OneRiver Digital
ASSET MANAGEMENT

market notes: Good Bad News

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Bad news is turning good. Financial conditions are easing with the moderation of inflationary pressures. This will smooth the economic downturn. But digital financial conditions have tightened sharply, constraining asset performance. Disciplined growth is the path forward.

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1. There is no tidy historical analog for understanding the current macroeconomic cycle. Inflation's resurgence brings back memories of the 1970s. But the resemblance is surface and a poor guide to future outcomes. Longer-term inflation expectations are anchored. Demographics are a headwind. Forward government debt is high. Central bank balance sheets are large. And international balance sheets are more connected than ever at a time of geopolitical strife. Principles more than analogs will be key to the next cycle – there is no growth without discipline.

2. The Fed is the center of attention, not surprisingly, given the rapid shift to tightening. A year ago, short-term interest rates were expected to rise to roughly 1% today, with a gradual increase to 2¼% over time (Figure 1). Instead, short rates will end this year near 5%, with an expected decline to 3¾% in the longer term. Investors were accustomed to a well-telegraphed policy response; they were shocked by a forceful move to contain the rise in inflation. The boring rate cycle transformed into a definitive expectation of economic recession.

3. Even simple analytics say that the past year was all about the Fed. Short-term interest-rate expectations explain 81% of the variation across equity, corporate bond, and currency markets this year, a jump from 35% during the previous four years (Figure 2). Digital asset markets receive a lot of attention for outlier price movements. Yet, they merely fit the profile of traditional markets on this metric. Rate expectations capture 76% of the variation in the One River Digital Core Index this year, nearly double the previous four.

4. But bad news is turning good. The end of the interest rate tightening cycle is near. Our latest Macro Pulse takes activity data from the ISM survey and applies a transition matrix to different stages of the cycle to arrive at a score between 0 and 100. The bad news – activity is consistent with recession. The good news – unlike the period of economic weakness in the first half of the year, capacity constraints have eased dramatically. Delivery times, order backlogs, and prices are all contracting sharply, reinforcing a cyclical downturn in inflation.

5. Even better news still is that traditional financial conditions are easing. Lower bond yields, a weaker dollar, and strong equities are easing financial conditions despite expectations of further interest rate hikes. This is an automatic stabilizer to cyclical weakness. But there's a catch. The degree of easing in financial conditions will be limited by real policy rates. Whereas real rates were priced to be negative over a 10-year horizon last year, they have flipped to positive. More costly capital will impose more discipline on the next growth cycle.

6. This mix of macro and financial conditions is not the sweet spot for digital asset markets. During the short history of recessionary phases, when our Pulse is low-and-falling, Our Digital Core Index returns are negative on average (Figure 3). It is in later stages of the cycle where macro tailwinds tend to unlock the fastest growth in digital assets, with periods of high-and-rising activity averaging monthly returns of 21.6%.

7. Today, tight conditions in digital asset markets are countering the easing from traditional markets. In the wake of the FTX bankruptcy, our Digital Financial Conditions Index is near its tightest of the past year, with a Pulse score of 10 (scale 0-

