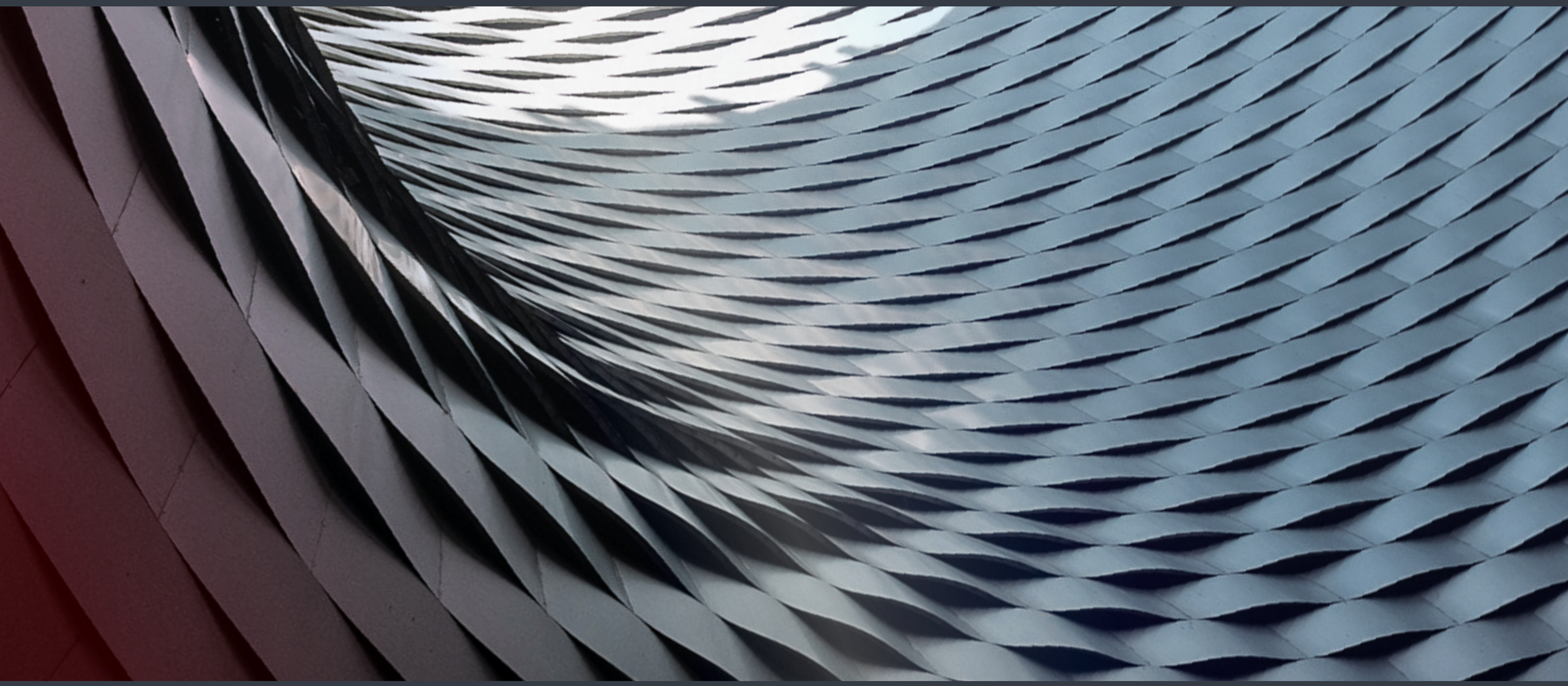
valantic

Report No.5 2023

Sell-Side Fixed Income Expert Network Report

The long wave of electronification in fixed income



Research by acuiti management intelligence

Content

Intro

Welcome to the fifth Sell-Side Fixed Income Expert Network Report, put together in association with Acuiti. In this quarter's instalment, we examine the deepening electronification of fixed income markets. This is a secular trend that has been taking place for many years, and continues to gain momentum as clients demand greater efficiency in their operations. More and more firms are now connecting to electronic platforms and looking to how much of their workflow they can automate.

In this report, we examine how this is taking shape, exploring the adoption of portfolio trading, the continuing electronification of repo markets, as well as the effects that a growing move towards cross-products sales is having on fixed income teams. We also look at the broader impact of market volatility this year, including senior executives' sentiment on staffing and broader financial stability.

As you review the report, please feel free to reach out to us directly and provide us with your thoughts, views and feedback on topics that you would like to see included in the next edition.

Joachim Lauterbach
CEO, valantic FSA

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Head of Electronic Trading,

Portfolio trading on upward trajectory

One of the most notable trends within fixed income electronification in recent years has been the rising popularity of portfolio trading. This has boomed in the US, with volumes on Tradeweb's US platform reaching over $270bn in 2022 — a **19%** year-on-year increase. The venue provider estimates that US portfolio trading now makes up about 5% of TRACE volumes across credit markets.

European portfolio trading constitutes a lower percentage of global volumes (typically accounting for **20-25%**), according to some estimates (the US constituting most of the rest). But conversations with providers show that adoption is ratcheting up, with European firms keen to latch onto what they see taking place in the US.

