

A Strong Start for Digital Assets in 2023

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Digital asset prices, led by Bitcoin, have had a strong 2023 so far. Bitcoin is up by more than 70% this year, and Ether is up by more than 50%.¹ Together, these two assets still account for over 63% of the total market cap of the digital assets space. While the U.S. Federal Reserve (Fed) may continue raising interest rates, the market seems to expect that the recent bank failures (Silvergate Bank, Signature Bank, Silicon Valley Bank, Credit Suisse, Federal Republic Bank) will lead to central bank easing. Lower interest rates would benefit long-maturity assets, such as certain digital assets. Moreover, several traders have been caught off-guard, and short sellers expecting more downside in digital assets have had to liquidate positions, leading to higher prices.

We believe we could be on the cusp of the fourth major bull market in crypto, although the exact timing is uncertain. Our belief is that the next bull market will be enabled by advancements in the speed and scalability of the blockchain networks, more intuitive user interfaces and innovations in blockchain wallets, as well as developments in digital identity, which will pave the way for Web3 applications. The critical determinant, of course, will be the user applications that will take the market by storm, and we will keep monitoring potential candidates on a continuous basis.

Despite dismal price action last year, digital assets are supported by a healthy and vibrant software developer community. The number of monthly active developers actually rose last year by 5%,² which is significant and confirms our view that developers remain actively engaged in their respective blockchain ecosystems.

Layer 2 Networks Finally Coming Into Their Own, Promising to Solve the Scalability Issue

The main impediment of current Bitcoin and Ethereum networks has been their inability to handle a large volume of transactions. It is estimated that without a layer 2 solution, Bitcoin can only handle approximately 7–10 transactions per second, while Ethereum can only handle approximately 15–30 transactions per second. While it is on Ethereum's road map to be able to ultimately handle 50,000–100,000 transactions per second, this is not a reality at the moment. In contrast, Visa is said to handle at least 1,700 transactions per second, although there are some estimates that Visa could handle up to 24,000 transactions per second, and Visa itself is claiming this number to be as high as 65,000 transactions per second.³

One way to solve the scalability issue of blockchains is to use a layer 2 network, which is built on top of a layer 1 blockchain. Layer 2 networks move transactions off-chain, roll them up and bundle multiple transactions into a single transaction, which can then be secured on the layer 1 blockchain, benefiting from the underlying blockchain's security and robustness. This bundling enables faster throughput, faster

settlement and lower prices. For Bitcoin, the most well-known layer 2 solution is the Lightning Network, while for Ethereum, there are several options available, including optimistic rollups, zero-knowledge rollups (ZK rollups) and sidechains. It looks to us at the moment that instead of using “sharding”, which was expected to split the Ethereum network into separate ‘shards’ and thereby increase the capacity of the network, Ethereum developers are currently focusing their attention on layer 2 networks and planning to achieve scalability that way.

Digital USD Tokens Emerging as a Major Use Case

Stablecoins—digital tokens issued on public blockchains and pegged to an underlying asset, such as a currency or a physical asset—were initially used in trading and interexchange settlement but have become increasingly popular in payments and remittances. Because stablecoins are global and accessible to anyone, they offer an attractive way to cheaply and securely transmit money around the world 24/7 and settle transactions (almost) instantaneously. The world’s largest stablecoin, Tether’s USDT, is particularly popular in Asia, while in the West, Circle’s USDC is widely used. Stablecoins are designed to offer stability, while an asset like Bitcoin is more volatile.

To give an idea of the magnitude of transaction volumes, last year, Visa settled \$12 trillion worth of payments, mainly related to consumer spending, while stablecoins settled \$8 trillion worth of on-chain transactions, higher than the \$2.2 trillion settled by Mastercard or \$1 trillion settled by American Express.⁴ This year, it is possible that the combined amount of stablecoin transactions will exceed the payments settled by Visa. These stablecoin transaction volumes, of course, are not related to consumer spending but rather to payments, trading and decentralized finance and do not take into account trading volumes on centralized exchanges.

Competition for Instant Payments Heating Up

The market for instant settlement of payments seems to be in flux at the moment. Crypto regulations in both Europe and the U.S. are focusing on stablecoins and are expected to set stringent reserve requirements for stablecoin issuers and also forbid interest being paid to stablecoin holders. We view transparency requirements into reserve assets of stablecoin issuers as important but also believe that attention should be paid to issuers’ risk management, cybersecurity and blockchain code testing quality.