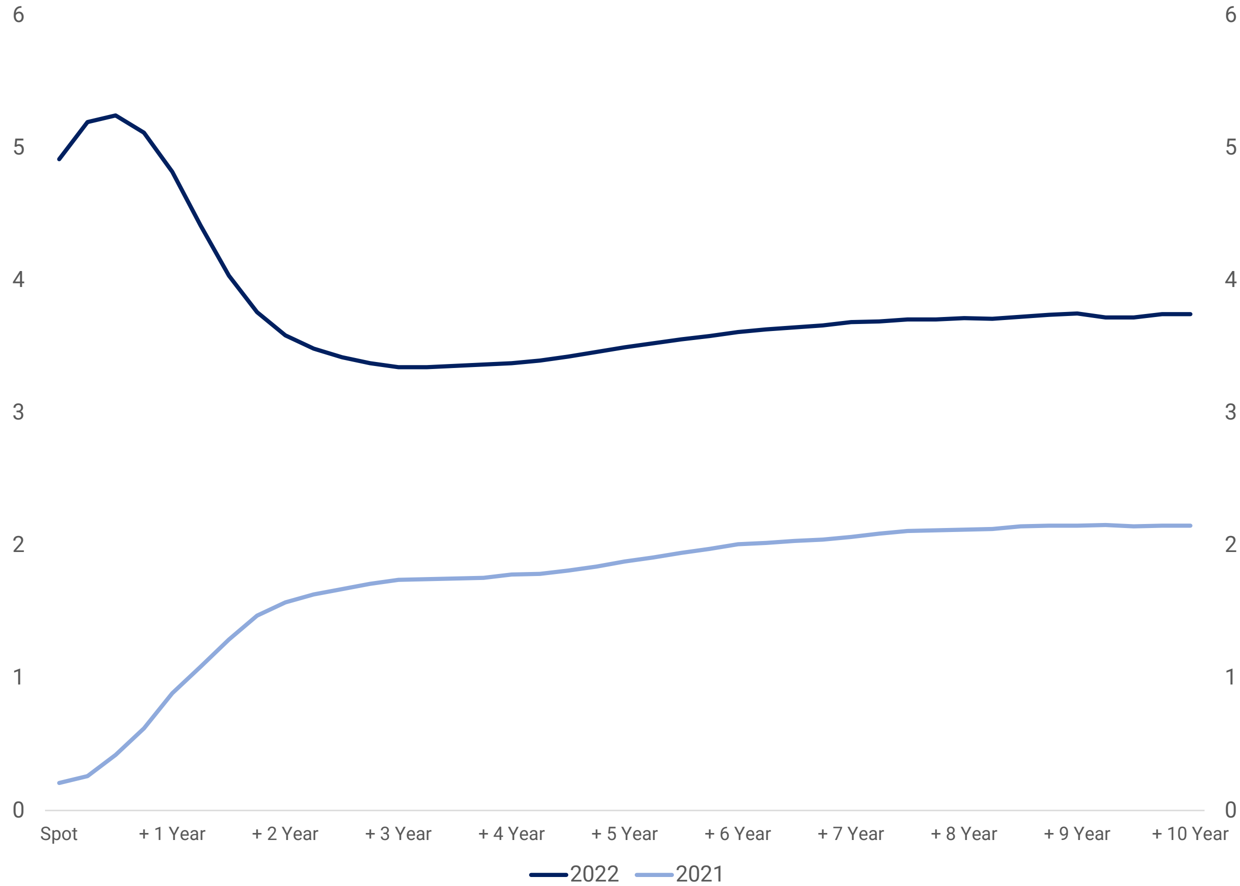
100, lower is tighter, Figure 4). Uncertainty about the knock-on effects from further forced deleveraging is evident in tightening across all components of financial conditions – the decline of income yields, the rise in credit yields, and the decline in equity valuations.

8. This pattern of returns is typical of a commodity market. Excess investments at the late stages of a macro cycle take time to cleanse. The tightening in financial conditions is a reminder to the digital ecosystem– the market will impose austerity both with positive real interest rates and a substantial risk premium to constrain investment. The market signal is clear – the next cycle must be disciplined, reducing the amplitudes of the boom and the bust.

9. Don't forget the Fed balance sheet policy – another disciplining force. The Fed aims to shrink its balance sheet to achieve a desired level of banking reserves. But the connection between assets and reserves is less predictable now. Excess reserves are higher in the past two months, despite an acceleration in quantitative tightening. Why? Well, the easing in financial conditions reduced market demand for central bank liquidity facilities, which are new to this cycle. Those conditions increased reserves. More reserves mean more quantitative tightening.

