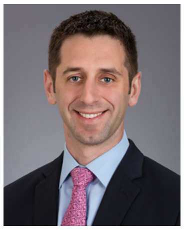
15 for '15: Top Trends to Watch in 2015



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Market structure happenings have been fast and furious since 2009, and 2014 did not disappoint. Mandatory SEF trading finally began, fixed-income electronic trading continued its steady incline, the current shape of the U.S. equity market was once again brought to the forefront, and the cost of capital continued its assault on the banking industry.

Looking forward we expect the pace of change to accelerate. Not only will the regulatory train keep on rolling, but some glimmers of volatility late in 2014 coupled with a futures market pointing to a rate rise by year's end should give us a more active market that will put the new and still-evolving market structure to the test.

Given the expected pace of change, what started out as a top ten list for 2015 evolved into our 15 for '15. We are not so naïve to think that anything on this list will come and go within the course of the year, but we do believe that an inflection point will be reached for each, and as such, must be watched closely throughout 2015. Without further ado, this is what we will be keeping an eye on:

1 Rates and Volatility Finally Rising

This is an economic trend and not a market structure one, yes. But given that Fed policy impacts pretty much everything these days, including market structure globally, it can't be ignored.

The market has been obsessed with the timing of a Fed-induced rate rise since at least 2013. While comments over the past 18 months from both Ben Bernanke and Janet Yellen should have induced a rise in rates, they remain no higher than they were in the summer of 2011.

I am no economist, but I do believe that both the futures market and Yellen's own words mean rates will finally begin the journey upward in 2015. And with rising rates (and declining bond prices), volatility should start to return across the board. The accompanying increase in trading volumes should create more opportunities for everyone involved to make money—which in turn should buoy the entire financial services sector.

2 U.S. Banks Getting a Real Taste of Basel III

If volatility and interest rates were all that banks had to deal with in 2015, then the future would look pretty bright. Sadly, structural changes brought about by regulations continue to beat up the bottom line. With much of Dodd-Frank now implemented, the biggest elephant in the room in 2015 is Basel III.

Top 15 Trends

1. Rates and Volatility Finally Rising
2. U.S. Banks Getting a Real Taste of Basel III
3. A Lack of New Corporate Bond Regulations
4. In Corporate Bond Trading, Only Evolutionary Changes
5. Client UST Trading Creeping into Dealer-to-Dealer Land
6. Cash Equities: Tough Business With a Glimmer of Hope
7. Unbundling Debate in European Equities Raging On
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9. NDF Clearing Mandate Impacts the Futures Market
10. The Fight to Make FX Fixings Continuous
11. European Mandatory Clearing Coming on Scene
12. Continuing Reduction of U.S. Swap-Clearing Members
13. ETFs and Index Funds Beating Up on Active Management
14. Cloud Computing Moving Closer to Business as Usual
15. The Instant Messaging War

Full global implementation of the rules will not be completed for several more years, but one of the first big impacts to the U.S. banking industry will hit this year—disclosure of the Supplementary Leverage Ratio (SLR). The SLR is the U.S.'s interpretation of leverage-ratio requirements defined by Basel III. While the banks have been preparing their balance sheets for this for some time, the market will finally have a more apples-to-apples comparison of bank leverage. As the last few years have taught us, disclosure brings with it questions, and questions often lead to change.

3 A Lack of New Corporate Bond Regulations

Corporate bond liquidity is one of the biggest market structure stories of 2014. Developments in this market are largely organic—meaning regulatory mandates are not forcing change, instead change is happening based on supply and demand. It is true that the higher cost of capital created by Basel III has driven dealers to shrink balance sheets, and in turn, pushed clients to look for new ways to trade. But everything past that one catalyst is the result of natural market forces, and we expect that trend to continue into 2015.

The SEC is talking a big game when it comes to fixed income, but our analysis leaves us confident that beyond some retail-focused disclosure rules, we will see no large-scale regulatory changes to the corporate bond market in the near future. The one wildcard: If the theoretical liquidity crisis that some are predicting actually emerges and Main Street's 401(k)s take a beating, the SEC will have no choice but to act. Exactly how they will act I will leave to my analyst peers in Washington.

