BITFINEX Alpha

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INTRODUCTION

Welcome to the latest issue of Bitfinex Alpha.

In this issue, we start the week with our look at the latest macroeconomic developments and what this means for crypto markets.

The recent Consumer Price Inflation print though expected to be high, still delivered shock value. We delve deeper into both inflation indicators and employment data. We also take the viewpoint of the NFIB survey to understand the true state of the US economy. Our conclusion is that it is no longer a question of whether we will head into a recession, but about how deep and how wide it will be.

On the crypto front, we are seeing an apparent decoupling of bitcoin from treasuries, as the negative correlation between the two assets increases dramatically - whether this remains a permanent trend remains to be seen.

On the bright side however, we conclude that despite this gloom, the creativity and the energy of the crypto markets remain unabated. Our research indicates that while we are clearly in a post-capitulation market where market participants have faced forced liquidations and remain heavily underwater on spot positions; the crypto market still offers significant investment opportunities, as ethereum and NFT volumes see a spike in transactions. Over 10k new wallets are buying their first NFT every day on ethereum, and the blockchain is near an all-time high for NFT projects with more than 10 sales a week.

Our round up of crypto news highlights, the filing of Chapter 11 bankruptcy protection for Celsius, but as the excess of the previous market cycle is washed out, it is positive that innovation continues to flourish in the crypto sphere. Even algorithmic stablecoins are not dead, with a new type of stablecoin currently being debated (positively) by the Aave community.

Read on for more details.

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GENERAL MARKET UPDATE

Latest Inflation Data

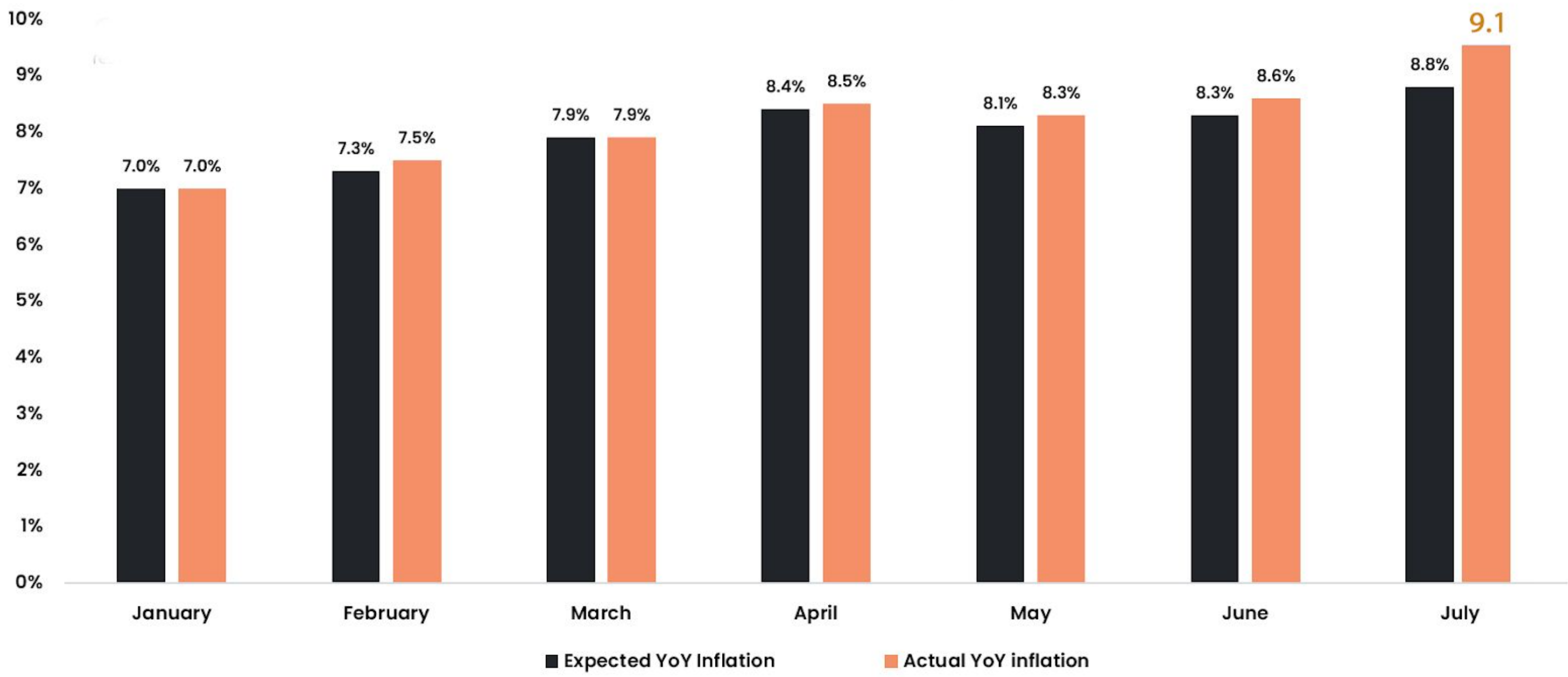


Figure 1. Actual Year-On-Year (YoY) Inflation Vs. Expectations; Source: Investing.com

The Consumer Price Inflation report that came out last week, reported higher actual inflation numbers than expected. At 9.1% YoY, it was the highest reported rate for 41 years.

As previously discussed in the last three issues, inflation momentum is accelerating and pressure continues to rise. However, while much of the mainstream media focuses on the headline of the CPI print, we look at two more relevant statistics that we think could worry the Federal Reserve further.

- MoM headline and core inflation has been at the highest levels in over 20 years: Inflation momentum is failing to decelerate and even picking up.
- Inflationary pressures are extensive now: Roughly 75% components of the CPI basket have seen prices increase by more than 4% over the last 12 months. It's not only used cars or energy prices anymore; it's everywhere.

