Credit trading: never more choice for the buy side

By Fabrizio Testa, CEO of MTS and Andy Webb, Managing Director of trading model consultancy, Omega Derivatives.

At first glance, the prospects for European bond markets look decidedly inauspicious for investment banks and their buyside clients, with rising costs and regulation acting to reduce liquidity and ultimately to degrade buyside returns. However, as this apparent thundercloud contains a substantial silver lining, which the buyside could fully explore to its considerable advantage.

The thundercloud

For the investment banking industry, European bond markets are currently not a pretty sight. Underlying economic conditions remain weak, with the EU (28 countries) fiscal balance (as a percentage of GDP) still negative, at -2.4% for 2015[1]. Brexit has further added to the gloom: the EC's July consumer confidence figure for the EEC area fell to minus 7.6 in July from minus 5.8 in June – its lowest level since December 2014.

At the same time, investment banks have their own more industry-specific concerns, with rising costs and the regulatory burden of complying with Dodd-Frank, Basel III, MiFID II, EMIR and MiFIR. Increasing capital requirements represent an appreciable proportion of this burden. While less severe than expected, the January 2016 decision by the Basel Committee on the amount of capital banks have to maintain for their trading books still represented an average increase of 40% over the levels previously required.

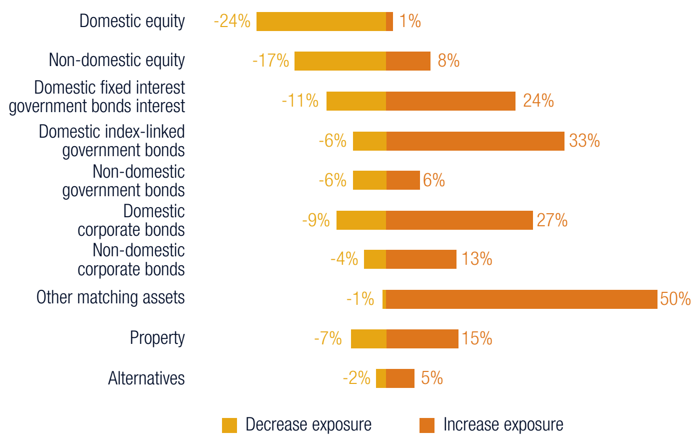
While these changes will have generic impact on investment banking activities, one of the business areas likely to be hit hardest is fixed income, as banks respond to increasing cost and regulatory burdens by either withdrawing completely from fixed income or just focusing on niches. The net effect for the buyside of these changes would appear to be declining liquidity, greater volatility, wider dealing spreads and increased slippage on orders. A recent report by TIAA[2] points to a rise of nearly a third in high grade bid/ask spreads between September 2014 and September 2015, plus a decline of ~50% in dealer inventories for both investment grade and high yield corporate bonds between January 2014 and July 2015.

The silver lining

Despite this apparently gloomy prognosis, things for the fixed income buyside are actually considerably better than they appear. Firstly, demand from investors is increasing strongly. According to Boston Consulting Group estimates, assets under management are set to rise from ~USD74trn in 2014 to ~USD100trn by 2020. The proportion of this allocated to fixed income also appears to be growing. A 2016 survey of 1,100 European institutional investors by Mercer[3] revealed that growth-oriented fixed income rose sharply between 2014 and 2015, from 27% of allocated plans to 40%.

The same survey also highlighted investors' future plans to shift from equities towards various categories of fixed income. Allocations to domestic and non-domestic equity were expected to see net declines of 23% and 9% respectively. By contrast, allocations to domestic fixed interest and domestic index linked government bonds were expected to rise by 13% and 27% respectively, on a net basis. In the case of corporate bonds, domestic issues were tipped to see allocations rise by a net 18%, while for non-domestic corporate issues the corresponding figure was +9% (see Figure 1).

