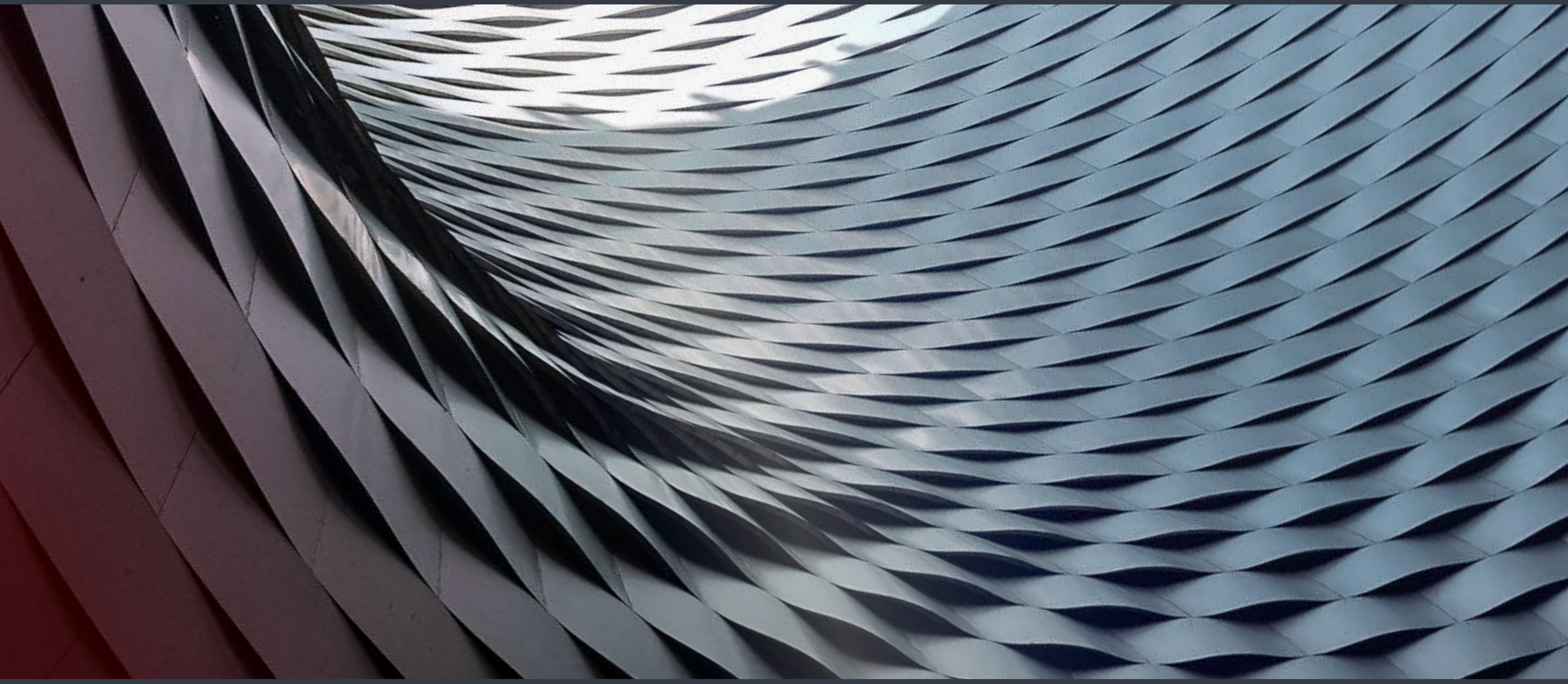
valantic

Report No.4 2023

Sell-Side Fixed Income Expert Network Report

Optimizing growth in 2023



Volatility boosts traditional business models
06

Investment prospects
09

Portfolio demand set to accelerate
12

Research by acuiti management intelligence

Content

Intro

Following what turned out to be a very solid 2022 for fixed income, widely reflected in Q4 results published across the street, we have seen a renewed interest in fixed income as an asset class, with further appetite for investment in the space within the sell-side community.

In our fourth edition of the sell-side fixed income network report in association with Acuiti, we take a quick look back at 2022 to understand how the network fared and review some of the key drivers of business growth.

We also look at 2023, determining where the network sees areas of growth, technology investment and headcount budgets, and which areas that spend will be focused upon. Finally, we take some time to understand the e-trading capability demands that are trending and polled the network on their view about the future of a consolidated tape and when it will happen.

