market notes: Back to Basics

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Marcel Kasumovich, Deputy CIO
Coinbase Asset Management

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1. If boring is beautiful, these are some of the best-looking markets of all time. Options markets provide the richest articulation of the point, capturing a broad distribution of future outcomes. In crypto, volatility expectations are near record lows, at 32.7% for the next week. And those expectations skew higher to insurance puts at the next big option expiration date of Sep 29, 2023, indicative of cautious sentiment. Global markets are hunting for a new narrative to break the boredom.

2. Of course, it's never boring. Space created by quiet periods is consumed by curiosity and creativity. Builders build. New crypto wallets on Telegram, decentralized social networks like friend.tech, and the rapid integration of Layer 2 scaling solutions all point to a different cycle – one more attentive to user experience. Mainstream players like Visa are leading from the front, broadening from their payment authorization model to a settlement system with stablecoin – disintermediating banks.

3. Failure is not only an option when building – it's the ingredient for great outcomes. After all, failure is captured in market signals and begs for builders. The 2017 surge in Ethereum exposed the limits of the Layer one protocol – fees are untenable when there's a lot of demand. A scaling problem, and the building thereafter, focused on "Ethereum killers" to solve it. Things look very different after the 2022 downturn, as scaling solutions move into the mainstream with the backbone in the Ethereum network.

4. The downturn is a return to simplicity. Three assets capture more than 80% of the market capitalization of the digital ecosystem – Bitcoin, Ethereum and US dollar stablecoin, two base layers and the most established tokenized asset in the ecosystem. The creative destruction path that got us here is a sign of strength, accelerating solutions to previous problems. Now, building has shifted to user tools and regulations around them, like Privacy Pools that are critical to bringing crypto into the mainstream.

5. Regulatory clarity will be a dominant feature of the next cycle. After all, if 2022 didn't disrupt the core blockchain technologies – there was no downtime in the big three – it isn't going anywhere. That's not enough for institutional adoption. Traders aren't fussed about the longer-term narrative, drawn more to inefficiency, volatility, and liquidity of crypto markets. Investors want to know what they own. Is it an inflation hedge? A technology asset? Insurance to banking risk? All of the above – it's dynamic.

6. Inflation. The rise in world inflation with the decline in digital asset markets is regarded as skeptic proof that bitcoin is not an effective hedge. It's asking too much for any asset. US dollar prices for everything declined alongside rapid monetary tightening, a signal of disinflationary not inflationary

forces. Bitcoin's decline was the byproduct of the burst of a bubble – a duration bubble driven by the policy response to the pandemic. The correlation of all assets to that period cannot be extrapolated.

7. Gold is a terrific benchmark. Longer term, gold has been an effective hedge against inflation (Figure 1). But the effectiveness was in spurts, not linear. It took nearly three decades for gold to regain its 1980 highwater mark. Why? Orthodoxy – real interest rates were high, and deficits were low. Orthodoxy is the kryptonite to gold, in digital form too. Gold and bitcoin yield nothing. Orthodoxy overpays savers. Oddly, today the market is convinced we are in a period of orthodoxy despite high and rising government debt.

