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market notes: Judging by the Cover

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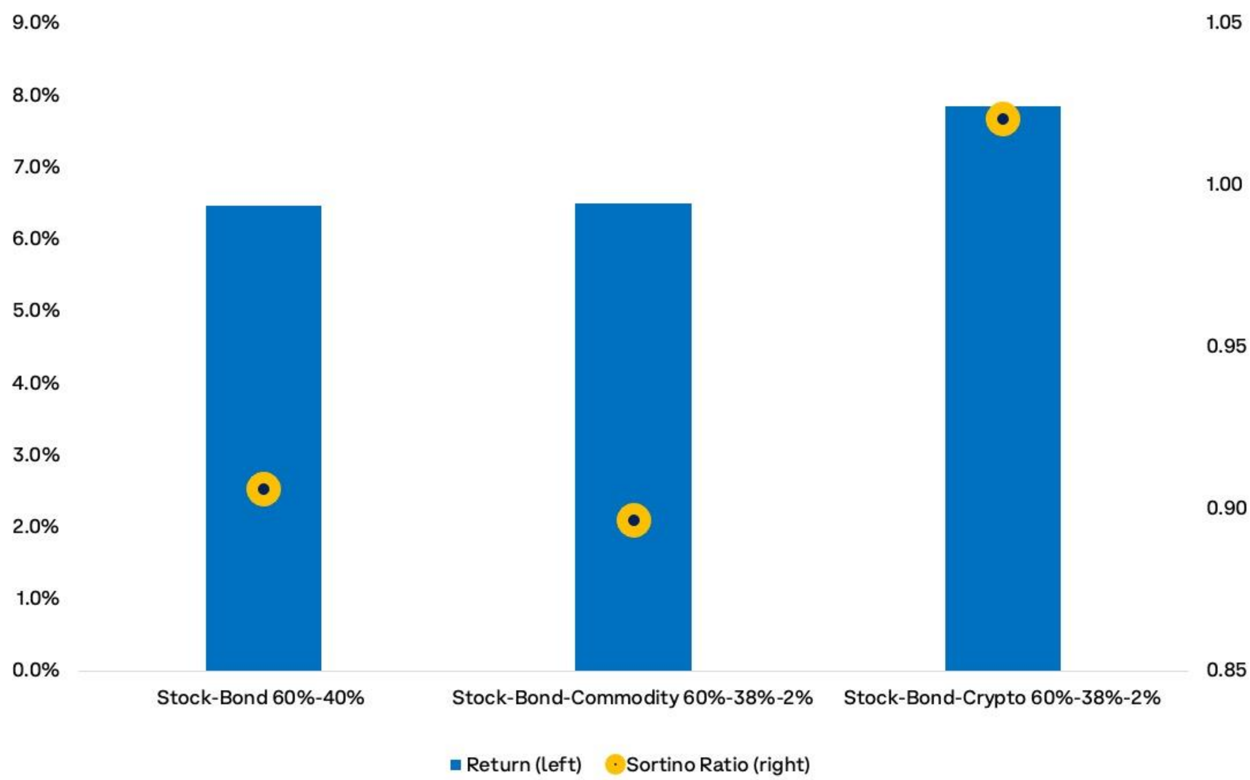
Figure 1: Crypto Contribution – Better Downside Portfolio Risk!



Source: Bloomberg LP. Coin Metrics. CBAM Calculations.

Notes:
1 "Stocks" are the S&P 500 Total Return Index, the S&P price change plus reinvested dividends.
2 "Bonds" is the US Treasury Total Return Index, the price change on US dollar, fixed-rate, nominal debt issued by the US Treasury.
3 "Commodity" is the Bloomberg Commodity Price Index, reflecting returns in commodity futures markets.
4 "Crypto" is the Coinbase Index, published and distributed by MVIS.
5 Hypothetical portfolios are weights that are rebalanced monthly and costless for research purposes only.
6 The Sortino ratio is calculated by the annualized return above a risk-free rate divided by the portfolio volatility during negative return months, from January 2017 to April 2024.

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7/5/24 - Marcel Kasumovich, Deputy CIO, Coinbase Asset Management

1. Experiences are a gift. Forget about "good" or "bad" outcomes. Both are experiences to build on. Today's cheers are tomorrow's jeers—you must be willing to be hated to be loved. Magazine covers frequented by investors typify the dilemma as reliable reverse indicators. *Business Week* declared the "Death of Equities" in 1979. *The Economist* artistically foresaw the extinction of crypto after the FTX collapse of 2022. Both were emotional omens, fixated on outcomes over lessons.

2. What's the key investor lesson from crypto asset markets? Their youth and immaturity offer unexpected benefits to portfolios. Bitcoin and equity markets have shared broader cycles, especially the 2022 downturn caused by rapid, synchronized global policy tightening. But crypto cycles respond faster than traditional assets. Portfolio tools show a surprising benefit of these uneven correlations—crypto *reduces* a portfolio's downside risk relative to returns (Figure 1).

3. This seems counterintuitive. How can assets like crypto, which often drop by 50%, help mitigate downside portfolio volatility? The answer lies in their speedy cycles. During the "Banking Crisis" of March 2023, bank failures in the first half of the month led to new policies that provided fresh liquidity to the financial system. Bitcoin initially responded quickly on the way down and then even faster on the way up, adding value to portfolios when traditional assets were struggling.

