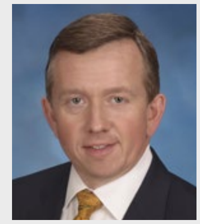
USAA MARKET COMMENTARY — 12/20/17

2018 Investment Outlook

By John C. Spear, CFA, USAA Mutual Funds Chief Investment Officer



A couple of significant political and economic events taking place in the last few weeks of 2017 — more monetary tightening by the Federal Reserve and a slashing of U.S. corporate tax rates — stand to shape investing conditions well into the coming year.

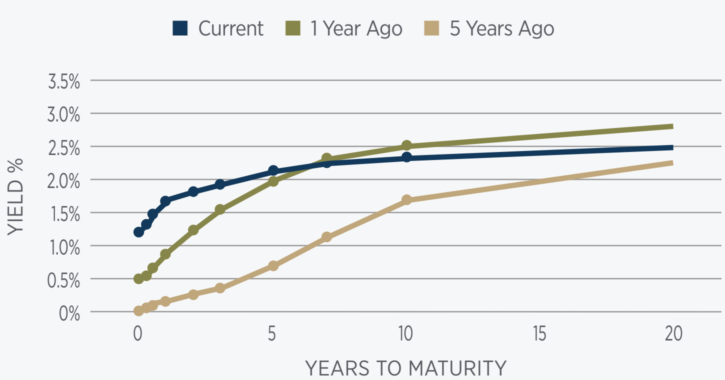
In raising short-term interest rates in mid-December, the Fed followed through on its goal of three rate hikes in 2017. With U.S. economic growth picking up in the past two quarters, there were some worries that the Fed might signal an accelerated pace for rate increases in 2018 — this would likely disrupt both stock and bond markets. Instead, policymakers cited soft inflation as the key reason to stick to a gradual upward path — at this point, three rate increases are penciled in for 2018 and two more in 2019.

But while the Fed controls rates for Treasuries with very short maturities, the rates on longer-term bonds are determined by the market. Figure 1 below shows how the Treasury yield curve has flattened in 2017, with the front end rising sharply in response to Fed action but the yields at the back end remaining fairly constant.

FIGURE 1

FED HIKES PUSHING UP SHORT RATES, BUT NOT LONG END

U.S. TREASURY YIELD CURVE



Source: Thomson Reuters Datastream as of 11/2017

OVERVIEW

- We believe the current U.S. bull market for equities extends into a 10th year, though it's hard to argue that next year's returns for large caps or small caps will come close to matching 2017's stellar results. In our view, a strong fourth-quarter rally has priced in most if not all of the upside for stocks stemming from tax reform.
- Our asset allocation portfolios continue to tilt toward international stocks, mostly based on relative valuation. For non-U.S. developed markets, the upturn in global gross domestic product (GDP) growth and easy money policies could benefit export-led economies. For emerging markets (EMs), earnings growth is projected to rise faster than for DMs.
- A case can still be made for long Treasuries as a hedge against risk assets. Short-term bonds may be attractive in a gradual rising-rate environment, and municipal bonds have appeal even after their late-year run-up. Despite very tight spreads, improving corporate earnings could buoy credit, including high-yield.

A flattening yield curve creates concern because it could eventually give way to an inverted yield curve in which short-term rates exceed longer-term rates. Every recession in the past half-century has been preceded by an inverted yield curve, though not every inversion has later resulted in a recession.

So the question becomes who's right — pessimistic bond investors who see at best a continuation of the current slow GDP growth trend and who fear a recession triggered by a Fed overshoot on rates, or optimistic stock investors who believe federal tax reform will juice both the economy and the equity market?

Lowering the corporate tax rate from 35% to 21% would provide a significant cash flow and bottom-line boost, as would a low one-time tax on trillions of dollars in profits now held overseas. These events would, however, be priced in fairly quickly, so the result may only be a short-term jolt for share prices. We may be seeing that jolt now — in the fourth quarter through mid-December, the Standard & Poor's 500 (S&P 500) index was up more than 6.5%.