As our focus once again moves to our next report, we ask you to let us know if there are questions that you would like to put to the network. We also encourage you to nominate new members so we can continue to discuss key fixed income topics with the broadest audience possible.

We hope that you will find the latest report useful as a benchmark and we look forward to speaking with you all in the coming months as we prepare the next report.

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Optimizing growth in 2023

Last year was an era-changing one for fixed income markets. Central banks pulled back from their interventionist stance in bond markets and pivoted to tightening monetary policy as they fought against inflation. This brought sustained volatility to markets that had been characterized by mostly benign conditions for nearly a decade.

That, in turn, created pain for a lot of investors, as the twin hits of inflation and the withdrawal of a central bank backstop in markets reset bond valuations along the curve.

The resulting volatility was a boon for many sell-side traders, however. It provided a revenue boost to desks that had been starved of activity during the quantitative easing era, and was reflected in Q4 earnings results.

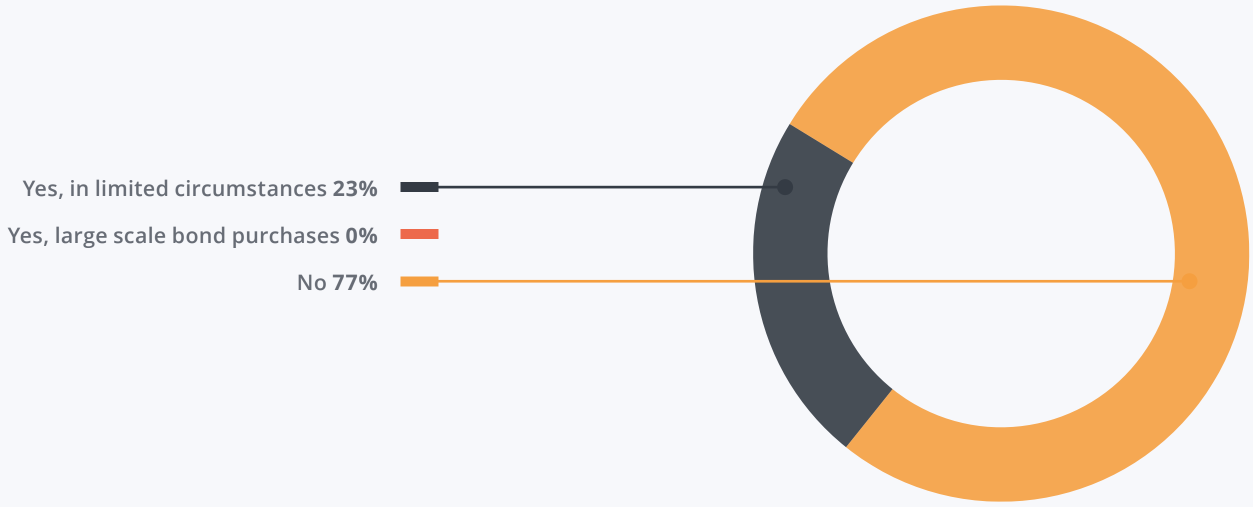
While many investors started the year taking heart from recent data indicating a slowdown in US and eurozone headline inflation rates, it is far from guaranteed that rate setters will begin to loosen monetary policy in 2023. The most recent prints show inflation is still well above the Fed and ECB **2%** target ranges with some institutional investors not envisioning a scenario where the inflation rate will re-align with the Central Banks' targets any time soon. Others are opining that the Fed and ECB may re-calibrate their inflation targets to **3%**.

Some investors have detected a more dovish rhetoric in recent announcements made by officials, but this has come alongside a consistent commitment to staying the course on fighting inflation with restrictive policies. Adding to the uncertainty are geopolitical and macroeconomic concerns such as China's lifting of zero-Covid policies and how long the war in Ukraine will last. This has made getting a read on market sentiment for the year ahead a challenge.

Despite all these uncertainties, the latest survey of the valantic FSA Sell-Side Fixed Income Expert Network found that members of the network had a broadly positive outlook for the year ahead. Most expect that their departments will increase investment in technology. Sentiment was more bullish on the prospects for increasing headcount too. That was despite a mixed outlook for financial industry employment, with some tier one names announcing big job cuts in other divisions, like investment banking.

Assessing market conditions, few in the network expect that central banks will return to take their pre-inflation presence in bond markets. Over three quarters thought they would not, while just under a quarter thought they would only in limited circumstances.

Do you think central banks will return to bond buying in 2023?



