BITFINEX Alpha

Issue: 06-02-2023
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EXECUTIVE SUMMARY

Early calls for a pause in rate hikes, following last week's 25 basis point increase, are likely to fall on deaf ears. With inflation at 6.5 percent, we are still a long way above the Fed's two percent target.

Furthermore, employment demand is robust, and the number of vacancies is growing. Indeed, such is its strength that non-farm payroll data out last Friday severely wrongfooted economists. For now, the Fed will not stop tightening, but as we have argued before, if hiring and wage growth changes meaningfully, then interest rate policy will also change.

Data from the housing market suggests that we are seeing some weakening already in the economy. Residential construction as a proportion of GDP is already falling, and the number of new building permits is declining, a data point that we believe will see a further drop in the coming months. But there is still more wood to chop before the inflation demon is beaten and interest rates can take a breath.

In stark contrast, Bitcoin metrics are looking bullish. Selling from both short-term and now even long-term HODLers has been profitable for the last 90 days, with the market successfully absorbing any selling pressure. While it does not imply that the market is back to the up-only territory, it does indicate strength in the spot markets, which only appears in late bear and early bull markets.

Other technical indicators are also positive. The 90-day EMA for Bitcoins that last moved when prices were lower has now been up for the last 30 days, having risen around 20 percent. Furthermore, as discussed in last week's *Bitfinex Alpha*, the net adjusted Spent Output Profit Ratio is now above one, an indication that net sales are profitable, while the ratio of Realised Profit to Losses (RPLR) is also above zero, another gauge of profitable selling. To contextualise this, the last time the RPLR hit 0.2, was in 2019, and Bitcoin's price had fallen to around $3,600. It then went on to rally around 19x to the record highs of late 2021 just under three years later. This time round, when Bitcoin was trading around $16,000 last November, this indicator was again around 0.18, its lowest since 2011. If history repeats itself, it could rise significantly again. A 10x rise would take BTC to $160,000.

Even on a longer time frame, the technical indicators are flashing green for Bitcoin. The reserve risk ratio for BTC, which perceives the conviction of HODLers, is low. The lower the ratio, the higher the conviction. Similarly, the well-known Market Value Realised Value ratio has also recovered, with market value now above-realised value.

Such positive news came against a backdrop of more recrimination in the rest of the crypto world. Last week, the court-appointed 'examiner' of Celsius, the bankrupt crypto lender, revealed that her investigation showed that the company appeared to be behaving like a Ponzi scheme.

In the meantime, Osprey Funds sued Grayscale over alleged misleading advertising, and Alameda Research sued Voyager (both companies are also bankrupt) for loan repayments it said it was owed.

We also had news that the crypto protocol BonqDao was hacked after a bug was exploited in one of its oracles. More positively, however, Ethereum developers opened the new Zhejiang testnet to test the process by which long-staked ETH that had been securing the network as part of last year's Merge could be released.

In our Learning Section, we explain the role of the FOMC and Quantitative Easing and Tightening. It's a good refresher of how the US central bank works.

Happy Trading!

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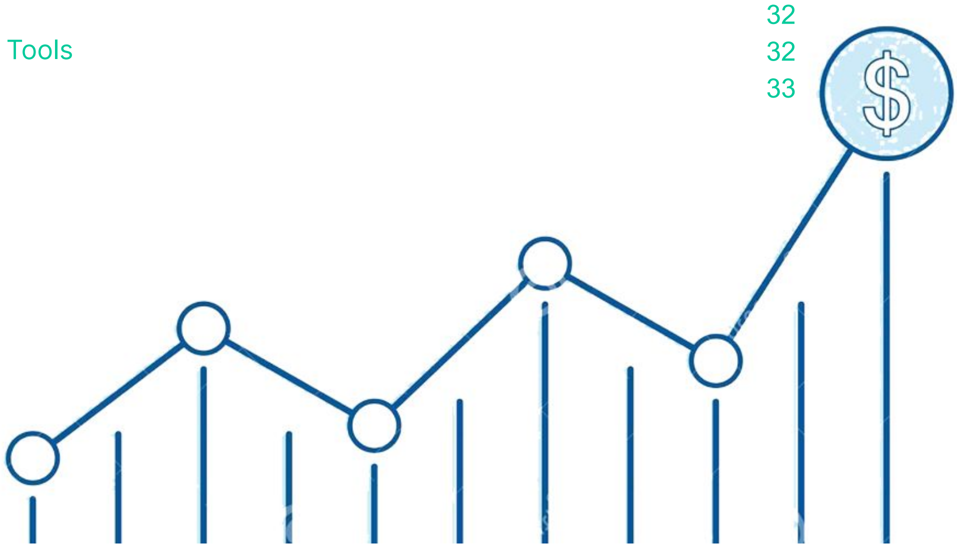


GENERAL MARKET UPDATE

25 Basis Points Hike: Will the Fed Stop Tightening?

As we predicted in the previous *Bitfinex Alpha*, the Fed hiked its policy rate by 25 basis points (bps). For the past three decades, price stability has been defined by a two percent inflation target, which is far below the current 6.5 percent CPI reading and last year's nine percent inflation peak. On Tuesday, February 2nd, the Federal Reserve (the Fed) hiked its policy rate by 25 basis points, its eighth consecutive hike. This is, however, lower than the previous hikes in 2022.

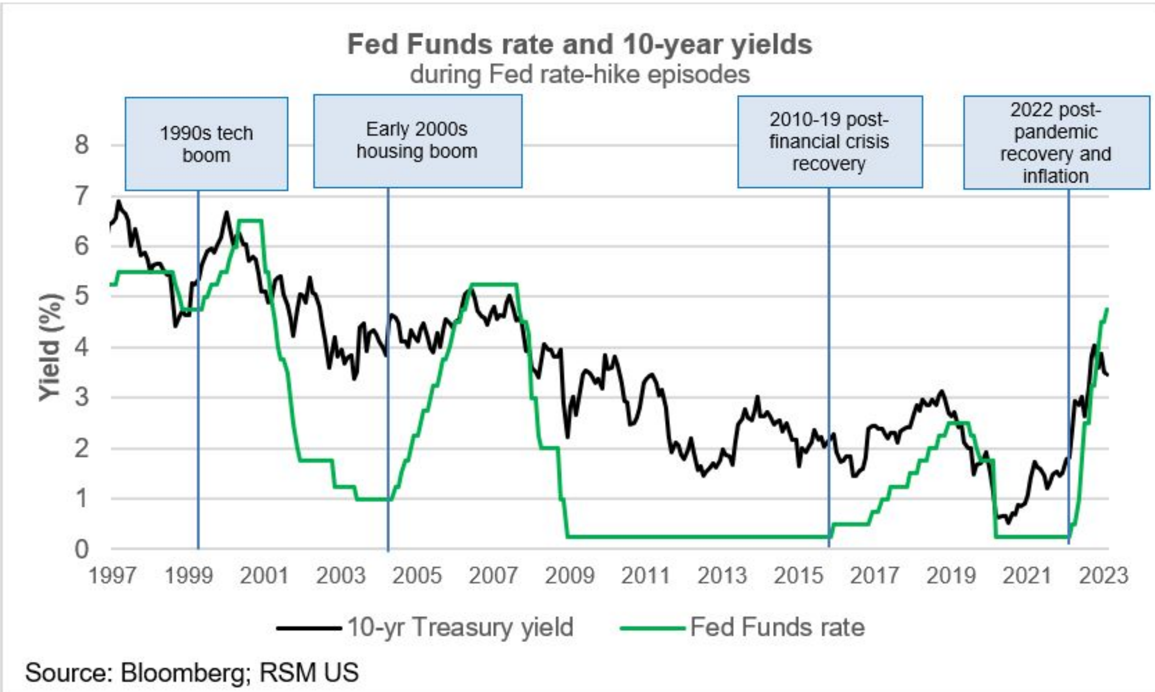


Figure 1. Federal Funds Rate and 10-year Treasury Yields (source: Bloomberg , US Federal Reserve, RSM US)

The FOMC reiterated that ongoing rate hikes are necessary to attain a sufficiently restrictive monetary policy that will return inflation to two percent, over time. Fed Chairman Jerome Powell also emphasized that the central bank will not abandon its near-term focus on bringing down inflation.

According to Powell, the softening of the labour market is a likely side effect of the Fed's efforts to reduce inflation. The Fed chairman's statement underscores the possibility that the impact of the rate hikes over the past year will be felt for the rest of 2023, and may cause a contraction in the economy.

There have been signs of weakness in the economy. Hiring has slowed for the past five months. A variety of data such as manufacturing and consumer spending also point to a spreading weakness. Hence, some economists point out that the slowing economy and easing inflation can support the case for a pause in the next FOMC meeting.

