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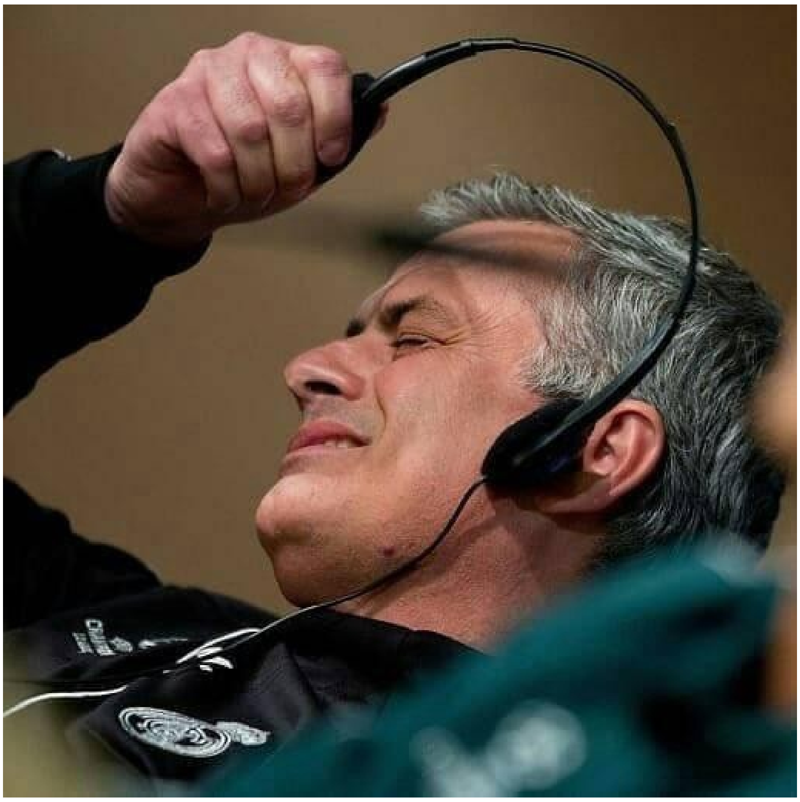
Conceptualising Capitulation



Jose Mourinho hearing the Aggr tape as Bitfinex machine gun sells 100k clips.

At the time of writing this piece, the crypto market is boring and shitty (both very technical terms).

Majors are down a lot from their highs, most altcoins are offering their best impression of the 'Wall Street Cheat Sheet Chart' (not the good part), volatility has been crushed, and the macro spill over has turned crypto-native traders into Bloomberg Terminal headline slaves.

With the spectre of their unrealised all-time high net worth weighing heavily on their conscience, speculators are trying to squeeze water from a rock.

More colloquially, speculators are looking for a bottom in the market so they can buy Bitcoin, Ethereum, a bunch of altcoins, and have another go at 'making it'.

Edgeless mental masturbation is at an all-time high as crypto circles have seamlessly, or perhaps shamelessly, shifted from experts in infectious diseases, to fluent Fed speakers, to geopolitical savants.

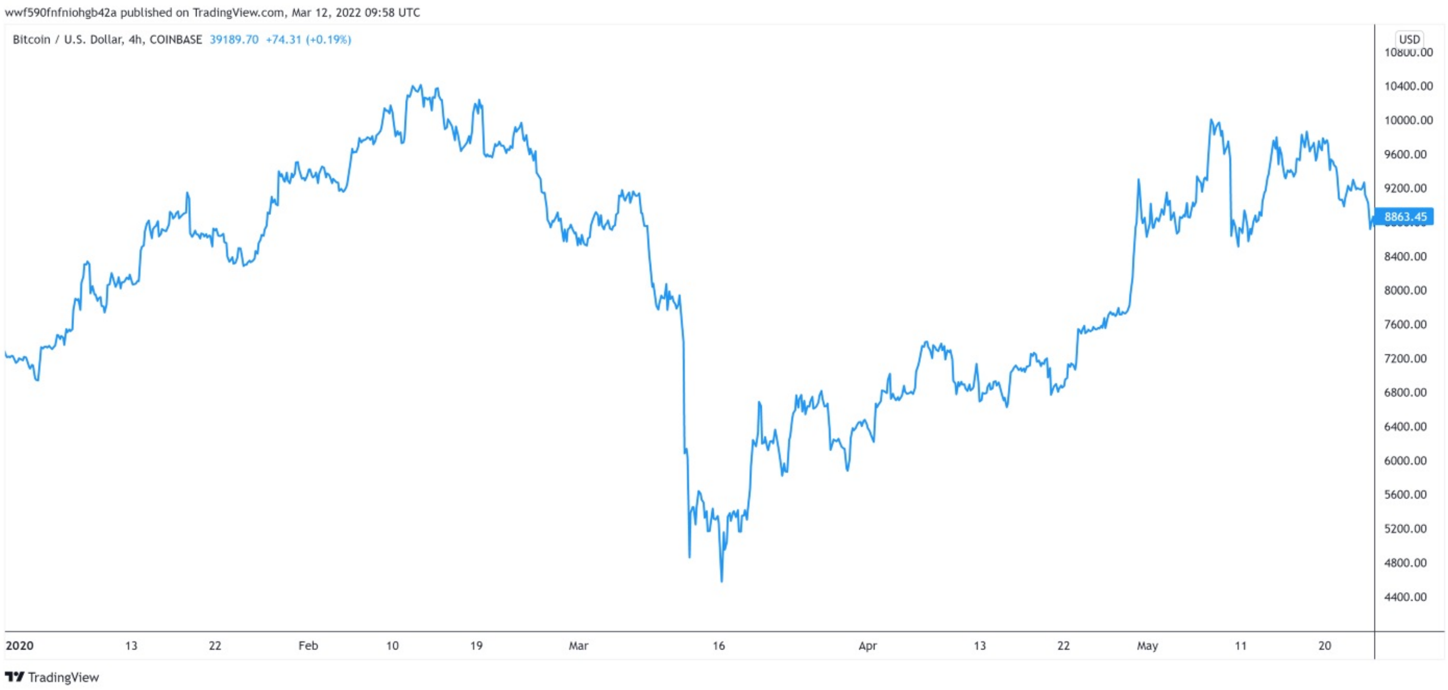
One of the more widespread arguments for the markets not finding a bottom is that there hasn't been a notable capitulation event yet.

