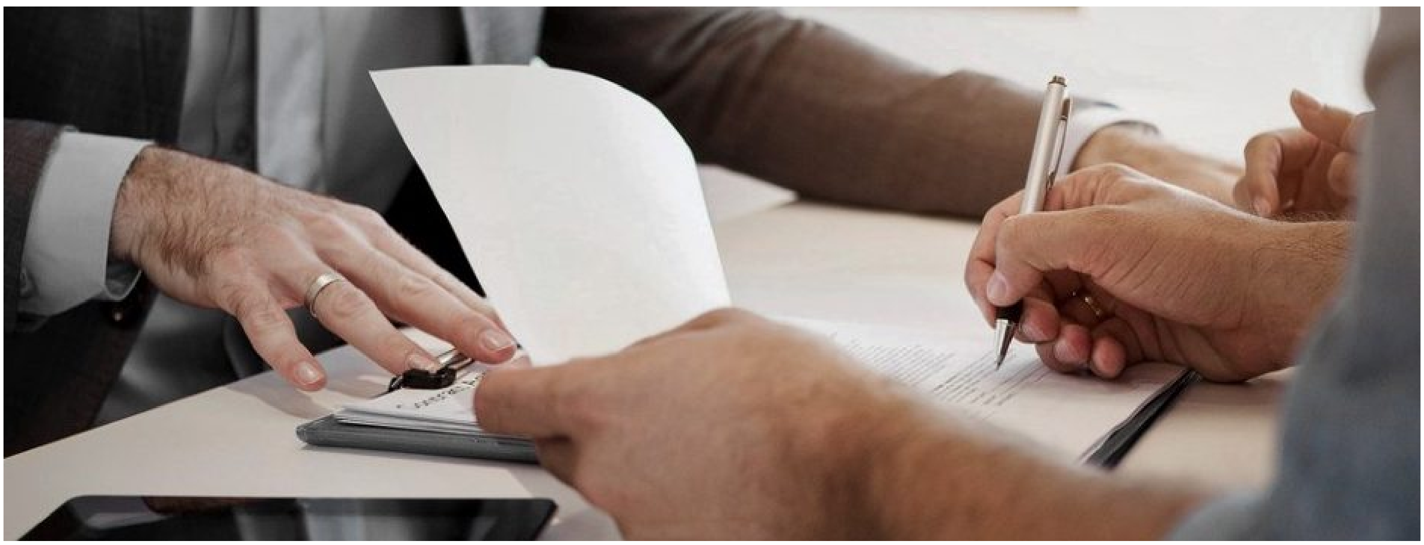
Read Thrivent Asset Management's views on the latest market volatility

MARKET UPDATES

Where to turn as inflation and interest rates rise

By Gene Walden, Senior Finance Editor | 02/22/2022



With inflation spiking and interest rates rising, David Royal, Thrivent Chief Investment Officer, and Steve Lowe, Chief Investment Strategist, recently tackled some of the key questions facing the market during this turbulent time.

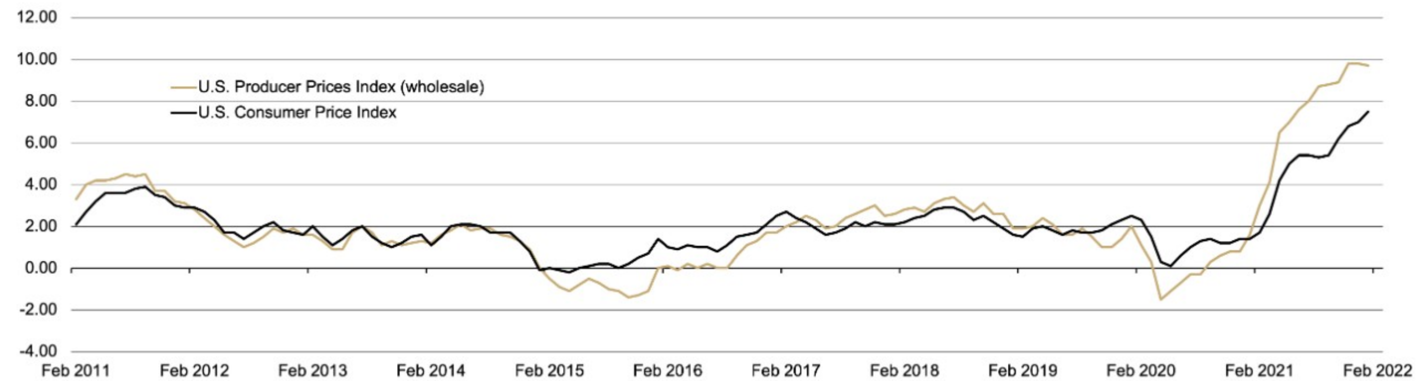
Inflation has jumped to the highest levels since the early 1980s, roiling markets and hitting consumers' pocket books.