However, even with easing inflation, prices have increased to about three times the yearly average from the decade before the pandemic. We keep in mind that the Fed aims to bring inflation back to the pre-pandemic two percent. If the Fed loosens its monetary policy prematurely, its credibility will take a major hit, and future efforts to control inflation will be costlier.

In short, it is too soon for the Fed to stop tightening. The calls for a pause early this year will likely be erroneous and more rate hikes should be expected. We believe, however that it won't be too long until we're done. If the upcoming inflation data will continue to show an easing of price pressures, then the next two or three rate hikes will be sufficient to convince the Fed to pause.

Labour Market: Still Defying Expectations

After a series of massive rate hikes that started last year, many market participants anticipates the labour market to start crumbling, yet the recent labour data continues to defy expectations. Labour demand in the US climbed higher in December after two consecutive drops in the previous months, according to the Bureau of Labour Statistics report released on Wednesday, February 1st. Job vacancies surged to 11 million in December from 10.4 million in January, driven mostly by seasonal industries like leisure, hospitality, trade, and transportation.

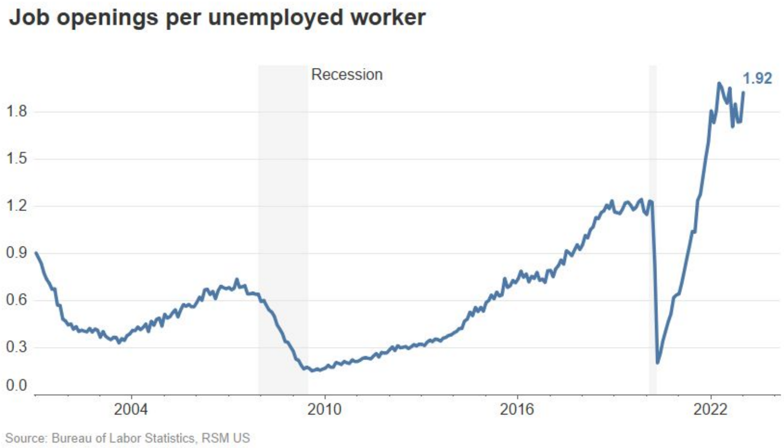


Figure 2. Job Openings per unemployed worker (Source: US Bureau of Labour Statistics, RSM US)

In December, there were 1.9 job openings available for each unemployed worker, up from 1.7 in November. While many market participants have been expecting a downturn in the labour market, the recent report shows that the mismatch between labour demand and supply may not fade very soon.

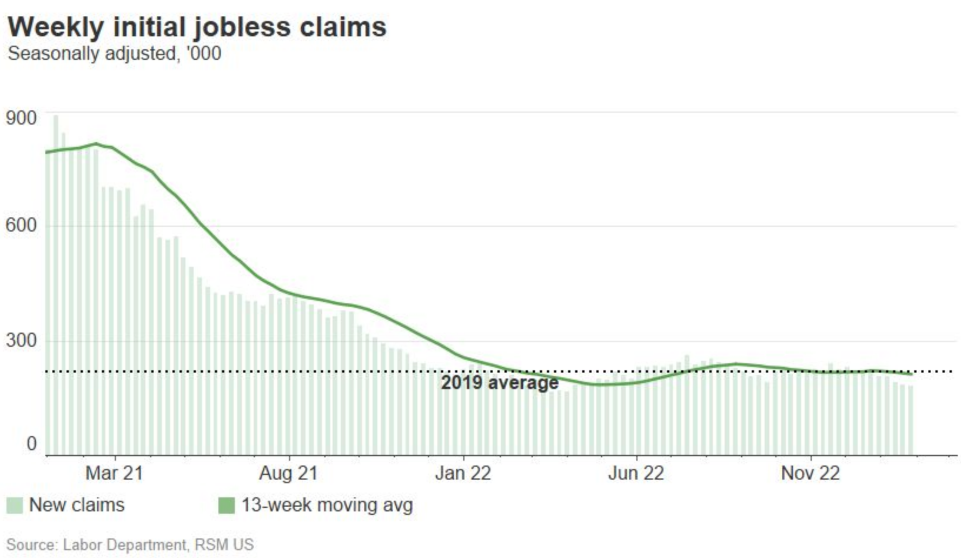


Figure 3. Weekly Initial Jobless Claims (Source: US Labor Department, RSM US)

In last week's *Bitfinex Alpha*, we reported massive layoff announcements from big tech companies. This disconnect between the rising number of layoff announcements and the declining number of jobless claims proves that headlines don't always reflect the actual economy.

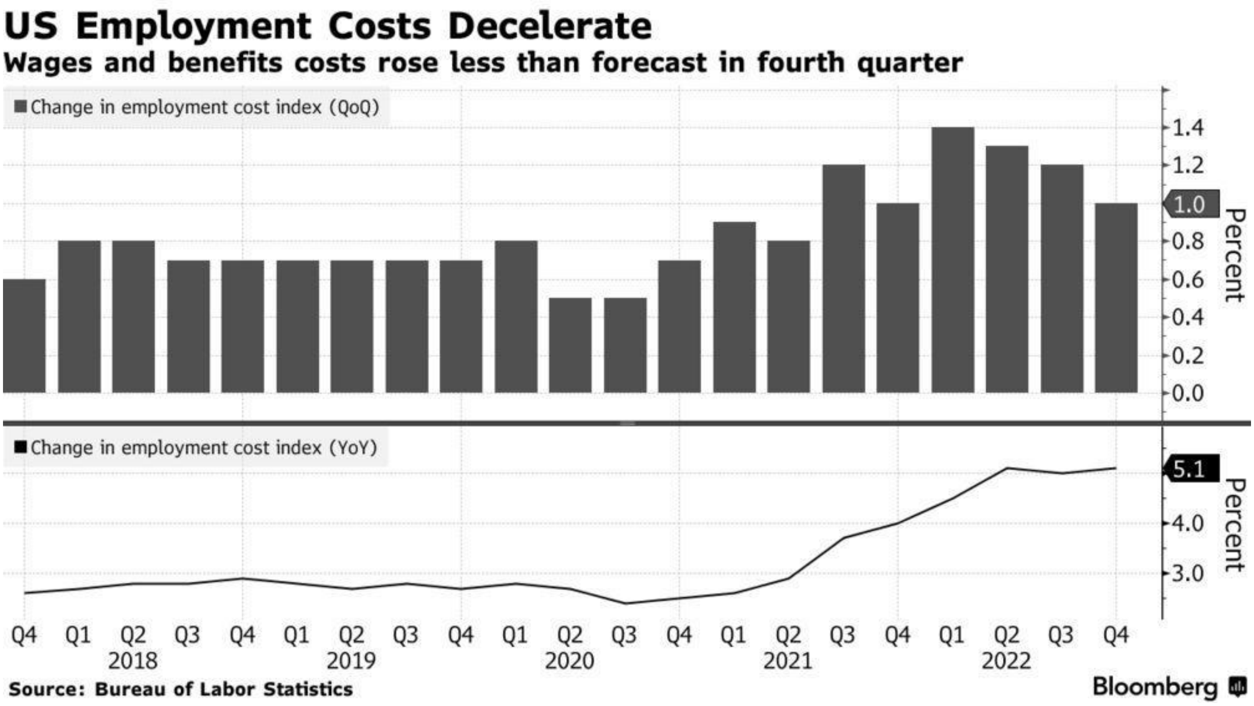


Figure 4. US Employment Cost (Souce: Bloomberg, Bureau of Labour Statistics)

Wage inflation should remain a concern given the labour market's continued tightness.

The US employment cost index slowed for the third consecutive quarter at the end of 2022, but wages still increased by one percent. Though wage growth has slowed since its peak in 2022, it is still increasing faster than the Fed would like.

Worker pay increased at a rate close to the highest level in the past 40 years, increasing by 5.1 percent year-over-year (YoY) , up from five percent in the third quarter of 2022.