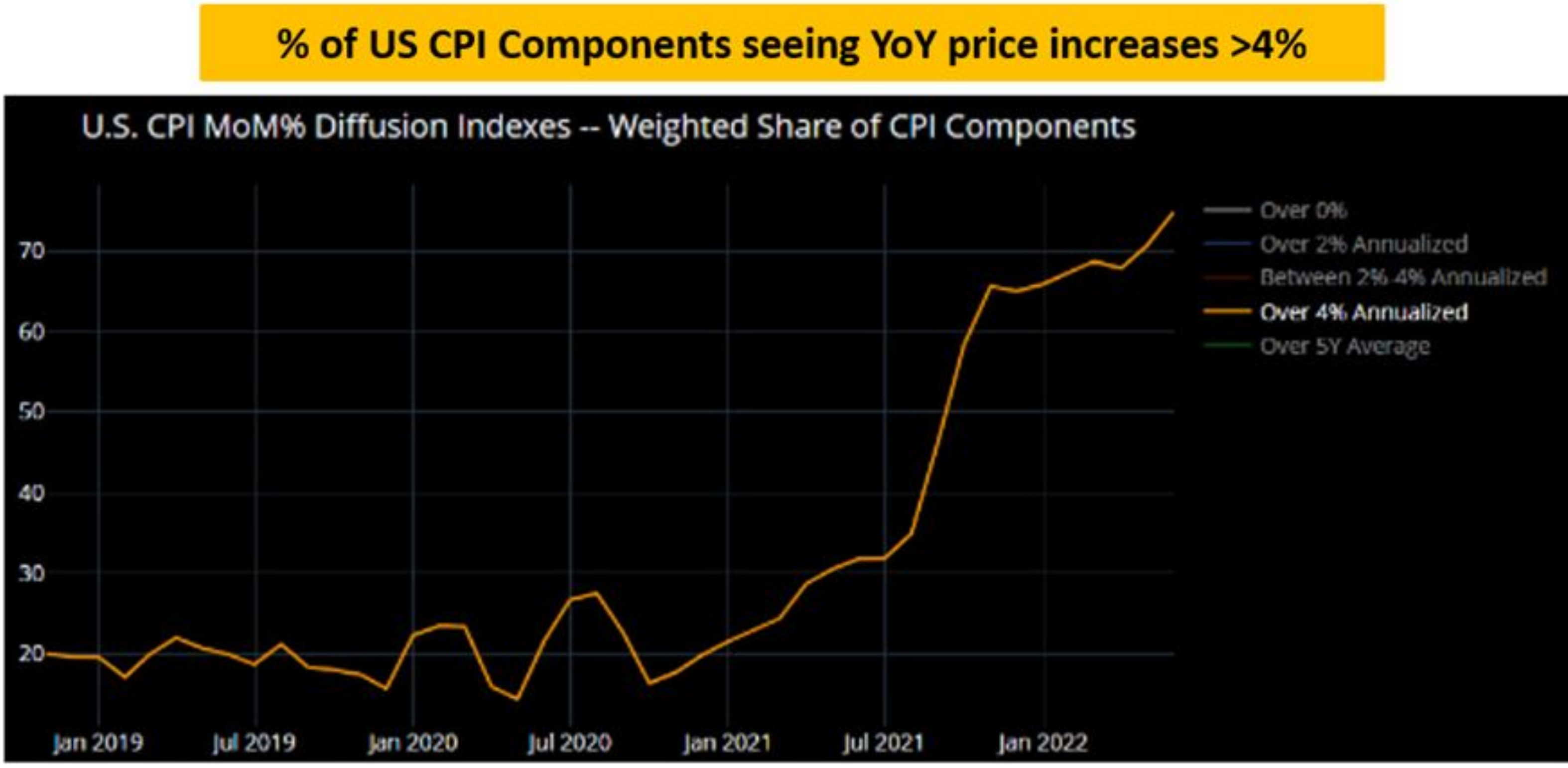


Figure 2. Percentage of CPI components seeing price increase>4%; Source: TheMacroCompass

As discussed in our previous issue (link: https://bit.ly/3Il1WIi), the recent downturn in energy prices and the cooling off of the housing market have not yet been reflected in the CPI data; given that CPI is a lagging indicator.

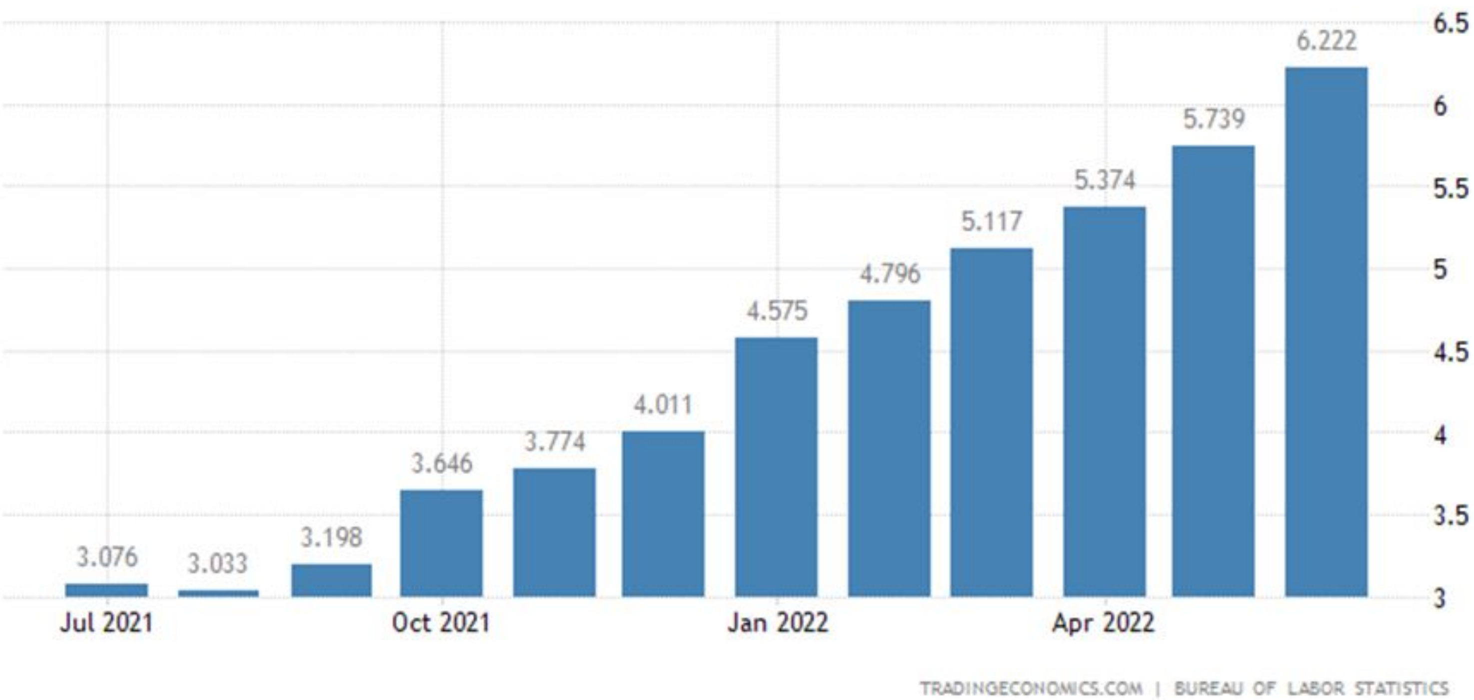


Figure 3. Service Inflation; Source: Bureau of Labor Statistics

Figure 3 above, however, shows the sharp rise of service inflation, which now sits at 6.22%. Service inflation accounts for 57% of the consumer price index, pushing the headline inflation higher despite commodity and energy prices cooling down. Service inflation has historically been stickier and the continued increases we have seen over the past 12 months tells us that this inflation might just stick around.