4. Portfolio rebalancing also plays a crucial role. In passive portfolios, rebalancing maintains stable long-term asset allocations by adjusting for underperformance and outperformance to avoid market timing. Portfolios reduce exposure when an asset is underperforming and increase it when it is outperforming. Those investors would be reducing crypto risk during cycles of its outperformance, thus mitigating the downside portfolio risks from their large drawdowns.

5. Let's look at current market dynamics through this lens. Crypto assets have materially underperformed. The Coinbase Core Index is down more than 20% from its peak in March. This comes at a time when broader markets are performing well—the S&P 500 Index is up nearly 10% over the period, global stocks are higher, commodity markets are stronger, and even bond returns are slightly positive. Ironically, the outcome reinforces crypto's additive portfolio features.

6. Investors want unique volatility. But that's not a one-way street. Today, crypto allocations are trimming the wings of recent portfolio performance, which is a far more palatable outcome than adding to common drawdowns. Idiosyncratic episodes also raise useful questions with wider investment implications. Is crypto a leading indicator

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of broader negative outcomes to come, like November 2021? What are the lessons from the unique features driving crypto markets?

7. At the macro level, bad news is good again. Our Macro Pulse signals a recession, and survey-based data reinforce the message. But it is not a sudden stop, not a financial fracture. In fact, prices are the only component showing growth, reinforcing the theme of an “inflationary recession.” It reopens the door for policy rate cuts in the United States, with Europe, China, and others already easing. Asset markets signal that policy responses can avoid a deep downturn.

8. Crypto markets are also unlikely to be a warning sign for broader market instability. Unlike in 2021, there are few signs of excessive leverage or sudden spikes in volatility now. The current downturn has been orderly, without panic-driven liquidations. But there is always a broader story—we uncover it by studying cross-market correlations (Figure 2). On these metrics, crypto has been most connected to EM currencies and tech innovation in the recent past.

9. But don’t extrapolate. The maturity of digital asset markets hinges on institutional adoption, which brings the necessary investor discipline. That’s when correlations will likely stabilize. The absence of significant buying during June's rebalancing, particularly in Bitcoin ETFs, indicates that digital assets have yet to become a staple in institutional passive portfolios. We might see more stable correlations with institutional adoption and more dispersion across disparate assets.

10. Recent trends demonstrate that crypto assets bring unique volatility. The value created by that volatility is true in the good and bad outcomes. Today’s market inefficiency is the opportunity and the risk. The bad news is good again, and crypto asset markets are unlikely to decouple from that broader narrative for long. That’s the opportunity and the risk. Keep your eyes on the weekend magazines—judging the book by its cover might be the best opportunity signal of all.

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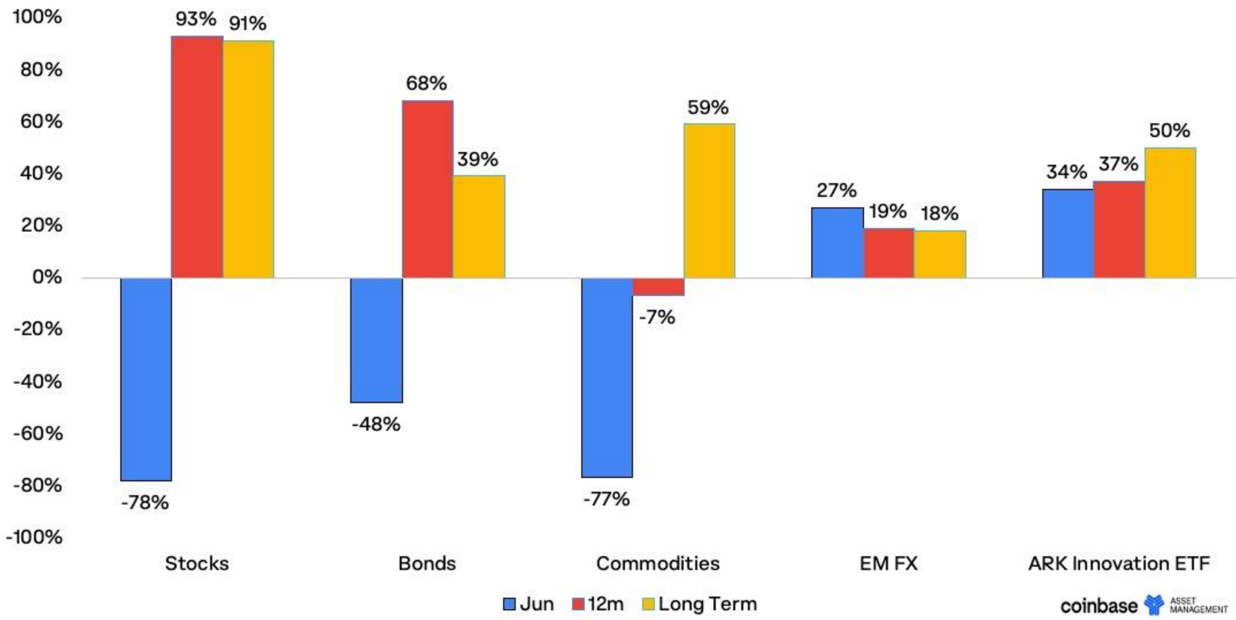
Figure 2: Crypto Correlations – EM FX and Innovation



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5 EM FX is USD.MXN spot exchange rate.

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