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Risk bytes

Newsletter

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ETH 2.0 – Initial misconceptions

With the Merge still penned for a 15th September launch, there are some common misconceptions about the capabilities of the Proof of Stake (PoS) network:

Speed

Ethereum will not actually become observably faster for transactions, as the Merge only impacts the consensus layer and not the actual execution layer.

Fees

Ethereum will not get any cheaper, and fees are likely to stay relatively the same as the Merge has no impact on block space – the key element of fees.

Staking

If you're already staked to the Beacon Chain, you will not be able to immediately un-stake after the Merge, with timeframes likely to be around 6-12 months for a second major upgrade known as 'Shanghai' that will unlock the ability to stake.

If expectations are different from reality, how will this impact the price of ETH post-Merge?

ETH 2.0 - Potential risks

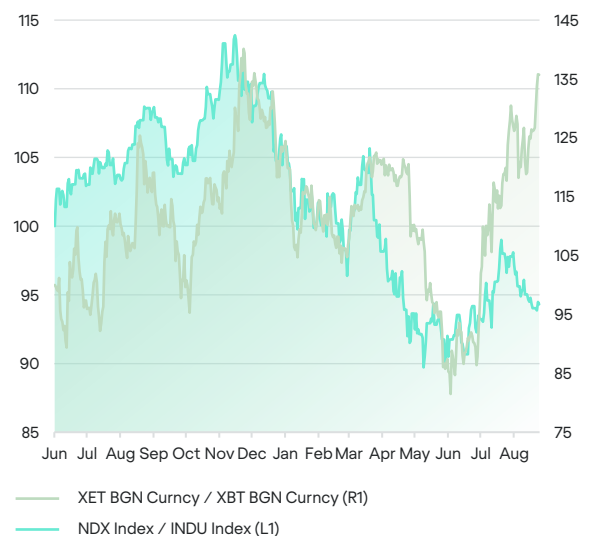
There are some concerns over the recent spike in ETH borrowing rates, and whether it could disrupt orderly liquidations: the fact that liquidators won't have access to ETH as collateral since the majority of ETH will be borrowed. This could in turn lead to some positions becoming uncollateralised.

Alongside this, high Lido Staked ETH (stETH) borrowing rates could also trigger an unwind of the leveraged ETH - stETH positions. If the ETH borrowing rate rises above the current 4%, trades will become unprofitable, and the unwind could be disruptive for the stETH-ETH basis.

ETH/Nasdaq Correlations

Historically, BTC has always been closely compared to traditional market movements and cryptocurrency as a whole has been heavily correlated to Nasdaq. For a different point of view, the below chart compares two ratios: ETH/BTC (green) and Nasdaq/DJI (cyan).

Source: Bloomberg – 06/08/2022



It indicates ETH is more aligned to growth/tech stocks, hence more sensitive to interest rate volatility and could also serve as an ETH sentiment indicator, especially after the Merge. The correlation de-coupling occurred in July, so it could likely be driven by the Merge market expectations.



Binance Stablecoin auto-conversion

Earlier this week, Binance announced that it will auto-convert all USDC, USDP (Pax Dollar) and TUSD (TrueUSD) into BUSD on September 29th. BUSD hit market share all-time highs of nearly 32% following the move.

Although customers will still be able to withdraw funds in these stablecoins when exiting Binance, it is noticeable that USDT is not on the list. This means that Binance's move may have the potential consequence of slowing USDT's decline in market share. This is the first time ever that Binance has consolidated, rather than opened transaction corridors.

Interest rate impact on Stablecoins

With Central Banks raising interest rates to curb a skyrocketing inflation, it is time to think how stablecoin prices may be affected by rising interest rates. According to CoinShares, stablecoin issuance is mainly dominated by Binance (BUSD), Circle (USDC) and Tether (USDT). In order to assess the impact of interest rate rises on each of these stablecoins, we up stressed the yield curves of their reserve assets by 75bps and 175bps. We then used the collateral breakdown of each stablecoin's issuer, as published in CoinShares (see Figures below), to find out the expected percentage drop in stablecoin prices.

USDT

We carried out our analysis regarding the impact on USDT price, assuming that: 5.25% of Tether's stablecoin price is backed by corporate bonds with short and medium terms to maturity, with each maturity carrying an equal weight on the price impact analysis.

We observe that a **75bps increase** in interest rates is expected to cause a **0.2% drop in USDT price**. Similarly, a **175bps increase** in interest rates is expected to cause a **0.5% drop in USDT price**. These price drops are not significant and are aligned with the fact that USDT is backed only up to 5.25% by corporate bond reserves.

USDC

We carried out similar analysis to assess the impact on USDC price, assuming that: 78% of Circles' stablecoin price is backed by short-term US Treasuries, whose maturities range from 1-5 years. Each maturity carrying an equal weight on the price impact analysis.