In our view, how long the benefit lasts depends more on how companies choose to spend their windfall. They could keep buying back stock — this has been a primary driver of stock prices during the post-financial crisis period. They could also increase dividends or seek out merger or acquisition opportunities.

The market is signaling that it wants companies to increase capital expenditures (capex), which have been modest during the slow economic recovery. Recent market analysis shows that, since the start of 2016, the companies with the highest capital spending have seen their share prices rise twice as fast as the most prolific share repurchasers. But companies aren't likely to increase capex unless they can look ahead and see more customers, regardless of how much extra cash they have on hand.

Consumer confidence and spending are now at multi-year highs, almost certainly due in large part to the planned cut in individual tax rates. However, the payoff from capex tends to come with a lag, so corporations would have to be confident that the economic upswing is long-lasting. Otherwise, the incentives to focus on short-term stock gains will be difficult to resist.

ASSET CLASS OUTLOOK

Synchronized global GDP growth with low inflation has provided a steady tailwind for equities in 2017. EM stocks have been the year's star performer, with their total return through November topping 32% (Figure 2). The run-up for U.S. stocks has stretched valuations that were already lofty, particularly for small caps, with extremely low volatility — the S&P 500's largest peak-to-trough dip in 2017 (through mid-December) was less than 3%.

FIGURE 2

2017 PERFORMANCE BY ASSET GROUP (THROUGH NOVEMBER 30)

Large U.S. Stocks	S&P 500	▲ 20.5%
Small U.S. Stocks	Russell 2000	▲ 15.1%
International Stocks	MSCI EAFE	▲ 23.6%
Emerging Markets	MSCI Emerging Markets	▲ 32.9%
Treasury Bond	10-Year U.S. Treasury	▲ 1.9%
General Bond	Barclays U.S. Aggregate Bond	▲ 3.1%
Tax-Exempt Bonds	Barclays Muni Bond	▲ 4.4%
High-Yield Bonds	Barclays U.S. Corporate High Yield	▲ 7.2%
Gold	Gold Spot Price	▲ 10.5%

Source: Thomson Reuters Datastream as of 11/2017

The same macro trends have benefited credit, particularly high-yield. The 10-year Treasury has languished in the risk-on environment, with safety-minded investors venturing farther out the yield curve for more income. Tight municipal bond issuance relative to demand bid up prices while pushing down yields. Gold peaked in September on geopolitical worries before falling off on U.S. dollar strength tied to rising GDP expectations stemming from tax reform.

Some high-level thoughts about various asset classes as we head into 2018:

U.S. EQUITIES

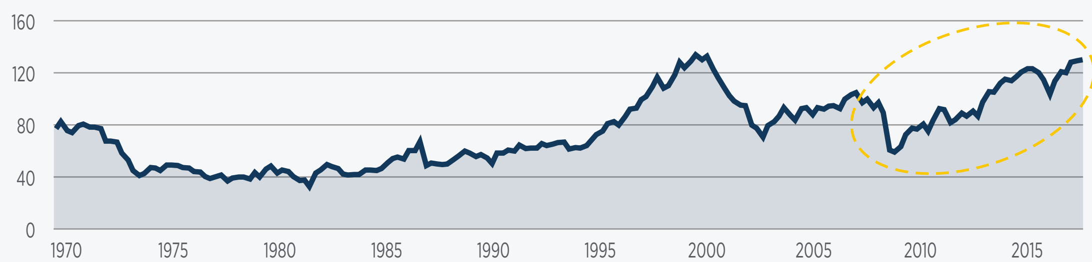
While we believe the current bull market extends into a 10th year, it's hard to argue that next year's returns for large caps or small caps will come close to matching 2017's stellar results. We have modest expectations, especially early in 2018 — once first-quarter earnings are out, we may have a better idea how the actual impact of tax reform compares to the rosy forecasts.