The most immediate effect of this withdrawal will be volatility, according to the network. While this benefited many trading desks in 2022, members were also conscious that it carries risks for the market – most notably in reduced liquidity, as a huge price-insensitive buyer withdraws.

What impact will central banks' withdrawal of bond buying programs have on markets in 2023?

01. Increased volatility

02. It will disturb the whole market

03. Decreased liquidity, increased bid offer spreads, larger downside price potential

04. Illiquidity and dislocation

The economic uncertainties affecting other corners of their firms have also tempered some fixed income heads' optimism that divisional profits from last year will run into investment in 2023.

Volatility boosts traditional business models

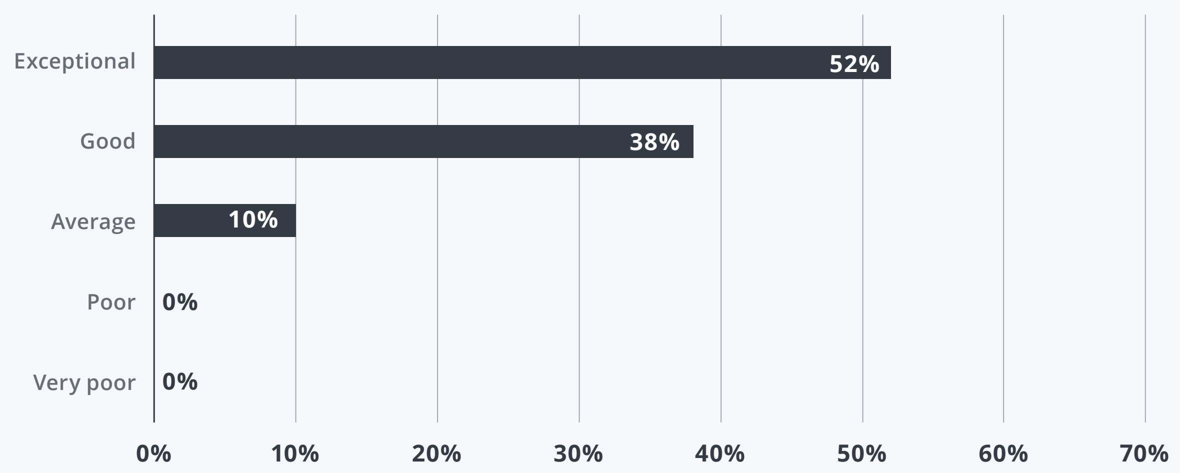
Market movements in 2022 meant sell-side fixed income traders enjoyed a boost in revenues from traditional trading operations.

Bank of America's FICC division recently reported year-on-year revenue growth of **49%**, taking in $2.3bn during the fourth quarter of last year. It took the division's full year revenue to its highest level since 2010.

Similar success was posted by JP Morgan and Goldman Sachs' FICC units, which reported **12%** and **44%** revenue growth (to $3.7bn and $2.7bn), respectively. Citigroup's and Morgan Stanley's fixed income revenues grew by **31%** (to $3.2bn) and 15% (to $1.4bn). Jefferies saw a **71%** surge in its bond trading revenue.

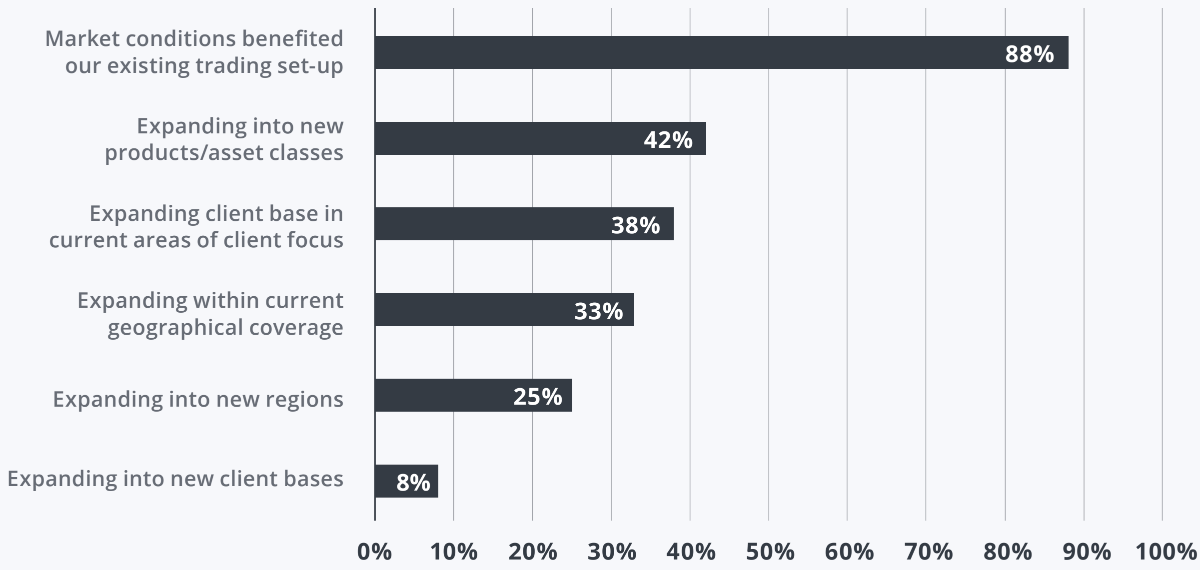
The success of the tier one bond trading shops was reflected across the sell-side, with sentiment buoyant in the fixed income network. Over half of the fixed income network said that relative to an average year, 2022 had been exceptional for their fixed income business. Over a third said it had been good and none said poor or very poor.