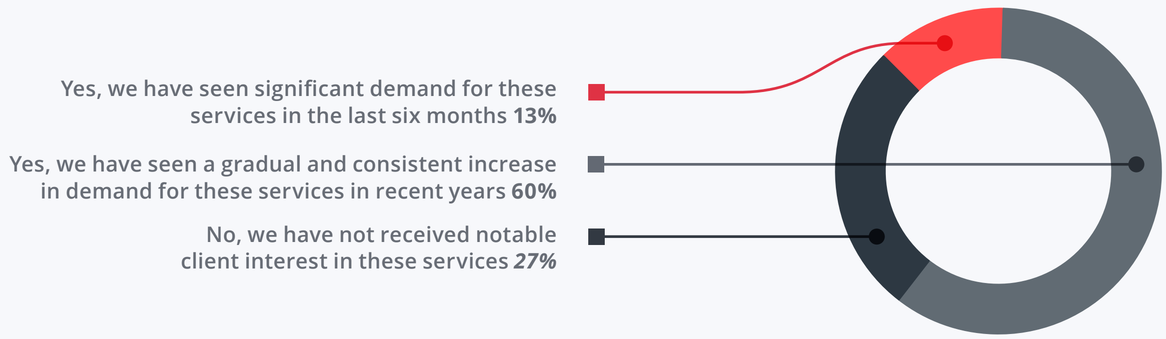
This was reflected in survey data, which shows the network has seen a steady build in demand over recent years.

Sell-side providers mainly attribute client interest in portfolio trading to a desire for efficiency, as the buy-side seeks to create, execute, and optimize portfolios faster and with less headcount and reduced transaction costs.

Clients are also choosing the protocol for discretion during periods of market stress, minimizing their footprint in already volatile conditions when clients need to trade but don't want to move already volatile markets. During the UK LDI crisis, for example, market participants noted spikes in portfolio trading volumes, as clients who were forced into trading bonds sought to do so with as little slippage and as much discretion as possible.

The steady climb in European portfolio trading was reflected in survey responses, with a majority of respondents reporting a gradual and consistent increase in demand for portfolio trading services.

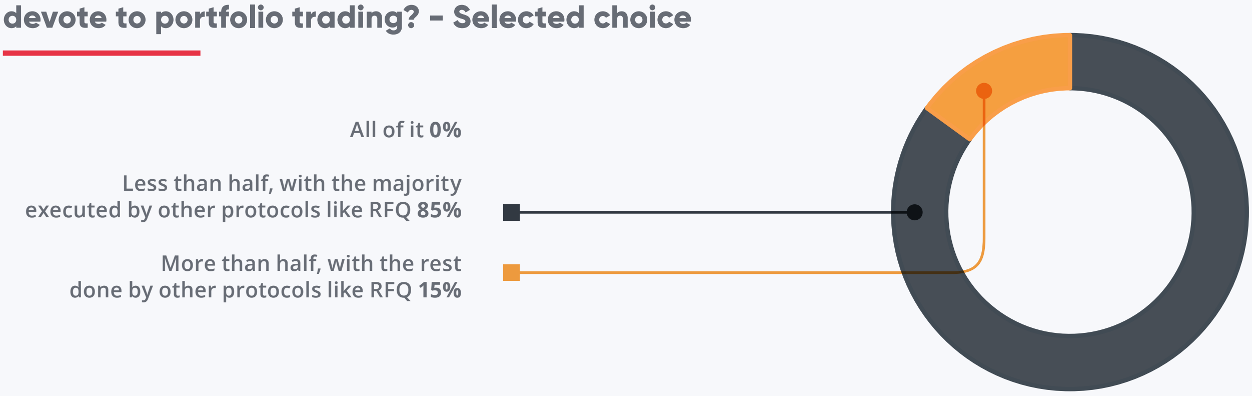
Are your clients demanding greater portfolio trading functionality?



This has taken in an increasing range of market participants and led to portfolio trading services being offered for other fixed income assets, such as emerging markets and covered bonds.

However, while portfolio trading is growing, it is still not the dominant form of execution for many European clients. Among the network's clients, most execute under half their electronic activity via portfolio trading, with the majority done through other protocols like RFQ. Interviews supporting this report suggest that clients are not treating electronic protocols as an 'either/or' choice. Instead, they have been seen to prize flexibility, enjoying the ability to switch between protocols, depending on the market conditions or trading purpose.

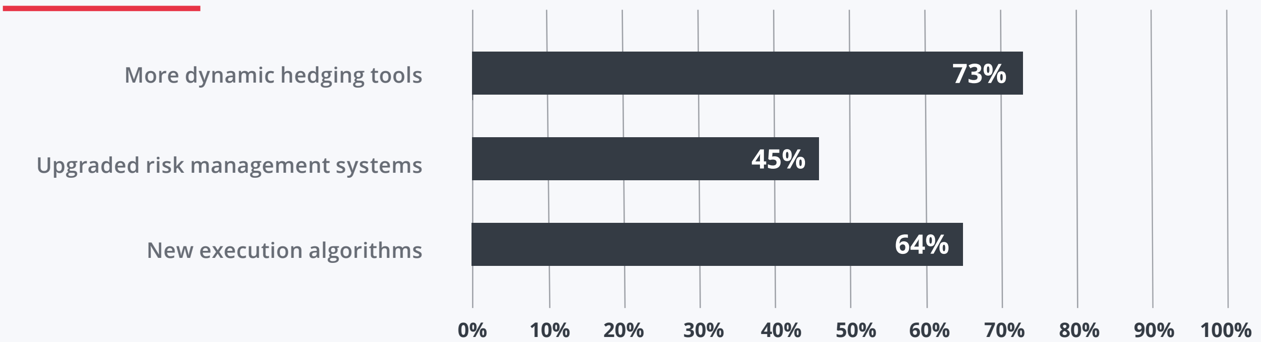
What proportion of their electronic trading activity do clients devote to portfolio trading? - Selected choice