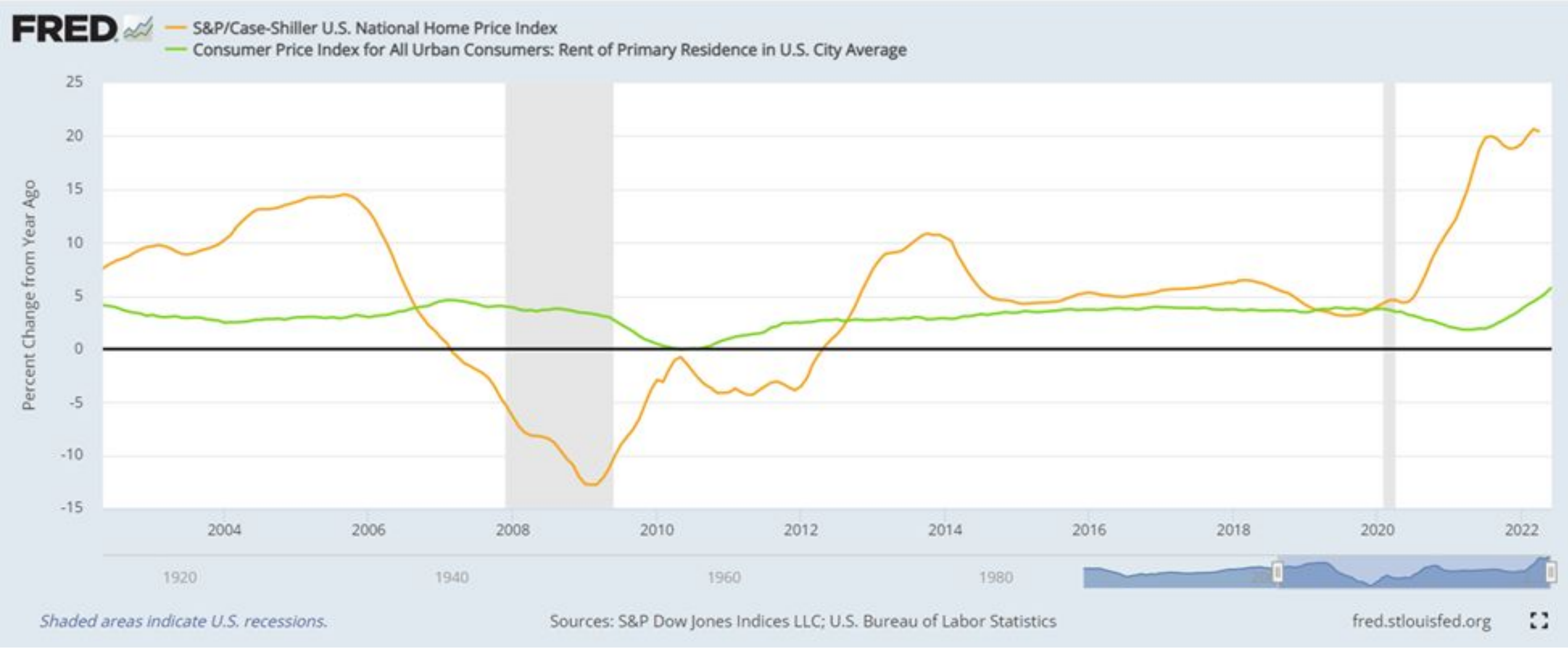


Figure 4. S&P/Case-Shiller Housing Price Index & Rent CPI (source: FRED)

Another critical driver for inflation is housing costs which represents 32% of CPI. Rent price inflation increased by 0.8% in June and 5.8% over the trailing twelve months, the largest gain in 36 years.

The S&P/Case-Shiller Price index is also up 20% year over year, leaving room for rent prices to move even higher.

Fed Funds data suggests that a 100 bps hike is in the process of being priced in, so we cannot discard that scenario either.

If however, the Fed sets its monetary policy stance based only on CPI, which is a lagging indicator, it will add fuel to the recession fire, by potentially introducing too much tightening. CPI is a great indicator, but it only tells us what has happened and not what is happening now. Therefore, it is essential to consider factors like the labour market and the National Federation of Independent Business' survey, which is a leading indicator.

Labour Market

While consumers endure the scathing effects of red-hot inflation, data from the job market adds some contrasting colour to the recession scenario that many are expecting. Prices of goods and services might be rising sharply, but the discussion at hand is: Is there sufficient employment to endure those costs? The data here is mixed.

Taking the labour data reports in isolation, one may say we are far from a recession due to strong demand. However, after accounting for negative revisions to prior NFP (Non-Farm Payrolls) reports, the pace of job creation over the last 3 months is much less impressive.

The labour force shrank by over 350,000 people: the number of total employed people in the US divided by its total population in the 25-54 year age bracket dropped below 80% as seen in figure 5 below.

