BITFINEX Alpha

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EXECUTIVE SUMMARY

Flat is the new up. Last week's US retail sales report came in unchanged for July, seemingly unaffected by inflation - and therefore indicating that the Fed's work is definitely not done.

As we head to the next data point to get clues on the state of the economy, all eyes will be on today's (August 23) August PMI flash data, plus a whole raft of economic reports due in the next four days.

We recommend six beautiful charts to focus on that illustrate the condition of three critical areas of the economy: inflation, recession risk and the labour market.

In addition, expect more jawboning this week from central bankers as the annual Jackson Hole symposium gets underway on August 25-27. With the next FOMC meeting not until September, there is a lot of time for market noise and speculation, but in our view the only real question is: Do we get a further 50 or 75bps point hike in rates?

The market remains hopeful, a narrowing of the spread between 2-year treasury and the Effective Federal Funds rate is evident, implying the markets believe that the heavy lifting of Fed rate hikes has peaked.

Meanwhile the equity market has seemingly run out of steam, and the focus for now will likely be on Jackson Hole and the slew of economic reports that will be announced this week.

Crypto markets reacted accordingly and Bitcoin is at a 3-week low. On-chain selling from miners also seems to have slowed with only 6200 BTC sold in July, half of what was sold the previous month. The hash rate however, is not growing as weaker BTC prices do not encourage production. That said though, interest and activity is growing, with 928,000 active addresses on a 7-day average recorded this month, compared to 834,000 in mid-June and daily transaction volumes are growing.

Finally, in our special Learning section, we focus on one of the most anticipated crypto events in history: the Ethereum Merge. What is it, why was it proposed, and what difference will it make in the end? We try to elucidate it by describing it in terms of spaceships, and we analyse the economic implications for Ethereum and for Ether. Read our Learning Section to find out more.

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GENERAL MARKET UPDATE

Consumers Remain Resilient

We conclude a quiet week in the markets in terms of price fluctuations. Despite elevated goods and services prices, US retail sales for July, released on August 17, remained flat, demonstrating the resilience of consumers. Retail sales measure the change in the total sales value at the retail level. It is the primary indicator of consumer spending.

The principal driver of the report was falling gasoline prices, which also impacted revenues at service stations. A shortage in the automotive inventory also contributed to the shortfall.

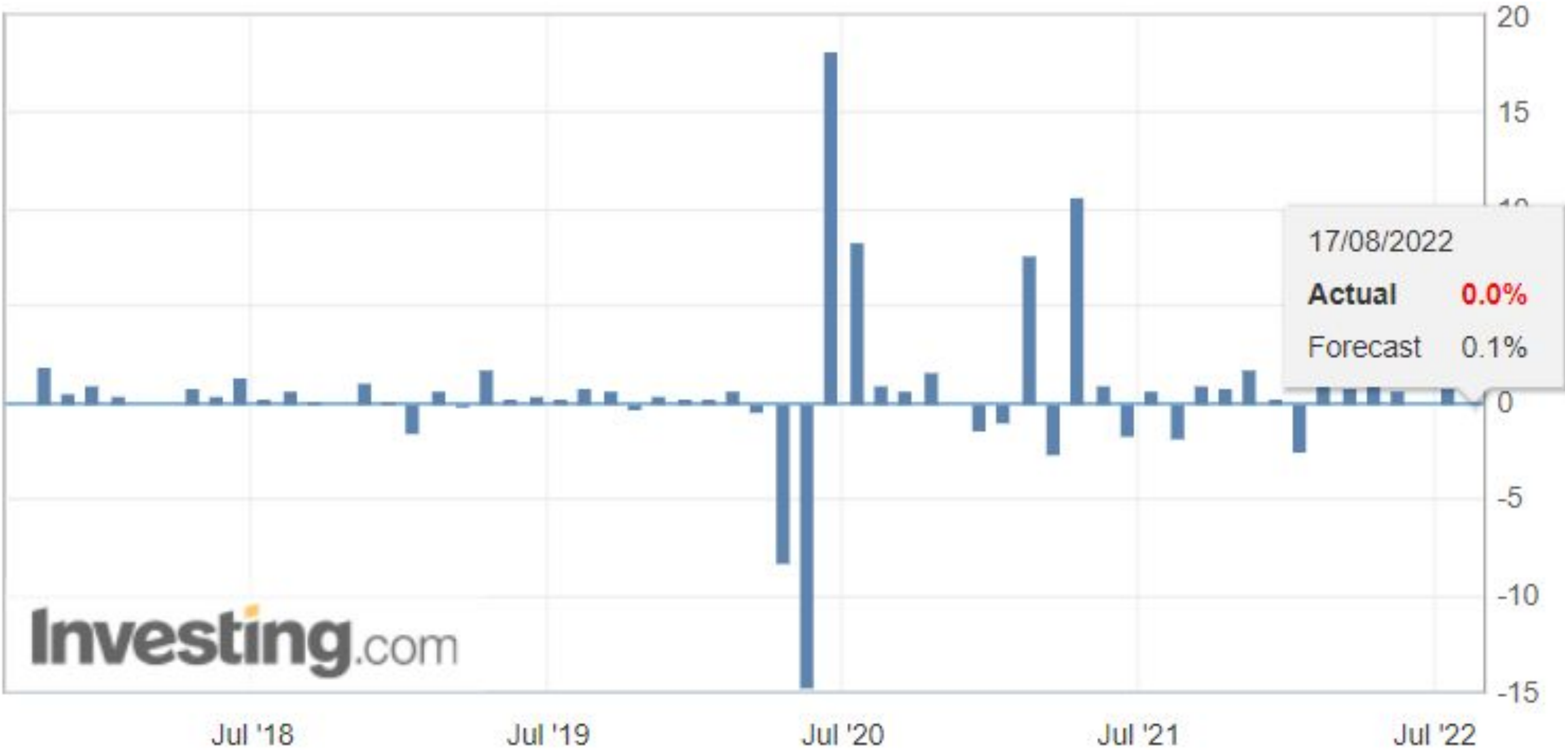

Figure 1. Month-On-Month Change in Retail Sales (source: investing.com)

Excluding automobiles, gasoline, building materials and food services, retail sales increased 0.8% in July, with nine of 13 categories experiencing a rise in expenditure, headed by online sales. This follows a downwardly revised 0.8% increase in June. Retail sales are presently up 10.3% year on year, against CPI of 8.5%, indicating that retail sales are increasing, even on an inflation-adjusted basis.

Consumer spending appeared to creep up at the start of the third quarter this year, allaying concerns that the economy was in a slump. Combine this with pay rises from a tight job market, and it could propel consumer spending for the rest of the year. As per the Commerce Department's report on August 17, the Federal Reserve is expected to be on an aggressive monetary policy tightening course.

The retail sales report followed publication of Fed minutes from the July 26 FOMC meeting, which emphasised that the central bank would continue to raise interest rates until inflation is controlled. The Fed discussed the importance of short-term aggressive rate hikes because the most recent inflation numbers indicate there's still a long way to go before policy objectives and price pressures converge, even if there is some evidence of inflationary pressures easing.

Unlike the June minutes, when the Fed suggested that the July hike was either a 50 or 75 basis points hike, there is no forward guidance for the September 20-21 FOMC meeting. The Fed still has a lot of time to decide the rate hike for the upcoming FOMC meeting. There are still several data points to delve further into, including jobs, inflation and other reports that will shape the decision regarding a 50 or 75 basis point hike, and these will be significant determinants of policy adjustments and will define market direction.

This week, attention will be on the August flash Purchasing Manager Index numbers, which will provide an update on economic conditions at the crossroads of decreasing global demand and elevated consumer prices. Six charts illustrate three main areas to keep an eye on ahead of the August PMI release: inflation, recession risk, and labour market conditions. Further, the Fed's Jackson Hole symposium on August 25 – 27 is also expected to provide further clues of central bank thinking.

Inflation

Slower input cost inflation reflected less pressure from manufacturers and service providers, as shown in the Manufacturing Input Prices PMI chart below. Fewer supply constraints drive this ease in inflationary pressures for manufacturers.

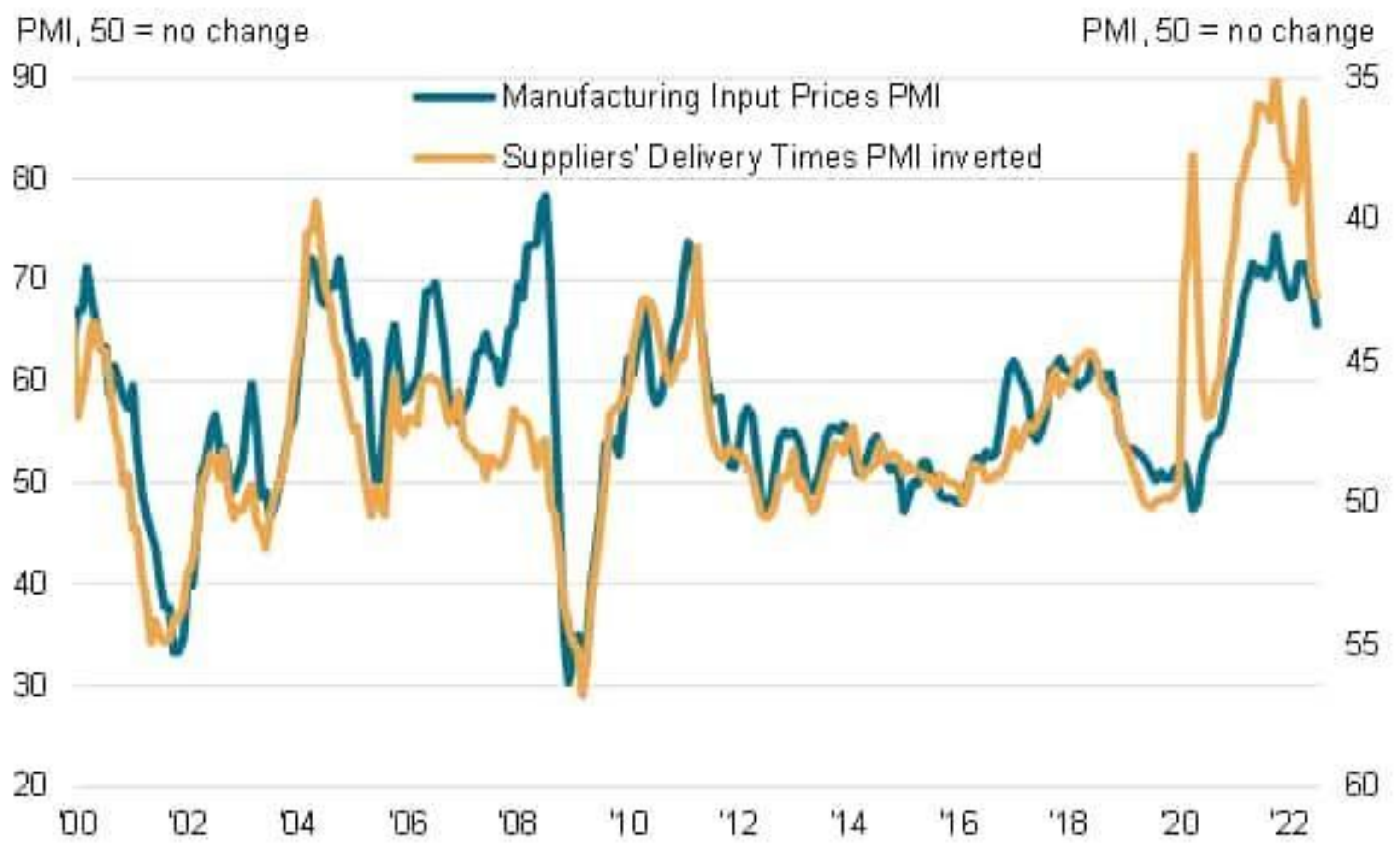

Figure 2. Ease in Supply Chain Pressure in Global Manufacturing Sector (Source: S&P Global, J.P Morgan)

Global Supplier's Delivery times cooled down in the last quarter after it rose to its highest level in November 2020. Capacity improvements from suppliers, weaker demand for raw materials and fewer constraints in Chinese ports have reduced lead time delays. While delivery times are still higher than pre-pandemic levels, and are indicative of significant supply issues, there has been a consecutive drop since April this year.

