A look ahead to the end of 2023

The stress of higher interest rates is beginning to take its toll on the economy. Additionally, surging oil prices, which put upward pressure on inflation, are worrying investors. We expect the economy to continue to slow.

Inflation and the Federal Reserve (Fed) remain the key. We expect that Fed is mostly done with rate hikes, but likely intends to keep rates higher for longer.

We are roughly neutral on U.S. stocks as we see growing headwinds on equities. Caution on equities into 2024 is merited.

Bonds are increasingly attractive. We are still positive on bonds and favor high-quality. We expect the economy will slow in the coming quarters, causing the Fed to pause any further action.

Asset allocation current outlook

Equity vs. fixed income

The hawkish shift depicted by the Fed’s most recent summary of economic projections, along with labor unrest and political uncertainty, have served to elevate anxiety among investors and push the equity market into a tactically oversold condition.

The rapid uptick in longer-term rates represents an additional source of concern, as the relationship to the shorter end of the yield curve has changed.

While much is riding on the tenor and tone of company reporting for Q3, the developing oversold condition, as well as improving seasonality, have enhanced the prospects for a bullish rebuttal to recent pessimism.

Our allocations maintain a small equity overweight and a bias toward adding to that weight, given further weakness.

Equities: U.S. vs. international

We are underweight international primarily in Europe and emerging markets.

We favor domestic over international in the intermediate-to-long term for a variety of reasons including peak globalization, a higher degree of innovation domestically, greater demographic issues internationally, structural issues in Europe, and a more favorable climate for businesses (e.g. regulation) domestically.

Nearer term, while international markets may provide some safety on a relative basis in the event the largest names in the S&P 500® Index give back some of their massive gains year-to-date, this possibility is not compelling enough to reduce our international underweight at this time.
Asset allocation current outlook

Equities: Market cap

While we are overweight both large and small-mid (smid) cap stocks due to our overweight in domestic equity and equity overall, our overweight to smid is concentrated in mid-caps.

The S&P 500 Index has outperformed small and mid-cap indices this year on the backs of the biggest names in the index, where the equal-weighted index has tracked small and mid-cap indices relatively closely.

Longer-term, the growth of private markets and private companies remaining private for much longer, combined with the increased benefits of scale for larger companies, results in our preference for the large cap over the small cap in public markets.

Fixed income: Duration

We expect the Fed to pause rate hikes in the fourth quarter to assess the lagged impact of higher interest rates, which impact the economy with a lag of a year or more.

An additional Fed hike is possible if inflation remains sticky, which would bring the top of the Fed Funds rate range up to 5.75%.

After pausing we expect the Fed to hold rates steady into 2024 but eventually cut rates in response to a slowing economy and lower inflation.

We expect the 10-year/two-year yield curve to continue to steepen over time, which typically happens as the economy nears or goes into an economic slowdown.

Fixed income: Credit quality

Fixed income credit spreads were little changed in the third quarter. Through the rest of the year, we expect credit markets to be increasingly driven by concerns over a slowing economy, tightening financial conditions and the lagged impact of higher interest rates, including the Federal Reserve holding rates higher for longer.

Both investment-grade and high-yield corporate bond credit spreads are below their long-term median and average.

Defaults already have started rising, particularly for leveraged loans, where credit quality has deteriorated. We expect defaults to continue to rise but remain below prior recessionary peaks.

*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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