Relative to an average year, how strong was 2022 for your fixed income business?



In interviews for this report, senior fixed income executives backed this view and pointed to the profitability of traditional trading models last year, especially in European government bonds where, these desks had previously suffered during the long period of quantitative easing and low interest rates.

What were the main drivers of your revenue growth in 2022?



The second highest driver of revenue growth in 2022 was expanding into new products and asset classes. Given the era-ending changes in monetary policies that began last year, this was already expected to some degree. Investment houses are rebalancing their portfolios to better match their risk-return profiles with the new realities of market conditions.

There is an expectation among the network that these rotations would benefit more traditional and liquid markets like government bonds which have now moved out of negative yielding territory. The expectation was that this would disadvantage more illiquid asset classes like alternative investments, as investors shifted allocations to safer investments with newly higher yields.

In which products do you expect the most client demand for fixed income e-trading in 2023?

01. European Rates
02. US Rates
03. Emerging markets
04. IG Credit
05. Fixed income derivatives
06. Fixed income ETFs
07. CDS
08. ESG
09. HY Credit
10. New RFRs

This was reflected in e-trading expectations, where the survey found that executives are expecting European and US rates to attract the most client demand. These markets have greater liquidity (both electronic and voice) than other fixed income products. The trend is also reflected in conversations that valantic FSA is regularly having with the market, where there is strong interest in investing in, and updating, legacy rates trading technology stacks to gain competitive advantage.

Interestingly, emerging markets came third on the list, above IG credit. Both are markets where voice brokered liquidity has traditionally disappeared during crisis conditions. The priority given to emerging markets may reflect the profitability that the network reported from the asset class last year.

Compared to the valantic FSA outlook for 2022, ESG has also dropped off in importance for 2023, falling below fixed income ETFs in its importance to firms.