Consequently, Global Output Prices PMI suggests that companies are moving their prices following cost developments on the supply side. Output prices PMI tells us that consumer price inflation from OECD countries (Organisation for Economic Cooperation Development) will drop in the coming months. However, it is important to note that the ongoing energy crisis and other supply chain issues continue to put upward pressure on inflation.

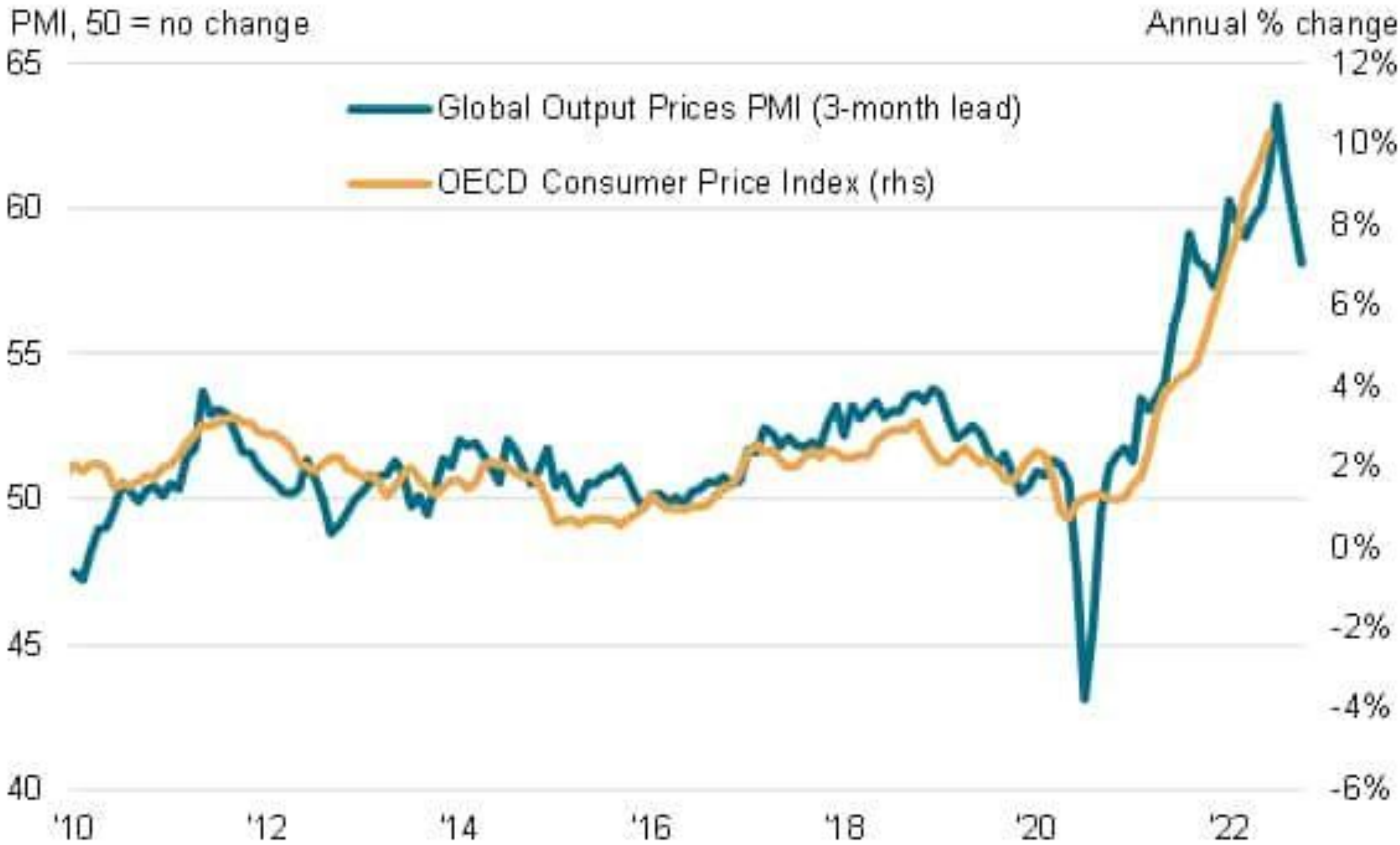

Figure 3 PMI Suggesting peak consumer price inflation was reached (Source: OECD, S&P Global, J.P. Morgan)

Recession Risk

In July, more companies mentioned the word "recession" since the global financial crisis. More companies reporting economic worries might hurt global demand, investment and jobs, according to a survey by S&P Global.

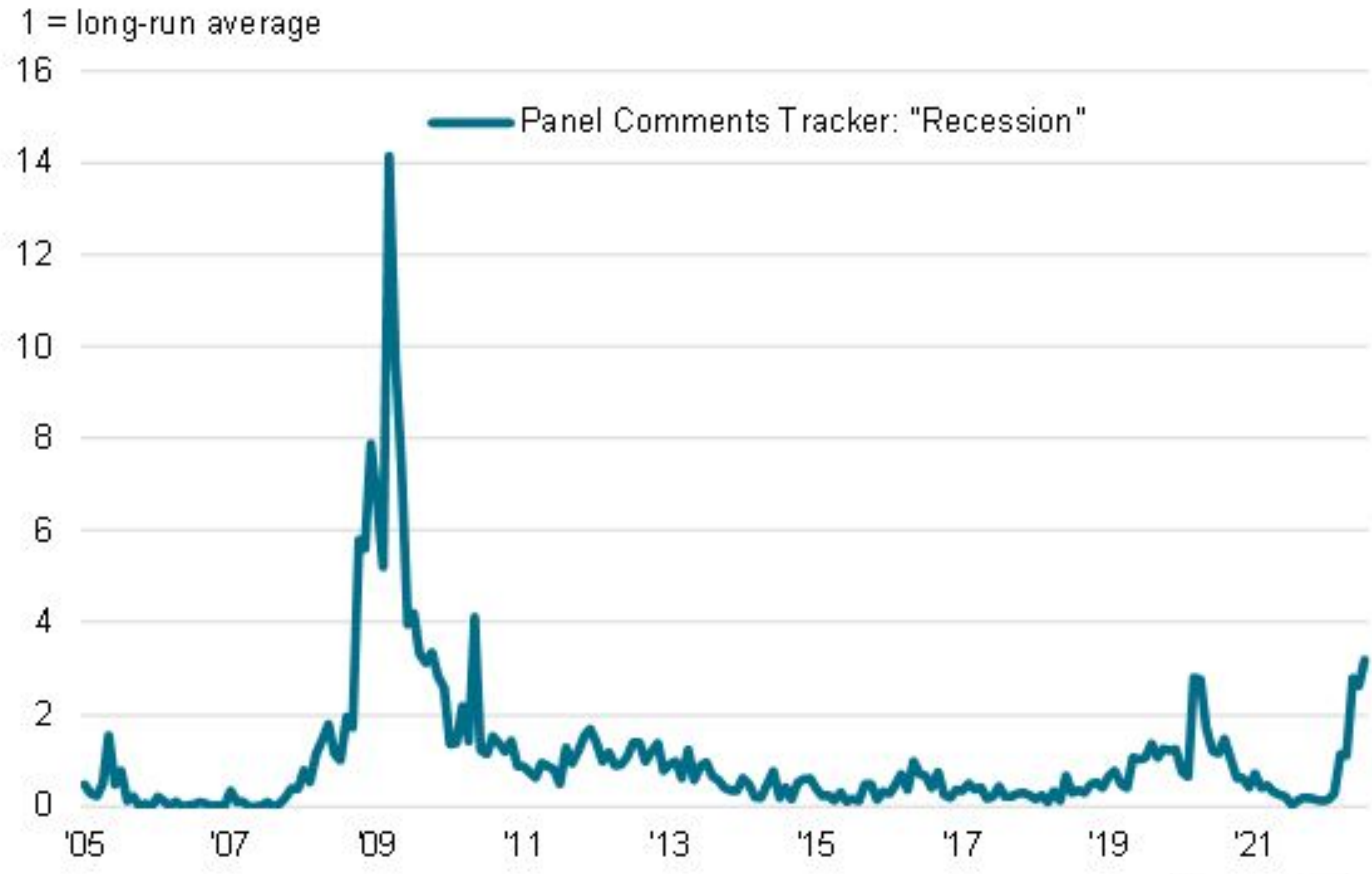

Figure 4. Survey Result on Firms Regarding Recession (Source: S&P Global)

While the number of firms mentioning recession increased slightly in July, global growth slowed, with the Composite Output Index for developed countries falling to 49.0. This signalled the first contraction in business activity outside of those seen in the pandemic, and it was the first time since October 2012. Even though the Federal Reserve, the European Central Bank and the Bank of England have all begun the process of tightening policy, PMI data is currently in an area that historically has been consistent with loosening policy.