4 In Corporate Bond Trading, Only Evolutionary Changes

If you've read our research over the past year, you'll know it's not the first time we've talked evolution over revolution regarding corporate-bond electronic trading. While the liquidity status of the bond market was a top market-structure story of 2014—and there's been excitement around several new platforms—we expect the evolutionary state of the market to continue through the next 12 months.

Before spring hits in New York, at least a half dozen of these new bond-trading platforms will be officially live, all with innovative technology and new mousetraps. Having had the pleasure of meeting with most of these companies, I'm thinking that the financial markets have risk-takers and innovators to challenge the status quo. Sadly, very few of the platforms on the list will stand the test of time, as bond dealers are only interested in providing liquidity to a small number of platforms and investors only willing to show their intentions on the same few.

2015 will bring with it a growth in corporate-bond e-trading and further adoption of trading protocols that go beyond traditional request for quote (RFQ), but a big-bang market structure change is not in the cards.

5 Client UST Trading Creeping into Dealer-to-Dealer Land

About half of client U.S. Treasury trading was executed electronically in 2014, nearly all of it via the RFQ model. Conversations with investors tell us they are generally satisfied with the pricing and liquidity they get electronically through the two main dealer-to-client platforms: Bloomberg and Tradeweb.

Even so, broad fixed-income liquidity concerns have caused even the biggest money managers to ensure they have new outlets to trade if things get tough. With eSpeed now under the Nasdaq umbrella and ICAP slowly but surely upping their buy-side interaction, it only makes sense that investors will start to look over the wall to see what they're missing. Automated market makers are making spreads tighter, and anonymous trading could become more attractive as volatility picks up.

RFQ isn't going away—relationships are still king after all—but where there is liquidity, investors will come.

6 Cash Equities: Tough Business With a Glimmer of Hope

The broker-dealer business for cash equities has been a tough one ever since decimalization and Regulation NMS came on the scene about a decade ago. Margins are tight, technology costs are high and competition is fierce, with smaller firms using their tech savvy to compete with the big boys. The reintroduction of regulatory scrutiny and the court of public opinion in 2014 only made matters more complicated.

Despite the challenging backdrop, Greenwich Associates research showed that the total commission wallet in U.S. equities grew in 2014 for the first time since 2008. An expectation of higher volatility (and higher volume) coupled with the expectations of our buy-side research participants to spend more in

2015 leave us hopeful for a continued positive trend. That does not mean the equities business will become more profitable, however, only that the total pie up for grabs is getting bigger. Given the negative trend over the previous five years, we'll take any signs of life.

7 The Unbundling Debate in European Equities Raging On

The unbundling debating in Europe makes regulatory scrutiny of the equity markets in the U.S. look like child's play. ESMA and the FCA have proposed a complete unbundling of all research advisory services including corporate access. The rules would require asset managers across Europe to use their own money rather than that in the individual portfolios to pay for research and advisory services.

This means buy-side investors will need to account for research as part of their P&L directly. We see three possible outcomes: The buy side pays for research directly and raises fees; the buy side creates its own research and doesn't pay the sell side; or the buy side goes without research altogether, likely hitting fund performance. None of the possibilities look good. Expect this debate to rage throughout 2015.

8 Futurization Getting a Boost

Investors need economic incentives to change their habits. Bid-ask spreads in the swaps market are often tighter than for futures, so that won't drive the swaps market to futures. Initial margin (IM) requirements for swaps are much higher than they are for futures—in some cases double—and these are in effect now. So why no change? IM only creates a cost for the investor if they don't have the securities or cash on hand to post. The market today is so awash with cash and cash equivalents that very few are funding their margin—so thus far the cost of the extra margin for swaps is a non-issue.

That could soon change. If rates finally begin to rise and market participants begin to put cash back to work, then those high-IM balances could start to hit fund performance. Only then will portfolio managers start to ask their traders why they're doing a swap instead of a Eurodollar strip or Eris contract. The bottom line: The futurization story is long-running, but it is far from over. Look for 2015 to finally start giving us winners and losers.

9 NDF Clearing Mandate Impacts the Futures Market

I first started looking at non-deliverable forward (NDF) clearing in 2012. Here we are entering 2015, and what do we have? Nothing. Only assurances that the CFTC is "looking at it."

