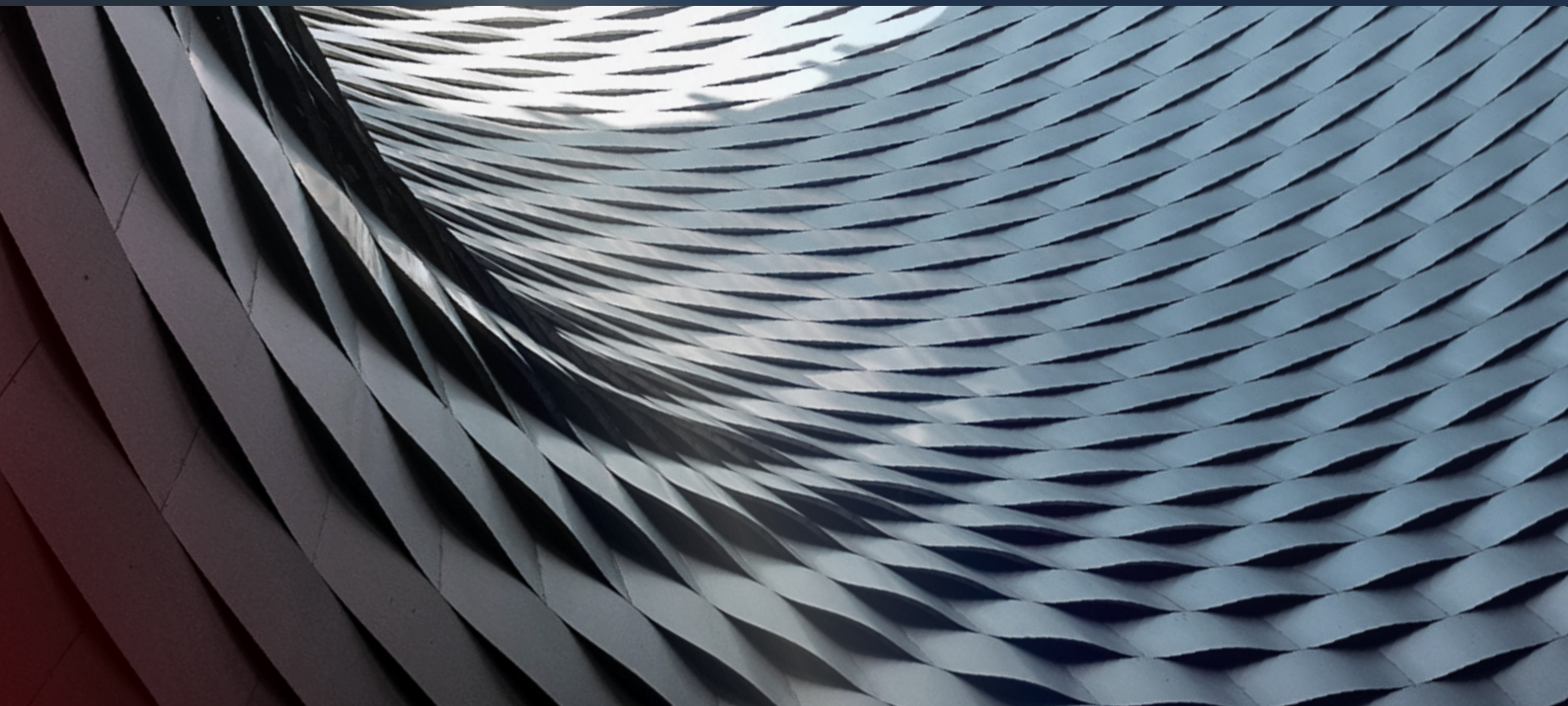


Sell-Side Fixed Income Expert Network Report

The future of fixed income markets



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Intro

Welcome to this, the first valantic FSA Fixed Income Experts Network Report. We have worked with expert network specialists, Acuiti, through Q4 last year to recruit and solicit views from a range of industry participants.

As we started to grow our business internationally, we realized that there was a lack of shareable industry intelligence and have created an invitation only forum for views to be shared on key industry topics.

