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Roundtable: Buy-side eyes challenges of new European market structure



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Buy-side eyes challenges of new European market structure

Europe is changing rapidly in the run-up to the 2016 introduction of mandatory clearing. Here the buy-side considers the twin prospects of a shrinking sell-side and fragmenting liquidity.

Luke Jeffs, Editor, FOW: The industry is in flux and the buy-side face a myriad of challenges but what are the key challenges facing the investor community as Europe moves into a period of regulatory change?

VJ Angelo, President and Managing Director, Gmex: There are many questions. Having been presented with a fait accompli in terms of the time frame for things like OTFs and mandatory clearing, the key question is how is that affecting the buy-side approach to the market, not just in terms of their present-day processes for assessing trading strategies but also how they're looking forward at the next 18 months? How are they interacting with various participants in the market, the sell side particularly, and how are they viewing potential interaction with CCPs, which they've never really had such a direct engagement with previously? Another question is how are they approaching risk both from a trading perspective and from a corporate perspective with the change in current environment?

All of those factors are rolled up in the interaction and the day-to-day processes which the buy-side hasn't normally had to deal with in the way that they're going to have to in the future.

Stuart Deel-Smith, Director, NLX: There are a lot of changes afoot in the

industry that were initially driven by regulation. What we're now seeing is a shift from the two exchanges that have dominated the European rate space for the last 30 years to potentially four or five execution venues.

We believe competition in execution is good as it brings greater efficiency, cheaper fees, and more choice to the buy-side. But in clearing, is competition and fragmentation a good thing or a bad thing in terms of collateral efficiency?

We are also seeing the sell-side banks becoming more actively involved with the buy-side - in broader trade and secondary market activities.

Richard Metcalfe, Director of Regulatory Affairs, Investment Management Association: We've been following the whole process from the day after Lehman Brothers collapsed when the concerns were about recovering assets. Funnily enough, that remains an issue. You've got a major issue in terms of collateral, which is crucial when you're talking about derivatives.

A lot of models have been developed relatively recently within CCPs. The right level of segregation is going to remain an issue at least until the point where the clearing obligation kicks in.

Jeffs: And that's still a way off...

Metcalfe: Not in terms of project management. And in any case, at the back of your mind you've got the point about the impending treatment collateral for bilateral derivatives. There are strong incentives to look closely at clearing if hedging instruments are integral to what you do, which is true for a lot of buy-side firms.

The other important thing is the challenge asset managers have with a whole hinterland of clients, some of whom may be very occasional users of derivatives and may not have thought they are caught by this regulation.

Luke Hickmore, Senior Investment Manager, Aberdeen Asset Management: The point about project management is important. We've been preparing for change for a long time. We had to prepare for US clearing and Dodd-Frank and then start preparing for clearing in Europe because we thought it might have happened at the end of this year. That fact that mandatory clearing has been pushed out means we've got more time to prepare but it doesn't stop the ball rolling.

Huw Davies, Fixed Income Product Specialist, Ignis Asset Management: Since the financial crisis, we've moved from away from clarity about pricing. Today in the derivatives market as a whole but particularly in terms of pricing swaps there seems to be a lack of transparency. Increasingly this is also true in the repo market.



LUKE JEFFS



STUART DEEL-SMITH



RICHARD METCALFE



LUKE HICKMORE

The real challenge ahead is to find areas where we can access the products we need when generally the sell side, to us, seems to be retreating from certain markets. The sell side is certainly under increasing pressure from changing regulations to alter the way it operates.

Jeffs: Is the buy-side getting the sort of answers that you want or is it starting to become a concern?

Davies: Having recently come from the sell side, my experience is that it's extremely difficult to give clarity to a client. There is not really too much information you can transfer when pricing derivatives to a client. Everyone operates with a different view of where their funding curves are and therefore there isn't really a level playing field.

So when you've entered into a swap, when you come to unwind it getting a competing quote to value that swap and having clarity that those quotes are comparable is very difficult. That's the real frustration.