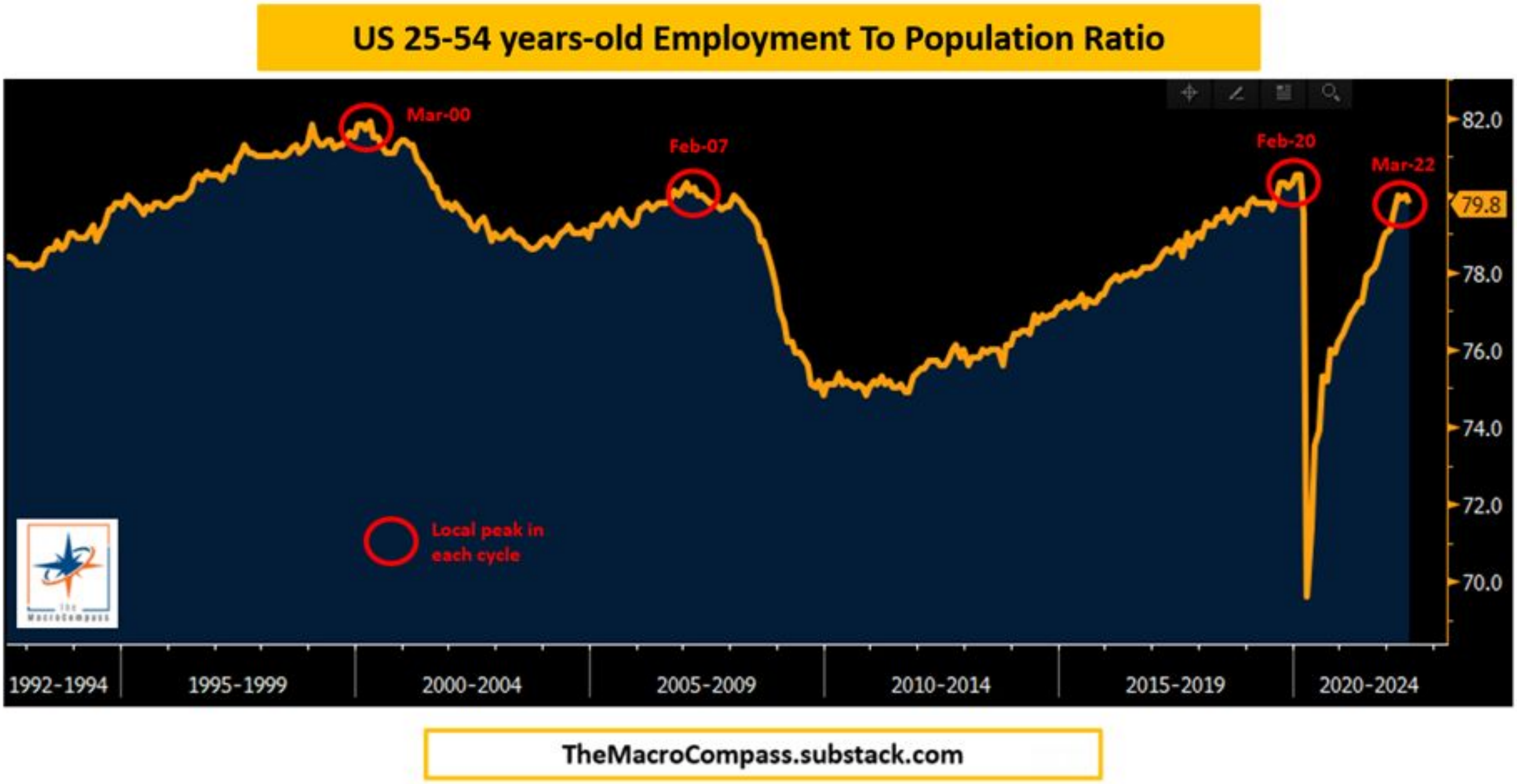


Figure 5. Bloomberg data interpreted for employment to population ratio (source: TheMacroCompass)

Historically, over the last 30 years, at the peak of each economic cycle, this ratio has exceeded 80% multiple times, but when this level has been breached and weaknesses have started to emerge (Mar 2000, Feb 2007 and Feb 2020), the next 12-18 months have been particularly slow for the global economy.

In the current cycle, we have not even reached this point, before we are seeing a downturn again. This indicates that there are signals of increasing unease in the labour market.

Some vindication of that view was reinforced by Google's recent announcement that they are going to materially slow down their hiring over the next 6 months.

Figure 6. Initial Jobless Claims Since 1970s (source: FRED)

Analysing initial jobless claims for the last five decades, one can see that there is always an initial gradual increase in jobless claims before it spikes sharply with the economy heading into a recession. If we look at the current job market, there is again a slight uptick which reinforces signs of a slowing economy.

The labour market is a coincident/ slightly lagging indicator and hence one could expect to see some material weakness emerge over the next few months.

NFIB survey

The National Federation of Independent Businesses conducts a survey of 800 small US companies and serves as a decent forward-looking indicator.

The lead time is generally a few quarters and currently employment and economic activity-wise, it's not looking good.

- Small companies currently have the worst outlook on expected volume of sales since 2009.
- The diffusion index built with answers to questions addressing the outlook companies have for general business conditions is captured in figure 7 below.

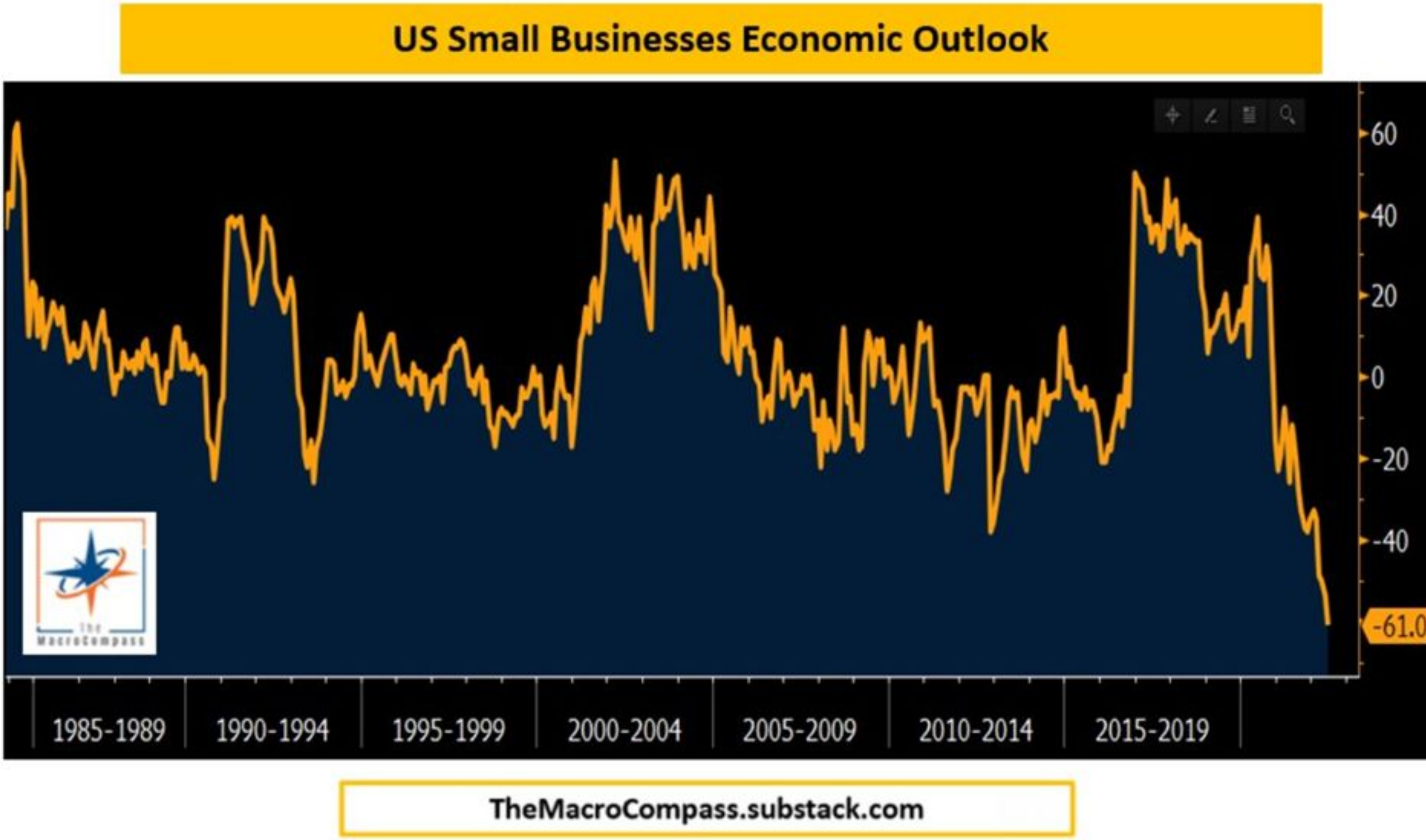


Figure 7. (source: TheMacroCompass)

What is the Fed's Next Move?