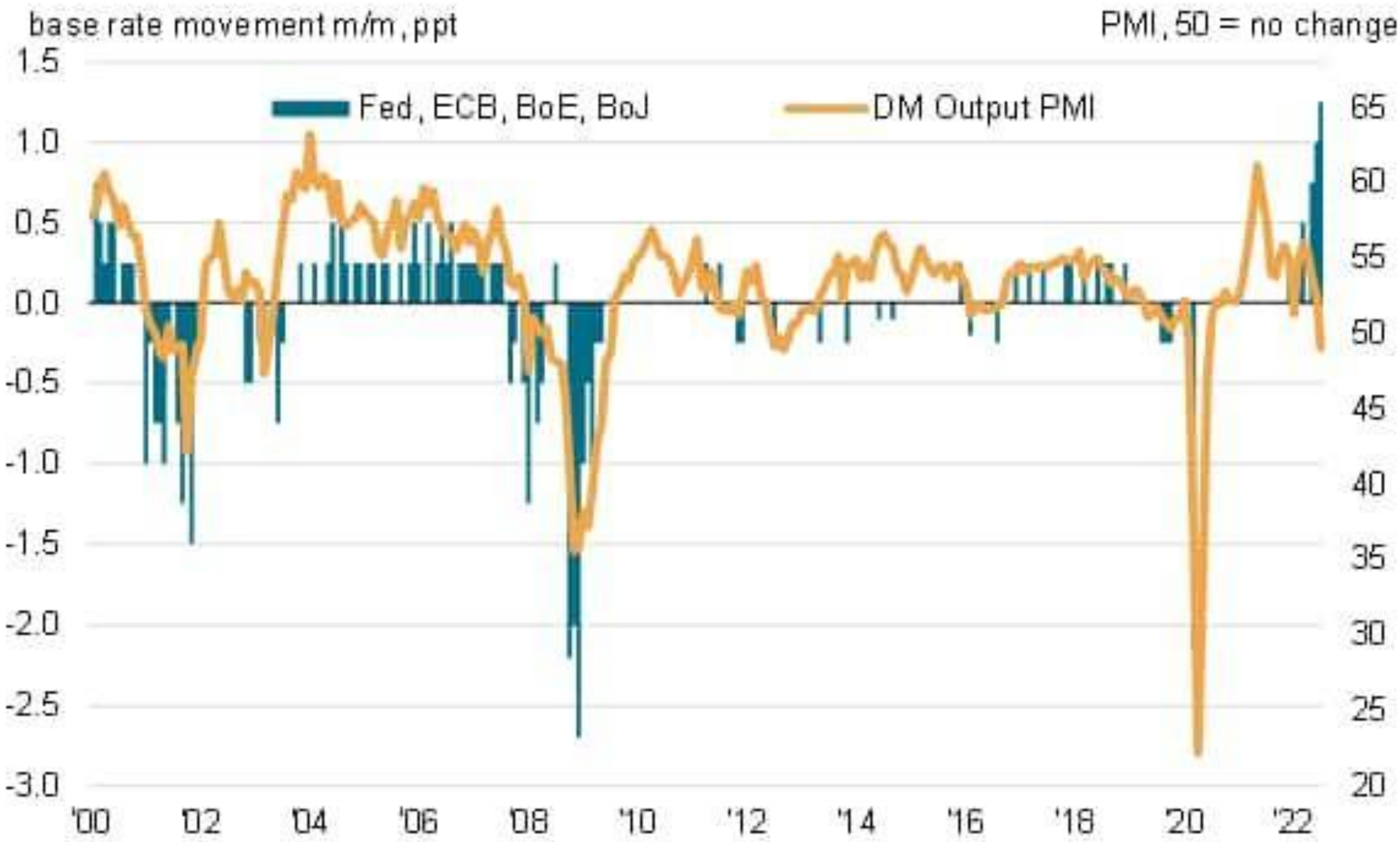

Figure 5. Rates rise as Economic Activity Declines (Source: S&P Global & JP Morgan)

Labour Market

If a recession does occur, the unemployment rate is likely to determine how long it lasts and how deep it goes. If job data remains resilient, it will likely encourage global central banks to continue their aggressive tightening to tame inflation.

July's reading of 52.1 on the Global Composite Employment Index (Developed Market Employment) was above the index's long-run average of 51.3, indicating reasonably robust job creation.

If we see a fast decline in employment, it might lead to a deeper downturn and drive a transition to looser monetary policy, or at least a pause in the hiking cycle. Comparing July job growth to new orders in the chart below suggests it will likely further slow down in August. Weaker jobs market figures put central bankers in a position where significant rate hikes risk growing unemployment and undermining economic conditions. Policymakers may be pressured to loosen policy in these circumstances.

Figure 6. Developed markets Employment and New Orders Data (Source: S&P Global)

Central banks may be apprehensive of rising nominal wages as firms battle for fewer workers due to global labour shortages. In this case, policymakers may welcome a rise in the unemployment rate.

Reports of increased wage costs hit a record high (since 2005) in July, as illustrated in the chart above, signaling substantial and growing pay pressures globally. Indicators of pay pressures will be critical to observe in the following months due to the tight labour market, high job openings and rising living costs.

Figure 7. Reports of higher input cost in firms due to wages (Source: S&P Global)

BONDS

The yield on the 2-year Treasury note rose by two basis points (bps) to 3.23%, the yield on the 10-year Treasury note increased by ten bps to 2.97% and the yield on the 30-year bond rate increased by eight bps to 3.22%. All contributing to a decline in Treasury prices.

Figure 8. 2-Year Treasury Bond Yield and Effective Federal Funds rate

Though the Fed shows no signs of stopping rate hikes, the Treasury market is already looking ahead because comparing the 2-year yield to the effective Fed funds rate suggests that aggressive monetary policy may be nearing its peak.

The 2-year rate is regarded as the critical indicator to track near-term policy expectations. The correlation between the 2-year Treasury yield and the effective Fed funds rate (the rate set by the Fed to direct overnight lending to banks) provides a real-time indicator of market expectations regarding current policy settings. The spread between the 2-year rate and the Federal Funds rate has narrowed considerably in recent weeks, implying that the market's judgement of the spread between where rates should be and present levels is narrowing. This is a significant change from late last year when the 2-year Treasury yield began rapidly climbing while the Federal Funds rate stayed steady. The growing gap at the time predicted that the Effective Federal Funds rate would shortly rise, which of course it did.

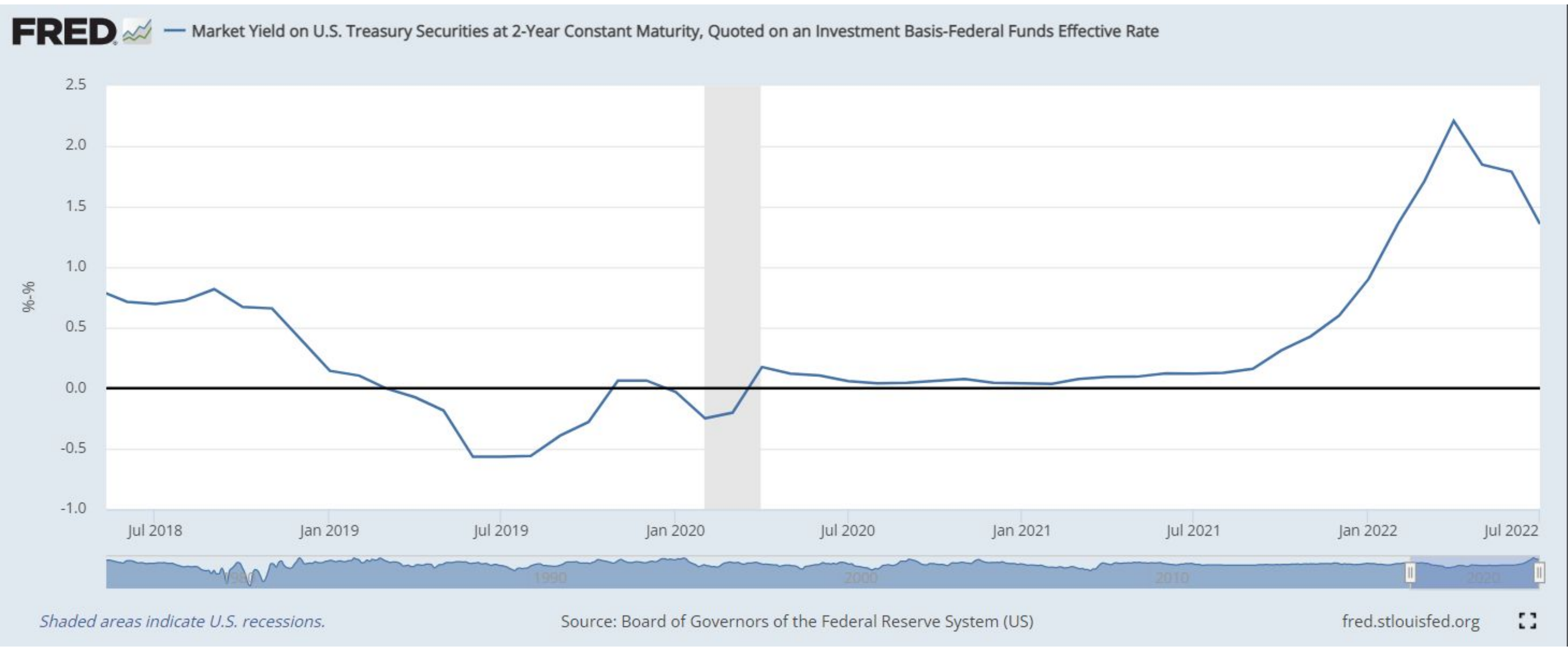

Figure 9. Spread for 2-Year Treasury Yield and Effective Federal Fund Rate

The chart above illustrates the spread for the 2-year rate less Effective Federal Funds Rate to provide a clearer picture of the connection. The spread's increase from late 2021 to early 2022 has dropped dramatically in recent weeks. That suggests that the market's estimation of the gap between where the EFF should be and where it is now has shifted significantly (based on data through August 18). Based on the falling 2-year/EFF gap, the Treasury market looks to be increasingly comfortable with the prospect that the heavy lifting for Fed hikes has peaked beyond September 21. Perhaps this is because the market expects inflation to peak soon (if it hasn't already) or that rising interest rates will induce a recession, easing inflation.

Forecasts are of course susceptible to uncertainty. Thus, the 2-year/EFF spread might be deceiving. Having said that, this spread must be monitored carefully in the coming weeks. One thing is certain: if this spread rises, the market is signalling that the Fed is losing control of the policy/inflation story. For the time being, though, the market is pricing in some progress through Fed policy.

Let's see whether that line of thought holds up in the next few weeks.

EQUITIES

The S&P 500 index lost ground towards the weekly close, ending a four-week winning streak. The market's upswing was halted after the release of FOMC meeting minutes from July. These minutes contained statements suggesting the central bank would continue to raise interest rates soon.

Figure 10. Dow Jones Industrial Average, S&P 500, Nasdaq Composite Price

The Dow Jones Industrial Average fell 292 points (0.9%) to 33,707, while the S&P 500 Index lost 55 points (1.3%) to 4,228 and the Nasdaq Composite was down 260 points (2%) to 12,707 on August 19. In moderate volume, 3.7 billion NYSE-listed shares and 4.5 billion Nasdaq-listed shares changed hands, respectively. Any conviction to continue a rally in the stock market has weakened in the face of Fed rate forecasts, rising bond yields, and a revival of the U.S. dollar index rally, up by 1.3% this week.

Figure 11. U.S. Dollar Currency Index

Next week, with earnings season coming to a close, all eyes will be on the economic calendar and the Federal Reserve. Federal Reserve Chairman Jerome Powell will deliver the keynote address at Jackson Hole, and we expect more volatility as economic watchers and investors digest the slew of economic data emerging this week.

