

Given the sharp decline in the stock market in June and the accompanying volatility, David Francis, Head of Equities, and Mark Simenstad, Head of Fixed Income at Thrivent Asset Management, share their views on the key factors impacting the markets.

Soaring oil prices

Sustained high crude oil prices are a significant risk to the economy. Consumer spending is being crimped as more money is being spent directly in the form of higher gas prices and indirectly via higher prices for food and other manufactured goods. Geopolitical issues and speculators have been blamed for oil prices that seem much higher than underlying fundamentals would suggest.

Outlook: High prices are finally having an impact on consumer behavior in developed economies, with demand falling as prices have increased. Many emerging economies have historically subsidized energy prices, insulating their populations from much of the recent price rise, which delays the demand response. Those subsidies have been reduced which will also reduce growth in oil demand. Nonetheless, energy prices are at levels that if sustained, will likely cause a recession.

Economic growth – is recession in the cards?

The U.S. economy has slowed considerably over the past year. However, we have yet to see a negative gross domestic product (GDP) number for the nation. The second half of 2008 is also unlikely to see negative GDP given the fiscal and monetary stimulus injected into the financial system in the form of lower short-term interest rates and the stimulus checks sent to American taxpayers.

Outlook: To lessen economic risk, we believe that oil prices must decline or at a minimum, stabilize. While certain segments of the economy like auto and housing are definitely experiencing recessionary conditions, export sales, energy and equipment markets as well as the farm economy are strong. The financial markets certainly have performed as if a recession is underway so the issue now is length and severity. Our current view is that the groundwork is in place for modest growth but a healthy financial system and reasonable energy markets are prerequisites.

Inflation

As mentioned above, rising energy prices have spread into higher costs for food and the weakening dollar has made imported goods more expensive. Controlling inflation is a top priority for the Federal Reserve, as it seeks to avoid widespread expectations of a sustained inflationary environment.

Outlook: Slowing economic growth and a pullback in food and energy prices would likely alleviate the building inflationary pressures. Importantly, wage growth remains reasonable for now, suggesting inflation has not become embedded in psychology.

Interest rates

The Federal Reserve Board retained its 2% target for short-term interest rates at its latest meeting, indicating that further stimulus is not likely needed but that its bias was toward higher rates to combat rising inflation. Higher rates would also support the weak U.S. dollar.

Outlook: We agree with the current market consensus that the Fed will remain on hold for the near future but that a move higher could be in the cards if the economy were to strengthen as expected and the fragile credit markets continue to stabilize.

Housing

The downturn in the housing market has weighed heavily on consumers, many of whom no longer have the ability to tap the equity in their homes. Delinquencies and foreclosures are a significant problem. And the spread of the subprime mortgage security fallout through the financial system has been a leading source of concern for investors who worry that the massive write-downs are not close to an end.

Outlook: Asset values typically overshoot on both the upside and downside. So while the rise in housing prices was overdone on the upside, the fall in prices could go too far on the downside as well. Improved affordability via lower interest rates and home prices is a positive, though it will take some time to work through the significant backlog of homes on the market.

Corporate profits

U.S. companies are still making money and, with the exception of financials, auto and some consumer-related sectors, are seeing prospects for decent profit growth. The weakness in the U.S. dollar has been a boon to multinational companies, firms that generate a significant amount of sales overseas.

Outlook: Earnings results will vary greatly by sector, with those that are able to pass on price increases to customers doing better while profits in other sectors will be squeezed. Even though the expectation is for earnings growth to decelerate further, a mid-single digit pace is not all that bad and certainly better than the negative situation suggested by many headlines.

Possible catalysts for better stock market conditions

Although many risks remain in the near term, we could see a lift in the stock market if investors begin to gain some comfort that conditions are likely to improve later in the year and into 2009. Several potential catalysts that would help in this regard include

- ◆ The credit crunch that gripped the financial markets continues to ease
- ◆ Federal Reserve and the U.S. Treasury stimulus works its way through the economy
- ◆ Housing market stabilizes and consumer confidence picks up
- ◆ Energy and food prices ease or at least stop rising sharply
- ◆ Corporate profitability and economic growth rebound
- ◆ Significant capital is available for investment should perceived risks diminish

Bottom line

Despite the large number of issues hanging over the market, we believe that there are reasons for optimism. Equity valuations across most market capitalization ranges have improved substantially and in our opinion have priced in an economic downturn worse than that which will likely be experienced. There also seems to be an above average amount of fear and trepidation, with buyers less willing to step in during market weakness. In past downturns, markets have often put in a bottom when investors lose hope of a market recovery and finally capitulate. Investors also need to remember periods of volatility and uncertainty are a normal part of stock market investing.

While the markets could remain volatile in the near term, we would encourage investors to have the fortitude to stay in the markets. When they rebound, stocks typically tend to move quite quickly. Stock markets often anticipate changes in the fundamental economic news by approximately six months, so being in the market is key to participating in its eventual recovery. While diversification across various asset classes and market capitalizations cannot prevent losses, it can help cushion downturns and help investors avoid making decisions that could jeopardize their long-term investment programs.

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