Since the CPI report, the chances of a recession have increased significantly. How far the Fed is going to tighten its policy will determine the economy's path towards a recession.

The expectations for a 250-275 bps target rate rose to 44.6%. These expectations, however, have since subsided. Shortly after the CPI report was released, *The Wall Street Journal*, reported that Powell will be sticking to 75 bps, taking 100 bps off the table.

TARGET RATE (BPS)	PROBABILITY(%)			
	NOW *	1 DAY 14 JUL 2022	1 WEEK 8 JUL 2022	1 MONTH 15 JUN 2022
200-225	0.0%	0.0%	0.0%	18.3%
225-250	69.1%	55.4%	92.4%	71.5%
250-275	30.9%	44.6%	7.6%	10.2%

* Data as of 15 Jul 2022 03:22:59 CT

Figure 8. Fed Interest Rate Hike Expectations; Source: CMEgroup.com

Energy prices have fallen, core inflation is decelerating, but initial jobless claims are starting to climb gradually.

The Fed has a tough battle ahead.

As shown in the labour data earlier, the Fed has to curb the demand for workers for consumer demand to come down. Currently, there are 1.9 available jobs for every unemployed worker. To get back to an inflation rate of 2% would mean pushing the unemployment rate much higher than where it currently stands.

The Fed must be confident that it will be able to pull down inflation to a sustainable level. Their stance is clear, that the cost of lowering inflation to 2% outweighs the cost of putting the economy into a "mild" recession.

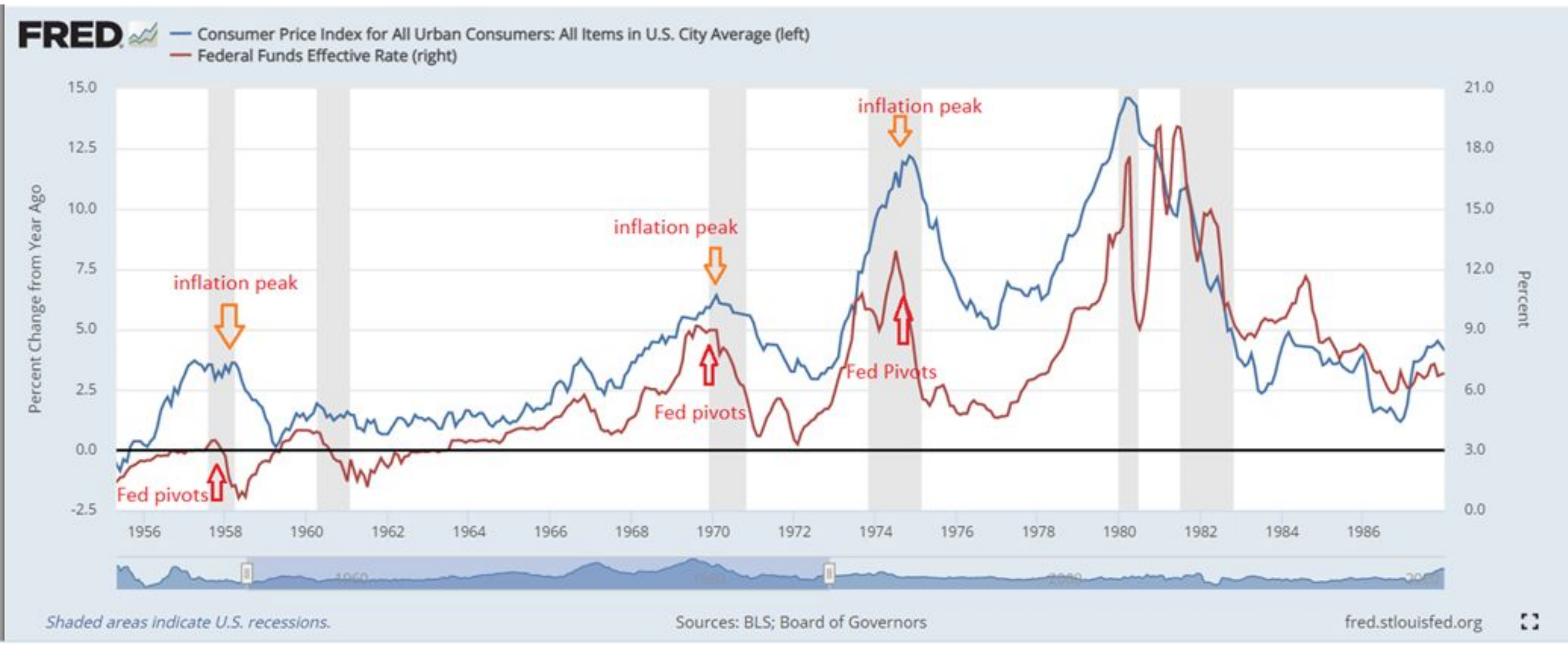


Figure 9. Consumer Price Index and Federal Funds Rate (1960s to 80s)

The goal is to prevent inflation from rebounding, which was the mistake made in the 60s and 70s when the Fed pivoted too soon from a tight monetary policy and caused inflation to spring back higher in the 80s.

This forced the Fed to raise interest rates to 20%, known as the Volcker shock, which forced the nation into a deep recession. Hence, the inflation data now has to be convincing enough for the Fed to feel comfortable about inflation decreasing to a sustainably low level.

Figure 10. Yield Spread Between 10Y and 2Y Treasury Bond Yields (source: Bloomberg)

The yield inversion between longer and shorter-dated US treasury bonds has traditionally been a harbinger of a recession. The 10-year and 2-year treasury yield curves currently differ by about 12 basis points, the maximum in over two decades. The 10-year treasury note yield dropped 12.4 basis points below the 2-year rate, far exceeding the 9.5 basis point spread last April. The 2-year rate, sensitive to monetary policy, popped 9 basis points higher after the CPI reports were released. Meanwhile, the 10-year rate slid 4 basis points and hence the more profound inversion.