The biggest challenge going forward is that we need access to multiple curves, a breadth of product but most importantly clarity of pricing of those products.

Hickmore: This is the plumbing that's needed to keep the system working well, to get to the outcomes that you need for your clients, whether that's about hedging a risk or taking a risk. It's the basic underlying stuff and it's Victorian.

If you go down there and have a look around at what is going on you find it's obscure, it's getting narrower because the liquidity's disappearing and it's pretty dirty at times. It's not somewhere you're very comfortable and I guess our hope is as we get near clearing and get a new raft

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of products to replace the old plumbing, redo the basics of all of this and ultimately move to a place where these things become part of our everyday life like a bond future is today.

Jeffs: Rod, what are your thoughts on what's been discussed so far?

Rod Banus, Executive Director,

Nomura: Where do you start? For me the discussion emphasises the challenges that we're under in terms of the front-to-back reinvention of the marketplace. We are seeing a clash between the old F&O world which was pretty simplistic and a new world that is emerging.

The problem we're all facing now is the multitude of paths on the transaction and product side. From an F&O perspective the challenge is around regulatory oversight of best execution which is coming very fast at us.

Traditionally the sell side always felt they were providing this. Now that's being turned on its head so we are in a situation where you've got the buy side looking for clarity on new products and understanding the market but at the same time the brokers and providers of that information are being challenged.

Traditionally the focus for the sell side has always been customer demand and turning that almost immediately into production, backed by revenue and volume.

We are currently in a situation where we are looking to provide services but the revenue stream has just been extended out.

That provides a challenge because we are also facing increased costs which we need to meet with revenue. It's old-fashioned but that's the way of it and I think from our perspective, there is a desire to try and devolve away for the traditional clearing model.

Yes, we're the providers of clearing but we want to empower the buy side to be able to do much more of what traditionally has been the sell-side clearing role.

There is a view that the sell side doesn't like individually segregated accounts but in reality we do because it empowers the buy side but we need better technology to deliver it.

There's a lack of competition in that space as it stands. Maybe the delay will allow more participants to get involved in that, which would be welcome.

The challenge for us then is that our role is to navigate our clients through the plethora of the different offerings and the changing market.

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Jefferies: If there's half a dozen new products and exchanges and presumably you're going to do two or three, what determines which are the two or three you choose to back?

Banque Paribas: I'm not sure that you can actually pick a winner at this stage; that will emerge as the market develops. The delay to mandatory clearing in Europe will in no doubt be helpful to LCH. From a sell-side perspective, what we try to do is to provide a comprehensive view of the landscape. But to achieve that venues and CCPs need to be clearer about the information they give and not overcomplicate it, because at the end of the day the market wants to keep it simple.

Hickmore: In many ways it's the same problem we have with clients. You're talking to clients about the kind of accounts they can set up in clearing and trying to guide them on which works best for them and for their systems but essentially they're going to want to make their own decisions. We represent some pretty big insurance clients and talking to them about the kind of accounts that are around this month; could be very different next month.

The technicalities and details for each one of those accounts could be really important. Whether you go for segregated or omnibus segregated or a futures-and-options-type approach to it with full omnibus has big implications both legally and practically and impacts how you manage collateral through the cycle.

So in a way we're glad we've got more time but we want the landscape to settle down and to have a sense from a pure clearing perspective what the offerings are and have all the information in order to make a decision.

For us, the total cost becomes an interesting question because there are different ways to look at that. Of course you have your transactional costs and you can see how what CCP you use or what product you trade. But it becomes a lot more subtle when you start thinking about collateral and that is a particular problem for us.

“ The situation we are in today is that exchanges are about launching contracts designed to drag as much business as possible into the CCP. That's completely the wrong approach ”

VJ Angelo

Collateral for me's a big problem. Being efficient with the collateral, not using too much and therefore depressing the rest of the returns in the account becomes an incredibly important part of the cost analysis we do for every trade.