The late-year spike in share prices has driven the value of the U.S. equity market deeper into record territory relative to GDP (Figure 3). Stocks have climbed from roughly 60% of GDP at the market bottom in March 2009 to about 130% of GDP now. This extreme valuation — nearly as high as the late 1990s dot-com bubble's peak — supports our view that most or possibly even all of the tax reform benefit for stocks is already priced in.

FIGURE 3

U.S. STOCK PRICES HAVE GROWN FAR FASTER THAN ECONOMY

EQUITY MARKET VALUE AS PERCENTAGE OF GDP



Note: U.S. equity market represented by the Wilshire 5000 Index | Source: Thomson Reuters Datastream as of 4Q/2017

The S&P 500's 20+% total return this year (through November) has been powered by technology and other growth-oriented sectors. Toward year-end, investors began rotating into cheaper value sectors — including financials, industrials and consumer staples — that in the past have done well during times of faster GDP growth. In our asset allocation portfolios, we maintain a tilt toward value stocks due to relative valuation.

U.S. BONDS

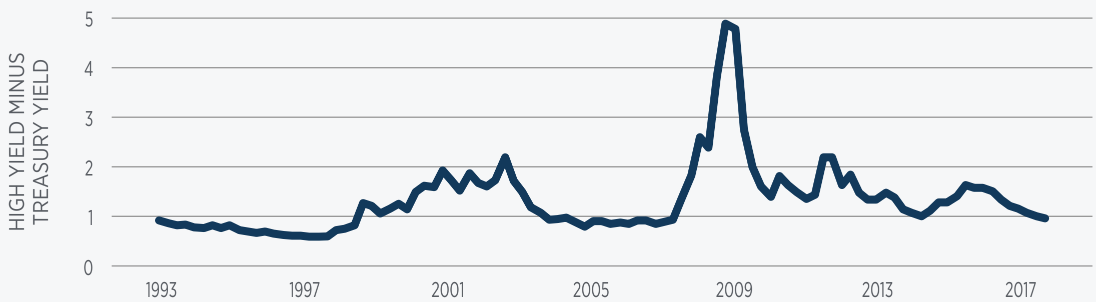
Strong demand for long-dated Treasuries has pushed their yields lower than they were in December 2016 despite the three Fed rate hikes in 2017. Through mid-December, the year-to-date total return on a 30-year Treasury bond was roughly 11%, ranking it among the best-performing fixed income categories. While rising rates pose a serious threat, a case can still be made for the long bond — it can act as a hedge against stocks and other risk assets, as well as against a Fed overshoot.

We think short-term bonds may be attractive in a gradual rising-rate environment, as they offer an opportunity to earn incremental income with less exposure to declining bond prices. Relative to Treasuries and other fixed-income assets, municipal bonds remain attractive even after their late-year rally. Federal tax reform and higher interest rates could crimp further muni supply in 2018, which could support prices.

FIGURE 4

TIGHT HIGH-YIELD BOND SPREADS HAVE PERSISTED IN PAST

YIELDS RELATIVE TO COMPARABLE TREASURIES



Note: High yield represented by Bloomberg Barclays U.S. High Yield 2% Issuer Capped Index
Source: Thomson Reuters Datastream

Volatility has been picking up for high-yield given worries that very tight spreads may soon widen. Tight spreads, however, can last for prolonged periods (Figure 4). We think solid economic growth and improving corporate earnings could buoy high-yield and investment-grade bonds. High-yield has also tended to fare well in rising-rate environments due to their higher coupons.

