

Buy The Dip?

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Abstract

Due to the wild volatility of cryptocurrency, many investors and experts have tried to make accurate price prediction for the asset class. Likewise in this project, we attempt to build the best price predictive model for Bitcoin and Ethereum and identify the most crucial variables that contribute to their prices. Among CART, random forests and Gradient boosting, we find that random forest model is the best price predictor for both assets. Next, we compare and contrast the most important features, analyzed via variable importance plots and partial dependence plots. For both assets, S&P500 and 5-year inflation expectation are the biggest features contributing to their prices. Where they differ is the third most important variable, which is gold price for Bitcoin and oil price for Ethereum, respectively. Utilizing these results, investors can make smart investment choices based on macroeconomic factors and market performance.

Introduction

Bitcoin, the first digital currency run on blockchain technology, has recently gained traction as a potential currency to substitute for fiat money such as the U.S. dollar. A massive ‘money-printing’ by the Federal Reserve in response to the 2008 financial crisis and the Covid crisis has raised concerns about the strength and sustainability of the dollar value. Since then, market participants have been increasingly treating Bitcoin as a hedging asset. Devoid of the intrinsic value, however, Bitcoin has experienced a massive fluctuation in terms of asset prices. Specifically, at the onset of the Covid crisis in March 2020, Bitcoin price dipped as low as \$5,165. It grew more than tenfold to \$61,283 in exactly one year, and hit as high as \$64,400 before crashing back down to hovering around \$25,000 in the beginning of the year 2023 (See Fig 1). Due to such high volatility (See Fig 2), investors have taken massive interest in predicting the short-term Bitcoin price.

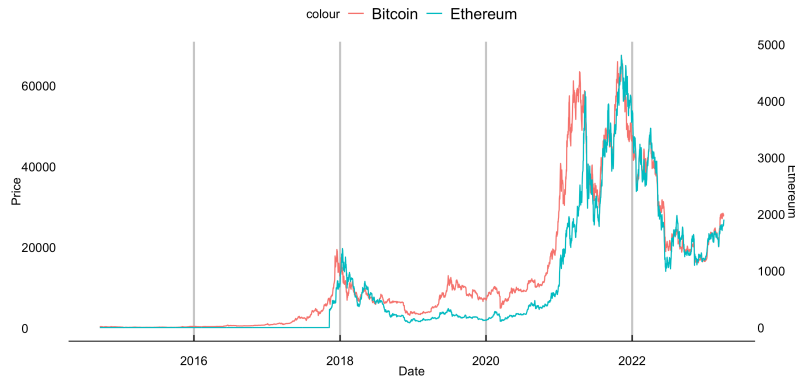


Figure 1: Bitcoin (BTC) and Ethereum (ETH) Price Comparison

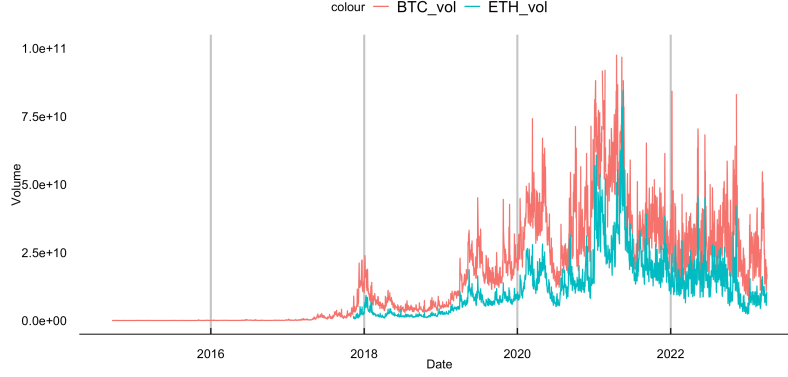


Figure 2: Bitcoin (BTC) and Ethereum (ETH) Volume Comparison

This report answers two main questions. First, we attempt to test a variety of models and find a model that best predicts Bitcoin price. We test the prediction power between CART, Random Forest, and Gradient Boosted trees model. We will pick the model that gives the lowest value of RMSE. Second, after identifying the best-predicting model, we attempt to find a variable that contributes the most to the price prediction. Next, we will run above models not only on Bitcoin but also on Ethereum, the next popular cryptocurrency, using common features. In doing so, we are able to identify which features matter more to each cryptocurrency. This finding can help investors make well-informed investment decisions; they may be able to diversify their digital asset portfolios in response to market performance and macroeconomic shocks using our model. Specifically, S&P 500, the market performance index which include the top 500 companies in terms of market capitalization sizes, contribute to the price changes of both cryptos the most, followed by 5-year inflation expectation. However, we find that gold price change affects Bitcoin price change more, and oil price change affects Ethereum price change more.

