WHAT TO EXPECT IN THE 2018 EQUITIES MARKET

Part I - MiFid II: Challenges and Opportunities in Electronic Trading

Key Takeaways

- While the challenges of MiFid II are formidable, the new regulation will likely create extensive opportunities for firms on both the sell-side and the buy-side that have invested in the necessary people and systems.
- MiFid II will fundamentally change the way equities are traded, especially in large blocks, underpinning an increased emphasis on electronic trading.
- Systematic Internalisers (SIs) could allow firms to differentiate their liquidity proposition
- Increasing platform and technology costs for both buy and sell-side could offer those with the resources an opportunity to extend a competitive lead in Execution.

The magnitude of the changes that will be brought about when MiFid II is implemented in January 2018 can be challenging for those that are unprepared. But for buy-side as well as sell-side firms that have made the necessary investments in their systems and their personnel, the opportunities arising from the new legislation could be extensive.

"The bottom line is that by intensifying requirements for transparency, MiFid II is likely to accelerate the trend towards the increased use of technology in the trading process," explains Paul Beattie, Director in the Customised Execution Services (CES) Group at HSBC Global Markets. "As this technology develops, it could have a profound influence on the buy-side's decisions on where and how to route their trades, and on how those trades are monitored and analysed post-transaction."

The two key rules that could change everything

Simon Cornwell, Head of CES at HSBC Global Markets, says that two big changes arising from the implementation of MiFid II will be especially noteworthy. The first is the prohibition after January 3 of Broker Crossing Networks (BCNs), alternative trading systems that have allowed trades to be matched directly between institutions, rather than via an exchange. The second, says Cornwell, will be restrictions placed on the remaining "Dark" MTF Books with, limiting total trading in any individual equity instrument to 4% of daily turnover per venue, and to 8% in total.

"Potentially, these two changes could lead to large liquidity dislocations because some of the venues where the most liquid stocks are traded today will no longer be viable in their current form," says Cornwell. "This is driving much of the innovation we are seeing today among market participants. This could continue as the market moves more towards the use of conditional venues and continuous auctions"

In this new world, says Cornwell, the principal objective of HSBC's Customised Execution Group is to stitch together the innovations in liquidity created by MiFid II and present them to customers in a usable format across the life cycle of a trade. "Ultimately we want to ensure that our buy-side clients are able to integrate with HSBC as an execution provider in a seamless way," he explains. "This means that it is our job to integrate the various different liquidity sources and optimise the performance of our algorithms in order to meet the execution objectives of our clients.

Addressing transparency requirements

This also means that there is a requirement to develop and provide the transaction cost analysis (TCA) applications that the buy-side will need under MiFid II to explain and if necessary defend their best execution policy. As Cornwell explains, although TCA has always been important for the buy-side, it could become integral to the trading process under MiFid II as firms adopt a more systematic approach to evaluating their brokers on a proactive as well as a retroactive basis. "We are already seeing some clients implementing quantitative processes for reviewing their sell-side counterparties on a one and three-month basis and optimising flows accordingly."

Cornwell says that for a bank as well-capitalised as HSBC, which is unencumbered by legacy systems and has invested in the necessary technology well in advance of MiFid II, the new legislative regime could create a wealth of new opportunities. One such opportunity is utilising Systematic Internalisers, a part of the European Trading landscape since Mifid I which have been the subject of much media debate recently.

As Cornwell explains, strict transparency requirements mean that it is a mistake to see SIs as reincarnations of dark pools. "SIs will bring enhanced transparency, because they will be publishing quotes on market data feeds which other banks and brokers, as well as buy-side firms, will be able to plug into their smart order routers."

HSBC believes that the provision of access to high-quality, customisable liquidity could be one of the distinguishing features of its SI. "We have always provided our clients with capital through our cash execution business," Cornwell explains. "The MiFid II SI regime will allow us to do so in the context of a new regulatory construct."

Technology paving the way to enhanced client service

More broadly, Cornwell says that MiFid II, perhaps paradoxically, may be an example of regulation that creates more opportunities than threats for well-prepared and highly-resourced banks. "MiFid II was very much in our minds when we built our new platform, which has given us the capacity and flexibility we need to adapt to the new legislation," he says. "As it was built at the same time as our prime brokerage business was being expanded, it has also allowed us to integrate it with the other innovative balance sheet products we can offer, providing clients with a more holistic service."

