WHITE PAPER

Fixed income market evolution

How can broker dealers navigate the intricate credit trading market and position themselves for success?

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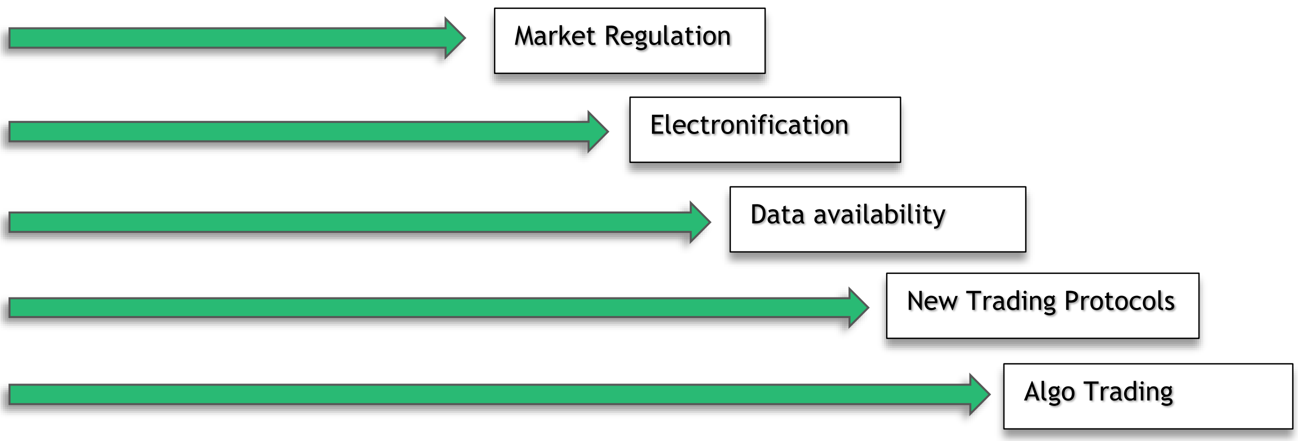
Introduction

The signs are clear within the credit trading universe, a market that has seen only moderate progress in almost two decades compared to other asset classes like equities and FX, is seeing great momentum on many levels. Electronification, trading protocols, electronic trading venues, pricing and bond coverage are all pushing the bond market towards a critical inflection point regarding how trading is going to be conducted in the future. Broker dealers are at the centre of this transformation that is impacting their day-to-day business.

Exhibit 1: Drivers of bond market transformation



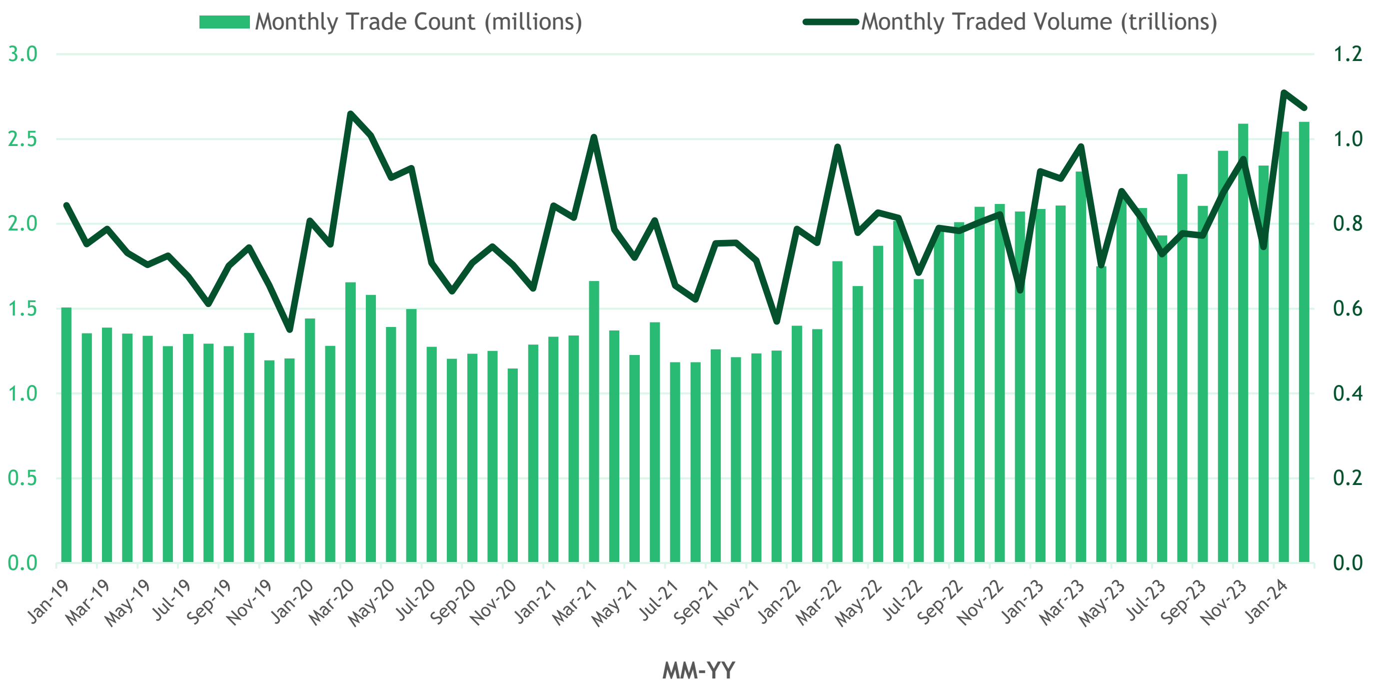
Even though structurally different to other asset classes, the bond market is becoming even more sophisticated and, as a result, more intricate for its participants to navigate. For example, new entrants into the market in the form of electronic trading venues, like Trumid, join the incumbents Bloomberg, MarketAxess and Tradeweb increasing the momentum of change and innovation and making it essential for broker dealers to keep up. The market transformation is becoming even more pronounced where market structure and technology are considered; portfolio trading and algorithmic trading have improved market liquidity and bond coverage. These developments are positive for sell-side and buy-side adding to the existing pluralism of the bond market.