As demand for portfolio trading becomes more widespread across the client space, investment will be needed to offer competitive services. Those in the network who were competing in portfolio trading reported that they had to make. the most adjustments with acquiring or building more dynamic hedging tools.

New execution algorithms were also ranked highly — these are of great importance given clients often choose portfolio trading for certainty of execution. With market participants reporting that a 1,000-line item portfolio trade in Europe can now be executed in under an hour, speed is also clearly becoming a competitive area.

What workflow adjustments have you had to make to provide competitive portfolio trading services to clients?



Rise of Repo

Another tool that market participants are increasingly using to navigate fixed income markets in 2023 is repo. ICMA's most recent survey of the European market, conducted in December 2022, showed a new high in activity, with the total value of outstanding repo contracts on the books of the 61 firms that participated in the survey reaching **€10.374bn**.

That record marks the continuation of an upward trend that began in 2020. This uptick in activity has coincided with increasing client use of electronic repo platforms, which received an initial boost from the EU's Securities Financing Transaction Regulation. The new rules introduced reporting and data collection requirements that are efficiently served by electronic platforms, such as the creation of unique trade identifiers and trade time stamps.

Electronic momentum was then sustained during the Covid-19 pandemic, when repo traders accelerated their engagement with electronic platforms. This demand was driven not just by the need for technological solutions for execution and supervision under remote working conditions, but also the need to adapt coordination between front, middle and back-office staff for trade processing — tasks that platform technology was well placed to support.

Since 2022, activity has been further buoyed by central bank interest rate hikes and withdrawal of market stimulus measures such as TLTRO.

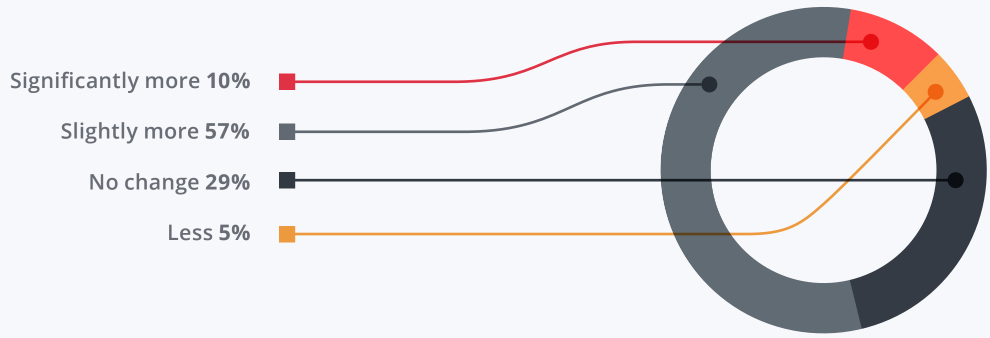
This has had multiple positive effects on repo markets. The paring back of TLTRO has created the need for new secured funding channels among banks. Meanwhile, the move from negative and zero to positive interest rate policies has increased front-end yields, making repo returns more attractive.

The sustained periods of volatility accompanying these rate hikes have also attracted opportunistic trades from leveraged and macro trading strategies.

Volatility has also increased the frequency of margin calls on derivatives — a dynamic already elevated by uncleared margin rules — increasing the need to access cash collateral across the market. Rising rates have also pushed up the variation margin that large institutions like pension funds have to meet as floating payers on swaps. This has increased the need to access cash collateral at speed, which has pushed third parties that offer these services to seek how to improve their offerings.

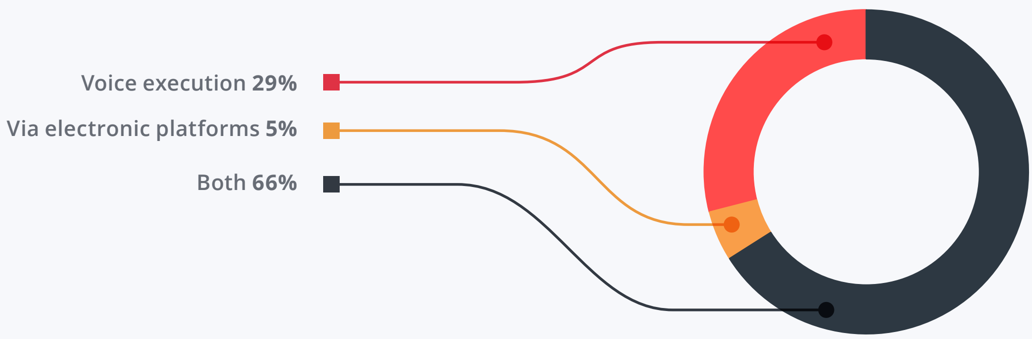
These trends have been reflected in the network, which has witnessed more repo activity from its clients. Accessing collateral for increased margin calls and a desire to increase yields were both cited as drivers for this uptick.