Figure 1: Percentage of plans expecting to change investment strategy



This may seem counter-intuitive – if access to fixed income liquidity is becoming problematic, why increase allocation to fixed income? In practice the situation is less clear cut. Firstly, a number of non-banks are starting to move into the business of making prices in fixed income. Some are spin-offs from alternative asset managers, while others have different origins. While they may lack the reassurance of formal credit ratings held by the large investment banks, they tend to have new, highly efficient, purpose built technology infrastructures, potentially capable of supporting firm pricing in size.

This fits well with another trend in the buyside's favour: the electronification of fixed income markets. In contrast with voice broking, this delivers improved transparency, better data quality, reduced costs and tighter dealing spreads. In addition, it enables the development and choice of new trading protocols, plus facilitates the evolution of new tools to discover and execute against liquidity efficiently. The trend towards electronification also looks set to endure in the light of recent progress: according to BIS figures[4], electronic trading volumes rose by more than 40% between 2010 and 2014 (see Figure 2) and the bulk of this growth was attributable to dealer-to-customer activity (see Figure 3).

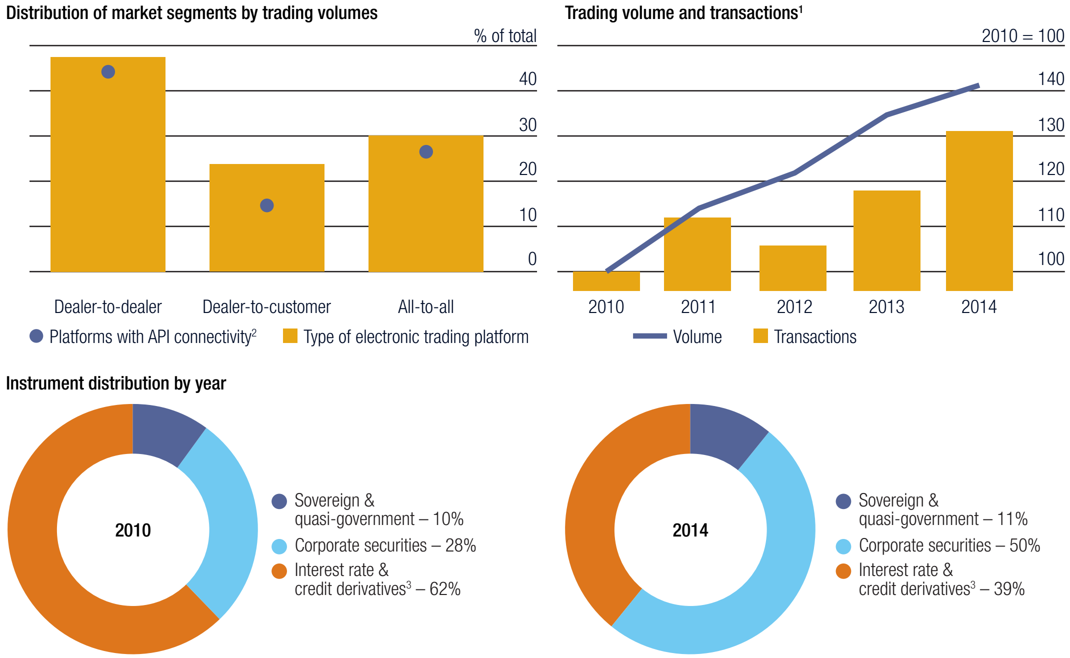
A further favourable factor is that buyside investors can be reassured about underlying supply. Recent issuance levels have been strong. For instance, corporate investment grade EUR bond issuance hit six-year highs in late 2015[5]. While EUR sovereign bond issuance is expected to slow slightly in 2016, the recent trend has been strong, with 10, 15 and 30-year issuance in 2015 particularly robust[6]. In the US, the trend has been even more pronounced, with corporate issuance in 2015 hitting an all time high and government issuance still comfortably above the USD2trn level first established in 2009[7].

Turning a silver lining to a gold reality

While the underlying situation for the buyside in fixed income is positive in the general sense, the key is how to maximise this opportunity in practice. Demand – in the form of increased buyside allocations to fixed income – and supply – in the form of ample issuance are clearly both present, but how best to combine them in an efficient trading experience? It seems likely that there will be more direct buyside participation in both primary and secondary markets in the coming years. However, for maximum benefit this will need to be accompanied by a willingness on the part of the buyside to explore new trading methods and platforms that suit asset managers' specific trading strategies.

