A look ahead: First quarter 2020 outlook

What are some key factors influencing the economy and markets in the coming months?

**Positive trends and reduced uncertainty.**
- Positive trends in employment, inflation and the services sector offset manufacturing weakness.
- A “phase one” agreement on trade and tariffs between the U.S. and China appears in place.
- Recent election results in the U.K. should help clarify Brexit-related uncertainties.

**Interest rates.**
- The Federal Reserve (Fed) has signaled its plan to leave rates unchanged throughout 2020.
- Other central banks are expected to maintain similarly accommodative monetary policies.
- This should result in a slight increase in interest rates and a modest steepening of the yield curve.

**Monetary policy still cautious.**
- We expect growth to stabilize in the early part of 2020 and accelerate in the later half.
- Credit spreads have narrowed, which is consistent with continued growth and low recession risk.
- We expect positive earnings growth but believe market estimates of growth is too high.

Asset allocation views: current outlook

**EQUITY VS. FIXED INCOME**
- We maintain a modest underweighting to our long-term strategic allocation to stocks.
- We expect moderate domestic earnings growth and price multiples to stagnate.
- While interest rates remain low, we expect them to rise slightly, pressuring fixed-income prices.
- Global economic conditions are improving and trade-related uncertainties have declined, but we still feel prudence and tight risk management is appropriate.

**Tactical vs. strategic position**

<table>
<thead>
<tr>
<th>Position</th>
<th>Total equity</th>
<th>Total fixed-income</th>
<th>U.S.</th>
<th>International</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tactical</td>
<td>-</td>
<td>-</td>
<td>+</td>
<td>+</td>
</tr>
</tbody>
</table>

**Equities**
- We recently resumed increasing our international exposures.
- We expect U.S. equity markets to generate positive returns, moderate earnings growth and high valuations suggest a lower ceiling than international markets.
- Equities overseas are generally less expensive, have similar or greater profitability upside and are more levered to improving global growth and trade resolutions.
Asset allocation views: current outlook (cont’d)

### Equities (cont’d)

<table>
<thead>
<tr>
<th>MARKET CAP</th>
<th>Tactical vs. strategic position</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lg. cap</td>
<td>![Lg. cap diagram]</td>
</tr>
<tr>
<td>Mid/sm. cap</td>
<td>![Mid/sm. cap diagram]</td>
</tr>
</tbody>
</table>

- We remain overweight to large caps but have continued to reduce the magnitude.
- We remain cautious toward small caps due to their historically higher leverage and inferior profitability trends.
- However, the valuation gap between larger and smaller stocks is significant enough that we are looking for opportunities to reduce the small cap underweight further.

### Fixed income

<table>
<thead>
<tr>
<th>DURATION</th>
<th>Exposure relative to strategic targets</th>
</tr>
</thead>
<tbody>
<tr>
<td>Shorter</td>
<td>![Shorter duration diagram]</td>
</tr>
<tr>
<td>Longer</td>
<td>![Longer duration diagram]</td>
</tr>
</tbody>
</table>

- Interest rates increased during the fourth quarter as the Fed moved to a stable interest rate policy.
- Optimism that trade tensions are easing also pushed rates upward.
- We expect longer term interest rates to move slightly upward, but not back to levels seen a year ago.
- We shifted our duration positions from modestly long to modestly short to help protect against rising rates.

- While parts of the yield curve inverted in the third quarter, the yield curve became steeper during the fourth quarter, when longer-term U.S. Treasury rates increased faster than shorter-term rates.
- We expect the steepening trend to continue as long as we don’t start to see a slowing economy.
- During a steepening, the back-end (longer-term) part of the yield curve typically underperforms, so we are underweight longer maturity securities and roughly equal to overweight shorter-maturity securities.

### Credit Quality

<table>
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<tr>
<th>CREDIT QUALITY</th>
<th>![Credit Quality diagram]</th>
</tr>
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</table>

- Corporate credit markets modestly outperformed higher quality fixed-income markets in the face of rising rates and narrowing credit spreads.
- Accommodative monetary policy should continue to support credit-sensitive fixed-income assets while low yields in Treasuries and global fixed-income should also support demand for higher-yielding securities.
- Overall, we are generally neutral on credit, with the supportive environment and demand for yield counterbalanced by higher valuations.
- We would move further to higher quality credit on signs the economy is slowing more significantly.
- We would move to lower quality credit if we see signs of an upturn in global growth and improving valuations.

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