

Liquidity Landscape

H1 2022

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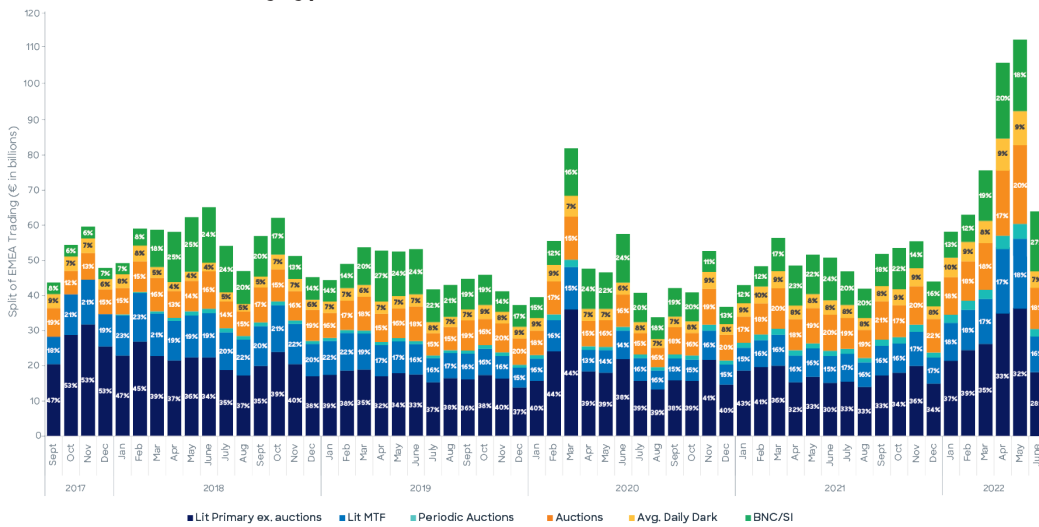
Geopolitical risks combined with rising interest rates and inflationary pressures continue to ensure volatility and market impact remain centre stage in European secondary markets. As the risk of a new global financial crisis (GFC) accelerates and equity allocations are being cut, European intraday liquidity is increasingly sporadic which, with rising volatility, is creating the perfect storm for traders to deliver on best execution. This time around though, traders in Europe also have added complexity of Brexit which is increasing the multiplicity in where and how liquidity may form as the consequences of splitting the European regions liquidity finally emerge.

Intraday liquidity in continued decline

Overall liquidity being in decline is nothing new, however one-way markets post central bank policy changes and heightened risk of recession have impacted market makers' appetite to post-liquidity. As Systematic Internaliser (SI) liquidity shifts from bank capital provision to electronic market making, increased volatility technically offers greater opportunity to trade. However wider macro concerns, together with added regulatory complications such as the introduction of CSDR and the mandatory buy-in regime, continue to hamper market making appetite, particularly when trading illiquid names.

Exhibit 1

Breakdown of EU flow by type

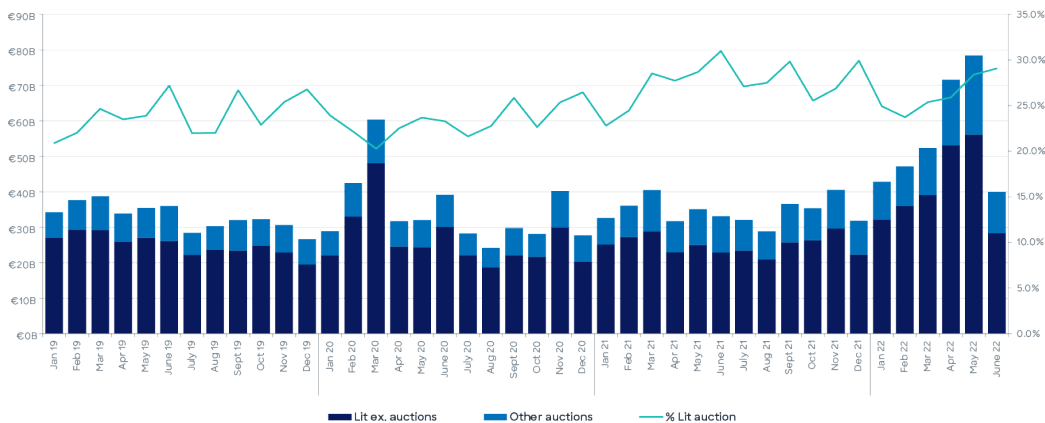


Source: Cboe Market Data and Bloomberg Data, Sept 2017 – June 2022

While EMEA trading turnover reached record levels in H1 2022, this was followed by a sharp decline in June (see *Exhibit 1*). More importantly, lit primary activity was at an all-time low of 28% market share, almost halving from the previous peak in of 53% pre-MiFID in 2017 and again in March 2020 (see *Exhibit 2*).

