Crypto outlook: new flows needed to mark the end of the crypto winter

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The sentiment in the crypto industry turned positive after BlackRock filed for a spot bitcoin exchange-traded fund (ETF) in the US in June 2023. BlackRock is not the first nor the only ETF issuer filing for an application, but it is a leading ETF issuer with large market weight and gives credibility to the crypto space. Since the BlackRock filing, the price of bitcoin is up 11% while the price of ether has declined by approximately 5%[1]. The industry lacks a clear short-term catalyst.

In fact, in the short-term, bitcoin could face some selling pressure from potential sales of Mt. Gox creditors[2], which are expected to be paid back their assets in bitcoin/cash by 31 October 2023. In addition, in September, the US bankruptcy judge gave permission to the current CEO of bankrupt FTX to start selling up to $100 million of cryptocurrency per week. We do not believe this will lead to a crash in crypto markets as the company has hired crypto firm, Galaxy, to hedge and stake some of these assets. The amount to be sold is large though - FTX is said to seek the sales of $3.4 billion in cryptocurrencies, including $1.2 billion in Solana, $560 million in bitcoin, and $192 million in ether[3].

Macro matters

We believe the crypto industry is influenced by liquidity and central bank actions. The US Federal Reserve's (Fed) annual change in M2 money supply was still negative in August and the Bloomberg liquidity index, which focuses on reverse repurchase agreements (repos)[4], has been on the downward trend since March (although in the last two weeks it has seen an uptick). Constrained liquidity in the short-term could dampen the upside potential in crypto prices.

However, if central bank liquidity improves and central banks start stimulating economies by lowering interest rates, this could provide a favourable environment for crypto assets to fully capitalise on other bullish catalysts.

Approval of a spot bitcoin ETF in the US could be a major long-term catalyst for bitcoin

We have previously written about the implications of a potential approval of a spot bitcoin ETF. A spot bitcoin product which tracks the actual price of bitcoin is a much more efficient way of gaining exposure to bitcoin than closed-end products or futures, which suffer from futures rolling costs. We also believe that, as the rest of the world is putting crypto regulation in place and allowing companies to experiment with different business models, the political pressure to do something with US crypto regulation is also mounting.

Another bullish catalyst for the price of bitcoin is the bitcoin halving[6] event, next expected in April 2024. Historically, this has led to a major bull run in the price of bitcoin. Will the effect at this stage, when already at least 19.7 million bitcoins out of 21 million have been mined, be as impactful as before? Probably not. We believe that macro liquidity has been and continues to be an equally important driver for the prices. If these two events take place at the same time, this could lead to a meaningful demand/supply imbalance and a meaningful appreciation in the price of bitcoin.

Short-term US treasuries competing with ether staking yield

While owners of ether (ETH) can earn passive staking yield by holding ETH and being willing to lock the ETH away and participate in authentication of Ethereum network's transactions, the competition from risk-free short-term treasuries is evident at this time. The 3-month US treasury bill has a 5.5% yield[7] while the ETH staking yield has declined to an average annual yield of 3.4% . This is because the number of validators has increased but the number of Ethereum transactions has been declining since May 2021. We believe this is due to low transaction throughput on the Ethereum network, high transaction fees, and slow settlement times. This weakness on the network is expected to be addressed later this year when scalability upgrade Proto-Danksharding will be implemented.

Ethereum continues to be the most widely adopted smart contract blockchain among developers by a wide margin[9]. Once its main weaknesses (that is, slow transaction speeds and high transaction costs) get addressed with Proto-Danksharding, we will follow with interest whether software developers from other layer 1 blockchains will move to Ethereum. While we do not believe that there will only be one blockchain ecosystem that survives, Ethereum is very modular and, hence, could attract developers from other smart contract networks that have failed to gather momentum in the past two years.

Regulatory uncertainty weighing on Ethereum

Earlier in the year, the US Securities and Exchange Commission (SEC) filed a lawsuit against Coinbase claiming, among other things, that staking-as-a-service offering is a security. The SEC under its current chairman has been unwilling to state that Ethereum is not a security. This uncertainty over the categorisation of Ethereum, the proper regulator for the asset, and staking-as-a service offering could be some of the reasons why ether has had a more muted price performance than bitcoin. We do not expect to see a short-term solution for this regulatory debate, although some favourable court case outcomes have been helpful, but hope that progress will ultimately be made on the legislative front.

Ether staking concentration fears resurfacing

After the Ethereum network moved from a proof-of-work to a proof-of-stake consensus mechanism as a way to authenticate transactions on the Ethereum blockchain (also called the 'Merge'), some market observers have raised concerns over Ether staking concentration. In general, the Ethereum network's governance is not handled on-chain but via developer calls where different opinions can be discussed and where community consensus is required.

However, there are concerns that once one Ether staking entity controls 33% of Ether staked, there is a possibility that they could stop blocks from finalising. Even in this case, they would still not be able to sign transactions on others' behalf. At the moment, staking-as-a-service provider Lido has a 32% market share

of all Ether staked . This does not appear to be a big problem as Lido distributes staked Ether to at least 29 independent node operators who run their own local infrastructure, get a share of the staking yield, and who can also reject the Lido policies.

Developments in three main areas needed to get ready for the mass-market

One of our theses has been that, in order to reach a true mass market, developments in the following three areas are needed:

1. **Scalability upgrades:** to make blockchains faster, cheaper and capable of handling a large number of transactions.
2. **Improvements to user interface:** to eliminate the complex use of wallets, browsers, private keys etc.
3. **Digital identity and privacy:** ability to move around different blockchains with digital identity where zero-knowledge proof technology, for example, could be used to authenticate users without them having to share private information with third parties every time they make a transaction.

Multiple innovations are currently being developed and we expect to see a number of product announcements in the coming 6-12 months. In the end, it will be the compelling applications built on blockchains that will take the crypto market mainstream. The transactions are likely to cost just pennies and go through in seconds. And the end user will not even know they are using blockchains, their experience will just far better than what they have experienced before.

The full outlook can be viewed here.

[1] Bloomberg, 9 October 2023.

[2] Mt. Gox was the world's largest decentralized crypto exchange for bitcoin in 2013 and it was based in Japan. It handled up to 70-80% of bitcoin's trading volume during that time. In February 2014, Mt. Gox experienced a hack and this resulted in bankruptcy. This hack affected over 850,000 bitcoins, of which 200,000 were recovered. After a decade-long court case, the creditors are finally expected to be paid by 31 October 2023.

[3] Bloomberg.

[4] In repos, the central bank is injecting liquidity into the market.

[5] Bloomberg, 9 October 2023.

[6] Bitcoin halving: when new bitcoin rewarded for miners every 10 minutes or so gets cut in half; expected to be cut from 6.3 bitcoins to 3.1 bitcoins in April 2023; takes place approximately every four years.

[7] Bloomberg, as of 9 October 2023.

[8] Ethereum.org, staking yield.

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