BITFINEX Alpha

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EXECUTIVE SUMMARY

After 425 basis points of interest rate increases over the last 12 months, there has finally been some reward. The latest reported decline in consumer price inflation has not only given risk assets a boost, but also provided leeway to the Federal Reserve to relax the pace of future rate increases. Currently, another 25 basis point rise is expected at end-January, although critical factors for inflation still remain to be tackled, including wage inflation.

Consumers are certainly feeling more bullish, with sentiment forecasts predicting three percent inflation, which is half of where we are now.

It should be noted, however, that even this bullish indicator is still 100 basis points higher than the Fed's preferred two percent inflation target, and with import prices rising as the US dollar depreciates on a trade weighted basis, the fight against inflation is not over yet.

The bond markets also acknowledge this. The yield curve remains resolutely inverted, with the spread between two-year and 10-year treasuries, now at its widest in four decades.

In crypto markets, Bitfinex Alpha's predictions of volatility for end of December and early January played out, as did our view that whales would be a key driver for price rises. The last week saw a substantial wipe out of shorts, with the ratio of short versus long liquidations for Bitcoin and Ether, at its highest since July 2021.

While the rally looks promising on paper, the reality is that there are still limited traders in the markets with the recent leg up driven purely by sentiment, low funding rates and cascading short liquidations. The market remains highly illiquid and with the sharp fall in Open Interest over the weekend, a pull back is still possible.

In the meantime, the crypto space remains anything but boring. The last week saw FTX lawyers announcing they had uncovered $5 billion in assets, while former CEO Sam Bankman Fried again sought to explain the bankruptcy and the events leading up to it. El Salvador voted to introduce a new digital asset securities law, paving the way for the long-awaited Volcano Token, of which Bitfinex is the financial technology provider. And Voyager received preliminary permission from the bankruptcy courts to sell its customer accounts to Binance.US for over $1 billion. The SEC also charged Gemini and Genesis for selling unregistered securities and NEXO, the crypto asset lender was raised by police in Bulgaria.

It's always interesting in crypto!

Happy Trading!

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GENERAL MARKET UPDATE

Inflation Slows: Paving the way for Slower Rate Hikes

After reaching a 40-year high last summer, the inflation rate in the United States fell by 0.1 percent in December, marking the first decline since the start of the pandemic in 2020 and suggesting a continued slowdown in inflation, according to a report released by the US Bureau of Labor Statistics on Thursday, January 12.

Annual inflation rate has now dropped for a sixth consecutive month from 7.1 to 6.5 percent. This is the lowest rate in the past 12 months and is down from a peak of 9.1 percent in June 2022.

The continued decline in overall goods prices was critical in improving the inflation numbers. The prices of used automobiles fell by 2.5 percent, the value of energy dropped by 4.5 percent, and some items in the service sector, such as airline tickets, fell by 3.1 percent.

The 9.4 percent decline in gasoline price compensated for the 0.8 increase in 'shelter' costs, and placed downward pressure on the headline inflation print for December.

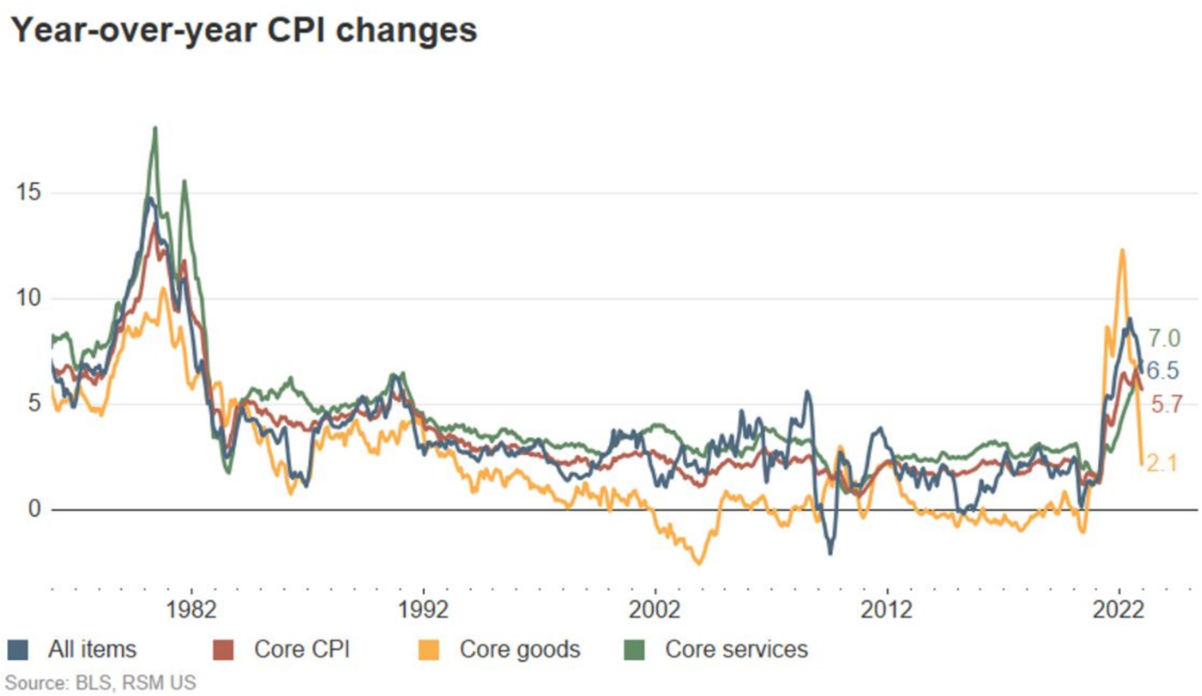


Figure 1. YoY reported figures for CPI and its components (Source: Bureau of Bureau of Labor Statistics, RSM US LLP)

