not zero, unemployment) while also ensuring price stability (a low and stable rate of inflation). Inflation has been averaging just 1.4% over the last year, comfortably below the Fed's target of 2%, while employment seems to have improved only begrudgingly. Some Fed officials are now arguing that as long as employment remains soft, inflation should be allowed to run above the 2% target. Their view may prevail. I believe the Fed will be slow to increase interest rates until the employment situation is much firmer, even if inflation rises above 2%. This may take some investors by surprise.

Once inflation does move higher, it will be interesting to see where the Fed positions short-term interest rates. It has said that when inflation hits 2% it expects the federal funds rate—the rate at which banks borrow from each other overnight—to be 4%. The Fed sets the target for the federal funds rate. From 1980 through 2000 it averaged three percentage points more than the rate of inflation. Since 2000 it has averaged half a percentage point below inflation. (See Exhibit 5) I think a fair question is whether and when the Fed will return to a policy that looks more like the one we had prior to 2001.





Like the Federal Reserve, the European Central Bank also has an inflation target of about 2%. Unlike the Fed, the ECB has only one mandate: price stability. The absence of an employment mandate may explain why the ECB has been less aggressive with monetary policy than the Fed. Despite a double-dip European recession that lasted a couple of years, the ECB has kept short-term rates in Europe above those in the U.S. It also has elected not to copy the Fed's quantitative easing program, which involves buying bonds to help keep longer-term interest rates low. The fact that inflation has been running even lower in Europe than in the U.S., declining recently to just 0.5%, helps to explain the ECB's recent decision to establish a negative interest rate for banks depositing money with it.

The Bottom Line

Despite a contraction in the economy in the first quarter, the U.S. stock market has continued to advance. The S&P 500 Index has risen 5.5% so far this year. Leading indicators suggest continued economic growth in most developed economies. Although I expect the Fed to wind down its quantitative easing program by the end of the year, it is likely to keep short-term interest rates low for perhaps longer than previously expected.

We have favored large European companies for quite some time. Returns on European stocks usually correlate highly with returns on U.S. stocks but have lagged since 2009 as Europe worked through its double-dip recession. As the European Central Bank becomes more accommodative and Europe recovers, we continue to see opportunity in European stocks. This strategy seems to be bearing some fruit. The Euro Stoxx 50 Index of 50 large European stocks has gained 5.83% so far this year.

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