This report is the first in a series of quarterly reviews that will be based upon the interaction of the network membership. As well as gauging market sentiment, the network allows participants to benchmark their views against their industry peers on operational, regulatory and technology related issues. We plan to add specialist sections starting in the next edition.

This quarter, we have focused on the current state of the market and a look ahead to the challenges and opportunities that 2022 will present. As we start the

year with a sense of renewed optimism (again), the prospect of inflation and central banks increasing rates appears to drive a view of growth this year, with expansion into new products top of the agenda.

With the current report published, we now turn to planning the next edition. If you have questions you would like to see answered or would like to nominate a new member to the network itself then please reach out.

We will look forward to discussing your ideas further with you.



Joachim Lauterbach,
CEO, valantic FSA



Andy Browning,
Head of Electronic Trading,
valantic FSA



Growth strategies for 2022

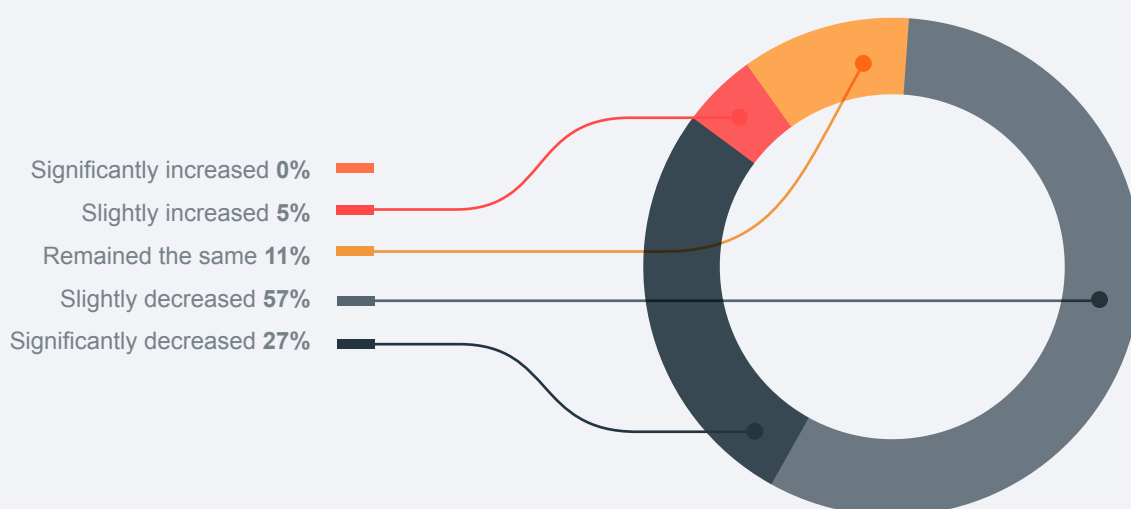
For fixed income businesses across the sell-side, 2022 is set to be a year in which new opportunities will emerge. Members of the valantic FSA Sell-Side Fixed Income Expert Network are optimistic about the year ahead as opportunities abound in multiple areas from inflation to ESG.

The backdrop to the current state of the market is a period of relatively challenging conditions. Over the past decade, the low interest rate policies pursued by the

world's most influential central banks have depressed volatility and made it harder to profit. At the same time, competition has increased as the electronification of the market has brought with it new challenges and new entrants to the market.

Nine out of ten members of the Expert Network said that margins for sell-side intermediation in fixed income markets had decreased over the last three years with 27% pointing to a significant decrease. >

Have margins for sell-side intermediation in fixed income markets have gone up or down over the past three years?



There are myriad drivers of reduced margins for the sell-side. According to members of the Expert Network, the rising costs of regulatory compliance has been the key issue, selected by 58% of respondents as a top 3 factor behind reduced margins. This was followed by increased competition from non-bank electronic liquidity providers (ELPs) and increased fees and costs from trading venues.