Methods

Data:

After reading a few existing studies regarding price prediction of an investment asset, we have learned that a wide spectrum of macroeconomic and market performance factors, such as inflation, interest rates, and market volatility are incorporated in building price predicting models. In addition to these common factors, we have also added some other variables we deemed important in terms of predictive power. Our data set consists of relevant daily asset prices, macroeconomic and market performance indicators, which are mainly collected from Yahoo Finance and Federal Reserve Economic Data (FRED).

First, we have daily prices of Bitcoin (BTC), Ethereum (ETH), oil, and gold. Inflation is measured by two proxies, yield on 10-year Treasury note (TNX) and 13 Week Treasury Bill (IRX). CBOE volatility index (VIX) estimates equity market volatility, while CBOE crude oil volatility index (OVX) measures oil market uncertainty. SP500, which tracks the top 500 U.S. stocks, is used to compute the US stock market performance. All of these data were collected from Yahoo Finance.

In addition to aforementioned inflation proxies, 5-Year breakeven inflation rate (inf5y), which implies market participants' inflation expectation for the next five years, was also added. Equity Market Volatility: Infectious Disease Tracker (DISEASE) was included to account for the economic impact of COVID-19. U.S. dollar index (DXY) measures the performance of dollar against a basket of other world currencies. Policy-related uncertainty is measured by Economic Policy Uncertainty Index (EPU), and stock market uncertainty is measured by Equity Market Uncertainty Index (EMU). All of these data were collected from FRED.

Lastly, we added Credit Default Swap (CDS), which basically is a financial derivative through which a seller can swap his credit risk with that of a buyer. As this indicator measures dwindling of centralized financial markets, we thought it would be interesting to see its relationship with the price action of cryptocurrency, a decentralized asset class. This data was separately collected from Investing.com.

Below is a summary statistics of all of the variables used.

sumtable {vtable}

Summary Statistics

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Variable	N	Mean	Std. Dev.	Min	Pctl. 25	Pctl. 75	Max
DXY	2304	112	7.3	93	110	116	128
CDS	1969	11	12	2	5.5	12	86
EMU	3381	70	94	4.8	13	91	1230
EPU	3381	123	98	3.3	64	144	861
Inf5y	2315	1.8	0.54	0.14	1.5	2.1	3.6
Disease	3380	5.8	10	0	0	8.4	113
Oil	2332	63	21	-38	48	74	124
Gold	2330	1454	273	1051	1240	1753	2052
Bitcoin	3123	13175	16045	178	715	19048	67567
Ethereum	1974	1153	1164	84	217	1744	4812
IRX	2329	0.95	1.2	-0.1	0.043	1.7	4.9
TNX	2329	2.2	0.75	0.5	1.7	2.7	4.2
VIX	2331	18	7.5	9.1	13	22	83
OVX	2331	40	20	14	29	46	325
SP500	2331	2897	844	1742	2105	3644	4797
Month	3384	6.4	3.5	1	3	9	12

Methodology:

In predicting Bitcoin and Ethereum price, we compare three main models: Classification and Regression Trees (CART), Random Forest and Gradient Boosting. To briefly recap what we learned in class, tree is a simple predictive model that is widely used in machine learning.

CART, also called “recursive partitioning”, is a basic tree-fitting algorithm. Basically, we grow the tree recursively as to make deviance as small as possible. When we reach our minimum size or complexity stopping points, we will stop growing and prune back to make candidate trees. Lastly, we will choose via cross validation.

Random forest is perhaps the most popular generic nonparametric regression technique as the model not only requires little to no cross validation and is also fast and effective. Here, we will fit trees to number of bootstrapped samples of the original data. This process, also called bagging, usually produces a better fit with lower variance than a single tree. It adds more randomness as we ‘randomly’ choose features subsets in building a tree, hence the name ‘random forest.’ After fitting a tree to each bootstrapped sample, we will average the predictions of all the different trees, producing an aggregated result, which should be more accurate.