Most profitable markets in 2022

01. Emerging markets
02. Fixed income derivatives
03. European rates
04. US rates
05. IG credit

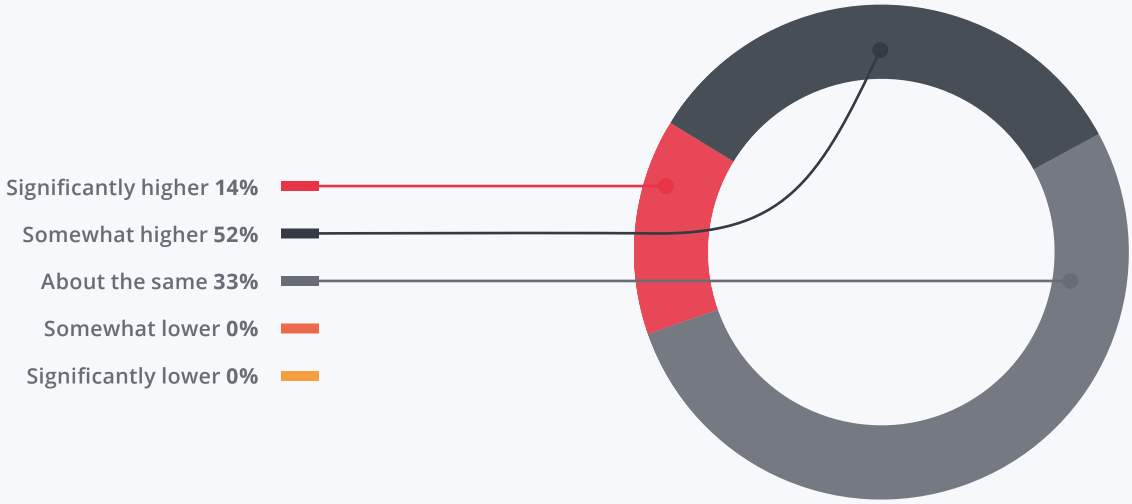
Investment prospects

The healthy revenues that sell-side fixed income traders booked in 2022 stand in contrast to the cost reviews and job cuts that are being implemented in other banking desks. While market volatility has benefited trading desks, broader uncertainty in financing conditions is creating a gloomier outlook for markets like M&A.

Most of our survey respondents expect their technology investment budgets for 2023 to be higher than in an average year. Most of those anticipating a rise in investment said that budget growth would not be significant, though. This may be a result of the climate of cost-cutting in other areas of banking.

Interviewed executives also pointed to a potential lag effect, where CEOs had emphasized even broader cost-cutting measures last year when outlooks were bleaker. These chiefs were now somewhat bound to those commitments in the near-term at least.

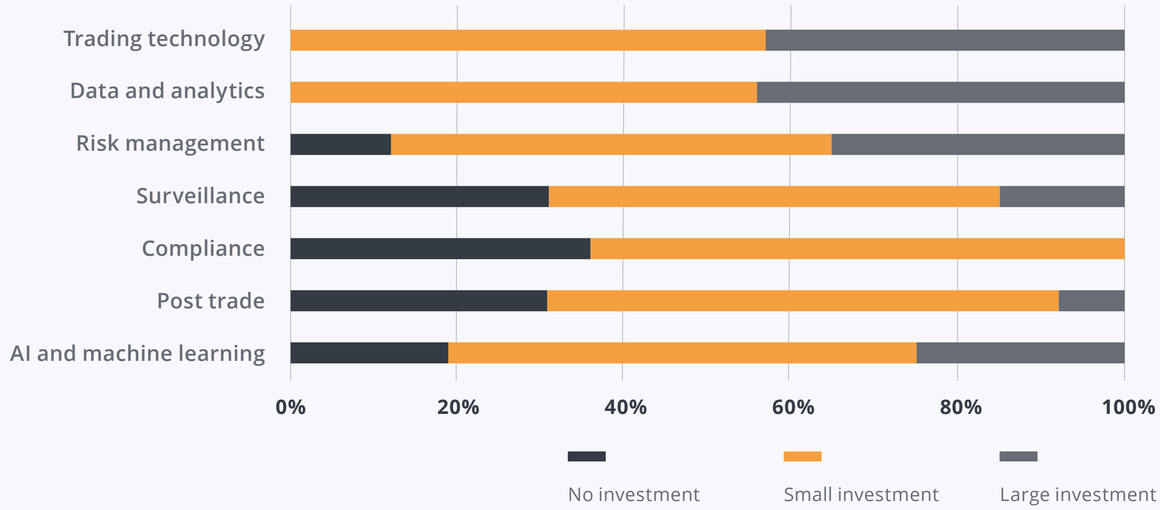
Compared to an average year, how big is your technology investment budget for 2023?



Interviews also pointed to an increasing challenge that some sell-side desks would have to contend with this year. As new investors look to participate in the improving returns on offer in government bond markets, e-trading desks have to think about how best to engage with them. The tendency of some of these newcomers may be to favor voice execution as they lean on the expertise of brokers in less familiar markets.

For example, network members reported that accounts with more flexible mandates that take higher beta positions and move in and out of credit and rates markets have tended to favor voice relationships to executing on electronic platforms, as they try to source bonds. Educating these market participants on the benefits of electronic execution could be a priority going forward.

Where are you planning to invest in 2023 with regards to technology?