So the basic £50 for the trade or 1% is a tiny part of the cost. The really big cost is how much collateral I'm going to need and how much that's going to drag on the performance of our funds.

Angelo: We've had quite a lot to do with clearing houses in the last year being a venue coming into what's been proclaimed as the new horizontal model for CCPs.

We've had various level discussion with almost every CCP out there. The choice eventually was Eurex, which took a minority stake in our business, but we're not necessarily married in that respect.

The issue with the CCP model is at what point does it become a competitive infrastructural add to the market and what point is it a utility? And where do you draw the line between a utility and a competitive entity? One argument is that if a CCP is going to hold a vast majority of the market's collateral it should be a utility.

When LCH Swapclear was first conceived in the early 2000s it was effectively a utility. It was 90% owned by the 12 – 14 banks around then and that made sense.

If you're going to open the entire thing up to competition, great, but it's got to be a relatively short window of competition, it's got to be a period in which there is some clarity relatively quickly and there's got to be an understanding of the offering.

The situation we are in today is that exchanges are about launching contracts designed to drag as much business as possible into the CCP. That's completely the wrong approach. It doesn't address the underlying need of the market which is the fundamental restructuring the market in response to the financial crisis.

The other problem you've got is the CCPs are saying, 'we like a horizontal model', but actually they are staying vertical.

Hickmore: We've been through the selection process for CCPs. There's not a massive structural difference between them but the choice comes down to the products being offered. You end up starting from



where you should start: what do I need for the business, what do I need to get done, what kind of products and how am I going to be able to execute them, what kind of flexibility do I need and what direction can we shift this book?

So you do start from the right place but you're not fitting a perfectly round peg in a perfectly round hole, you have to shave it around the edge and persuade clients to change their views and change your approach.

At the end of the day, how much time do you want to spend on these products as a fund manager, right? You want to pick it off the shelf, hedge your position, to move on and make another choice or another structural change or think about a longer-term move.

If you think about where yields should go over the next few years – and the depth of fund managers are saying that yields are going to go higher – you think about the amount of savings that have found their way into fixed-income products over the last five, six, seven, ten years; it's an enormous chunk of people's savings pots



COLLATERAL FOR ME'S A BIG PROBLEM. BEING EFFICIENT WITH THE COLLATERAL, NOT USING TOO MUCH AND THEREFORE DEPRESSING THE REST OF THE RETURNS IN THE ACCOUNT BECOMES AN INCREDIBLY IMPORTANT PART OF THE COST ANALYSIS WE DO FOR EVERY TRADE. – LUKE HICKMORE

which have booked a massive amount of profit over the last five years.

Suddenly yields start going up and they're clamouring for their fund managers to hedge. Unless they've got a product

that's going to be easy to pick off the shelf they're just going to use a ten-year gilt future and they'll probably end up living with a massive amount of skew risk.

Now, if there's products out there that



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THE FUNDAMENTAL PREMISE AROUND WHERE TRADING SHOULD GO HASN'T CHANGED; WHAT'S HAPPENED IS WE'VE HAD A SPLIT IN THE MARRIED-UP, JOINED-UP TIMING OF IMPLEMENTATION PROPOSED BY THE G20 AGREEMENT, WHICH HAS CREATED THIS SPREAD OF LIQUIDITY.

- VJ ANGELO

can get ahead of that problem that's great but we need to be talking about and developing them now. I almost wish that central clearing was going to happen this year to give that lightning strike and drive the market on.

Angelo: I guess the question is: are you seeing a differential in pricing, the broadening of spreads and the passing on of costs?

Davies: It comes back to my earlier point about clarity, about the various costs that are internal to investment banks and whether changes in the pricing of various products is genuinely because of charges that are not obvious from the other side of the trade.

Hickmore: It differs depending on the size of your business. The bigger fund managers have access to pooling of capital and as you go down the spectrum it's harder and harder to get access to that capital.