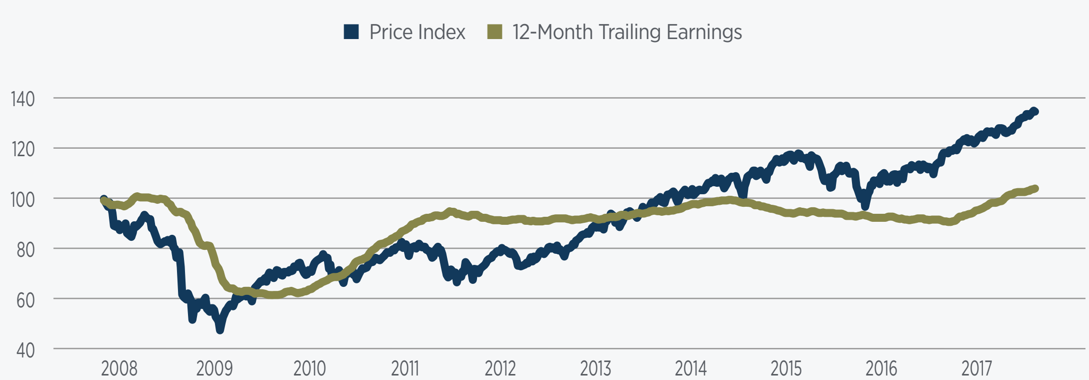
DEVELOPED MARKET EQUITIES

We have long been constructive on non-U.S. developed market stocks on a relative valuation basis. Heading into 2018, this conviction is fortified by the upturn in global GDP growth that could help the export-led economies of the eurozone and Japan, as well as the likelihood that the respective central banks will maintain an accommodative monetary policy. In recent quarters, earnings growth has turned upward (Figure 5) after years of languishing.

FIGURE 5

EARNINGS GROWTH PICKS UP PACE IN DEVELOPED MARKETS

MSCI WORLD INDEX PRICES AND EARNINGS



Note: Prices and earnings rebased to 100 on 12/1/2007
Source: Thomson Reuters Datastream as of 11/30/2017

The eurozone is at an earlier point in the economic cycle than the U.S., and with consumer and producer sentiment at its highest since 2000, there's reason to believe its GDP and profit growth trends can continue. European companies focused on the regional economy could see some lift alongside the exporters. In Japan, the stock market hit a 26-year peak in December on a pick-up in GDP growth and improving profitability. We see signs this momentum could be sustained.

Even as GDP growth picks up, inflation expectations remain below target in both the eurozone and Japan. We think share prices could benefit from the continuation of monetary stimulus by the European Central Bank and the Bank of Japan. And the Federal Reserve's monetary tightening could be a boon for exporters in both areas if it strengthens the U.S. dollar.

