BITFINEX Alpha

Issue: 06-03-2023
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EXECUTIVE SUMMARY

In the dream scenario, a "soft landing," with moderating inflation and a resilient and growing economy, would be ideal. However, after more evidence of re-accelerating inflation and strong consumer spending in February, the possibility of higher US interest rate hikes continues to loom large over the markets. The S&P 500 lost half of its January gain last month as investors re-evaluate their expectations. The bond market too, after initially being optimistic in January that the Fed will pause soon, has also changed its view on rate hikes.

Regardless of whether the Fed can manage a soft landing, the apparent stickiness of inflation suggests that the US economy is in for a rough ride in 2023. While we anticipate more rate hikes, the Fed's tightened monetary policy from last year is starting to have its effect on the economy. Short-term rates are now significantly higher than long-term rates which is evident in the deep inversion of the yield curve. This affects businesses as it increases the cost of borrowing, and the latest ISM report produced evidence of the impact of higher credit costs in the contraction seen in the manufacturing sector, in the latest ISM report.

As both businesses and consumers are squeezed, consumers are also losing confidence in the economy. Consumer Confidence remains below the range indicative of a healthy economy and suggests a prolonged economic slowdown. The higher and longer the Fed allows elevated interest rates to remain in place, the more pain we expect to be inflicted onto the economy.

In the crypto markets, we are expecting increased volatility in the short-term. Total crypto market cap fell below the psychologically significant $1 trillion mark, following the sharp fall in both Bitcoin and Ether prices at the end of last week. Market dynamics continue to be dominated by futures market with far more significant liquidations - over $210m in just one day - and now happening in the space of minutes. Volatility seems here to stay.

Against this market backdrop, the US Securities and Exchange Commission (SEC) continues to have a busy first quarter. Robinhood revealed it has received an investigative subpoena from the SEC over its crypto listings, custody, and platform operations; while Silvergate, a leading crypto bank, delayed its annual filing to the SEC as it evaluates its ability to remain operational, after suffering significant losses.

TrueUSD (TUSD) became the 5th largest Stablecoin as Binance mints 130 million TUSD in a week. Meanwhile, Ethereum developers are set for the final trial for their Shanghai upgrade, which will allow the release of locked-up ETH. It's never uninteresting in crypto.

Happy Trading!

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GENERAL MARKET UPDATE

“Soft Landing” Scenario Continues To Fade Out

A "soft landing," with moderating inflation and a resilient, growing economy, would be ideal. However, market sentiment suggests that turbulence ahead is more likely.

The possibility of higher US interest rates continues to loom large over markets, and recent Personal Consumption Expenditure (PCE) inflation data has not helped in changing this sentiment.

Figure 1. S&P 500 climbed higher in January anticipating a rate hike pause – only to drop into the monthly close in February as investors re-evaluate labour, spending, and inflation data (Tradingview)

In February, the S&P 500 has declined by five percent, reflecting a re-rating in the markets. Prior to this period, the S&P had seen a year-to-date gain to February 2nd of 9.3 percent, driven by assumptions that the Federal Reserve (the Fed) will pause its rate hiking cycle early this year. Recent data showing robust hiring, strong spending and inflation re-accelerating have led investors to re-evaluate their expectations.

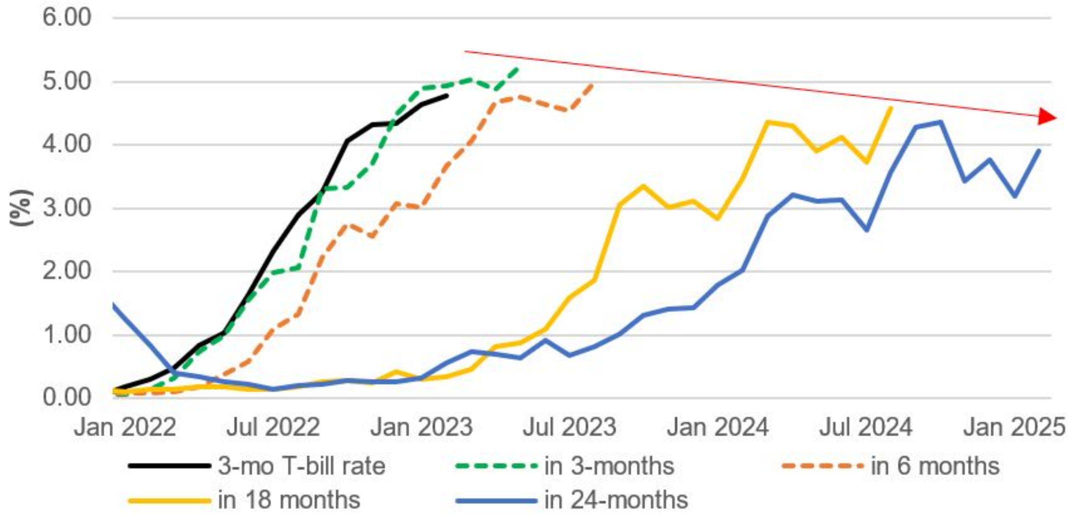


Figure 2. Market Expectations for the path of the Fed's Policy: Forward rates of three-month T-bills in 3, 6, 18 and 24 months (Source: Bloomberg, RSM US)

Earlier in the year, the bond market had also priced in the possibility of a pause in rate hikes. The forward rate for three-month Treasury bill provides insight into the market's expectations for future interest rates. Since the three-month Treasury bill rate is a short-term interest rate, it is particularly sensitive to changes in the federal funds rate and hence used to anticipate rate hikes. The forward market for three-month rates dropped in January, when it briefly anticipated that the Fed will pause raising interest rates early this year. Now, the forward market anticipates a federal funds rate to reach 5.25 percent at the June FOMC meeting. Beyond that, it predicts a gradual decline to around 4 percent in the year 2025.

