February commentary

News Highlights

1. Tesla bought $1.5 billion worth of bitcoin
2. Bank of New York Mellon to custody bitcoin and other cryptocurrencies
3. Mastercard to open up network to select cryptocurrencies
4. Coinbase S-1 filing shows $322m of net income in 2020
5. NFT art gains notoriety with Christie's first auction
6. Exchange tokens tripled in price fuelled by Coinbase valuation
7. BlockFi is raising a Series D funding round at $2.85 billion pre-money valuation
8. Tether settles with NYAG for $18.5m and agrees on quarterly disclosures

Charts of the month:

Figure 1: YTD Future basis for March (green) and June (blue) maturities. Both contracts have experienced a similar rise and drop cycle during the month, with, however, the shorter-term annualised rates reaching 3x multiple on longer dated contracts.

Source: Tradingview

Commentary:

February has seen some of the most meaningful headlines in the history of Bitcoin. Our Top 3 in the monthly news highlight give a flavour: Tesla allocates >5% of its cash to Bitcoin, BNY Mellon announces that it will custody Bitcoin for its clients and Mastercard it is going to support cryptocurrencies on its network (according to its CIO, also Blackrock is "dabbling" in Bitcoin). And the popularity does not end here: Mark Cuban turns out to be a DeFi expert, Cathie Wood predicts a multi-trillion dollar Bitcoin market cap, CME launches Ethereum products, JP Morgan advices a 1% allocation to the asset class, Ontario regulator approves the first Bitcoin ETF and SEC Commissioner Peirce says market is ready for a Bitcoin ETP, and, to conclude, St. Louis FED published a DeFi paper.

With such watershed news, one might be surprised to find the market closing the month in a 25-35% drawdown. As these things go in crypto, however, the MTD performance is still anywhere between the +35% for Bitcoin, and the +75% for a basket of major blue-chip altcoins.

Notable winners this month have been the exchange tokens that, as tracked by the EXCH-PERP contract traded on FTX, have gained more than 160% MTD, despite having a quarter of their value since ATH on February 19th. The astral conjunction of Coinbase IPO (that offered to the public a glimpse on the exchange business economics) and the booming of Binance smart chain as a substitute for DeFi on Ethereum (being a free-to-use centralised copy of Ethereum) has fuelled the impressive growth in valuations, making BNB (Binance coin) the third most valuable crypto asset for a few days.

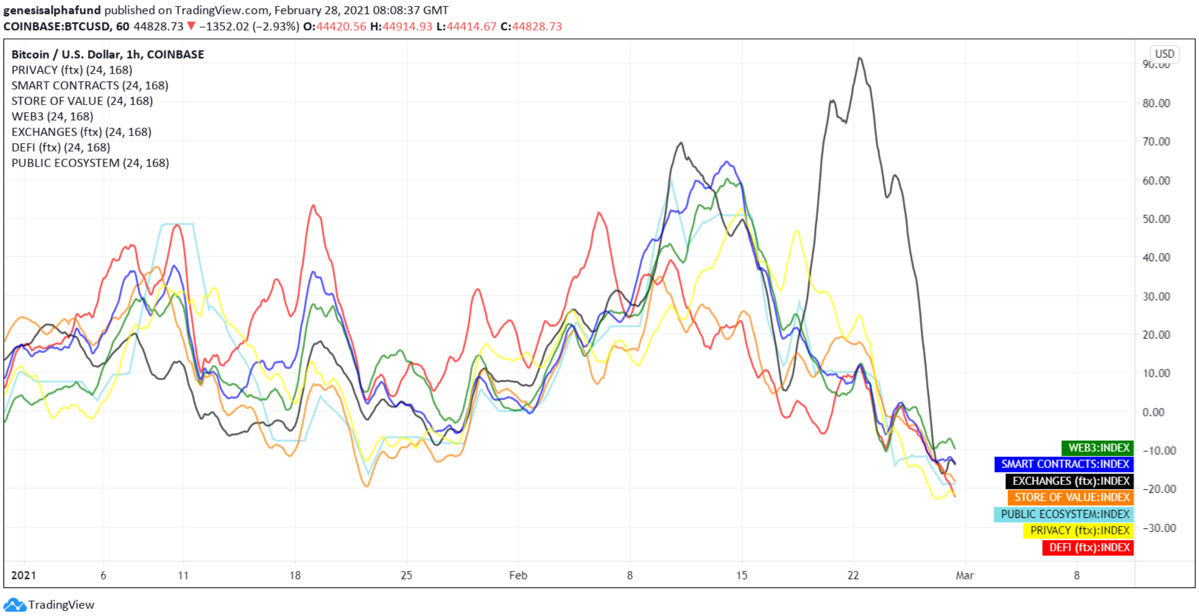

Figure 2: Rolling weekly returns for the main sectors in crypto. Notable how concentrated these returns have become during the current pullback.