Exhibit 2

Continuous Lit activity



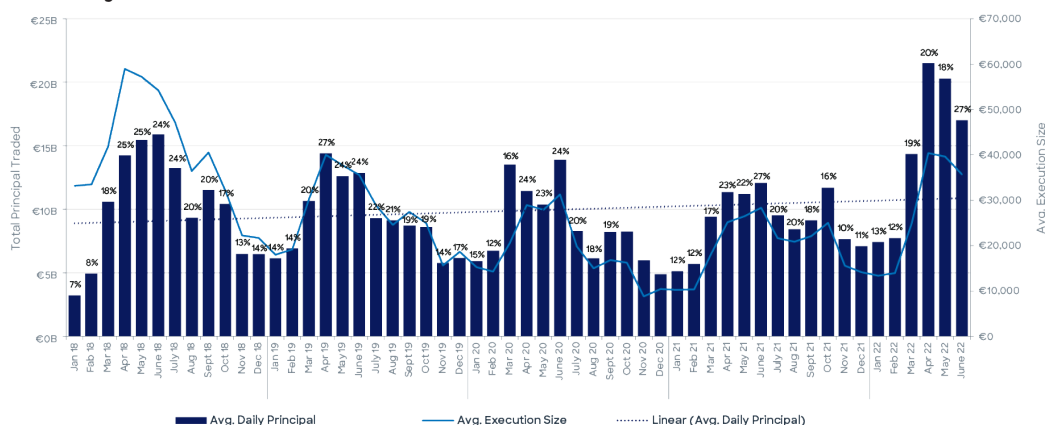
Source: Cboe, Jan 2019 – Jun 2022

Deciding when, where, and how to trade has further implication when noting the recent updated Q+A from ESMA regarding the new definition of Algorithmic Trading.¹ This will include automatic generation of orders and order-execution optimization as well as automated order routing systems which could have implications for the asset management community under Article 17 of MiFID and RTS 6. ESMA acknowledge the challenges this creates when asset managers are using third-party systems where they may have no direct control over the system operation and how the algorithms are deployed and recommends that firms address this “through contractual arrangements with the system provider, where the latter commits to ensure that the system, its operation, and the algorithms deployed are compliant with the relevant legal requirements.”

European regulation remains focused on encouraging greater intraday liquidity through reducing off primary market activity—introducing minimum thresholds for the Reference Price Waiver (RPW) and limiting the ability for SI to match at mid-point when trading above twice the standard market size but below the Large in Scale (LIS) threshold. The result is likely to be anything other than a return to the lit primary. SI activity hit 27%, levels not seen since April 2019 with dark volumes falling to just 7%. Alongside SI provision steadily increasing, the average order size of SI flow has been increasing reaching 40,000 shares in April, pushing back slightly in May to decline to 35K in June but still far higher than January/ February this year where average fill sizes stood at 13K shares.