Figure 11. Market yield on 10-Year US Treasury Securities

The benchmark 10-year treasury yield may have peaked at 3.5% in June this year. If the economic slowdown continues, the 10-year yield may continue to fall from its peak in June this year. The yield spread on the ICE Bank of America US High Yield index, commonly used to benchmark the junk bond market, has increased by over 50 basis points since June. The yield spread is an important gauge of risk to holding high-yield bonds and signals a high risk of default when it widens.

Figure 12. ICE Bank of America High Yield Index, Option-Adjusted Spread

Though recession seems inevitable, its magnitude remains highly uncertain. This uncertainty in the market urges investors to de-risk their credit exposure as they prepare for an economic slowdown.

As discussed in our previous issue, treasury bond yields are commonly used as the discount rate for equity valuations.

Figure 13. S&P 500 index 4H

As the market anticipated the next CPI print, the S&P 500 sold off, but pressure on equity prices started to ease after the *Wall Street Journal* reported that a 100 bps increase was unlikely, followed by a statement from Fed Governor Christopher Waller supporting a 75-basis points rate hike. Is this the bottom? Probably not. The S&P 500 has fallen more than 20% year to date and historical recession data shows that the market is more likely to continue a downtrend.

Figure 14. Inverse Correlation Between Inflation Adjusted 10-Year Treasury Securities Yield and bitcoin (source: FRED)

An interesting development in the correlation of the 10-year treasury yield with bitcoin is that the 90-day correlation coefficient had reached -0.95 by the end of June. This correlation value tells us that the two variables are moving in the opposite direction 95% of the time, which is highly inversely correlated.

When the real yield is high, there is a lesser incentive to buy other assets like bitcoin, stocks or gold. This explains the correlation, but the percentage is staggering and indicates that there may be some decoupling between bitcoin and treasury yields and equities too, given the role treasuries play in equity valuation models.

ON CHAIN ANALYSIS

Miner Capitulation

There has been a little change with regards to market valuation, momentum, and on-chain data. Hence, we decided to focus on specific limited insights on the state of bitcoin markets for this issue.

If we look at miner activity, it is clear that they are particularly pro-cyclical. They accumulate bitcoin during a bull market and purchase more mining rigs. However, there is a delay between their date of purchase and when they are switched on, for a variety of reasons like delivery delay and scaling costs of the facilities. As a result, historically, the peak in hash rate has followed the top in the price of bitcoin.

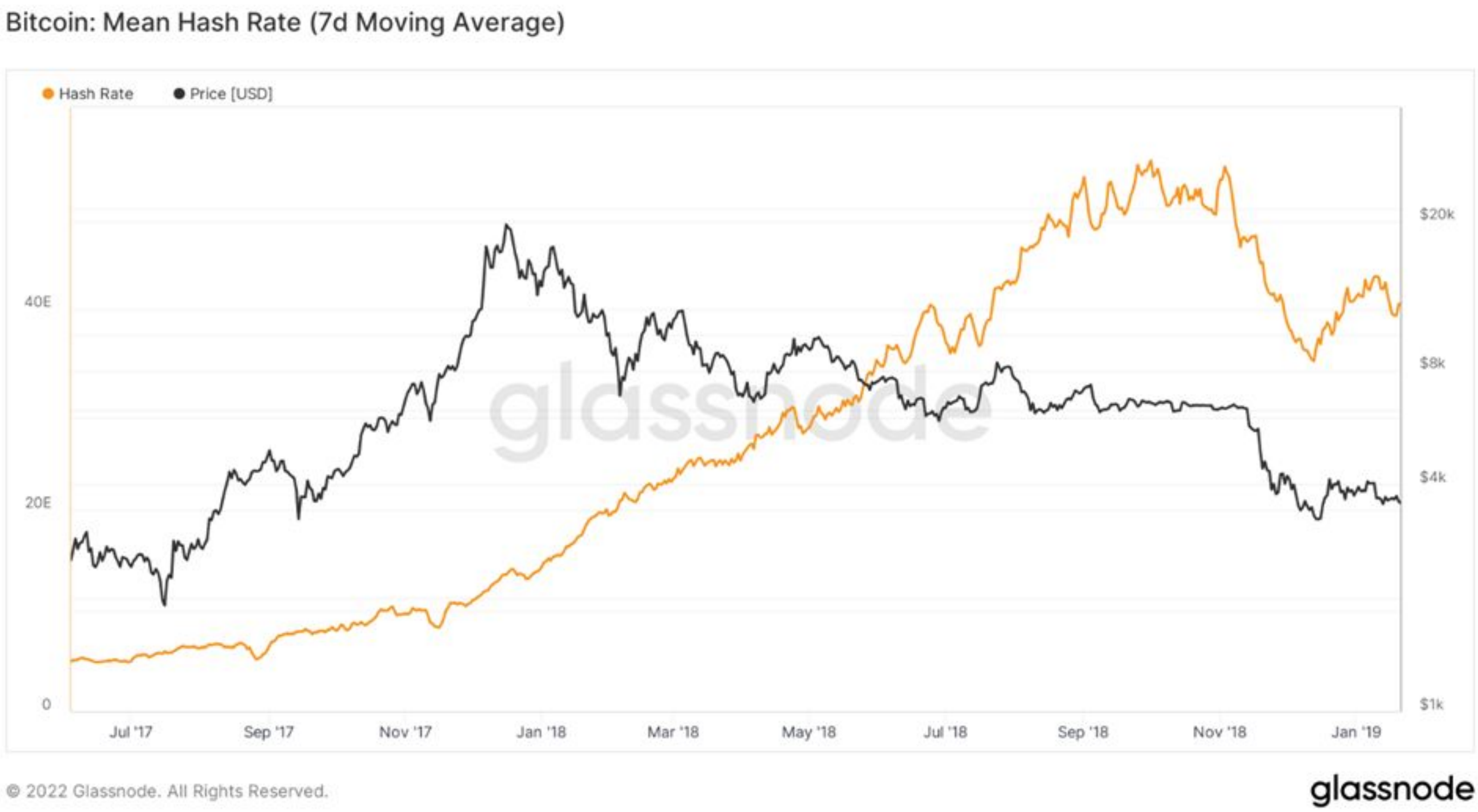


Figure 15. Mean Hash Rate vs bitcoin price (source: glassnode)

As this onboarding of new machines takes place and bitcoin's price draws down, miners' margins get thinner.

This effect is happening right now, as machines continued to be plugged in at an aggressive rate into early 2022, but the bitcoin spot price declined by roughly 70%. On top of that, there's a new variable adding to the reduction in margins for miners which is the increase in energy costs driven by supply chain issues throughout late 2021 and Q1 2022.