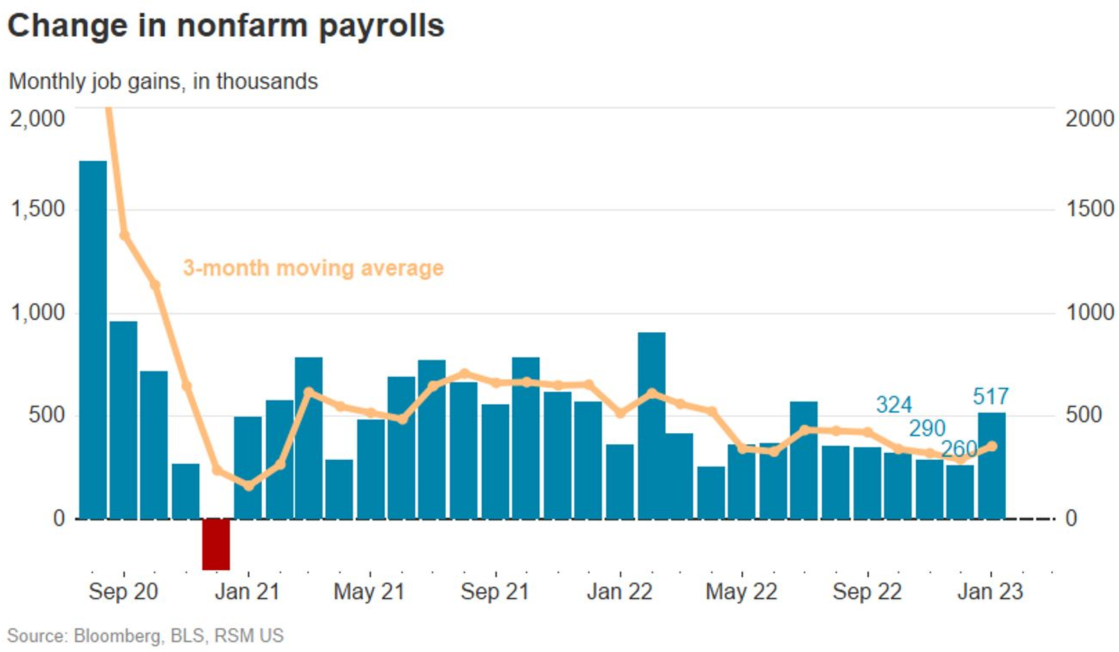


Figure 5. Change in Non Farm Payrolls (Souce: Bloomberg, Bureau of Labour Statistics)

Following the robust jobs opening report last Wednesday, the market was again surprised on Friday, February 3rd, when a blowout in US hiring in January led to the jobless rate falling to a 53-year low. Nonfarm payrolls increased 517,000 last month after an upwardly revised gain of 260,000 in December. The unemployment rate slid to 3.4 percent, the lowest since 1969. The report's only apparent evidence of moderation was a 0.3 percent increase in hourly compensation.

The employment figures severely wrongfooted economists, who according to a Bloomberg survey, had expected just a 188,000 increase in payrolls and an increase in the unemployment rate to 3.6 percent.

One caveat, however, is that seasonal noise often causes issues when the Bureau of Labor Statistics estimates the January jobs picture, and the first employment estimate of the year serves as a valuable warning not to overestimate one report. The January jobs data will very likely be revised downward in the following months, so take the top-line estimate of a 517,000 gain in total employment with a grain of salt.

Certainly though, the policy implications of recent employment reports are clear: the Fed will not stop tightening. How long interest rates stay elevated depends in large part on the trajectory of hiring and wage growth. The Fed has made it clear that it intends to do whatever it takes to dampen the high demand for labour, which is putting upward pressure on wages and, in turn, inflation. The recent job data proves that the Fed is up for a longer fight, which strengthens our case that rate hikes will not pause too soon.

Where is the Housing Market Heading?

The construction cycle in residential housing is very influential cycle for the overall economy. Right now, it is seeing downward momentum that is dragging economic growth.

Though the residential construction sector is just three to six percent of the whole economy, residential construction is extremely significant considering its high multiplier nature. The chart below shows the contribution of residential construction with respect to US Gross Domestic Product (GDP). Normally, when the housing impulse in the economy is this negative, it's highly common for the economy to already be in a recession.

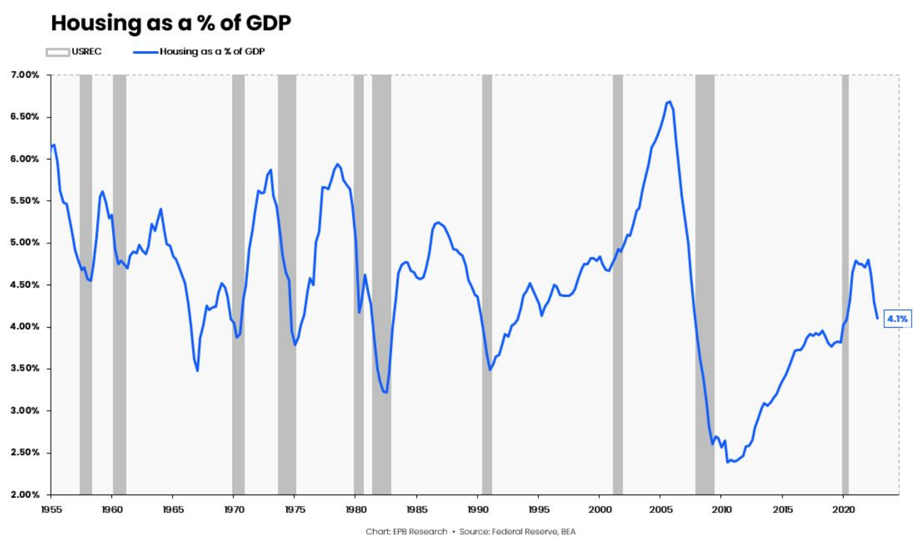


Figure 6. Housing as a percent of GDP(Source: Census Bureau)

Although the housing sector alone cannot explain its present breakdown, it is still worth looking at what recent housing data is telling us and identify the drivers of its current downturn.

We pay attention to the construction activity rather than the price of homes because price is a lagging indicator. House prices can take time to be reflected in the market due to changes in demand in housing, supply and availability of homes, changes in interest rates among many others. Construction spending, on the other hand, serves as a direct measure of investment and responds more quickly to changes in demand and economic conditions.

The chart below shows the total spending of residential construction spending in the economy, where it peaked in May 2022.

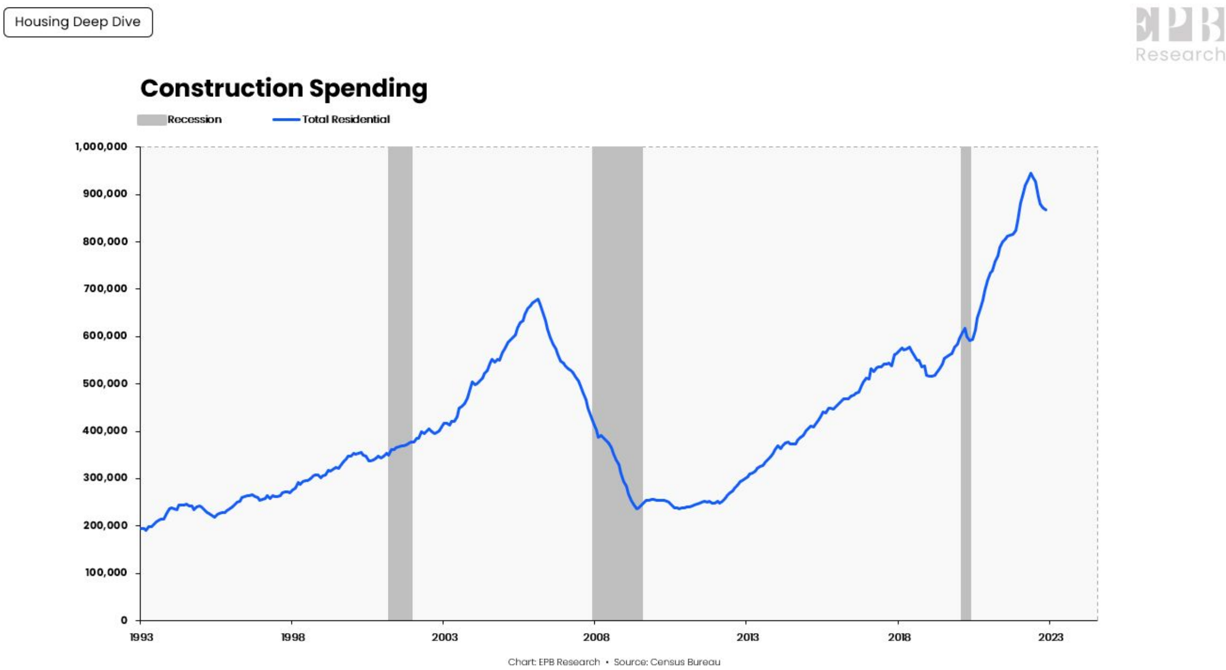


Figure 7. Construction Spending on Residential Houses (Source: Census Bureau)

We can further break down construction spending into single-family or multi-family categories. (single-family homes have just one dwelling unit while multi-family residential properties have between two to four like duplexes and triplexes) Looking at the chart below, single-family spending is declining while multi-family construction spending is still exploding. Separating construction spending into remodelling or construction, the remodelling category has not declined significantly since it peaked after the pandemic lockdowns.