This term is notoriously poorly-defined.

Loosely, it's some crescendo moment in a market where all the weak hands finally give up and sell, and those sales are picked up by their ingenious counterparties, thus forming the bottom. Subsequently, the market rallies and the bottom sellers avoid rebuying their bottom sales out of regret, disbelief, or other feelings.

In terms of crypto markets, the primary reference point for a capitulation event, supplemented by a healthy dollop of recency bias, is the March 2020 crash.

At its most extreme, Bitcoin/Dollar dropped 40% within a day.



The day I stopped feeling feelings.

Using March 2020 as an example, capitulation comes to mean something along the following lines:

> *Capitulation is enormously one-sided, outsized, volatile move to the downside (exacerbated by forced sellers of spot and derivatives).*

The basic premise is essentially everyone who wanted to sell, and a ton of people who didn't want to sell but were forced to sell, sold.

There are also much more interesting microstructural arguments for markets bouncing in these scenarios (large liquidations generally being mean-reverting, very attractive arb opportunities when markets get extremely dislocated, cheap/backwardated futures, favourable perpetual swap funding, market orders having a larger price impact when the orderbook has been 'wiped' and spreads are wide, options becoming massively mispriced, and so on) but the principle is the same — sellers are most likely done selling and they were (forcibly or not) inefficient in doing so → bounce time.

It's easy to fantasise about being the legend that steps in front of a massive move and buys it (ahem) but here are some things to consider, in no particular order.

1. You may not be in a position to even attempt to catch the volatile downside move. By definition, these moves are caused by (or at the very least exacerbated by) liquidation cascades. This entails speculators getting liquidated en masse and others trying to avoid that same outcome by reducing their positions and/or adding collateral. Having cash and no positions to babysit is a luxury.
2. Margins of error in estimating when the selling will stop tend be very large. Your idea to buy could be 'correct' and you still might have to eat a 10%–20% move against you at the extremes. That's why knife-catching with leverage is particularly precarious. What can sometimes work is identifying a high time frame 'value area' to buy and being mentally prepared for a significant spike through it (which you should technically see as a discount).
3. Liquidity evaporates. These one-sided moves are very toxic, so spreads will reflect that. Liquidity providers will also

typically be quoting smaller sizes. Colloquially, this makes for 'thin' order books i.e. market order fill prices will be worse and the price impact of market orders will be much higher.

4. It's unnecessary. As we'll discuss when identifying other forms of capitulation, buying the bottom of an outsized move isn't a prerequisite for great returns. Although there are much better arguments to illustrate this point, consider the following: nobody's bull market 'flex' (returns-wise) is buying the Bitcoin or Ethereum bottom. It's usually the conditions that followed that bottom, quite often months later, that facilitated the eye-watering returns. Having a sense of the bottom certainly helps with timing altcoin discounts, but it's not necessary (especially when considering the cost of being wrong on your knife-catch).

So, we've effectively dealt with one form of capitulation. In essence, extreme downside volatility and all the blow-ups that come with it. Easy in hindsight, generally much more difficult in practice, especially if you're stepping in front of it as opposed to waiting for the screams to end.

My personal and off-handed take is that catching the nuke as it's taking place is quite fun, but more often than not, price will come back and retest the extreme of the move anyway. It also usually does so in a much more orderly and tradeable fashion. Just look at a BTC/USD chart, identify the big liquidation-driven moves, and you'll see that price offers more than one opportunity to do business at or near that same extreme. This applies to more or less vanilla directional punts, to be clear.

Anyway.

This option alone leaves us with a rather bleak outlook. Essentially, wait until everything turbo nukes and goes to zero with some of the scariest high time frame candles you've ever seen, buy when the liquidations stop and everything is broken (derivatives pricing, exchanges themselves, and so on), pray you don't get another leg down, and hold through weeks of low volatility grind that may follow (if you're right).