To utilize the hash rate in an actionable manner, we must consider hash ribbons. Hash ribbons juxtapose the 30-day and 60-day moving average of hash rate to create a proxy for momentum moves in miner dynamics. When the 30DMA crosses below the 60DMA it is a bearish cross.

Currently, we have seen a bearish cross take place, indicating we are indeed in a period of miner capitulation.

Figure 16. Hash Ribbon with 30D and 60D moving averages. (source: glassnode)

The key takeaway from the above data is that we are currently witnessing a post-capitulation market where forced selling has taken place across all fronts, from lenders like Celsius and BlockFi, funds like 3AC and most importantly by the miners.

On-Chain Wallet Data

Let us also analyse what the on-chain wallet data aggregation models tell us.

We can explore the LTH (Long Term Holder) spending and their bitcoin cost basis. The LTH-SOPR (Spent Output Profit Ratio) is the profit captured by long-term holders, a value below 1 would indicate holders selling coins at a price lower than their cost basis.

The 2018 bear market bottom for LTH-SOPR was 0.48. Figure 17 shows the current LTH-SOPR of 0.68 and hence long-term holders are at a loss of 32%.

Figure 17. Long-Term Holder Spent Output Profit Ratio

When the crypto market capitulates, assets are transferred to new buyers or Short-Term Holders. However, there will be a gradual increase in LTHs as retail is flushed out of the market. As mentioned earlier, bottom formation is characterized by the transfer of assets from low to high conviction holders.

This would mean that LTH will have an increasingly larger share of the total unrealized loss. Hence, for the market to bottom, coins held at a loss should be owned mostly by LTH who have generally higher conviction and are less sensitive to volatility.

glassnode

Figure 18. bitcoin: Long & Short-Term Holder Supply in Profit/Loss (7 Day Moving Average) ; Source: Glassnode

Crypto Market never fails to deliver

The capitulation talks might be well founded, however, opportunities in crypto are ever evolving and the most dynamic market still offers probably the highest returns.

Over 10K+ new wallets buy their 1st NFT every day on ethereum. Recently, new wallets and returning wallets are growing and we are seeing an uptick. This is a promising segment-wide relief signal.

Figure 19. NFT Buyers data on Ethereum. (source: Nansen)

Ethereum is near an all-time high for the amount of NFT projects (2749) with 10+ sales a week.

While diminishing returns are an apparent reality led by Yuga NFTs like BAYC, Otherside and ETH price depreciation, for NFTs, there is a long-term uptrend of transaction activity. Markets geared to small projects continue hitting all-time user highs.

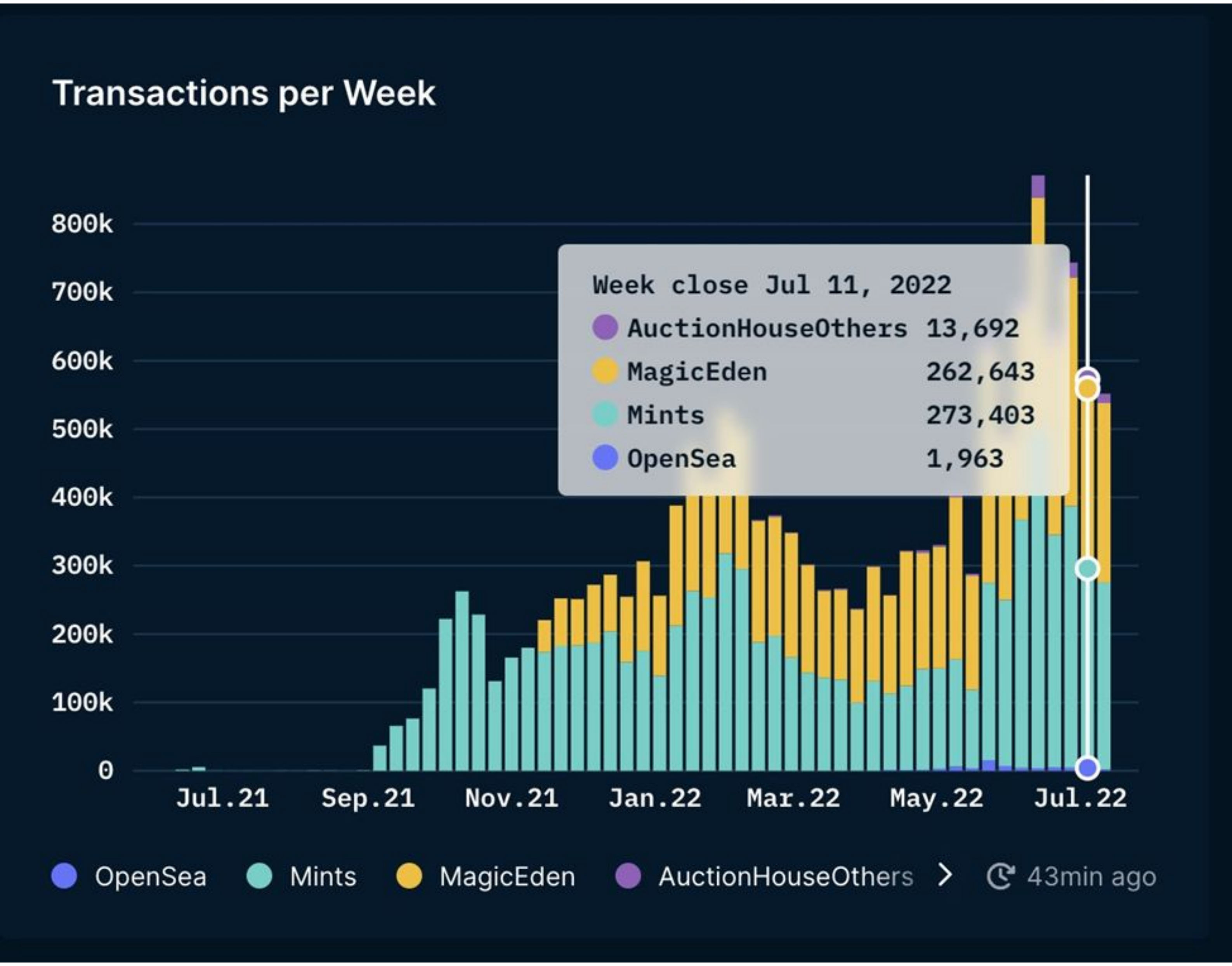


Figure 20. Transactions across smaller NFT projects (source: @researcher_paul on twitter)

CRYPTO NEWS

Q2' 22 Blockchain Private Funding and M&A Recap:

> The amount of venture capital invested in the blockchain industry fell by almost 22%, from $12.5 billion to $9.8 billion QoQ. Investment in the sector rose for seven consecutive quarters before this decline.