The good news is that there are already platforms capable of supporting this process in the

Figure 2: Fixed income trading on electronic platforms is picking up



1. Based on average daily trading volume and transaction data, excluding repo and fixed income futures for selected platforms; 2. API = application programming interface; 3. Interest rate swaps, fixed income options and credit default swaps.

Sources: Markets Committee (2016); authors' calculations

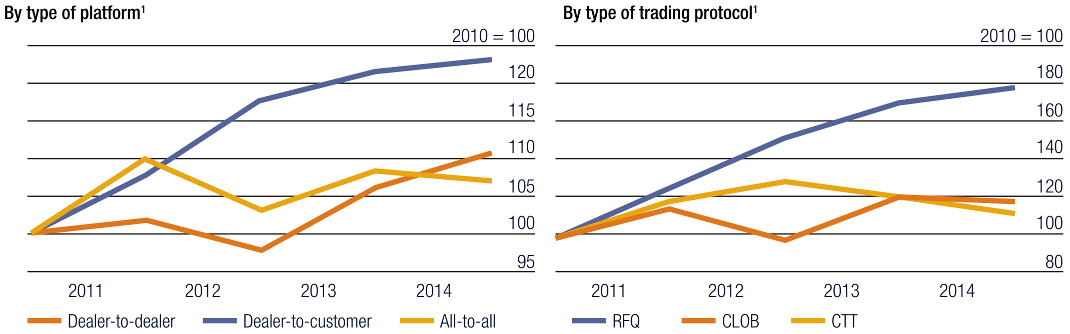
broadest sense, but the caveat is that not all of them will also be equipped to ensure the orderly and efficient evolution of fixed income markets. A key requirement is that any such platform or trading venue is a regulated entity. In line with most other participants in financial markets, the buyside is increasingly focusing on risk management and compliance. This is especially pertinent for the buyside active in fixed income, who have long been accustomed to dealing with rated counterparties, a situation that may change over time if non-bank price makers continue to grow their market share.

Any such platform also obviously needs to be connected to a global network of counterparties and their inventories to deliver the broadest range of instruments in sufficient liquidity. However, in order to take full advantage of this liquidity, the platform must also be able to offer connectivity to all existing leading OMS providers, plus offering a robust and well-documented API to facilitate the connection of other trading technology.

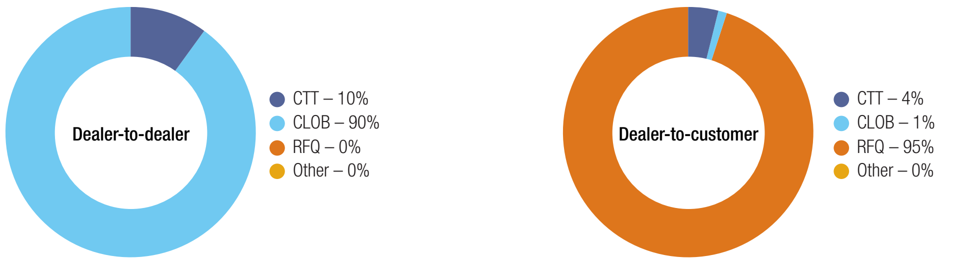
High quality normalised data are important for evaluating discretionary trading strategies, but are even more critical for increasingly popular quantitative and automated trading strategies (including in the context of automated multi-asset trading). An efficient and active electronic platform is well-placed to generate and curate such data.

Finally, as is apparent from the events of the past few years, the fixed income market is undergoing fundamental change that looks set to continue. In such an environment, innovation is at a premium, so any credible fixed income platform should be continually looking to anticipate participants' needs. One area where this is particularly relevant is pre-trade information. It seems clear that the buyside as a whole will be taking a more direct and hands-on role in their fixed income trading. For some,

Figure 3: Electronic trading grew most in dealer-to-customer markets



1. Based on average daily trading volume and transaction data, excluding repo and fixed income futures for selected platforms, broken down by either market segment (dealer-to-dealer, dealer-to-customer, all-to-all) or trading protocol (RFQ, CLOB, CTT).



