ASSET MANAGEMENT

market notes: Crypto Speaks Truth, Power is Listening

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6/23/23 - Marcel Kasumovich, Deputy CIO, Coinbase Asset Management

1. Correlation is not causation. The point is easily made when comparing two things that have nothing to do with one another. Like ice cream sales and shark attacks. It is far more subtle when normally used, showing the co-movement of two relatable factors. Like asset valuations and scarcity premium that argues for a rising bitcoin price. It makes for a nice chart that demonstrates the limits of quantitative research as it demands a qualitative assessment.

2. Crypto assets are often a line item in cross-asset correlation. The aim is to motivate its place in a broader portfolio. A low correlation combined with a strong return-to-volatility ratio ensures that crypto assets would have been additive to traditional portfolios. But on any historical analysis, this is a statement narrowly confined to bitcoin given its dominance. It is also an unusual framing as crypto assets span many traditional asset classes.

3. So, we asked ourselves a simple question: Are we starting to see a rise in dispersion across crypto assets that would demand a more refined categorization? It was a leading question. Last year's asset downturn was synchronized – not just in crypto but across all assets. The US dollar was the only asset up. And investors' high allocation to cash persists. To the naked eye, there has been far less correlation across crypto assets, evidenced by a higher degree of dispersion.

4. But the numbers tell a different story. Figure 1 is the simplest summary of the data. It shows the median daily return correlation between bitcoin and ether against the other top 24 assets. Yes, the median pairwise correlation spiked in last year's carnage, at a whopping 75% and 77% for bitcoin and ether. This was up substantially from the 51% and 55% figures in 2021. Surprisingly, the correlation remains stubbornly high so far this year.

5. Do our eyes deceive? It is tempting to explain away the observation – it could be a fluke across calendar years. But the result held up to stress tests. Instead, there is usually a simple explanation for a simple question beneath complex dynamics. In this case, dispersion is being driven by "beta asymmetry." Returns

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are correlated. But the sensitivity is lopsided – smaller assets respond more aggressively on the way down in bitcoin than on the way up.

6. What's going on? Our qualitative assessment - when capital is dear, cash flow is king. And the dominant protocols produce a lot of it. Bitcoin mining is tracking annualized revenue of $9 billion with attention to capital efficiency, not growth. Proceeds paid to use the Ethereum protocol are running $2 billion annualized. After last year's disappearing act of crypto assets and counterparties, investors are no longer hunting for the next great growth idea – they want the surety of survival.

7. Even stablecoins offer an interesting twist to the correlation dance. We include stablecoins in the exercise, appreciating that its correlation should be zero if "stable" is met. Taking the median cross-asset correlation controls for this outlier. But the result was revealing in subtle ways (Figure 2). A rising correlation between bitcoin and stablecoin occurs in periods of stress – it has risen against USDC this year alongside US banking strains while being low against Tether.

8. It is not just an idle statistical exercise – there are commercial implications, too. Bitcoin trading volumes against Tether dominate in the latest price surge. Tether was the counterpart to 78% of the bitcoin trading volume on the day of this week's price jump, on June 21. That's up from 63% in the prior month. Almost all of that gain came at the expense of a decline in fiat USD trading activity. The low correlation of Tether reflects an increased conviction of its health.

9. This comes at a time of great excitement about a potential rise in crypto adoption as powerful traditional players like Blackrock signal an intent to enter bitcoin's investment orbit. Even Fed Chair Powell accepted to Congress that "crypto appears to have staying power as an asset class." Tether dominating trading volumes means players already in the crypto ecosystem are leading the positive price reaction, speculating on a rise in future adoption.

10. This also has important implications for crypto asset allocation, evident in our Coinbase Indices. The Coinbase Core Index is a market cap weighted allocation across constituents, whereas the Coinbase Size Tilt Index mathematically raises exposure to smaller capitalized assets. It is routine for the Size Tilt index to outperform in rising markets – but not this time. In a cycle rewarding discipline and dominance, emerging assets may adapt to support leading ecosystems rather than try to displace them.