"After being dormant for years, inflation has really surged," explained Lowe. "But the Fed really struggled to recognize the persistency of inflation, and now they find themselves behind the curve. As a result, they have to play catchup, which means they have to raise rates relatively quickly.

That has left the markets struggling to forecast how the steepest and quickest hike cycle since the 1990s will affect the markets."

Wholesale & consumer inflation

February 1, 2011 – January 31, 2022



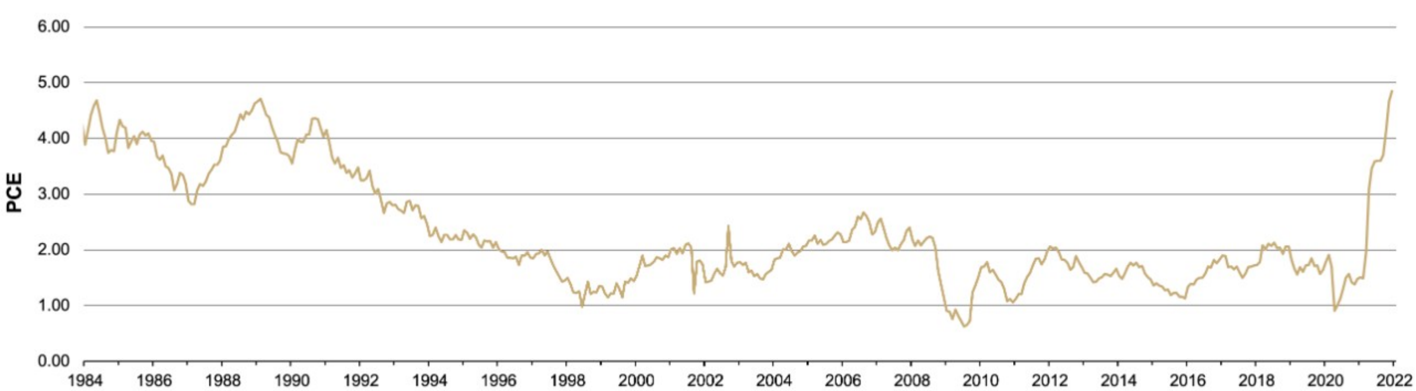
Source: Bureau of Labor Statistics

Lowe added that inflation "was fueled by the growing demand for goods, like technology, cars, and houses, and then we had shortages disrupt supply chains, which created a perfect storm of inflation. Recently we've seen it seep into other areas like wages, which is a little more concerning and one of the drivers of persistent inflation."

The Producer Price Index (PPI), which is commonly used as an inflation gauge, has been running between 9 and 10%, while consumer inflation has risen by about 7% over the past year, driven by strong demand, goods shortages, and rising commodity prices, such as gasoline. The rise in prices not only affects consumers, but it impacts corporate earnings, as well.

Inflation – U.S. Core PCE (Personal Consumption Expenditures)

January 1, 1984 – December 31, 2021



Source: Bureau of Economic Analysis

"If a company is paying higher prices, they have one of two options," explained Lowe. "They can either pass it along to the consumer – which is by and large what is happening – or they can absorb the higher prices. But that erodes margins for companies and ultimately impacts earnings. Our expectation is that margins will generally hold up but may drop off a little bit."