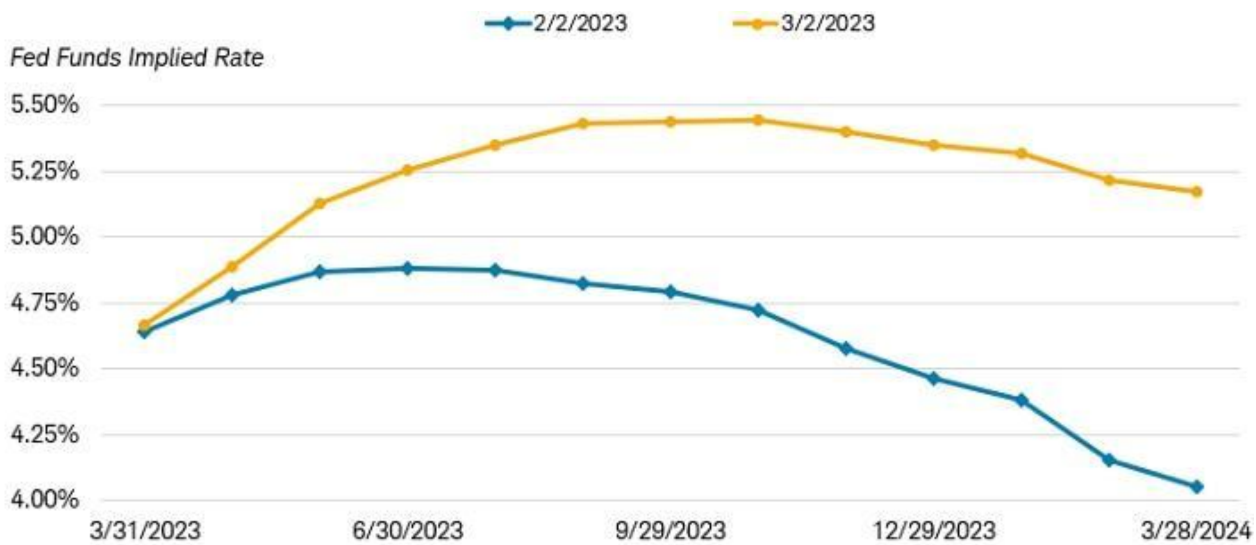
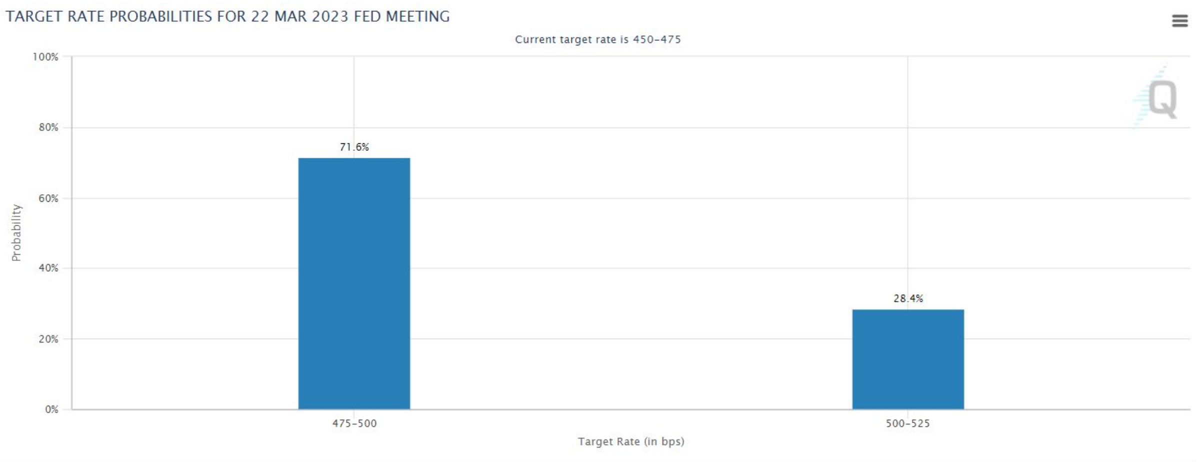


Figure 3. Market estimate of the federal funds rate using Fed Funds Futures Implied Rate, February vs March (Source: Bloomberg)

In the previous issue of *Bitfinex Alpha*, we illustrated just how hot the economy was. We expect the Fed to hike by at least 25 basis points for each of the next three FOMC meetings. This gives us a terminal federal funds rate in the range of 5.25 to 5.5 percent by June. This is up 50 basis points compared to a month ago. We also do not rule out the possibility of rates going as high as six percent if future economic data still shows inflation to be sticky, with a "hard landing" for the economy becoming an increasingly likely scenario.

How Hard will the Fed hit the brakes?

Regardless of whether the Fed can manage a soft landing, expectations of more rate hikes and the apparent stickiness of inflation tells us that the economy is in for a rough ride. The Fed's Summary of Economic Projections will be released at the upcoming FOMC meeting on March 21st and 22nd. Post that, investors will have a better insight into the Fed's plans. There are some expectations that the Fed will increase by 50 basis points but we think that is unlikely.



TARGET RATE (BPS)	PROBABILITY(%)			
	NOW *	1 DAY 2 MAR 2023	1 WEEK 24 FEB 2023	1 MONTH 3 FEB 2023
450-475 (Current)	0.0%	0.0%	0.0%	2.6%
475-500	71.6%	68.6%	73.0%	97.4%
500-525	28.4%	31.4%	27.0%	0.0%

Figure 4. Target Rate Probabilities for March 22nd, 2023 Meeting (Source: cmegroup.com)

It is likely that the Fed will hike by an additional 25 basis points bringing the target range for the federal funds rate to between 4.75 and 5 percent. The Fed just scaled back its rate hikes in January, so we don't expect them to change course too soon. However, the current estimate for the terminal rate (or the peak funds rate) could rise depending on the Fed's assessment of how much tightening it would need to significantly push down inflation.

