Financial markets Q2 outlook

A quarterly update across multiple asset classes from the financial markets specialists at PwC

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Market volatility in the second quarter was fueled by continued uncertainty over the global economy, a downward shift in expected growth rates, and the risks of open trade negotiations.

Click any topic below to learn more

Market trends

By David Lukach

US market volatility rose in the second quarter as uncertainty increased.

The markets continued to be volatile in the second quarter with continued uncertainty over the strength of the global economy, a downward shift in expected growth rates, and the risks of open trade negotiations.

Globally, central bankers have paused or lowered rates in the quarter. The ECB noted that it did not expect rate increases until 2020 or later.

The Federal Reserve and central bankers continue to monitor inflation and employment. There has been minimal increases in US inflation despite low unemployment levels. Low energy prices have had a beneficial impact year to date, however, any adverse impact to global oil supply could be disruptive in the near term.

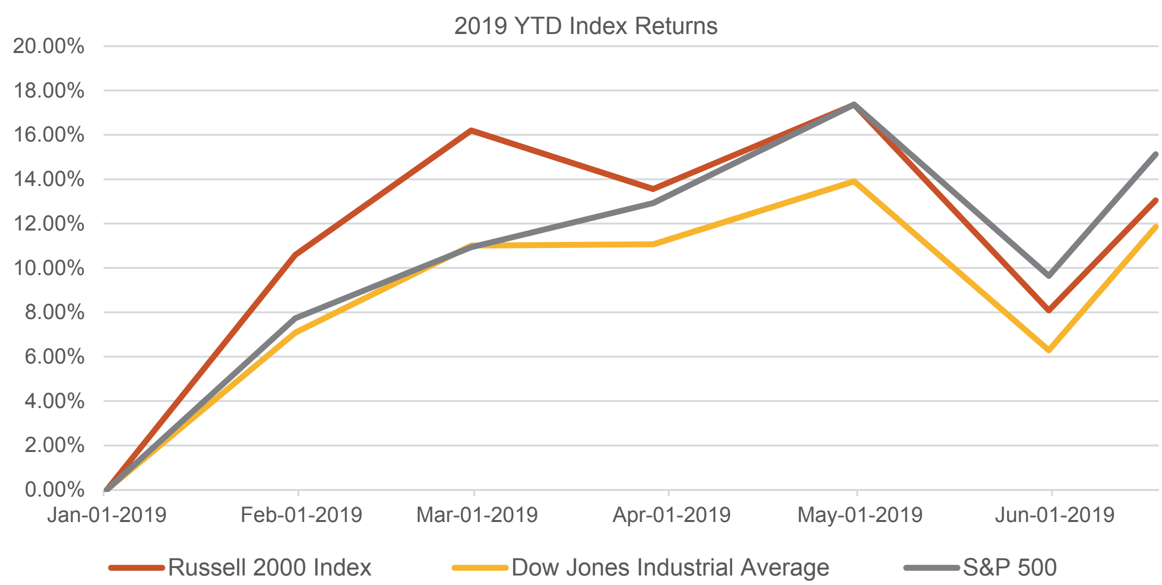
In late June, the spread between the 1 and 10 year UST rates remained narrow. At its June meeting, the Federal Reserve left the benchmark fed funds rate target steady at 2.25% and 2.5%. It noted that the labor market “remains strong” and the economy continues to expand at a “moderate” rate. At this time, the Fed does not expect to reduce borrowing costs in 2019. Fed Chairman Jerome Powell noted that it would “closely monitor” the economy in light of waning inflation and growing “uncertainties.”

There has been a slowdown in growth expectations for China, and Europe continues to work through a multitude of issues influencing growth and economic recovery. European leaders and central banks continue to assess the next steps to support their economies.

The market continues to respond to revised expectations for growth and remains sensitive to the risks from adverse news and developments. Investors continue to seek out opportunities for returns in a low interest rate environment that is likely to continue for at least the next 12 months. These pressures have continued to suppress borrowing rates and have provided an opportunity for borrowers to lock in costs at historically low levels. At the same time, the equity markets have rebounded since the beginning of the year, albeit with significant volatility and market swings over the last six months.