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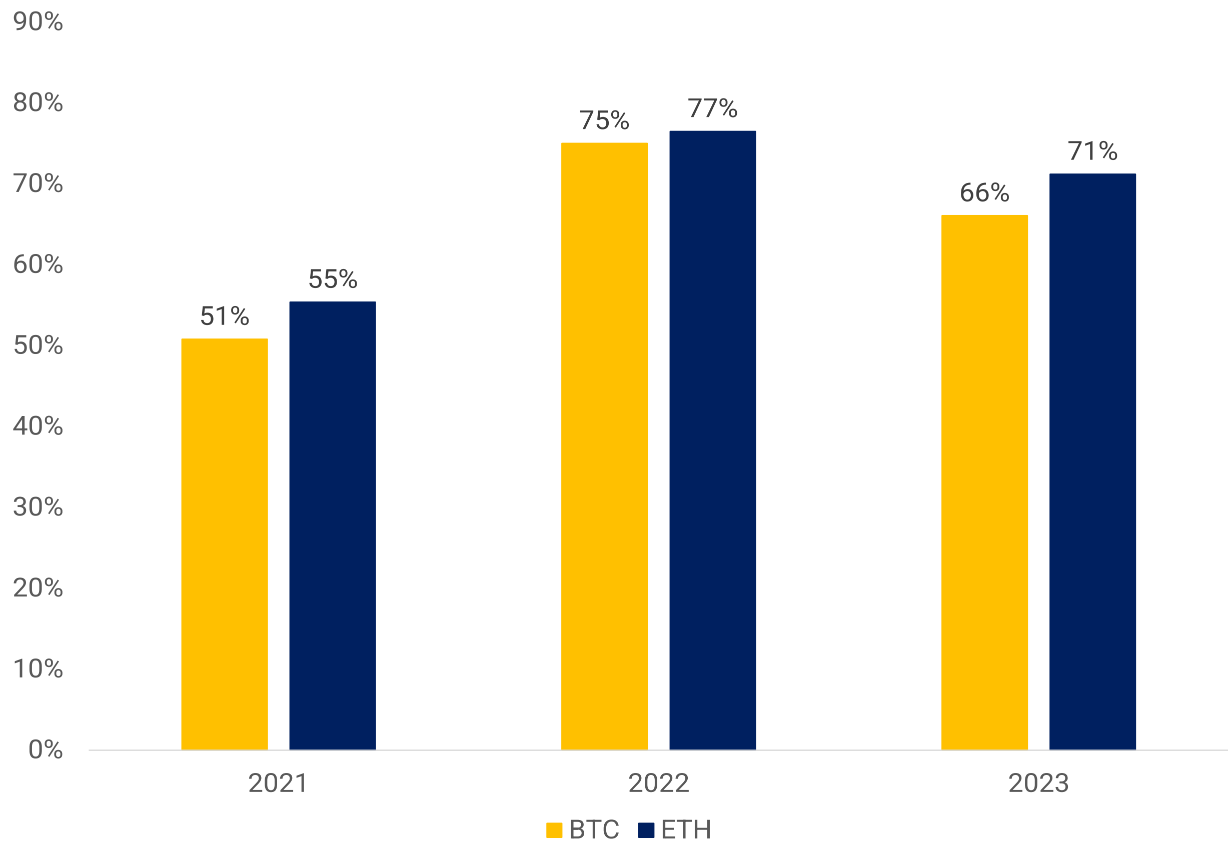
Figure 1: Cross-Asset Crypto Correlations Surprisingly High in 2023



Source: CryptoCompare. CBAM Calculations. The numbers represent the median pairwise correlation of BTC and ETH versus the Top 24 assets by market capitalization. 2023 is through June 16.

