USAA MARKET COMMENTARY — 6/20/18

2018 USAA Midyear Update

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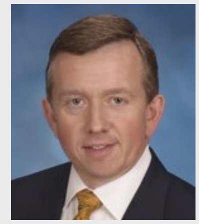


After the Federal Reserve's latest interest rate hike in mid-June, Chairman Jerome Powell boiled the U.S. macro environment down to a mere dozen words: "Growth is strong. Labor markets are strong. Inflation is close to target."

Mr. Powell's observation came as the Fed signaled that two more rate increases may be coming in the second half of 2018, which would bring the total to four for the year. Of course, faster action on rates is far from a lock at this point — it assumes current macro conditions persist and perhaps even pick up speed. That said, while we still think three hikes in 2018 would suffice, it makes sense from a market expectations standpoint for the Fed to give a clear early warning that a fourth increase could be in the works.

A little detail and texture to add to the chairman's spare sentences:

Economy

Not only is the U.S. economy doing well, so are non-U.S. developed market and emerging market economies. Forecasts call for global GDP growth to be in the 3% to 4% range in 2018 and 2019, with a faster pace expected in the emerging world compared to the developed economies (Figure 1). In the U.S., now in its 10th year of economic expansion, interest rates remain low and last year's federal tax cuts have benefited businesses and consumers.

There are, however, a couple of wild cards in the deck: a global trade war is brewing, which would almost certainly crimp growth, as could the price of oil if it rises much above the current $75 range for Brent crude.

KEY TAKEAWAYS

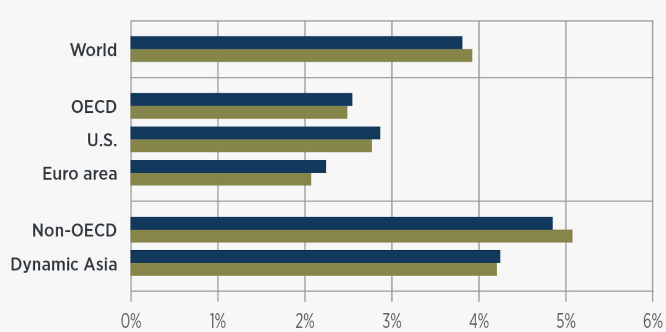
- The U.S. is now in its 10th year of economic expansion, with interest rates and inflation still low and last year's federal tax cuts benefiting businesses and consumers. A couple of wild cards in the deck: a brewing trade war and rising oil prices.
- While we still think three interest rate hikes in 2018 would suffice, it makes sense from a market expectations standpoint for the Fed to give a clear early warning that a fourth increase could be in the works.
- Our overarching outlook is cautious, given economic and geopolitical uncertainties. Our asset-allocation portfolios are neutral across the board: equities (underweight U.S. and overweight non-U.S., based on relative valuation), bonds and commodities.

FIGURE 1

NEAR-TERM GLOBAL GROWTH FORECAST LOOKS SOLID

REAL GDP GROWTH ESTIMATE, 2018-2019

■ 2018 ■ 2019



Note: Dynamic Asia is comprised of Malaysia, Philippines, Singapore, Thailand, Vietnam, Taiwan, Hong Kong

Source: Organization for Economic Cooperation and Development (OECD)

Jobs

Headline unemployment dipped to 3.8% in May, the lowest rate since early 2000, and a broader measure of joblessness that includes underemployed and discouraged workers is also trending downward. The latest numbers show that, for the first time since records have been kept, there are more job openings than unemployed workers. And the Fed predicts unemployment could get down to 3.5%. Wage growth, however, remains surprisingly sluggish given how tight the labor market has gotten. The modest pay bumps have been largely matched by inflation — this stagnation in real wages creates some worries about future cutbacks in consumer spending.

Inflation

Prices rose at a rate of 2.8% in May, the highest monthly move in more than six years. Core inflation (backing out volatile food and energy prices) was 2.2%, and the Fed's preferred measure was a few tenths lower still. Looking out five and even 10 years, the market expects annual inflation to be right around 2% — which also happens to be the Fed's target rate. Chairman Powell and the central bank are trying to strike a critical balance: Keeping the money supply too loose for too long risks a spike in inflation (especially with unemployment so low), while tightening too quickly could choke off economic growth.