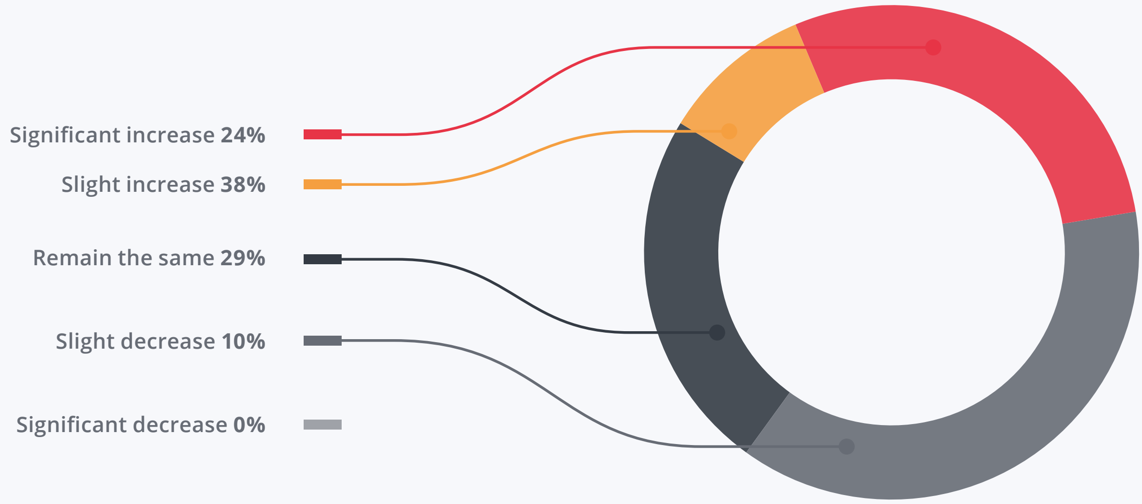
For those who are planning to invest in technology, the largest priorities were trading technology as well as data and analytics. The investment focus on trading technology reinforces that senior executives recognize the long-term trend towards electronic trading, even when the politics of winning budget for investment are complicated in the near term.

Interviews also supported the importance of investment in data and analytics. Members reported that greater efficiency in the internal use of data would be a priority for their firms this year, with emphasis on analyzing where different data sets are used most within the organization and in some cases, reducing the number of vendors that they buy data from.

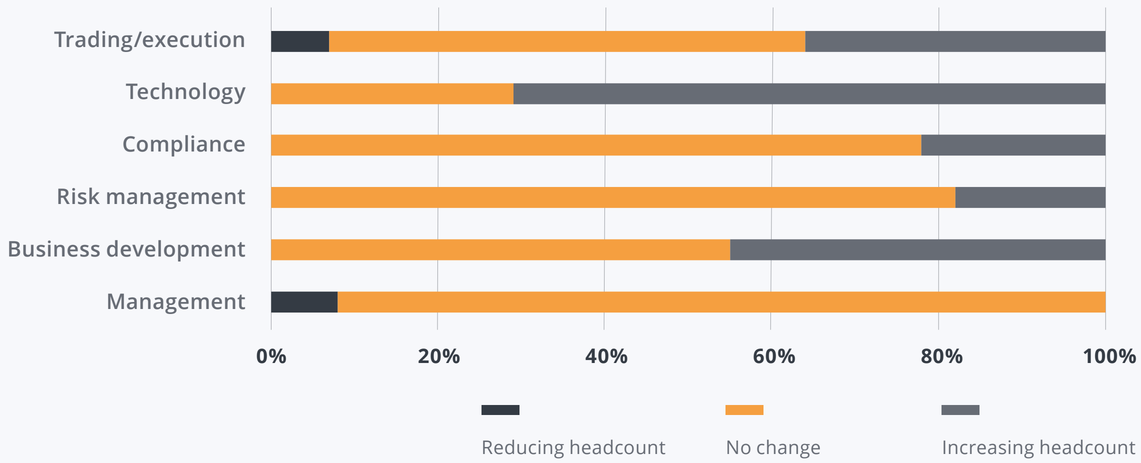
The importance of technology spend was also highlighted in hiring intentions, with these the most budgeted for hiring departments. Business development as well as trading and execution skills were also in demand. For trading and execution, interviews showed a recognition that a new generation needs to be brought through on these desks, with many senior staff starting to approach the end of their careers. Network members have reported that coding and greater e-trading adeptness will be important skills that they want this new generation to bring to their trading desks.

The need for new talent was reflected more broadly across institutions, with most of the network planning an increase in their headcount this year in fixed income.

How do you expect your headcount to change in 2023?



Where are you budgeting to change headcount in 2023 in the following areas?



Portfolio demand set to accelerate

When considering trends within the electronification of fixed income, network members most expected portfolio trading to continue its growth. US fixed income has been a faster adopter of this trend, but the network expected that it will play an increasingly important role in European markets this year.