Following a year of rapid tightening, it makes sense for the Fed to slow down the pace of rate hikes because changes in monetary policy have a lagging effect on inflation numbers. In fact, there are indications that the policy is already restrictive enough to slow down economic growth.

The yield curve has historically been a harbinger of recession. It is currently inverted across the Treasury market, which implies that short-term rates are significantly higher than long-term rates. The spread between the two-year and 10-year Treasury yields has dropped by nearly 90 basis points, the deepest inversion since the 1980s. The yield curve has historically been a reliable indicator of a recession happening within 12 to 18 months. However, the depth of inversion has not always corresponded to the severity of a recession.

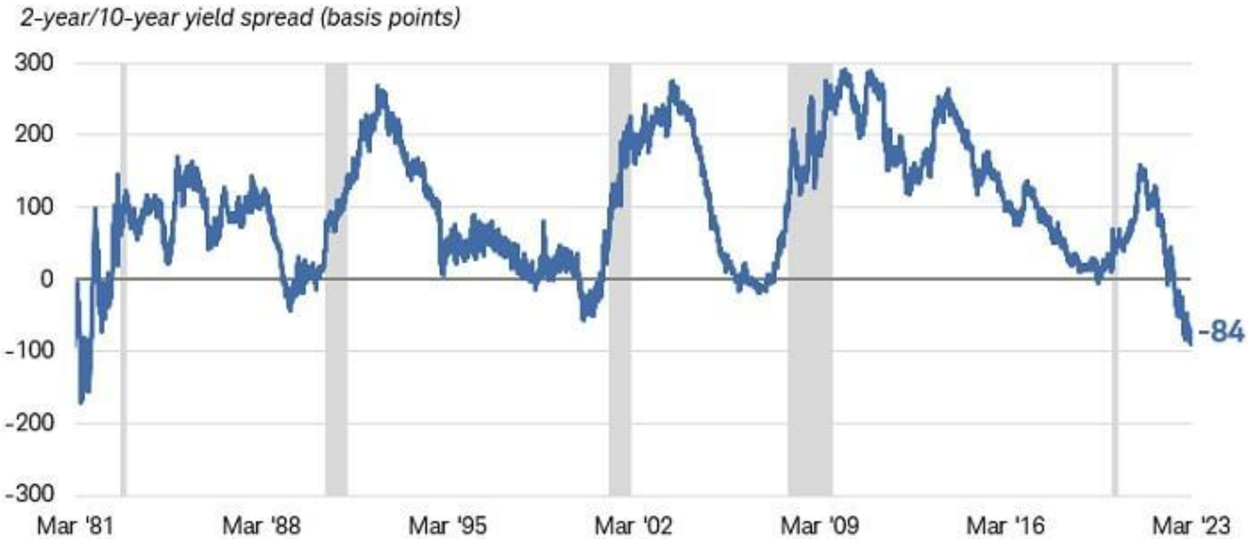


Figure 5. Two-Year/ Ten-year spread, in basis points. Daily data as of 3/1/2023 (Source: Bloomberg)

An inverted yield curve will result in a slowdown in lending activity. Financial institutions such as banks tend to borrow at short-term rates and lend at longer-term rates and earn the difference. Lenders increase the cost of borrowing and reduce the amount of what they are willing to lend when short-term rates climb significantly higher than long-term rates.

Since the desired effect of stricter monetary policy is to increase the cost of capital to sufficiently reduce economic activity, lending standards are tightening for both business and consumers.

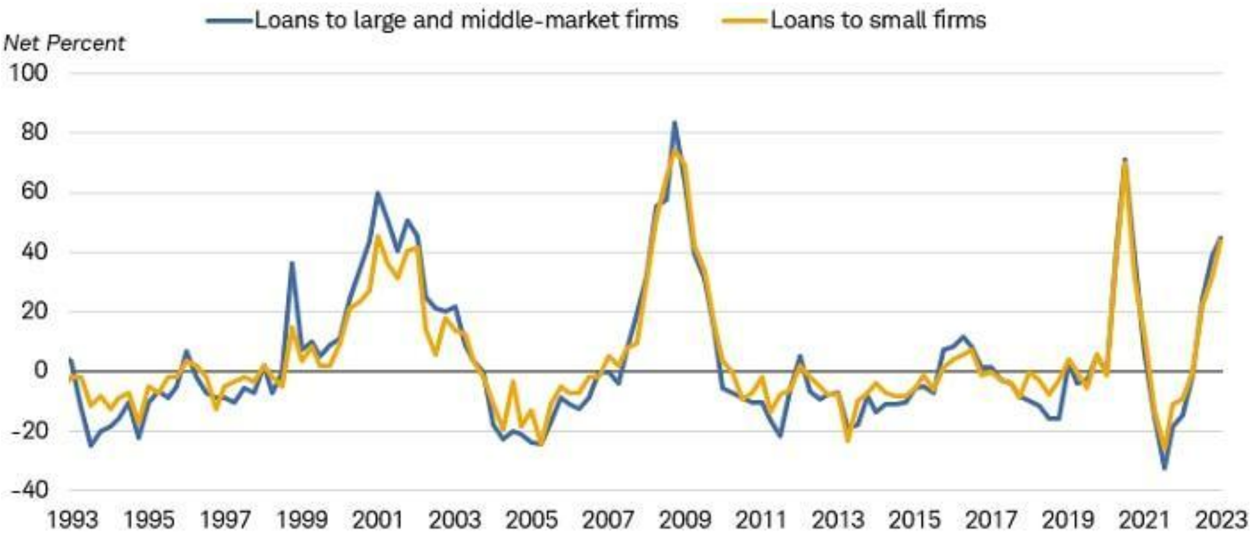


Figure 6. Commercial and industrial loan standards: Federal Reserve's Senior Loan Officer Survey: Net Percent of Domestic Respondents Tightening Standards for Commercial & Industrial Loans for Large/Medium Sized Firms and Small Firms (Source: Bloomberg)