Lowe said that inflation becomes more dangerous when people start to expect it to continue and change behaviors, which may start a cycle of inflation. "Our view is that it will stay higher than it has in the past but will start to ease as supply chains unclog, which could be a year-long process. The market expects that the Fed will be successful at dampening inflation and that supply chain shortages will ultimately ease, and demand will also decline."

Worker shortage

With 11 million job openings but only seven million unemployed people in the work force, the current labor shortage has increased wage pressure, which translates into inflationary pressure.

"A lot of people left the labor force during the pandemic for a variety of reasons, along with this massive wave of retirement," explained Lowe. "This labor shortage is concerning for the Fed because what you don't want is a wage-price spiral. You don't want inflation embedded into wages to start a cycle of price inflation. I think this will ease over time as people come back to work, which we've seen in recent jobs reports. As more people return to work, that should ease wage pressures."

About half of the states in the U.S. have raised their minimum wage in the past year, which could potentially drive further inflation, although a higher minimum wage may be a moot point in many cases since companies have had to raise wages to attract workers.

"I think the minimum wage issue is kind of taking care of itself," said Royal, "because you can't find anyone to work for $15 an hour, much less under $15. We did see an increase of about 0.3% in the labor force participation rate, which is good news because the solution to the wage price spiral is to get more people in the work force."

Fed actions

The market anticipates about seven rate hikes this year, beginning in March with at least a quarter point hike. But exactly how fast the Fed raises rates will depend on how the economy is doing.

"One complicating factor this year is that inflation is a huge political issue because of the mid-term elections," explained Royal. "The Fed is not supposed to be subject to political pressure, but they may feel forced to tighten more quickly than they otherwise would because of the political pressure."

"The Fed has two basic tools – rates and the balance sheet," added Lowe. "Through the pandemic they were buying treasuries and mortgages. That's going to end in March. And then they're going to start shrinking their balance sheet – quantitative tightening. That will also work to push up rates."

Globally, there has also been a sea change, with European yields expected to climb from negative rates to positive rates over the next year. "This is a global phenomenon," said Lowe. "Inflation is an even bigger issue outside the U.S. where countries are much more energy-sensitive than we are."

Market volatility

Every recession has been preceded by an inversion of the yield curve (with short term rates moving higher than long term rates) – but not every inversion has led to a recession. While the yield curve has not inverted in the current cycle, that's something economists are watching closely.

"The takeaway is that there is a lot of rate uncertainty and inflation uncertainty that has created volatility in the market," said Lowe, "We had unprecedented monetary and fiscal support, providing a huge tailwind in the market, but that has lessened. With the training wheels coming off, that impacts every market."

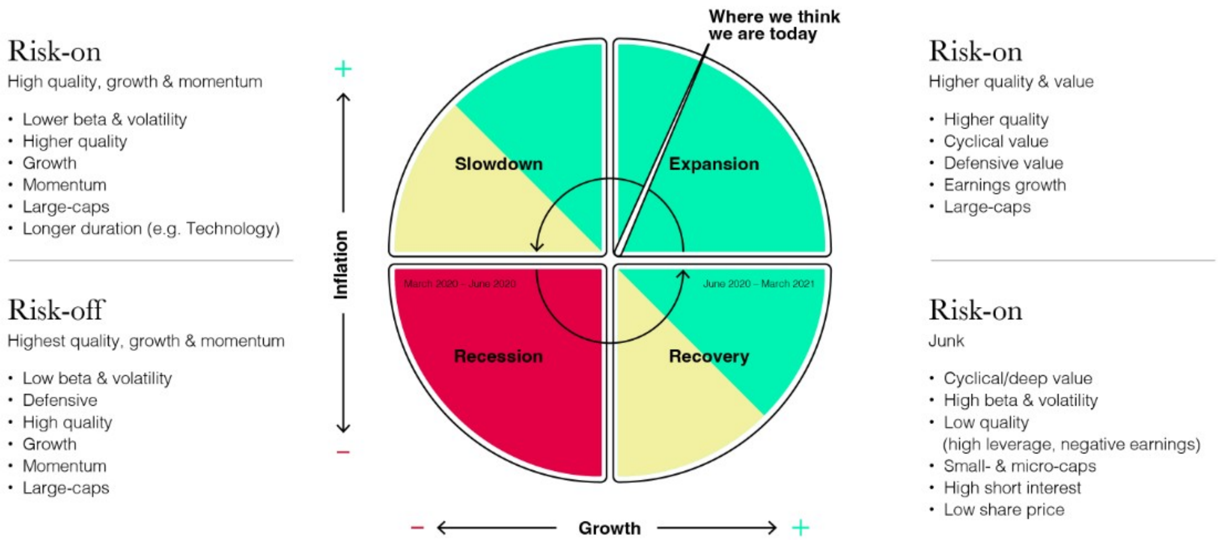
Despite the uncertainty and volatility of the current environment, Lowe doesn't view the market outlook negatively. "Markets can and have performed well during Fed hiking cycles because the Fed is generally hiking when the economy is strong. So, we expect solid returns but more muted than the past two years when we had outstanding returns."