Table 1. Important Economic Reports to Watch for the Week

Economic Reports	Release date
S&P Global Flash U.S. Composite PMI	August 23
July Pending Home Sales Index	August 24
Gross Domestic Product (Second Estimate) and Corporate Profits (Preliminary), 2nd Quarter 2022	August 25
Personal Income and Outlays, July 2022	August 26
University of Michigan final Consumer sentiment index	August 26

Cryptocurrency

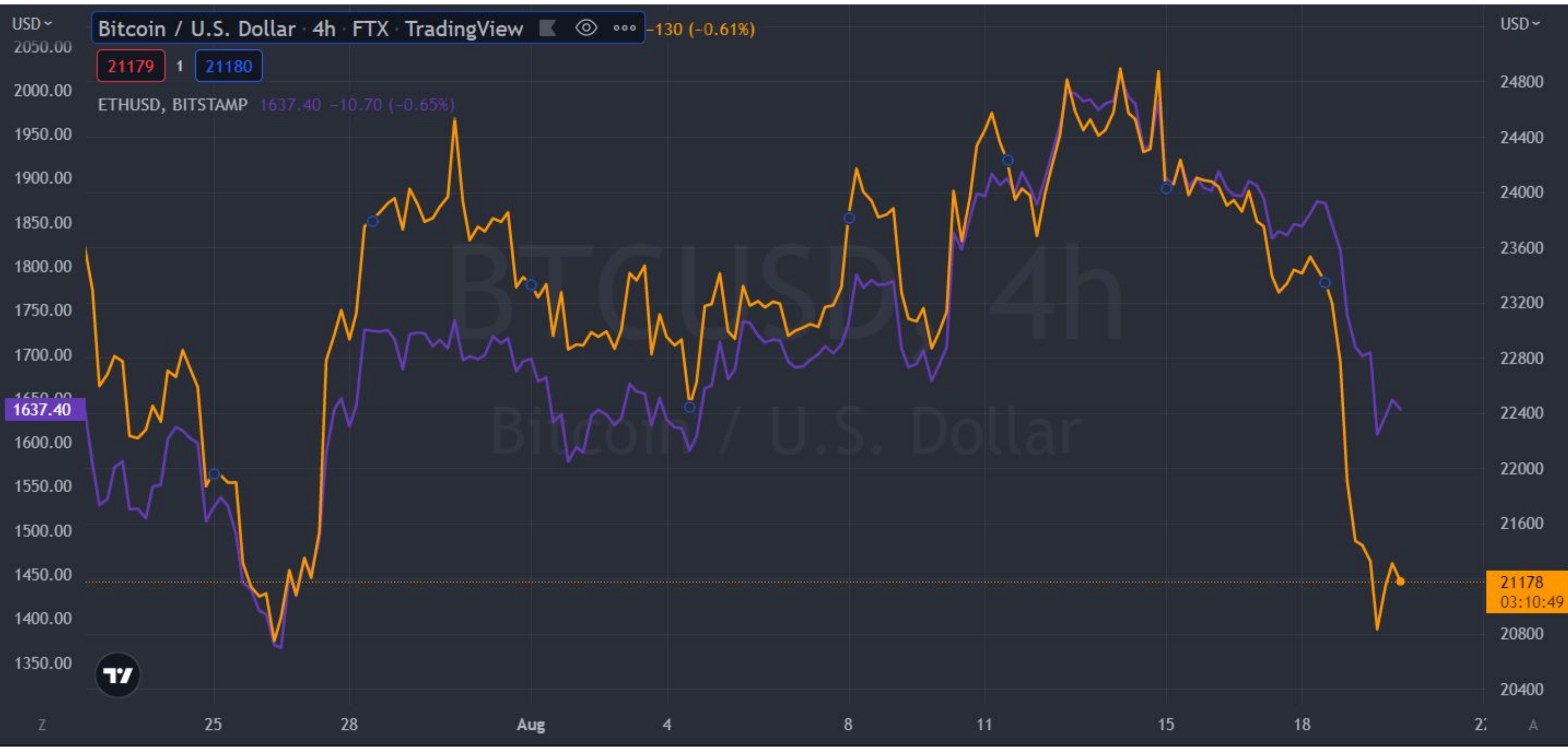

Figure 12. Bitcoin and Ethereum Prices in USD

With the S&P 500 rejecting and failing to continue its recovery, cryptocurrencies fell sharply on Friday, with sudden selling dragging Bitcoin to a three-week low. Bitcoin appears to have lost its momentum, dipping significantly and currently trading at $21,187 as of August 20. Ether, the world's second-largest cryptocurrency, also fell, trading at $1,637. The total market cap of the cryptocurrency market has decreased by more than $58 billion. After Fed officials crushed hopes for relief from rate hikes anytime soon, the crypto market retreated along with stocks as investors fled towards riskier assets.

Summary

- Retail sales showed consumer spending remained resilient through July.
- In recent months, reduced supply-chain friction, and a cooling commodity market have eased inflationary pressures. Slower input cost inflation eased manufacturing and service provider pressures.
- Central banks may be apprehensive of rising nominal salaries as firms battle for limited workers amid global labour shortages.
- The S&P 500 ends the week in the red, snapping a four-week winning streak.
- The spread between the 2-year rate and the EFF has narrowed considerably in recent weeks, implying that the market's judgement of the spread between where rates should be and present levels is narrowing.
- The link between the 2-year Treasury yield and the effective Fed funds rate indicates market expectations about current policy settings. The difference between the 2-year rate and the EFF has recently reduced, indicating that the market's assessment of where rates should be is narrowing.
- Last Friday's sell-off pushed bitcoin to a three-week low, and crypto market cap dropped more than $58 billion

WHAT’S ON-CHAIN THIS WEEK?

Miners find relief

This week, we attempt to answer the most crucial question concerning BTC miners. Is the worst behind us?

Public miners are still liquidating their Bitcoin holdings, but not nearly to the same extent as during the mining bloodbath earlier this summer. A new generation of forced Bitcoin sellers emerged as a result of significant Bitcoin price depreciation in May and June when well-known institutions dumped around 240,000 BTC. Public Bitcoin miners had spent 2021r accumulating one of the largest Bitcoin treasuries due to their "HODL at any cost policy." The public Bitcoin miners, like most ardent holders with such significant hoards, could not however elude the grasp of the bears, triggering the sale of thousands of Bitcoin in May and June at fire sale rates.

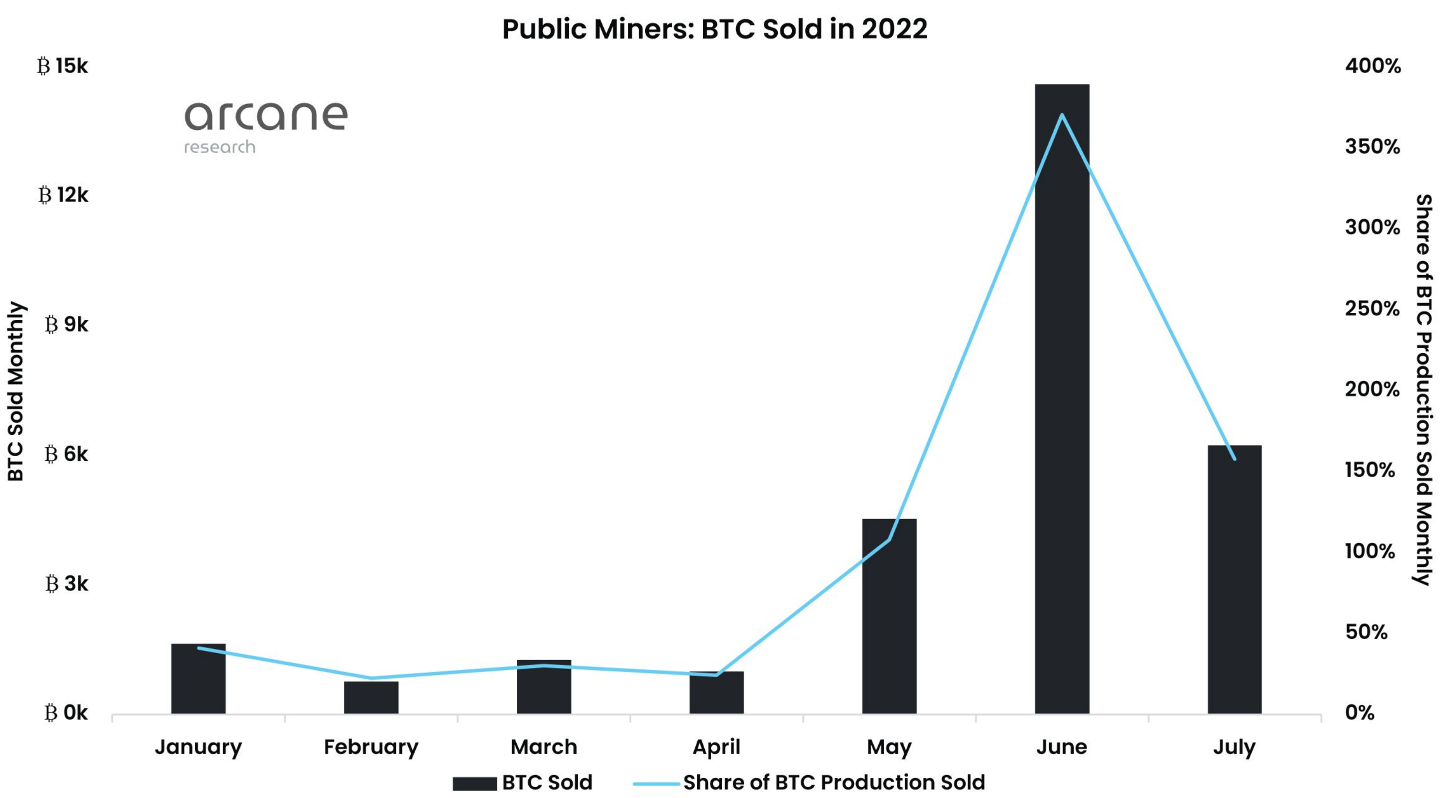

Figure 13. Public BTC miners monthly production and selling rate. (source: arcane research)

Since then, the public miners' selling pressure has diminished because they sold 6,200 BTC in July (data for August so far is not confirmed, but reported numbers follow the same trend of diminished selling), which is less than half of what they sold in June. Despite the decline evident from the above figure, it is prudent not to call bull yet since July still had the second highest selling numbers out of all the months in 2022.

What is the reason behind this decline?

Miners are very reactionary entities. They do not speculate on market movements regardless of their treasury balances. The reason is – simply because they do not need to. BTC mining could merely be seen as any other mining operation rather than something related to the crypto industry. The way miners react to market movements is apparent through their on-chain activity. Their primary objective is to keep mining and accumulating BTC throughout the bull/bear market and use that as collateral to acquire more machinery and space to mine more Bitcoin further.

Now, keeping this behaviour in mind, we analyse the July decline. The dark side of the "hodl at any cost strategy", is that the lower the Bitcoin price goes, the more likely miners who follow this strategy are to sell their Bitcoin. While the BTC price plummeted 41% in June, it rebounded in July and gained 26%. This naturally gave the public miners some breathing room, and June's forced selling was followed by reduced selling and even some accumulation by the miners. July has seen more natural selling pressure related to de-risking as part of funding expansion plans, as explained in the section above.