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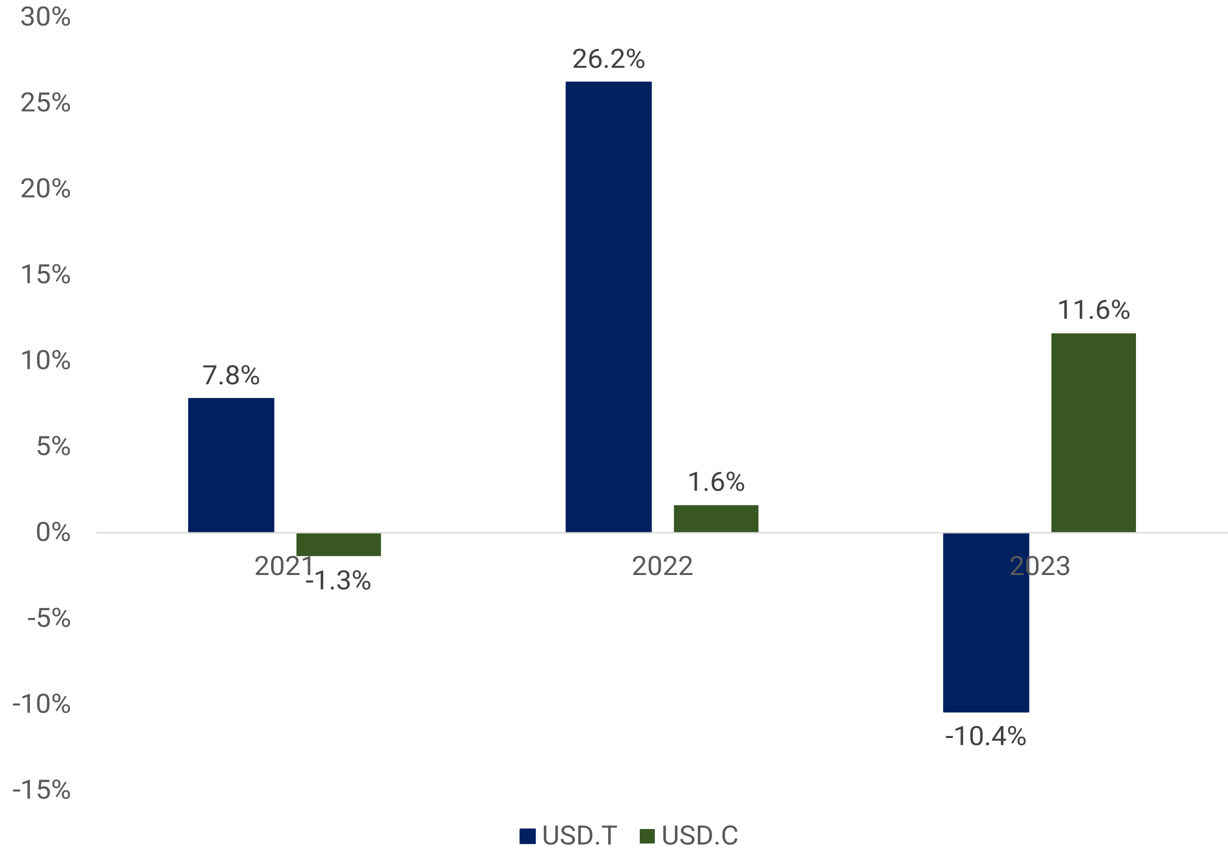
Figure 2: Stablecoin Correlations to BTC and ETH



Source: CryptoCompare. CBAM Calculations. Average daily return correlations of USD.T (Tether) and USD.C (Circle) to BTC and ETH. 2023 is through June 16.

Indices and other financial benchmarks referenced herein are provided for illustrative purposes only, are unmanaged, reflect reinvestment of income and dividends and do not reflect the impact of advisory fees. Investors cannot invest directly in an index.

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