Exhibit 3

SI activity



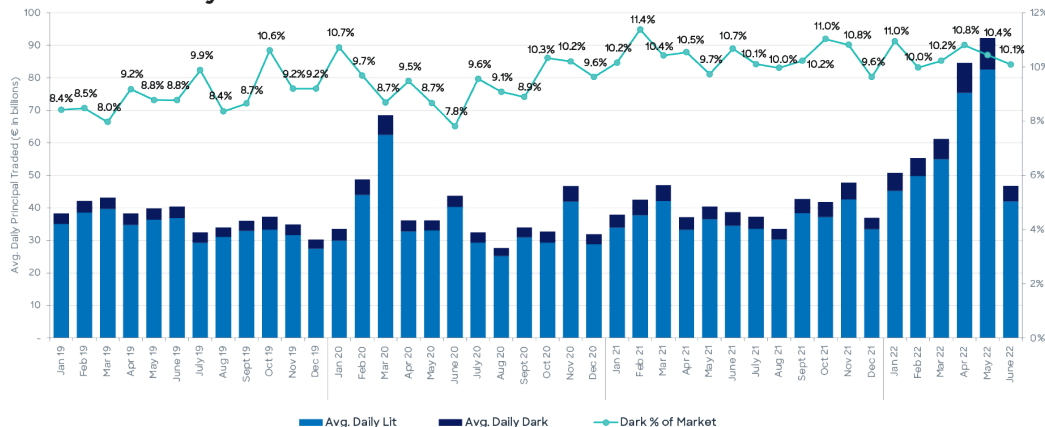
Source: Bloomberg, Jan 2018 – June 2022

The use of SI as a replacement for the broker crossing network exists as a means of lowering execution costs, but Broker Preferencing models also help brokers keep exchange fees and trading costs to a minimum. SI activity is automated provision of risk which flows according to market conditions, consequently thinning intraday liquidity which also exacerbates SI provision towards periods of greater trading activity such as the close.

While average Daily Lit volumes surged in April and May to €75B and €82B respectively, this halved to €42B, representing 29% of the market. Average dark volumes in comparison remained around the 10% mark—just 4.7B shares traded in June 2022 (see Exhibit 4).

Exhibit 4

Lit vs. Dark activity



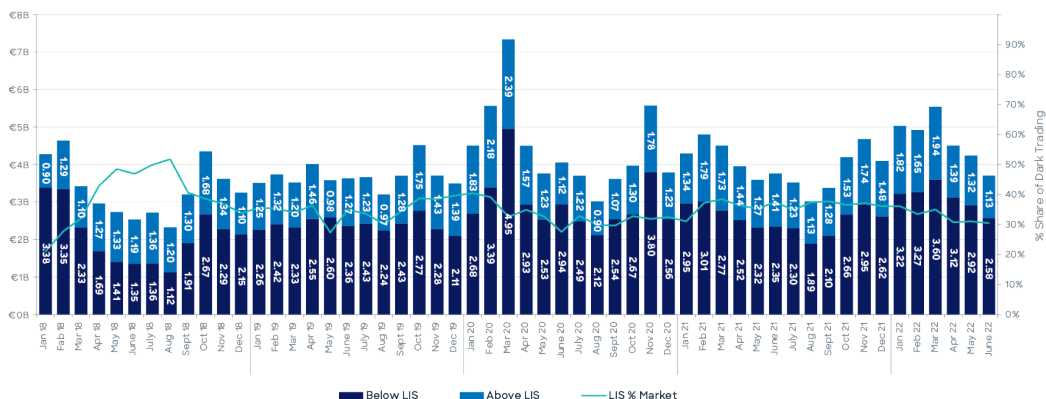
Source: Cboe and Bloomberg, Jan 2019 – June 2022

¹<https://www.esma.europa.eu/press-news/esma-news/new-qas-available-6>

The percentage of dark trading that is above LIS is now much lower than the start of the year, similar to levels last seen in Q1 2021 (see *Exhibit 5*), likely due to greater urgency to trade in current market conditions but remains a steady third of dark market activity (see *Exhibit 5*).