Are your clients making more use of repo markets?



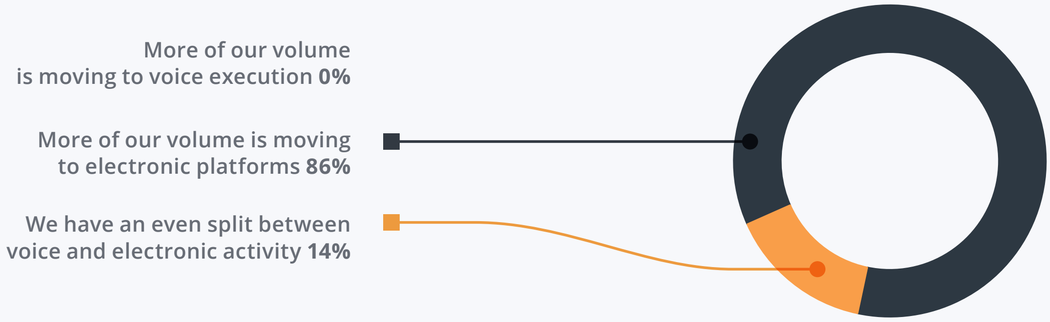
Electronification is also taking place here, with the network reporting a mix of voice and electronic execution as the most popular model among their clients for accessing the repo markets. Using electronic platforms as the primary mode of trading repo was still only done by a minority of the network's clients, though, combined with voice execution, it is becoming more popular.

How do your customers predominantly access repo markets?



However, it is clear that momentum is growing, with the network reporting a growing amount of repo volume moving to electronic platforms and the increase in electronic platforms becoming available to participants.

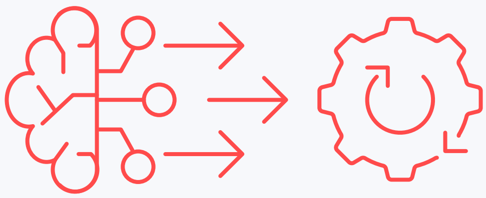
How is the split in activity betwween electronic and voice among your client base changing?

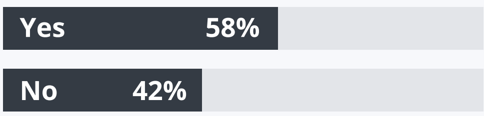


AI trends upwards

Fixed income is no exception to the enthusiasm for artificial intelligence that is sweeping across various industries. Indeed, over half of the network have already integrated it and machine learning into their workflows to some degree.

Do you integrate Artificial Intelligence or Machine Learning into your workflows?



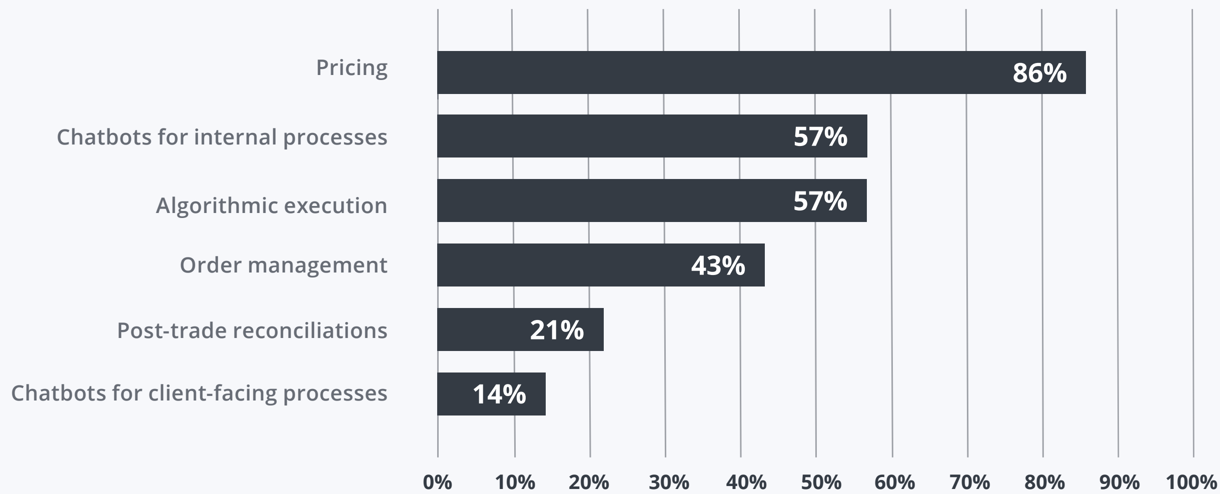


The area where AI and ML is most expected to drive efficiencies is pricing. Here, executives have cited the technology's capacity to improve price discovery by creating order books for markets that traditionally haven't had them. In this instance, AI could be used to aggregate flow from different trading feeds to create an order book — scraping, extracting, and analyzing quotes on multiple messaging systems and the squawk box to bring together prices in markets where liquidity has traditionally been opaque and fragmented.

Algorithmic execution was also seen as an area where AI and ML could drive new efficiencies.