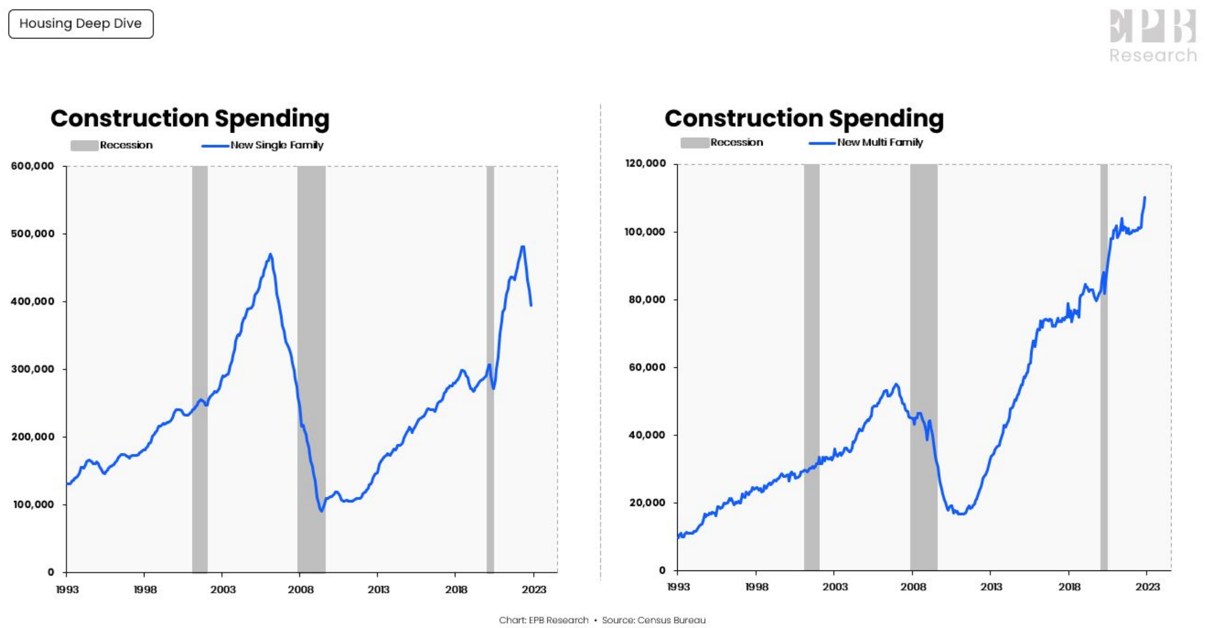


Figure 8. Construction Spending on New-Single Family (Left) Construction spending on New Multi-Family (Right) (Source: Census Bureau)

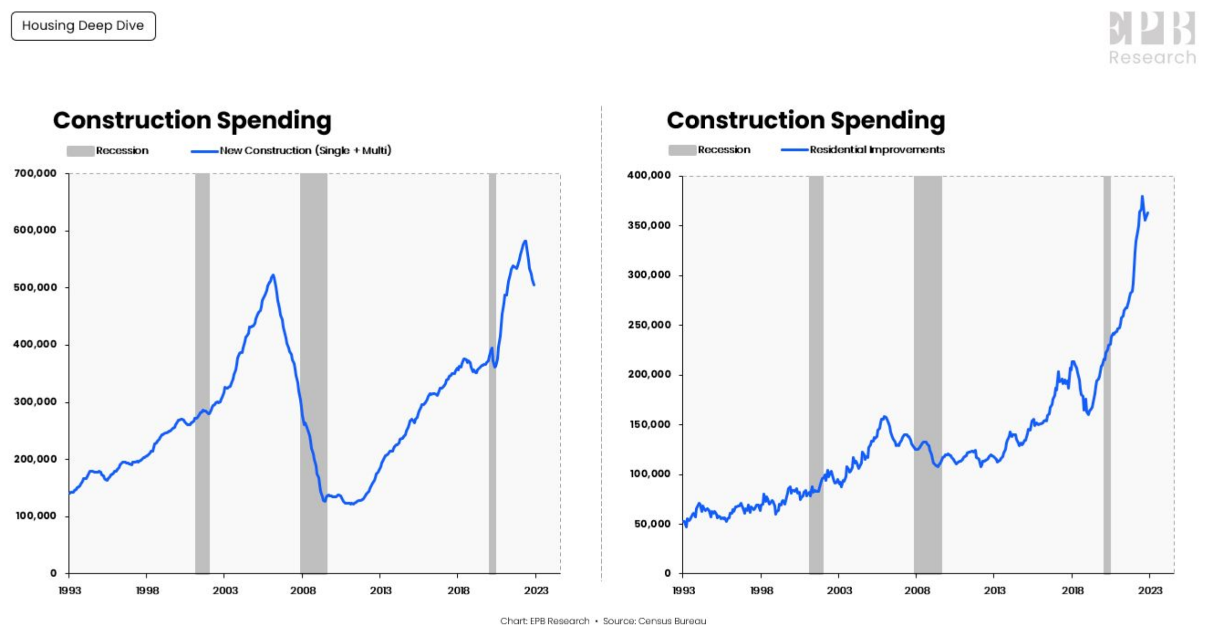


Figure 9. Construction Spending : New Construction (Left) and Improvements or Remodelling (Right) (Source: Census Bureau)

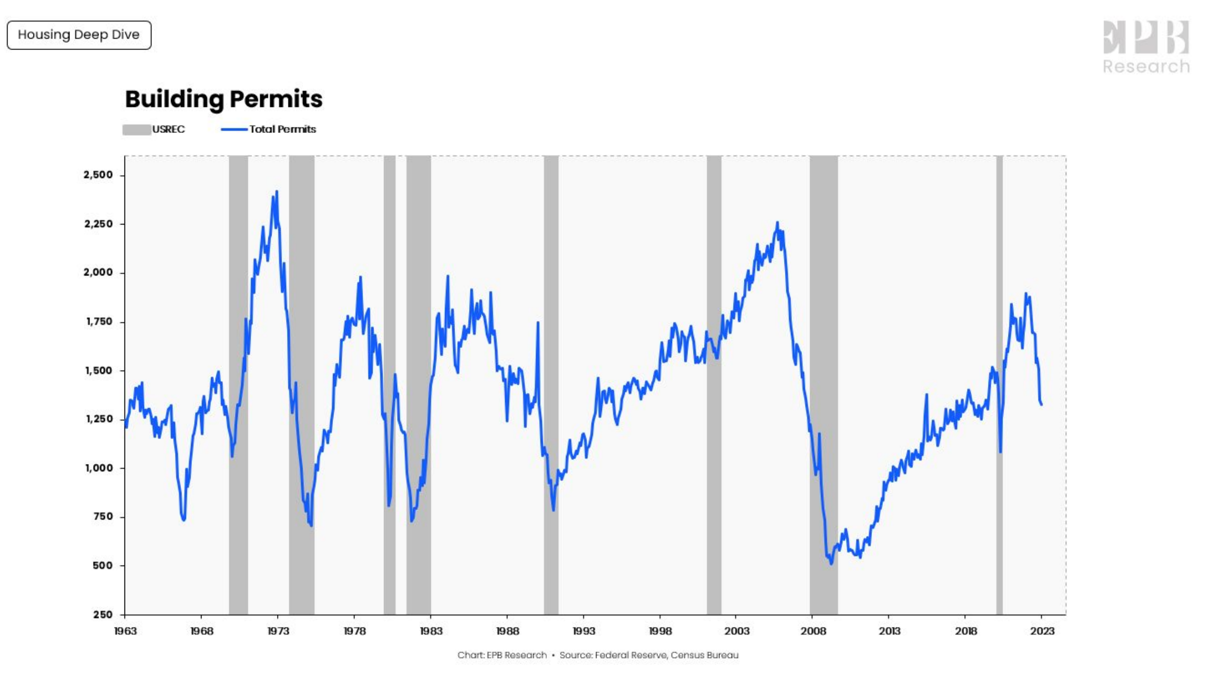


Figure 10. Total Building Permits in the US (Source: Census Bureau)

The issuance of building permits is a very reliable leading indicator for spending in residential building construction. Permits are required before any residential construction work may commence. Building permits peaked on March 2022 before residential construction spending peaked in May 2022.