Gradient boosting is an ensemble method like random forests. However, here you recursively fit simple trees to its ‘residuals’. That is, while random forests fits trees simultaneously, gradient boosting builds one tree at a time. This model adds the newly crushed tree into the fit in each stage along the way and so the final fit is the sum of many trees. Gradient boosting can work better than random forests with finely-tuned parameters. However, it is more sensitive to noise, thus more easily encounters over-fitting problems.

Our random forests give us **variable importance plots**, which provide a list of the most significant variables

in descending order. Using these plots, we can gain some useful insight into which variables contribute the most to our model. We compare the results for Bitcoin and Ethereum.

After our model has been fit, we calculate **partial dependence plots**. These plots visualize the relationship between price and the five most significant variables from the variable importance plots, taking account of the joint effect of other features.

Results

Bitcoin

We compared out-of-sample RMSEs of CART, Random Forest, and Gradient Boosted tree models, and found that the Random Forest yields the best performance (lowest RMSE) on the testing data (see Table 1). Here, **Bitcoin** is the target variable, and all of the variables mentioned in the Methods section excluding the **DATE** variable, are used as predictors. We used the `randomForest` function to fit our model and `VarImpPlot` function to display the list of important variables contributing to the model.

Table 1: Model performance with out-of-sample RMSEs (Bitcoin)

Model	RMSE
CART	2274.872
Random Forest	941.807
Gradient Boosting	1233.553

Random Forest

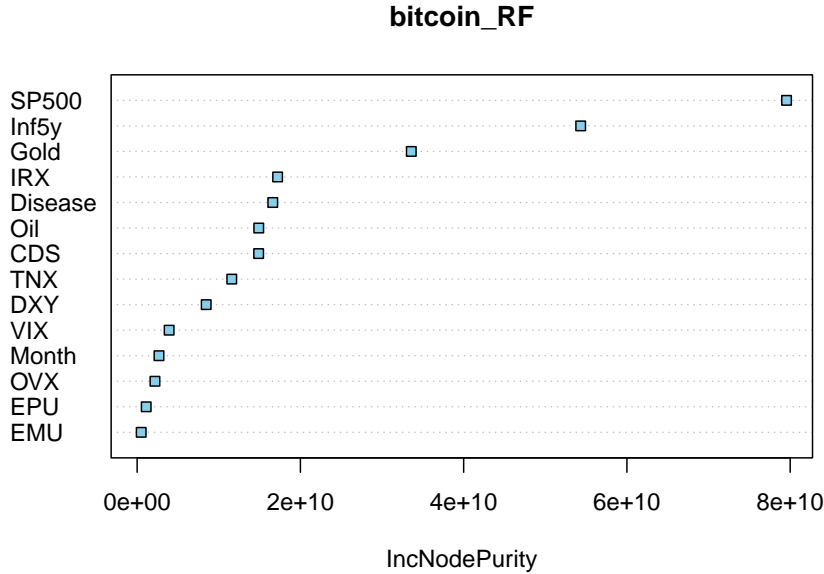


Figure 3: BTC Random Forest

Figure 3 shows that **SP500, Inf5y, Gold, IRX, Disease** are the five most important variables for bitcoin price prediction in our model.

