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market notes: New Bull Market, Old Wall of Worry

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02/23/24 – Marcel Kasumovich, Deputy CIO, Coinbase Asset Management

1. Markets aren't wrong, opinions are. Acting on opinions, investors are forced to adjust to market realities. George Soros famously quipped "I'm only rich because I know when I'm wrong." Better, faster, cheaper – that's the promise of crypto technologies entering the mainstream driving positive investor opinion. But the internet of money has yet to receive widespread acceptance of the internet – experts in payments infrastructure are of the opinion that "the fair value of bitcoin is still zero."

2. If you wait for price to decide on an opinion, you've almost surely waited too long. Engage in the details. That's where opinions are tested, long before price. Regulated incubators are built precisely for that purpose. It led the Hong Kong Monetary Authority to provide guidance on the tokenization of real world assets. It also encouraged adoption by larger organizations like the United Nations, who have been testing crypto rails for more than five years. It works.

3. Yet, investors are prone to fighting yesterday's war. The brutality of the 2022 downturn leaves investors more often asking what could go wrong. Are the early-warning indicators of excesses ignored in the previous cycle percolating? Focus on simple themes. The last cycle was about "killers" – Bitcoin being displaced by Ethereum, Ethereum to be displaced by more efficient layer ones. The theme now is attentive to "lovers" – building on durable, resilient layers.

4. Ethereum's transition to proof-of-stake solidified its role as a center of gravity. Executed in a bear market, there were fears of a rush for the exits from staked assets that gained access to liquidity. The reality was the polar opposite. A rush of staking inflows drove yields down to 3.4% from 5.2% with 25% of Ethereum locked to provide validation services. Rather than a lengthy exit queue, those looking to stake ETH were the ones checking their watches with a peak wait time of 45 days.

5. Strong demand for staking ether is a step to its realization as the "reserve currency" in the Ethereum ecosystem. Take decentralized finance. The top application is Lido, a tool that facilitates staking on Ethereum. There is nearly $30 billion in locked value, with every financial detail available for investors to assess in real time. Of the top ten applications, only one isn't compatible with Ethereum – JustLend, dominated by lending for the Tether stablecoin.

6. Decentralized applications are also seizing the Ethereum opportunity. If investors are committed to holding ether as a reserve asset, why not utilize the capital as collateral to move out the risk spectrum and enhance returns? The magic of decentralized platforms is that such innovations

are explored without committees and centralized planning. An opportunity presents itself – it's pursued. And new protocols are making it easier to utilize dormant collateral to build on Ethereum.

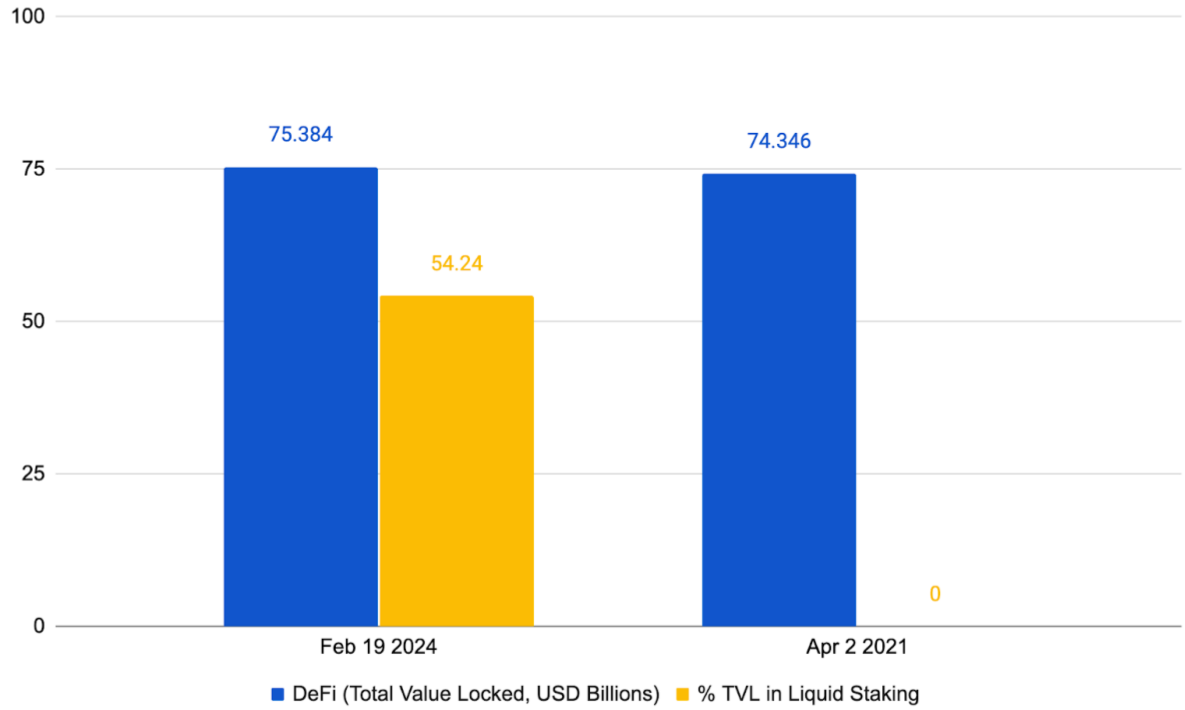
7. Take EigenLayer – or "your own" layer. It's a protocol designed for restaking. Building on Ethereum can be costly given the capital required for staking and the like. EigenLayer offers investors the opportunity to let developers utilize their staked ether collateral. It's a cost-effective capital rental to those building on Ethereum. Demand is strong. Though only on testnet for less than a year, EigenLayer has surged to the fourth largest DeFi application measured in locked value.

8. The excitement around EigenLayer has spurred broader interest in valuation climbs for other restaking protocols. Yields of 15-30% in Pendle Finance harkens back to a period of unsustainable yield farming. And Vitalik doesn't like it. Applications not native to the Ethereum ecosystem are leveraging its security. It caters to lower-risk use cases only, where those restaking must absorb any application failures. It leaves investors climbing the wall of worry.

9. Vitalik's message is simple enough – when rebuilding the financial system, don't repeat the same mistakes. Market downturns are a brutal redistribution of wealth and loss. Patient providers of capital are rewarded and excessive leverage is penalized. Ether's role as a reserve asset means investors will hunt for ways of utilizing that dear collateral more effectively. That invariably is a move out the risk spectrum. And it needs to be conducted with a buyer-beware mindset. No bailouts.

10. Share opinions. Question everything. Doubt convention. These are all healthy traits for any investor. The fear of repeating the boom-bust of the previous cycle is a natural concern. But we are too early in the cycle for DeFi to be flashing broader risk of excessive speculation. Au contraire, the first signs of moderation in bullish momentum have option markets leaning to defensive, downside protection. It's a new bull market climbing the old wall of worry.

Figure 1: DeFi Then and Now – Lower Risk Profile



Source: DeFiLlama. CBAM Calculations.

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