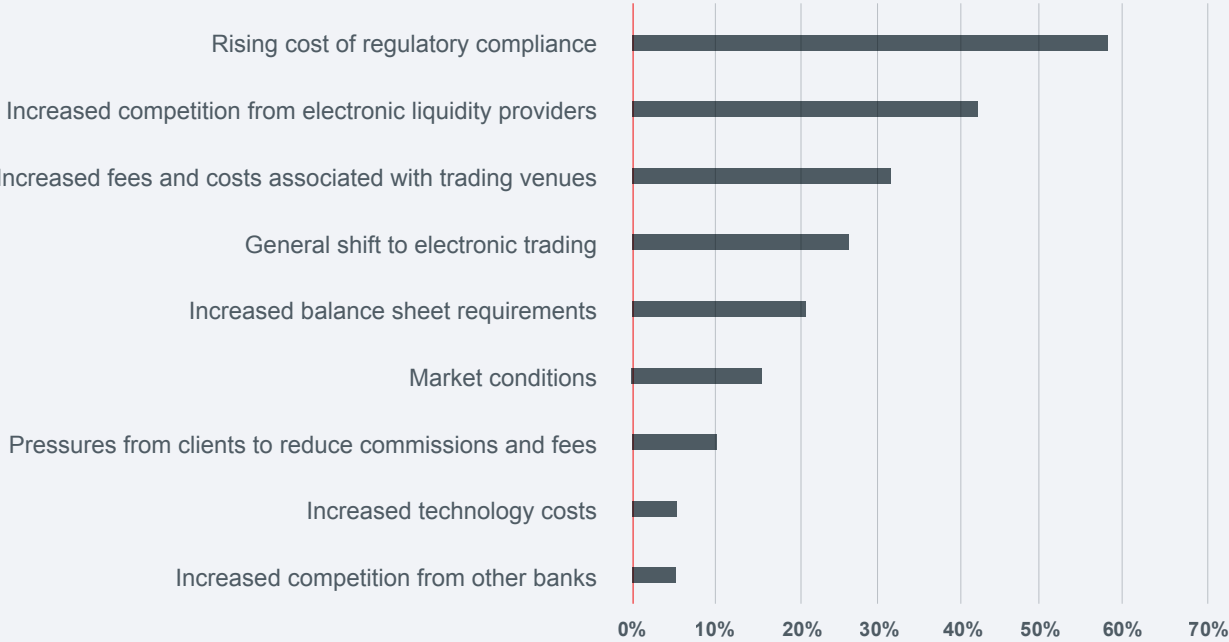
The increased costs resulting from more regulation is not the only concern of the sell-side. Interviews suggest that anxiety results as much from regulatory divergence as from tighter rules. Bankers see divergence creating an unlevel playing field when competing with peers regulated in other jurisdictions.

One example cited was the greater capital charge levied onto loans compared to tradeable securities by Basel III standards. This has crimped the European balance sheet banking model, tailored to bank lending. The traditional US bank model of intermediation has sailed much more comfortably in these conditions.

European bankers say these constrained and competitive conditions have made it hard to boost profitability in their fixed income operations, adding that they need greater capital to provide the same services to their clients as US banks.



Which of the following has had the biggest negative impact on margins?



OPTIMISM FOR 2022

However, despite the challenges the industry has faced, members of the network are looking ahead to 2022 with optimism. The inaugural reading of the valantic FSA Sell-Side Fixed Income Sentiment Index records a positive reading of 57 in terms of outlook for the first quarter of 2022 (see page 8) and optimism is running high for the year as a whole.

