

US Capital Markets Face Uncertainty Entering 2019, With Volatility Likely to Continue

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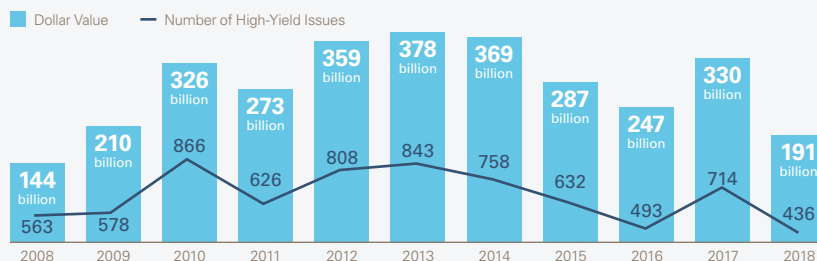
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Performance in the U.S. capital markets was mixed in 2018, with the equity new issuance market showing strength through most of the year and the debt issuance markets softening. The initial public offering (IPO) market had its strongest year since 2014, though it weakened in the fourth quarter due to significant market volatility. In 2019, the U.S. economy is forecasted to continue to grow, albeit at a slower pace, and most economic indicators remain sound, with an unemployment rate of 3.9 percent and 312,000 jobs added in December 2018. However, ongoing concerns over interest rates, domestic and geopolitical events, trade and the decelerated pace of global economic growth could cause further market volatility.

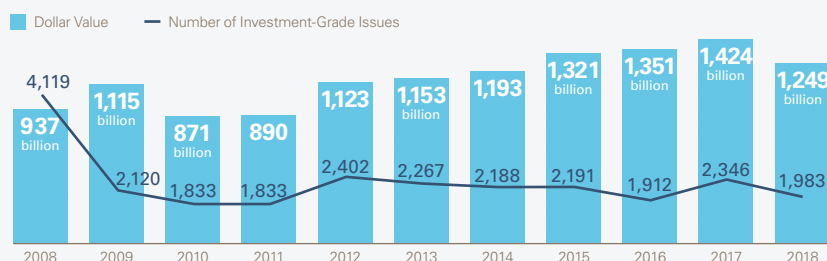
Debt Markets. The U.S. high-yield debt market ended 2018 42 percent lower by dollar volume and 39 percent lower by number of issuances than 2017. The \$191 billion in total issuance was the lowest since 2008 (\$144 billion), and the number of issuances fell to 436, the lowest in two decades. (High-yield activity in 2018 was frequently replaced with term loan B issuances, which are more attractive to investors when interest rates are rising and provide borrowers with covenant packages that are increasingly bond-like in flexibility.) Proceeds from U.S. high-yield bond offerings were largely used for refinancings (67 percent of issuances), with only 16 percent used for M&A activity. For the first time since 2008, in 2018 there were no issuances in December — a period of over 40 days without an issuance that continued until January 10, 2019.

US High-Yield Corporate Bonds Source: Bloomberg



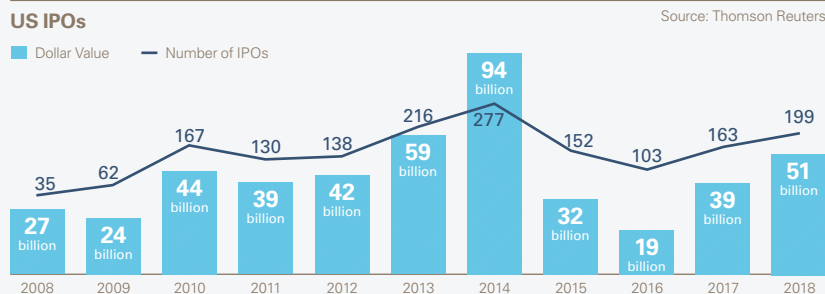
U.S. investment-grade debt market volume in 2018 was \$1.25 trillion (1,983 issuances), ending seven consecutive years of increases after a record volume of \$1.42 trillion (2,346 issuances) in 2017. Increasing interest rates and market volatility combined with the December 2017 tax reform, which encouraged repatriation of overseas cash and reduced the tax benefits of issuing debt, caused the decline. The largest issuer by volume was CVS Health Corp., with \$40 billion raised in connection with its acquisition of Aetna, representing the third-largest U.S. corporate bond transaction in history. Overall, investment-grade issuances related to M&A increased in 2018 by dollar volume, totaling \$226 billion by year-end.