We observe that a **75bps increase** in interest rates is expected to cause a **3.6% drop in USDC price**. Similarly, a **175bps increase** in interest rates is expected to cause an **8% drop in USDT price**. These price drops are significant and are aligned with the fact that USDC is largely backed by US Treasuries.

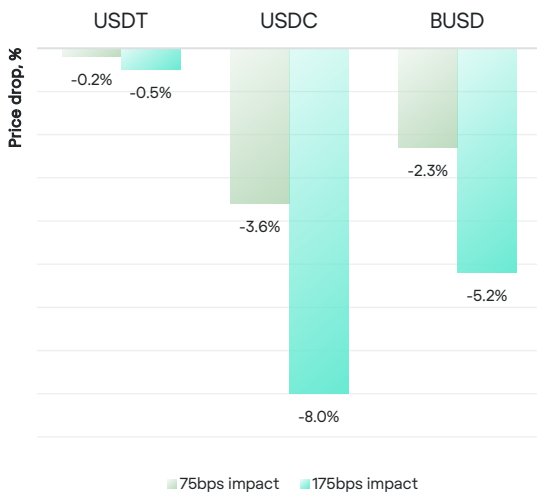
BUSD

Finally, we concluded our analysis on the impact of BUSD price. We assume that: 50% of Binance's stablecoin price is backed by US Debt Instruments of various maturities. Similar to USDT and USDC analysis, each maturity is assumed to carry an equal weight on the price impact analysis.



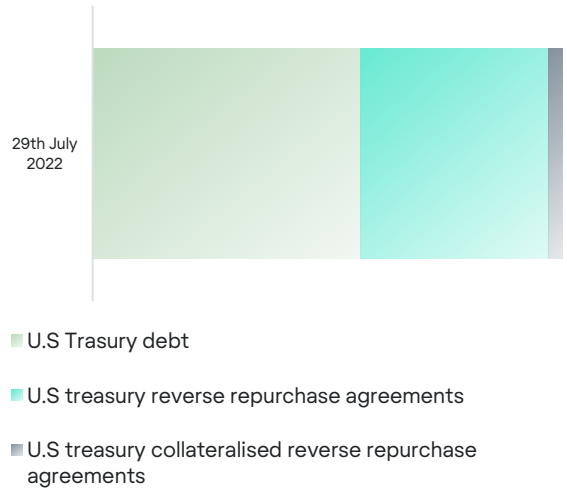
We observe that a **75bps increase** in interest rates is expected to cause a **2% drop in BUSD price**. Similarly, a **175bps increase** in interest rates is expected to cause an **5% drop in USDT price**. Note that in this analysis, we excluded reverse repo agreements and their corresponding impact in BUSD's price.

Stablecoin price impact



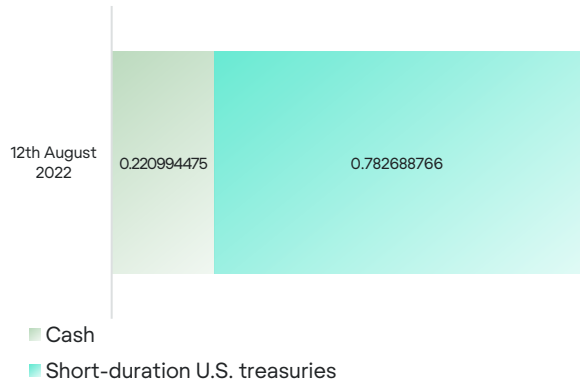
Binance reserves breakdown

Source: Paxos, Binance, CoinShares, data available as of close 16 August 2022



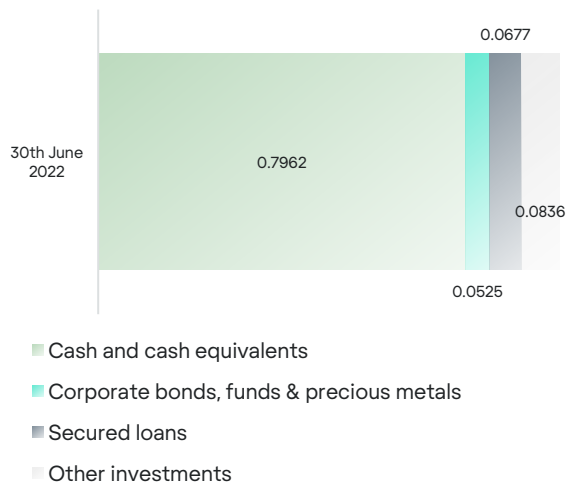
Circle reserves breakdown

Source: Circle, CoinShares, data available as of close 16 August 2022



Tether reserves breakdown

Source: MHA Cayman, CoinShares, data available as of close 31 March 2022



Source: CoinShares



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