Any changes in the trends or new events are likely to drive volatility levels until the markets assess the longer term effects.

Stay tuned.



Commercial mortgages

By Matthew Berkowitz

June's annual Commercial Real Estate Finance Council (CREFC) Conference concluded with overall positive market sentiment.

The general outlook for 2019 remained strong for CMBS and CRE CLO issuance and performance. There is continued focus on the risks to the end of the current market cycle. The broader discussion highlighted the potential impact of the 2020 US elections, Brexit, and other geopolitical factors. Based on current real estate fundamentals (even though moderating), the lending market should be able to avoid major disruption in 2019.

The implementation of new CECL accounting requirements has generated significant discussion and there is no consensus around its potential effect on the CRE lending market. An additional concern is the coming retirement of the LIBOR benchmark rate in 2021 and the need for operational plans to implement its potential replacement—SOFR.

There is ongoing uncertainty for LIBOR linked-securities that were issued without legal provisions that document the impact of a change in rate that exists in recently issued CMBS documentation. Market participants must continue to assess their exposure to LIBOR and develop action steps for originating new loans based on SOFR to minimize operational disruptions.

Consumer lending

By Frederick Elmy

Strategic partnerships between issuers and technology companies, an uptick in delinquency rates, and the rejection of a CECL proposal are key market developments.

March 2019 – Apple teams with Goldman Sachs on a credit card that will be used with Apple Pay[1]

April 2019 – Accounting rule maker FASB rejects proposal on loan losses[2]

May 2019 – Citigroup teams with India's Digital Paytm for a card launch[2]

May 2019 – US credit card delinquency rates are rising, particularly among young borrowers[2]

June 2019 – Amazon launches a credit card for the underbanked with bad credit[3]

Market focus areas and observations

Consumers: Consumer spending continued to rise quarter over quarter with an uptick in delinquency and charge-off rates. According to the Federal Reserve Bank of New York, about 8.1% of credit card balances held by individuals aged 18 to 29 were delinquent by greater than 90 days in Q1 2019. This represents the highest level since Q1 2011, but it is below the 14% rate in Q3 2008. Credit card rewards programs continue to drive growth, with a Gallup survey showing that US residents have an average of 3.7 cards.[4]

Issuers: A number of financial institutions proposed an alternative to CECL that would require reserves for the first 12 months' worth of expected loan losses versus all future expected losses. Any difference between 12 months and expected losses would be recorded in other comprehensive income. The FASB voted against the proposal and initial estimates are that the CECL requirements will require a 10% to 45% increase in credit loss reserves.

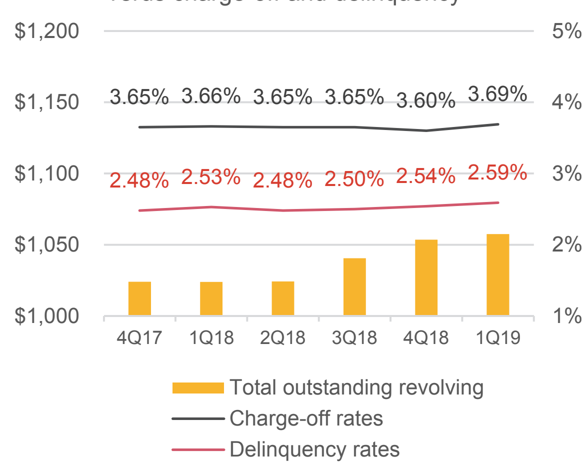
The competitive landscape continues to rise as issuers partner with technology businesses:

- Citigroup announced its partnership with the Indian mobile-payments company Paytm to issue the service's first physical credit card.
- Goldman Sachs teamed with Apple to launch a card designed to be used with Apple Pay and offers 2% daily cash back.
- Digital payment company Venmo is evaluating a credit card launch.
- Amazon and Synchrony Financial are launching Amazon Credit Builder, a program for shoppers with no credit history or bad credit who would otherwise be excluded from Amazon's loyalty cards.