Chatbots for internal processes were cited as an area ripe for AI/ ML too. But few members of the network were as keen on their application to client-facing processes, with few seemingly willing and confident. that AI can replicate the subtleties and nuances of client interaction at present.

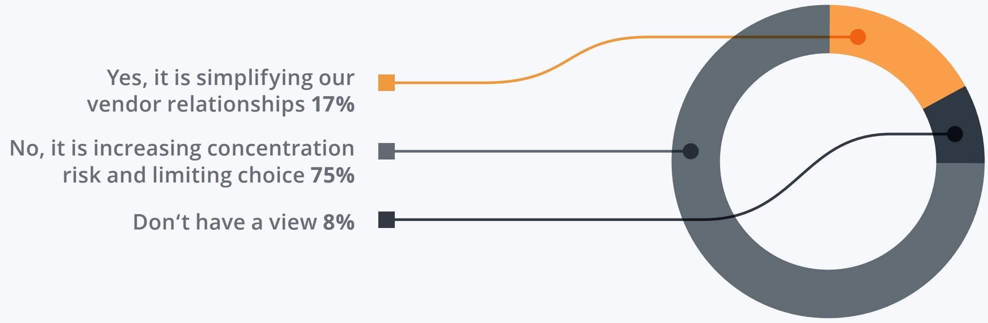
Where do you anticipate AI or ML will drive the most efficiencies?



M&A creates concerns

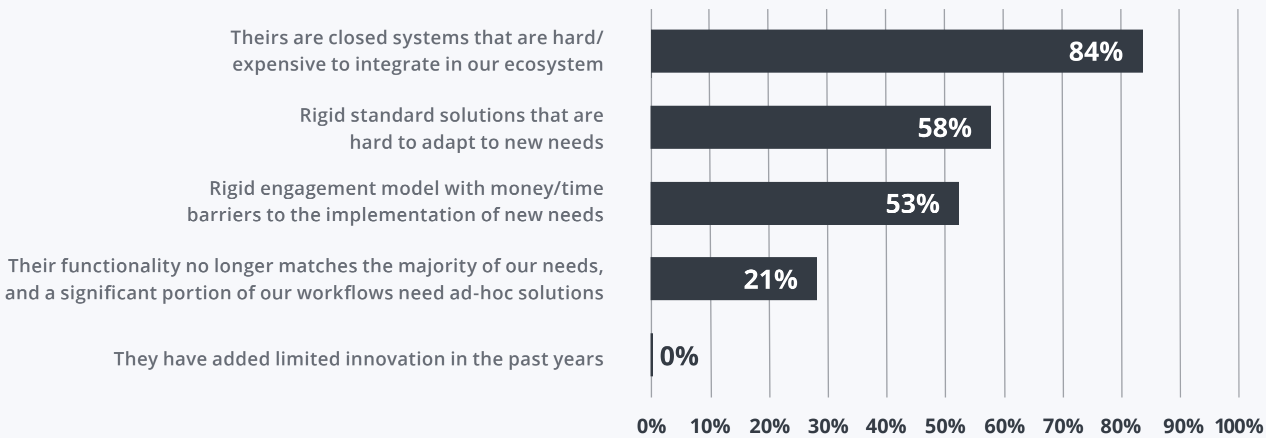
Recent months have seen high-profile M&A among fixed income service providers and most of the network did not see this as a positive development, citing increasing concentration risk and limiting choice.

Following recent M&A of tech vendors in Fixed Income, do you consider consolidation of third-party software providers good for the fixed income industry?



More broadly, the network saw problems with integrating its tech vendors' systems into their own ecosystems, citing this as a difficult and costly process. Rigidity, both of standard solutions and engagement model, was cited as a constraint when needing to adapt systems to new needs. The growing need for a more tailored approach was cited as a key decision criteria when on-boarding new vendors, signaling how the market is looking for a shift from a vendor-centric to a client-centric engagement model.

What do you see as the major limiting factors in your relationship with tech vendors regarding their ability to add value to your workflows?