Core inflation rose to 0.3 percent month-over-month (MoM) from 0.2 percent the previous month. Year-over-year (YoY) however, core inflation is 5.7 percent, down from a previous reading of 6 percent. Moreover, the three-month annualised core inflation rate also dropped from 4.3 percent to 3.1 percent, which is encouraging for all risk assets. With wage growth hovering around 5 percent (from the last Employment cost index report), this drop should come as a welcome relief to the Federal Reserve (the Fed), which is worried about overshooting its goal of preventing a wage-price spiral.

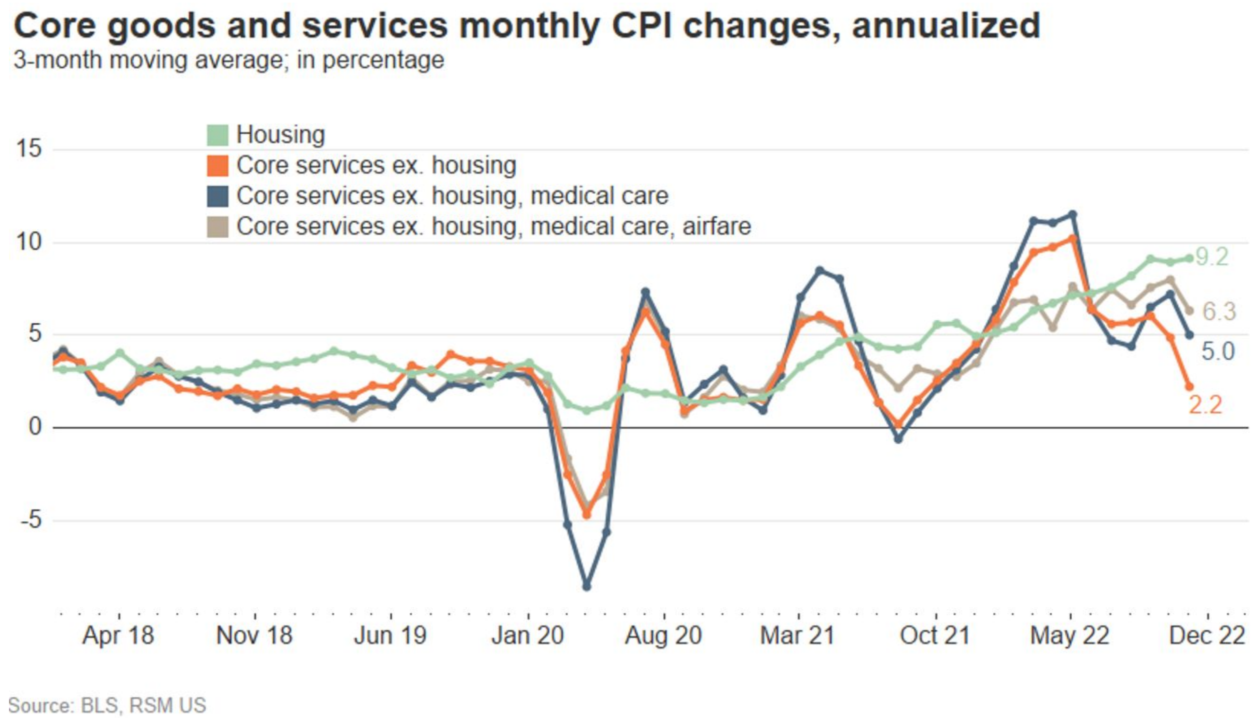


Figure 2. Core goods and services MoM CPI changes since 2018. (Source: Bureau of Bureau of Labor Statistics, RSM US LLP)

The Fed has raised its policy rate by 425 basis points over the past year. The recent inflation print shows ample evidence that inflation is cooling down, and the year's outlook is promising. The latest CPI data gives a more distinct pathway for a potential pause from the Fed’s jumbo rate hikes in 2022. Moreover, the spike in energy prices from a year ago will decrease, allowing for a more reliable yearly inflation rate comparison. This will put downward pressure on top-line and core inflation to nearly four percent this year.