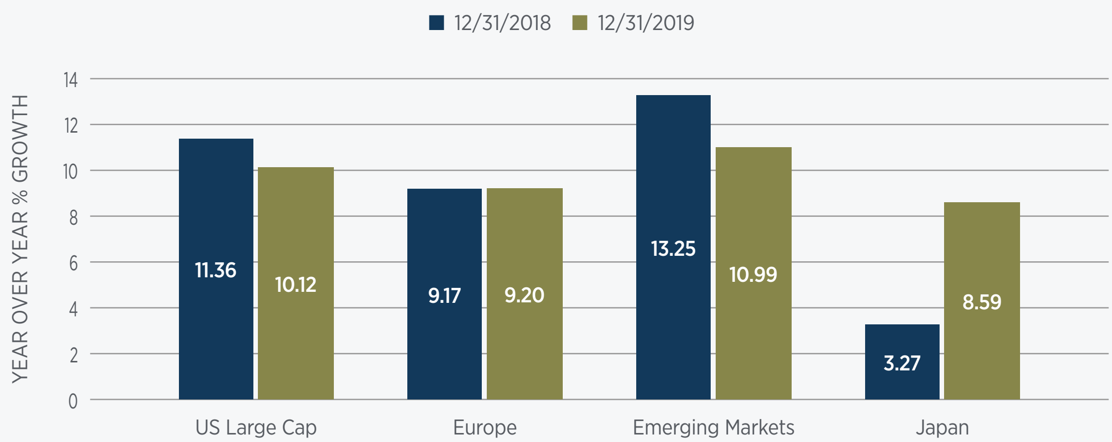
EMERGING MARKET EQUITIES

Even after their outstanding 2017, we believe EM stocks continue to offer an appealing long-term investment opportunity. They are cheap relative to the United States and other developed markets on a valuation basis, and their earnings growth is projected to rise faster than that of DMs over the next two years (Figure 6). This indicates that EMs may be earlier in the economic cycle. History suggests that EM performance trends can play out over multiyear periods, and we're still early in the current upswing.

FIGURE 6

EARNINGS OPTIMISM HIGHEST IN EMERGING MARKETS

ESTIMATED PROFIT GROWTH BY REGION



Source: Thomson Reuters Datastream as of 11/2017

Technology has been a critical driver for the EM asset class, pushing valuations up to levels that cause us some concern. Our asset allocation portfolios are focused more on value sectors, which are more attractively priced. We are positioned for a rotation to the cyclicals, which could be expected if global GDP growth continues to accelerate and sector fundamentals improve. In this scenario, EM value would stand to outperform EM overall.

The constant caveat for EM is that its shallower capital markets often make its stocks more volatile than the deeper developed markets. EM investors need always be mindful that even an enjoyable ride upward will likely include some bumps along the way. One potential disruption is monetary tightening by China after several years of expansive policies that was a key contributor to stronger global growth and to asset appreciation.

COMMODITIES

Energy stocks have far underperformed the rally that lifted oil prices into the high-$50 range in the second half of 2017. We think investors have little faith that the price can go up much from here as U.S. shale players boost output in an already well-supplied market. Another consideration is U.S. dollar appreciation.

Demand from China has been the key driver for industrial metals, many of which have enjoyed double-digit gains in 2017. Mining stocks strongly outperformed the S&P 500 early in 2017, but they later fell back in line with the index. The miners tend to be highly correlated to the underlying commodity price, so Chinese demand should continue to be influential. The push for more electric vehicles could also help certain metals.

Gold's 2017 peak came in early September, after a weak jobs report and North Korea's nuclear threat pushed investors toward safe havens. Dollar-positive factors heading into 2018 stand to pose headwinds for precious metals: the prospect of more Fed rate hikes and the possibility that lower household and corporate taxes could stoke economic growth. Gold miners have extracted pretty much all of the benefits of cost-cutting, so future profits will likely be linked to top-line growth.

As always, we encourage investors to speak with one of our financial advisors, who can help determine which investment vehicles are suited for you based upon your individual goals, objectives, risk tolerance and time horizon.

800-531-8722 | usaa.com

Investing in securities products involves risk, including possible loss of principal.

This material is provided for informational purposes only by USAA Asset Management Company (AMCO) and/or USAA Investment Management Company (IMCO), both registered investment advisors. The material is not investment advice and is not a recommendation, an offer, or a solicitation of an offer, to buy or sell any security, strategy or investment product. The views and opinions expressed in the material solely reflect the judgment of the authors, but not necessarily those of AMCO, IMCO or any affiliates as of the date provided and are subject to change at any time. All information and data presented herein has been obtained from sources believed to be reliable and is believed to be accurate as of the time presented, but AMCO/IMCO does not guarantee its accuracy. The information presented should not be regarded as a complete analysis of the subjects discussed. Any past results provided do not predict or indicate future performance, which may be negative. No part of this material may be reproduced in any form, or referred to in any other publication, without express written permission of AMCO/IMCO and USAA.

Diversification is a technique to help reduce risk. There is no absolute guarantee that diversification will protect against a loss of income.