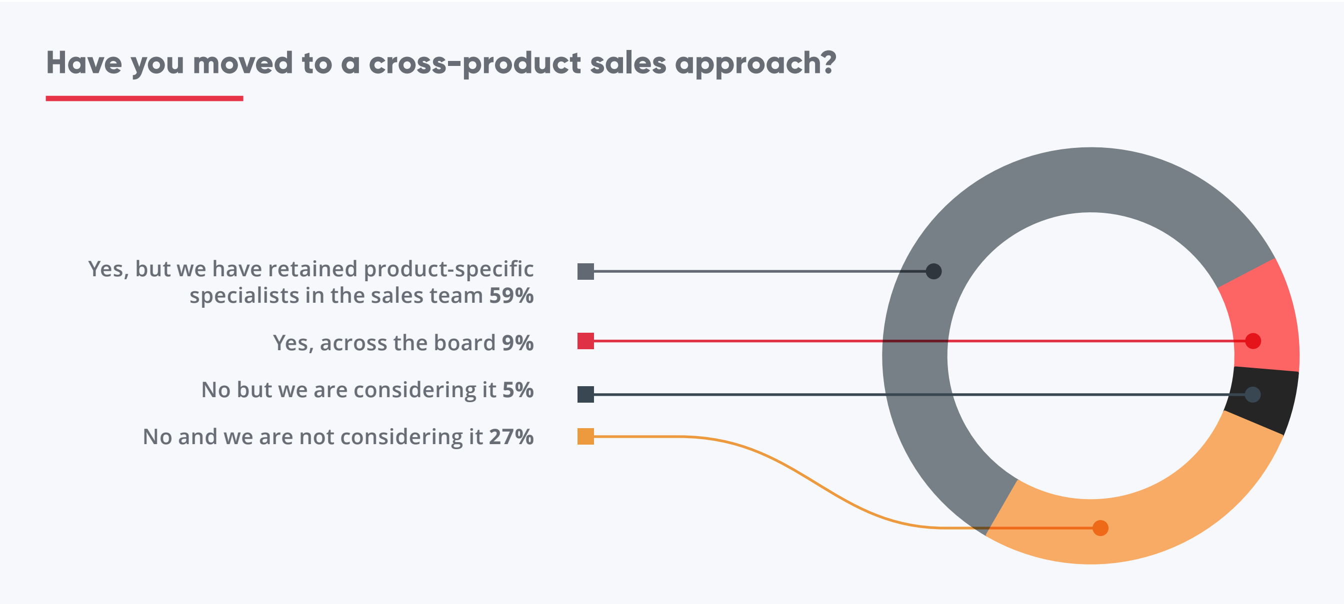
Moving to a cross-sales approach

With pressure on headcount affecting most of the industry, many firms are seeking a more efficient sales model that optimizes human resources. Most of the network reported moving in this direction, although the move had been cautious for most. A majority still retained product-specific specialists within their team.

With the rising rates cycle changing the calculus of asset allocation for many investors, it can also be important to retain staff that have expertise in more niche and complex markets. Some of the network have noted increased inquiry this year about products like exotic derivatives, for example.

Despite pressure on the sales role, interviews still showed that executives hold it in high importance as a function for understanding the needs and behavior of investors. For example, despite a turning interest rate cycle, some desks in the network have reported difficulties in persuading their clients to exit strategies constructed during the last rates cycle, such as shifting from alternative investments to more traditional fixed income products like govvies and derivatives referencing them.

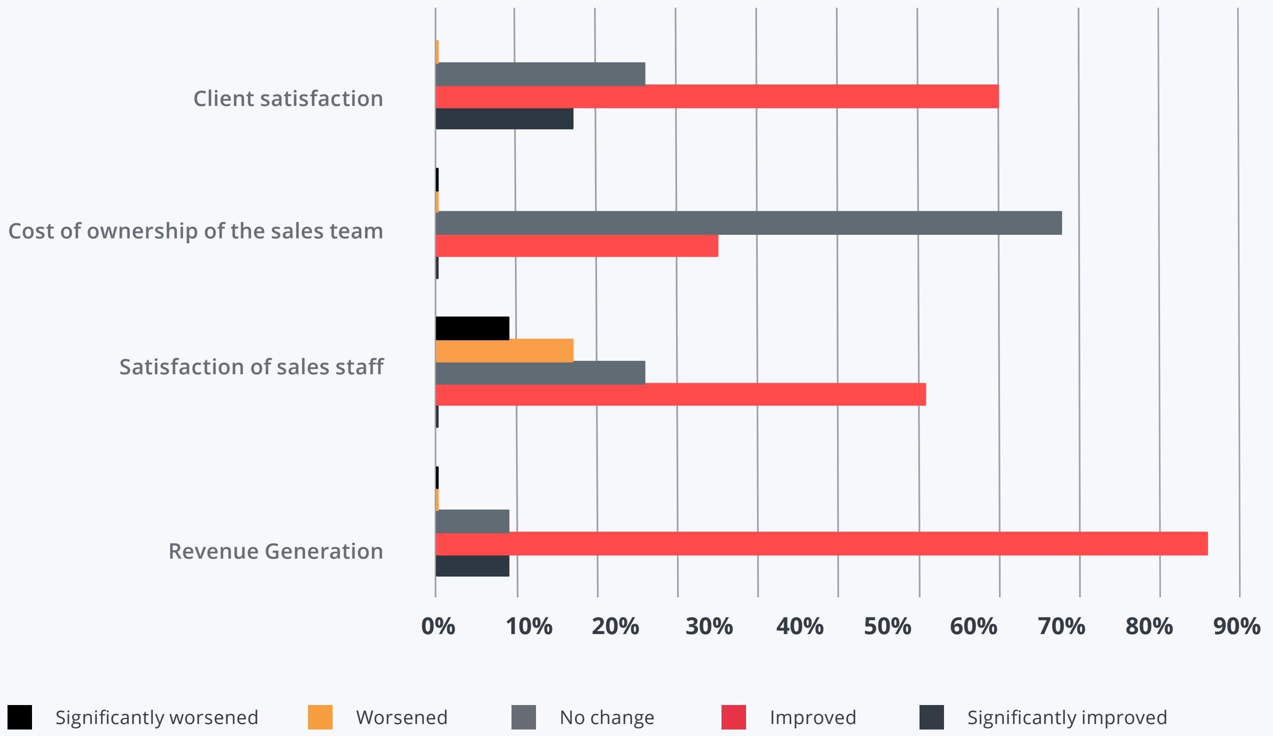
This has partly been driven by the more complicated liquidity profile of these investments (making exiting them harder), as well as the fact that alternative investments are often private and not marked to market — insulating them from the immediate effects of volatility. Skilled sales team are an important part of the strategy for understanding these constraints and pushing for reallocations over time.



