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Top Market Structure Trends to Watch in 2023

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Liquidity can dry up more quickly when those with the capital on hand are not able or willing to put it to work

ESG remains a convenient way to frame an investment, but over time, it may not contain everything investors and regulators are looking for

The past year has been one of both transition and preparation. Transition away from a decadeslong low-rate environment, equity bull market and COVID lockdowns. Preparation for market structure changes on the back of the March 2020 liquidity crunch and meme stock craze, in the form of regulatory proposals and the comment letters both for and against that have quickly followed.

That transition and preparation have paved the way for 2023 to be a year of regulatory implementation and acceptance that current market conditions are the new baseline. Some of that is good: clarity for crypto market oversight, a continued focus on the needs of retail traders and fixed-income investments that actually produced useful yields. Some less so: The search for the next tail risk will continue in earnest, a looming global recession and the aftermath of the previous year's asset value declines.

Keeping all that in mind, here are the top market structure trends our team will be watching in 2023:

1 The Search for the Next Tail Risk

The last three years have left us feeling that black swan events aren't all that rare anymore. The pandemic, sub-zero oil, supply-chain shutdowns, the Archegos collapse, U.K. pension liquidity issues, and the FTX bankruptcy, to name just a few. But despite the long string of market-moving blowups, the macroeconomic environment has the market waiting for the next shoe to drop.

Whether in search of the next big short or simply to manage risk, interest rates rocketing higher alongside depressed risk markets have left market participants worrying about everything from private credit to crypto to consumer lending to housing. Markets simply going down in value does not mean that those markets will fail. As such, these and other market subsegments might ultimately prove resilient after a decade of new regulations. But keeping watchful eyes on these trends and others remains prudent.

2 Crypto's Dot Com Moment and the Flight to Quality

In 2000, the Nasdaq 100 lost nearly 40% of its value, and then in 2001, it lost another 20%. That spectacular popping of the dot com bubble took with it hundreds of startups, many of which seemed like (at least for a brief moment) they might change the world. But amid all of that failure, the world was given the likes of Amazon and Google—two companies that most certainly did change the world.

Crypto is in the middle of its dot com moment. While we'll never make predictions about the prices of digital assets or the size of the crypto market in general, we do strongly believe that the washout we're currently witnessing will leave fewer vertically integrated firms and, instead, more specialized firms with stronger governance and risk management. These will be overseen by more stringent regulations that will take the whole market segment forward.

Think of it as a flight to quality and the further adoption of institutional-grade services, with professional crypto investors increasingly looking to brands and institutions they know not just by name recognition, but which have a real track record of prudent governance and putting clients first. And with these changes, we'll likely see an increase in institutional allocations to crypto and maybe even ... a spot Bitcoin ETF.

3 Capital as the Most Important Commodity

2022 came with its share of liquidity concerns and systemic scares related to margin calls and collateral management. The common denominator was capital. The more capital a firm has on hand—whether a broker, dealer, investor, clearinghouse, or proprietary trader—the greater its ability to handle (and potentially take advantage of) unexpected market shocks.

Global regulators learned this after the 2008 credit crisis and changed numerous rules to ensure capital was plentiful at the most important institutions. The banks' resilience over the past three years is proof that this has worked. However, this big capital cushion also proved that liquidity can dry up more quickly when those with the capital on hand are not able or willing to put it to work.

In the coming months, we'll be keeping an eye not only on proposed regulatory changes related to capital and collateral, but also the technology and processes used by market participants to make their capital go as far as it can while still maintaining the same (or greater) level of risk management.

4 The Quantification of ESG

ESG has occupied a lot of the investment community's mind share over the past few years, as end investors and regulators have advocated for greater incorporation of ESG factors into investment decision-making. Yet, ESG as a term is not the culmination of incorporating green factors into investing—it is a step in what has already proven to be a much longer journey toward investing with a focus on strategies with sustainability impacts.

The industry is continuing to shift toward a more quantitative approach to this type of investing. Some ESG elements today contain a level of value judgement (e.g., views of social and governance issues), which can conflict with end investors who want both to support sustainability initiatives and maximize returns. The ability to acquire and analyze the necessary data to fully integrate ESG into decision-making in a more quantitative way (think assessing the climate risk of a muni bond) is progressing, but not all managers have solved this thorny issue. Sustainability is becoming the umbrella watchword, and includes climate risk, carbon markets and other elements of green investing.

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5 Electronic Bond Trading's "What's Next"

Electronic bond trading had an exceptional 2022 (and 2020, and 2021, for that matter). But with e-trading levels relatively flat (40% of investment-grade bonds now trade electronically) in the second half of 2022, the bond market has begun looking for its "what's next."

The Holy Grail of bond e-trading remains the block trade. We certainly see more electronic trades over $2 million in size today than we ever have. But the biggest of institutional blocks ($5 million and up) continue to happen bilaterally. Furthermore, the average trade size market-wide has actually declined in recent months, as markets moved more electronic and retail demand jumped alongside yields.

That said, trading via direct pricing streams, session-based trading, new tools that allow dealers to find liquidity in their networks, and all-to-all liquidity will all play a big role in the market's next step forward. Exactly what catches on, with whom, to what extent, and the role new regulations will play are the big questions that 2023 will hopefully answer.