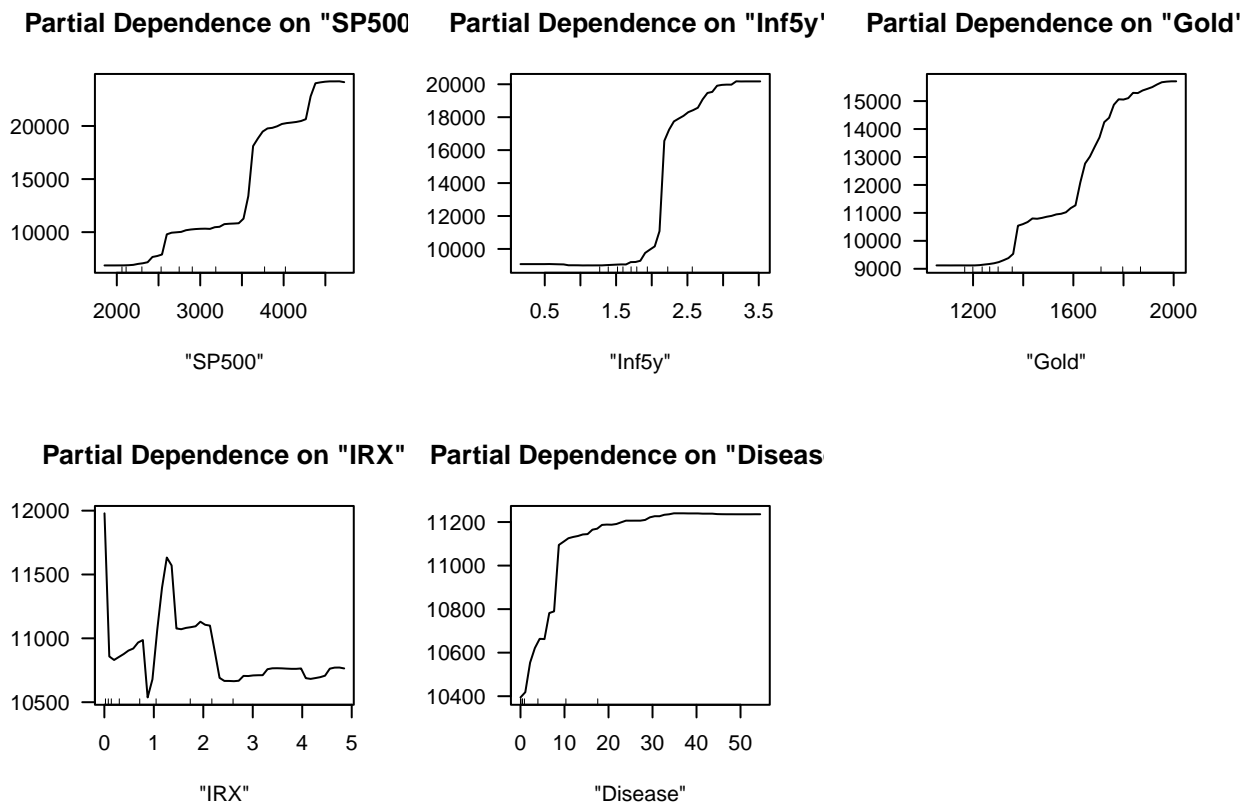


Figure 4: BTC Partial Dependence Plots for The Top Five Features

Figure 4 is the partial dependence plots to isolate the partial effect of individual features on the outcome. Here, we analyze the relationship between the target variable (dependent variable) and a specific predictor variable while holding all other predictors constant.

Looking at Figure 4, we observe that all variables, except for **IRX**, display increasing dependence plots. Thus, **SP500**, **Inf5y**, **Gold**, **Disease** features individually have positive effects on predicted outcome, while **IRX** has a negative effect on the predicted outcome.

Ethereum

Same as Bitcoin, we once again find that the Random Forest performs the best on the testing data as it produces the lowest RMSE (See Table 2). The same set of features and models as Bitcoin price prediction above were used for Ethereum for direct comparison.

Table 2: Model performance with out-of-sample RMSEs (Ethereum)

Model	RMSE
CART	2274.872
Random Forest	941.807
Gradient Boosting	1233.553

Random Forest

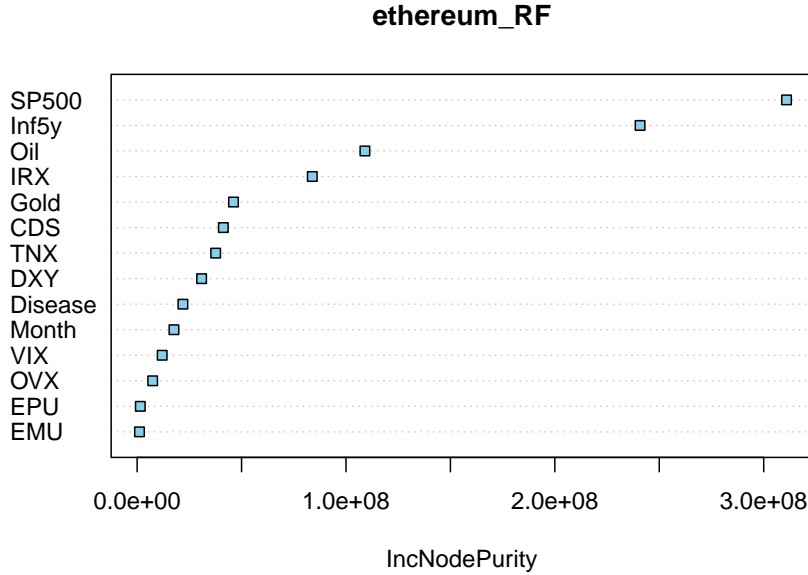


Figure 5: ETH Random Forest

From Figure 5, we find that **SP500**, **Inf5y**, **Oil**, **IRX**, **CDS** are the five most important variables for Ethereum price prediction in our model. **SP500** and **Inf5y** have the highest importance in both Bitcoin and Ethereum, but we see a divergence in the the third factor: gold for Bitcoin and oil for Ethereum.