Market data

Total US credit card debt as of March 31, 2019[5]	$1,057.5 billion			
Charge-off rate (Q1 2019)	3.69%			
Delinquency rate (Q1 2019)	2.59%			
Seasonally adjusted				
[6]*($ in billions)*	2017	2018	2018 YTD	2019 YTD
US ABS supply – credit cards	$47	$36	$10.7	$9.1

Total outstanding revolving credit verus charge-off and delinquency[5]



[1] MarketWatch – marketwatch.com
[2] The Wall Street Journal – wsj.com
[3] CNBC – cnbc.com
[4] The Motley Fool – fool.com
[5] Federal Reserve G. 19 Release 06/07/19 – Data as of April 2019
[6] JPM – Global ABS_CDO Weekly Report 03/05/2019

Debt and equity securities

By Shaan Elbaum

The public equity markets experienced heightened volatility during the second quarter driven by international trade talks, a global slowdown in GDP growth, and inflation expectations.

The public equity markets showed modest increases in the second quarter of 2019. The S&P 500 IT and Defense sectors had the largest returns at 5.9% and 5.7%, respectively. Energy and Biotech posted the lowest returns at -4.7% and -0.4%, respectively.

Twenty-five private equity deals (eight US based, 17 international), each over $1 billion in value, closed during the second quarter.

The larger deals included Brookfield's $13.2 billion buyout of Clarios, and Hellman & Friedman's $11 billion buyout of Ultimate Software Group.

The one-month LIBOR rate and the 10-year US Treasury yields decreased in the second quarter. The Fed left the benchmark interest rate unchanged at 2.5% in June and said any further rate cuts will be based on the FOMC's assessment of economic indicators.

There has been an increase in the amount of dry powder in the private markets, driven by 74 new private equity and debt funds closing during the quarter.

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Debt and equity markets return

Public equity markets	**CY 2018**	**1Q19**	**2Q19**
Dow Jones Industrial Average	(5.6%)	11.2%	3.1%
S&P 500	(6.2%)	13.1%	3.9%
S&P 500 Information Technology (Sector)	(1.6%)	19.4%	5.9%
S&P 500 Energy (Sector)	(20.5%)	15.4%	(4.7%)
S&P 500 Biotech (Sector)	(7.3%)	2.0%	(4.8%)
S&P 500 Financials (Sector)	(14.7%)	7.9%	5.5%
VIX	130.3%	(46.1%)	12.5%
Median public market multiples (S&P)	**CY 2018**	**1Q19**	**2Q19**
Debt to EBITDA	2.39x	2.63x	2.71x
EV to EBITDA	10.34x	11.75x	12.11x
Debt markets	**CY 2018**	**1Q19**	**2Q19**
1M LIBOR	2.50%	2.49%	2.40%
10-Year US Treasury	2.69%	2.41%	2.07%
US Fed funds rate	2.50%	2.50%	2.50%
US prime rate	5.50%	5.50%	5.50%
Private equity	**CY 2018**	**1Q19**	**2Q19**
Dry powder	$57.4b	$50.5b	$82.8b
% of funds focusing on debt versus equity investing	N/A	19%	10%
% of funds focusing on distressed investing	N/A	19%	14%

Source: Capital IQ and Pitchbook

Second quarter data as of June 24, 2019

Hospitality and leisure

By Warren Marr

Despite continued economic risks, the US lodging industry is expected to remain on stable footing through the balance of the year.