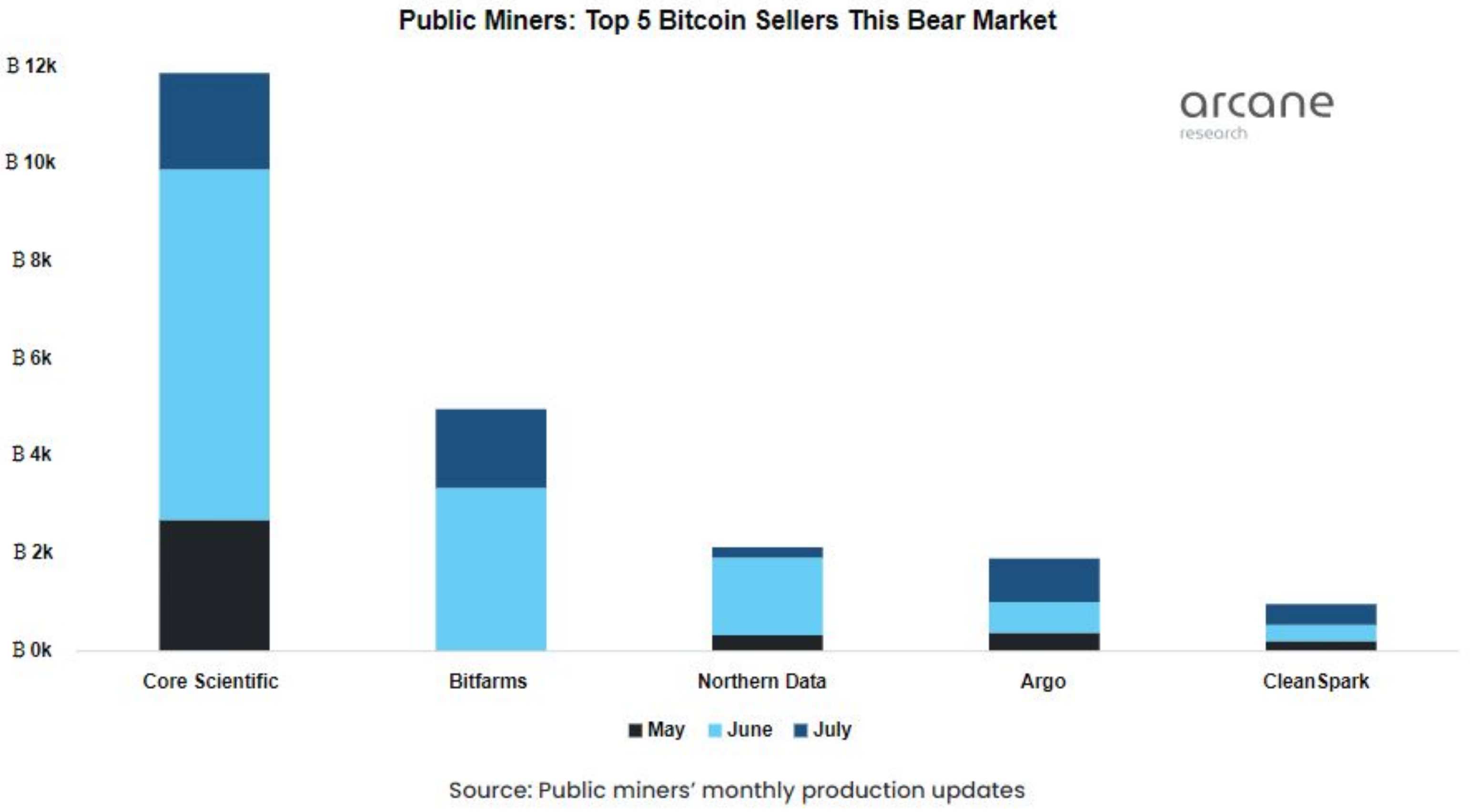

Figure 14. Top Bitcoin sellers since May amongst Miners. (source: arcane research)

The forced sellers from June also spent some time that month reorganising their balance sheets. Core Scientific and Bitfarms were two of the miners with the most extensive amounts of equipment and Bitcoin collateralized debt, although they both reduced these amounts dramatically in June. Since they were compelled to sell- to avoid being liquidated, these businesses were the biggest Bitcoin sellers in May and June, easing the foot off the selling pedal in July.

Negligible Hash rate growth

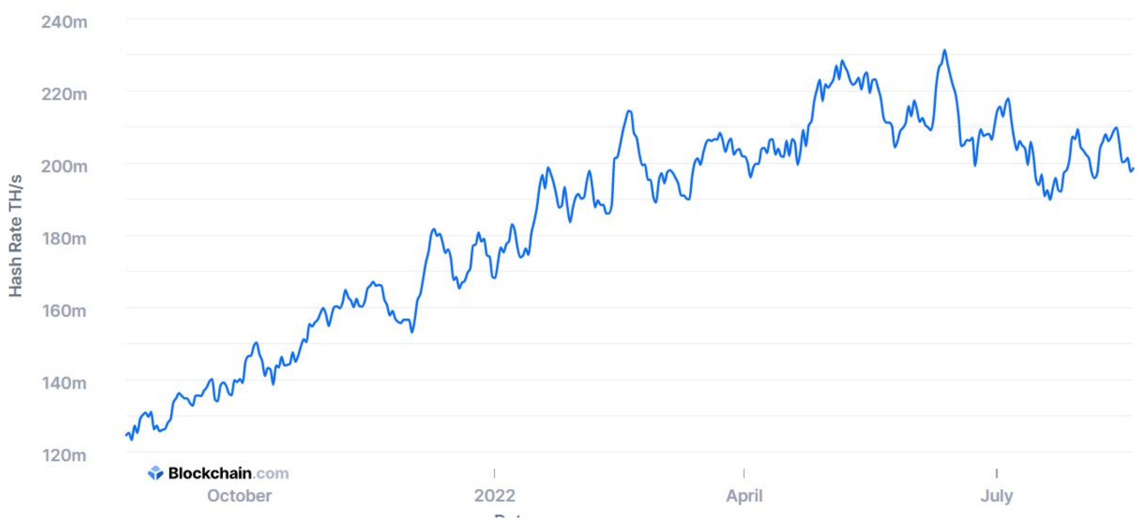

Figure 15. Total Hash Rate (TH/s) (source: blockchain.com)

There has been zero sustained growth in the Bitcoin hash rate since March. The current rate is hovering at around 220 EH/s (exahash per second), the same as six months ago. The weak Bitcoin price has disincentivised miners from expanding capacity. In addition, supply chain issues have made hash rate expansion challenging as there is a considerable lack of data centre capacity to plug in the machines.

Hash rate growth has fallen short of all expectations since the beginning of the year. *Bytetree* had predicted the hash rate to surpass 300 EH/s by the end of 2022 but the stagnating growth and massive decline over the past two weeks only gives us reason to believe that the hash rate could have already peaked for the year.

Aside from that, we observe that the quantity of active addresses is returning to normal. Currently, there are 928,000 active addresses on a 7-day average, up from 834,000 in the middle of June.

In addition, daily transaction volume has climbed by 13% in the second and third week of August in addition to the rise of active addresses. The average transaction cost over the previous seven days was only $1.4, despite the fact that on-chain activity has been increasing. Transaction costs are now quite low historically, only 1.7% of miner revenues. Since 2011, the historical average has been 3.2%.

NEWS FROM THE CRYPTO SPHERE

$107.9 Million Loss in Q2/2022, Greenidge Cancels Expansion to Texas

Figure 16. During the second quarter, Greenidge saw its revenue fall 17%.

Bitcoin (BTC) miner Greenidge Generation Holdings (GREE) announced Monday, August 15, that it will “pause” some parts of its expansion in Texas. Instead, it will focus on existing sites in South Carolina and New York.

The company released a statement saying that it had paused plans to develop specific additional sites in the ERCOT market (Electric Reliability Council of Texas, which manages the Texas electrical grid).

The company instead chose to focus its operations on two areas in South Carolina and New York. According to a statement on August 15th, the company suffered a net loss of $107.9 million in the second quarter, mainly due to a one-time non-cash charge of $71.5 million.

Greenidge Generation's Chief Executive Officer, Jeff Kirt, said that the ~60% drop in Bitcoin prices in the second quarter, and the rise in global energy prices presented a “challenging earnings environment.”

“The sudden change in mining economics has driven us to refocus our strategy to prudently prioritise liquidity and capital preservation over aggressive growth – while maintaining our relentless focus on operational performance,” Kirt said.

The company expects to have at least 3.6 EH/s of mining capacity by the first quarter of 2023, having finished the second quarter at 2.5 EH/s.

During the second quarter, Greenidge mined 10.7% more bitcoin (621 BTC), but its revenue fell 17% compared to the first quarter to $31.3 million.

The New York's Department of Environment Conservation recently denied the company its air permit renewal. However, The company stated that it would challenge the regulator's decision and continue mining in the meantime.

While no adjudicatory proceedings have been scheduled to date, Greenidge has been advised that, based on the progression of previous and ongoing cases of a similar nature, the appeals process may take several years to resolve fully.

Do Kwon Speaks Out On Terra LUNA's Collapse

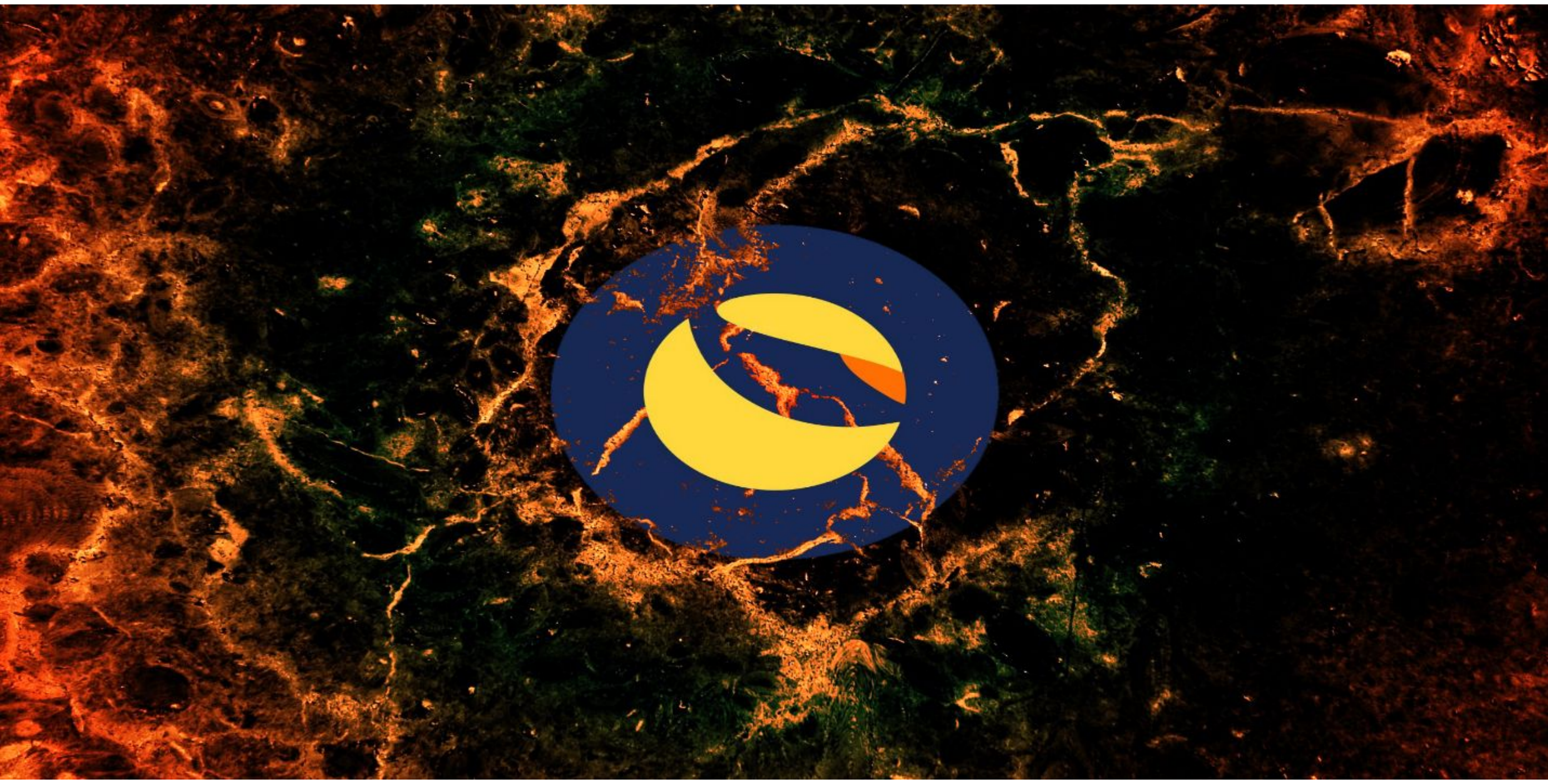

Figure 17. This would be the first public appearance for the Terra Luna founder since May.