For broker dealers especially, it is important to be able to see “the forest” as well as “the trees” at the same time i.e., the big picture as well as the more detailed market developments. Their trading metrics are being examined by the buy-side and the rest of the sell-side and have an impact on their daily trading activity. Broker dealers have a number of tools at their disposal to help them continuously assess their position in the market, a critical one is benchmarking as we will be discussing further in this paper.

Bond market, the big picture

Bonds used to be the less lively one among asset classes, sometimes one of the “more quiet” areas anyone would find on the trading floor. The gradual transformation of the market though has changed all this. Faster markets, additional liquidity suppliers, restricted inventories for broker dealers, and new electronic venues have had a considerable impact on bond markets. Overall market data shows a healthy bond market, with traded volumes growing in the last two years and especially active in the first two months of 2024 with more than 5 million trades counted and more than $2Tr in volume in the US corporate bond market according to FINRA.

Exhibit 2: US Corporate Bonds Monthly Trades / Volumes (Left axis: trade count, Right axis: traded volume)



Sources: FINRA

In the US, TRACE (introduced in 2002), had a substantial impact to price transparency and the gradual electronification of the bond market. At the same time in Europe, where a consolidated tape is not available yet, the regulatory environment has become more structured as per the MIFID directives, again focussing on price transparency and best execution. The aim in both cases is the same - how to make the bond market more efficient and spur further innovation.

A virtuous self-feeding cycle is happening where innovation pushes the bond market forward while at the same time impacting the existing market structure and then this market structure evolution creates further innovation. The outcome is new trading styles for “high-touch” and “low-touch” execution, new ways of price and data distribution and new technologies that brings everything closer together. In the next section we are shedding more light on the above by looking in more detail at the key trends in the bond market.