In the U.S., the Federal Reserve is planning to launch an instant payment system called FedNow in July 2023. The network will not be based on blockchain but will be able to settle payments in seconds and support transactions between consumers, merchants and banks. Some believe that the closure in mid-March 2023 of Silvergate’s SEN network and Signature Bank’s Signet network, both offering instant settlement services where clients were able to move assets between fiat currencies and crypto exchanges at any time, could have had something to do with the launch of FedNow. Around the world, central bank digital currencies (CBDCs) are also being actively developed. They offer a digital form of government-issued currency that is not pegged to any physical commodity, and these digital currencies will continue to be based on the fractional reserve banking system.

In Europe, the European Commission adopted a legislative proposal in late October 2022 that mandates all banks to offer instant euro payments to any individual with a bank account in the eurozone. At the moment, the EU banking sector, on average, lags behind other major international markets in instant payments, although single-country solutions have been adopted, and variations between countries are large. In some European countries, instant payments cover 70% of banks, but in others, only 1% of payments are settled instantly. The European banking sector has stated that it needs up to two years to make banks instant-payment-ready.⁵

Europe has its own version of an instant settlement network. BCB Group, regulated in the UK and Switzerland, offers the BLINC network, which links crypto companies to the banking system and enables business accounts to trade in fiat and digital assets 24/7. The company already offers fiat-to-crypto rails in sterling, euros, Swiss francs and yen in Europe and plans to add USD fiat-to-crypto rails by early Q2 2023. BCB's goal is to plug the gaps left by the SEN network. Unlike SEN, BLINC is multicurrency-based and is not tied to any single credit institution. It was designed as a payment network to provide on-ramps to banks in Europe, the UK and Switzerland. The company emphasizes that its funds are always 1:1 backed and are unleveraged and un-rehypothecated.⁶

1 Source: Coingecko.com

2 Source: Electric Capital, 2022 Developer Report

3 Source: Visa Fact Sheet, 2022

4 Source: CoinMetrics

5 Source: Euromoney

6 Sources: BCB Group, Coindesk

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There are risks associated with investing, including the possible loss of principal. Crypto assets, such as bitcoin and ether, are complex, generally exhibit extreme price volatility and unpredictability and should be viewed as highly speculative assets.

Crypto assets are frequently referred to as crypto “currencies,” but they typically operate without central authority or banks, are not backed by any government or issuing entity (i.e., no right of recourse), have no government or insurance protections, are not legal tender and have limited or no usability as compared to fiat currencies. Federal, state or foreign governments may restrict the use, transfer, exchange and value of crypto assets, and regulation in the U.S. and worldwide is still developing.

Crypto asset exchanges, liquidity providers, networks, protocols, settlement facilities, service providers and other participants in the digital asset ecosystem, and/or crypto assets related to the foregoing, may stop operating, permanently shut down or experience issues due to security breaches, fraud, insolvency, market manipulation, market surveillance, KYC/AML (know your customer/anti-money laundering) procedures, non-compliance with applicable rules and regulations, regulatory investigations or orders, technical glitches, hackers, malware or other reasons, which could negatively impact the price of any cryptocurrency

traded on such exchanges or reliant on a digital asset ecosystem participant or otherwise may prevent access or use of the crypto asset.

Crypto assets can experience unique events, such as forks or airdrops, which can impact the value and functionality of the crypto asset. Crypto asset transactions are generally irreversible, which means that a crypto asset may be unrecoverable in instances where: (i) it is sent to an incorrect address, (ii) the incorrect amount is sent or (iii) transactions are made fraudulently from an account. A crypto asset may decline in popularity, acceptance or use, thereby impairing its price, and the price of a crypto asset may also be impacted by the transactions of a small number of holders of such crypto asset. Crypto assets may be difficult to value, and valuations, even for the same crypto asset, may differ significantly by pricing source or otherwise be suspect due to market fragmentation, illiquidity, volatility and the potential for manipulation.

Crypto assets generally rely on blockchain technology, and blockchain technology is a relatively new and untested technology that operates as a distributed ledger. Blockchain systems could be subject to internet connectivity disruptions, consensus failures or cybersecurity attacks, and the date or time that you initiate a transaction may be different than when it is recorded on the blockchain. Access to a given blockchain requires an individualized key, which, if compromised, could result in loss due to theft, destruction or inaccessibility. In addition, different crypto assets exhibit different characteristics, use cases and risk profiles.

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