6 Progress in Equity Market Structure Reform

While we can't with a straight face predict the outcome of the recently-released SEC proposals[1] in 2023, it feels increasingly clear that the most significant reforms are coming to equity market structure since Reg NMS. Protecting the retail investor will remain front and center, but regulators will need to spend more time on cost/benefit analysis to ensure the incremental improvements are worth the money required to get us there. Market participants will continue to seek additional data demonstrating the market impact of the proposed rules, hoping to ensure that we are not robbing Peter to pay Paul.

Some proposals will move to the final rule stage before the year is out, while others may be hotly contested and delayed in hopes of holding out for a new regulatory regime. Various market participants will continue to fight back, some vigorously and loudly, against what they see as picking winners and losers in the battle for market share and mils. There will likely be more lawsuits. We might even get clarity on the "competing consolidators." And just maybe, with a little luck, 2023 is the year that we can finally relegate the payment for order flow (PFOF) debate to the dustbin of history, alongside a financial transaction tax (FTT) in the U.S.

7 Making Traditional Assets Crypto-Native

In 2022, we watched the "tokenization of everything"[2] unfold, driven by the rapid settlement, fractionalization and transparency inherent in blockchain-based financial assets. Now, with at least one attempt on the books to tokenize virtually everything, including mutual funds, collectibles, real estate, and private equity, we will be watching whether the most traditional financial assets, like bonds, see blockchain-based issuance take off.

Large institutions like UBS have launched digital bonds that are publicly traded/settled on both blockchain-based and traditional platforms and exchanges. The European Investment Bank (EIB), SBI and other traditional financial institutions have also dabbled in crypto-native bond issuance. And despite ASX abandoning the distributed-ledger-based Chess replacement, we see more use cases taking off, particularly in Europe, where the sandbox is a bit friendlier for experimentation.

8 Alt Data for Investing: Not So Alternative Anymore

We published our first research on the use of alternative data[3] for investing in 2017—six years ago. Since then, alternative data or "alt data" has been defined as unique data sources that can add valuable explanatory power to both quantitative and fundamental investment models. Heading into 2023, our research suggests that alternative data is no longer alternative. For instance, nearly half the buy-side firms we spoke with pointed to using alternative data in the portfolio construction process—a number that will only continue to grow.

Another sign that alt data has gone mainstream: Such data for investment and trading decisions used to be procured separately from an alt data specialist. Today, however, traditional financial information vendors, such as Bloomberg and Refinitiv (an LSEG company), have expanded into this market and developed offerings and marketplaces tailored to the needs of even the most sophisticated end investors.

The question for investors is no longer whether you use alternative data but, instead, how could you not?

9 Electronic Communication is the Only Communication

Spending on surveillance technology by capital markets firms rose to $1.8 billion in 2022, a contrast to the $2 billion in fines levied on financial institutions by the SEC and CFTC since December 2021. The explosion of electronic communications (e.g., chat) at the hands of the pandemic drove the regulatory community to launch a probe investigating how global financial firms are monitoring employee communications, particularly in unauthorized apps such as WhatsApp, resulting in both these fines and the incentive to invest more in surveillance tech.

Audio and video communications (aka aComms) monitoring is a prime area where more investment in technology will materialize. Coalition Greenwich research has shown that the monitoring and mining of audio and video files (think about all of those recorded Zoom meetings) represents an underserved opportunity for solutions providers. While it is possible to monitor these communications, technology such as natural language processing (NLP) is still fairly nascent and far from perfect.

We expect regulatory as well as market forces to continue to shape market participant behavior, with artificial intelligence doing the heavy lifting over time. Surveillance is a truly multi-asset class problem, with FTX's alleged transgressions reminding us that even decentralized finance (DeFi) will need oversight going forward.

10 Outsourcing More Than Just Trading

Outsourced trading has been one of the hottest topics in equity market structure over the past few years with no signs of slowing down. In fact, our 2022 research on the topic—A Deeper Dive into the Outsourced Trading Evolution[4]—continues to be one of our most downloaded reports of the year. With over 40 providers in existence today compared to fewer than 10 in 2018, the opportunities and appetite to outsource trading-related functions continue to grow. In fact, most market participants we speak with say their single biggest current challenge is hiring and retaining trading-desk talent, a problem outsourced solutions can solve.

But the talent gap is not exclusive to traders, and certainly not the only one outsourceable to third-party providers. There are few brokers and asset managers who currently have the time and resources needed to focus on designing, building and maintaining their own algo technology stacks, and fewer still who will have those resources in the future. The increasingly vital ancillary functions of quant researchers, algo developers and strategists, FIX specialists, market data technicians, data scientists, software engineers, and others are already beginning their own evolution from in-house to outsourced. We see this trend continuing as the concept gains acceptance across the industry.

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[1]https://www.sec.gov/rules/proposed/2022/34-96494.pdf

[2]https://www.greenwich.com/market-structure-technology/top-market-structure-trends-watch-2022

[3]https://www.greenwich.com/equities/alternative-data-alpha

[4]https://www.greenwich.com/equities/deeper-dive-outsourced-trading-evolution

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