



Market Report | 07.02.2023

Market Review 2022: Overleveraged market participants mark the premature end of the bull cycle

In line with the Federal Reserve's change of direction, the crypto bull market culminated its cycle in November 2021. After almost two years of considerable price increases, the first cracks in the foundation appeared, which would later lead to the collapse of several respected market participants.

In November 2021, most cryptocurrencies reached their peak. What followed was an inevitable outcome: the demand side could no longer absorb the daily influx of new tokens. In 2022, the risk-off trend that had been triggered by Quantitative Tightening (QT) in global markets particularly impacted the overheated digital asset sector.

This new trend exposed profound issues that the industry had been able to evade for too long due to continuous price increases. The euphoria surrounding the Web3 ecosystem, which was still in its infancy, had spawned many immature projects that were often equipped with ponziomic "tokenomics". Projects without real-world utility and tokens that could only be kept alive through continuous new adoption collided with overleveraged market participants. This toxic mixture unfolded into a downward spiral, resulting in the first bankruptcies of prominent actors and a contagion effect that spilled over to all other poorly positioned speculators.

Grayscale Bitcoin Trust (GBTC): first shadows on the horizon

The foundation for a leverage chain was already laid in 2020. In the United States, there was a void of exchange-traded instruments to participate in the rapidly rising prices of digital assets. For many investors, an exchange-traded product in the form of a trust from crypto specialist Grayscale was the only option to profit from price increases of the largest cryptocurrency. However, the instrument named

Grayscale Bitcoin Trust (GBTC) was equipped with a one-sided mechanism. The closed-end fund contained the option to exchange bitcoins for GBTC to later sell them on the stock exchange - but not vice versa. Dedicated market participants could therefore sell their GBTC shares received against Bitcoin on the stock exchange after a lock-up period of 6 months. As more and more investors invested in GBTC, a remarkable premium in the double-digit percentage range established itself in the exchange-traded product.

A perfect target for crypto hedge funds that already held Bitcoin. Through a delayed arbitrage trade, the funds could redeem their Bitcoin holdings for Grayscale Bitcoin (GBTC), wait six months, and then cash in on the premium. Resourceful market participants with higher risk tolerance financed the entire trade with external capital and deposited the GBTC shares as collateral during the waiting period to re-enter the lucrative loop with even more borrowed capital. It quickly becomes clear that this highly lucrative business only works in the optimistic scenario in which GBTC has a premium to Bitcoin.

Poor risk management brings down the first overleveraged players

The GBTC trade makes it clear that there were enough lenders for leveraged transactions. In the crypto world, these are called centralized lenders. Because even the crypto lending business, i.e. lending against digital securities, was a very lucrative pursuit during the bull market.



As the efficiency of the crypto markets increased and new investment products emerged, the initial GBTC premium gradually diminished and turned the trust into a ticking time bomb. As crypto prices fell, the premium soon turned into a discount. Since the exchange-traded product was also used as collateral for further loans, GBTC became a problem that weighed increasingly heavily on the books of the parties involved. Crypto hedge funds like Three Arrows Capital (3AC) were particularly affected by the reversing credit spiral due to their high exposure to this trade. Accordingly, lenders were also caught up in the dwindling collateral: Genesis Global Trading, which operates under Grayscale's parent company, later filed a claim for \$1.2 billion against the already insolvent 3AC hedge fund.

Terra/Luna crash creates further holes in balance sheets

Misfortune rarely comes alone. In the bull market, massive demand for digital assets collided with an equally active and creative creation of various tokens. One novel construct that emerged in this environment was the algorithmic stablecoin UST, whose security was based on newly created seigniorage tokens LUNA. Such mechanisms are essentially designed to function only under steadily increasing demand. And so it happened in the changed environment, as it had to. The then \$60 billion construct was overwhelmed within a few days by its own Ponzi-like mechanism. The market value of the entire ecosystem collapsed to less than one billion, leaving numerous market participants with a total loss.



Figure 1: Terra LUNA/USDT Chart | Source: Tradingview

The fact that so many investors were involved in Terra/Luna was due to the guaranteed annual return of over 20% that investors received when depositing their UST stablecoins with the affiliated credit portal Anchor Protocol. This warning signal was often ignored at that time. Thus, not only risk-seeking venture capital investors (3AC) fell victim to the Terra construct. Centralized crypto lending services like Celsius and BlockFi, which promised their customers double-digit returns on their deposits, were also caught with excessive Terra/Luna exposure. The first chain reaction was triggered.

FTX/Alameda - amateurish risk management turns into fraud

One of the last lifelines for struggling lending platforms came initially from the then-second-largest cryptocurrency exchange, FTX. Founded in 2019 by Sam Bankman-Fried and Gary Wang, FTX quickly became one of the most innovative and rapidly growing platforms in the crypto world. Its subsidiary, Alameda Research, which was originally focused on quantitative trading strategies, increasingly acted as a venture capitalist over time. The conglomerate made dozens of investments, issued and borrowed loans, while its CEO Sam Bankman-Fried made generous donations to US politicians and signed advertising deals worth hundreds of millions of dollars.