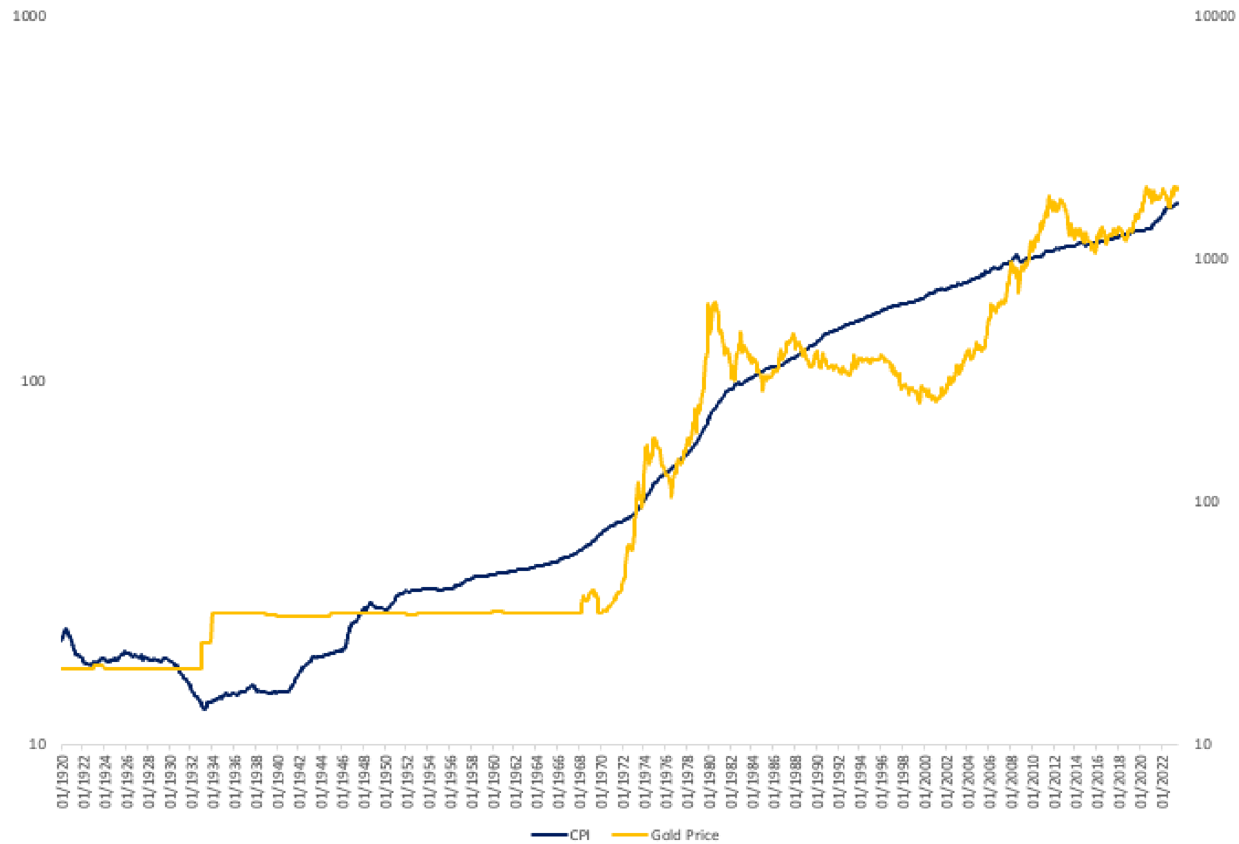
8. So, when does bitcoin behave differently? Energy costs is one framework for modeling its dynamism. Bitcoin transforms energy over time. That's the proof-of-work business model. Spend all sorts of energy solving an uninteresting puzzle in the name of security. It works and is highly valued. Today, bitcoin is trading near its average cost. It's a commodity, and its volatility reverts to commodity norms. If energy costs double, so too will the cost of production and bitcoin's price, all else the same. It's an inflation hedge.

9. When the price of bitcoin races ahead of its cost of production, it is capturing something other than commodity forces. Technology. Speculation. That's for the investor to determine. Moving up the tech stack with price should be readily visible. Things like the Lightning Network open the door for bitcoin as banking rails, for instance. But the investment attributes need to be acknowledged head-on. It's not static and cannot be extrapolated. Volatility must be higher in those periods.

10. "What's the point?" It's a common and fair question when things are boring. Digital assets are at a very early stage of their adoption cycle. The burden of proof of the next cycle is to capture the imagination of users. Investors will follow. The macro mantra of what digital assets can do is a tired narrative. It is invisible builders who are answering the question. Efficiency gains. Bitcoin is internet money. It can drive the marginal cost of financial intermediation to zero – if we let it.

2200 Atlantic Street, Suite 310, Stamford, CT 06902, NFA ID: 0535413

Figure 1: Gold as a Hedge…On Average, Not Always



Sources: Federal Reserve Bank of St. Louis. Bloomberg LP. CBAM Calculations. Log levels. Jan 1920 base period. Gold right axis.

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