The increasingly sophisticated client demands for electronic offerings were also reflected in the expectation that more would ask for increased cross-asset functionality this year; a trend that valantic FSA identified and started addressing in its trading solution in 2022. This points to the evolution of e-trading capabilities and the increasing confidence that market participants have in executing more complex trading strategies on platforms.

What workflows/functions do you think will see the most client demand in 2023?

01. Portfolio trading

02. Increase in cross-asset functionality

03. Pre-trade analytics tools

04. Consolidated tape data

05. Direct dealer connectivity

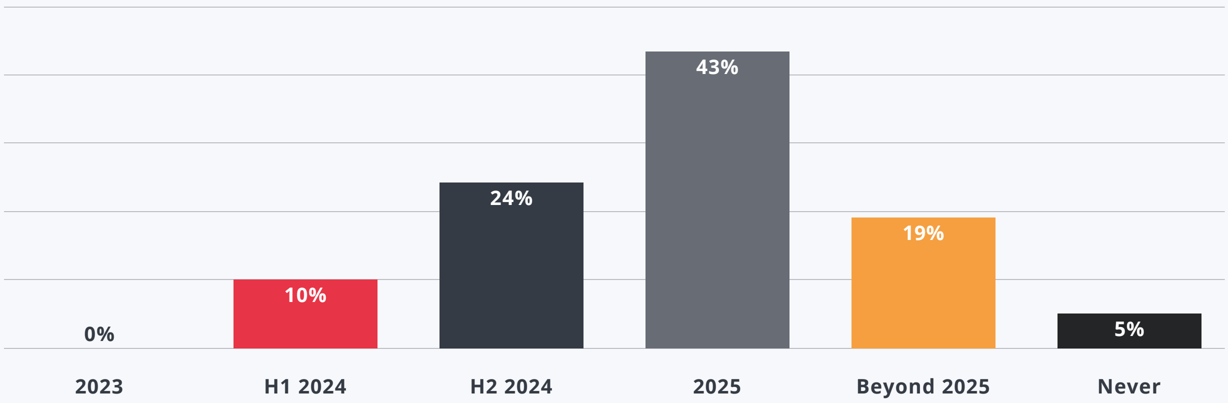
06. Post-trade analytics tools

07. Hedging

Consolidated tape still years out

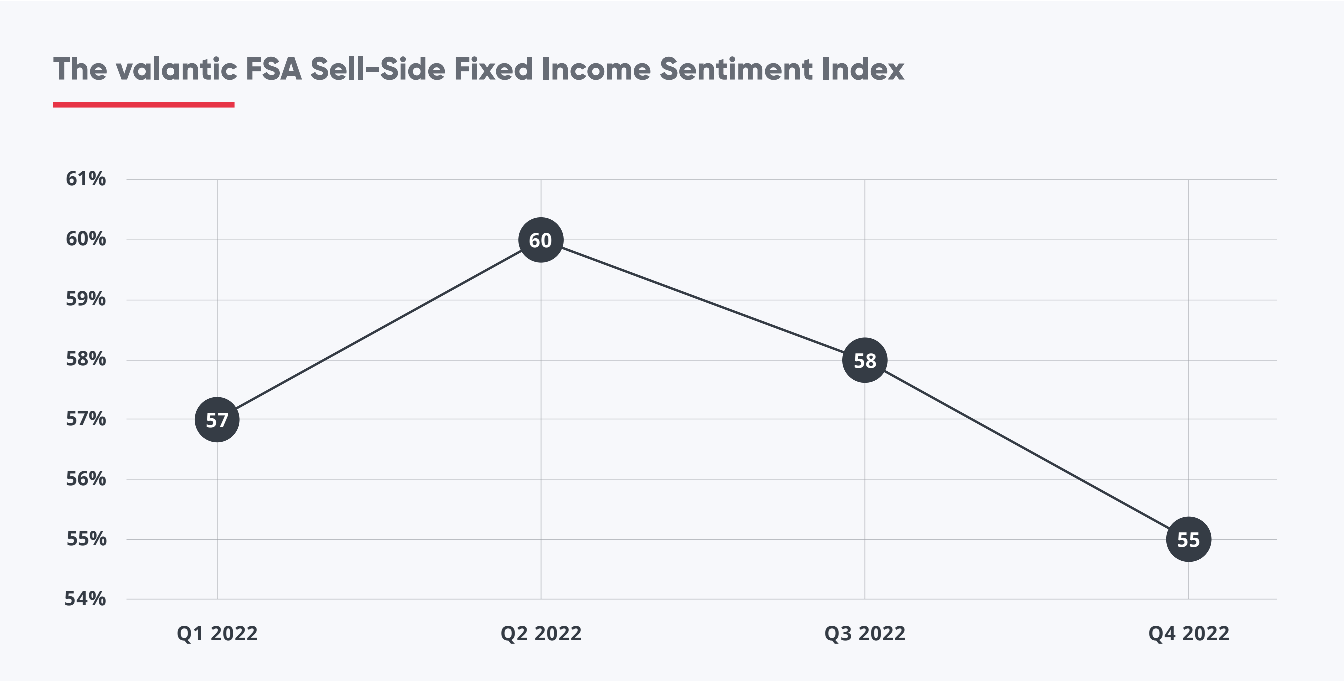
The majority of the network (**68%**) still thinks that consolidated tape is needed in fixed income markets. However, most think that it will not be introduced in the EU until 2025 or beyond.