So this whole concept of rising costs isn't one the larger players in the industry are really facing yet but when we move to phase one of mandatory clearing, when the sell side have to clear, that's going to be the testing point.

Deel-Smith: There are two key issues

here – liquidity and execution, vs cost of clearing. In the early 90s, there were over 100 trading banks in the City of London, offering a competitive market landscape. Then there was a period of consolidation through the 2000s and you ended up with several dominant bank balance sheets that could essentially take down the risk, price up anything and wear it, up until 2008.

Post financial crisis, regulatory changes have trimmed down the risk appetite of those big tier-one banks while that of hedge funds and the Buy-Side industry has increased.

Liquidity from the tier-one banks has been shrinking but it hasn't yet fully been replaced in these other venues and that process is ongoing.

We're also moving to a market in which there will be several execution venues in London in the rates space.

Execution fragmentation is not necessarily a problem. Looking across to the States, the model of order routing that exists in the equity market shows you can execute anywhere. The problem comes down to fragmentation in clearing and settlement. Is that a good thing? I would argue no from a collateral efficiency standpoint, but there is other dimension of credit risk to consider. Some asset managers forfeit collateral efficiency for the sake of diversifying counterparty risk.

Now, essentially all the CCPs are mov-

ing to Value-at-Risk or a version of some sort of value-add risk model. Prisma has gone that route; LCH has gone that route, ICE is busy with it.

The only thing that differentiates them is cross-margining. How big is their OI, where does their OI sit? And then the theme is the non-interoperability of CCPs and whether that is really a good thing for the market as a whole?

Hickmore: But isn't there an issue here in that we're moving from a multiple-counterparty system to a single-counterparty or a restricted number of counterparties.

So you've moving from seven or eight investment bank counterparties for your swaps to two or three CCPs.

The question then becomes, do you end up pooling the products into one CCP so that you do your rates derivatives at one CCP and your credit derivatives on another one so you can get those cross-margin benefits?

Metcalfe: This goes back to the point earlier about whether CCPs are a utility. Either way, what happens if they get into difficulty? That's a huge loose end and CCPs have different answers to that question. What is reasonable in terms of haircutting variation margin and who's going to be paying? You've got to consider that however low the risk, there is a possibility that your customers' margin is going to get the haircut and that's got to be factored in.

But I'd like to pick up on the point on liquidity. There are bounds to liquidity and liquidity has a cost. I don't think the policymakers are looking to increase liquidity because, at least in some minds, they associate it with froth and excess. They view it as, at best, rent extraction and at worst hideous speculation.

If you look at some of the other issues that are on the policy agenda, it's all about pushing longer-term investment, it's how much more can we encourage the development of European long-term investment funds. It's how you can avoid possibly pro-cyclical movements in the markets where a lot of people are in one asset class and move out into another.

We've seen a very good paper come out from the Bank of England recently on that very topic. So when you put those two things together you start to suspect

that the environment for liquidity – in the sense of turnover – is not going to get any better.

Angelo: I'd disagree to an extent. I agree with the froth theory, they are trying to centralise liquidity. They're certainly trying to get liquidity in one place because then they can watch what's going on.

What is quite bizarre though is that in attempting to centralise liquidity they've managed to fragment it phenomenally by creating competition.

Metcalfe: I would add a further qualification. There's an element of trying to concentrate trading. There's an assumption that because it happens in some sort of centralised venue, ideally on a CLOB basis, the capacity will always be there.

I'm not sure the lesson has been learned from not just the financial crisis but previous episodes that you cannot manufacture liquidity, whether in the sense of turnover or more importantly capacity. Liquidity in the sense of capacity has a cost and the asset owners are the ones who can provide it.

Another point about fragmentation is that enough of it seems to be happening along national or jurisdictional lines, particularly in the derivatives market, which has traditionally been the cross-border market par excellence.

How much that has an impact on the overall liquidity is an unknown quantity.

