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ASSET MANAGEMENT

Market Notes: Digital can handle the tightening... can traditional?

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Market conditions can tighten with or without central banks. Just ask digital asset investors. The peak tightening in digital financial conditions was in June 2022, and prices have decoupled from traditional forces since then. The current digital tightening cycle is unique – it was led by credit, now the land of opportunity.

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1/ Navigation is driven by the human desire to explore, innovate, and create. Knowledge builds on itself. The tools used for land, sea and air navigation were adapted for space navigation. And 6.8 million miles from Earth, that navigation was deployed this week to autonomously crash an aircraft into an asteroid at a speed of 14,000 miles per hour to redirect its course. Massive redirection in financial markets, in contrast, is guided by forces harder to define.

2/ Just when you think you understand market forces, the invisible hand claps to surprise you. Digital asset markets were the quiet ones in the third quarter. The One River Digital Core Index rose 3% in the face of traditional markets pushing in the opposite direction – a 9% decline in global commodity prices, a 7% rise in the US dollar, and an 80- basis-point surge in 10-year US Treasury yields. Digital assets are not suddenly immune to macro markets – they are just far more advanced in the tightening cycle.

3/ It turns out, financial conditions are an especially powerful tool to employ in navigating digital assets cycles. Without a lender of last resort, there is no policy intervention that can be used to interrupt market adjustments. A tightening in financial conditions must be cleared through capital and price. There is no alternative. We built a Digital Financial Conditions Index (D-FCI) using short-term interest rates, credit, equity, and foreign exchange all tied to the digital ecosystem, building on the work from traditional markets.

4/ The D-FCI measures tightening and easing of financial conditions through broad market components (Figure 1). Short-term rates in the digital ecosystem are low when demand for capital is low, a tight condition. A rise in credit spreads constrains financial conditions, which we capture through bitcoin mining. Lower equity valuations for publicly traded digital companies imply a higher cost of capital and tighter conditions. Finally, a decline in the value of digital assets relative to the US dollar is a contraction. The D-FCI equally weights the components after normalizing by volatility.

5/ Financial conditions correlate strongly with digital asset prices – tighter conditions are associated with lower asset prices and vice versa. The relationship is also strongly non-linear, by now a familiar beta characteristic of digital markets (Figure 2). It is a for-now not a forever relationship. We attribute it to the young nature of the assets, more prone to boom-bust cycles. As capital entering the ecosystem matures, so too will the discipline in using that capital and the impulse to prices. Financial conditions will be slower to adjust, and the volatility of assets will decline.

6/ Even with the strong historic tendency, there is plenty of nuance in how digital assets respond to tighter financial conditions. We isolate cycles of five material tightenings in financial conditions to illustrate the point: Nov 2018, Jun 2019, Feb 2020, Feb 2021, and Oct 2021. We focus on tightening cycles as we are in one. There is also an important asymmetry – D-FCI tightening is abrupt and brief whereas easing is gradual and lasting. In the five cycles, the D-FCI tightened by an average of 10% within the first two months, capturing the vast majority of total restraint.

7/ Digital asset prices follow unique patterns in those cycles. Figure 3 shows the average price response starting from the initial tightening in conditions against the current cycle. The price impact is mostly immediate – on average, 94% of the One River Digital Index adjustment happens in the first month! Five months after the start of tightening, asset prices typically resumed their uptrend. But the tightening in conditions that started in October 2021 looks nothing like the historic norm.

8/ For one, asset prices responded slowly to a more gradual tightening in financial conditions. It was a macro market move rather than narrowly tied to digital assets, a slower-burn that served as an early-warning signal with a persistent rise in interest-rate expectations. Further, the pressure on asset prices has lasted much longer than the norm. In the five cycles, asset prices had more than fully recovered levels from the initial tightening in financial conditions; today's Index values are severely depressed, at less than 25% of the norm.