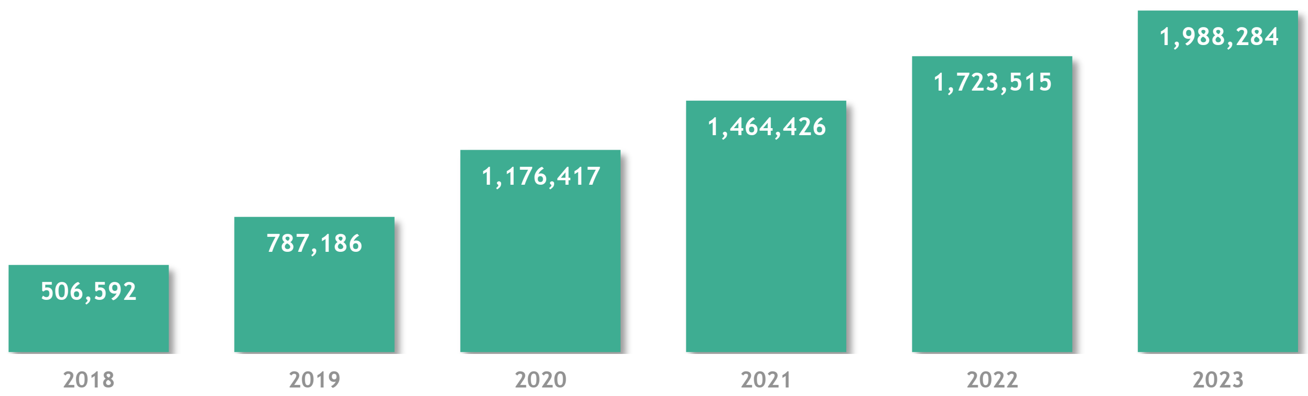
Bond market, key trends

In this section we would like to explore the key trends that influence the evolution of the bond market, more specifically from a broker dealer perspective. These key trends are not new, though their increasing momentum is a result of macro and fundamental factors. Market transparency, technological evolution, cost and time efficiencies together with new trading protocols and products are only a few of the reasons that push the bond market forward.

Strong electronification momentum

Even though market electronification has been in the making for more than two decades now, it is only in the past 5 years that it has gained critical momentum. One of the events that accelerated its pace has been the Covid pandemic which "forced" banks to a certain extent to move parts of their trading floor to a trader's home study almost overnight. It is not a single factor though driving electronification forward, the evolving regulatory environment under MIFID II, new trading protocols and overall changes in market structure gives electronification a faster pace than what we have seen in the past. Various sources currently estimate the electronically executed volumes in Europe and the US to be in the range of 43% to 47% for investment grade bonds and 30% to 35% for high yield bonds an increase on average of 20% in the last 5 years.

Exhibit 3: Electronic trading is rising (USD millions)



Sources: Tradeweb – US High Grade and US High Yield, Fully Electronic and Electronically Processed Trades

Even though the electronification of the market is increasing steadily there is still a considerable percentage of bonds trading via voice, as per the numbers presented above this is at least 50% of investment grade bonds in Europe and the US in terms of volume. This represents a small trade count with a much larger volume attached, these "high touch" trades require more time for broker dealers to price as they may be more complex or less liquid. What will it take to electronify more high touch trades to get the bond market over the current transitioning period into a predominantly electronic market similar to what we have in equities and FX? The next few years will be critical as the bond market will become even more integrated; bond data availability, technological and regulatory advances will play an important role. Broker dealers will be at the centre of this transformation.

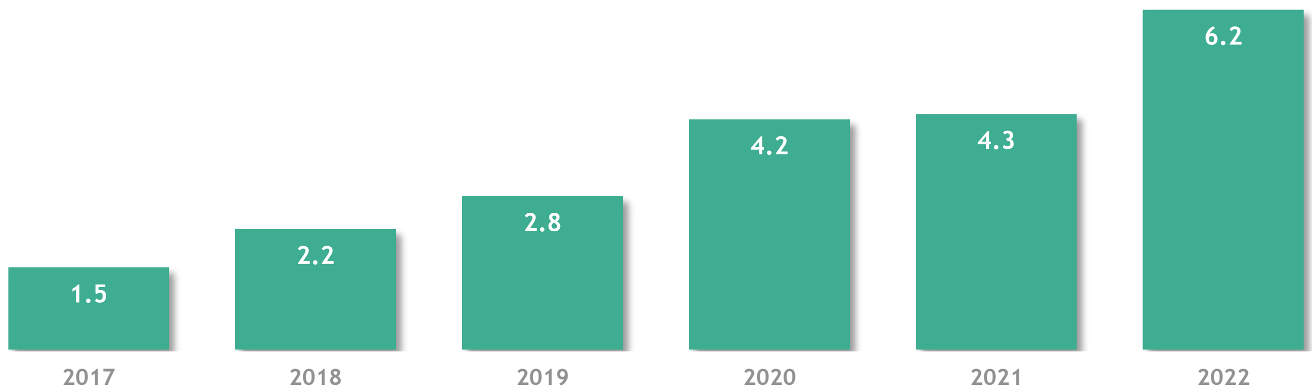
Trading protocols and product evolution

A number of factors have contributed to the innovative developments currently within credit trading. Protocols like portfolio trading have been around for a number of years continuously gaining in popularity with rising trading percentages. Portfolio trading involves trading a basket of bonds where credit quality and risk varies under one transaction / price which effectively means either the entire order is executed or nothing at all.