Exhibit 5

Large In Scale (LIS) as a % of overall Dark Market

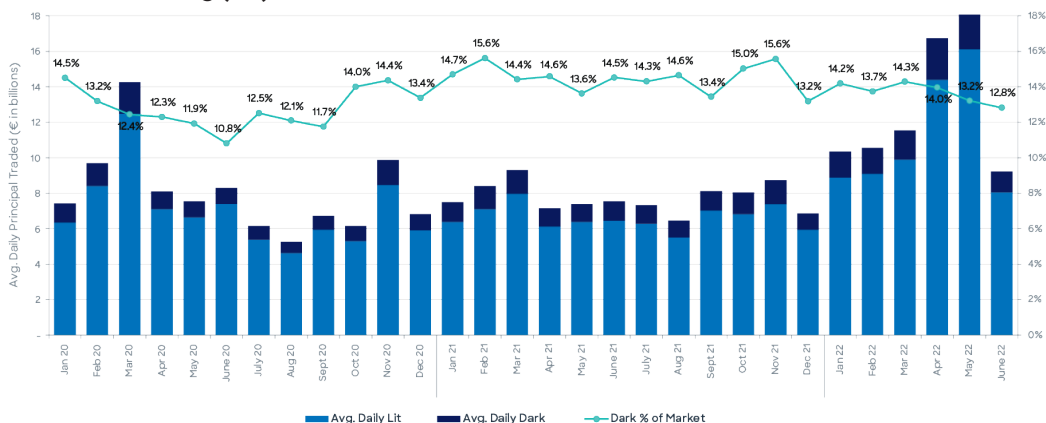


Source: Cboe and Bloomberg, Oct 2020 – June 2022

However, the difference between UK and EU venues as a proportion of activity continues to represent the differences between how UK markets trade (risk) relative to those in Europe (agency)—both in terms of overall dark volumes (see *Exhibits 6 and 7*).

Exhibit 6

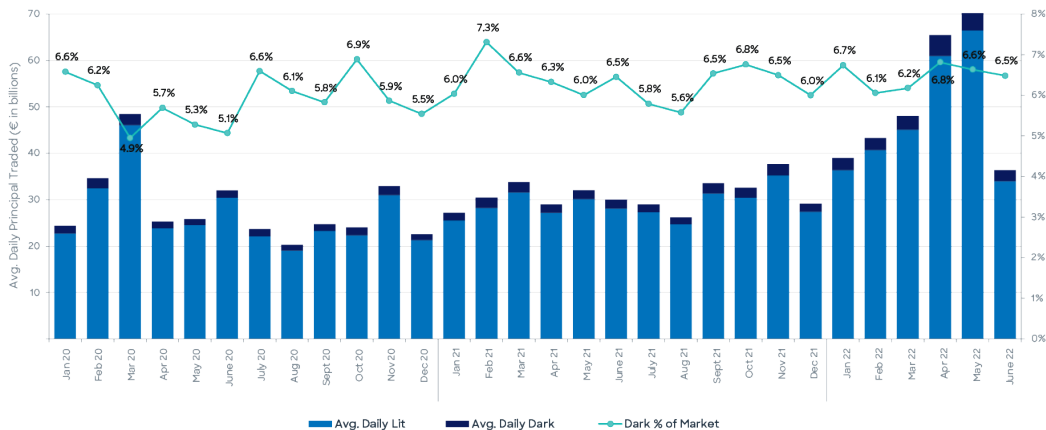
Dark vs. Lit trading (UK)



Source: Cboe and Bloomberg, Jan 2020 – June 2022

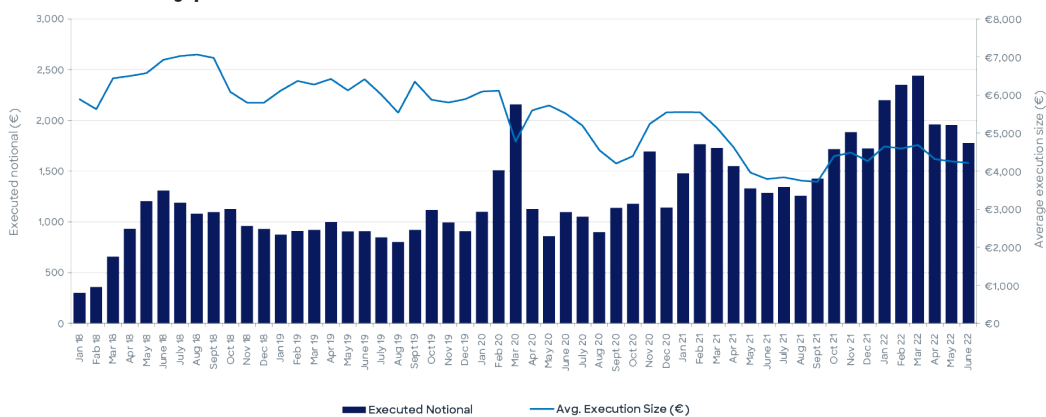
Exhibit 7

Dark vs. Lit trading (EU)