Some components of construction spending haven't declined significantly, yet. Building permits for example, do not appear to have bottomed out and are likely to fall further, suggesting that residential construction spending won't turn higher in the next three to four months. It underlines the possibility that the housing market will be a vulnerability in an already-slowing-down economy.

WHAT’S ON-CHAIN THIS WEEK?

More On-chain Metrics Flip Bullish

Bitcoin Balance statistics now favour the HODLers

As per *on-chain* data, over the last 90 days we have seen an upswing in the Bitcoin Realised HODL (RHODL) Multiple, which is a bullish indicator. The RHODL Multiple has now sustained an uptrend over a 90-day window, which means that selling by HODLers during this period has been at a consistent profit. It also demonstrates that there is a small uptick in demand by new or small investors in BTC. Profits are being taken now not only by short-term holders but even long-term HODLers, however, the market has been able to absorb the selling pressure, and longer-term investors are starting to spend coins confidently.

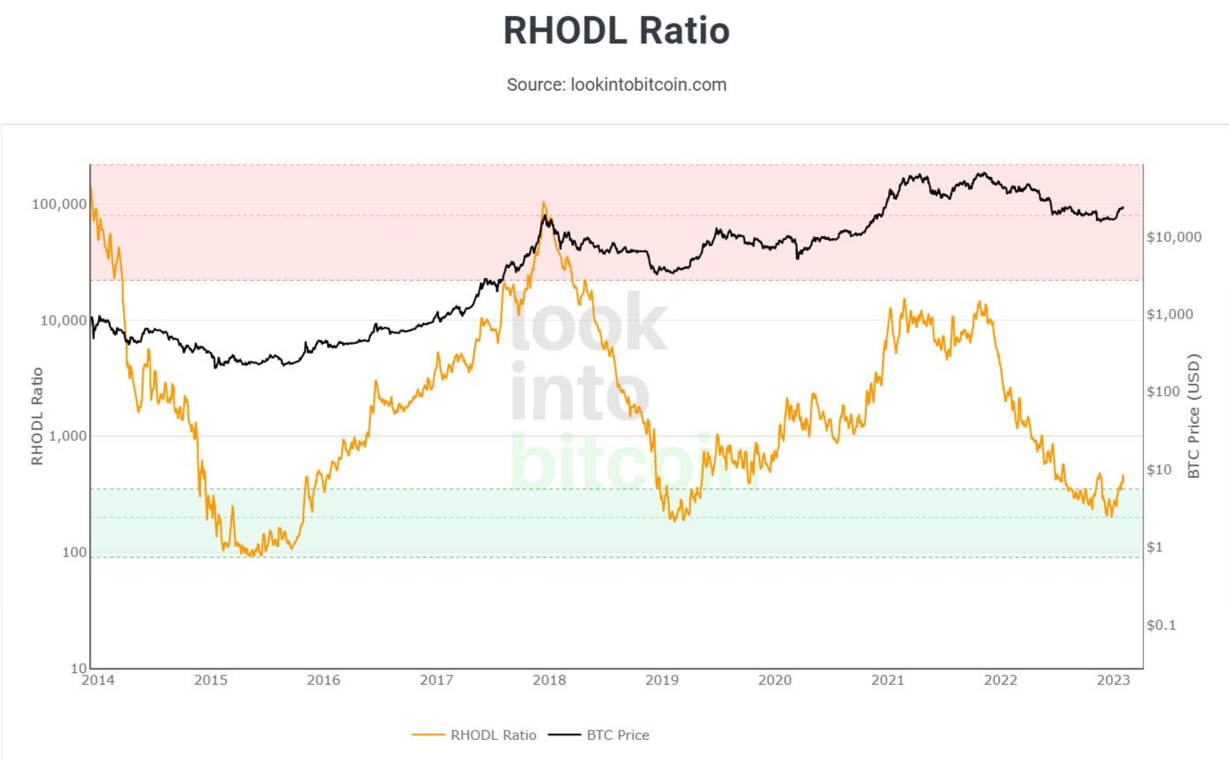


Figure 11. Visualising BTC RHODL multiple. (source: lookintobitcoin.com)

Figure 9 shows how longer term investors are starting to realise profit, although this is at a much smaller rate and much later in time than short-term investors as covered in the previous edition of the *Bitfinex Alpha.* While this might seem bearish, the BTC price is relatively stable and has not been affected much by this. This does not imply that the market is back to up-only territory but it does indicate strength in the spot markets which only appears in late bear and early bull markets.

BTC Supply In Profit Increases. One of the *Glassnode* indicators in its "Recovering from a Bitcoin Bear" dashboard is whether or not the 90-day Exponential Moving Average (EMA) of Bitcoin Supply in Profit has been in an uptrend over the last 30 days or not. This indicator is also flashing green.

Supply in Profit is the number of Bitcoins that last moved when USD-denominated prices were lower than they are right now, implying they were bought for a lower price and the wallet is holding onto a paper profit.

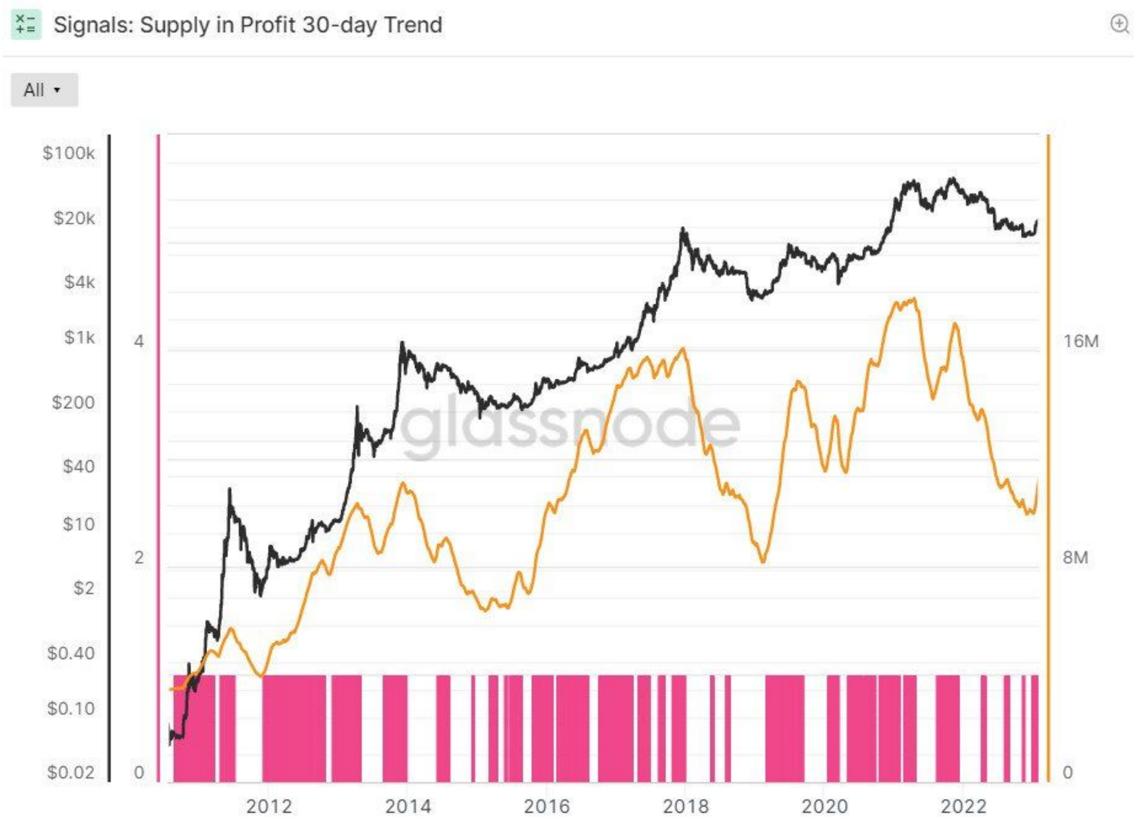


Figure 12. BTC Supply in Profit trending higher. (source: Glassnode)

The Supply in Profit indicator has increased by over 20 percent since the new year. This implies that larger and longer-term investors currently hold profitable on-paper spot positions. This is healthy for the latter half of a bear market as a sustained 30-day uptrend after an extensive downtrend on this indicator has historically provided a good buy signal for the following two years.

Last week, we had talked about the Spent Output Profit Ratio (SOPR) for various investor profiles. The net adjusted SOPR for the entire market has risen above one, implying the net BTC moved on-chain is in profit right now. A move like this after a prolonged spell below one (net BTC moved at a loss) has been a fantastic buy signal historically. This is also testament to how Bitcoin is being moved for a profit with price remaining stable.