US Investment-Grade Corporate Bonds Source: Bloomberg



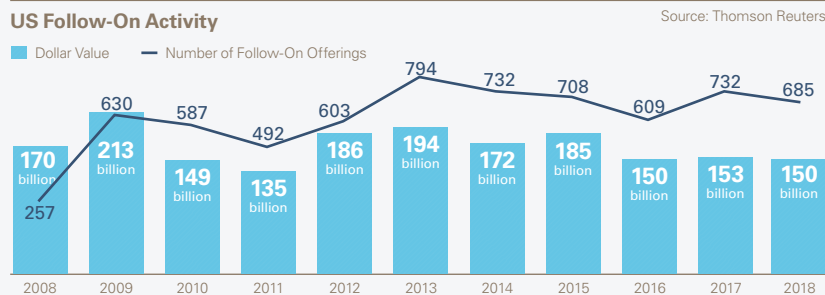
Equity Markets. After a volatile start to the year, the Dow Jones Industrial Average, S&P 500 and Nasdaq composite achieved record highs in the third quarter of 2018, driven by a strong economic backdrop and solid corporate earnings (fueled in part by the impact of tax reform, which led to a record \$1 trillion of stock buybacks that boosted earnings per share). Fourth-quarter volatility, however, erased the year's gains, and the three indices ended the year down 5.6 percent, 6.2 percent and 3.9 percent, respectively, from 2017, their worst annual performance in 10 years. Volatility soared in the fourth quarter, driven by concerns over slowing global economic growth, rising interest rates, U.S.-China trade tensions and policy uncertainty arising from White House communications.

Strong markets in the first three quarters helped make 2018 the best year for U.S. IPOs since 2014, with 199 IPOs raising \$51 billion. IPO volume was 31 percent higher than 2017 and 168 percent higher than 2016. While aftermarket performance was mixed, overall, IPOs significantly outperformed broader market indices.



The leading sector for IPOs by volume in 2018 was technology, with a number of tech unicorns completing highly anticipated IPOs. Other top sectors were health care and consumer products and services. Special purpose acquisition companies continued to constitute a significant amount of IPO volume, with 43 deals, representing 19 percent of total IPO proceeds. In 2018, 33 China-based companies completed IPOs, raising \$9.2 billion, a 140 percent increase over 2017. In addition, music-streaming service provider Spotify garnered significant attention when it went public in April 2018 by means of an unconventional direct listing, potentially leading the way for a select few others to follow suit. (For example, messaging platform service provider Slack has discussed a possible direct listing.) Companies also continued to take advantage of recent Securities and Exchange Commission (SEC) accommodations, such as the ability for all issuers to confidentially submit draft registration statements and omit certain financial statements previously required for interim drafts. (See "SEC Continues Steady Progress With Regulatory, Enforcement Goals." See also "New HKEx Rules Spur Bumper Year in Hong Kong Capital Markets, but Lasting Impact Remains Unclear.")

Follow-on activity was relatively flat, both by dollar volume and number of deals. Block trades represented 28 percent of total follow-on offerings, down slightly from 30 percent in 2017 and down significantly from a record 49 percent in 2016. The decline in block trades is attributed largely to weaker aftermarket performance resulting from tighter discounts to market price relative to marketed follow-ons.



Looking Ahead

The U.S. economy enters 2019 in its ninth year of expansion, with stock markets on pace to eclipse the bull run of 1991-2001 as the longest in history. But whether the capital markets are capable of continued strength depends on several factors.

Economic Growth. The U.S. economy expanded at an accelerated pace in 2018. U.S. gross domestic product grew 3.1 percent, marking the first year since 2005 that the economy expanded above 3 percent. The strength was driven by increases in government spending, healthy corporate profits and increases in consumer and business spending. The U.S. dollar rose in value 4.3 percent in 2018, according to the U.S. dollar index, demonstrating positive sentiment toward the U.S. economy.

Many economists expect the pace of U.S. economic growth to moderate in 2019. While a reduced economic growth rate does not necessarily mean a recession is imminent, it could negatively impact stock prices and corporate earnings, and reduce investor confidence. Nevertheless, many economists have indicated that a recession in 2019 is unlikely, and investment banks remain generally bullish on the near-term outlook for capital markets activity. However, the longer the government shutdown lasts, the more pressure there is on some of these forecasts.

Corporate Earnings. Moderating earnings growth could present challenges to capital markets activity, with a forecasted decline from 9 percent in 2018 to 7-8 percent in 2019. However, with S&P 500 multiples at five-year lows, arguably the market already has adjusted prices in anticipation of a slowdown. Stronger-than-anticipated earnings growth could improve investor confidence and slow recent market declines, facilitating activity as issuers seek to take advantage of rising valuations. On the other hand, weaker-than-expected earnings could contribute to market volatility and dampen capital markets activity.