As long-term, income-oriented bond investors, we welcome higher interest rates. It's true that rising rates have a negative effect on bond prices, but it's equally true that coupon payments over time account for the lion's share of a fixed income investment's total return.

From an equity perspective, if higher U.S. rates appreciably drive up the dollar, there is a risk that financial conditions may tighten more than global stock markets can handle.

ASSET CLASS OUTLOOK

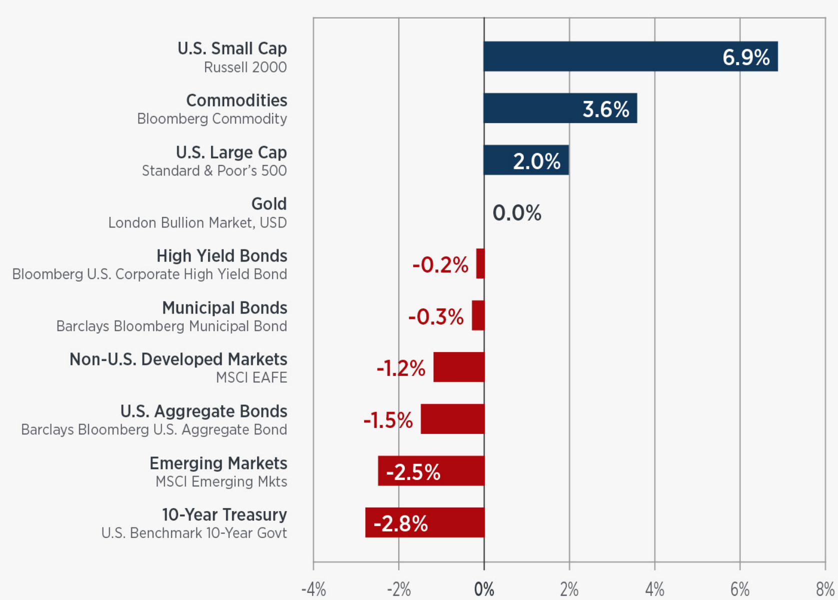
U.S. stocks have been the standout performers in the first half of 2018. Small caps, up nearly 10% year to date through mid-June, have benefited from the corporate tax cuts, trade uncertainties and a strengthening U.S. dollar (+5% between mid-March and mid-June). Double-digit earnings growth and a pickup in revenue growth have been key drivers for large caps, while rising oil and natural gas prices fueled commodities.

Long-dated Treasuries have struggled as rising interest rates — yield on the 10-year note has climbed from 2.4% to nearly 3% this year — have knocked down bond prices. U.S. investment-grade corporate bonds got off to their worst start in years on higher rates that widened spreads.

FIGURE 2

EARLY 2018 FAVORS U.S. EQUITIES, COMMODITIES

YEAR TO DATE PERCENTAGE RETURN



Note: Equity, fixed income expressed as total return
Source: Thomson Reuters Datastream as of 5/31/2018

Our overarching outlook is one of caution during what could be a touchy time economically and geopolitically. Our asset-allocation portfolios are neutral equities (underweight U.S. and overweight non-U.S., based on relative valuation), neutral bonds and neutral commodities.

U.S. EQUITIES

Earnings growth and revenue growth expectations for the Standard & Poor's 500 were buoyant coming into 2018, and they have steadily climbed from there. As of mid-June, the consensus full-year forecast is 20% earnings growth and close to 8% revenue growth. Share prices have also been supported by widening profit margins. These factors have contributed to the bull market for stocks extending into a 10th year.

But after more than a decade in a deflationary environment, companies are beginning to contend with cost headwinds as the prices for labor, material inputs and freight rise. Tariffs and other trade impediments could further add to these inflationary pressures. Companies able to generate strong top-line growth while controlling variable costs stand to outperform.