At that time, no one knew that there was no separation of powers between the cryptocurrency exchange FTX and the trading firm Alameda. Even worse, contrary to its own policies, FTX moved its clients' funds to Alameda's balance sheet and, in exchange, received second-class illiquid tokens of its own exchange (FTT) as collateral. What was initially perceived as financially healthy on the outside was, in reality, an extremely unstable structure that collapsed within two weeks of the discovery of fraud.

The impact of the FTX scandal revelation has rippled deeply throughout the industry. The actions of CEO SBF and other FTX/Alameda officials must be classified as criminal due to recent revelations. In addition to the billions in losses suffered by



customers and counterparties, the entire sector's reputation has been severely damaged.

"Crypto's Enron" leads to "Lehman moment"

The parallels between the 2008 financial crisis and the current situation in the cryptocurrency markets are striking. A group of semi-regulated financial actors chase attractive returns, which can be even higher due to easily accessible leverage. The game is simple, as loans can be secured by illiquid, second-rate collateral: what used to be a bundle of junk mortgages dressed in AAA clothing is replaced in the digital age by self-created "utility" or "governance" tokens - and we find ourselves in exactly the same movie.

The vulnerabilities of the troubled institutions do not differ from the traditional financial market. Leverage, lack of diversification, and unrealistic balance sheet management often lead to collapse in stressful situations. However, there is no central bank in the crypto market that comes to the aid of "too big to fail" market participants and creates zombie firms with a non-market conforming interest rate environment. Here, the free market decides on life and death. This creates a robust, superior, and more sustainable market compared to the traditional financial market, occupied by crisis-resistant participants who must have their risks under control.

Crypto has come to stay

At first glance, the wreckage left by the market correction is substantial. In addition to the price losses, there is a understandable distrust from the general observer of the sector, whose confidence now needs to be slowly restored. Despite all the damage, it should not be forgotten that the origin of the misery that the industry has maneuvered itself into has little to do with Bitcoin or the blockchain, whose integrity has remained unscathed since its inception. After all, a blockchain system is built on mathematical proofs, not trust. If too much of the latter is combined with highly speculative and sometimes dishonest players, the ancient ingredients of a financial crisis are present. The end result is likely to be a better-positioned and sustainability-focused infrastructure.

If we focus on the fundamental developments in the blockchain industry, we can undoubtedly see significant progress. The two-year bull market was wild, and the hangover from the party was accordingly severe. Nevertheless, the further developed infrastructure around crypto and its derivatives is remarkable. Venture capitalists have recently invested billions in infrastructure, and an estimated 300 million people worldwide now use crypto applications. With a growth rate of nearly 100%, the one billion mark could be exceeded as early as 2024.

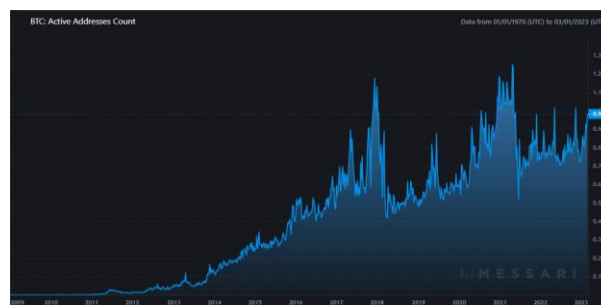


Figure 2: Active Bitcoin addresses | Source: Messari

The combination of added ingredients has the potential to revolutionize interactions on the internet. Through tokens, users are directly integrated into an ecosystem - this has also been discovered by reputable companies outside the financial world. The synthesis of blockchain-based applications with Web2 and real-world applications ultimately leads to the metaverse or Web3. Through the successful Ethereum merge, this will be enabled in an environmentally friendly (PoS) framework.

The new financial world merges with the old

Thanks to continued regulation, the area is increasingly merging with the traditional financial sector, and this makes perfect sense. Blockchain-based financial systems create transparent, manipulation-free, and efficient settlement processes that outperform current financial infrastructures. Markets that are available 24/7 and risk systems controlled by smart contracts liquidate underfunded credit lines without any doubt. However, the Financial System 2.0 or Web3 will not exist autonomously.



A merger of the respective systems will ultimately lead to the greatest benefit and guide us into the next era, which can be compared to the advent of the internet in the 2000s. When exactly the music will continue to play remains uncertain. However, what is certain is that the recent price correction is not uncommon for the market. Exponentially growing markets exhibit higher volatility compared to established asset classes. The additional risk must be paid to participate in the exponential developments.



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