We need to look at net realised profit/loss ratio to understand how this is still a bullish signal.

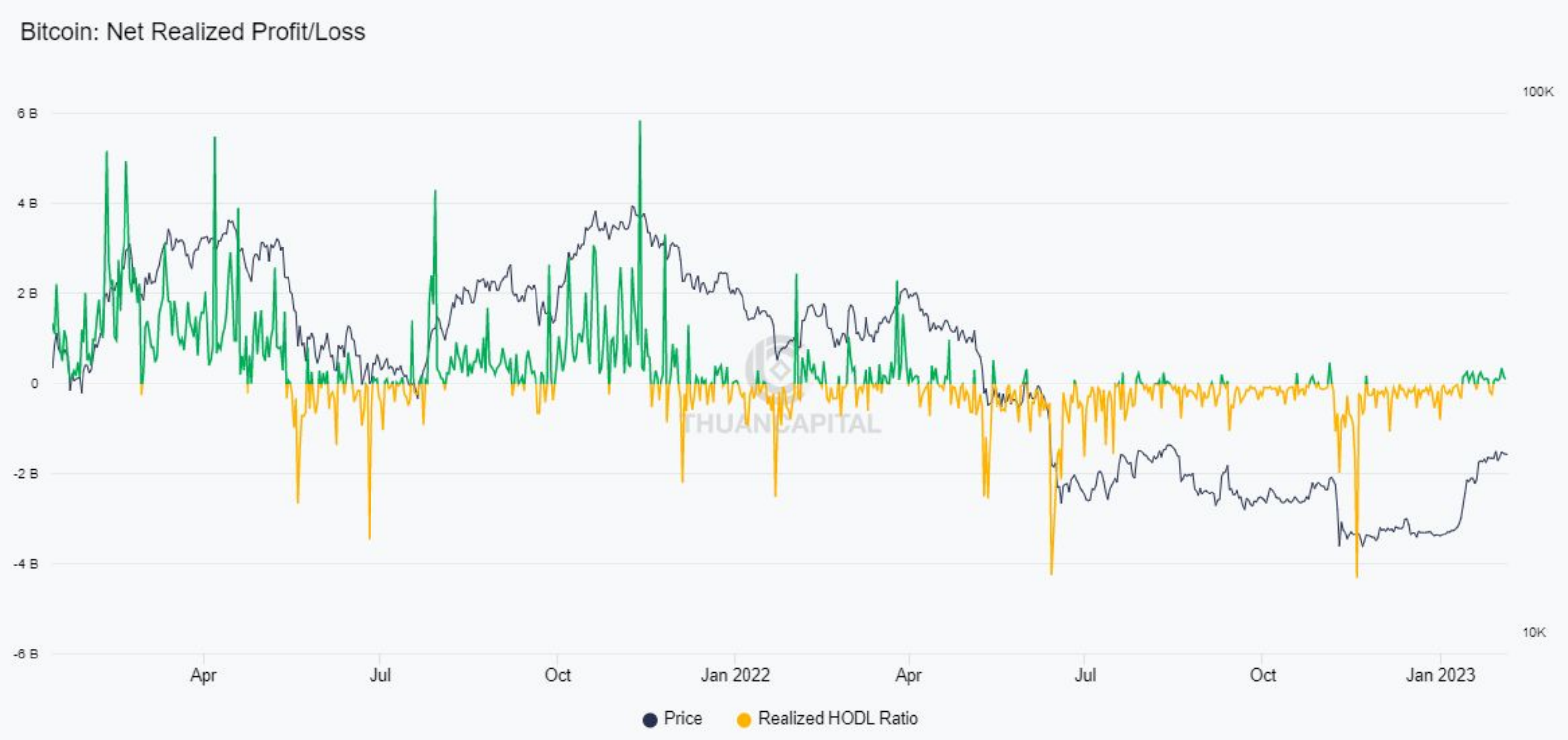


Figure 13. Realized P/L in Profit. (source: analytics.thuancapital)

The 30-Day Simple Moving Average (SMA) of the Bitcoin Realized Profit-Loss Ratio (RPLR) indicator recently moved above zero for the first time last April. That means that the Bitcoin market is realizing a greater proportion of profits (denominated in USD) than losses.

According to indicator documentation, “this generally signifies that sellers with unrealized losses have been exhausted, and a healthier inflow of demand exists to absorb profit taking”. Hence, this indicator is sending a bullish sign for a longer timeframe investor.

When the RPLR bottomed around 0.2 in 2019, Bitcoin’s price had fallen to around $3,600, but the cryptocurrency then went on to rally around 19x, hitting record highs in late 2021 just under three years later. The RPLR again recently bottomed around 0.18, its lowest since 2011, and Bitcoin was trading in the $16,000s in November 2022.

Bulls will be hoping for history to once again rhyme, and that the world’s largest cryptocurrency by market cap can post another exponential rally from lows over the next three or so years. A 10x rally from recent lows would see Bitcoin hitting around $160,000.

Longer Term Leading Indicators Suggest HODLer Conviction Is High

Figure 14. BTC price vs Reserve Risk. (source: glassnode)

Reserve Risk for BTC recently fell to its lowest level ever (lower than the 2019 or 2020 low), this indicates that the HODLer conviction is close to record highs. Reserve Risk is a long term cyclical oscillator that models the ratio between the current price and the conviction of long-term investors. The current price is the incentive to sell and the conviction in the ratio is a series of sub-metrics that factor in the opportunity cost of not selling. Lower the ratio, higher the conviction that investors have.

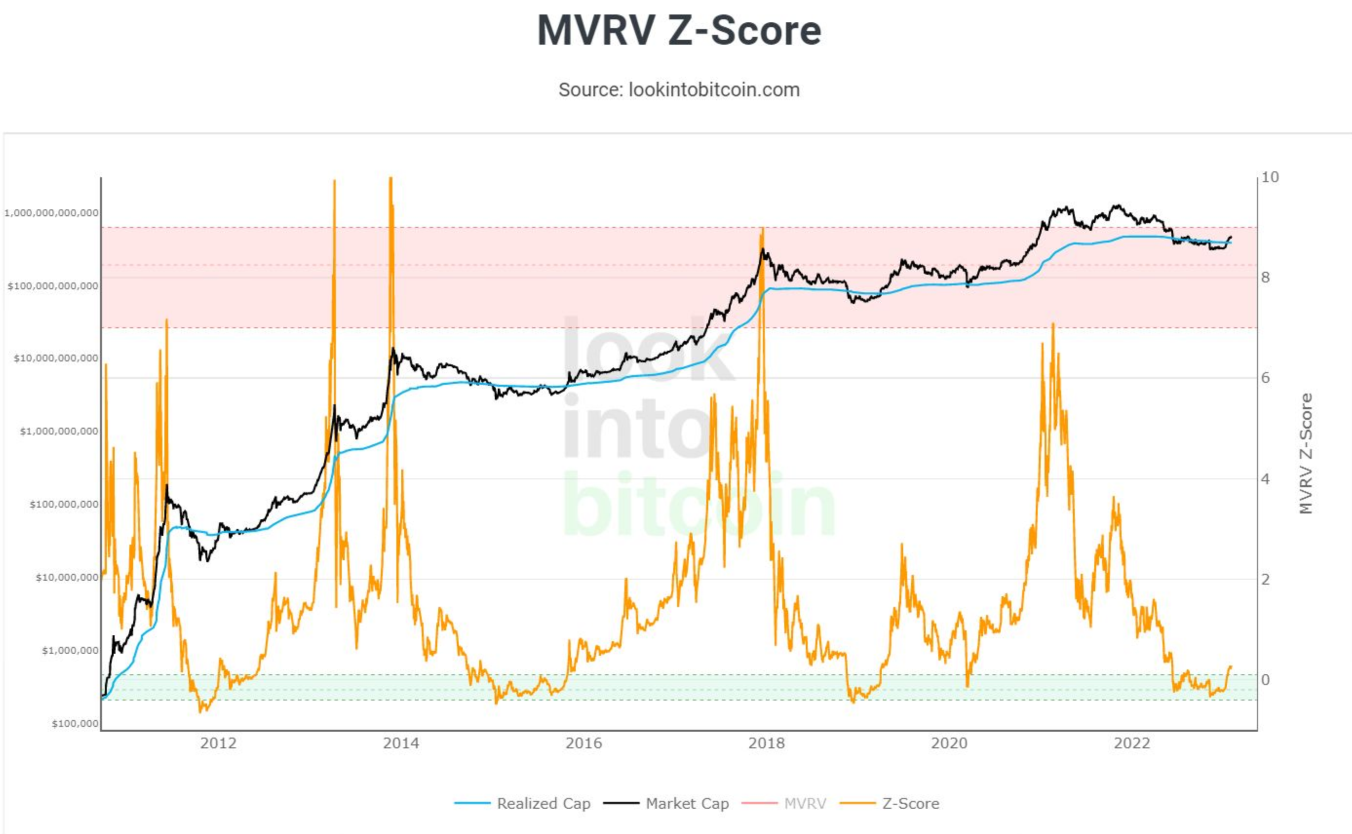


Figure 15. MVRV Z-score (source: lookintobitcoin.com)

The Market Value Realised Value (MVRV) ratio for Bitcoin has also recovered since the start of the new year. As seen in figure 15, the z-score entering the green box implies that the market value is below the realised value. Recovery for the asset after a prolonged spell in the green box has historically provided outsized returns. While this is another metric that’s flashing bullish, it is important to note that a violent move out of the box is normally accompanied by a period of consolidation and sometimes extended pullbacks for BTC.