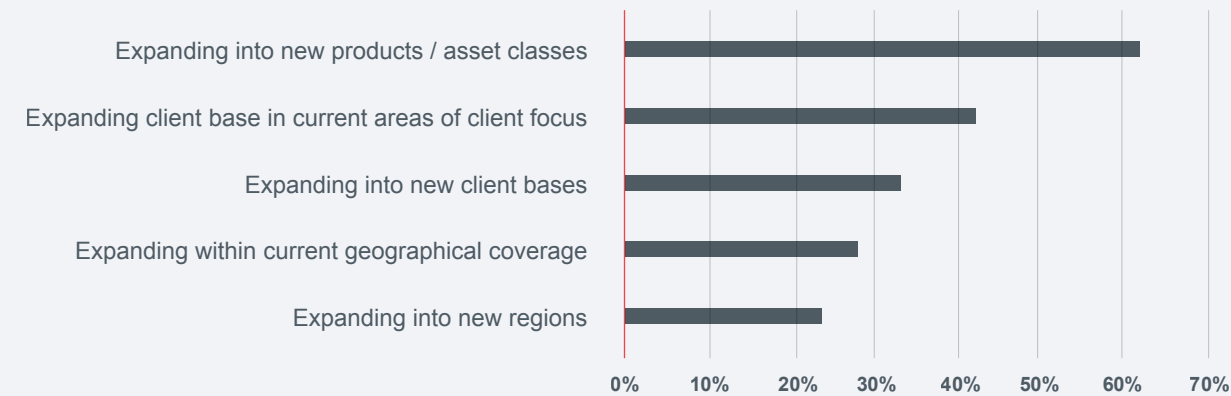
This year presents the possibility of the largest shift in the macro environment for over a decade.

After years spent grappling with a post-2008 monetary policy of ultra-low interest rates, the prospect of inflation and central banks withdrawing stimulus and hiking rates is something that many fixed income heads believe will result in significant growth in their businesses in 2022.

Aside from an improvement in the underlying market dynamics, members of the Expert Network are looking to growth from several areas in 2022. When it came to client acquisition, network members said that expansion into new products and asset classes was the biggest opportunity to win new clients.



What do you think are the top opportunities for the sell-side to expand in fixed income with regards to client acquisition?



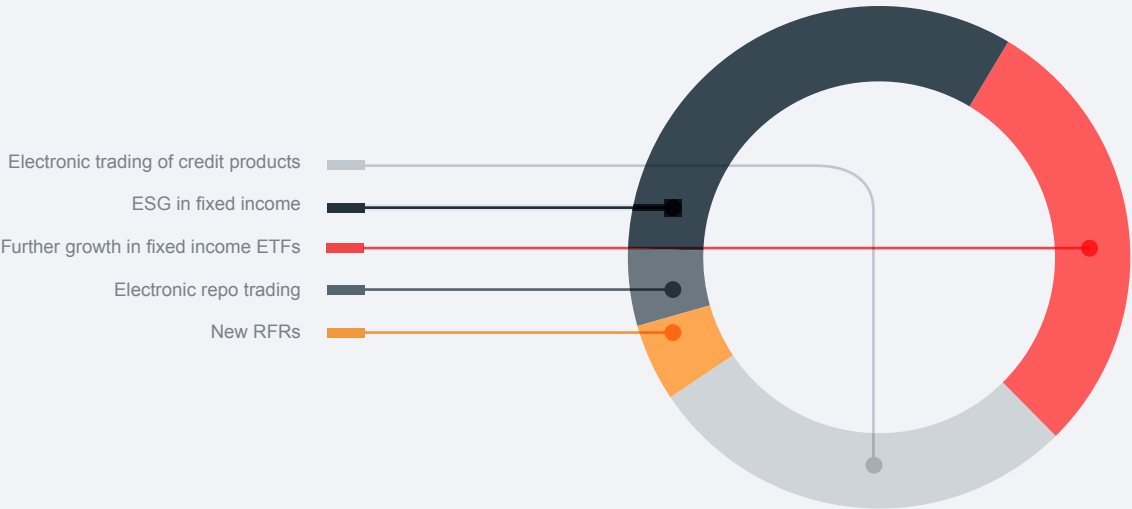
In terms of products and markets, a third of members of the Expert Network thought that ESG in fixed income presented the biggest opportunity in 2022 followed by further growth in ETFs and the electronic trading of credit products. Conversely trading in the new risk-free rates that are replacing Libor and electronic repo trading were not seen to present significant opportunity.

In Europe, where respondents were most bullish on the opportunity in ESG, the regulatory underpinnings for ESG financial markets are already well established. The NextGenerationEU program is also set to add to

momentum with plans for green investment projects. A variety of ESG debt instruments are already trading in secondary markets and new ESG derivatives have been launched by Eurex to support the growth of the nascent market.