Figure 6 is the partial dependence plots to isolate the partial effect of specific features on the outcome.

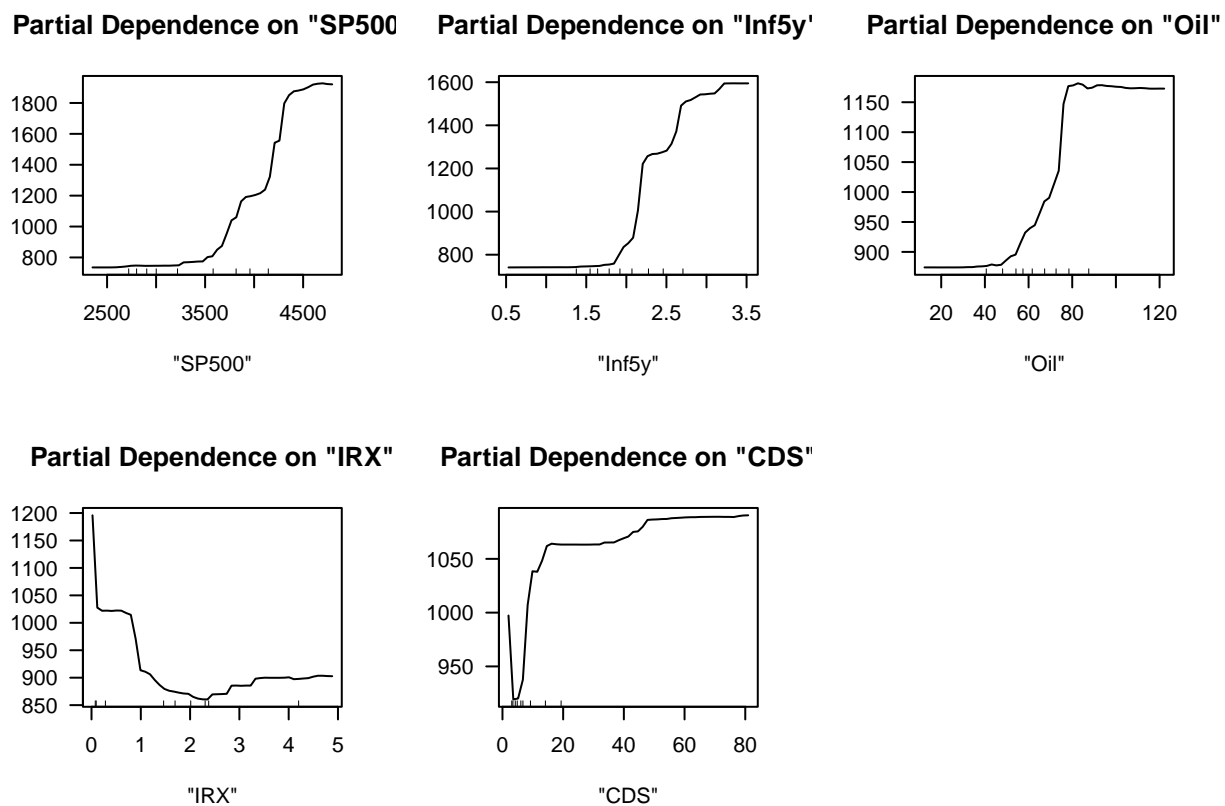


Figure 6: ETH Partial Dependence Plots for The Top Five Features

Similar to Bitcoin, all five variables, except for **IRX**, display increasing dependence plots. Therefore, we interpret **SP500**, **Inf5y**, **Gold**, and **Disease** features to have a positive individual effect on Ethereum price prediction in our model, while **IRX** has a negative effect.

Conclusion

Cryptocurrency price prediction has gained much attention as market participants are ushered into the era of new technology. In order to help investors make informed decisions and be able to include cryptocurrencies in their portfolios, we find the best-predicting model with the lowest RMSEs to be the random forest model. Also, using a common feature set on the two biggest cryptos, Bitcoin and Ethereum, we identify that **S&P500** and 5-year break-even inflation are the two most important contributing factors to both cryptos in the price prediction. This finding is worth a focus.