Source: Cboe and Bloomberg, Jan 2020 – June 2022

Periodic activity plateaus



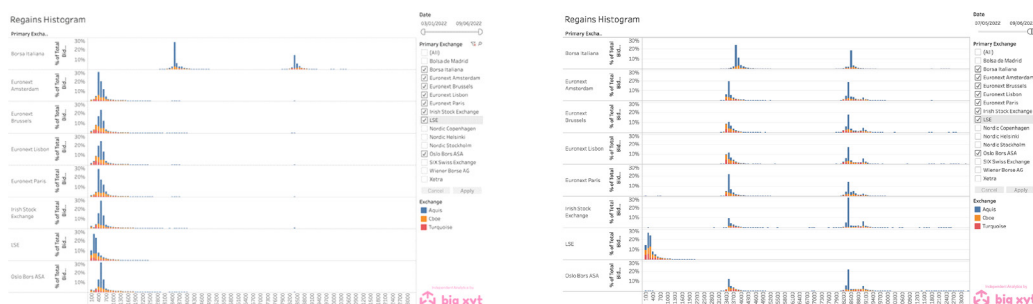
Source: Cboe and Bloomberg, Jan 2018 – Mar 2022

Although not notionally significant activity, periodics combined with rising SI activity at the close all adds to the volume trading away from continuous intraday lit markets. Despite the recent increase to 4%, Periodic Auctions declined back to 3% market share (see *Exhibit 8*). Given the regulatory intention to limit small-sized dark trading by increasing the minimum threshold for the Reference Price Waiver (RPW) to 2x Standard Market Size (SMS), along with pre-trade firm quotations for SI also increasing to 2x SMS,² the potential for their continued increase still remains. With Frequent Batch Auctions out of scope of the MiFID II reform, our view is that market participants will once again increase their use of periodics rather than return to continuous lit markets.

While the trajectory for SI market share is in decline, there is a clear cyclical nature to the provision of risk capital—one to watch as to whether this will continue given current geopolitical events.

It is difficult to see how intraday liquidity will improve in the short term, whatever the regulatory intent. While the multiplication of SIs post-Brexit has been well documented, understanding how liquidity will flow from UK venues to EU venues is less understood. The recent move by Euronext to relocate their servers as per regulatory requirements to locate trading technology in the EU from the UK is creating a further challenge to content with. The exhibits below (see *Exhibit 9*) illustrate the impact of price regains on relevant MTFs following a price change on the primary before and after the Euronext data centre move (using LSE as a reference to demonstrate impact). While this again potentially offers increased incentive for market makers to post liquidity given the additional latency, for buy-side traders, the added delay leaves them further exposed.

Latency times post-data centre moves



Source: Big XYT

²https://ec.europa.eu/info/publications/211125-capital-markets-union-package_en

What should Traders do next?

As volumes continue to decline, all trading models will need to adapt to shifting liquidity patterns—and here technology will become the mainstay in uncovering real liquidity. Rather than this being the ability to uncover additional SI liquidity or trade in small child orders using periodics, the focus will revert again to the important role agency brokers have in creating trading interest in a controlled environment where information leakage is minimized—particularly if this is to create liquidity not currently posted on the market.

The best example of this is the ability to build positions, such as the Liquidnet LSE trade where an initial order of £35M increased to one of £150M (see *Exhibit 10*).

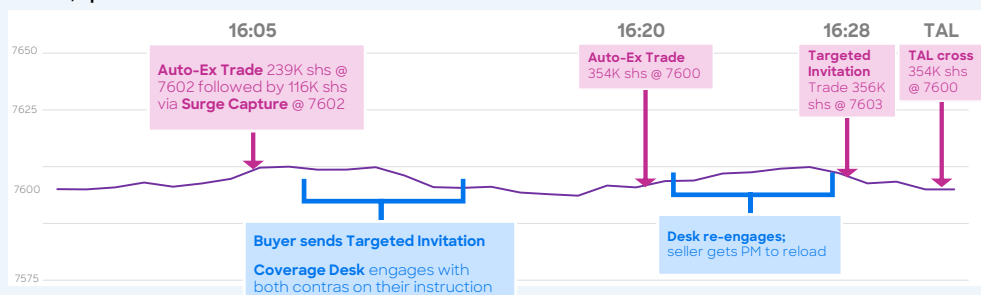
Exhibit 10

Block Trading Service execution of LSE

London Stock Exchange Group (LSE LN): \$148M/3x days volume

- Liquidnet's strength is in combining a deep pool of liquidity, unique liquidity discovery tools, and an experienced voice broking service
- \$25M initial executions grew to \$148M through coverage desk engagement on behalf of buyer and seller, use of Surge, Targeted Invitation, Negotiation, and Trading at Last (TAL)

LSE LN, 4pm to the Close



Source: Liquidnet data. Multiple executions in LSE LN, 16 July 2021

As traditional voice trading continues its long-term decline, combined with consolidation of algorithm providers and trading strategies, liquidity formation will continue to adapt. Rather than liquidity forming in straight blocks, flow is needing to be teased out through a combination of electronic book building and algorithmic trading. To successfully achieve this requires trusted relationships between the buy and sell side.

