OneRiver Digital
ASSET MANAGEMENT

market notes: More Listening... Hearing the Skeptics

18 NOVEMBER 2022

Financial markets are humbling. That's their job. Brutal efficiency in capital allocation and destruction. It is powerfully evident in digital assets without a lender of last resort. Stay grounded in principles.

Marcel Kasumovich, Deputy CIO, One River Digital

1. The dramatic events in digital asset markets are burning bridges; not all will need to be rebuilt. Opponents of decentralized digital technologies see recent turmoil as an opportunity to reinforce that the digital ecosystem provides limited value. Those voices are welcomed, though we see things differently. The attraction of trusting in math is greater now, not lesser, as we learn the fallibility of behavior yet again.

2. With the longest history, the Bitcoin protocol is the best benchmark for market downturns. This is the fifth bear market for digital assets, each with a different root cause. 2011 saw prices fall 99% to one cent on a security breach at the dominant exchange, Mt. Gox. 2013 was the introduction of Chinese restrictions. Repercussions from illicit Initial Coin Offerings surfaced in 2017. 2021, the shortest downturn, took only six months to reach new highs. That we are talking of the fifth downturn is not a footnote. It is resiliency.

3. The failure of leveraged intermediaries has nothing to do with digital technologies. It is about human psychology. The details are tantalizing. But they will enter a long list of historical episodes that have faded from memory. It took nearly a decade for US saving-and-loan associations to be cleansed. In the end, one-third of associations were extinguished by 1995 on account of fraud. Losses? 82% were borne by taxpayers. It was also the birth of 'junk bonds.' The good ideas survived.

4. The broader macro value of the Bitcoin protocol is definitive – cutting out the middleman with more efficient technologies. This is a feat for financial transactions where security and scale are paramount. Almost 14 years since its inception, the Bitcoin protocol is functioning with 99.98% uptime. It works. So far this year, the Bitcoin protocol has settled trillions of dollars in transactions and paid $8.89 billion to those competing for the rights to validate transactions. Without fail. Real cash flows.

5. Skeptics ascribe the wide fluctuations in market prices to the absence of value. What makes the ecosystem tick is the network and the power used to keep it running. It is built to handle "bad news," unlike most enterprises that are pro-cyclical. Should the Bitcoin network shrink, the algorithm adjusts to make it easier to compete in creating blocks of transactions. An easier puzzle to solve lowers the input cost to producing bitcoin, compensating for the reduced value of rewards as dictated by its declining network. It's economics 101. The intrinsic value is the power to secure the network, its margin cost of production. Bitcoin is a commodity.

6. All of this is done leveraging a public good – the internet. Bitcoin pioneered a mechanism for transferring value in a secure manner over the internet. Google's intrinsic value similarly leverages the internet, a network effect, and a bunch of computers running with the goal of keeping your information safe. Google successfully harnessed the network effect while others have not – its revenues are nearly 37-times that of Yahoo!, after all. Not all can be winners.

7. What's missing are killer applications to capture the imagination of a skeptical audience. Debating the value of digital assets is fraught with "so what." This, too, is fair. So, narrow the Bitcoin protocol down to its core functionality – micropayments. The Lightning Network was built on the Bitcoin rails to shred the middleman. Global payments are a big and growing business. Revenues were nearly $2 trillion last year and will leap in the next decade. It is not that Bitcoin takes a share of this fixed pie. Rather, it removes a deadweight cost with security and scale of payments.

8. Credit is the middleman in payments. Instantaneous and final settlement makes that intermediation redundant. It's a better user experience with transformative capacity. Wearing an in-season jacket or using the latest app? Why not get paid for the advertisement you are making? We are all walking data machines. Digital rails allow us to monetize it from education to social media content