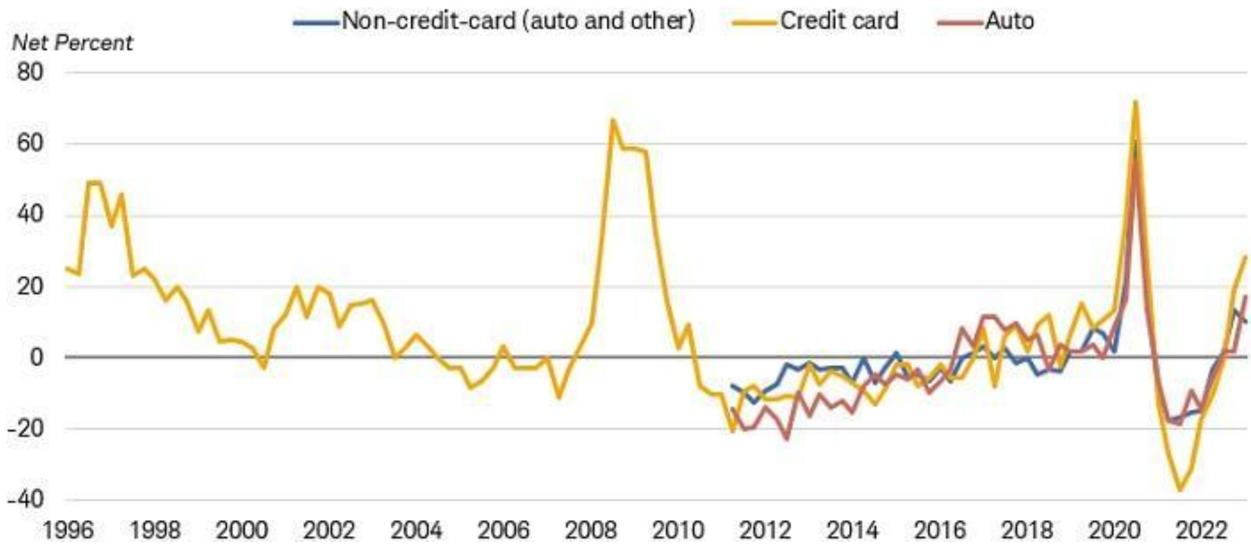


Figure 7. Consumer loan standards: Federal Reserve's Senior Loan Officer Survey: Net Percentage of Domestic Respondents Reporting Tightening Standards for Consumer Loans Quarterly data as of January 2023. (Source: Bloomberg)

The manufacturing sector has contracted for the third straight month as borrowing costs continued to affect demand. The Institute of Supply Management's (ISM) index in February was 47.7 which is still below the long-term neutral level of 48.7. The ISM indicates that an index higher than 48.7 indicates economic growth. A decrease in production and a decline in new orders are the main causes of the contraction.

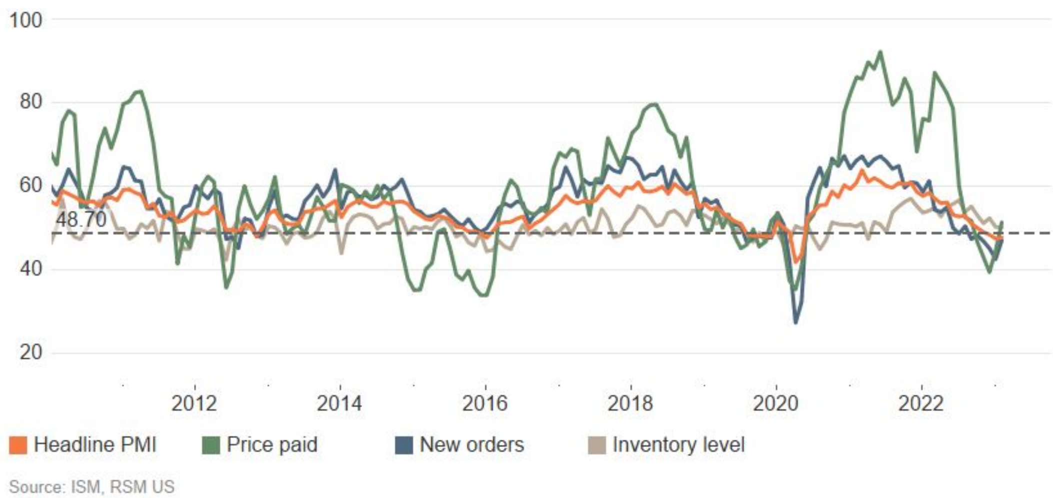


Figure 8. ISM Manufacturing Index: PMI above 48.7 indicates an overall expansion of the economy (Source: ISM, RSM US)

Figure 9. ISM Manufacturing Price Paid Rebounds in February (Source: ISM, Bloomberg)

