coinbase ASSET MANAGEMENT

One River Digital Asset Management has been acquired by Coinbase and is now Coinbase Asset Management. Additional details on the transaction may be found on the Coinbase blog. References to One River Asset Management and One River Digital Asset Management may be contained herein during the transition period but are subject to change.

market notes… Not all crypto assets are created equally.

6/9/23 - Marcel Kasumovich, Deputy CIO

1. Liquidity. It means different things to different people in different circumstances. To a high frequency trader, it is about the ability to access the market to move in and out of risk without a large price impact. To a market strategist, it is the invisible hand that is encouraging more leverage to support asset prices. To a central banker, it is the amount of money in the financial system that keeps bank activity moving along seamlessly.
2. US bank failures have been one of the biggest surprises this year, driven by tight liquidity conditions. New programs were created to ensure banks had sufficient liquidity to maintain normal operations. The Fed created the Bank Term Funding Program in March, which continues to expand having exceeded $100 billion on June 7, 2023. Liquidity that is leaving banks is being replenished through the new program, at a more punitive financing cost to the banks.
3. Bank deposits with the Federal Reserve are the simplest, broadest measure of central bank liquidity. In December 2021, it peaked at a record $4.3 trillion. In March 2023, bank strains emerged at $3.0 trillion. That doesn't make $3 trillion a "magic number." It merely demonstrates the fragility of the financial system. Reserves were less than $3 trillion at the peak of the previous easing cycle. And banking frictions only emerged when reserves fell below $1.4 trillion.
4. And it isn't just a US issue. The European Central Bank is facing its own tightening challenges. What we learn about central bank liquidity – the number doesn't matter, it's all about the distribution. The weakest links are the first to failure. Europe's challenge is acute. At the end of March, Germany accounted for 31% of excess reserves at the central bank compared to 5% for Italy, well below its capital share. Liquidity tightening will hit Italy first, the weakest link.
5. It's a hot topic. Expectations for recession are elevated and there is a simple, known force that will accelerate liquidity tightening – the US Treasury rebuilding a cash buffer at the Fed. Ironically, the US debt ceiling was a boon for bank liquidity. As the Treasury drained cash from its Fed account, liquidity in the banking system rose. That's now going to work in reverse with a quick $600 billion build. Broad liquidity will fall well below $3 trillion, absent some other change.
6. Why the attention? Correlation. The expansion of central bank balance sheets has been tightly wound with US equity values since 2009. And when equity valuations went too high relative to central bank liquidity – like now – crashes followed, and central bank liquidity shot higher. Same for bitcoin recently (Figure 1). Of course, the liquidity tightening is more symbolic than causal. You know what liquidity was doing in the 1990s dot com bubble? Nothing.
7. So, liquidity is a powerful market correlation that won't last forever. Crypto asset markets were the first casualty of the initial liquidity tightening, with the peak of prices coincident to the start of the tightening in liquidity conditions. Yet, the fragility of the banking system is juxtaposed

against the durability of crypto asset markets on the latest tightening. Some crypto assets raced higher as bank fragilities were realized in March – the large ones.

8. The resilience of crypto asset markets isn't an accident. The Darwinian culling of the weakest links is a feature. The chaos created is leading to a new orbit of smaller protocols centered around Bitcoin and Ethereum. Bitcoin and Ethereum now garner a 95% share of the Coinbase Core Index. The contours of the rise in asset valuations are also far different than past cycles, with the larger assets leading the charge.
9. Even the SEC revelation of specific crypto assets as potential securities is not a material one for asset prices. Figure 2 illustrates the Core Index against an equally weighted basket of assets the SEC observed as potential securities. In the second half of last year, this index of smaller crypto assets was either on-par or stronger than the Core Index. They underperformed by 45% since March – liquidity tightening is a more likely force than anticipated regulatory action.
10. Liquidity matters. But correlation is not causation. The most interesting trends are the ones that emerge when perceived structural correlations break. Like the one breaking now between liquidity and large crypto assets. We know that central bank liquidity is going to tighten. We know that weaker links will be pressured. The judgment is degree, longevity, and market shifts that follow. New trends are defined when old correlations break. It's about to get interesting.