In which of the following markets/products do you think there will be the most opportunity in 2022?



For those firms targeting expansion in existing or new client bases, asset managers were the most cited company type for growth with over 50% of respondents selecting this segment as providing the biggest opportunity. This was followed by hedge funds and proprietary trading firms. Interestingly, respondents saw very little opportunity for growth in regional banks and, less surprisingly, within the retail market.

market in 2022 in which growth is likely to come from product innovation or expertise in existing client bases rather than expansion into new client types or regions. Expanding the base of products within the sphere of fixed income and delivering them to clients with greater efficiency (*see next section: Technology investment in 2022*) will be the keystone of growth for the sell-side in 2022.

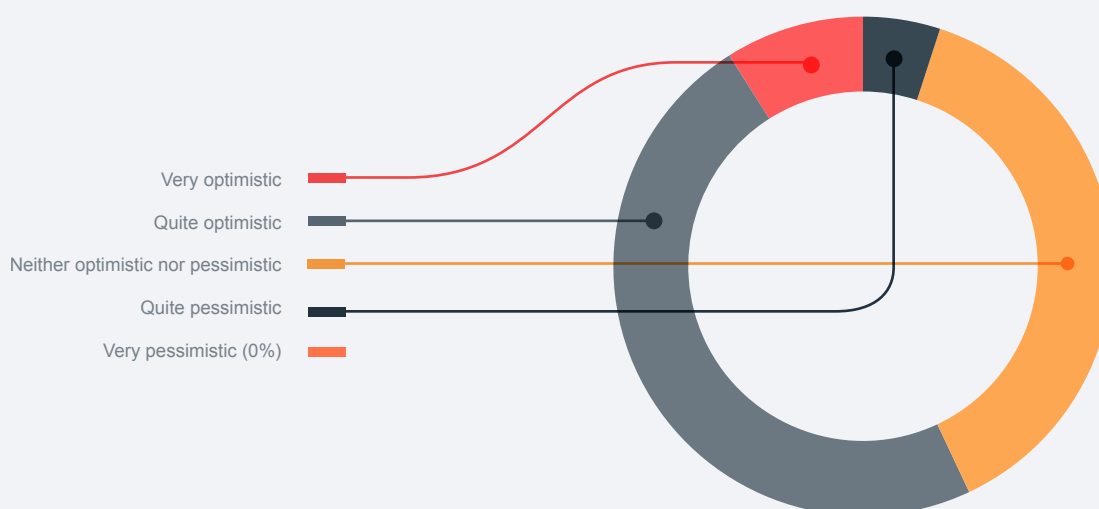
The views of the Expert Network with regards to the opportunities for growth point to a highly competitive

THE VALANTIC FSA SELL-SIDE FIXED INCOME SENTIMENT INDEX

The valantic FSA Sell-Side Fixed Income Sentiment Index tracks levels of optimism within the fixed income markets on a quarterly basis. The first reading of the survey shows a positive score of 57 suggesting

relatively high levels of optimism about business performance in the first quarter of 2022. The index will track changes in sentiment on a quarterly basis.

How optimistic are you about the business environment for sell-side intermediation in fixed income markets over the next three month?



TECHNOLOGY INVESTMENT IN 2022

The increased electronification of fixed income markets has been a key trend for some time and one that members of the Expert Network expect to continue to accelerate in 2022. The trend is influencing the strategy of top executives in several ways from dealing with increased competition to higher levels of investment in technology.

What are the top 10 barriers to expansion in 2022?

- | | |
|---|--|
| 01. Internal technology limitations | 07. Competition from other banks |
| 02. Accessing liquidity pools | 08. Finding skilled staff |
| 03. Low interest rate environment | 09. Ability to rapidly respond to changing client demand |
| 04. Competition from non-bank liquidity providers | 10. Third party vendors reducing the ability to innovate |
| 05. Overcoming fragmented data | |
| 06. Complexity around the libor transition | |

Of the top 10 barriers to growth cited by members of the Expert Network, around half can be addressed through investment in technology.