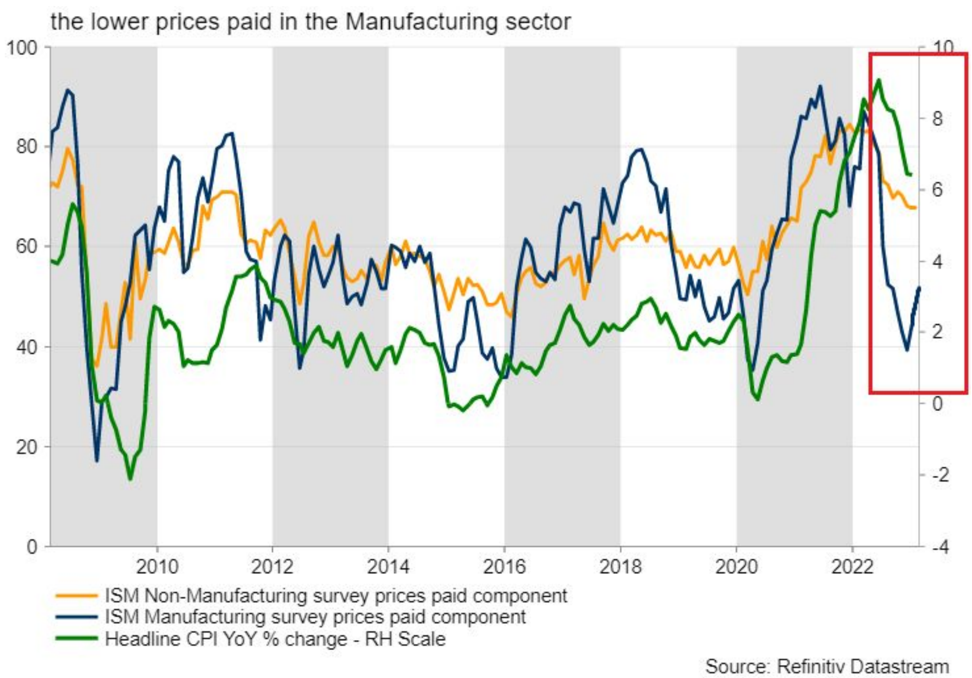


Figure 10. ISM Manufacturing Price paid picks up amid moderating headline CPI (Source: Refinitiv Datastream)

Despite inflation moderating, prices paid on manufacturing goods increased in February after consecutively declining for four months. This rebound in the prices of manufacturing goods, came as the imbalance we had previously seen between supply and demand, eased back to normal.

In the last quarter of 2022, inventories had been growing at a rapid rate as the disruptions in supply chain eased and shipping cost improved. As inventories accumulated and the inventory to sales ratio increased, suppliers had adjusted their pricing to align with demand, which lead to reduced prices. However, as demand caught up with supply, as seen in the strong consumer spending data for February, prices of manufacturing goods rebounded. This strengthens our case that inflation will remain sticky this year.

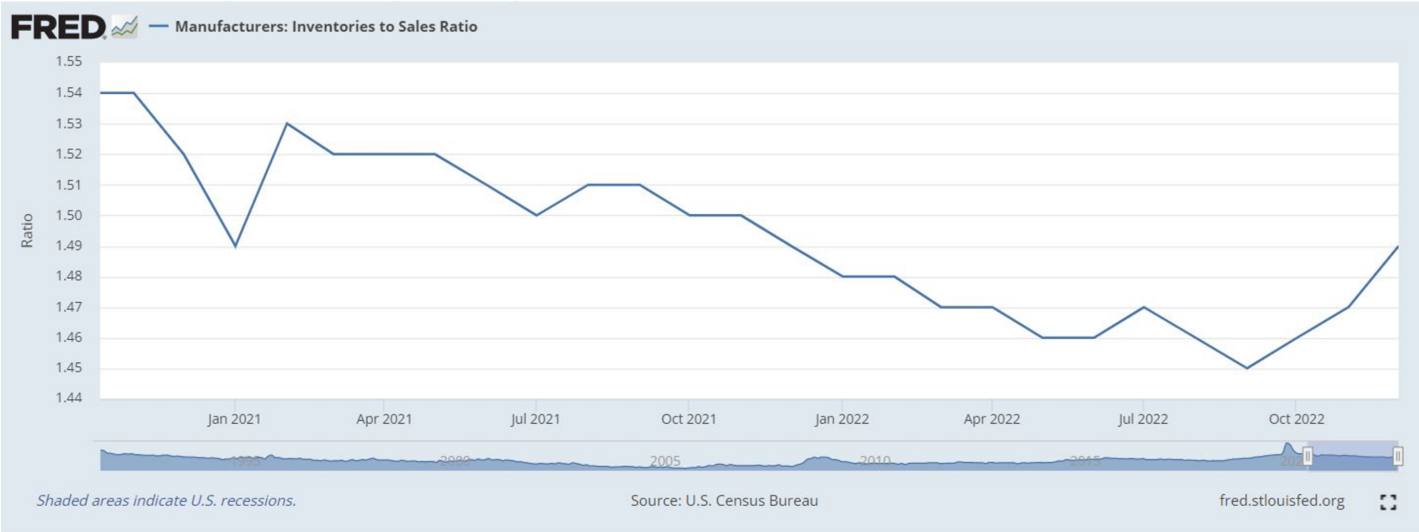


Figure 11. Increase in Inventories to Sales Ratio in the last quarter of 2022 as Supply Chain Eases and Inventories Build-up (Source: US Census Bureau)

The best-case scenario for the bulls would be a soft landing where inflation continues to recede while economic growth and employment continue to stay positive. However, given the market sentiment and effects of tightened policy on the cost of credit for businesses, we expect an economic slowdown this year.

Investors should be cautious as the economy seems bound for a bumpy ride.

Consumer Confidence Falls amidst rebound in recession fears

As high inflation and rising interest rates dampen U.S. growth, consumers are losing their confidence in the health of the economy, which in turn can further affect spending and contribute to a prolonged slowdown. Consumer confidence dropped to a three-month low of 102.9 in February, according to US Conference Board report, issued last Tuesday, February 28th. The *Wall Street Journal's* survey of economists had predicted a higher reading of 108.5 for the index.

Consumer confidence tends to reflect the perception of the economy's future. The index remains below the range indicative of a healthy economy. The worsened expectations are most likely to result in a rebound in inflation and our anticipation is that upcoming rate hikes could push the economy towards a hard landing.