Angelo: The fundamental premise around where trading should go hasn't changed; what's happened is we've had a split in the married-up, joined-up timing of implementation proposed by the G20 agreement, which has created this spread of liquidity. The split in the implementation of various regulatory changes and the breakdown in the timing of those has created the fragmentation and is leading to regulatory arbitrage

Metcalfe: Maybe there was a race to appear tougher but either way, it links back to the question of collateral and how easily that flows because what you seem to be getting now is a consensus from policy-makers, market participants, infrastructure providers etc over whether you can get the amount of collateral people need to the right place at the right time. And in a



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globally fragmented market that becomes more and more difficult.

Angelo: The issue is about compression and its impact on price discovery. A firm may have a price based on its portfolio and it has x amount of compression available on LCH so it's going to show a better price on LCH than another CCP. But that does raise the question of the concentration of risk.

There was an institution a couple of years ago that did an estimation of somewhere between four trillion and seven trillion dollars needed in terms of collateral when we go fully mandatory cleared across all the asset classes. And that was before forward FX became an issue.

Banus: We're assuming that we haven't lost that liquidity pool. As an investment bank I don't want positions littered around the place, I need to make that efficient as possible because it costs me more to do this now than it used to.

Metcalfe: Also if you're trying to price for the cost of collateral in the future world, it's a reasonable assumption that world is not going to be as stable in terms of short-term rates or other assets as now so you're going to have to price-in either higher rates or more volatility or both.

Angelo: It's interesting you mention liquidity. We've just run an analysis on the interest rate swaps on the top four currencies from 2012 to now doing some projections and I was absolutely flabbergasted by the numbers I saw on US dollars, which experienced a 60% drop between 2011 and today, taking in the period of transfer to

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clearing and the SEF regime. That comes back to the liquidity issue. Will we see euros and sterling take a similar hit when OTFs and mandatory clearing comes in?

Personally I think we will not because I think we've got a far longer window for implementation. We've also got a template for what not to do from the US implementation

Davies: So where do you think the big mistakes were made in the States?

Angelo: I think they pushed it too far too fast. I can understand why. The minute the banks started lobbying hard for delays, the politicians were only going to go one way. I think the mistake was that when they got past the political will not to give the extension, they stopped listening to the pragmatic issues around it so mandatory clearing happened way too fast.

Even now we're talking to end users in the States who still don't have CSAs in place, who don't have proper technology connectivity, they think they are just going to do something else.

Jeffs: What do they do, set up a futures pool?

Angelo: A lot of them are. In fact, that's the only option at the moment. They're still searching for any option that's out

there, they're experimenting and playing around with whatever's going on but, yes, a lot of them are heading down the futures world.

Hickmore: And has there been any obvious home for that business? You've seen the growth of the Eris Exchange in the US but have you seen a big increase in bog-standard futures as well?

Angelo: No. Volumes have dropped on CME, and on ICE/Liffe and Eurex in Europe, which is obviously not in the same world we're discussing but they have gone down on the standard existing contracts.

We've also done analyses of the volumes on the DSF contracts, and it's interesting to see the peaks and troughs in volumes.

The CME sees incredible spikes around the delivery months where you've got an average of three or 4,000 contracts, spiking up to 80,000 straight back to three or 4,000 contracts.

The OTC business hasn't found a home. We hear anecdotal stories of insurance companies remaining open long-end interest rate risk because they're either a) confused or b) don't want to take on the complexity.

The liquidity's actually not moved elsewhere, it's just virtually disappeared.

Hickmore: The other interesting thing for me is that you talk to your colleagues who are doing annuity hedging and they don't want to do anything bar interest rate swaps.

They need flexibility, exactness and the decay of the asset. But if they're facing a world where the liquidity is shifting and capital is restricted so they are going to have to revisit their models, rethink how they do those annuity hedges and keep the cost to the end investor reasonable because that's where the risks lie.

Angelo: We sat with a buy-side client who went through our product and said: "Great but we need swaps" for precisely the reason you mention. One of his counterparts in the same institution was quoted in an article saying the biggest problem we've got is not that swaps don't work, it's there's no-one to trade with on the other side. So the bid offer spread has widened so far the value of the swap is drifting away.

