market notes - The Hated Rally’s Next Chapter.

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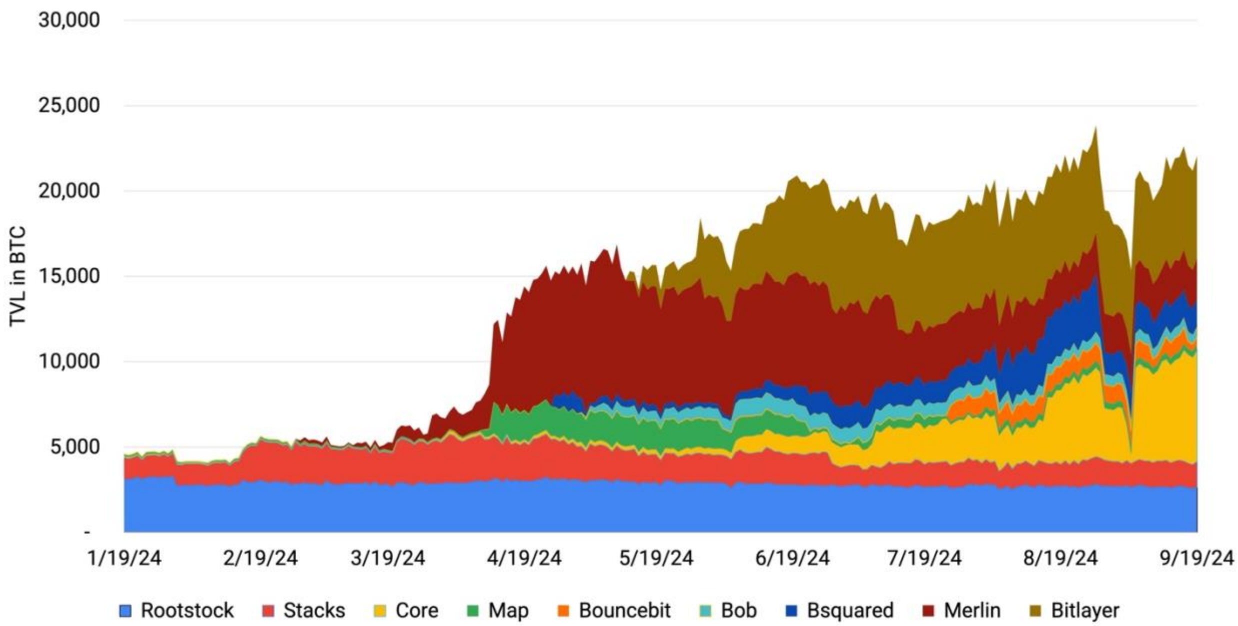
Figure 1: Bitcoin Layer 2s — Building Back Even Better



Source: Block Pro. DeFiLlama.

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9/20/24 – Marcel Kasumovich, Deputy CIO, Coinbase Asset Management

1. It's the rally that has defied all expectations—and investors love to hate it. When interest rates shot up, a crash in home prices and a steep decline in growth stocks seemed inevitable. Safe-haven assets like gold and bitcoin were predicted to be "safe-sells" under the weight of a strong US dollar. But the markets didn't play by the script—or at least not for long. With the Fed now beginning an easing cycle, the hated rally enters its next chapter—gradually, then suddenly.

2. This cycle stands alone—there's no historical analog that fits. While we've seen rate cuts without significant economic or market downturns before, like in Fall 1998, the circumstances were vastly different. Back then, the global debt crisis triggered a severe deflationary shock. Oil prices plummeted below $20 a barrel, making it cheaper than

water, and gold sank to decade lows, a tenth of today's all-time highs. This time, we're venturing into uncharted waters.

3. But why is this next chapter unfolding so gradually? We've entered the first institutional cycle for crypto, where the spotlight is on how crypto technologies will be monetized to modernize the future of traditional finance. For now, "crypto" doesn't have a defined place in traditional portfolios—it's primarily about exploring bitcoin and a select few other digital assets. As institutions chart this slow course, the future of finance is being quietly rewritten.

4. Bitcoin leads that future, even if in unexpected ways. It's not playing the role of money for good reason. If you could pay for a coffee with dollars or bitcoin, most believers would choose dollars. Bitcoin is, instead, evolving into the digital gold of this new ecosystem, supported by its growing adoption as a long-term investment. The layers built on the Bitcoin protocol are the transformative pieces—and they, too, are quietly surging this year (Figure 1).

5. Institutions want to be part of that future, looking for compelling user experiences to shape it. Their focus is narrow and deep, much like the crypto market itself. US dollar stablecoins and broader payment solutions have emerged as the dominant application. This trend is underscored by mainstream brands like Revolut moving to adopt stablecoins, signaling a shift towards more integrated and accessible digital finance—driven by profitability, not hype.

6. Payments infrastructure will certainly not grab social media headlines. But it's laying the foundation for the future promise of crypto technologies. This evolution towards micropayments intersects with artificial intelligence—robots don't have bank accounts. What role does a bank play in that world? A digital wallet functions like a narrow bank, used for payments, not for credit. Regulated as low-risk intermediaries, these wallets can reshape the financial landscape.

7. The separation of risk-taking should be welcome news for prudential regulators. By segregating risk and increasing transparency, it mitigates counterparty and systemic threats that arise from commingled, opaque balance sheets. But achieving this will require deeper institutional buy-in beyond bitcoin, encompassing a wider range of financial players. Being better isn't enough— adoption will depend on regulatory alignment and market readiness.

8. The real challenge lies in creating regulatory tools tailored to new technologies versus retrofitting these innovations into existing frameworks. It slows progress. BIS Nexus Project aims to knit these infrastructures together, with very little technical detail provided. India has joined the four ASEAN countries testing those cross-border rails. Their offering is that local instant payment rails are stitched together through "Nexus" for global payments.

9. Can a retrofitting model win? India is the most compelling case—a universal infrastructure that banks plug into seamlessly. Users of these payment rails generate valuable data that can be leveraged for credit services and the like. With nearly 50% share of global real-time payments and over 100 billion transactions—most on PhonePe—India's infrastructure shows the power of a well-designed, centralized system. For regulators, the familiar is reassuring.

10. But India is also the outlier, not the norm. There is no single global regulator to dictate such a model for international payments, while existing infrastructure providers like Swift GPI are developing their own fragmented systems. Meanwhile, other central banking efforts such as FedNOW have faced limited adoption. Why? Private operators are embracing decentralized infrastructure when given a choice. It's universal, cost effective—and it works.

11. While centralized systems sputter, US dollar stablecoins saw turnover of more than $25 trillion annualized last week. It's not the cycle investors planned for, but it may be better for adoption. The key theme here is infrastructure—the foundation for killer applications. Bitcoin and Ethereum are core infrastructure. Players like ChainLink, HyperLedger, and Circle become crucial to stitching together old and new worlds into a singular mosaic.

12. It's an institutional cycle, and institutions aim to monetize the new rails of financial technology in the old-fashioned way—patiently, deliberately, and through strategic integration with traditional finance.

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