Portfolio trading or PT was made possible as technology advanced and bond data became readily available (see also next section on data sources), at present anecdotally representing up to 8% of total bond volumes traded electronically. The benefits of PT are obvious to the buy-side: certainty of execution, improved pricing, trading in size and saving time, all packaged under one price, are just a few. There are respective benefits for broker dealers where PT can help save costs and time in their workflow, diversify their exposure and attract more “high touch” business from the buy side.

It would be an omission not to mention ETFs at this point, as bond exchange traded funds have really taken off in the past 5 years. ETFs are also linked to a certain extent to the adoption of portfolio trading since they have become the main tool for broker dealers to hedge a portfolio of bonds. Increased transparency, additional market liquidity and cost-effective trading are only a few of the benefits ETFs provide. Blackrock has reported that ETF trading is “on the rise”, see graph below, and has forecasted ETFs AUM will reach $6 trillion by 2030, this is equivalent to 5% of the entire fixed income bond market.

Exhibit 4: US bond ETF trading (USD trillions)



Sources: Blackrock, Bloomberg. Blackrock: “The Great Yield Reset” report

The growth of the ETF market has boosted another key trend in bond markets, algorithmic trading. Fixed income has followed in the steps of equities and FX in establishing algos in the first instance for trading in small sizes (odd lots). Broker dealers leverage algo trading in many ways: to price a greater range of bonds than would be possible with existing resources, to provide accurate prices faster, to efficiently collect and combine multiple pricing sources especially in Europe where a consolidated tape is not available. In a report in 2023, titled: “New Frontiers in Fixed Income Liquidity”, Flow Traders stated that around 50% of the volumes in European High Grade bonds for sub 1 million ticket sizes is due to algo trading.

Broker dealers need more data

For the broker dealers all the latest market developments create opportunities and challenges. A few of the opportunities are listed here:

- Greater automation means expanding the business with little or no additional resources.
- Broader bond data availability makes pricing more accurate.
- Market electronification creates further liquidity optionality.

At the same time broker dealers face a number of challenges including:

- Many more market parameters need to be considered and combined.
- It is critical to continuously assess their business and make sense of the available data.
- Everything happens faster, humans and technology need to be in sync and technology is key.

More than anything else the consumption and synchronisation of data across many sources is the “holy grail” for broker dealers as it becomes the fuel behind their trading activity.

Data sources for broker dealers

Data has always been at the heart of the credit trading business, liquidity or pricing information, market specific research, rankings and competitor analytics. Each type of information has a critical role to play in a successful trading operation. A number of data sources are currently available for broker dealers to leverage including:

1. MIFID II directive

Under the latest MIFID directive put in action in 2018, broker dealers are obliged to report their trades to an Approved Publication Arrangement (APA), an organisation authorised to publish trade reports on behalf of investment firms. APAs make available this data to the wider market for post-trade transparency. Broker dealers use the APA data for price discovery and volumes traded.

2. Electronic venues

Electronic venues like Bloomberg, Marketaxess and Tradeweb provide trading data to the broker dealers that participate on their platforms. This source of data is very useful for ranking and competitor analytics. There are two points to note here: a. the increasing number of electronic venues makes it more challenging for broker dealers to aggregate and normalise data in order to compare “apples with apples” and b. even though a great percentage of the market activity is captured by trade count, there is still a considerable part of the market in terms of volume that needs to be considered (approximately 50% of trading by volume for European and US investment grade bonds is still conducted by voice).

3. Consolidated tapes

The US market is serviced by TRACE (managed by FINRA) a consolidated tape in existence since the early 2000s has been a major driver behind the market development providing consistent real-time pricing for trades. In Europe, there is no consolidated tape yet although now both EU and UK have set expectations that there will be respective bond tapes in the second half of 2025. The equivalent of TRACE in Europe currently is TRAX managed by MarketAxess that provides 80% coverage of the credit market.

Alex Wolcough, CEO of GreenBirch Group commented: “The policy makers in the EU and UK who oversee the set up of the consolidated tape, still expect the market to pay for it. So here lies the challenge – most potential buyers of the tape would benefit if the data is as close to real-time as possible; having said that, the policy makers will still allow for extended reporting deferrals. If too many trades are deferred and for too long, where is the value in the bond tape? There is a concern that the anticipated benefits may be diluted and as a result the business of being a consolidated tape provider may not be viable.”