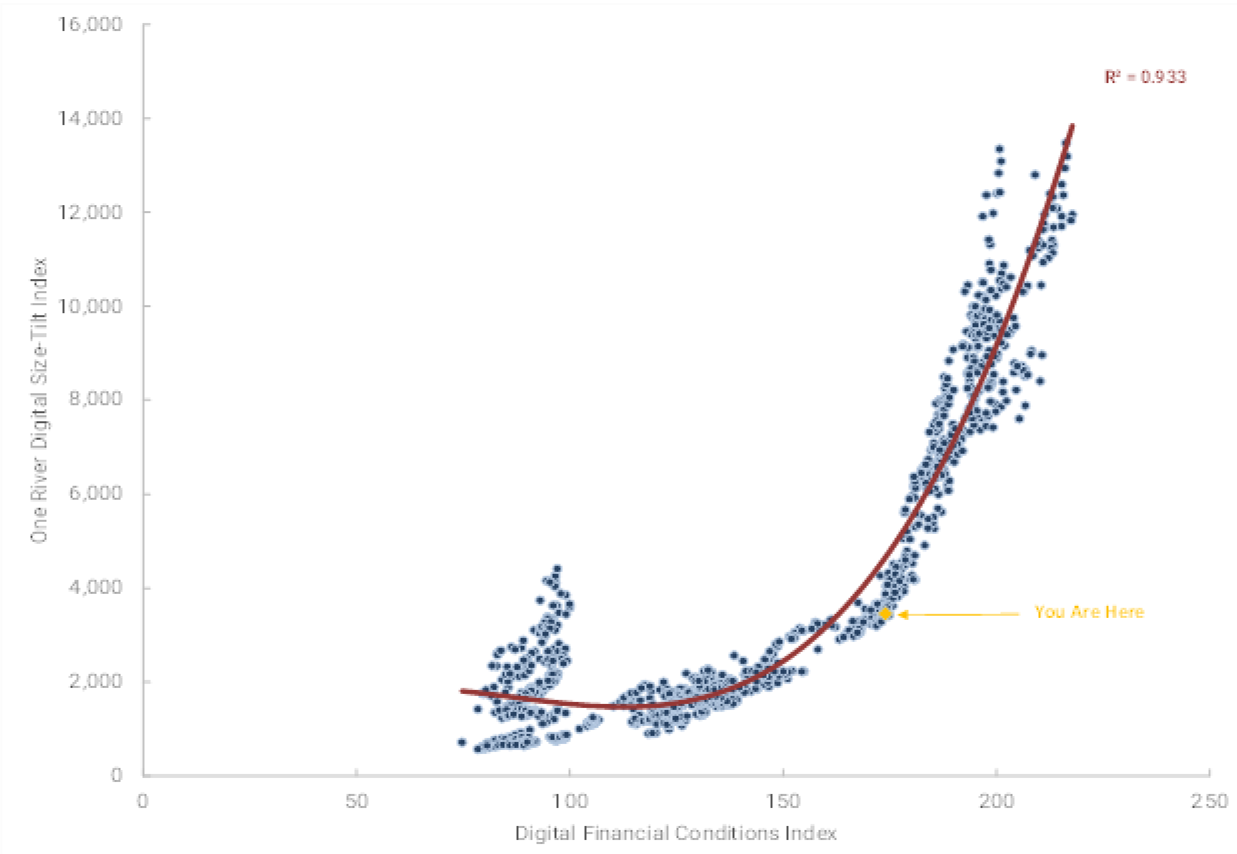
9/ Navigation tools in finance are not scientific. They require judgment. Our read is that credit is the driver of this cycle's tightening in digital financial conditions, for the first time in its short history. Demand for new investment capital is limited, a persistent restraint. The three-month annualized yield implied by bitcoin futures is 56 basis points, down from a peak of nearly 20% a year ago when the tightening cycle started. Borrowing costs for bitcoin mining have leaped to 28% from less than 2% over that period. Credit was the leading force in the tightening, and credit discipline will lead the way out.

10/ Market attention is squarely on central bank tightening. But financial conditions can adjust without central banks, too, as they have in digital asset markets. Financial conditions were tightest at the end of June, around the same time that digital assets began to chart an independent path from traditional markets. The D-FCI is integrated into our Digital Pulse as a complement to the Fundamental Pulse. The tightening is restoring discipline to digital asset markets. Credit stands to be the greatest beneficiary.

