Our View

A look ahead: Second quarter 2021 outlook

March 31, 2021

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

Improving economic conditions

- New metrics tracking mobility of consumers shows activity rising, which is considered a good precursor to stronger economic activity.
- Government policies have provided low-cost capital to corporations, putting both in a position to spend and invest.

Rising interest rates

- Interest rates have been rising in recent months, which is another sign of perceived economic strength.
- With short-term rates anchored at low levels by Federal Reserve (Fed) policy, the yield curve has steepened—historically one of the best indicators of impending economic growth.
- The rising rates and strengthening economy have led markets to rotate away from growth stocks and toward more economically sensitive areas like value and small-cap stocks.

Inflation concerns

- These positive developments have also contributed to growing anxiety around inflation.
- Commodity prices have surged, and housing values have vaulted higher, but we’re yet to see reported inflation statistics rise—they are still around 1.5%.
- Inflation is a lagging indicator, though, and inflation is likely to at least hit the Fed’s long-held target of 2% inflation; the risk is if inflation overshoots well past that mark.

The big picture

- It’s hard to bet against a market supported by sound economic fundamentals, consumers with lots of money to spend, and a government in full out support mode.
- However, rising interest rates, increased inflation concerns and high equity valuations provide some pause.
- A strong economy should help corporate earnings justify the high valuations, but if earnings disappoint, equity markets will likely falter.

Despite all the positives outlined here, we don’t recommend aggressive positioning, rather staying invested with a slightly cautious bent.

Asset allocation views:
current outlook

<table>
<thead>
<tr>
<th>Equity vs. Fixed Income</th>
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<tbody>
<tr>
<td>U.S. economic data continues to improve, unemployment is falling, consumer savings rates and levels are near all-time highs and vaccination rates are strong and accelerating.</td>
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<td>Additionally, the recent passage of a $1.9 trillion spending bill should help juice an already recovering economy.</td>
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<td>All that should lead to strong corporate earnings growth of the next few quarters and strong equity markets, but there are still risks looming that could eventually lead investors out of equities, such as rising rates, a steepening yield curve and possible tax increases.</td>
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Tactical vs. strategic position

<table>
<thead>
<tr>
<th>Total equity</th>
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<tbody>
<tr>
<td>Strategic</td>
</tr>
<tr>
<td>Tactical</td>
</tr>
<tr>
<td>Total fixed-income</td>
</tr>
<tr>
<td>-</td>
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<tr>
<td>+</td>
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Asset allocation views: current outlook (cont.)

### Equities

<table>
<thead>
<tr>
<th>Released</th>
<th>U.S.</th>
<th>International</th>
</tr>
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<tbody>
<tr>
<td>Tactical</td>
<td>+</td>
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**U.S. vs. Int’l**
- Within equity, we continue to favor domestic over international, and within international, we have shifted preferences to developed over emerging markets.
- Emerging markets performed well relative to developed in 2020 but that has begun to reverse itself.
- The accelerating strength of the U.S. economy has led to higher rates and a strengthening dollar, two things that have historically been negatively correlated to emerging markets.

**Market Cap**
- Small caps have outperformed large caps over the past couple of quarters after years of lagging.
- We’ve continued to add to small caps and are now close to neutral.
- There are many positive signs that suggest a continuation of the small cap rally, such as accelerating vaccine rates, improving economic conditions and fiscal and monetary support; but it is possible that the rapid transition to small-cap leadership is nearing its limits and a short-term reversion could be possible.

### Fixed-income

**Duration**
- Medium and long-term rates rose sharply during the quarter amidst signs of economic recovery, increased vaccinations and anticipated increases in government spending.
- That, combined with expectations of higher inflation and more Treasury debt issuance, put upward pressure on interest rates.
- The highly accommodative Fed kept rates from rising even higher, but we expect longer-term interest rates to continue their rising trend.

**Yield Curve**
- The yield curve steepened sharply during the first quarter with short-term rates anchored at low levels by easy Fed policy and long-term rates increasing with signs of economic confidence and expectations of more government spending.
- The spread between 2-year and 10-year Treasuries doubled during the quarter.
- Bond prices fall when interest rates rise, so we are underweight longer-term bonds relative to shorter-term bonds, which works well in periods of steepening.
- However, we continue to look for signs of “Yield Curve Control” from the Fed which would seek to flatten the yield curve to prevent high rates from adversely affecting economic growth.

**Credit Quality**
- Credit markets were mixed for the quarter as spreads were little changed and interest rates rose, negatively impacting more interest-rate sensitive segments like investment-grade corporates and emerging-markets debt.
- We expect a positive backdrop for credit in the next few quarters with increased vaccinations leading to further reopening of the economy, along with continued fiscal and monetary support.
- Higher interest rates will likely dampen total returns, but should also increase yields.
- We currently favor lower-quality segments, like high yield bonds, as the economy should continue to strengthen and they provide higher incremental yields than higher-quality securities.

**Exposure relative to strategic targets**

<table>
<thead>
<tr>
<th>Overweight</th>
<th>Underweight</th>
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<td>1–3 yr.</td>
<td>4–7 yr.</td>
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1Credit 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.

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