While currently less prevalent in fixed income than in equities and FX, ELPs are providing significant competition for the traditional sell-side. Over the past five years, ELPs have significantly expanded their direct-to-client offerings. ELPs competing in the fixed income markets have come from the world of ultra-low latency trading in which billions of dollars are invested to shave micro-seconds off a trade and harness cutting edge market making technology.

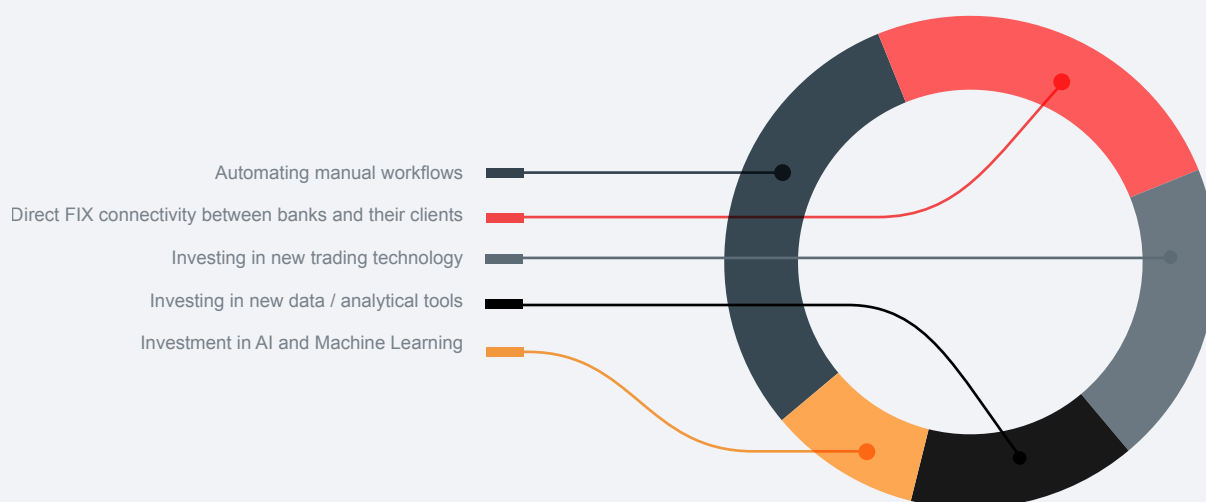
To meet this competitive threat and the demands of the continued electronification of fixed income markets, the sell-side is upping the investment in technology.

As with markets in more advanced stages of electronification, the trend to date has been for more vanilla and commoditized products to move onto platforms first. Voice traders still generally have a greater share of larger and more complex trades but this is shifting, with some exotic, multi-asset packages and structured products already being traded electronically. >

The views of the Expert Network suggest that there is some way to go for banks investment in technology - internal technology limitations were cited by mem-

bers as the biggest barrier to expansion. To increase efficiencies and thrive in 2022, the sell-side will have to increase investment.

What do you think is the top opportunity for the sell-side to expand in fixed income trading with regards to technology investment?



Automating manual workflow was seen as the biggest opportunity for technology investment followed by direct FIX connectivity between banks and their clients and investing in new trading technology. Investing in data and

analytical tools and in AI and machine learning are also top priorities for the market and ones that are likely to grow in importance as the technology evolves.

THE BATTLE FOR TALENT IN 2022

Interviews for this report raised an interesting counterpoint to the idea that electronification leads directly to job losses on trading desks. While recognizing the increasing electronification of fixed income markets, senior executives are seeking to develop a new breed of traders. When hiring for desks, senior management is not just looking for knowledgeable market makers and adept risk takers but professionals with a strong understanding of IT and algorithms.

Finding that talent is hard and feeds into the war for talent currently driving up salaries in the City of London. Not only are banks competing with each other for hires but also with asset managers, ELPs and hedge funds – as well as other industries like tech. This trend has only grown over the years and since the pandemic has heated up – especially for more junior roles with about 5 years' experience – where salaries are said to have rocketed.



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