By the letter of the law, NDFs meet the criteria to be mandated for clearing. But the longer we go with no mandate, the more we start to wonder if it's worth everyone's time. NDFs make up about 3% of the overall FX market, which doesn't feel like systemic risk. And the initial margin requirements would be punitive as clearinghouses will be forced to manage the risks inherent with volatile currencies. I do not suspect, however, that those things concern the CFTC. Their job is to implement the law, and to do so they need to put NDFs into clearinghouses.

10 The Fight to Make FX Fixings Continuous

The FX-fixing scandal was one of the big focal points of 2014. From a market-structure perspective, we shouldn't spend much time thinking about what traders say in chat rooms (more on that shortly), but instead why in a market with over 80% of volume executed electronically we still rely on a single point in time each day to set the "official" price. It is not clear if the regulators will move fast enough or come down hard enough on the industry to drive real change to this process in 2015, but you can certainly expect third-party providers to come to market with new 21st century solutions.

11 European Mandatory Clearing Coming on Scene

Mandatory clearing will finally hit Europe in 2015, but not with the same splash it did in the U.S. First, most clients won't be required to clear until 2016. Voluntary clearing may start to take hold as dealers pass along the higher capital costs of doing bilateral trades, but most clients will take a slow and measured approach to clearing until they are told they have to get moving.

Second, mandatory client clearing has been done before. Sure, European and U.S. rules are different, as are the clearing models themselves. But the U.S. made enough mistakes along the way that the Europeans are sure to avoid many of the same pitfalls. The best part of mandatory clearing in Europe? Global harmonization is finally starting to arrive, and with it, fewer ways to avoid changes that are at this point inevitable.

12 Continuing Reduction of U.S. Swap-Clearing Members

One of the major goals of financial reform was to expand the list of sell-side service providers used by institutional investors in the hopes of reducing systemic risk. With more firms available, the thinking goes, the less risk to the system if one should fail. While that theory still holds, the regulations thus far have had the exact opposite effect. For example, Greenwich research shows 65% of client swaps trading going through the top five banks. Clearing is next.

In the past few months, two major banks have decided to no longer clear swaps for clients. Too much work and too much money for too little (if any) profit. In 2015 we expect to see more of the same. Even the biggest FCMs are crying foul to regulators, pointing out that it's nearly impossible to make money clearing swaps under the current regime. And while regulators don't often concern themselves much with the banks' ability to make money. Banks won't clear swaps if they can't make a profit—and investors and corporate end-users will be left looking for new bilateral alternatives. Certainly not the outcome Washington was looking for.

13 ETFs and Index Funds Beating Up on Active Management

Active management isn't dead, but it is certainly set for a tough year ahead. Greenwich research has found that 21% of U.S. institutions now use ETFs as a part of their investing strategy, up from only 14% in 2011. And with both retail and institutional investment-fund consumers as focused as ever on management fees, the allure of index mutual funds only continues to grow.

Of course, there are and will continue to be portfolio managers who beat their benchmarks and earn their performance fees. But with the menu of low-cost index products continuing to grow and advisors providing asset allocation advice based on those building blocks, active managers will have to work harder and bring in better performance than ever before.

14 Cloud Computing Moving Closer to Business as Usual

Security and compliance concerns have kept financial market participants out of the cloud—until now. Everyone from hedge funds to FINRA is embracing both public and private clouds to increase processing power and flexibility while reducing total cost of ownership.

While cloud computing's mainstream status will help its growth in financial markets in 2015, so too will market participants working hard to cut costs where possible to make up for shrinking profit margins and growing regulatory expenses. Once the CTO and the COO see eye-to-eye, then progress isn't far behind.

15 The Instant Messaging War

I must admit—I smile a little bit every time I realize that instant messaging has become a point of heated competition and debate on Wall Street. I still remember the good old days of the 1990s, when I was able to self-install Yahoo IM on my work machine with no compliance concerns in sight.

Fast forward 15 years and millions of dollars are being invested to keep traders, portfolio managers and increasingly the rest of the market connected via chat. Why? Because controlling the communications mechanism for Wall Street gives the owner very sticky access to screen real estate and the information shared between firms and colleagues. Don't expect the major banks to pick a date and all switch en masse, but do look forward to one-upmanship from the competitors as they try to attract and retain users. ■