Trade Uncertainty. The ongoing U.S.-China trade dispute could continue to disrupt activity. To date, the U.S. and China have imposed \$250 billion and \$110 billion worth of tariffs, respectively, on the other country's products. (See "[Enhanced US Export Controls and Aggressive Enforcement Likely to Impact China](#).") Although a temporary "truce" was reached in December 2018 (including a 90-day pause on tariff hikes until March 1, 2019), an array of challenging trade issues remain unresolved. Until a final resolution is reached, the existing tariffs and continued uncertainty over U.S.-China trade relations may negatively impact business investment and consumer confidence. Moreover, other trade matters, such as the effects of the renegotiated North American Free Trade Agreement and tariffs on certain imported products (e.g., aluminum and steel) could also weigh on the markets.

Federal Reserve Activity. The monetary policy of the Federal Reserve impacted the capital markets in 2018 and could continue to do so in 2019. Under the new leadership of Jerome Powell, the Federal Reserve increased the federal funds interest rate four times in 2018, most recently

in December 2018, from 2.25 percent to 2.5 percent, and continued to pursue its plan to reduce the Fed's balance sheet (most recently at a pace of \$50 billion per month). However, Powell more recently indicated that the Federal Reserve will be patient with monetary policy as it watches economic performance. From a capital markets perspective, higher interest rates can reduce existing bond prices and make new bond issuances more expensive for issuers. In addition, market volatility from Federal Reserve activity and policy statements may lead to tighter and more unpredictable windows of opportunity for capital raising.

U.S. and Geopolitical Events. Political uncertainty both in the U.S. and internationally has significantly impacted the capital markets in recent months. On the domestic front, according to *The Washington Post*, White House tweets have moved markets by as many as 3 percentage points in a single trading session, such as when faltering trade relations with China were revealed on December 5, 2018. Meanwhile, the longest government shutdown in history effectively closed the IPO window in January 2019. Additionally, even when the

government reopens, IPO companies with a calendar year-end would need to price their offerings by February 14, 2019, if they want to go effective without providing 2018 audited financial statements. A prolonged government shutdown could have implications for the IPO market for the full year, as the SEC and issuers work through the pent-up backlog, and could potentially have broader economic effects if it impacts business investment and consumer confidence. Other elements of domestic politics may also continue to disrupt markets in 2019, with a survey by a bulge bracket financial institution finding that individual investors perceive the White House to be the greatest source of market risk in 2019. Political uncertainty outside the U.S. also may impact the markets, including Brexit and trade disputes, in addition to changes to foreign direct investment rules across Europe (see "[Foreign Investment Control Reforms in Europe](#)") and sanctions (see "[Key Developments in US Sanctions](#)").

¹ Sources for the data in this article are: Bloomberg, *Business Insider*, Dealogic, Deloitte, Moody's, Nasdaq, *The New York Times*, PitchBook, PwC, Russell Investments, Seeking Alpha, Thomson Reuters, UBS, Vanguard and *The Wall Street Journal*.

Equity Markets in 2019

Though fourth-quarter volatility disrupted strong equity markets in 2018, many equity capital markets and syndicate bankers across Wall Street believe 2019 could be another robust year for IPOs, as issuers look to take advantage of a U.S. economy that remains strong ahead of the anticipated next economic cycle. However, Wall Street is continuing to digest ongoing volatility and parse the uncertain political and economic landscape. As a result, first-quarter issuance is expected to be muted (exacerbated by the longest government shutdown in U.S. history, which has delayed the lineup of IPOs slated for January 2019 launches) before a potential recovery for the remainder of the year. Several tech unicorns, including Airbnb, Lyft and Uber, have announced plans to go public in 2019, and the pipeline in a number of industry verticals remains strong. However, if volatility persists longer than anticipated, it could push some issuers toward quicker and more certain exits through mergers and acquisitions. Equity professionals will watch market sentiment closely, particularly the appetite of hedge funds to buy new issuances, as many funds suffered negative returns in 2018.



Technology. After a very good year for technology offerings in 2018, with 48 IPOs compared to 26 in 2017, many anticipate the momentum to continue, as companies feel increasing pressure to hit available market windows. Significant activity is expected from high-growth software and internet and e-commerce companies that have high revenue visibility and large addressable markets. Additionally, a number of deals by technology services companies (which help businesses utilize and adapt to new technologies) are possible; however, activity by systems and semiconductor companies is likely to remain subdued. Chinese and other offshore issuers continue to make up a significant portion of the IPO backlog, but recent mixed aftermarket performances could soften demand.