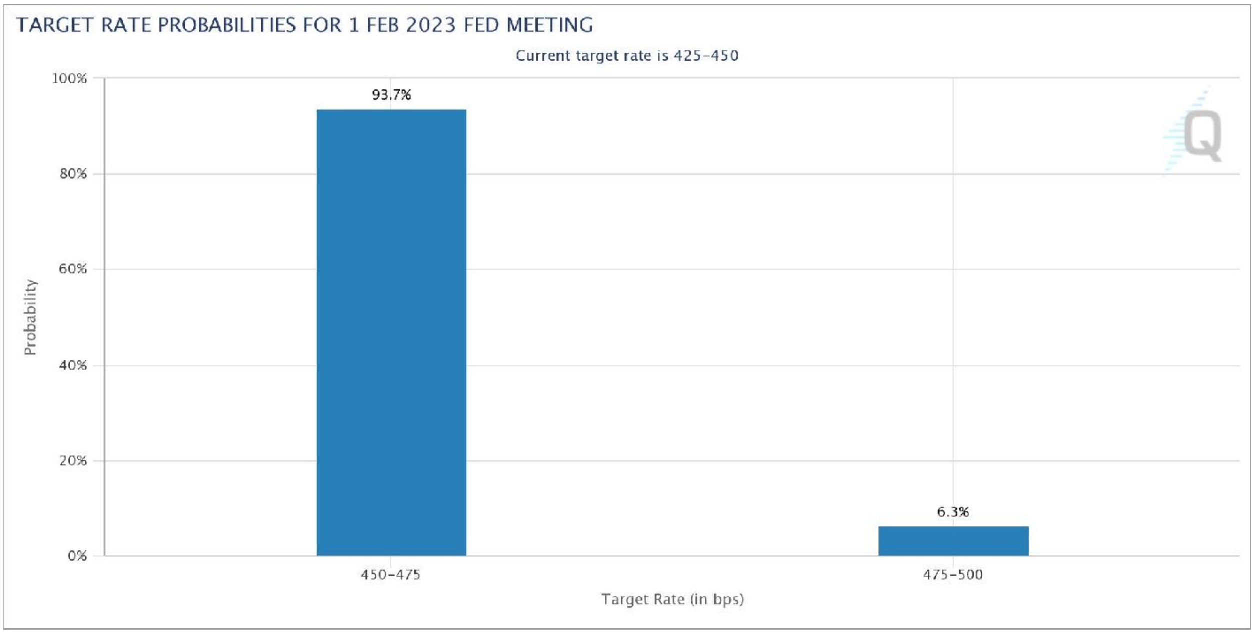


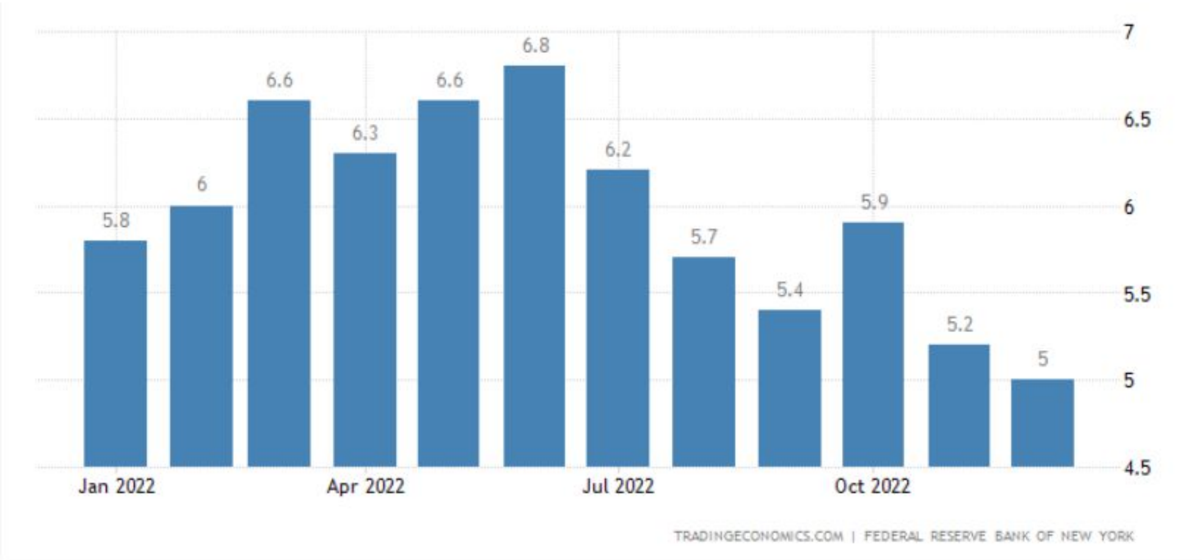
Figure 3. US Fed target rates. (source: CME Group)

According to CME Group's FedWatch Tool, the financial markets expect the Fed to raise rates by 25 basis points during its meetings on January 31st and February 1st. However, any decisions will be affected by the Fed's preferred metrics for wage inflation, the Employment Cost Index. The report will next be published with the fourth quarter data for 2022 on January 31st. If the index eases from the 5 percent increase in the third quarter, it will pave the way for a further slowdown in the pace and magnitude of rate hikes.

Improving Confidence Among Consumers

The most recent monthly survey of consumers shows that U.S. near-term consumer inflation expectations is the lowest in nearly two years.