In our view, the financial sector may be best-positioned to navigate what appears to be the late innings of the economic cycle. Rising interest rates — particularly at the short end of the yield curve — stand to be a boon for banks. At the other end of the spectrum might be consumer staples, which is especially vulnerable to higher commodity prices and is facing challenges in growing revenue.

INTERNATIONAL EQUITIES

The synchronized global growth story has been a key market driver, and when that story started showing some cracks this year, non-U.S. equities stumbled. The big question now is whether the growth slowdown overseas will prove fleeting or persistent.

In Europe, the slight output dip in the early months of 2018 appears to be traceable to bad weather and short-term capacity constraints when demand picked up. These factors would argue for the growth setback being temporary. But the growing prospects of a global trade war and rising commodity prices might suggest longer-lasting woes. Among developed markets, we see better opportunities in Japan and thus have increased the overweight in our asset-allocation portfolios while trimming our overweight to Europe.

Emerging markets are also subject to the negative impacts of trade barriers and higher commodity prices, and they also face a considerable threat if the U.S. dollar continues to gain strength as U.S. interest rates rise. Still, we continue to like EMs based on their attractive relative valuations, strong earnings growth and their earlier stage in the economic cycle.

FIXED INCOME

The Fed's tightening cycle has pushed up interest rates at the short end of the Treasury yield curve. Figure 3 shows the Treasury curve at the end of May compared to six months and a year earlier — over that period, the closely watched spread between 2-year and 10-year Treasuries narrowed from 93 basis points (0.93%) to 43 bp.

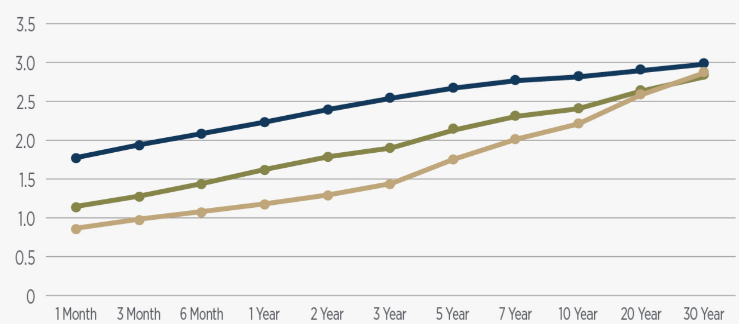
FIGURE 3

YIELDS UP AT SHORT END, BUT FLATTER FOR LONG MATURITIES

TREASURY CURVE SNAPSHOTS, 2017-2018

■ 5/31/18 ■ 11/30/17 ■ 5/31/17

Source: U.S. Department of the Treasury



A flattening yield curve spurs worries because it could portend a yield-curve inversion (2-year rates higher than 10-year rates), which in turn has often been a signal of an approaching recession. Even if a global trade war breaks out, we see little chance of a recession in the next 12 months, as exports represent a small percentage of the U.S. economy.

While investment-grade credit spreads remain tight, they have widened as a result of higher interest rates and rising corporate debt. The high-yield market has not seen the same spread widening, perhaps owing to the fact that high-yield has less exposure to interest-rate risk. High yield has often fared well during periods of rising rates, and with defaults currently very low, investors may perceive an opportunity to pick up incremental yield at manageable risk.

COMMODITIES

Through mid-June, commodities have enjoyed their best year since 2002, as economic growth shared globally among developed and emerging markets bid up demand expectations for oil, industrial metals and other resources. Gold, on the other hand, fell to lows last seen in late 2017 on higher rates and a stronger dollar.

Commodity-based equities are benefiting from the optimistic outlook — energy and materials have the highest consensus revenue and earnings growth forecasts among the S&P 500's 11 sectors for 2Q 2018, albeit from relatively low bases.

Looking forward, there are potential risks to the commodities upswing. The most obvious is the possible impact from a trade war, which could bog down the global growth trend as tariffs and other impediments push up commodity costs. A second headwind could come in the form of U.S. dollar appreciation — most key commodities are priced in dollars, so demand from non-U.S. buyers would stand to decline as prices move higher.

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