Terra founder Do Kwon, in a recent interview with Zack Guzman of *Coinage* on Monday, August 15, agreed that his confidence in the success of the Terra ecosystem, in hindsight, looked pretty irrational. He once commanded a sprawling crypto empire nearing $100 billion in value which imploded within six days in May.

“I’ve never thought about what could happen to me if this fails,” said Do Kwon.

According to a Blockworks report, Do Kwon claims there may be insiders at Terraform Labs (TFL), the entity behind the Terra project, who took advantage of the information on the protocol’s vulnerabilities to profit.

Although he did not name anyone, Do Kwon stated, “I, and I alone, am responsible for any weaknesses that could have been presented for a short seller to start to take profit.”

While the paper billionaire can't count the losses, Do Kwon describes it as a “down infinite” moment.

“There are probably not too many people that are alive with this type of experience, but it’s like, over the past five years, I just lived and breathed Terra," he said.

He said that Terra is not a Ponzi scheme as early investors have been hit hardest by the crash. Do Kwon himself faces fraud charges in South Korea, among other potential legal risks.

“So what we’re going to do is we’re just going to put out the facts as we know them. We’re going to be totally honest and deal with whatever consequences as they may be,” he told Zack Guzman.

Do Kwon, who had moved to Singapore before Terra's spectacular destruction, said he did so fearing the safety of his wife and child.

Genesis CEO Steps Down As It Cuts 20% Of Staff

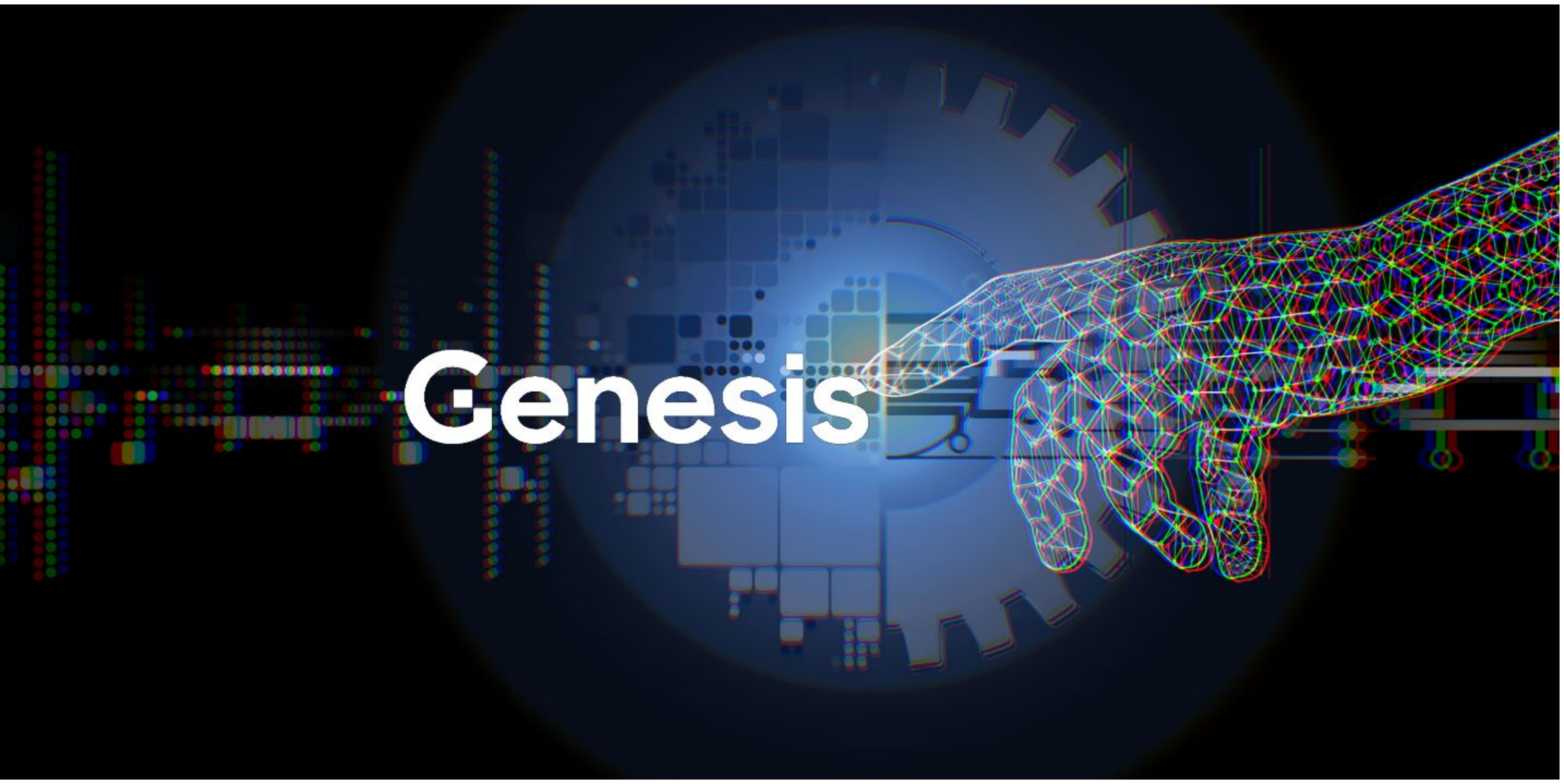

Figure 18. Genesis joins the long list of crypto exchanges and brokers that have layed off major percentages of staff.

Cryptocurrency broker Genesis Trading announced on Wednesday, August 17, that the company's CEO, Michael Moro, will immediately step down from his role.

The company's Chief Operating Officer (COO), Derar Islim, will serve as interim CEO while the company searches for a permanent replacement.

“It has been an honour to lead Genesis for nearly a decade and I look forward to supporting the company's next phase of growth,” said Michael Moro, who will continue to advise the company during the transition.

The company also said it was letting go of 20% of its 260 employees to reduce operating costs, according to *Reuters*.

“The changes and investments we're announcing today affirm our commitment to operational excellence as we continue to expand our services to meet the needs of our clients today and into the future,” said Derar Islim.

As part of the leadership reshuffle, Genesis also hired several key executives, who, as the company hopes will “further strengthen its governance and position the firm for the future.”

These include Chief Risk Officer Michael Patchen, Chief Compliance Officer Michael Patterson, Chief Technology Officer Matthew Johnson, Chief Financial Officer Alice Chan, and Chief Legal Officer Arianna Pretto-Sakmann.

Meanwhile, Genesis Senior Advisor, Tom Conheeney, said he was thrilled to join the Genesis board of directors.

“I’m thrilled to join the Genesis Board. I also look forward to working with Derar and the team to bolster key areas of Genesis and to expand the firm’s market position with more traditional financial institutions and alternative asset managers looking for investment opportunities in digital assets,” said Tom Conheeney.

Genesis is a wholly-owned subsidiary of Digital Currency Group (DCG) and has emerged as a digital asset trading and lending company with hundreds of institutional clients worldwide.

Bloomberg reported that Genesis was the biggest lender involved in the Three Arrows Capital (3AC) collapse after the hedge fund defaulted on margin calls from multiple partners.

Genesis is known to have lent $2.36 billion to 3AC. After taking over Genesis' obligations, Digital Currency Group, assumed several liabilities and filed a $1.2 billion claim against 3AC, which is currently in liquidation.

Dragonchain Sued By The SEC For Unregistered Crypto Asset Securities

Figure 19. Social investment platform eToro to acquire fintech startup Gatsby for $50M.

Multi-asset social investment network eToro announced on Wednesday, August 17 that it has signed a definitive agreement to acquire Gatsby, a US-based options trading platform.

Gatsby is a commission-free options and stock trading app geared toward a younger audience. It was founded in 2018 by co-CEOs and co-founders Jeff Myers and Ryan Belanger-Saleh.

In the filing for acquisition approval to the Securities and Exchange Commission (SEC), it was stated that the acquisition value of Gatsby reached $50 million. *TechCrunch* reported that eToro has received approval from the Financial Industry Regulatory Authority (FINRA), to move forward with the acquisition.

According to *TechCrunch*, eToro CEO and co-founder Yoni Assia stated that the acquisition will allow the trading network to offer its users in the United States "a safe and simple way to trade options, and give them more flexibility to use new strategies."

"Between 2019 and 2022, Roets, Dragonchain, the Foundation, and TDC allegedly offered and sold approximately $2.5 million worth of DRGNs to cover business expenditures to further develop and market Dragonchain technology, some of which occurred after a state regulator found DRGNs to be securities," the SEC said in a statement.

As a result, in a complaint filed in the Western District of Washington, the SEC charged the defendants with violating Sections 5(a) and (c) of the Securities Act of 1933.

eToro Expands To The US By Acquiring Fintech Trading App Gatsby

Figure 20. The crypto exchange joins an array of centralised service providers suspending withdrawals and trading.

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“We believe that options can offer retail investors opportunities to generate returns in today’s more challenging market environment. Scaling our U.S. business is a key goal and we are excited to be partnering with the Gatsby team,” he added.

Meanwhile, Gatsby Co-founder Jeff Myers stated that the product and vision compatibility between “Gatsby and eToro is undeniable” and has no plan to end the Gatsby story yet.

“We’ve long admired Yoni and the team he’s built and are very excited to continue our journey together with eToro,” said Jeff Myers.

eToro has grown into one of the world's largest investment companies. Assia explained that the company currently has more than 30 million users spread across 100 countries, which is triple the 10 million of eToro users reported in 2018.

“The company generated total commissions of $1.2 billion in 2021, growth of over 400% compared to 2019," said Assia.