4. Buy-side

It can be argued that a more qualitative metric is provided to broker dealers by their trading counterparties on the buy side. A number of asset managers conduct their broker reviews on a frequent basis in order to assess how the trading relationship with their broker dealers can be improved and as a result they share trading and other performance metrics as needed.

5. Benchmarking

Last but not least, benchmarking is a strategic tool for broker dealers as it provides a multi-dimensional analysis of their business where they provide and consume relevant information. Consistent, specialist analysis from third parties helps them more accurately measure performance across voice and electronic trading as well as compared to other market participants on an anonymous basis. We are exploring benchmarking in more detail in the next section.

Expand Research launches its credit benchmark

In a market that keeps advancing at an increasing pace becoming more and more sophisticated as well as complex as already described; Expand offers the tools to broker dealers to be able to navigate, understand and position themselves accordingly. Expand's new credit trading benchmark is based on years of experience running benchmarks in capital markets under dedicated teams with specialist skills like the one in FX that has been a market standard for more than a decade.

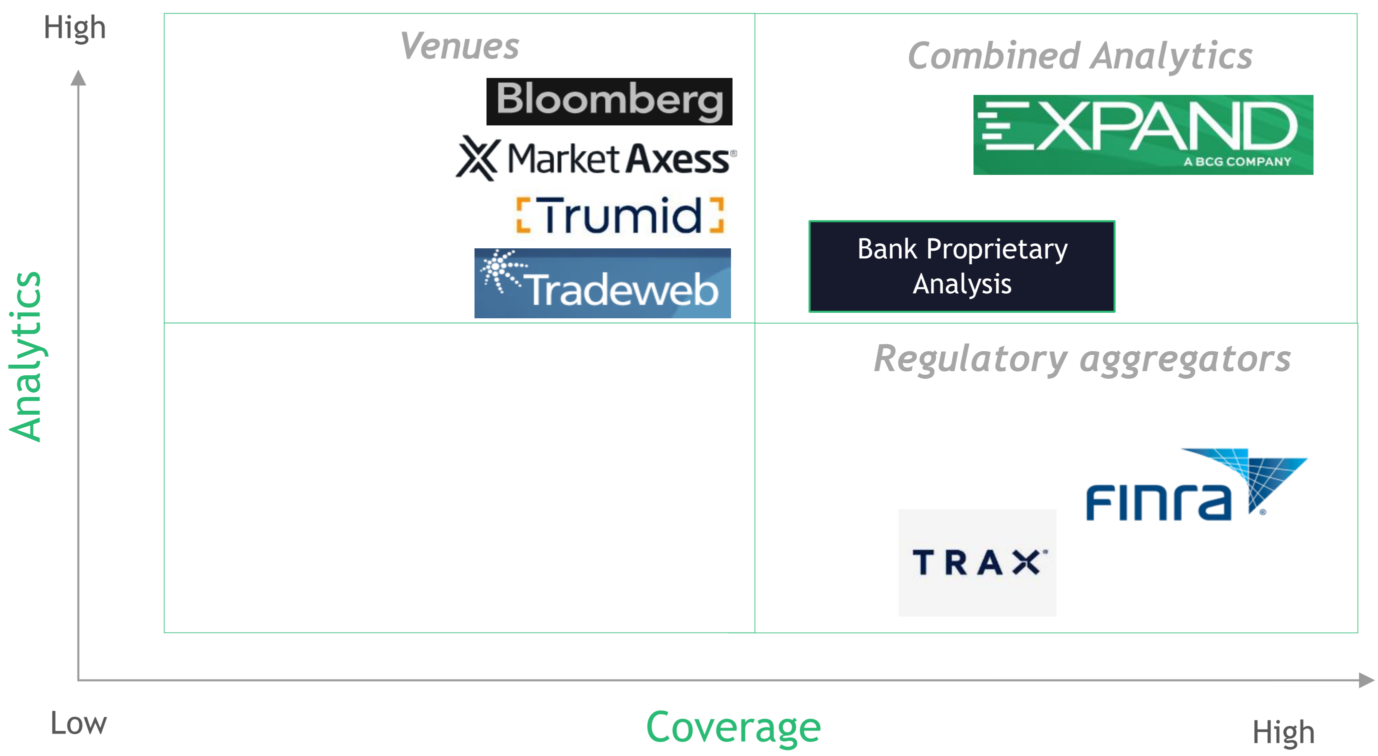
Leveraging benchmarking

The advantages of the credit trading benchmark for the broker dealers are clear:

1. Consistent methodology across the market

As discussed in the previous section, a number of important data sources are available at present. As expected the way data is reported, collected, and structured differs from one to another leaving broker dealers responsible for aggregating, cleaning and sanitising the data so that it can be comparable. This is costly and time consuming many times leading to data approximation. Expand with its benchmark centralises the data management under a consistent methodology that makes this data accurate following a transparent set of rules.

Exhibit 5: Expand's new benchmark combines broad market coverage and analytics



Sources: Expand Research

2. Complete picture for broker dealers

Whether it is the big picture they need or a “deep dive” analysis, the credit trading benchmark provides a wide range of individual or competitor analytics across voice and electronic trading, client type, client location, maturity, trade size etc. that will guide the trading desk aligning existing performance with their immediate or strategic plans.

3. Data continuity

Expand’s online portal offers a unique user experience; tracking performance over time as needed with a wide range of customisable parameters available, meaning that comparisons to past business decisions can be easily made. This is also offered via an API for broker dealers that would prefer to integrate this data to their existing internal dashboard.

4. Access to customised analysis

Expand’s dedicated capital markets team conducts regular detailed debriefs to broker dealers where market insights and findings are discussed and further analysed. The contact points most frequently are: Heads of the trading desk, Heads of Sales / eSales and Heads of market structure / eCredit. Reports are customised based on individual requirements and market conditions.

5. Ranking and comparison analytics

For broker dealers understanding how they compare to the rest of the market is critical. Their ranking gives them a tangible metric about where they currently stand as well as what is required for the relevant “desk” to achieve a top 3 or top 5 position in terms of traded activity at a bond type, client type or regional level.

Expand’s aim with the credit trading benchmark is to deliver a must-have tool for broker dealers aligning comparative analysis with strategic decisions.

Conclusion

The signs are clear within the credit trading universe, a market that has been languid for more than two decades compared to other asset classes like equities and FX, is seeing significant momentum in the past few years. The main drivers behind this substantial push forward are: a. advances in technology, b. changes in regulation and c. a maturing market structure.

These main drivers wrapped up by innovation and additional liquidity requirements have had observable impact on the credit market:

- Increasing market electronification, currently estimated at 45% by volume on average for US and European investment grade bonds,
- Healthy traded volume supported by new trading protocols like portfolio trading and products like bond ETFs; an impressive $2Tr of corporate bonds alone traded in the first two months of 2024 in US,
- Advancements in algorithmic trading offering more accurate pricing and broader bond coverage faster and more efficiently combining multiple data sources and dominating odd lot trading,
- New electronic trading platforms like Trumid join the incumbents Bloomberg, MarketAxess and Tradeweb offering further plurality and adding much needed innovation.

The credit market has become even more sophisticated and as a result of that more intricate for its participants to navigate. This environment creates a number of opportunities and challenges for broker dealers who need a variety of tools at their disposal in order to position themselves in a fast moving market. Fuelling their trading activity is a synchronisation of a number of data sources including data from: a. MIFID II reporting, b. Electronic venues, c. Consolidated tapes or their equivalents, d. Buy-side reviews, and e. Benchmarking.

For broker dealers benchmarking is a strategic tool that provides a multi-dimensional analysis of their business using consistent and reliable methodology across the market. Whether a “big picture” is needed or a detailed analysis of the various key permutations of their business versus the market, benchmarking provides, in a cost effective manner, the ability to link comparative intelligence to strategic actions. Expand Research with years of experience under its belt and specialist teams in place, offers its credit trading benchmarking solution at present to help broker dealers and the credit market as a whole advance even further.

About Expand Research

Expand Research LLP (Expand) is a wholly owned subsidiary of the Boston Consulting Group. Expand delivers unique decision-support services that enable senior leaders to develop, validate, and execute better business and technology strategies. Expand works with some of the world's largest financial institutions, enabling them to grow, compete, and operate with increased effectiveness. Expand is a specialist provider of benchmarks and market diagnostics and develops cutting-edge solutions to address the most pressing challenges the industry faces.

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