According to a report released by the New York Fed on Monday, January 9th, consumer inflation expectations continue to decline. The December survey of consumer expectations showed that people anticipate inflation of 5 percent a year from now, down from the 5.2 percent inflation expectation from November. This is the lowest percentage since July 2021. For the next three years, consumers anticipate inflation to settle at a three percent rate, unchanged from the survey result from November.



Calendar	GMT	Reference	Actual	Previous	Consensus	TEForecast
2022-12-12	04:00 PM	Nov	5.2%	5.9%		5.8%
2023-01-09	04:00 PM	Dec	5%	5.2%		5.2%
2023-02-13	04:00 PM	Jan		5%		4.7%

***Figure 4.* Consumer Inflation Expectations (Source: New York Fed, Tradingeconomics.com)**

The Fed pays close attention to how the public perceives inflation since actual inflation rates often mirror expectations.

Bumpy Roads Ahead: Import Prices Rebound

It's clear that inflation is slowing, and consumers are slowly gaining confidence towards the economy. Still, the war is far from won, and a bumpy road lies ahead towards sustainably low inflation. Import prices increased by 0.4 in December after falling by 0.7 percent in November, according to a report released by the US Labor Department on Friday, January 15. Economists had predicted a 0.9 percent drop in import prices, ex-tariff.

After dropping by 3.7 percent in November, the cost of imported fuel climbed by 0.6 percent in December. Cold weather across North America and strong demand for liquified natural gas from Europe caused natural gas prices to spike by 59.5 percent, marking the first monthly increase since June 2022. This offset the effect of a 2.7 percent decrease in petroleum.

***Figure 5.* DXY (Dollar Currency Index) increase in 2022.**

Despite the dollar gaining 5.6 percent against other currencies in 2022, the dollar had a rough time as the year ended. The depreciation of the dollar's trade-weighted basis continued into 2023, contributing to the elevated prices in core imports. Looking forward, the inflation developments will be influenced by the changes in the value of the dollar against other currencies.

US Financial Markets

The financial markets have had a rough start to the year, with many potential threats, like the US reaching its debt ceiling and the possibility of recession this year.

The cost of capital for companies is increasing amidst rising yields. Meanwhile, businesses face higher costs in shifting from cheap production in China. Additionally, the Ukraine crisis continues, and a worldwide economic contraction is on the horizon.

The global financial markets, most notably the U.S. bond market, reflect all this uncertainty. The increasing interest rates are intended to offset these threats, but it also results in increased capital costs for US businesses.

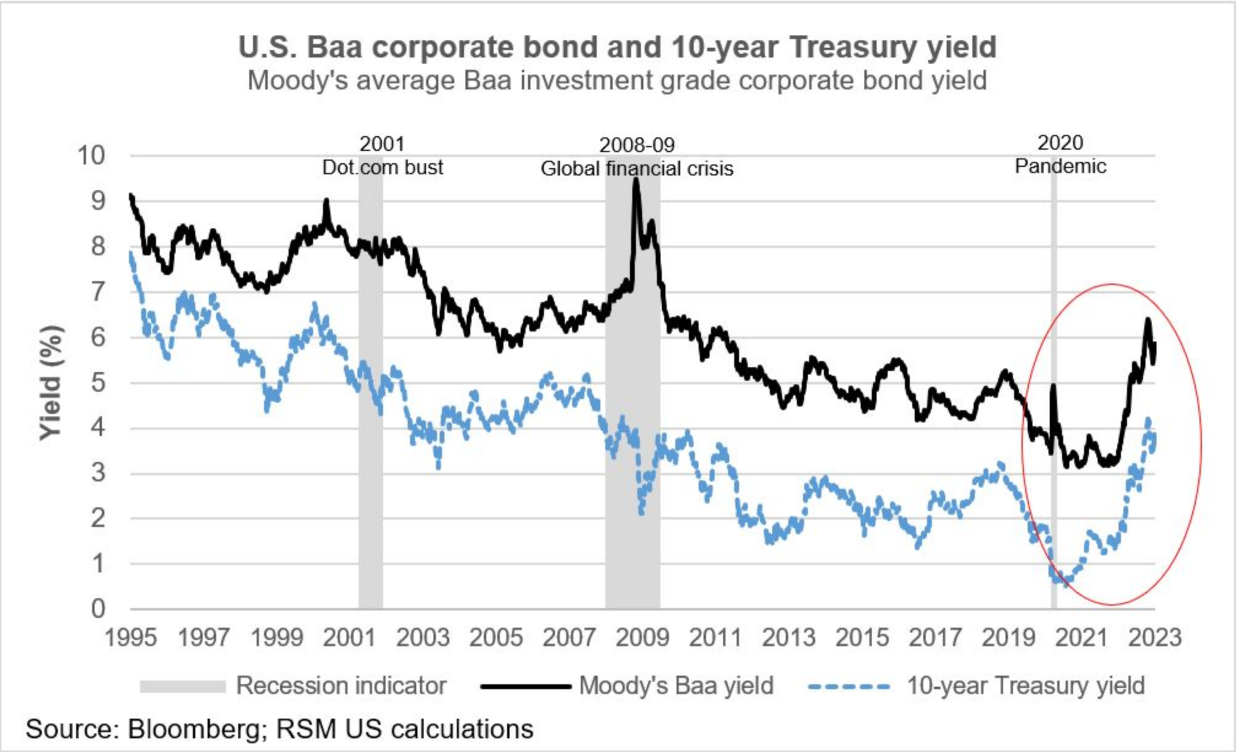


Figure 6. US 10-year Treasury yield vs Recession BAA corporate bonds. (source: Bloomberg)