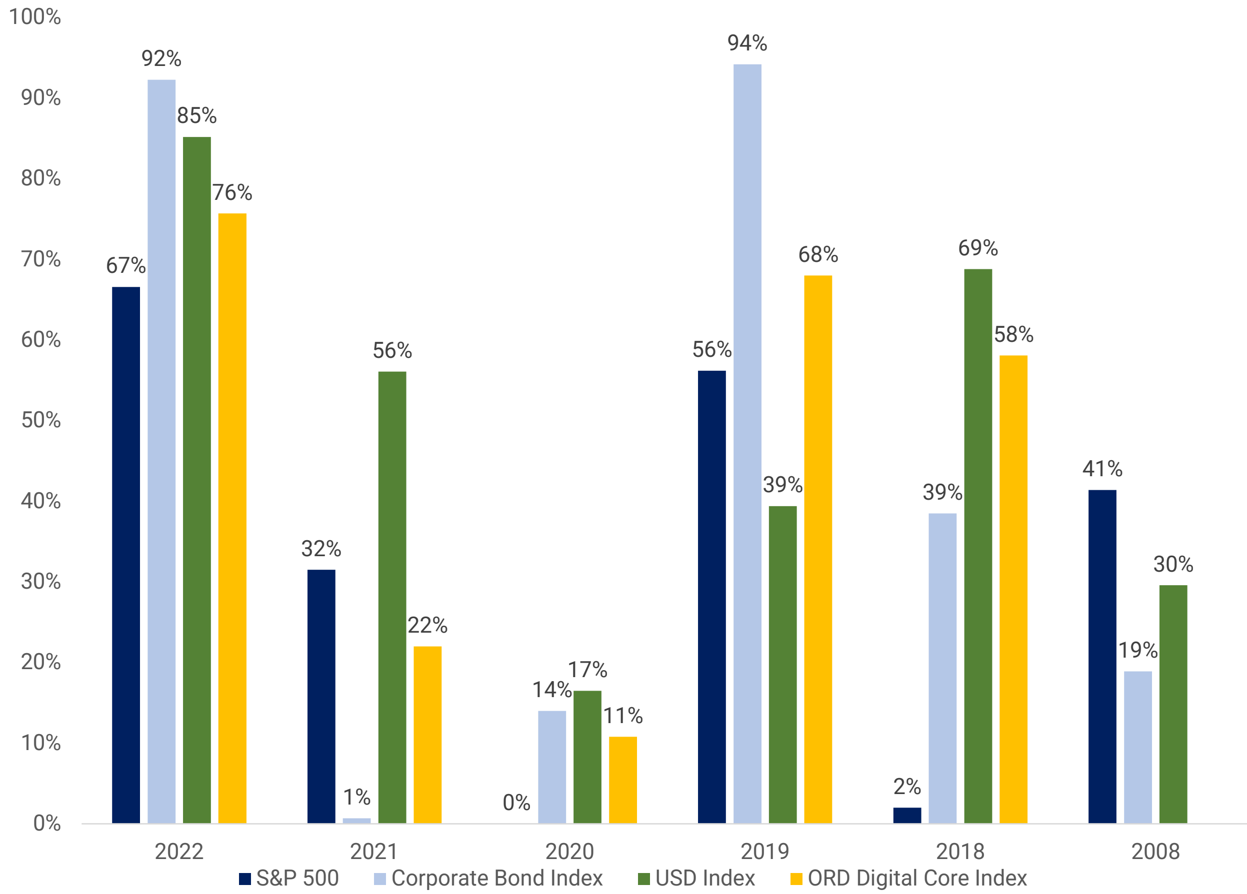
10. Who is likely to be the most disciplined of them all? Follow the incentives. Markets are discounting a rapid decline in inflation. Cyclical data are pointing in the same direction. But the Fed is aiming to keep real interest rates positive for an extended period. The combination of low growth and high real interest rates imposes fiscal austerity. Accommodating a higher inflation target and lower real interest rates may be more palatable. Digital assets don't get to choose – no discipline, no future.