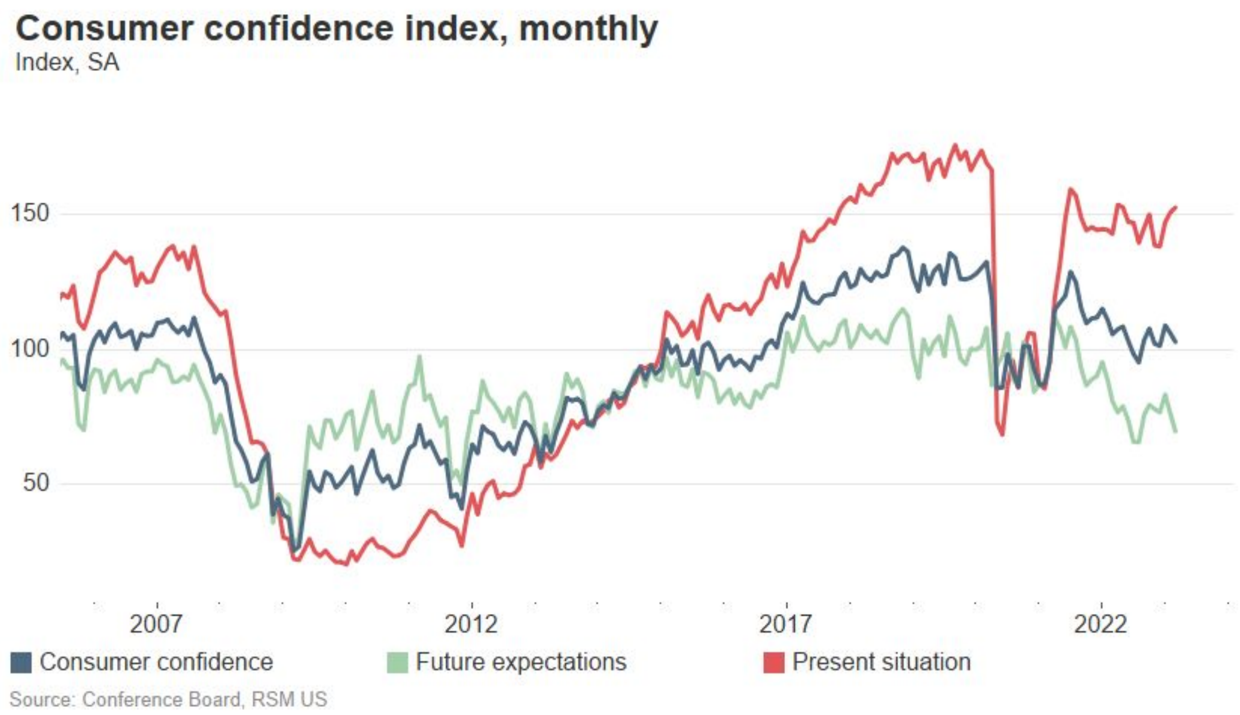


Figure 12. Consumer Confidence Index, monthly (Source: Conference Board, RSM US)

Though American consumers remain resilient, we cannot expect robust growth as the Federal Reserve is still determined to keep tightening monetary policy. Even if headline inflation (Consumer Price index) has slowed to 6.5 percent from a 40-year peak of 9.1 percent last year, it’s still more than triple the Fed’s two percent goal. The higher and longer the Fed allows the elevated interest rates to remain in place, the more pain they will cause the economy.

WHAT'S ON-CHAIN THIS WEEK?

Increased Volatility In The Crypto Market

Figure 13. Total Crypto Market Capitalisation.

Total Cryptocurrency Market Capitalisation fell below the one trillion dollar mark on Friday, March 3rd and closed the daily candle below this massive psychological level. It has been at or above one trillion dollars since January 25th, 2023. Prior to this, it had spent 225 days below this level. Major cryptocurrency prices tumbled last Friday, amid jitters about the health of crypto bank Silvergate (see page 19). BTC hit a low of $22,000, down around 4.9 percent on the day. Ether was down around 5.2 percent, and was trading in the upper-$1,500s. Total cryptocurrency market capitalisation fell to around $986 billion, down a little over 4.4 percent or around $43 billion on the day. This is alarming as typically, depreciations in percentage terms of BTC and ETH that is greater than total crypto market cap, has historically occurred only at local tops in prices.

All of this took place while volatility metrics picked up. Realised volatility and implied volatility have increased slightly over the past 10 days, however, these are long term indicators that lag behind price. Our conclusion is that short-term volatility will increase and the market will find itself ranging for the next week. On the higher timeframe, ranging after a drop like this has historically signalled that a short-term top may already be in or in the process of formation for Bitcoin. Our thesis in *Bitfinex Alpha* from two weeks ago could soon prove true, with a range formation here and an even deeper market-wide pullback being the two possibilities, as indicated in our analysis of the options market and the fact that we have already reached an eight month high.

The drop in prices resulted in a surge in trader liquidations. According to Coinglass data, long positions in the crypto futures market worth over $210 million were liquidated on March 3rd, the highest in nearly one month.

Figure 14. Total Crypto Market Liquidations. (source: coinglass)

This was the first significant liquidation of longs since the FTX implosion, nearly four months ago. The reasoning behind this is that the futures and derivatives market has been in "control" of the price recently as average Bitcoin futures Open Interest had increased to over $8.6 billion dollars around the monthly open for March 2023, 25 percent higher than average open interest of less than $7 billion since November. During this liquidation cascade, $800 million of futures open interest was wiped out in the BTC market alone, of which $190m was wiped out in 12 minutes. This was unprecedented not because of the total figure but because of the speed at which this took place.

Figure 11. BTC weighted aggregated open interest across exchanges. (source: coinalyze)