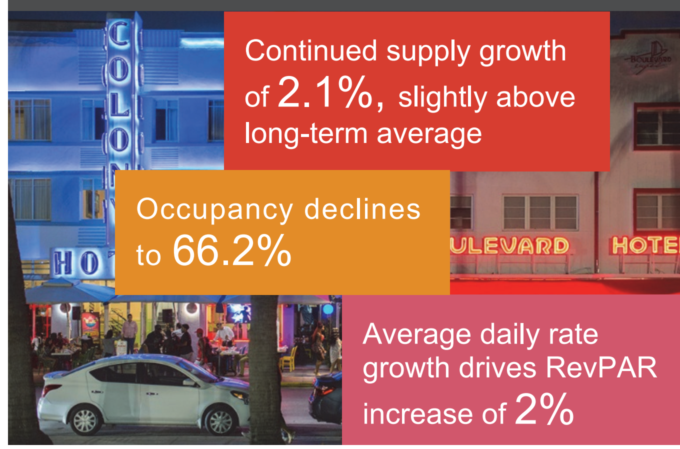
First quarter results came in below expectations. Occupancy levels rose 0.4 percent and ADR levels rose 1.1 percent for a RevPAR increase of 1.5 percent. The industry's performance in March is a concern. A favorable calendar comparison for Easter week was expected to result in stronger metrics, but March numbers were disappointing with occupancy flat and ADR-driven RevPAR up just 0.6 percent. The sector reported its lowest first quarter RevPAR growth since 2010.

Looking ahead to the remainder of 2019, the near-term US lodging outlook remains stable with unemployment expected to reach a cyclical low this summer at 3.5 percent, decelerating GDP growth, mixed inflation expectations, and softening growth in consumer spending.

Lodging supply is expected to increase at a rate just above the long-term average and RevPAR growth in 2019 is expected to continue to decelerate, driven almost entirely by growth in ADR.

The risks in this outlook include continued trade tensions and the effects of tariff-rate implementation, heightened political uncertainty, slowing economic growth, and tempered investor confidence.

Key takeaways: Q2 2019



Source: PwC Hospitality Directions US® May 2019

Real estate

By David Seaman and Steven Weisenburger

While fundamentals remain healthy, the forecasts for property types indicate a contraction and, potentially, a recession phase during the next three years.

Real estate cycles vary across markets and geographic areas, as well as within markets and geographic locations based on property type: office, retail, industrial, and multifamily.

This means that national cycles differ for the same property type across individual markets. An in-depth analysis of historical and forecasted stock data allows us to gauge each sector's likely shifts over the near term.

Office

Leasing remains positive in many office metros, but the market has begun to slow. The forecast for 2019 is for most office metros to move from expansion to contraction.

This trend is projected to continue over the next three years. Our outlook has 2021 as the year when more cities slip into recession, including New York, San Jose, Seattle, and Washington, DC.

Retail

The US is expected to show improvement in 2019 as the number of metros in the recession phase is projected to fall from 51 to 35 with six metros projected to move into expansion.

Cities forecasted to be experiencing expansion by the close of 2019 include Columbus, Dallas, Greensboro, Houston, Memphis, and San Antonio.

Industrial

As it moves through 2019 and 2020, the US industrial sector is projected to slide deeper into the contraction phase of the cycle. By the end of 2020, 52 of the 55 industrial metros analyzed will likely sit in contraction, up from 18 at the end of 2018. This shift is largely due to slower demand and an increase in new supply that typically follows strong sector fundamentals.

Multifamily

The US multifamily sector has outperformed the industry this cycle, and that trend is expected to continue through 2019.

In general, tenant demand has risen to meet higher levels of new supply, but a number of cities may be short on demand over the next few years. Demand is expected to slow in 73 metros by the end of 2020. Overall, a slowdown in leasing demand will be the primary issue for this sector over the forecast period.

Key takeaways: Q2 2019

70% of surveyed investors view market conditions for the industrial sector to favor sellers

$212B of dry powder is held in closed-end private real estate funds targeting investments in North America

Most surveyed investors foresee overall cap rates holding steady in 28 of 34 markets over the next six months

Sources: PwC Real Estate Investor Survey® 2Q 2019; Preqin Real Estate Online

Residential mortgages

By Yogesh Gupta

The second quarter of 2019 featured a surge in refinancing activity driven by a decline in interest rates.

The second quarter of 2019 saw a surge in refinancing activity driven by a decline in interest rates from over 5% in November 2018 to approximately 4% in June 2019.