Mercifully, I think there are other forms of capitulation that are worth being aware of.

Capitulation exists on both sides of the volatility spectrum.

That is to say, speculators can blow up and get carried out in one fell swoop on the outsized move, but they can also be victims of death by a thousand papercuts by gradually eroding their account in trying to breakout trade a rangebound market.

Let's briefly elucidate this trending and ranging distinction.

Everyone loves crypto when it trends. It's even better when pretty much the entire asset class is trending. Any arbitrary trendline and remotely passable horizontal line breakout become fair game for a momentum trade, and more often than not, the setup works out.

Crucially, that outcome is not a product of some sort of edge in the setup itself, but more so a product of the market conditions in general.

Problems arise when traders, conditioned by weeks and months of an upwards trending market and rewarded for chasing breakouts, apply the same strategy to a rangebound market. By definition, the rangebound environment suggests that the probability of breakouts with follow through is reduced and conversely the probability of breakouts resulting in failures is increased.

This becomes rather apparent across all time frames, but for the high time frame swing traders, they may be forced to confront a reality where they don't have a setup triggered for weeks, or potentially months.

Uncomfortable with this new reality, or simply by failing to identify it, speculators accustomed to much more benign conditions slowly chip away at their capital base as their go-to setups no longer offer an edge.

However, low volatility capitulation isn't just technical. It's also psychological.

Speculators used to trading several times per day every day across many assets just get bored and lose interest. Many of them will have joined crypto because it was trending and volatile, and in the absence of those two things, they either sell and give up or alternatively go LARP about stocks and FX.

To summarise, low volatility capitulation is when breakout trading dopamine fiends, unable to adjust to everything only going up forever, nuke their capital trying to trade a trend that isn't there, and/or go back to watching TikTok dances when crypto isn't 'hot' anymore.

The market can take your money all at once on one end of the volatility spectrum, or very slowly on the other end of it. The end result is the same.

A particularly brutal combination is when they are merged together i.e. high volatility nuke into 0 volatility grind.

November 2018, March 2020, and May 2021 are all decent examples of this.

First, the market takes your money quickly by straight nuking with no decent bounces to sell. Second, even if you survived the blow-up, the rough conditions (specifically the absence of volatility) make it such that it's nearly impossible to make back what you lost in any meaningful way. Third, because you're still haunted by the drawdown you ate and your paper all-time high net worth, you're conditioned to sell the bounce (and likely sell early/after the bottom is in) even if it means selling at the start of the uptrend.

Not fun.

There are other forms of capitulation which are less trading-related e.g. normies and celebrities who dabbled at the top finally fucking off and pretending it was a bad dream, crypto natives becoming embarrassed to mention crypto in real life, funds blowing up and big crypto businesses laying off staff, mainstream news perpetually dunking on crypto and how the bubble has burst, Saylor buying Ethereum, and so on.

They are less interesting and this article is already too long, but just some extra food for thought.

What's the moral of the story?

Well, everyone emphasises the importance of surviving in crypto, and they're right.

The point of this article was to outline what that actually entails in some degree of detail.

1. Don't risk your ability to take risk. High leverage and poor collateralisation in general significantly increase the likelihood that you don't make it. At the very least, don't become a forced seller. If you want to optimise things, have a stack of cash to throw at the market when everything breaks.

2. Tailor your trading to the environment. Sometimes that means no trading. That can remain the case for weeks or maybe even months. If you have to ask yourself whether you have an edge as your finger is hovering over the buy/sell button, you probably don't. Keep a journal, and take note when setups that were previously printing start to eat shit.

3. Capitulation exists at both ends of the volatility spectrum. Just because you survived the nuke, does not mean you'll immediately be rewarded with a trend. Just because there is no nuke, doesn't mean the market can't bottom.

4. You don't need to catch or trade the capitulation to be 'early'. You can buy momentum and constructive higher time frame market structure, assuming your ego can handle paying a higher price than your mate's 39th knife-catch. Example would be buying BTC/USD on the reclaim of $8000 or even the breakout of $12000 in 2020, even though the capitulation occurred much lower than that.

One final thing to note.

This framework is mostly aimed at Bitcoin and Ethereum.

If you have a core 'long crypto' multicycle thesis, most versions of that will have Bitcoin and Ethereum setting new all-time highs and gradually forming higher floors.

The likelihood of their survival and the likelihood of new all-time highs are fairly high assuming crypto doesn't go to zero forever.

The same cannot be said for the majority of altcoins, especially late cycle hype garbage.

Even the boomer altcoins that have survived several cycles generally trend down against Bitcoin and Ethereum on high time frames.

If you're holding garbage, the capitulation stuff is still broadly applicable, but the likelihood of recovery and new highs next cycle is vastly lower.

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It's a shitty ending to the article, but I'm rusty.

Reading wassie tweets on Twitter all day has substantially reduced my already average IQ.

I'll try to do more writing, at least for my own sake.

Links below have cool shit, so check them out.

Also, please leave a 'Clap' on this article so normies have a chance at making it.

Love,

Cred

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