OneRiverDigital
ASSET MANAGEMENT

market notes: Green Shoots

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Green shoots are emerging in digital asset fundamentals as correlations drop with traditional markets. Can ether become the digital reserve asset of choice? Or will ether's procyclicality keep USD stablecoin as King of Collateral?

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1. SpaceX conducted its 50th launch of the year, sending two US Space Force satellites into orbits that match the rotation of the earth. Some will see them as stationary, floating above us, others won't see them at all. Two side boosters landed back on earth, the 150th and 151st overall successful landings of an orbital-class rocket. So routine are these remarkable feats that they are no longer news. If digital is to integrate into the mainstream, so, too, will the early feats of the technologies become passing thoughts.

2. Ethereum aims to be the central building block for the future of finance. The successful migration to proof-of-stake raised confidence in realizing its future potential. It is ambitious, bold, and inclusive. You need ether to operate on the Ethereum protocol, to settle transactions. And if you hold ether, the migration to proof-of-stake offers you the opportunity to transform your holding into an instrument with perpetual yield that varies inversely with demand, like a bond. It is designed as the security asset of a digital ecosystem, playing the role of reserve currency in its grandest ambition.

3. The resilience of the digital asset market to its 2022 Great Financial Crisis cannot be understated. Ethereum hasn't stopped – literally and figuratively. There was no downtime, including the transition to proof-of-stake. An average of 1.15 million transactions per day are settling on the Ethereum protocol this year, almost identical to last year. But average transaction fees have collapsed with lower demand, driving the decline in Ethereum's valuation. Resilience and long-term viability were achieved at the expense of near-term valuation. Prices of digital assets are far more cyclical than the volume in network activity.

4. Decentralized applications built on the Ethereum protocol have also demonstrated resilience. Take MakerDAO, the largest protocol in decentralized finance by value. It built its business around financial access, centered on the stablecoin Dai. The math and risk management passed the stress test – Dai traded within two-tenths of a penny within parity to the US dollar. But it came with a severe decline in the protocol's valuation after a sharp decline in assets sold to protect the value of its stablecoin, a shift to fiat stablecoin collateral, and a rise in costly capital buffers.

5. Green shoots are emerging from the downturn. Our Fundamental Digital Pulse is improving, despite a challenging macro backdrop. The tight correlation between digital assets and equity markets is also receding. Prospective growth in Ethereum is grounded in developer activity. Despite the economic downturn, software development kits tied to the Ethereum protocol to create applications has grown by 178% so far this year (Figure 1). The focus is on scale. With scaling solutions come user applications that rapidly grow networks. It is a familiar narrative.

6. Does Ethereum have a beta problem? Ether has been 1.2x beta to the returns of bitcoin in the past year. This is a feature that investors are right to be alert to. The role of a reserve asset is ordinarily to act as a risk buffer – when you don't know what to do, migrate to the reserve asset of choice, and wait for clearer skies. The properties of a reserve asset must be broad enough to satisfy such criteria

– longer-term price stability and capital mobility are defining characteristics. Ethereum's recent transformations also make it more procyclical in three ways.

7. First, ether's supply algorithm adds to the cyclical variation. Ether's total supply since The Merge has been flat, instead of the 3.6% inflation that would have occurred under proof-of-work and 1.7% for bitcoin over the same period. Much is made of ether's deflationary potential – more activity comes with more fees for running the Ethereum network and more supply extinguished. This activity is more likely to occur when demand on the Ethereum network is high, a self-reinforcing mechanism for stronger prices. It adds to the potential cyclicality of the asset.

8. Second, the same cyclical behavior is prevalent for ether locked in smart contracts. Of the 120 million in current ether supply, 30 million are locked in smart contracts, a sharp rise in the past two years. Most of that gain is driven by ether locked for staking, which is not yet liquid. Of the ether flexible to move, cyclicality is readily apparent. In the months heading into the merge, for instance, the percentage of ether in smart contracts fell by more than 10% despite most of the newly locked ether being stuck in illiquid staking. It was a material withdrawal.

9. Third, maximal extractable value adds another pro-cyclical twist. When validators are called upon to make a block, they have the right to include transactions and reorder their priority. This lends itself to various forms of arbitrage that increase the earnings for block creation. The added yield from such activity has been substantial in the past, with a median of nearly 7%. But it is also dependent on activity and is, on average, stronger in bull markets. Higher yields increase demand for Ethereum's native asset, bidding up the price. This is yet another procyclical force to the ether demand-supply dynamic.

10. Ethereum's smooth Merge should be celebrated, but not dramatized. Capital buffers are important to financial systems and investors will demand risk mitigants in the next cycle. Ether may not fit the bill – its cyclical properties mean it will require over-collateralization to mitigate risk. Digital asset markets are more likely to self-select into a soft-centralized USD-based collateral system, as seen with MakerDAO. It is not the system decentralized players wanted, but it may be the one earned.

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