Greater use of electronic trading also enables monitoring of trading behaviour, algorithm performance, as well as that of individual traders. As electronic flow builds, understanding how to adjust trading strategies mid-flight requires a different style of engagement between buy and sell side. Rather than exclusively trading a single strategy, low touch is becoming high touch in approach, requiring extensive hand-holding throughout the execution period to blend algorithm strategies alongside larger blocks and actionable indications of interest (IOI). Strictly passive execution strategies work well in certain market conditions, but it is the ability to adjust to aggressively trade pockets of liquidity as and when it becomes available (or can be created) which will become the future mainstay of algorithmic trading to ensure low information leakage or footprint even when intraday liquidity is sparse.

Buy-side ownership of execution is extending from algorithmic selection to programmable parameters to speed up or slow down aggression levels. If historically, sourcing liquidity meant increasing the number of broker connections, now it is focusing on the quality of those connections and the ability to be able to monitor this quality—and that requires a smaller number of broker relationships to ensure sufficient data with which to monitor internal benchmarks and metrics to seek out execution enhancements. This not only requires trusted sell-side partnerships but also necessitates buy-side firms reversing the trend of exclusively relying on vendor off-the-shelf products, to incorporating internal technology stacks and partnering with an exclusive smaller number of brokers to cover a menu of liquidity provision.

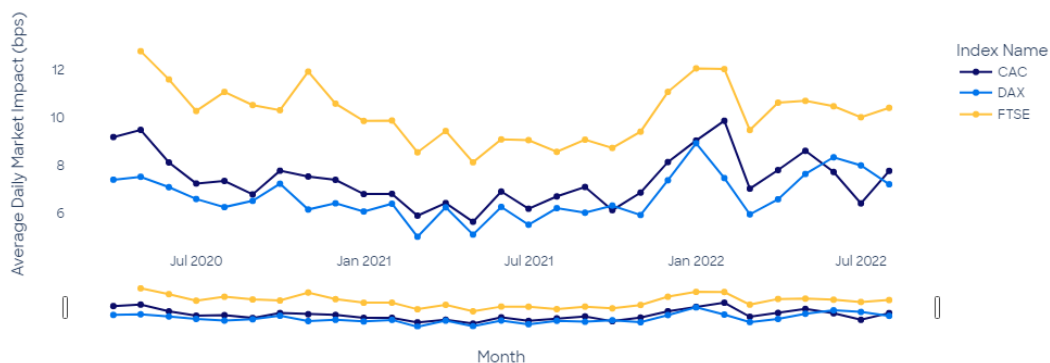
Execution as a Service (EaaS)

Sourcing liquidity in the future will not depend on establishing whether a broker's algorithm has achieved a VWAP benchmark but how the buy-side's execution partner is helping the firm perform relative to their peers and where improvements can be made to ensure that cost of trading can be kept to a minimum, particularly in markets where the cost of trading has risen (see *Exhibit 11*).

Exhibit 11

Market Impact estimate for 1x LIS execution

Mean Daily Market Impact averaged over a month



Source: Bloomberg and internal data, Jan 2020 – June 2022

Trading performance is moving up the decision tree to strategy selection, the time taken to reach that decision, and the ability to adapt according to market conditions which impacts the ultimate execution outcome. Buy-side traders are becoming less interested in individual execution reversion, but which trades need hand holding, which are “no-touch” and what can be traded via blocks and how these opportunities can be created using the broker services available. Sparse intraday liquidity will only accelerate this process. Despite regulatory policy interventions, volume is unlikely to return to the continuous lit but morph into the means of liquidity creation. A role which will sit firmly with the buy side but which will still require the back-stop of trusted execution partners—albeit with a more concentrated sell side.