The 10-Year U.S. Treasury note has climbed by over 200 basis points from 1.5 percent at the beginning of 2022 to 3.6 percent at the beginning of this year. The average yield of investment-grade BAA corporate bonds rose from 3.4 percent to 5.7 percent, totalling 240 basis points.

The risk level of the bond, known as default risk, is one of the critical components determining a bond's interest rate. The yield spread between corporate bonds and U.S. Treasuries widens in times of increased economic uncertainty, especially around recessions. As a result of the increased risk of default and business failure during a recession, bond purchasers will often demand higher interest rates. The spread between the guaranteed yield on Treasury bonds and the rates on corporate bonds is a clear indication of this.

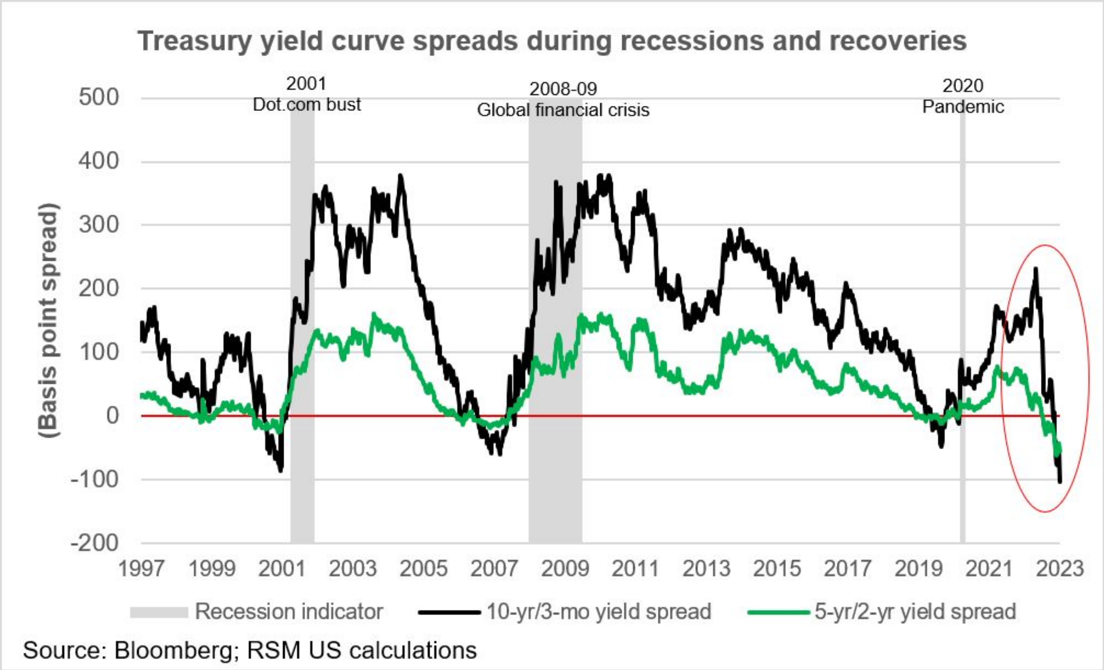


Figure 7. Treasury yield curve spreads during financial market crashes and recessions. (source: Bloomberg)

As a result, the yield curve has been "inverted," which occurs when short-term bond yields rise above the long-term bond yields, which has been a historically robust and reliable indicator of an economic recession. The spread between the yields on 2-year and 10-year Treasury notes is at its widest in four decades.

The bond market has been pricing in the possibility of weaker demand for capital in the coming months due to the Federal Reserve's efforts to cut demand and slow the economy. Hence, in the last three recessions, the spread between long and short-term bonds went negative.

Although the financial markets responded favourably to decelerating inflation late last year, tight economic conditions persist this year. A softer landing and faster return to normalcy would be possible if the Federal Reserve paused or slowed its rate hikes, as anticipated by the stock market if inflation continues to decline. The bond and money market continue to factor in the risk of a recession this year.

Stocks Soared after Inflation Prints

On Friday, January 13, the markets responded positively to important economic reports, sending U.S. stocks up by day's end and for the week. Friday's market gains included 0.3 percent for the Dow Jones Industrial Average (DJIA), 0.4 percent for the S&P 500 Index, and 0.7 percent for the Nasdaq Composite. The week's market performance was positive, with the DJIA up two percent, the S&P 500 up 2.7 percent, and the Nasdaq Composite up 4.8 percent.