> Southeast Asia has attracted almost $2.2 billion in private investment so far this year across 160 venture projects.

> DeFi saw the highest QoQ financing decreases in terms of money and deals.

> The popularity of NFTs/Gaming finance has officially flooded the M&A marketplace. Over the last two quarters, about 38% of all M&A deals in the sector occurred.

> Since the middle of June, the cryptocurrency market formally entered a second phase of the bear market, characterised by institutional insolvency and liquidation, or what some analysts have dubbed the "LTCM moment" (after Long Term Capital Management, a hedge fund that built up significant losses through leverage and destabilised the markets in 1997-98)

> A second blow to asset prices has been dealt to the market as a result of the liquidation and auction of institutional assets, the wave of divestments sparked by the loss of investor confidence, and the collapse of the institutions. The price of BTC has depreciated more than 70% from its all-time high. In comparison, the price of ETH has decreased by more than 75% from its all-time high.

Celsius Network Files for Chapter 11 Bankruptcy

Celsius had grown to manage more than $10 billion in assets and claims more than 1.7 million users. The company declared that it would stop all withdrawals, swaps, and transfers between client accounts on June 12, 2022. The U.S. Bankruptcy Court for the Southern District of New York received a voluntary Chapter 11 bankruptcy petition from Celsius and many of its affiliates on July 13, 2022. With the help of reorganisation, sale, or another method, Chapter 11 bankruptcy enables insolvent businesses to reorganise their debts. A total of 8 entities related to Celsius are declaring bankruptcy.

Figure21. (source: coinmarketcap)

The cryptocurrency lender earlier declared it had $167 million in cash and would keep customer withdrawals frozen. Only a small number of bitcoin businesses in the US have initiated bankruptcy procedures. Due to the lack of legal guidance, it is unclear whether account holders would be allowed to sell or recover their bitcoin assets during a bankruptcy proceeding.

Owners of Celsius accounts allowed the corporation permission to use, lend, sell, and rehypothecate the cryptocurrencies they deposited. In turn, Celsius used these resources in a range of lending, trading, and investment ventures.

Concerned about how the bankruptcy procedure would impact the value of their assets on Celsius, investors have virtually no resort but to acquire legal counsel.

We will keep an eye on the bankruptcy proceedings and provide updates should significant events occur.

Twitter sues Elon Musk over a $44 billion acquisition dispute.

Figure 22.

According to court records, on Tuesday night, Twitter filed a lawsuit against Elon Musk to compel him to pay $44 billion for the social media network.

Musk withdrew from the arrangement last week, citing his worry that the platform contains spam and bot accounts to an irresolvable degree. To prepare for the litigation filed in the US state of Delaware, Twitter recruited Wachtell, Lipton, Rosen & Katz LLP.

The lawsuit claims, and we quote, “Musk appears to believe that he, unlike every other party subject to Delaware contract law — is free to change his mind, trash the company, disrupt its operations, destroy stockholder value, and walk away. Musk mounted a public spectacle to put Twitter in play, and having proposed and then signed a seller-friendly merger agreement.”

Aave Proposes Decentralized, Yield-Generating Stablecoin GHO

Figure 23.

Aave has proposed the creation of a decentralised algorithmic stablecoin, GHO, as it looks to improve on the features of its lending platform.

The fully collateralized stablecoin will be native to the Aave ecosystem and initially available on the Ethereum network. It is expected to be offered on other Aave-supported blockchains based on future community votes as covered by coindesk.

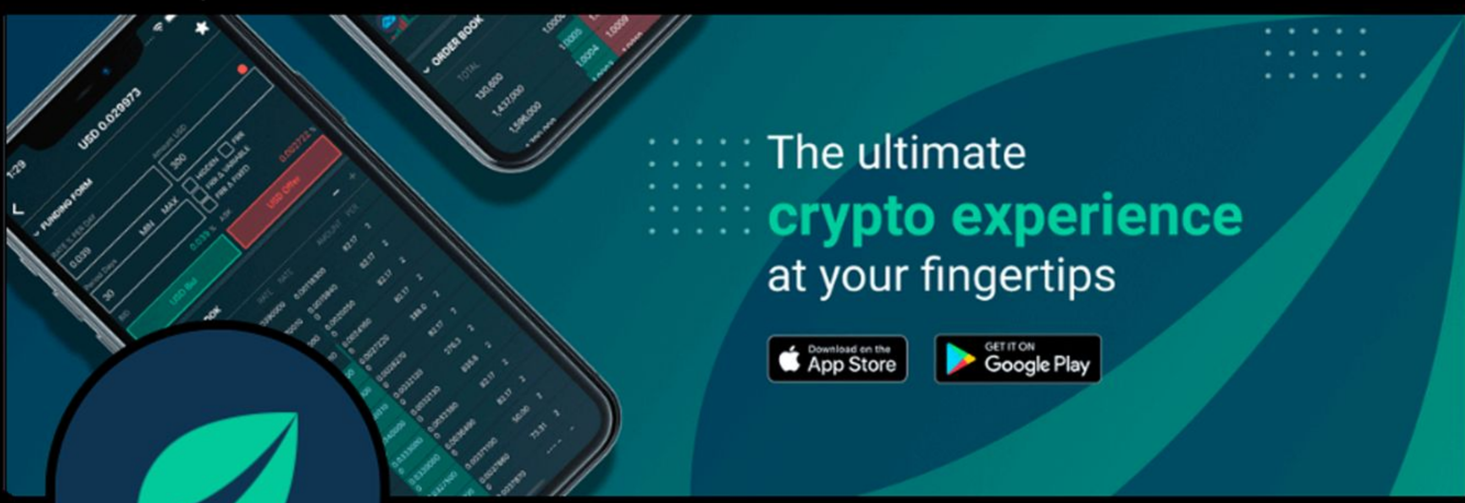
Still a proposal, the plan is for Aave to allow users to mint GHO tokens against their supplied collaterals. GHO will be backed by a basket of cryptocurrencies chosen at the user's discretion, while borrowers would continue earning interest on their underlying collateral.

Aave said the GHO stablecoin will rely on "facilitators" for the smooth functioning of GHO. A facilitator, such as another protocol, will have to be able to trustlessly generate and burn GHO tokens. The facilitators would have to be approved by Aave governance.

Facilitators, however, will have limits in place to ensure they don't abuse their powers. "For each facilitator, governance will also have to approve something that we call a bucket. A bucket represents the upward limit of GHO a specific facilitator can generate," the Aave proposal said.

Community voting for the creation of GHO is expected to begin soon, as per a *Coindesk* report.

Sentiment among Aave users remained mostly positive as of Friday. However, there were concerns around Aave controlling the interest rates offered to users and the intent of arbitrageurs who would work to maintain GHO's $1 peg.



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