Figure 1: Digital Asset Prices Undershooting

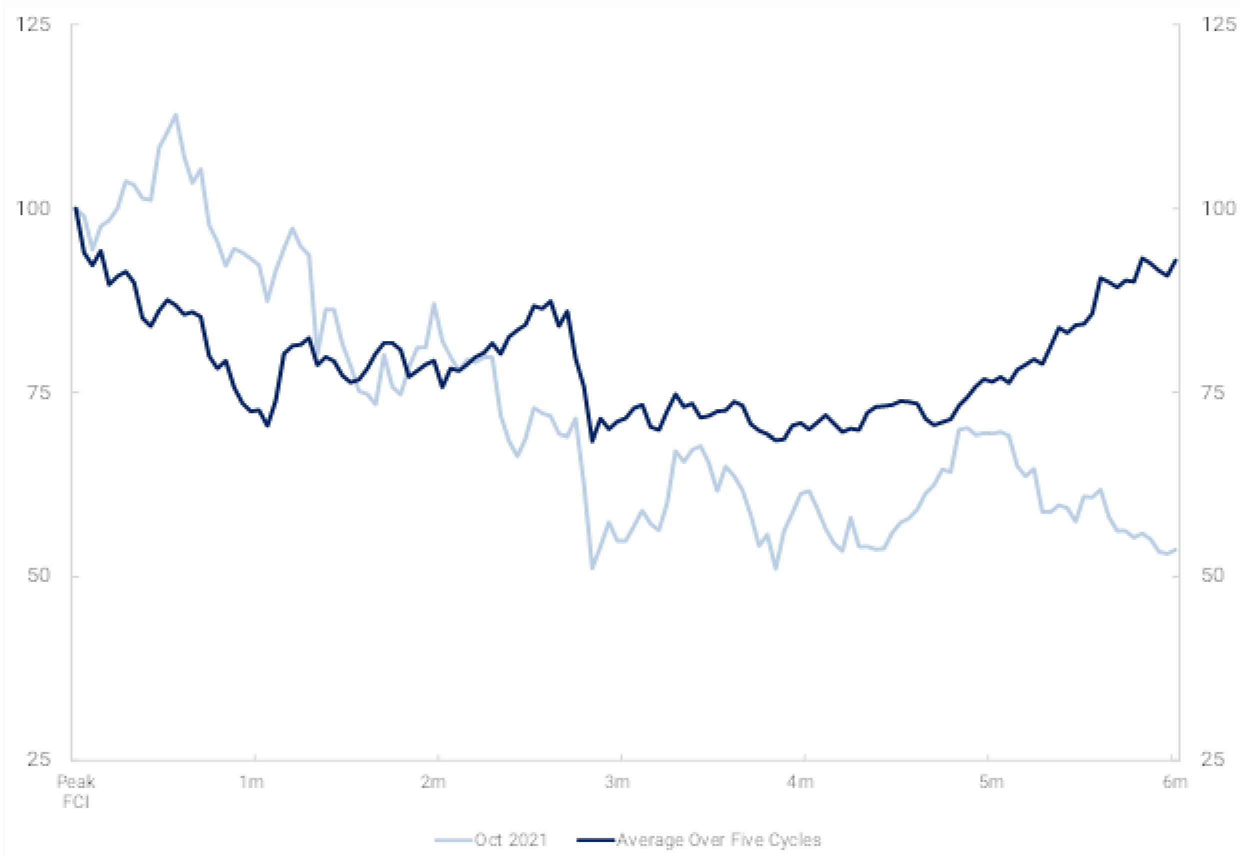
Source: Bloomberg LP. Coin Metrics. One River Digital Calculations.

Figure 2: Financial Conditions Non-Linear Impulse to Asset Prices



Source: Bloomberg LP. Coin Metrics. One River Digital Calculations.

Figure 3: Digital Asset Prices in Past Tightening Cycles



Source: Bloomberg LP. Coin Metrics. One River Digital Calculations.

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