Over a 12-18 month investment horizon, this behaviour for the MVRV Z-score indicator has a 100 percent success rate for price appreciation.

NEWS FROM THE CRYPTO-SPHERE

Celsius' Examiner Report Reveals that the Company's Problems Dated back to at least 2020

Figure 16. Celsius co-founder Alex Mashinsky

On January 30, Shoba Pillay, Celsius' examiner who was appointed by the US bankruptcy court, released a final report discussing the results of her examination of claims that Celsius' business operations amounted to a Ponzi scheme.

Shoba Pillay started the 689 pages long report by stating that "the business model Celsius advertised and sold to its customers was not the business that Celsius actually operated", adding that Celsius used its customers' crypto asset through further loans, investments or on exchanges to prop up the value of its CEL token while some company insiders were cashing out.

Pillay stated that the increase of the firm's proprietary CEL token have only benefited Celsius' insiders who held most of the CEL token and then made millions of dollars selling it before Celsius went bankrupt. Adding that Celsius' co-founder Alex Mashinsky sold at least 25 million CEL tokens, realizing at least $68.7 million on these sales while Daniel Leon, also a founder of Celsius sold at least 2.6 million CEL tokens for at least $9.74 million.

Pillay wrote that after Mashinsky's sales of large amounts of his personal CEL holdings, Celsius would buy back all of the CEL sold. According to the report, in total, Celsius spent at least $558 million buying its own token on the market.

In her report, Pillay quoted the former Celsius CFO Ms. Harumi Uratha-Thompson, commenting: "We are talking about becoming a regulated entity and we are doing something possibly illegal and definitely not compliant."

Another employee was quoted saying: "We spent all our cash paying execs and trying to prop up Alex's net worth in CEL token."

The document also stated problems with the company's accounting systems and risk management mentioning that "Celsius never fully implemented a robust risk management policy before it filed for bankruptcy." And that it has "significant tax compliance deficiencies" since "Celsius did not employ any dedicated tax professionals for the first three years of its existence."

Pillay also criticised the company's transparency, stating that Celsius' marketing materials and Mashinsky's interviews mislead customers into thinking that their digital assets belonged to them at all times while in reality, by signing the company's terms of use, customers transferred all "rights of ownership" to Celsius.

It is worth adding that on January 31, another court filing was published listing the names of some eligible customers of Celsius' Custody Program, who will be able to withdraw 94 percent of their eligible assets. The fate of the remaining 6 percent will be decided by the court at a later date, according to the filing.

Osprey Funds Sues Grayscale over False Advertising of its Bitcoin trust

Figure 17. Grayscale founder Barry Silbert (Left), founder and CEO of Osprey Funds Greg King (Right)

According to a *Bloomberg* report Osprey Funds, the digital asset manager, filed a lawsuit against its rival Grayscale Investments over false and misleading advertising of its Grayscale Bitcoin Trust (GBTC).

Osprey which runs a rival Bitcoin Trust (OBTC) accused Grayscale of misrepresenting its Bitcoin Trust (GBTC) by claiming that it would be converted into an exchange-traded fund (ETF) while knowing that this was never likely to happen.

Osprey also claimed that Grayscale managed to obtain its leading position only by false and misleading advertising. “Only because of its false and misleading advertising and promotion has Grayscale been able to maintain to date approximately 99.5 percent market share in a two-participant market despite charging more than four times the asset management fee that Osprey charges for its services.” Osprey wrote in the lawsuit.

It is worth adding that back in January 13, 2023, Osprey’s founder and CEO, Greg King shared an open letter to Barry Silbert, founder and CEO of Grayscale’s parent company Digital Currency Group (DCG), claiming that Osprey should sponsor GBTC instead of Grayscale.

“I think you should use your powers to cause Grayscale to withdraw as sponsor of GBTC and name Osprey sponsor instead”, King to Silbert in the letter.

“Effective management of the Grayscale Bitcoin Trust requires specific expertise and the trust of both regulators and all market participants. Grayscale and Osprey are the only providers with the required skill-set, but only Osprey has the trust.” Greg King added.

Alameda Research Sues Voyager For $445.8 Million of Loan Repayments

Figure 18. Former Alameda Research CEO Caroline Ellison (Left), Voyager co-founder and CEO Stephen Ehrlich (Right)

According to a court filing published on January 30, Alameda Research, filed a lawsuit against Voyager Digital seeking to get back a total of $445.8 million in loan repayments that Alameda research transferred to Voyager Digital.

These loan repayments Alameda transferred to Voyager are originally funds Voyager lent to Alameda research before Voyager filed for its bankruptcy in July 2022.

The document stated that following the commencement of Voyager's chapter 11 bankruptcy filing, Voyager demanded repayment of all of its loans to Alameda. Later on, Voyager was repaid in full and Alameda transferred to Voyager a total of $248.8 million in digital assets in September, $193.9 million in October, and $3.2 million of interest payments in August.

It is worth noting that, four months after Voyager filed for Bankruptcy, Alameda research followed along with a bankruptcy filing in November 2022.

Now, Alameda is trying to get the funds back using bankruptcy rules designed to ensure that some creditors are not favoured over others, court document shows.

Ethereum Staking Public Testnet Zhejiang went Live on February 1st

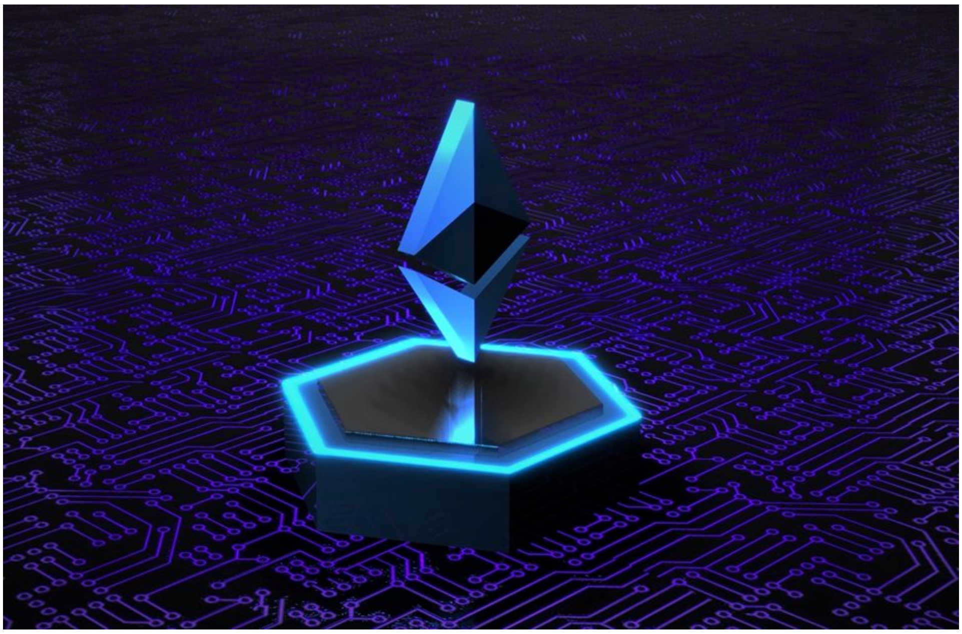


Figure 19. Ethereum's Shanghai hard fork is coming soon

On February 1, Ethereum developers opened a new testnet called "Zhejiang" that gave users the first preview of what the withdrawal process will be like after the Shanghai upgrade.

Ethereum's Shanghai upgrade is set for March 2023, and is meant to fix Ethereum's problem by making it possible for staked ETH on the Beacon Chain to be released gradually and open up an exit for long-time ETH stakers.