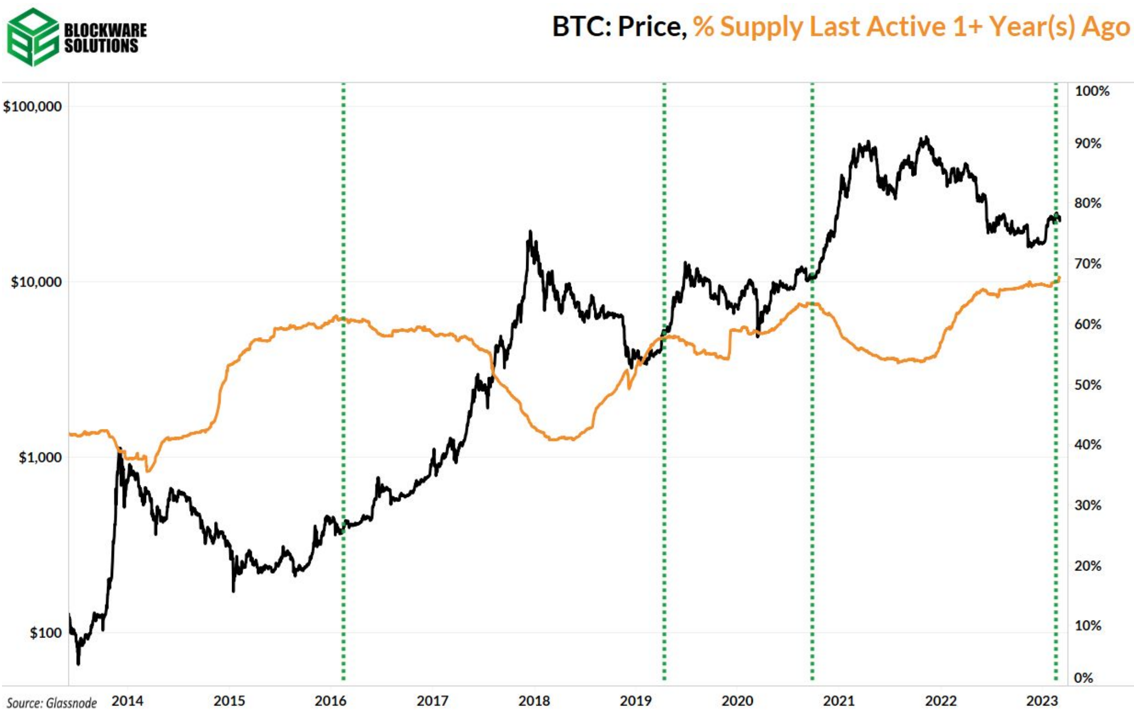


Figure 15.BTC supply inactive for more than a year. (source: Blockware)

When we refer to derivatives being in control of the price, this is because on-chain metrics have not changed. The crypto futures market seems flooded with higher risk appetite traders, as evidenced by the spiking open interest wipeouts and liquidations data. Spot trends and on-chain wallet balances still remain healthy for the bulls. This is better illustrated by Bitcoin's inactive supply soaring to all-time highs.

A liquidation cascade of this scale, one that occurs over the span of a few minutes has been a rare occurrence in the Bitcoin market over the past year. During the FTX implosion or the Luna crash, liquidations came in waves. On the minute timeframes, it was apparent how traders were still speculating and there was aggression from both sides (buyers and sellers) with multiple spikes in liquidations. Currently, we saw over $210 million in long liquidations. While this is a fraction of the figures recorded during black swan events in 2022, most of it occurred over the span of a few minutes. We can term this "bear market PTSD" because despite the healthier on-chain statistics and a large market-wide recovery, traders are quick to cut positions and open interest wipeouts have become massive as mentioned earlier alongside liquidation cascades. Any minor pullback is often accompanied by panic sellers (short-term traders exiting longs) and over eager shorts as seen by a small spike in net shorts during BTC's move to $22,000 entering the market hence exaggerating the effect on price.

The overall picture is one of increased volatility, alongside short term tight ranges where price may ping-pong aggressively between levels, at least for the coming week.

NEWS FROM THE CRYPTO-SPHERE

Binance Responds to Forbes' accusations

Figure 15. Binance CEO Changpeng Zhao

On March 1st, Binance issued a blog post intended to address claims by *Forbes* that Binance had secretly moved $1.8 billion of collateral meant to back customer-owned stablecoins, and put the assets to other undisclosed uses.

Forbes reported that Binance employed a comparable tactic to the one that caused FTX's downfall. In particular, it said that Binance transferred $1.8 billion to several hedge funds, distributing $1.1 billion to Cumberland and the rest to Amber Group, Tron, and even Alameda Research, sister-company to FTX.

The funds were supposed to be providing backing to Binance users' stablecoins, and *Forbes* claims that the company failed to inform its customers of the transaction, leaving their assets without any collateral from August 2022 to December 2022.

Binance responded to *Forbes*' allegations stating that those conclusions could only be made as a result of a fundamental misunderstanding of wallet management and that the transactions mentioned by *Forbes* are simply a case of institutional clients withdrawing their own assets from the platform rather than a case of misusing collateral and payments to hedge funds.

Binance added that it users’ assets were at no time undercollateralized because they always keep sufficient reserves within their accounts, which is verifiable via their proof-of-reserves system.

Furthermore, Changpeng Zhao, Binance CEO, expressed his deep disappointment towards the *Forbes* article, stating that it was written with a negative spin, “intentionally misconstruing facts”.

Silvergate Bank Unable To File its Annual Report On Time

Figure 16. Silvergate Bank CEO Alan Lane

On March 1st, Silvergate announced in a filing with the US. Securities and Exchange Commission (SEC) that it would not be able to file its 10-k annual report on March 16.

Silvergate said that the reason for the delay is that the company needs additional time to allow its independently registered public accounting firm to complete certain audit procedures.

Silvergate also mentioned that it was at risk of being “less than well-capitalised” due to recent losses that have negatively impacted the bank. Additionally, Silvergate is currently evaluating its ability to remain operational for the next 12 months and is re-evaluating its businesses and strategies in light of the challenges it faces.

This news has been met with a rapid reaction from crypto firms, including Coinbase, Galaxy Digital, Paxos, Gemini, Circle, Bitstamp, Crypto.com, and Cboe Digital, who announced that they would not be able to accept or initiate transfers to Silvergate.

Robinhood Subpoenaed by SEC Over Crypto Business

Figure 17. Co-Founder and CEO of Robinhood, Vladimir Tenev

On February 27th, Robinhood released its 10-k annual report, revealing that the company had received an investigative subpoena in December 2022 from the US Securities and Exchange Commission (SEC) regarding their cryptocurrencies' listings, custody of cryptocurrencies, and platform operations.