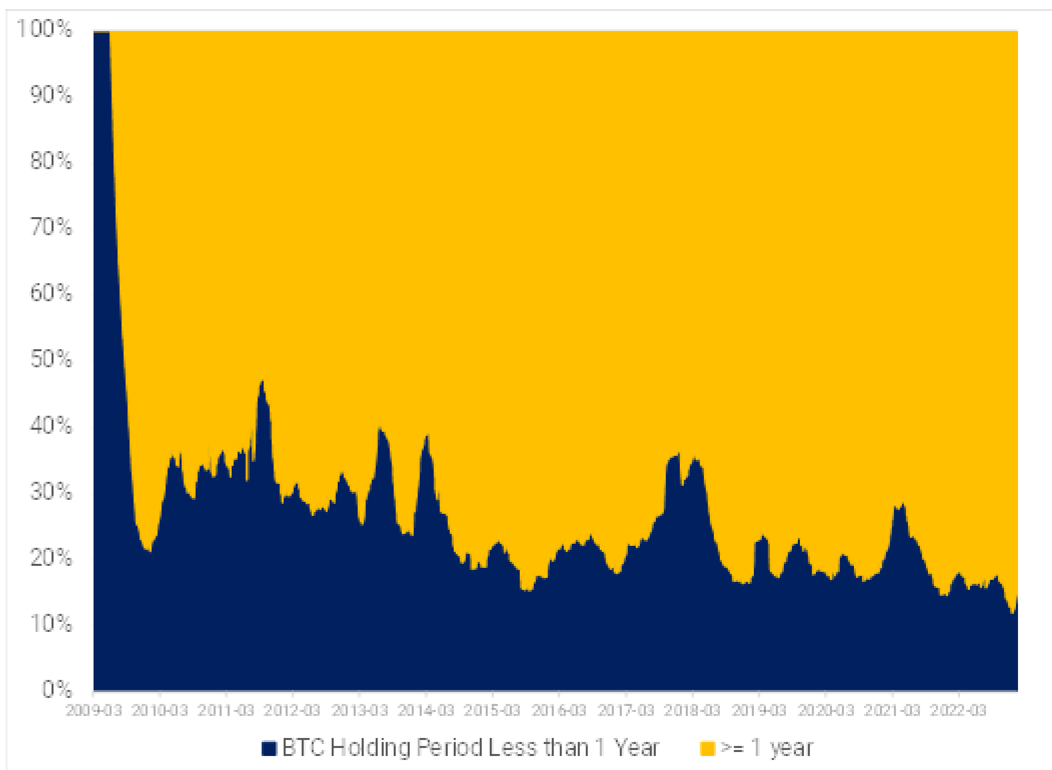
Private and Confidential: Any unauthorized use, distribution, modification, forwarding, copying or disclosure is strictly prohibited.

9. Decentralization has its limits. Some centralization is almost surely necessary, with most self-selecting into regulatory compliance. My income is somebody else's expense. Tax information will need to be shared to reconcile that information. Regulatory compliance and digital asset markets are not orthogonal concepts. There are regulated exchanges that interface with the SEC, CFTC, FinCEN, and OFAC and champion decentralization. Decentralized finance must be built with consideration of regulatory compliance.

10. This is evident in MakerDAO, the largest decentralized financial tool by assets. Balance sheets and income transparency are immediately available to the public with only a few lines of code. However, OFAC restrictions imposed narrow capital controls on USD.C stablecoin wallets, lessening their fungibility and value. Global regulatory compliance will apply to digital technologies. Permissionless intermediation will need to adapt or be limited in scale.

11. Innovation is noisy. Opportunity invites speculation. Excesses emerge. These are not new lessons that the digital ecosystem is teaching the world – people are simply re-learning them.

Figure 1: BTC Long Term Holders at a Record Share



Source: Coinmetrics. Glassnodes. One River Digital Calculations.

Private and Confidential: Any unauthorized use, distribution, modification, forwarding, copying or disclosure is strictly prohibited.

Disclaimer

This communication, including any attachments, is intended only for the use of the addressee and may contain information that is confidential or otherwise protected from disclosure. Any unauthorized use, distribution, modification, forwarding, copying or disclosure is strictly prohibited. If you have received this communication in error, please delete this message, including any attachments, and notify the sender immediately. The information and any disclosures provided herein do not constitute a solicitation or offer to purchase any security or other financial product or investment and is not intended as investment, tax, or legal advice. Unless otherwise noted, all information is estimated, unaudited and may be subject to revision without notice. Past results are not indicative of future results.

OneRiverDigital
ASSET MANAGEMENT

w: oneriveram.com | e: info@oneriveram.com
2200 Atlantic Street, Stamford CT 06902
NFA ID: 0461647 | FINRA: 167835