LEARNING SECTION

ETHEREUM MERGE

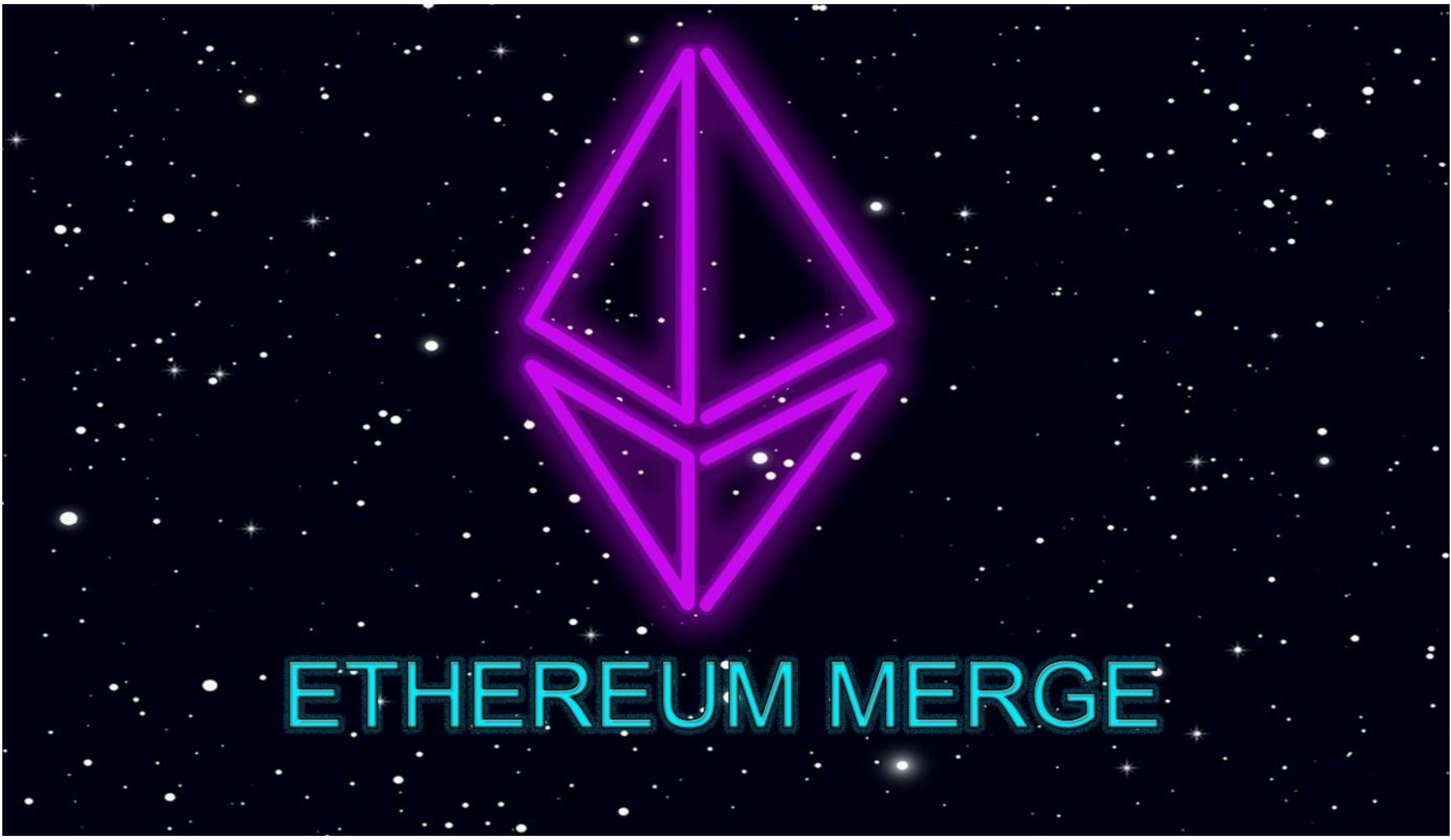


Figure 21. The Ethereum Merge

The Ethereum Merge is arguably the most significant event in the crypto industry since the Bitcoin whitepaper, and perhaps the most important upgrade in the history of the Ethereum blockchain. But what does the Ethereum Merge imply and how significant is it for the Crypto industry?

Purpose

We begin our understanding of the Ethereum merge, by first looking at the motivation behind it. Its main purpose is to transition from the blockchain's current proof-of-work model to a proof-of-stake consensus mechanism. The purpose is to make the blockchain more energy-efficient, secure and enable scalability in the future, including sharding. The proof-of-stake mechanism aims to reduce energy consumption by up to 99.95%

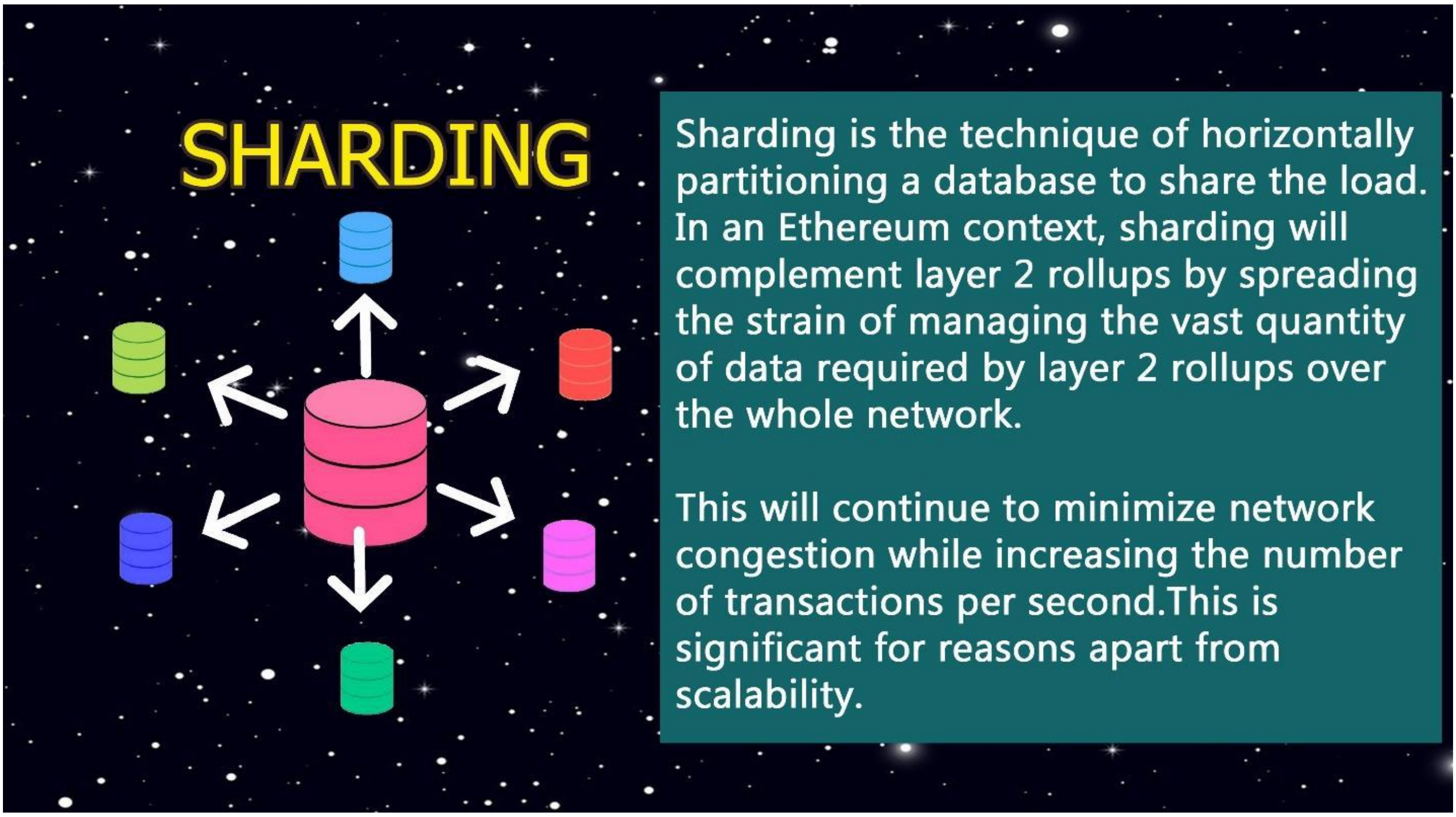


Figure 22. Sharding

In the proof-of-work mechanism, there are miners that purchase and run the rig. The miners require computational power to issue a block and earn a portion of the transaction fee. This is how the network is secured. On the other hand, with a proof-of-stake mechanism, the network is secured by validators that lock up a set amount of Ether in exchange for a chance to validate transactions and earn rewards through transaction fees.

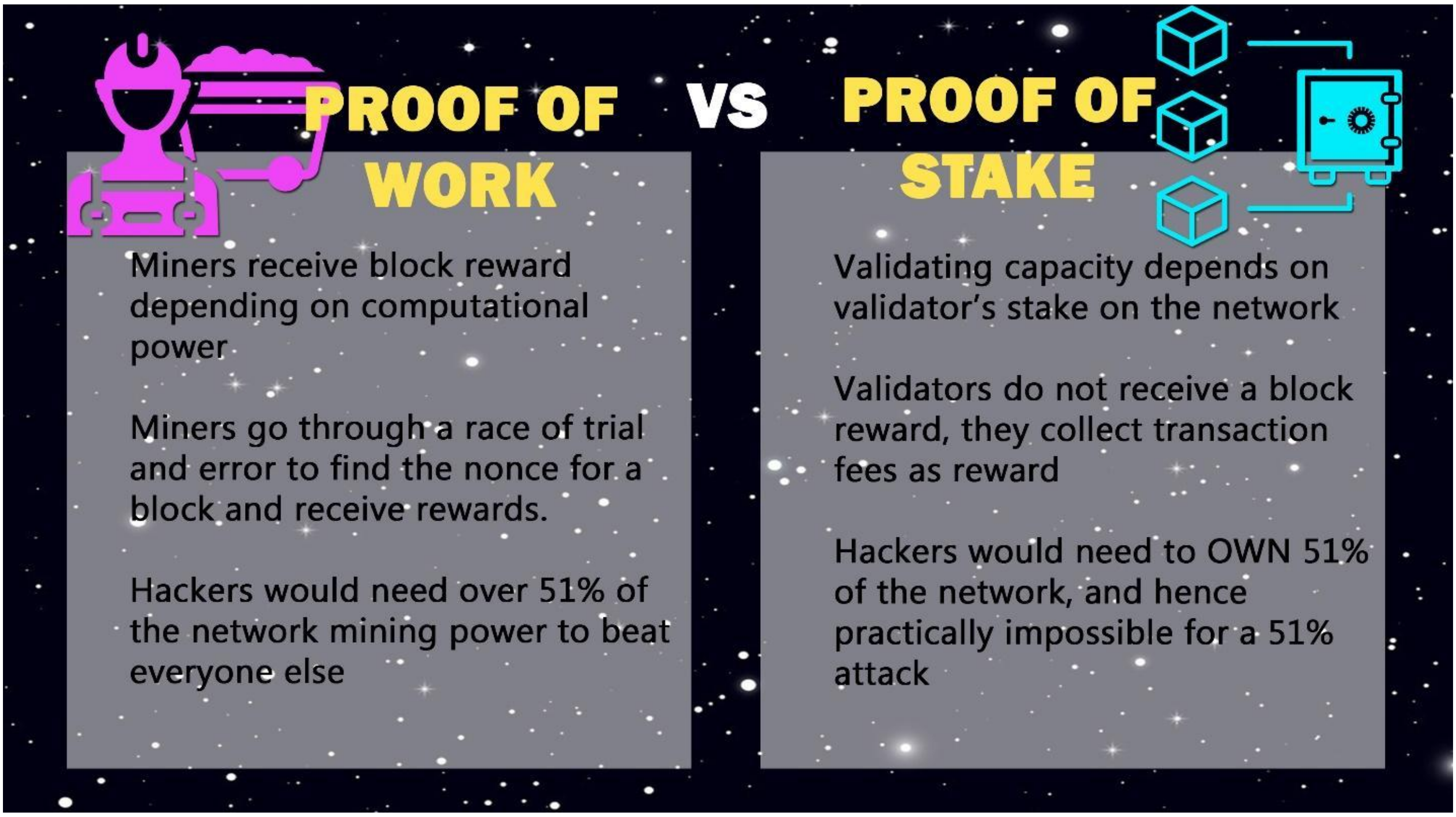


Figure 23. Proof-of-Work vs Proof-of-Stake

HOW DOES THE TRANSITION WORK?