Figure 8. S&P 500, Dow Jones Industrial Average and Nasdaq Composite rose for the week.

US stock markets had a good first full week of 2023, with key indexes posting substantial weekly gains and adding to their year-to-date gains. Focusing on inflation, the Consumer Price Index (CPI) continued to fall, but the core inflation, which excludes food and energy, climbed and import prices unexpectedly surged, dampening enthusiasm for the headline number. Last week's inflation report seemed to please investors since inflation has been a driving factor in the direction of the interest rates, which significantly affects the stock market.

WHAT'S ON-CHAIN THIS WEEK?

Bitcoin surges – bear market rally or macro bottom?

As covered in Bitfinex Alpha 35 (https://blog.bitfinex.com/bitfinex-alpha35), we discussed how the end of December and the first few weeks of January would bring immense volatility. Our thesis of spot accumulation by whales driving prices up also played out.

TOP 10 CRYPTOCURRENCIES

By Market Capitalisation

Rank	Name & Symbol	Market Cap	Price	1W %
1	Bitcoin - BTC	$398.35 B	$20,681	22.20%
2	Ethereum - ETH	$187.34 B	$1,530	21.14%
3	Tether - USDT	$66.28 B	$1	0.04%
4	Binance Coin - BNB	$48.65 B	$304.17	16.59%
5	USD Coin - USDC	$43.62 B	$1	0.01%
6	XRP	$19.89 B	$0.39	14.35%
7	Binance USD - BUSD	$16.5 B	$1	0.03%
8	Cardano - ADA	$12.07 B	$0.35	27.45%
9	Dogecoin - DOGE	$11.42 B	$0.08609	19.42%
10	Polygon - MATIC	$8.63 B	$0.99	23.45%

Figure 9. Top 10 Crptocurrencies by market capitalisation

Figure 11.** **BTC Aggregated perpetual liquidation data. (source: coinglass)

Short liquidations fuelled the entire leg up in Bitcoin and Ether. Short liquidations at $450M outweighed long liquidations by a ratio of 4.5. On January 14, the market witnessed the highest ratio of short liquidations vs long liquidations since July 2021. The liquidation figures and short vs long liquidation ratio is even more devastating among altcoins.

Figure 10. BTC/USD average 4H chart. (source: Bitfinex futures)

ByBit recorded its largest short Open Interest wipeout on BTC since the exchange was launched. The negative funding rates sub $16k, followed by increasing aggregated long-side open interest for BTC, were the driving force behind the price surge.

It is typical for bear markets to have a complete wipeout of shorts. The entire rally has been built on the backbone of continuous market shorts keeping funding low and prices being pushed up by forced liquidations and running stops.