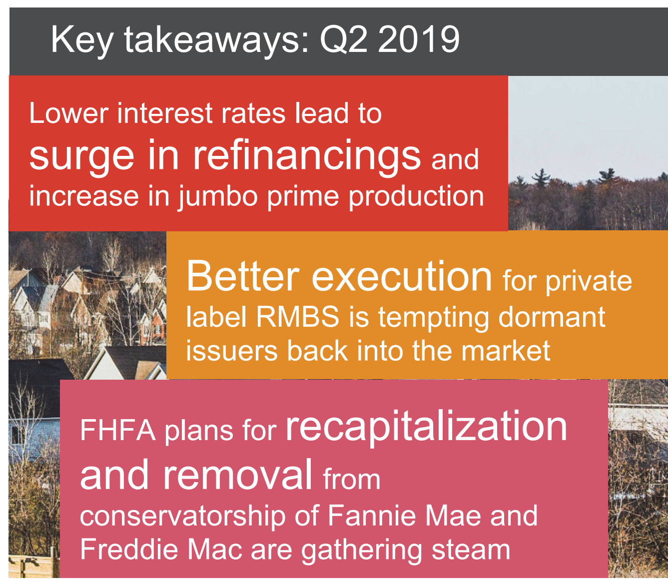
Interest rate declines accelerated in the second quarter due in part to an investor flight to safety resulting from fears of escalating trade disputes. The favorable interest rate environment was the primary driver of an approximately 20% increase in refinancing volume relative to the comparable period in 2018.[7]

Purchase mortgage production accounted for approximately two-thirds of origination volume. Purchase-mortgage lending declined across all major loan categories, although the jumbo prime market showed noticeable improvement for the first time in months.

The increased jumbo prime production, coupled with better execution for private label securitizations, has led to issuers returning to the securitization market where spreads have tightened to the point that securitization execution has become more favorable than whole loan sales.

The FHFA has continued to discuss options to recapitalize Fannie Mae and Freddie Mac with an initial public offering that would remove the GSEs from conservatorship.

The head of the FHFA, Mark Calabria, suggested that an IPO could be executed before the end of 2019, with major Wall Street banks already lined up to lead the offering.



[7] Inside Mortgage Finance – June 14, 2019

Digital transformation

By Chrisopher Merchant and Michael Zaydon

Standardized data models play a crucial role in the success of a company's digital transformation efforts.

A wide range of industries and business segments are making significant investments in technology modernization and digital transformations. Successful efforts have been driven by standard data models.

Company initiatives vary in size of investment and complexity. The following examples illustrate technology use cases we have observed in the market.

Asset management: Data standardization

The extent of data standardization is a key driving factor in the success of digital optimization efforts. A data model must facilitate scalable, controlled, and efficient processes that are integrated across a company's platforms and promote accountability.

Large global asset managers are redesigning processes to integrate proprietary data warehouses with workflow tools and standard valuation models to facilitate efficient and controlled flows of data and valuations across their firms.

Banking and real estate: Predictive analytics

Banking and real estate entities continue to navigate regulatory and market shifts including the current expected credit loss (CECL) standard and the end of LIBOR as a benchmark rate. There is increased demand for enhanced insights and predictive analytics to respond to these changes.

Market participants are demanding analytical tools to leverage massive amounts of historical market and pricing data to assess balance sheet impacts and inform business decision-making.

Credit, lending and securitization: RPA, OCR, and AI

There is increased demand for efficiencies related to the extraction, transformation, and analysis of the data found within key documents for direct lending, securitized products, and esoteric investment vehicles.

Businesses are leveraging customized tools that utilize a combination of robotic process automation (RPA), optical character recognition (OCR), and artificial intelligence (AI) to reduce the processing time and risks involved with document reviews.

Achieving digital transformation goals

Market participants with successful digital transformations by redesigning the end-to-end operating model, realizing sub-process efficiencies, performing predictive analytics, or deriving meaningful insights from reporting dashboards.

Key takeaways: Q2 2019

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