Source: Tradingview

Figure 2 maps out February market performance. We observe declining weekly returns starting from the 15th, with a substantial compression during the last week of the month. Return dispersion is expected to increase once prices start moving higher, with the virtuous offering substantially higher returns than slower sectors. Despite the downturn, the best names in L1 and Web3 have maintained positive returns throughout the month, with Matic, Cardano and Solana being the only $1b+ projects that concluded the week in black. DeFi, on the other hand, has been the big disappointment this month, after having reigned as absolute best performer during January and the first week of February, returns have deteriorated faster than the rest of the market, making it overall the worst performing sector MTD.

Turning to regulation, the news on listed Bitcoin products gaining market access might have been well received by most of the investing community, but it has surely caused others to worry.

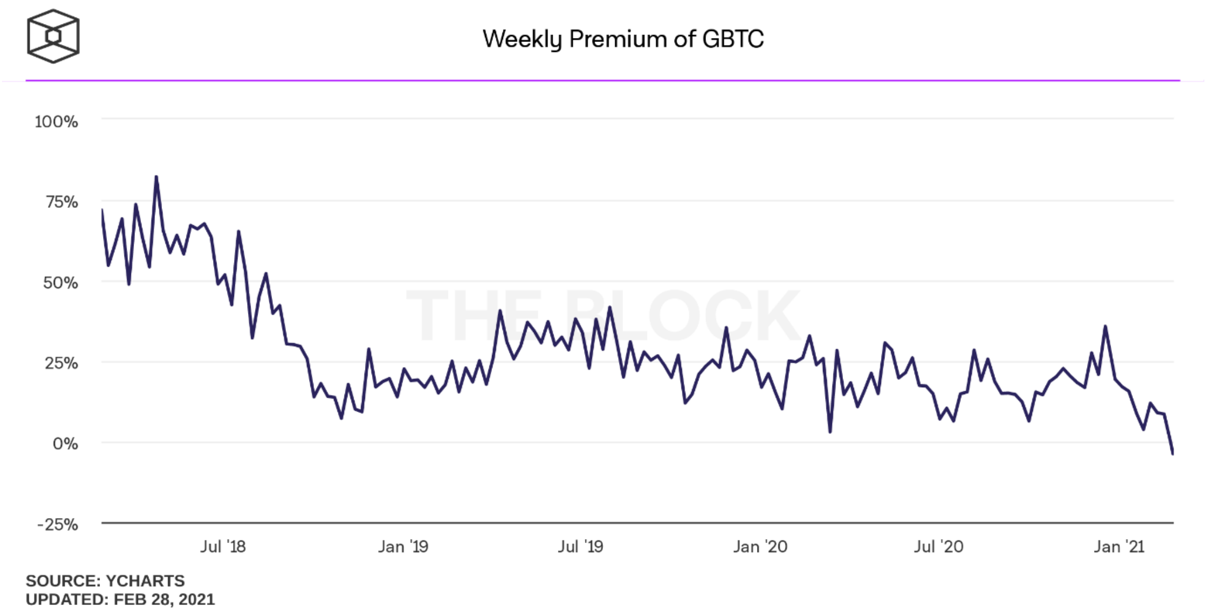

Figure 3: Weekly premium for GBTC shares traded on the secondary market compared to their NAV. For the first time this month, on the back of the increasing competition from other ETPs, the premium has turned in a discount, casting the shadows of a liquidity event caused by the unwinding of a levered and very popular trade, turned sour.