Those who have taken on the cross-product approach mostly reported improvement in client satisfaction, with clients benefitting from the increased amount of color they can get across markets from a single point of contact. We also found that the approach allows sales teams to identify relative value opportunities more proactively and easily, as opposed to a specialist structure where workload is much more closely linked to activity in a specific asset class. In addition to these points, the network. commented that revenue generation had also benefitted.

However, the worsening satisfaction of sales teams' points to a major drawback of the model — its tendency to create a constant heavy workload for staff that constricts the time available to conduct a deeper analysis of opportunities within one asset class, a luxury that the specialist model allows for. It may also be that the cross-sales model is better suited to firms that serve smaller and midmarket clients.

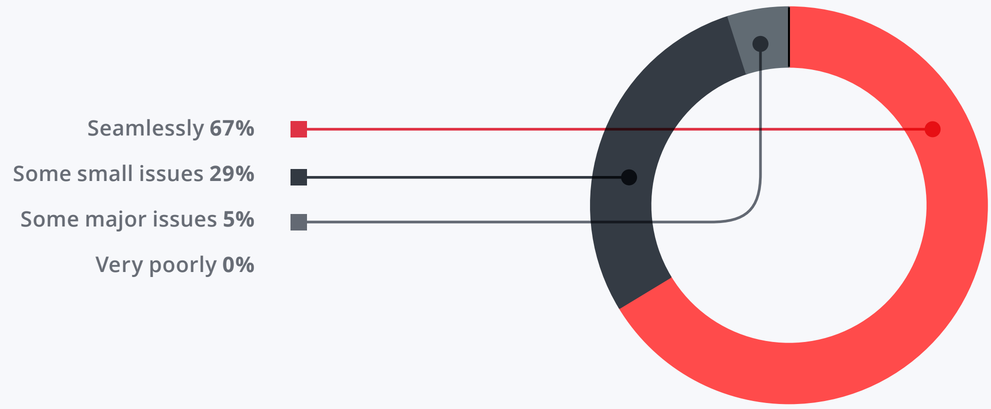
How has the move to cross-product sales impacted your business in the following areas:



Assessing the impact of market conditions

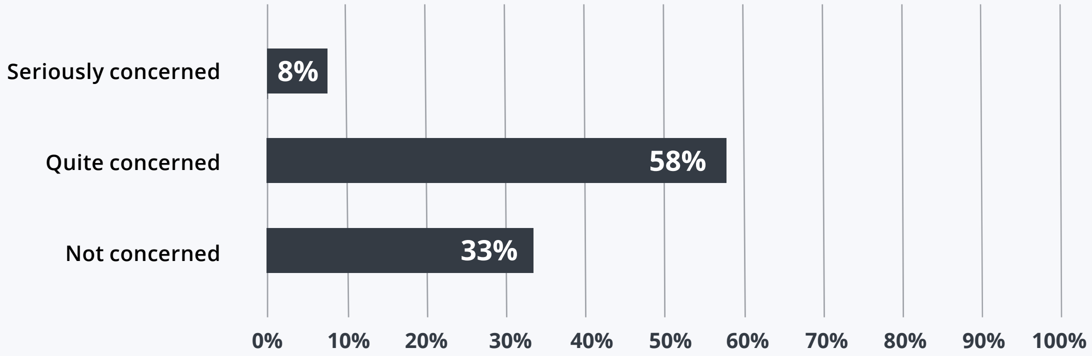
The trading conditions of this and last year have offered opportunities but also increased risks and tested many desks' systems. When assessing their workflows' performance during these challenging conditions, most of the network reported positive results, with only a very small proportion reporting major issues. Where problems arose, they took place in hedging, order management, quoting/ streaming, and post trade reconciliations.

How did your trading workflows perform during the recent volatility?



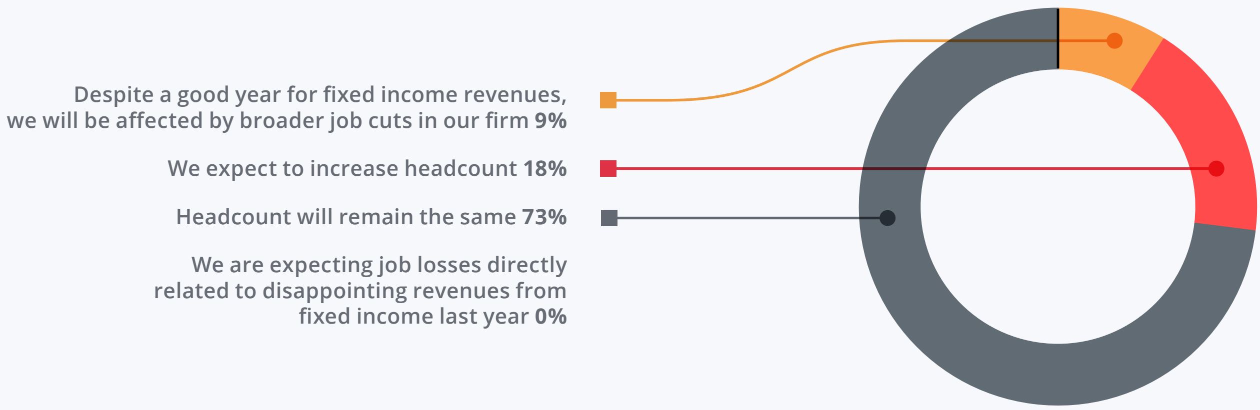
Despite mostly positive first-hand experiences, there is still a significant amount of concern about the wider effects of fixed income market volatility. The effects of rising interest rates on the balance sheets of US regional banks have made many nervous that other failures could emerge.