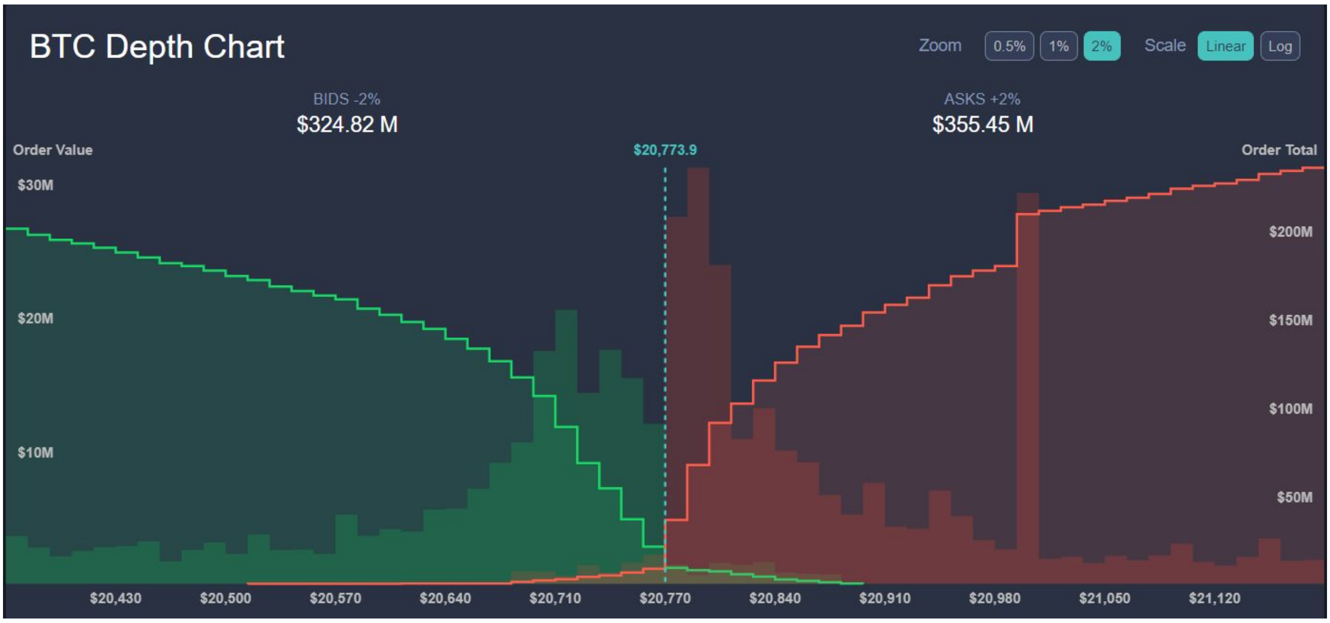


***Figure 12.** Bitcoin's two percent market depth across top 10 exchanges. (source: livecoinwatch)*

The move might be interpreted as organic, but it is entirely engineered by limited traders in the market, which is evident from the market depth remaining the same week-on week. The price impact from market orders is also the same as last week for BTC, and there is little change for altcoins. This means that even with the leg up, the market remains highly illiquid, and with the sharp fall in Open Interest over the weekend, a pullback might be expected with a cautious approach from bulls. (BTC price is $20681 at the time of writing)

We covered 2 percent market depth and how it represents market liquidity in Bitfinex Alpha's 36th edition.

NEWS FROM THE CRYPTO-SPHERE

FTX Recovers Billions in Cash, and SBF denies allegations

Figure 13. Former FTX CEO Sam Bankman Fried

At a court hearing on Wednesday, January 11, lawyers for FTX said the company had identified $5 billion in liquid assets. Andrew Dietderich, a partner at Sullivan & Cromwell representing FTX noted that the $5 billion includes cash, securities and liquid cryptocurrencies.

Bankruptcy Judge John Dorsey also gave the green light to go forward with the process of selling four FTX subsidiaries, including its units in Europe and Japan, as well as two regulated US companies, brokerage tech and infrastructure provider Embed and crypto derivatives platform LedgerX.

Judge Dorsey agreed to keep the FTX customers' list a secret for at least three more months in order to prevent identity theft and comply with privacy laws.

The announcement raised hopes that FTX might be able to return some money to its millions of creditors and customers around the world.

A day after the court hearing, Thursday, January 12, former FTX CEO, Sam Bankman Fried (SBF) published a pre-mortem overview in response to the criminal charges filed against him claiming that FTX customers could still be made "substantially whole."

In the statement, SBF wrote, "I didn't steal funds, and I certainly didn't stash billions away," and "Nearly all of my assets were and still are utilisable to backstop FTX customers." He added.

According to SBF, three things caused the FTX insolvency:

- Alameda's balance sheet grew to roughly $100 billion of Net Asset Value, $8 billion of net borrowing (leverage), and $7 billion of liquidity on hand.
- Alameda failed to hedge its market exposure sufficiently.
- An extreme, quick, targeted crash precipitated by the CEO of Binance made Alameda insolvent.

SBF also blamed Sullivan & Cromwell (S&C), one of FTX International's two primary law firms prior to bankruptcy and FTX US's primary law firm, for "pressuring" him into Chapter 11 filings and instating the new CEO John Ray instead.

On a final note, he stated that he still has a lot more to say about why Alameda failed to hedge, what happened with FTX US, what led to the Chapter 11 process, S&C, and more, adding that this is just the start.

El Salvador Law is allowing Bitcoin Bond Sales

Figure 14. El Salvador president Nayib Bukele

On Wednesday, January 11, El Salvador president Nayib Bukele stated that El Salvador's Legislative Assembly has just approved, by an overwhelming majority, the new Digital Securities Law.

As published on the Bitfinex blog, this new law establishes a legal framework around the issuance of digital assets and broader crypto tokens for fund raising. It provides a definitive regulatory framework for tokenised securities, altcoins, and businesses that wish to transact or offer services focused on digital assets.

The new digital asset regulatory framework will also establish a Bitcoin Fund Management Agency, which provides oversight and administration for public offerings of digital assets issued by the state of El Salvador and its institutions.

In a thread via Twitter from the country's Bitcoin office, the law will pave the way for El Salvador's "Volcano Token". This token is targeted to raise $1 Billion and would be backed by the proceeds generated from its geothermal Bitcoin mining operation, which harnesses energy from the nation's active volcanoes. By leveraging the nation's natural resources and geothermal energy, El Salvador's Bitcoin mining industry would utilise only renewable energy to create new Bitcoin.

The Volcano Token would help El Salvador to raise capital to pay down its debt, direct funds towards the creation of Bitcoin mining infrastructure, and fund the construction of "Bitcoin City".

The technology provider for the "volcano tokens" will be Bitfinex.

CTO at Bitfinex, Paolo Ardoino, commented that Bitfinex's role in the Volcano token issuance underlined its "commitment to financial freedom and Bitcoin adoption."

Binance US Bid for Voyager continues

Figure 15. Binance.US CEO Brian Shroder

During a court hearing on Tuesday, January 10, bankruptcy Judge Michael Wiles gave his preliminary approval for the bankrupt company Voyager to sell its customers' accounts to Binance.US for $1.02 billion.

However, this approval is not final; according to Judge Wiles, he still needs attorneys currently working on the deal to revise documents related to the offer before he approves them. The final approval will also seek Voyager's customers' vote.

Judge Wiles scheduled another confirmation hearing in March.