Added Royal: "Since the 1990s, in periods when the Fed is hiking rates, the markets have typically dropped a little bit and then actually outperformed over time. If recent history is any guide, the next six months after a rate hike cycle could be challenging, but long term, it could be a good time to be in equities."

Stock market prospects

Different types of stocks can lead the market during different periods in the economic cycle. "During a recession, you have low growth, low inflation, maybe even deflation," said Royal. "During those times, you want to be in defensive, low beta, low volatility areas, such as large caps, which generally carry less risk and less leverage than small caps.

The economic cycle based on growth & inflation



"As you move into that recovery phase," he added, "it can be a little counterintuitive. The types of stocks that tend to perform well in that phase are the areas that nearly went under a few months earlier – the riskiest stocks, cyclicals, deep value, high beta, low quality companies with high leverage, negative earnings, or poor credit ratings, including small and even micro caps – and we saw that in spades in the first quarter of 2021."

The economy very quickly moved out of that recessionary phase into the recovery period. "The recovery period is when the economy is still growing but growth is decelerating, and inflation is picking up," said Royal. "At that stage of the economy, you may want to be in some higher quality names but still cyclical value, defensive value, and areas with growing earnings. You may also want to move up in market capitalization during this period. As you've seen over the past nine months, small caps haven't done anything."

Entering a slow-down phase, Royal believes investors should move to the higher quality, growth momentum, longer duration segment.

"Think big cap tech. That's where FAANG is really going to shine – moving from value to growth. Right now, the correlation between growth and value is about as low as it ever gets, meaning growth and value are kind of trading back and forth as the market tries to figure out where we are in this expansion. As we see signs of economic slowdown – and we will at some point – that's when you would want to move toward large cap names – like growth and technology. And then to finish the circle, you would want to get a little more defensive as you start to see the economic slowdown progress and perhaps even accelerate."

The recent market sell-off was led by small and mid-cap stocks, many of which dropped 40% or more. "I view periods like this as an opportunity to buy great growth-oriented companies that are going to benefit from the next phase of the cycle because the sell-off was so indiscriminate," said Royal. "The types of quality companies we want to own are those that have little or low profits because they're growing their business and have a good business model that would allow them to switch to profitability almost any time they want."

Where to turn

"The market may decline during a Fed hiking cycle – which usually occurs during a good economy – but those tend to be buying opportunities," said Royal. "The market rarely goes into a severe bear market unless the economy goes into a recession. And there is nothing in the economic data to suggest that we're entering a recession in the next few quarters.

"If the Fed gets more hawkish," he added, "and we see the market sell off as a result, I think we would be adding equity."

But there are also opportunities for income investors. “If you’re worried about the value of the dollar declining due to inflation, the last thing you want to do is hold cash,” cautioned Royal. “If you’re worried about rates going up, we would suggest taking an equal amount of credit risk and interest rate risk. **Thrivent Opportunity Income Plus Fund** (**IIINX**) includes a good deal of floating rate debt—leveraged loans – which tend to generate higher yields as market interest rates rise.”

Another area that Royal believes may also fare well in a rising rate environment would be limited duration bonds, such as those found in **Thrivent Limited Maturity Bond Fund** (**THLIX)**.