Source: TheBlock

For the first time on record, the unthinkable happened (was it unthinkable? We called it out -too early- in July '20 as regulated BTC products started coming to the market): The Grayscale GBTC shares traded at a small discount to NAV in the secondary market (3iQ's QBTC-U Bitcoin Fund has traded at a discount of >5% for the last few days). The so-called "Grayscale trade" has often been presented as the -free money- for institutional investors willing to forgo the even higher returns offered by other market neutral alternatives, in exchange for a riskless regulatory arbitrage. For those unaware, the narrative went: subscribe in kind by giving your BTC to Grayscale in exchange for some shares, wait six to twelve months and sell your shares on the secondary market where hefty premiums can be extracted.

However, as hefty as a 10-30% APR might be, in crypto the opportunity cost is high, and the most sophisticated players have embraced this trade using 3-5x leverage, using the share themselves as collateral. It is known, due to SEC filings, that some crypto funds have exposure in the billions, leaving to wonder how such a big delta has been hedged in a $15b derivative market (the size of the BTC lending market is more difficult to estimate, but probably sits below $10b).

The repercussion on the market if institutions start to unwind the trade could be profound. Understanding what the tipping point could be is a challenge since, in theory, there is no built-in redemption mechanism, but Grayscale might nonetheless decide to liquidate the trust (as in the case of XRP), implicitly creating a price floor for the shares and reflexively incentivising demand if the shares start to trade considerably below par. If an aggressive unwind was to happen, however, we might just witness the biggest short squeezes in the history of Bitcoin markets.

None of this, however, has started to happen, with Futures basis in free fall and funding rates turning materially negative for the first time since the dip below $30K on January 27th.

Figure 4: Steepness of the yield curve between June – March maturities (blue) and September – June maturities (purple). Superimposed, the overall trend for the June – March spread during the first three weeks of the month.

Source: Tradingview

As discussed last month, when we said "…with June-March spread below 2% offering an asymmetrical payoff for a steepening play.", the market was ripe for a move up, which caused the spread to widen to almost 6%. With the March maturity approaching, the focus will shortly move to the belly and back contracts with maturities in June and September. This spread has exploded on the 14th/15th and traded horizontally, albeit with high volatility, since then. For those long June short March, it might be time to roll the short leg on the September maturity in a mean reversion play.

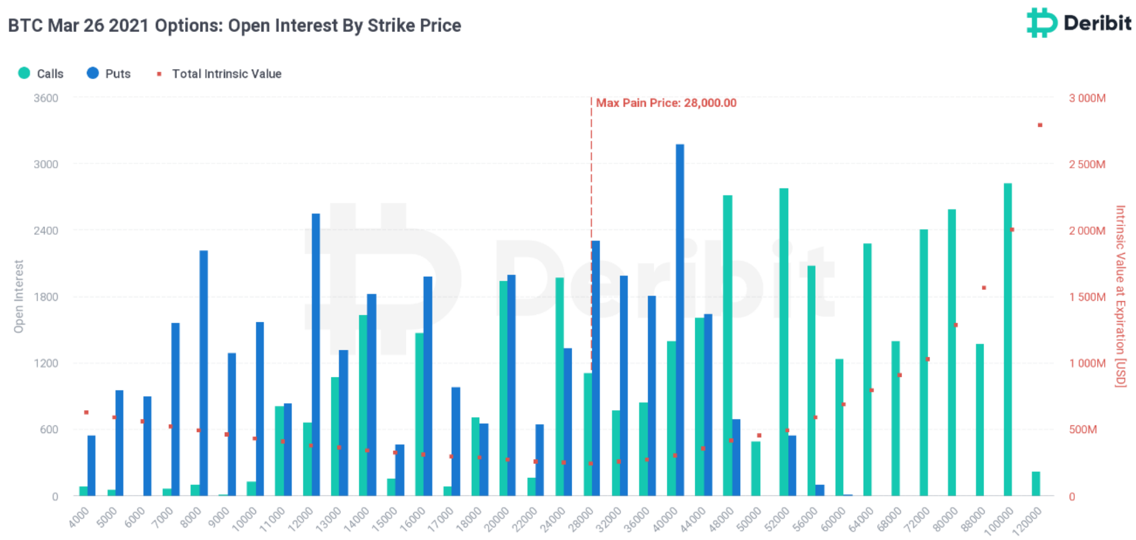

Figure 5: Open interest by contract type and by strike price for the March 26th maturity. Superimposed, the intrinsic value of the existing options at each strike level, and the corresponding max-pain price that minimises such intrinsic value. As the theory goes, option holders will take profit and sell calls at high prices while selling puts at low prices, causing dealers to unwind their delta-hedges and, in turn, pushing the spot price in an opposite direction and towards an equilibrium.