Deel-Smith: Does a deliverable swap future not provide the liquidity? You'll still have tier-one and top tier-two institutions providing bespoke OTC products but if we have a more liquid pool of deliverable swap futures which pretty much levels the playing field, it's somewhere to lay off the risk. Could that not resolve the issue?

Angelo: If people are trading it just to roll, you suck out the liquidity of the deliverable aspect. If you can't match up the deliverability or you haven't got banks willing to stand behind the deliverability without being in the futures contract then you suck out the liquidity as well and you actually end up with a situation where people are going to unwind the future and then go straight to the swap market and you'll end up with a credit or a liquidity crunch around the rolls.

So in theory it's absolutely the right sentiment, absolutely the right approach to reinvigorate liquidity in the swap market. In practice, when you come to delivery these guys are all going to walk away and the guys hoping to take delivery are going to be left there holding the bag and rushing into the swap market.

Deel-Smith: It's instructive to look at commodity markets with delivery. In

those markets less than 5% of contracts ever go to delivery. It's mostly price discovery, hedging and rolling the exposure and certainly that is my impression from the deliverable swap futures space. The banks want deliverability to keep it honest or to have that convergence to the spot market, but not for delivery per se but as a risk transfer mechanism to assist with the hedging and the pricing of OTC products.

Metcalfe: Too many people want too much out of the DSFs, the expectation is far, far higher than what's actually there. You've got a situation where you've got an increased number of alternatives on the table which in itself requires some thought. But you've also got a situation where everybody's waiting for everybody else to go first in terms of liquidity.

Hickmore: That's the key point, certainly for us; where are you going to execute, what are you going to execute? You're going to want to execute something that's got a bit of a track record, that's got depth to it, that you know is going to be there in three months' time.

Banus: The problem is that too many people want too much out of it. The buy-side wants a blend of the products but is yet to see any sort of real substance out there and is also facing challenges around the liquidity of the traditional market.

But ultimately liquidity will be restored because the markets will find a way.

Deel-Smith: There will always be a hybrid market. Investment managers need a specific hedge, they need the cashflow attributes of the OTC product. I don't think that's going away or will ever be replaced by DSF.

Hickmore: Well, they need a specific hedge that their actuarial department's told them they need and then next month they'll be told that they need a different specific hedge so you need to be careful about that.

Deel-Smith: I see the DSF more as a lubricant to the market to facilitate the pricing of the OTCs. Transactional volume is likely to go through the DSF because it's cheaper, collateral-efficient but it is not going to cannibalise the bespoke OTC products but rather support them.



Angelo: There is always going to be a swap market, there's no question about it. The gross national debt of the planet is something like \$120trillion and yet the swap market peaked at \$700trillion in 2011, so there's a huge tract of swap trading that has very little to do with marrying up the underlying assets and liabilities. There's a huge tract which is interest rate risk, there's interest rate trading, arbitrage, curve plays and the shifting of risk across the curve.

The shift now is that with the regulatory change a large part of the market needs the tailor-ability of a new product without the costs inherent in the swap market.

But we think the market wants malleability across the curve without a brick wall every quarter. They want something that reflects the OTC market but has the benefits of a futures contract.

The main issue, I think, between the swap market and DSFs is that DSFs are in a very intractable place except for one day a quarter when you actually have the rate that you're going to settle against. You want that kind of tailor-ability, that malleability the swap markets provides on a minute-by-minute, hour-by-hour, day-by-day basis, but with the cost and transparency of pricing advantages of a futures contract.

This is the reason we have chosen the full curve non deliverable Constant Maturity Future, model for the GMEX construction.

Jefferies: Gentleman, thank you all for your comments. It is obvious there is a lot of work that needs to be done on all sides before the market feels more confident about moving forward but I hope you agree this has been a useful exercise in assessing the current situation. 🌐

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