Robinhood said it had received the subpoena in December 2022, shortly after FTX filed for bankruptcy on November 11, 2022, and following the bankruptcies of several other major cryptocurrency trading venues and lending platforms earlier in the year.

Moreover, Robinhood mentioned that it has also received subpoenas from the California Attorney General's Office seeking information about the trading platform, business and operations, custody of customer assets and coin listings.

Robinhood stated that it's cooperating with these investigations, and that they expect to be subject to judicial or administrative sanctions for failing to offer or sell cryptocurrency in compliance with securities registration requirements, or for acting as a securities broker or dealer without appropriate registration.

TrueUSD Becomes 5th Largest Stablecoin as Binance Mints 130 Million TUSD in a Week

Figure 18. TUSD is now the 5th largest stablecoin by market capitalisation

On February 27th, it was reported that Binance minted 130 million worth of TUSD in the past seven days, resulting in TUSD becoming the fifth-largest stablecoin by market capitalisation.

In addition, crypto research firm CryptoQuant told *Coindesk* that TUSD exchange reserves experienced a 39 percent gain between February 13 and February 22, driven also mostly by Binance.

TUSD is a stablecoin pegged to the US dollar, issued by crypto firm ArchBlock, formerly known as TrustToken. The stablecoin's value is fully backed by fiat assets, meaning that each token represents one US dollar held in reserve. Collateral data for TUSD has been verified by ChainLink's proof-of-reserve monitoring tool on the blockchain.

The minting activity suggests that Binance has increasingly relied on TUSD as a stablecoin especially after facing regulatory scrutiny over its own branded stablecoin, BUSD. This has led to speculation that Binance may soon give a greater role to TUSD on its platform.

Ethereum Developers Are Ready For The Third And Final Tesnet For The Shanghai Upgrade

Figure 19. Shanghai Upgrade on Goerli Testnet is now set for March 14

Ethereum developers have set a target date of March 14 for the Goerli test network to undergo the Shanghai upgrade.

The Goerli testnet will serve as the final trial for the Shanghai hard fork before it is rolled out on the mainnet.

Tim Beiko, a project coordinator and core developer on Ethereum stated that if the Goerli testnet launch is successful on March 14, they will aim to proceed with the mainnet implementation.

Beiko also explained that while they have not yet decided on a specific date for the mainnet deployment, it is likely to be agreed upon during the upcoming developers' meeting on March 16, presuming that the Goerli testnet performs well on March 14.

The upgrade is highly anticipated by the Ethereum community as it is meant to make it possible to withdraw staked ETH from validator nodes for the first time and open up an exit for long-time ETH stakers.

Lido's Token (LDO) Falls 10 percent Following Rumours Of Receiving SEC Wells Notice

Figure 20. LDO Token drops by 10 percent following SEC rumours

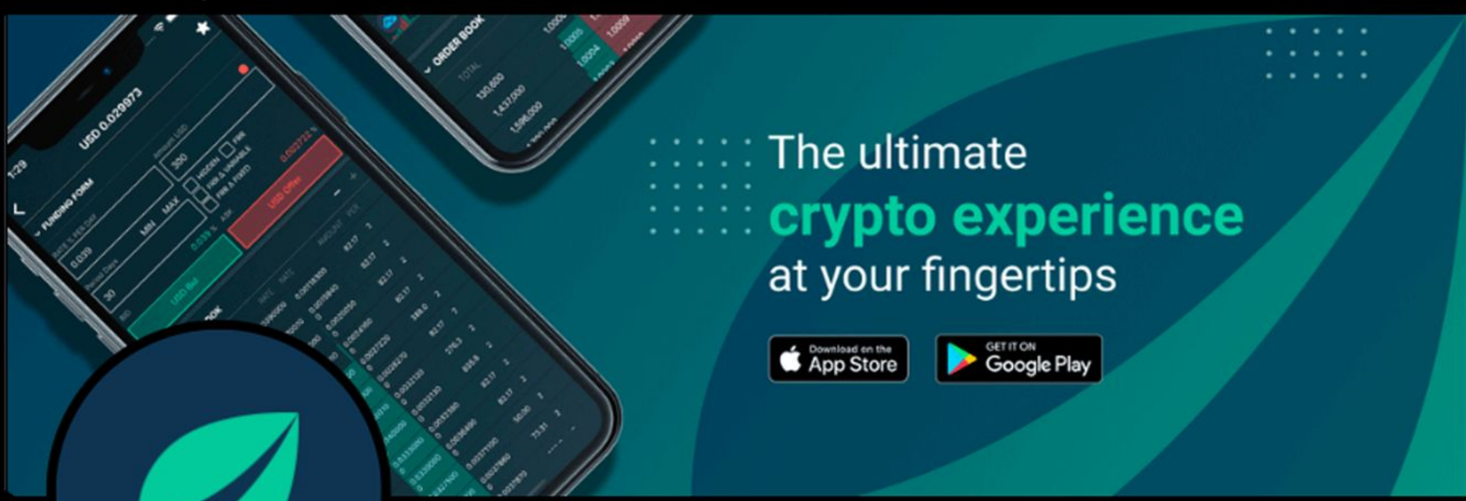
On March 5th, it was reported that Lido's token (LDO) dropped by 10 percent due to rumours that the US Securities and Exchange Commission (SEC) had served the largest Ethereum staking service with a Wells Notice.

A Wells Notice is a letter from the SEC detailing charges it is considering bringing against a recipient.

David Hoffman of the *Bankless* crypto podcast had previously asserted that Lido and other crypto projects had been served with Wells Notices, but later retracted his statement. Despite the retraction, the market responded to the Wells remarks, with the price of LDO falling 10 percent.

Andrew Thurman of crypto analytics firm Nansen tweeted that Wintermute, one of the largest crypto market makers, sold off around 10 percent, or $2 million, of its LDO holdings - seen as a reaction to the Wells rumours.

A spokesperson for Lido declined to comment on whether the protocol had received a notice.



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