Source: Deribit

Options market started displaying the first signs of a potential pullback during the second half of the month when the short-term Call-Put skew turned negative and, despite the rally to $58K, failed to turn positive again, demonstrating higher demand for protection. Looking at the open interest for the upcoming maturities on the 5th and 12th of March, we find the max pain price at $48K and $50k respectively, suggesting that the spot price might be due for a recovery (trading just above $45K at the time of writing). Looking at the more important March 26th maturity however, albeit still more than 3 weeks away, we find a max pain price of $28K.
While we can expect a considerable demand to close deep in-the-money call options throughout March, which will push dealers to sell Bitcoin exposure, not many put options are trading in-the-money above $40K, and the increasing demand for short-term downside protection only exacerbate such imbalance.

It should be noted, however, that this is a typical condition in a market breaking through ATH on a weekly basis, as most options are written at/out-of-the-money and therefore the max pain price will tend to trail the spot as more and more options are written at current prices. The concurrent pullback in prices due to an overheated derivative market and the uncertainties linked with the traditional markets, have however already weaken the crypto ecosystem posing additional short-term risk.

Zooming out from the daily price action, the crypto ecosystem displays an impressive growth over the past six months, with the institutionalisation of Bitcoin being the poster child. Looking at net position change in response to a price correction, new Bitcoin holders seems to be more and more resilient to pullbacks, both when compared with 2017 investors, but also when comparing the response to the January correction. This is to be expected, with a growing share of price-insensitive investors having allocated to the asset class in recent months.

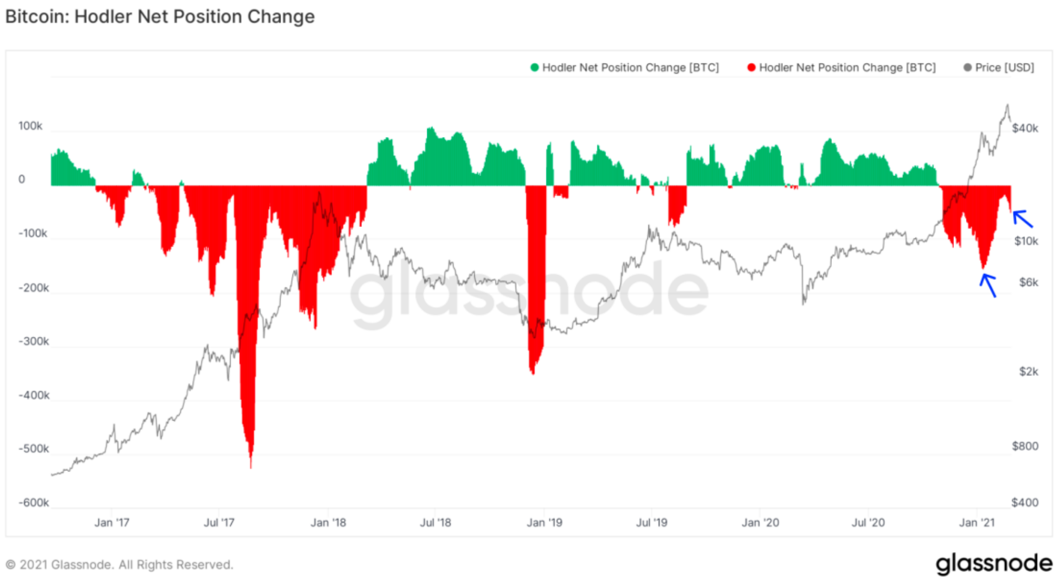

Figure 6: Bitcoin hodler net position change measures the changes in balances for long term investor wallets. It can be noticed that the recent pullback has not caused significant outflows even compared with the previous retracement in January.

Source: Glassnode

It is perhaps outside of Bitcoin however that the most profound changes are happening: DeFi has turned in a multi-billion dollars industry parallel to the centralised fintech alternatives; social tokens and NFTs are capturing the attention of influencers, artists and athletes; Banks and governments are looking to deploy blockchain systems for private placements and issuance of securities, with new regulation being approved.

Many sceptics are still debating the future of the space, but market-driven shocks aside, the industry seems poised for long term growth and an increasing entrenching in our everyday life.