RFQ = request for quote (request for market); CLOB = centralised limit order; CTT = click-to-trade

Sources: Markets Committee (2016); authors' calculations

previously accustomed to outsourcing execution risk to their bank counterparties, this represents a very significant change in working practice. Therefore, anything that facilitates efficient pre-trade discovery, such as a consolidated view of liquidity providers' inventory, runs and axes, will be valuable – especially if it is coupled to suitable trading platform. This will enable asset managers to use a single interface to search for the bonds they wish to trade without risking information leakage, identify an appropriate counterparty in an efficient and effective manner, and execute their trade.

Conclusion

Environmental changes in fixed income for the sellside in areas such as costs and regulation clearly have knock on implications for the buyside. While it may seem that these implications are prejudicial, the reality is much brighter. The buyside will benefit from increased diversity of choice across those banks that remain active in fixed income and new price making participants. There will be a need for many on the buyside to change the way they conduct their fixed income trading, but careful selection of a suitable trading venue can make this transition relatively painless and low risk. In doing so, they will also be selecting an environment that can future-proof their trading processes, reduce costs and enhance the quality of their trade execution. ■

Footnotes:

1. *Eurostat – http://ec.europa.eu/eurostat/tgm/table.do?tab=table&plugin=1&language=en&pcode=teina200.*
2. *"Reduced liquidity: A new reality for fixed-income markets" – https://www.tiaa.org/public/pdf/C27136_141011958_Bond-Market-Liquidity-White-Paper.pdf.*
3. *European Asset Allocation Survey 2016.*
4. *http://www.bis.org/publ/qtrpdf/r_qt1603h.htm.*
5. *FT/ Dealogic – http://www.ft.com/cms/s/0/e6bc098e-8f94-11e5-a549-b89a1dfede9b.html#axzz4FQrXwgy8.*
6. *https://www.research.unicredit.eu/DocsKey/fxfistrategy_docs_2015_150414.ashx?M=D&R=24189143.*
7. *SIFMA.*

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MTS

MTS has over 25 years of expert fixed income experience and operates efficient electronic markets in Europe and the US, catering to the diverse needs of issuers, primary dealers, market makers and investors. In Europe MTS has over 500 unique counterparties and average daily volumes exceeding EUR 100 billion. MTS US offers trading in global government bonds, corporate US bonds and emerging market debt.

MTS Cash – Interdealer market for fixed income rates products
MTS Repo – Order-driven market for electronic European repo trading
MTS BondVision – Multi-dealer-to-client electronic bond trading
MTS BondsPro – Electronic market for fixed income execution
MTS Swaps – Fully regulated electronic interest rate swaps platform
MTS Data – Real-time tradable prices for European fixed income

Find out more > www.mtsmarkets.com

ORB

London Stock Exchange Group's UK Order Book for Retail Bonds, an order-driven trading service, offers access to a select number of gilts, supranational and UK corporate bonds, developed in response to strong demand from retail investors for access to an on-screen secondary market in fixed income securities.

Find out more > www.londonstockexchange.com/traders-and-brokers/security-types/retail-bonds/retail-bonds.htm

MOT

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Find out more > www.lseg.com/areas-expertise/our-markets/borsa-italiana/fixed-income-markets/mot

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ExtraMOT is the multilateral trading facility, regulated by Borsa Italiana, for the trading of corporate bonds of Italian and non-Italian issuers already listed on other regulated markets of the European Union, branded bank bonds and debt securities issued by Italian SMEs. Launched in 2009 in response to demand from intermediaries and investors to be able to trade Eurobonds within an electronic and automated market which, using the same technology platform and the same controls as the MOT, could guarantee transparency and efficiency in the price formation mechanism (as opposed to the opacity that frequently characterises the over-the-counter or non-regulated markets).

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Fixed Income offering

EuroTLX

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Find out more > www.lch.com/en/asset-classes/repoclear

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