Figure 1: What a Difference A Year Makes – Short Rate Expectations



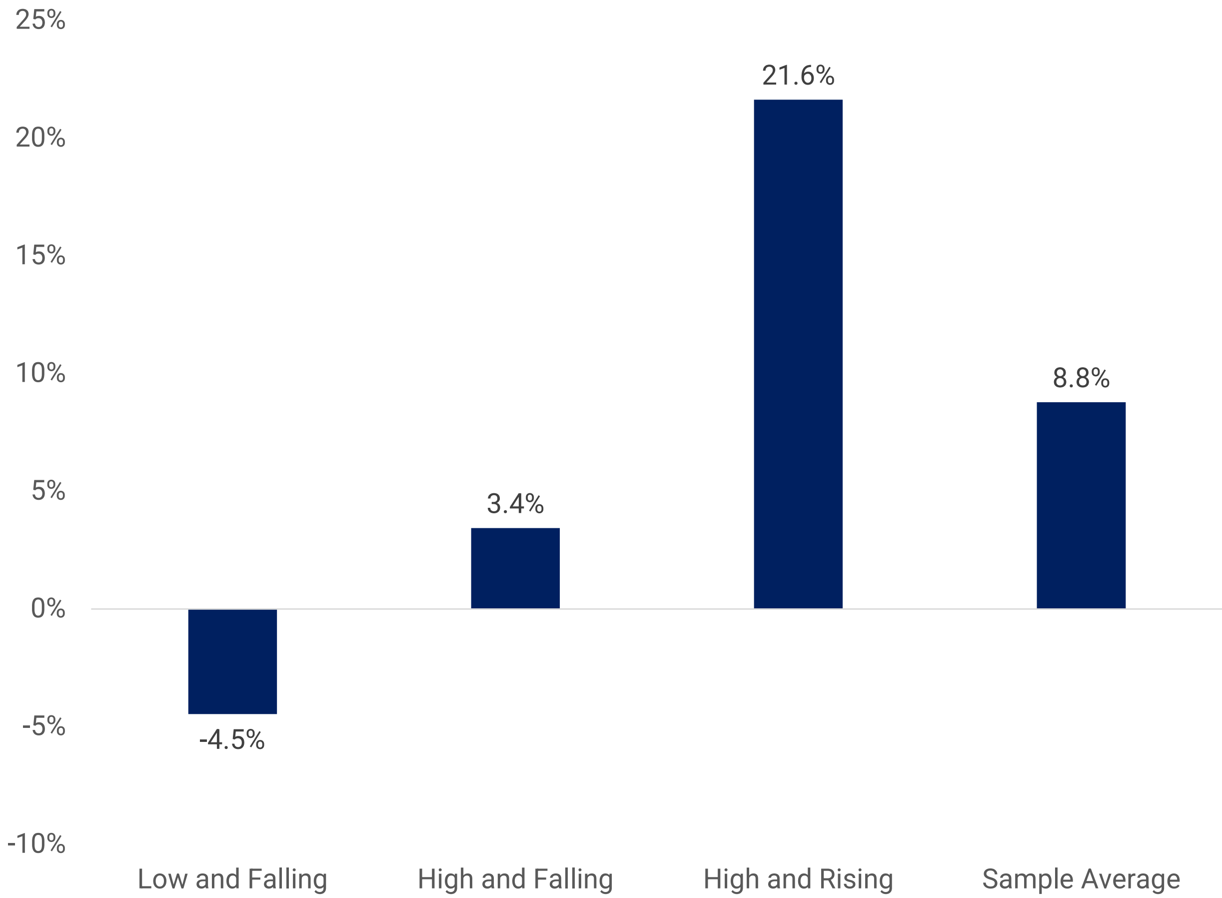
Source: Bloomberg LP. One River Digital Calculations. Spot rate starting in Dec 2022, Dec 2021 as of end-Nov in respective years.

Figure 2: Short Rate Expectations Explain Most Market Variation



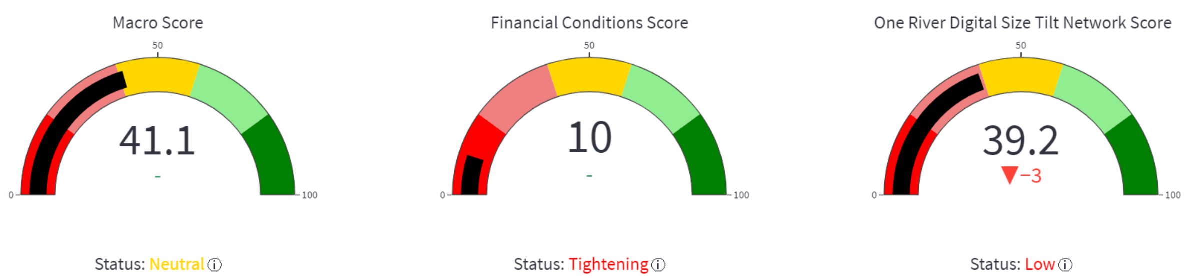
Source: Bloomberg LP. One River Digital Calculations. R^2 of Index log-level regressed against third-rolling Eurodollar future. Past results are not indicative of future results.

Figure 3: Macro Cycles and Digital Index Returns



Source: Bloomberg LP. One River Digital Calculations. Monthly returns based on the One River Digital Core Index.
Past results are not indicative of future results.

Figure 4: One River Digital Financials Conditions Index Pulse Scores



Source: One River Digital Pulse.

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