Meanwhile, Binance CEO, Changpeng Zhao (CZ) said at a conference in St. Moritz, Switzerland, that Binance's headcount growth goal in 2023 will be between 15 and 30 percent. CZ also hinted at a possibility of a decentralised exchange bigger than Binance 10 to 15 years from now.

The SEC sues Gemini and Genesis

Figure 16. Digital Currency Group CEO Barry Silbert (left), SEC Chairman Gary Gensler (middle), Gemini Co-founder Cameron Winklevoss (right)

Gary Gensler, Chairman of the US Securities and Exchange Commission (SEC), stated on January 12 that the SEC charged both Genesis and Gemini for the unregistered offer and sale of crypto asset securities through Gemini Earn.

The SEC said in a statement that both companies offered the Gemini Earn program to retail investors, a program that should have been registered with the Commission.

Gensler alleged that Genesis and Gemini bypassed “disclosure requirements designed to protect investors”. He added that the charges should “make clear to the marketplace and the investing public that crypto lending platforms and other intermediaries need to comply with our time-tested securities laws.”

In a tweet on January 13, Tyler Winklevoss, Gemini co-founder, said it was “disappointing” that the agency acted while Gemini and other creditors were working together to recover funds. “This action does nothing to further our efforts and help Earn users get their assets back. Their behaviour is totally counterproductive.”

After that, Gemini filed an answer, arguing that the SEC action should be aimed at Genesis and DCG since Gemini was also a victim of the Genesis/DCG Group’s conduct and that customers of Gemini Earn entered into an agreement with Genesis and not Gemini.

Crypto lender Nexo under investigation in Bulgaria

Figure 27. Nexo Co-founder Antoni Trenchev

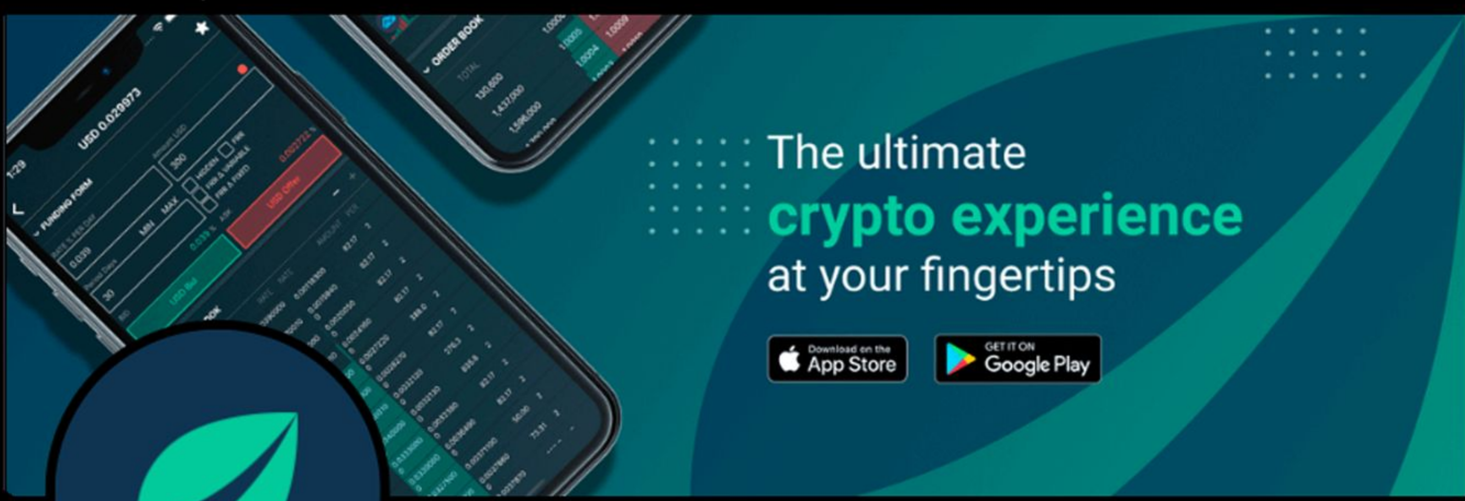
A Bulgarian office belonging to crypto lender Nexo is under investigation by authorities in Bulgaria.

In a Facebook livestatement published on Thursday, January 12, more than 300 police officers and prosecutors are investigating potential organised crime, money laundering, tax crimes, offences relating to unlicensed banking activity and computer fraud, Attorney General Siika Mileva said in the statement.

Bulgarian authorities said the main organisers of the scheme were Bulgarian citizens, and the suspected activity had been carried out mainly in Bulgarian territory. “Evidence has been gathered that a person who used the platform and transferred cryptocurrencies has been officially declared a person who finances terrorist acts,” Attorney General Siika Mileva added.

In response to these allegations, Nexo shared a Twitter thread stating that Nexo has 30+ anti-money laundering compliance officers who ensure that they retain a real-time picture of their clients, including adverse media publications, OFAC sanctions lists, sources and flow of funds, etc.

“We are always cooperating with the relevant authorities and regulators, and we are hopeful that we will have some exciting news in the weeks to come.” Added Nexo in a statement.



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