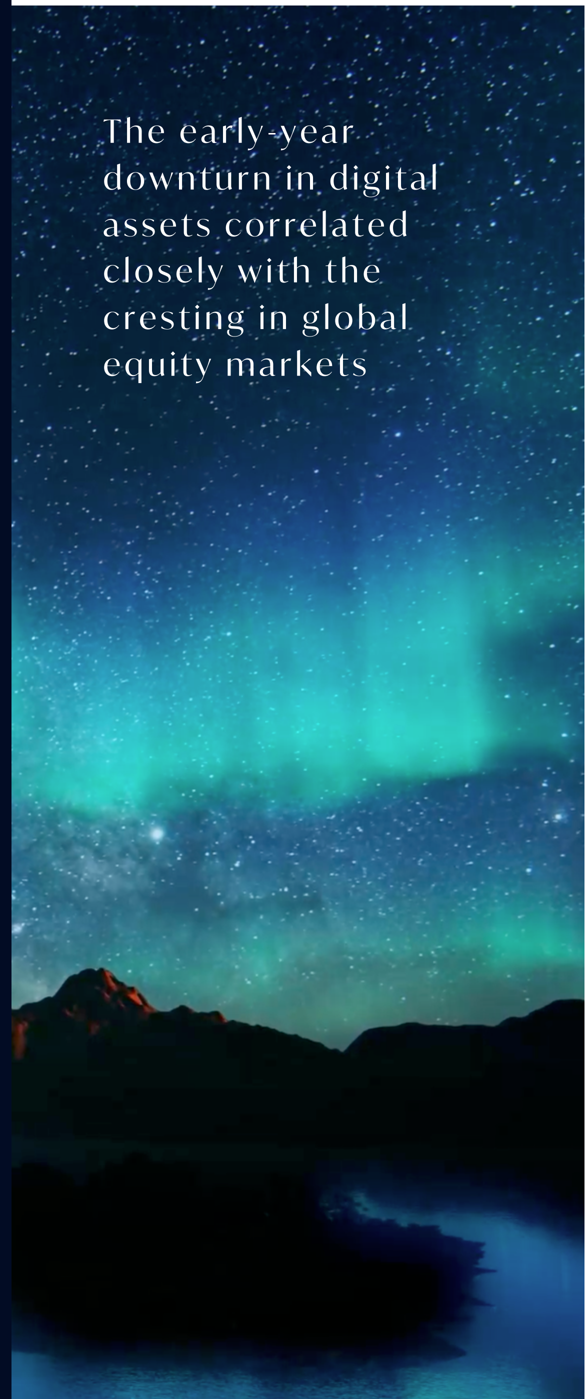
OneRiverDigital
ASSET MANAGEMENT



Market Notes

HIGHER VOLATILITY, MORE STABILITY

MARCH 2022

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Market Notes:
Higher Volatility, More Stability

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1. The early-year downturn in digital assets correlated closely with the cresting in global equity markets. The tight linkage on downturns questions the role those digital assets play in a portfolio. An inflation hedge? Digital gold? A play on tech growth? Naturally, there is no single answer. The ecosystem is young and maturing. Volatility remains high. Bitcoin could play the role of financial gold in the future, for instance. But it is asking too much now of a 13-year-old. After all, the volatility of digital assets is many times that of traditional assets for a reason – we don't know what they will become.

2. Bitcoin is the obvious candidate to play the role of digital gold. It will soon be the only relevant proof-of-work protocol whose security value is derived from its intense consumption of energy. A rise in the cost of energy through inflation or a devaluation of the US dollar raises the marginal cost of bitcoin production, hence capturing inflation-hedge properties. But bitcoin is trading well above its marginal cost of production, reinforcing that there are other factors beyond a narrow commodity model drive demand.

3. Ethereum is the obvious candidate to play the role of digital bond. The Merge of the current Mainnet to the Beacon chain has entered its final stages with the Kiln testnet to go live soon. After further upgrades are finalized, staked ether collateral will be liquid. Opposite of bitcoin, ether is trading at a steep discount to its intrinsic value as a perpetual bond, which ranges from 5,500 to 7,600 versus the US dollar the latest Coinbase estimates (here). The conclusion is the same – there are other factors driving demand and prices.

4. Leverage and risk are the likely common forces between digital assets and equity markets. The 2020 period is a good illustration. The correlation of daily bitcoin and equity returns was 43% for the year. This was dominated by one period. The correlation of bitcoin to S&P 500 daily returns was 55% from the peak price of bitcoin on Feb 12, 2020, to the Mar 16, 2020, lows; it was –16% in 2020 prior to the peak in the price of bitcoin and 33% after. There is no mystery as to what was happening in this period – rapid deleveraging.

5. Is deleveraging the shared fundamental factor between digital and equity markets? No, not at all. To the extent that investors are using core digital assets as a substitute for equity allocations, it will behave that way at times. But such behavior will be fleeting, more cyclical than structural. The severity of deleveraging in digital asset markets is greater than traditional ones by necessity – there is no buyer of last resort in digital assets. Prices fall until a willing buyer clears the market.

6. The absence of a buyer of last resort changes the way we think about risk in digital markets. The prevalence of a "Fed put" on equity markets has created the misperception that downside asset volatility is synonymous with crisis. Digital asset markets demonstrate the opposite. Protocols in decentralized finance (DeFi) protect their equity positions by liquidating high quality collateral long before loans are impaired. In Maker DAO, for instance, a loan is delinquent when collateral values fall below 150% of the loan value. The collateral being liquidated is the best quality digital assets in the ecosystem – mostly ether, and a bit of bitcoin.

7. The linkage between leverage and digital safe-haven assets is clear. But digital asset investors should appreciate and not fear it. After all, the rapid liquidation of collateral is there to protect financial stability of the ecosystem. Yes, this hurts the near-term price of digital assets. And it has also greatly reduced the valuation of DeFi

protocols despite a surge in revenues tied to liquidations. It is short-term pain required for long-term resilience. The digital financial system is stronger in the end.

8. The longer-term characteristics of bitcoin and ether may be more evident looking within the digital ecosystem rather than shorter-term correlations with traditional markets. Through this lens, there is no question that bitcoin and ethereum are serving as safe-haven assets. This is evident in the performance of our One River Digital Indices. Our Core Index has materially outperformed the Size Tilt Index so far this year, by roughly seven hundred basis points. It is driven by the outperformance of bitcoin and ethereum. If ether sneezes, DeFi catches the flu.

9. Digital assets have macro underpinnings like all assets. But the entire digital ecosystem, at $2 trillion, it is in its infancy of penetrating broader financial markets. Macro thematic expressions within the asset class will be the gateway for investors, and we are working towards categorizing digital assets into intuitive sectors (e.g., gaming, utilities, infrastructure). Even in those sectors, the correlations between digital and conventional asset markets will episodic as decentralized applications disrupt centralized counterparts just as Uber disrupted New York City taxi medallions.

10. The most important macro narrative on the immediate horizon is inflation. Longer-term inflation expectations are moving higher as war in Europe forces central banks to accommodate inflationary policies. 5y5y US inflation swaps, at 2.61%, are on the cusp of cycle highs. Core digital asset markets will protect against inflation and other risks as a matter of math. The inflation protection provided by bitcoin and ether is clear in the longer term – there is no supply response to an increase in demand, scarcity is a defining feature. Leveraged-driven downturns in digital assets are a traders' nightmare and an investors' dream. Leveraged buyer, beware.

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