In addition to that, liquid staking protocols or sometimes referred to as liquid staking derivatives (LSD), like Lido might benefit more from the Shanghai upgrade since they remove the barrier to entry by allowing ETH holders to participate in staking without having to lock in any tokens.

Ethereum developer Barnabas Busa confirmed on Twitter that the Zhejiang public testnet went live on February 1st, however, users won't be able to test withdrawals until six days later (February 7) when the Shanghai and Capella testnet go live.

Crypto Protocol BonqDAO Got Hacked

Figure 20. BonqDAO exploiter gained access to ALBT Troves

On February 1, crypto lending protocol BonqDAO reported that Bonq protocol was exposed to an oracle hack, with the attacker gaining access to ALBT Troves, where AllianceBlock's native token (ALBT) was used as collateral.

BonqDAO said "The exploiter increased the ALBT price and minted large amounts of BEUR (Bonq euro tokens). The BEUR was then swapped for other tokens on Uniswap. Then, the price was decreased to almost zero, which triggered the liquidation of ALBT troves." "Other troves remain unaffected. Bonq protocol has been paused. We're working on a solution that will allow users to withdraw all remaining collateral without repaying BEUR in the troves." BonqDAO added.

AllianceBlock shared that the exploit is isolated to BonqDAO troves and none of their smart contracts were breached.

Following the day of the hack, on February 2, BonqDAO released an update stating that "the unknown attacker was able to mint 100 million BEUR by manipulating the price feed of ALBT. They were able to do so because the implementation of the price feed contract which reads the price of ALBT from the Tellor Oracle contained a bug."

BonqDAO also mentioned that “AllianceBlock was not involved and/or responsible for implementing the price feed into the Bonq protocol.”

“Currently, more than 98 million BEUR are still on the attacker’s account on Polygon with no liquidity to exit.” BonqDAO added.

On February 3, AllianceBlock also issued another statement saying that “As a third-party protocol, AllianceBlock had no input or control over the design, implementation, and execution of the BonqDAO Protocol and smart contracts”

Matthijs de Vries, Founder and CTO at AllianceBlock, commented “Users who created troves on Bonq using ALBT as collateral will be reimbursed, and no ALBT goes back to Bonq Troves. AllianceBlock is committed to doing right by ALBT token holders, liquidity providers, and others. We are continuously working on how to approach the distribution of the new token best. We have the community’s interest at heart, and we will share more information once we have a comprehensive proposal.”

“The actual damage in numbers involving ALBT from the Bonq hack is closer to $1.6 million than the amounts previously reported by the media.” He added.

Learning Section

The Fed's FOMC

The Federal Reserve

The Federal Reserve (the Fed) is the central banking system of the United States, established in 1913 by the Federal Reserve Act with the dual mandate of promoting maximum employment and stable prices.

The Fed is responsible for implementing monetary policy which can affect spending, investment and overall economic activity.

The Fed's Dual Mandate:

The FOMC

The Federal Open Market Committee (FOMC) is the policy-making body of the Fed and is responsible for setting the direction of monetary policy in the United States. The FOMC is a 12 member group led by the Chair of the Chair of the Board of Governors, with 11 members from the Federal Reserve System. Each year, the FOMC holds eight regularly scheduled meetings, but can meet more often if it's needed.

The Fed's Monetary Policy Tools

1. Open Market Operations

Open Market Operations (OMOs) are a key tool used by the FED to increase or decrease the money supply.
The FOMC is specifically the branch in charge of these operations.
The OMOs involve the purchase and sale of the government securities in the open market to give or take liquidity from a financial institution or group of institutions.

2. The Discount Rate

The discount rate is the interest rate at which eligible banks can borrow from the Fed. If the Fed increases the discount rate, it becomes more expensive for banks to borrow, which discourages borrowing and decreases money supply.

3. Reserve Requirements

Reserve requirements are the minimum amounts of reserves the banks are required to hold against their deposits. The Fed can change these requirements to influence the money supply. If the Fed increases reserve requirements, it reduces the amount of funds available for lending.

4. Interest on Excess Reserves

The Fed can influence the federal funds rate by paying interest on excess reserves that bank holds at the Fed. If the Fed raises the interest rate it pays on excess reserves, it becomes more attractive for the banks to hold onto their reserves, which reduces supply for lending and hence put upward pressure on interest rates to

Quantitative Tightening

The Fed implements quantitative tightening when it seeks to reduce the size of its balance sheet and [redacted] money supply in the economy using the monetary tools at its disposal. This policy is implemented when the economy is in an inflationary environment or a period of economic growth.

Since mid-2021, inflation has been surging in the US, brought about primarily by pandemic related economic stress and the fiscal and monetary stimulus provided in 2020 and 2021 by the government in response to the pandemic.

In June 2022, the Fed began reducing its Treasury debt holdings by $30 billion and its mortgage-backed securities (MBS) holdings by $17.5 billion monthly, passively shrinking its assets as these securities "roll off" without being replaced.

How does the FOMC implement Quantitative Tightening?

1.Policy Decision

The Federal Open Market Committee (FOMC) meets regularly to discuss the current state of the economy and make monetary policy decisions. If they decide to implement quantitative tightening, they will announce this decision in a public statement.

2.Open Market Operations

The Fed uses open market operations to implement its monetary policy decisions. This involves buying or selling government securities in the open market, which affects the supply of reserves in the banking system.

3.Transmission of Higher Rates

The higher federal funds rate is transmitted to other interest rates in the economy, such as those for consumer loans and mortgages. This increases the cost of borrowing, which tends to slow down economic growth and reduce inflationary pressures.

4. Monitoring the Impact

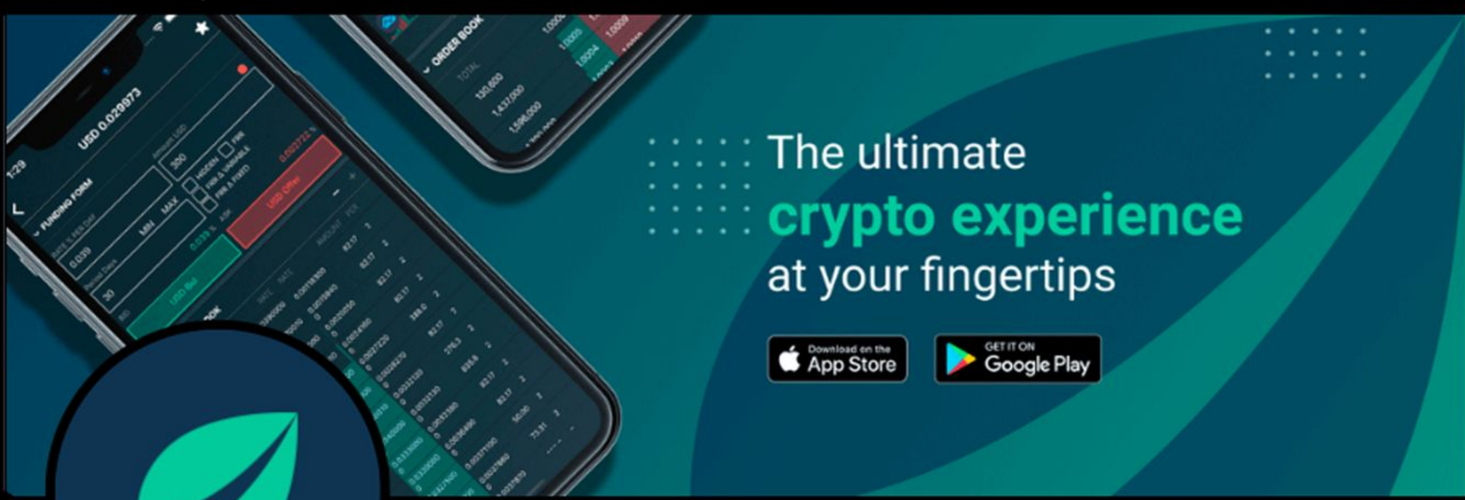
The Fed will monitor the impact of its policy actions on the economy and make additional adjustments as needed. If the economy is slowing too much or inflation is not moving towards the target, the Fed may halt or reverse its tightening policy.

5. Reduction of the Balance Sheet

Over time, as the Fed continues to sell securities and the reserves in the banking system decline, the size of the Fed's balance sheet will decrease. This process of reducing the balance sheet is what is referred to as "quantitative tightening."

What is Quantitative Easing?

The Fed implements quantitative easing to stimulate the economy by putting money back into the financial system – the exact opposite of quantitative tightening. The Federal Reserve purchases large quantities of Treasury securities and mortgage-backed securities issued by government-sponsored enterprises and federal agencies. The Fed implements quantitative easing in times of economic crisis or stalled growth.



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