Figure 1: Breaking Bad Correlations – Don't Extrapolate the Lines

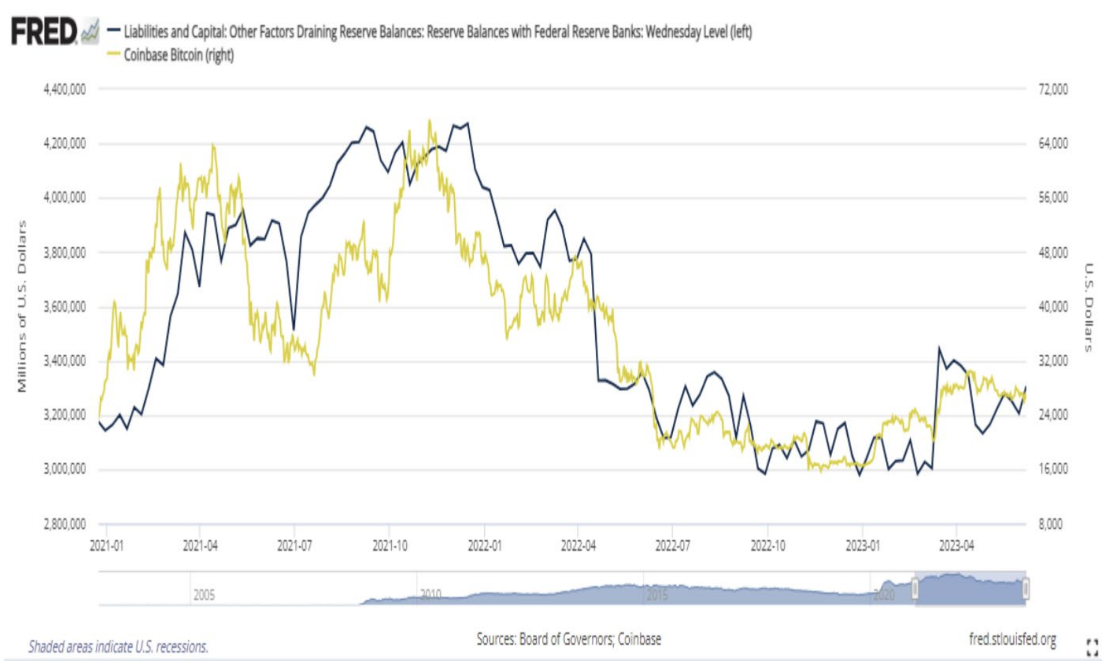
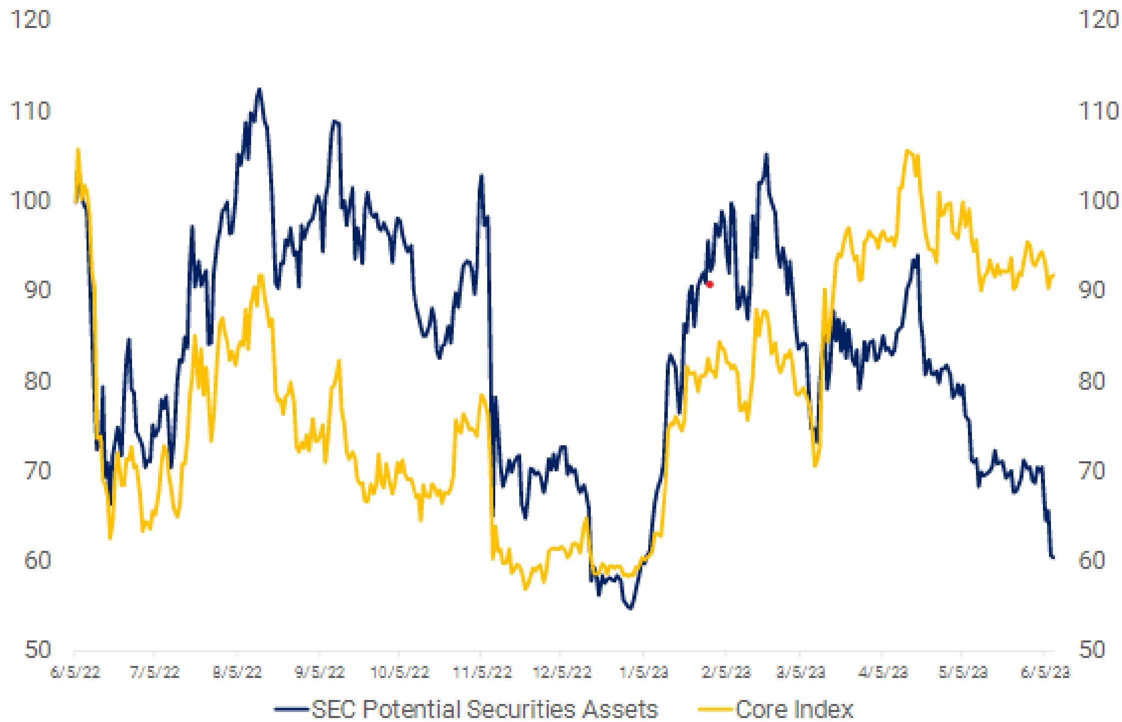


Figure 2: Liquidity Mattered More than Regulatory Policy



Source: Coin Metrics. CBAM. Our Calculations. Securities assets are ATOM, BNB, COTI, SOL, ADA, MATIC, FIL, SAND, MANA, ALGO, AXS, CHZ, NEAR, FLOW, ICP, VGX, DASH and NEXO. Stablecoin are excluded, as in the Core Index. Values are rebased to set June 5, 2022 equal to 100.

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