Another option that may be well-suited for income investors would be **Thrivent Multidimensional Income Fund** (**TMLDX**). “It has more fixed income alternatives to drive yield, such as closed-end funds, convertibles, and preferred,” explained Royal. “So that would be a nice piece of the puzzle.”

He also suggests considering a moderately conservative allocation fund, such as **Thrivent Diversified Income Plus Fund** (**THYFX**), with about a 20% allocation to equities and a fixed-income allocation that seeks to provide more income than traditional bond funds.

For equity investors in a high inflation environment, Royal suggests investing in a fund such as **Thrivent Large Cap Value Fund** (**TLVIX**), “which holds a large allocation of energy, cyclical, and financial stocks – areas that would benefit from an inflationary environment.”

All information and representations herein are as of 02/22/2022, unless otherwise noted.

The views expressed are as of the date given, may change as market or other conditions change, and may differ from views expressed by other Thrivent Asset Management, LLC associates. Actual investment decisions made by Thrivent Asset Management, LLC will not necessarily reflect the views expressed. This information should not be considered investment advice or a recommendation of any particular security, strategy or product. Investment decisions should always be made based on an investor’s specific financial needs, objectives, goals, time horizon, and risk tolerance.

Past performance is not necessarily indicative of future results.

Related insights

A look inside cryptocurrency's wild ride

Volatility, hype and user growth have pushed cryptocurrency into the limelight. Learn what attributes attract crypto owners and how this currency is used beyond transactions.

06/14/2022

Finding income in the current investment market

Searching for income in today's market environment feels a bit like hunting for that cool oasis of water in a parched desert. It can be difficult to find, but not impossible. Learn more about the right kind of risk.

06/14/2022

JUNE 2022 MARKET UPDATE

Job growth continues despite economic concerns

Although concerns have been growing over the prospects for an economic slowdown, job growth was strong in May, retail sales were solid, and manufacturing activity was steady. Learn the details in Thrivent's June 2022 Market Update.

the details in Thrivent's June 2022 Market Update.

06/07/2022

FUND COMMENTARY [PODCAST]

Rollercoaster markets [PODCAST]

How volatility in the markets and economy is being driven by inflation.

06/07/2022

Asset Management for Financial Professionals

MUTUAL FUNDS

INSIGHTS

RESOURCES

ABOUT

SITE MAP

thrivent®

Mutual Funds for Individual Investors

Financial Professionals

Interval Funds

Managed Accounts

Variable Portfolios

Find a Thrivent financial professional

Thrivent.com

PRIVACY & SECURITY

Call us. We're here to help. **800-521-5308**

Monday through Friday: 8 a.m. to 6 p.m. Central time.

Check the background of Thrivent Distributors, LLC on **FINRA's BrokerCheck**.

Investing involves risks, including the possible loss of principal. The prospectus and summary prospectus contain more complete information on the investment objectives, risks, charges and expenses of the fund, and other information, which investors should read and consider carefully before investing. Prospectuses and summary prospectuses are available at thriventfunds.com or by calling 800-521-5308.

No communication or content, including investment analysis tools and information about the Thrivent mutual funds, on this website is intended to provide investment advice or recommendations of any kind nor is it a solicitation to buy or an offer to sell any security and may not be relied upon as such. The information provided is also not intended as a source for tax, legal or accounting advice. Please consult with a legal and/or tax professional for specific information regarding your individual situation. Thrivent Distributors, LLC has undertaken no review of the individual circumstances of any investor and makes no representations with respect to the suitability of any investment for a particular investor.

The distributor for the Thrivent Mutual Funds is Thrivent Distributors, LLC, a registered broker-dealer, and member **FINRA**/**SIPC**. Any purchase, sale or redemption of the Thrivent Mutual Funds will be executed through Thrivent Financial Investor Services Inc., the transfer agent for the Thrivent Mutual Funds. Asset management services provided by Thrivent Asset Management, LLC, an SEC-registered investment adviser. Thrivent Distributors, LLC, Thrivent Financial Investor Services Inc. and Thrivent Asset Management, LLC are subsidiaries of Thrivent, the marketing name for Thrivent Financial for Lutherans.

The site is intended for financial professional use.