The finding that **S&P500** has a positive effect on both Bitcoin and Ethereum suggests that these two cryptos play a role of “complements” to the **S&P500**. When the market is booming, so will the two cryptos, allowing the investors to expand their portfolio options. This hypothesis is further strengthened by ‘the robustness check’ on the pre-Covid era. We restrict our sample periods to only up to Dec 2019, the pre-Covid era, and look at the variable importance plots on both cryptos. Looking at the pre-Covid periods allows us to successfully block the Federal Reserve’s ‘money-printing effect’ and any noises that may have ensued. We still find that the **S&P500** tops in importance. (See Figures 7 and 8 in Appendix for the pre and post-Covid variable importance plots.)

Not only complements to the market performance, Bitcoin and Ethereum can also play a hedging role, as suggested in the partial dependence plot of 5-year breakeven inflation. **Inf5y** is found to have a positive marginal effect on both cryptos according to our model. And **Inf5y** reflects the market inflation expectation over the next five years. Thus, rising **Inf5y** is linked to a negative market performance as it suggests that the market jitters. We see that **Inf5y** positively affects the two cryptos, and this suggests that as the investors expect unstable market, they may run to these cryptos. Therefore, these two cryptos can both be complements and substitutes for the general market.

Our third finding gives market participants more information to diversify their investment portfolios: the gold price has a positive marginal effect on Bitcoin and the oil price has a positive marginal effect on Ethereum. Investors can put their money into buying Bitcoin as they see gold prices moving up, and they can do so in Ethereum as they see the oil price swinging. The differential that arises from the third important variable in terms of contributing to price prediction allows investors to respond to market-related shocks much more flexibly. To sum up, our model and the findings in this report can help both crypto enthusiasts and market participants make well-informed investment decisions.

TL;DR: BUY THE DIP! (NFA)

Appendix

Because **S&P500** is the most important variable in predicting the price of both Bitcoin and Ethereum, we wanted to compare the market capitalization of some of the top performing stocks in **S&P500** to that of the two cryptocurrencies. The result is visualized in Figure 9. Bitcoin’s market cap is about the same size as that of Tesla and Meta, while Ethereum is ranked lower than Coca-cola. As one can see, there is a lot more room for growth in terms of market cap for both Bitcoin and Ethereum, which implies that their prices may go higher as more retailers and institutions invest in them in the future.

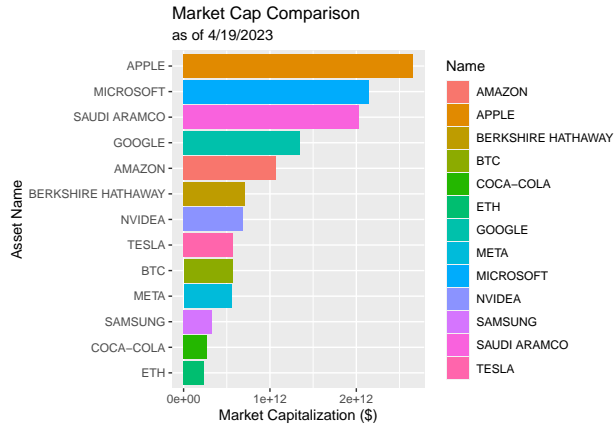


Figure 7: Market Cap Comparison Between BTC ETH and Top Performing Stocks in SP500

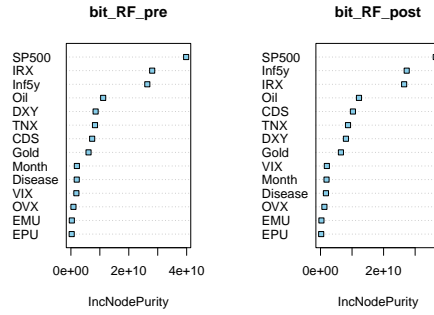


Figure 8: BTC Variance Importance Plot Pre vs Post-Covid

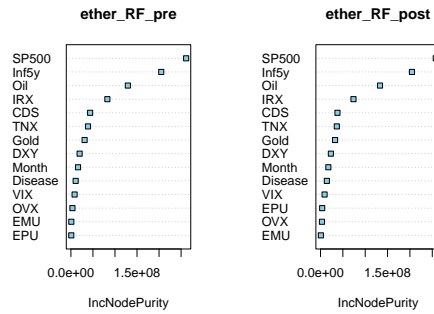


Figure 9: ETH Variance Importance Plot Pre vs Post-Covid