When do you think a consolidated tape for fixed income in the EU will be introduced?

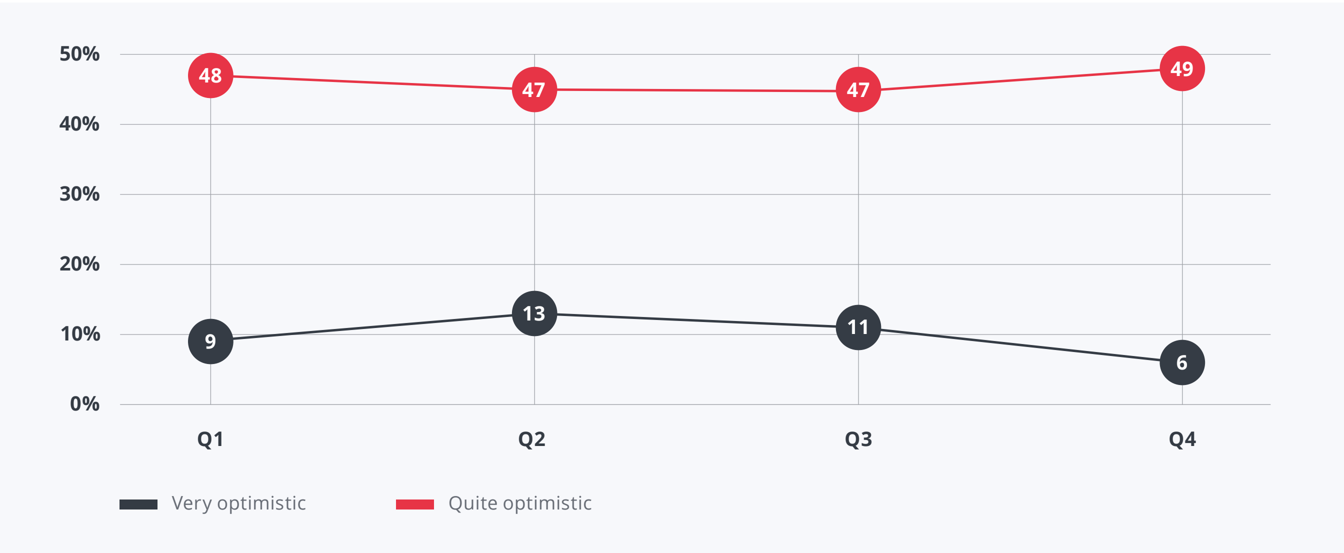


When consolidated tape does arrive, **57%** of the network think that it should be administered by multiple firms, as opposed to a single one (**43%** thought this to be the best path).

The valantic FSA Sell-Side Fixed Income Sentiment Index



This index is calculated as a percentage of the total number of respondents from the Expert Network that were optimistic about their business performance in the upcoming quarter.



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Our heritage in financial markets goes back to over twenty years of building highly robust electronic trading and workflow automation solutions across Fixed Income, FX and Equities. Today, we provide our platform as a series of composable building blocks that address the core business needs of our clients. These are used to create fully customizable workflows for our clients' internal trading operations and to strengthen the electronic relationships with their customers.

We help our clients gain greater insight with our data-centric platform architecture and compelling HTML5 front ends. We supplement this with low-code development tools that enable our clients to further complement and customize our trading platforms.

Working in true partnership with our clients, our goal is to help them address their key business problems, while reducing their total cost of ownership through our complete SaaS and Managed Services offerings.