Instead of a major transition to a new consensus mechanism, researchers and developers for Ethereum decided to break the transition into two steps. First is shipping the Beacon Chain that runs in parallel with the Mainnet. The accounts, balances and smart contracts in the mainnet using proof-of-work while the Beacon Chain runs in parallel using proof-of-stake. This allows the Beacon chain to be tested for a period of time without having a direct impact to the mainnet and hence minimizes the dangers that comes along with a major transition. Running the Beacon Chain in parallel also gives enough time for the users to stake ETH to lock a sufficiently huge amount to secure the network.

The second step is merging the Beacon chain with the EVM state of the Ethereum Proof-of-work mainnet.

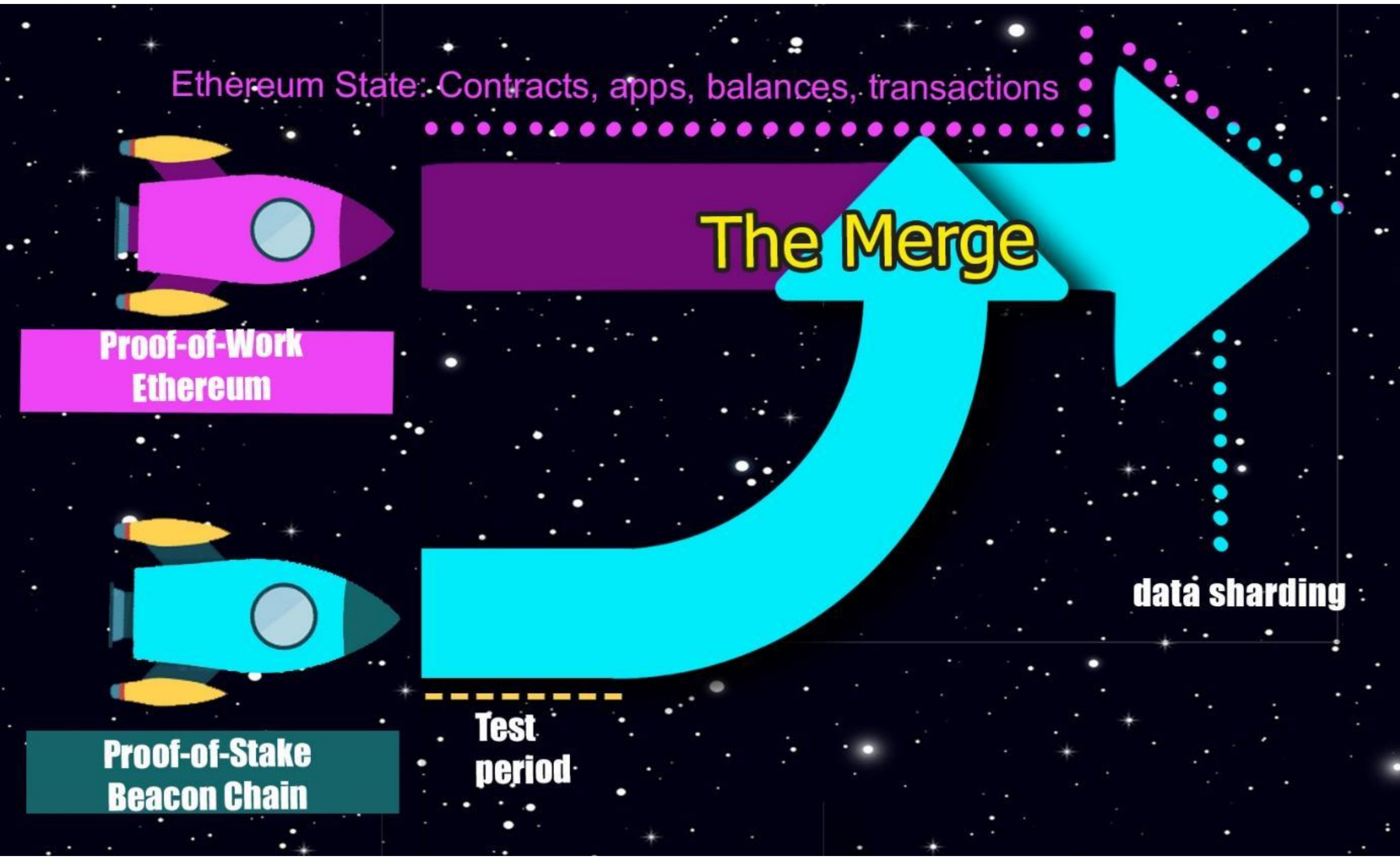


Figure 24. Ethereum Merge with the Proof-of-Stake Beacon Chain

We can imagine the mechanism of the Ethereum Merge as two spaceships running in parallel, the main Ethereum network being the old spaceship and the ‘Beacon chain’ being new. The old spaceship will have to undertake a long, demanding voyage but its engine is not made for such a journey. On the other hand, a newer spaceship was built with an engine that is robust and more suited for the voyage but has not been field tested.

The aim is to replace the old spaceship's engine with a new one without requiring the old spaceship to make a complete stop. At the same time, the new spaceship's engine has to be tested under the same conditions. So, the new spaceship runs in parallel with the old one. After the new spaceship is tested, the spaceships will swap engines mid-flight.

In this case, the old spaceship will be primed for the difficult voyage without stopping. In the case of Ethereum, "stopping the spaceship' will cause major disruption to Ethereum users. Also, in this switch, astronauts in the old space ship or in this case, the Ethereum users, will not have to transfer to another spaceship and will barely notice any change. The rest of the Ethereum state, its transactions, applications, contracts and balances remain unchanged and are carried along during the Merge.

THE ECONOMIC IMPLICATIONS

The Merge will put an end to the argument that Ethereum, DEFI and NFT’s are bad for the environment. This will make Ethereum an attractive investment for institutions that need to comply with ESG rules.

Moreover, the Merge will decrease the issuance of ETH tokens. If the Merge is successful, the proof-of-work network will stop existing and hence decrease the issuance of ETH. Currently, the total ETH supply increases by 4.3% annually which is a way of incentivising miners to secure the blockchain. After the Merge, the validators will have exclusive right to block creation thereby reducing Ethereum’s energy requirement. This decrease in issuance is popularly referred to as the “Triple Halving”.

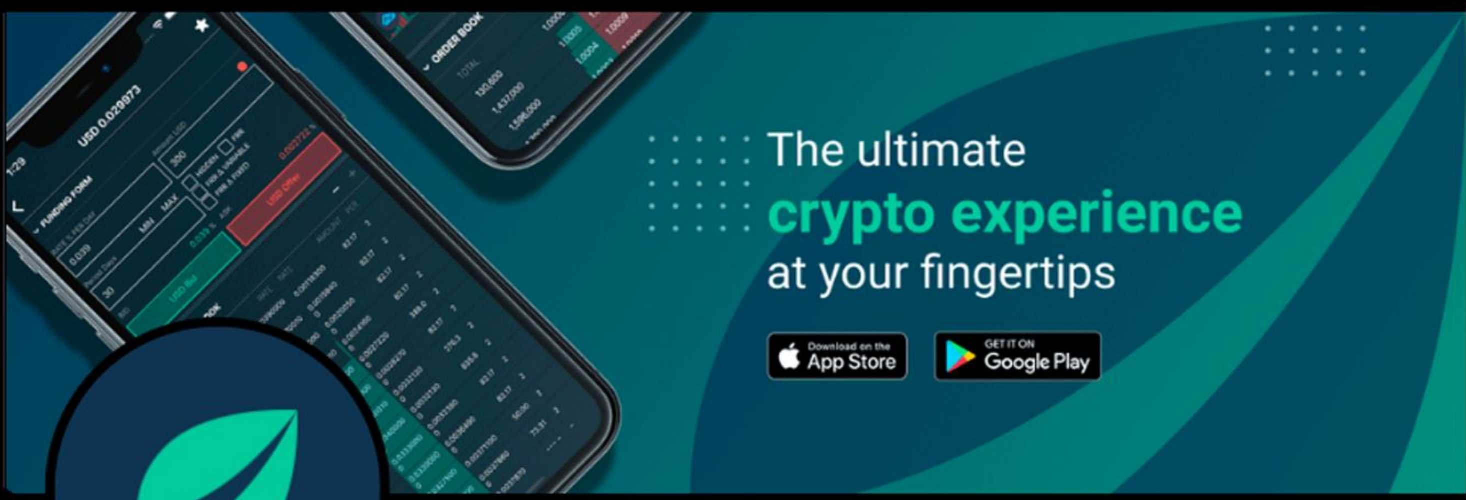
The Triple Halving is caused by three things:

1. Issuance of ETH dropped from 4.5% to 0.4%. Investors are watching the Merge as they expect that the decrease of issuance in ETH will play out with the basic Economic law of Supply and Demand and anticipate the price to go up.
2. In August 2021, ETH burning was the most significant upgrade in the network, known as the London Hard fork. To confirm transactions on the blockchain, users pay a gas fee. The gas fees are paid for the computing energy required to validate transactions. In the London Hard Fork, the transaction fees are taken from the circulating supply instead of giving all transaction fees to validators. This makes ETH become scarcer.
3. ETH staking on the Beacon chain is a way of securing the network. Users are compensated with block rewards for staking ETH. Staked ETH will prevent users from withdrawing their staked ETH until six months after the Merge. This too will reduce the circulating supply

Another important implication of the Merge is that users will be able to participate in securing the network in their own homes instead of this activity being the exclusive preserve of institutions and large miners. This will make the network more decentralised and hence more attack-resistant.

What do You need to do before the Merge?

If you own ETH or ERC-20 token whether in a hot wallet or cold wallet you do not need to do anything. Despite the change from proof-of-work to proof-of-stake, Ethereum's entire history since its inception remains intact and unaltered. Any funds in your wallet prior to The Merge will remain accessible following The Merge. You are not required to take any action upgrade.



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