The fixed income securities are subject to price volatility and a number of risks, including interest rate risk. Interest rates and bond prices move in opposite directions so that as interest rates rise, bond prices usually fall and vice versa. Interest rates are currently at historically low levels. Fixed income securities also carry other risks, such as inflation risk, liquidity risk, call risk, and credit and default risks. Lower-quality fixed income securities involve greater risk of default or price changes. Securities of non-U.S. issuers generally involve greater risks than U.S. investments and can decline significantly in response to adverse issuer, political, regulatory, market and economic risks. Fixed income securities sold or redeemed prior to maturity may be subject to loss.

Investments in foreign securities are subject to additional and more diverse risks, including but not limited to currency fluctuations, market illiquidity, and political and economic instability. Foreign investing may result in more rapid and extreme changes in value than investments made exclusively in the securities of U.S. companies. There may be less publicly available information relating to foreign companies than those in the U.S. Foreign securities may also be subject to foreign taxes. Investments made in emerging market countries may be particularly volatile. Economies of emerging market countries are generally less diverse and mature than more developed countries and may have less stable political systems.

MSCI Developed Market Indices are unmanaged and based on the share prices of approximately 1,700 companies listed on the stock exchanges in the 22 countries that make up the MSCI World Index. They are calculated without dividends, with net and gross dividends reinvested.

The unmanaged MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets.

The unmanaged MSCI EAFE Index comprises 21 MSCI country indices, representing the developed markets outside of North America: Europe, Australasia and the Far East. It aims to include in its international indices 85% of the free float-adjusted market capitalization in each industry group, within each country

Gold is a volatile asset class and is subject to additional risks, such as currency fluctuation, market liquidity, political instability and increased price volatility. It may be more volatile than other asset classes that diversify across many industries and companies.

The Bloomberg Barclays U.S. Municipal Index covers the U.S. dollar-denominated long-term tax exempt bond market. The index has four main sectors: state and local general obligation bonds, revenue bonds, insured bonds and pre-refunded bonds.

The Bloomberg Barclays US Corporate High Yield Bond Index measures the U.S. dollar-denominated, high yield, fixed-rate corporate bond market. Securities are classified as high yield if the middle rating of Moody's, Fitch and S&P is Ba1/BB+/BB+ or below. Bonds from issuers with an emerging markets country of risk, based on Barclays EM country definition, are excluded.

The Bloomberg Commodity Index is made up of 22 exchange-traded futures on physical commodities. The index currently represents 20 commodities, which are weighted to account for economic significance and market liquidity.

The MSCI USA Index is designed to measure the performance of the large- and mid-cap segments of the U.S. equity market. The index covers approximately 85% of the free float-adjusted market capitalization in the U.S.

The MSCI Europe Index captures large- and mid-cap representation across 15 developed market countries in Europe. The index covers approximately 85% of the free float-adjusted market capitalization across the European developed markets equity universe.

Standard & Poor's 500 Index and S&P are registered trademarks. The S&P 500 Index is an unmanaged index of 500 stocks. The S&P 500 focuses on the large cap segment of the market, covering 75% of the U.S. equities market. S&P 500 is a trademark of the McGraw-Hill Companies, Inc.

The Russell 2000 Index is an unmanaged index that consists of the 2,000 smallest companies in the Russell 3,000 Index and is a widely recognized small cap index.

CFA® and Chartered Financial Analyst® are registered trademarks owned by CFA Institute.

USAA Investments is the marketing name for USAA Investment Management Company.

USAA mutual funds advised by USAA Asset Management Company, a registered investment adviser; distribution services provided by USAA Investment Management Company, a registered broker-dealer.

Trust Services offered by USAA Federal Savings Bank. Member FDIC.

Financial planning services and financial advice provided by USAA Financial Planning Services Insurance Agency, Inc. (known as USAA Financial Insurance Agency in California, License # 0E36312), a registered investment adviser and insurance agency and its wholly owned subsidiary, USAA Financial Advisors, Inc., a registered broker dealer. | ©2017 USAA. 248153-1217