Figure 4 - spread between US10Y & JP10Y (LHS, orange) vs USDJPY (RHS, green)

up. This attraction, however, hinges on the ability to hedge currency risk—a practice primarily realized through FX-swaps. Such derivatives involve the exchange of one currency's performance over some interval for another's, therefore allowing investors to own a foreign security without bearing any currency risk, for a typically small cost. Crucially, differences in monetary policies significantly impact exchange rates, with a nation's superior monetary policy often translating to a more robust currency that outperforms competitors.

A compelling illustration of this phenomenon occurred last year with the Federal Reserve's rate hikes leading to a rally in USD. The prospects of higher yields in the US pushed money managers in Japan to buy UST while hedging their USD exposure, therefore leading to massive capital flight from Japan to the US, a trend reflected by evolution of the USDJPY pair. As the reader can see from Figure 4, the interest rate spread between the US and Japan closely tracks changes in their relative exchange rate.

Now, consider a currency like the Argentinian peso (ARS), notorious for being mismanaged. Hedging against the ARS with a USD exposure incurs significant costs, as there is high expectation of the USD outperforming atop high uncertainty regarding future market dynamics for the ARS. Conversely, swapping USD exposure for ARS exposure could potentially yield a payout in ARS terms. However, within the traditional fiat framework, this avenue for a positive carry USD remains limited, as the USD's perpetual demand inherent to its central role in the system diminishes such opportunities.

Enter a currency like Bitcoin, which consistently outperforms the USD over long-enough time periods due to its robust monetary policy. Hedge Bitcoin against the dollar, and the dynamics flip — now, you receive a payout for hedging. This phenomenon boils down to opportunity cost. Selling Bitcoin exposure for USD exposure essentially means relinquishing returns that, on average, remain positive. As Bitcoin is still in its monetization phase, it remains very volatile and thus makes a poor cash instrument in a fiat world. But one can still benefit from Bitcoin's superiority even by selling back exposure, given the likely and average result of a stable balance in dollars plus a positive yield.

B. Analysis of Bitcoin Covered Shorts Performance

This is perfectly demonstrated by Bitcoin's derivatives market. It stands as one of the few markets structurally inclined towards contango, where future prices consistently surpass spot prices—providing a pathway to a positive cash-and-carry arrangement by shorting the current dollar value of one's Bitcoin balance.

The largest and deepest Bitcoin derivatives market is the perpetual market. Invented by BitMex in 2016, perpetual swaps are a true Bitcoin financial innovation leveraging the ability of Bitcoin to settle around the clock.

Traditional futures contracts expire at market close on a certain date, and therefore, for any given asset, multiple futures contracts are always trading in parallel. This approach fragments the order book and forces market participants to roll their old contracts into new ones as the old expire to maintain their net position, with contracts that may trade at significantly different prices due to basis—difference between future price and cash price of a commodity.

Conversely, as aptly expressed by their name, perpetuals trade continuously in a market where premiums are paid between long and shorts on a peer-to-peer basis every 8 hours, thereby closing the spread between spot and futures markets. This allows the convergence towards a single market for Bitcoin futures and also provides market participants with the ability to hedge with little management and no need to roll.

Per BitMex data, between 14th of May 2016 (launch of perpetuals) and 13th of July 2023, the funding rate was positive 72% of the time.

We can go further and look at the historical performance of Bitcoin hedged against the dollar using perpetual swaps. Below is a chart displaying the performance of a $100 position held idly in covered shorts since the launch of perpetual markets:

Figure 5 - BTC covered short cumulative returns