Overall, are you concerned about the market's ability to absorb moves in fixed income that were experienced during the recent volatility



These broader macro concerns, combined with uncertainty about future economic performance, have pushed many banks to cut or plan cuts to their workforce. Our network does not expect that this will overly affect trading and execution desks, though. These teams have generally performed well as a result of the market volatility this and last year. While the broader climate within their firms may make expanding teams harder, there seems to be confidence that they will be shielded from the job cuts taking place elsewhere.

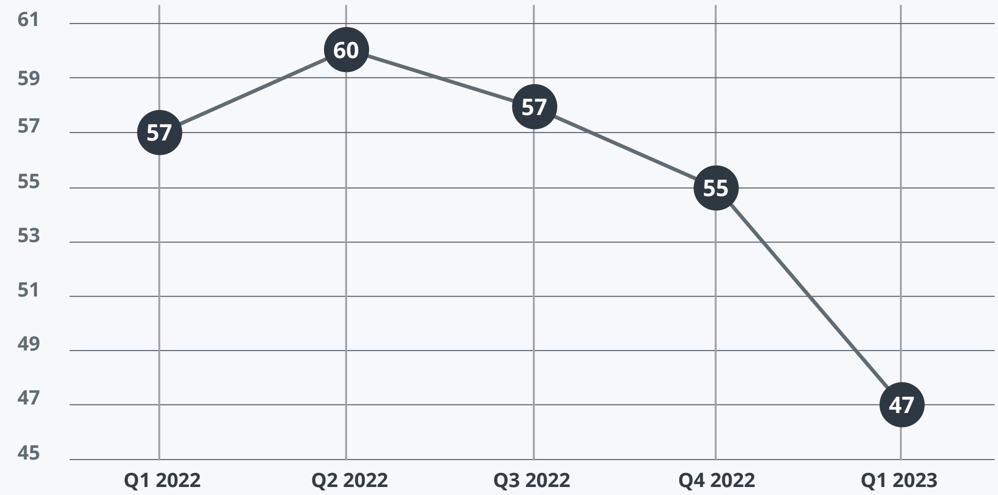
What are your expectations for headcount on your trading and execution desks this year?



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.

The valantic FSA Sell-Side Fixed Income Sentiment Index



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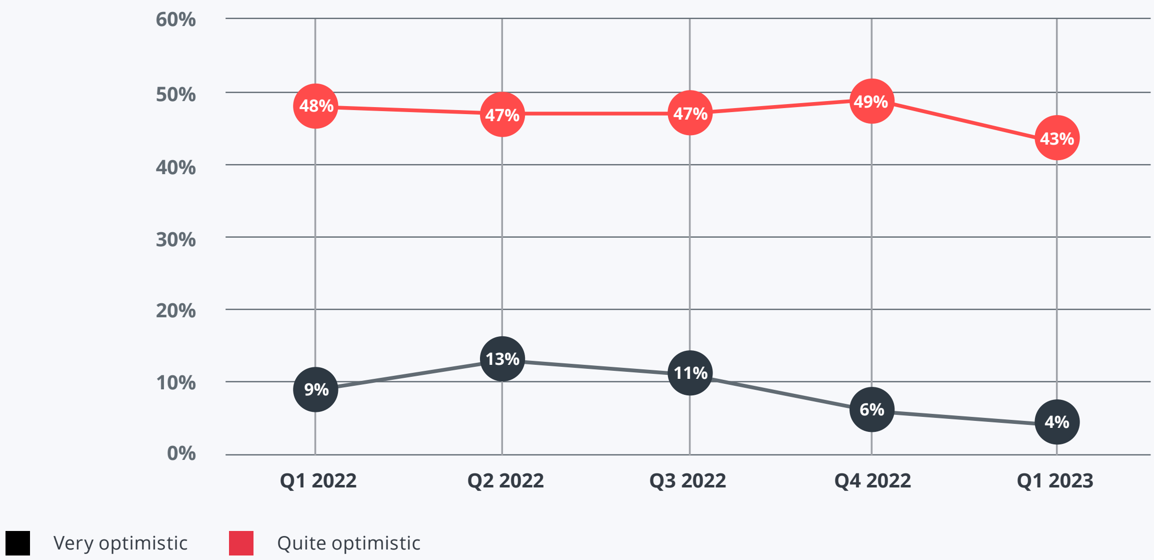

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Our heritage in financial markets goes back to over twenty years of building highly robust electronic trading and workflow automation solutions across Fixed Income, FX and Equities. Today, we provide our platform as a series of composable building 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.

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