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Health Care. Continued IPO deal flow by biotech and life sciences companies, as well as a number of public debuts by medical technology (medtech) and device companies, meant 2018 was another strong year for the health care sector. Heading into 2019, the deal pipeline remains robust, although for biotech companies it appears smaller than in past years. On the other hand, significant follow-on activity is expected by recently public biotech issuers, and a number of private biotech companies appear to be exploring “crossover” financing rounds to bridge to an IPO, thereby potentially replenishing the pipeline. Meanwhile, a number of medtech, health services and specialty pharmaceutical issuers are reportedly exploring IPOs, although for the latter, heightened political scrutiny around drug pricing could derail issuance activity. (See “[Trump Policy Actions Could Reshape Health Care and Life Sciences Landscape.](#)”) The trend toward increasing levels of “insider participation” in IPOs (whereby existing investors disclose nonbinding indications of interest to buy shares in the offering) is expected to continue.



Industrials. Offering activity in the industrials sector slowed in 2018, and the trend is expected to continue in 2019, driven largely by skepticism toward issuers tied to the construction, manufacturing or housing industries, which can be more sensitive to economic downturns, and by continued trade uncertainty. These companies instead may shift focus to capital management strategies, which could lead to an uptick in stock buyback activity and recapitalization transactions. However, as with 2018, M&A activity may drive sporadic equity issuances across the sector. One potential bright spot remains in the automotive technology sector, with a number of companies — both domestic and foreign — that offer solutions for electronic or autonomous vehicles securing late-stage private funding and appearing poised to pursue IPOs.



Financial Institutions. Issuances by financial institutions in 2018 were solid, driven by rising interest rates, the impact of corporate tax cuts and deregulation. Sentiment for 2019, however, is mixed, with cautious optimism if recent volatility subsides, while recognizing that the economy may be in a late cycle and offering windows could close. The financial technology sector continues to be attractive — particularly the payments processing space, where valuations remain elevated. The market also looks attractive for midcap property and casualty insurers, as the subsector has outperformed broader market indices. The outlook for regional banks, which suffered significant valuation degradation in 2018, and consumer finance companies, particularly those exposed to subprime borrowers, is less optimistic. All eyes will be on Federal Reserve activity and whether rate hikes will continue and, if so, at what pace.



Consumer. Despite a better-than-expected year for consumer equity offerings in 2018 and a strong macroeconomic outlook for U.S. consumers, expectations for 2019 are modest, particularly given the sell-off in retail names in the fourth quarter of 2018. However, despite a reset in valuations, cautious optimism exists for new issuances in the general retail and consumer discretionary sectors, with several sponsor-backed companies potentially eyeing public market exits. Conversely, significant issuance activity in the restaurant and specialty retail areas is less likely. As in past years, technology-oriented consumer companies (companies selling consumer goods through online or subscription models) continue to generate significant attention, but many are still pursuing midstage private funding rounds and need to prove their ability to grow revenues or diversify product and service offerings before testing the public markets.



Real Estate. Real estate issuance in 2018 remained solid, despite market volatility and a challenging fourth quarter. Real estate investment trusts (REITs) led the way, accounting for over half of the total issuance, followed by lodging, gaming and real estate services companies. In the year ahead, investors may look to the real estate sector, and REITs in particular, as a defensive sector that can provide more stable returns in a rising interest rate environment. With funds continuing to pressure managers to be more selective in allocating capital, issuances from REITs with active growth opportunities through either acquisitions or developments likely will continue to garner investor attention and drive equity issuance. The alternative real estate sector (such as retirement living, student housing and private hospitals) also may see increased activity, as real estate investors seek ways to generate higher returns relative to the broader REIT universe.



Energy. High expectations in 2018 for capital markets activity in the energy sector turned out to be largely misplaced. U.S. crude oil prices reached \$75 a barrel in July 2018 (their highest level since 2014) before dropping sharply, ending the year at around \$54 a barrel. Volatility in oil prices and concerns about slowing economic growth and an oversupplied oil market are likely to continue, causing uncertainty in the new issuance market. Some still see potential for deals driven by M&A financing needs, particularly in the exploration and production space, while others view dividend-yielding stocks in the upstream and midstream sectors as an attractive place for investors to put money to work. While there is a substantial deal backlog in the oilfield services space (some of the pent-up supply began to emerge in 2018, but not at anticipated levels), volatile oil prices could suppress activity.

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