thrivent
Asset Management

Our View

March 31, 2025

A Look Ahead: Q2 2025 Outlook

Our focus remains on the fundamental trends that drive markets, aiming to assess material changes such as tariffs that could alter the long-term outlook for stocks or bonds. We stand by a core tenet that tolerating shorter-term periods of uncertainty and volatility rather than making large changes to investment portfolios in response to short-term data helps avoid the risk of locking in losses by being out of the market for the inevitable rebound in returns.

The U.S. economy has slowed and further weakness is likely. Inflation has been sticky and likely to rise further.

We will closely monitor labor markets and consumer spending for signs of further weakness, as well as signs of margin pressures in U.S. companies that could lead to changes in their behavior, including increased layoffs and declining investment. Likewise, inflation data will remain a critical factor in assessing the outlook for both stock and bond markets, if only to better gauge how the Federal Reserve (Fed) will react to any further slowdown in economic growth.

With a longer-term view, we remain constructive on the outlook for the U.S. economy once uncertainty clears and the ability of the global economy to weather a multitude of surprises.

Asset Allocation Current Outlook

WEIGHTING KEY ● Current quarter ○ Previous quarter (if changed)

Fixed income vs. equity

Historical analysis often provides valuable insights for constructing a plan of action. This is especially true when experiencing extreme events. Accordingly, we have run a series of analyses examining comparable market patterns over the past 75 years.

Our view is that the most likely path going forward involves a period of consolidation after the initial sell-off, followed by a renewed market rally. Though the phase preceding the rally is likely to exhibit significant volatility and extend over several months, price movements generally remain within a reasonably defined range. Further declines can and do occur, but they don't typically result in meaningfully lower levels.

Reducing equity exposure now could prove to be an error over the long term. Consequently, we are actively seeking opportunities to enhance our modest overweight position in equities within allocations.

Weighting

Fixed income ○ ○ ○ ● ○ Equity

Equities: U.S. vs. international

We maintain a preference for domestic over international stocks, with our primary underweight being in Europe followed by emerging markets.

The global trade shock from tariffs could take some of the wind out of the sails of European equities' strong Q1 performance, as the region relies more heavily on exports. New tariffs are immediate while increasing investment will take time to implement, and significant increases in spending are likely contained to Germany within the European Union (EU).

We still believe China faces considerable challenges related to their real estate market, and now a renewed trade war with a country (the United States) that is less dependent on exports for growth.

U.S. ○ ● ○ ○ ○ Int'l

WEIGHTING KEY ● Current quarter ○ Previous quarter (if changed)

Equities: Market cap

Weighting

Large caps ● ● ○ ● ● Small caps

Domestically, we are overweight both large and mid-caps, while being neutral-to-modestly underweight in small caps. 2025 earnings expectations in small caps declined in Q1 (a continuation from last year) to a larger extent than the S&P 500® Index, and the prospects for that trend reversing in the short-term are dim in our view.

Economic growth is likely to disappoint expectations this year which should disproportionately weigh on small cap earnings. Additionally, small caps' ability to adapt to tariffs via passing prices increases to customers, among other measures, is less as compared to large caps.

A shift towards reducing regulation would likely work to offset some of the added relative burden for small caps, but overall scale and higher profitability will continue to advantage large caps.

Fixed income: Duration

Short ● ● ● ● ● Long

The Fed kept the Fed Funds rate steady in the first quarter after cutting the target rate three times in the last four months of 2024, lowering the upper band of the Fed Funds rate to 4.5%.

As a result, we expect the Fed to move cautiously as it assesses the inflationary impact of tariffs potentially offset by slowing growth. As the Fed gets more clarity, we expect around two rate cuts in the second half of the year. However, the Fed may stay on hold longer should higher inflation expectations become embedded.

The Fed would cut its target rate more aggressively should growth slow significantly and recession odds rise. Short-term Treasury rates should be driven by Fed Funds expectations over the next year, while longer-term rates will be driven by growth concerns and flight-to-quality flows offset by selling from international and leveraged investors, large deficits, and inflationary pressures from tariffs.

We are positioned close to neutral in duration with long positions in the short end of the Treasury curve and roughly neutral long-term Treasuries.

Fixed income: Credit quality*

High quality ● ● ● ● ● Low quality

Fixed income credit spreads increased moderately in the first quarter as concerns over economic growth slowing increased and equity markets declined amid greater volatility. Spreads, however, remain below long-term median levels.

Economic growth has been solid, resulting in healthy corporate earnings and balance sheet fundamentals, which support lower spreads levels.

We expect slower growth and sticky inflation but with increasing tail risks of a more meaningful downturn. We also expect defaults to remain at relatively moderate levels. However, the risks are skewed toward episodic volatility and wider spreads with tariffs likely to dampen growth while pushing up prices.

We are positioned roughly neutral credit risk versus our long-term strategy within broad fixed-income portfolios. We favor higher quality fixed income such as investment-grade corporates, securitized credit, and the higher rating tiers of high yield. We also favor high-quality collateralized loan obligations (CLOs) over leveraged loans. Securitized credit such as mortgages also look attractive.

Any indexes mentioned are unmanaged and do not reflect the typical costs of investing. Investors cannot invest directly in an index. The **S&P 500® Index** is a market-cap weighted index that represents the average performance of a group of 500 large-capitalization stocks.

*Credit Quality ratings are determined by credit rating agencies Moody's Investor Services, Inc. or Standard & Poor's Financial Services, LLC.

Past performance is not necessarily indicative of future results. Investing involves risks, including the possible loss of principal.

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