Part II - Unearthing Opportunities in Emerging Markets: The Outlook for Saudi Arabia

Key Takeaways

- Concerns over geopolitical risk, global monetary policy and high valuations may make 2018 a challenging year for emerging market equity investors.
- Against this backdrop, there are a host of technical and fundamental reasons why Saudi Arabia has the potential to deliver returns that are largely uncorrelated to other emerging markets.
- Saudi Arabia could be an appealing index play for investors in 2018.
- Privatisation, IPOs and accelerated reform will all be drivers of opportunity in 2018 and beyond.

When HSBC's Dubai-based Managing Director of Institutional Equities, Osman Raie, recently visited 55 clients in the US, they were pleasantly surprised on a number of fronts by the compelling story relayed on the outlook for the Saudi Arabian equity market. The institutional clients Raie met were encouraged by the size of the Saudi market ("Tadawul"), which with a capitalisation of $470 billion (as per Tadawul website, on 14 September 2017) is the largest and most liquid in the Middle East. "Perhaps more important is the diversity of the market, with the number of opportunities offered by more than 170 listed companies, many of them in non-oil sectors" says Raie. He adds: "These range from retail to healthcare, breaking down the popular perception that Saudi Arabia is a mono-economy driven solely by commodities". Roughly half of the Kingdom's population of 32 million is made up of the under-25s (as per UN Population data), who form the backbone of an increasingly demanding and aspirant consumer society.

Two reasons to consider Saudi Arabia: reforms and indices

The driving factor that HSBC believes could see Saudi Arabia become one of the most exciting stories in the emerging market universe in 2018, is the Kingdom's reform agenda – Vision 2030. The first phase of this reform process has been focused on liberalising the Kingdom's capital market and integrating market practices with international standards. This process is driven in part by Saudi Arabia's commitment to cutting its sizeable budget deficit, which is projected by HSBC at 8.4% of GDP this year (Source: HSBC Global Research report Saudi Arabia, Razan Nasser, 13 September 2017), and promoting the accelerated expansion of the Kingdom's non-oil economy. This proactive and progressive capital market liberalisation is part of broader mosaic of reform being introduced under 'Vision 2030' that has been personally espoused by His Highness King Salman Bin Abdulaziz Al-Saud. "Pivotal to 'Vision 2030' is the diversification of the economy through the promotion of private sector investment," says Raie.

The process of reform is already well underway. "A market that has historically been closed to overseas participants is now open to Qualified Foreign Institutional Investors (QFIs) with assets under management of at least $1 billion," explains Raie. "A more recent development attesting to the Kingdom's commitment to integrating the Tadawul with the global capital market was the move in May of this year from a T+0 to a T+2 settlement cycle, which aligns the Saudi equity market with global practices."

These initiatives are critical steps in Saudi Arabia's journey towards attaining emerging market status from the world's most influential index providers. Two of these – MSCI and FTSE – have already put Saudi Arabia on their watch-lists, which many analysts believe is the precursor to the elevation of the Kingdom to emerging market status. FTSE annual country classification review results will be released after US market close on the 29th of September. "This would be a game-changer for the Saudi equity market because it would unleash an inflow of funds from international index-based investors. We continue to engage existing QFI investors and other global clients through our Roadshow programmes, webinars and with the use of our award winning Global Research platform to discuss what ascension would mean from a flow perspective," he adds.

The frontier market success story of 2018?

Given that Saudi Arabia would account for 2.5% to 3.5% of the most widely-tracked emerging market indices (Source: HSBC QPS: Saudi Arabia Update (Post MSCI Market Classification), 23 June 2017), Raie says that the market could expect to see passive inflows of $15 to $20 billion from overseas institutions benchmarked to these indices citing the work from HSBC (Source: HSBC QPS: Saudi Arabia Update (Post MSCI Market Classification, 23 June 2017)). These inflows, he says, would create a supply-demand dynamic that would more than offset some international investors' misgivings about the valuation of Saudi equities, which are currently trading on forward multiples of 18 to 19 times earnings (Source: HSBC Global Research report GEMs & MENA bottom-up databases, 13 September 2017).

There are other reasons why international demand for Saudi equities is likely to remain strong. "Dividend yields are appealing, return on equity (ROE) levels of listed companies are strong, and the Saudi riyal's continued peg to the US dollar eliminates currency risk for many overseas investors," Raie says.

This all bodes well for the rising supply of Saudi equities that will be a by-product of accelerated reform. The most striking illustration of the government's commitment to privatisation is the planned listing of Saudi Aramco, expected in 2018, which will further increase the Kingdom's weight in emerging market indices. With several upcoming IPOs known to be in the pipeline, Saudi Arabia is sure to command the attention of the international investor community in 2018 and beyond. "Saudi Arabia will without doubt be one of the most exciting emerging or frontier market stories in 2018," concludes Raie.