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market notes: Bitcoin Futures and Farmers

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9/15/23 - Marcel Kasumovich, Deputy CIO, Coinbase Asset Management

1. Bitcoin and farmers are joined at the hip. Strange bedfellows? History matters. The Senate Committee on Agriculture is a driving force behind regulatory clarity in the crypto ecosystem. The Commodities Futures Trading Commission (CFTC) has a reporting line into the Agriculture Committee as it was created in a period when farmers were a critical part of commodity trading. Love bitcoin? Explain it to a farmer — you're on the same team.

2. The CFTC is not the natural guardian of consumer protection. It was created in 1974 with an eye on regulating futures trading in commodities, dominated by sophisticated players in agriculture markets. The CFTC was subject to controversy in the late 1970s after ordering an emergency closure of the wheat market, criticized as regulatory overreach. Today, the CFTC operates with less than one-quarter of the SEC budget, the latter facing cutback pressure.

3. For all the talk about regulatory uncertainty, the CFTC is clearing a pathway to clarity. It's just not broad – yet. We don't agree with all of it. But let's focus on what we know. Bitcoin is a commodity. So is Ethereum. How can we be so sure? Observation. CFTC regulates futures. Bitcoin and Ethereum are listed futures. Commodities are their domain. And the SEC is following their lead, having granted approval for futures-based exchange-traded funds.

4. It's an odd starting point for crypto exposure. After all, one of the central appeals of crypto assets is the ability to own and transfer value without centralized intermediaries. But futures are catering to investment demands, not banking philosophy. And we can learn a lot from their data. Regulators require traders of a certain size and volume to report on their exposures. It is aptly named the "Commitment of Traders" Report.

5. Each week, the Report provides a rich breakdown of futures activity by the type of trader. Total open interest – the total number of longs or shorts – is decomposed into exposure by Commercial (producers), Non-Commercial (financial), and Non-Reportable (small traders). It's back to the basics – total longs equal total shorts, futures are a zero-sum game and not a buy-and-hold strategy. As an investment tool, you better know the motivations of the players.

6. The interesting element of Bitcoin – almost all are financial players. The typical breakdown is commercial hedgers that produce the commodity on one side and speculative traders providing liquidity on the other. It's the perfect transfer of risk. Commercial hedgers are rewarded for a more stable cash flow, reducing revenue volatility with financial futures. Hedge funds focused on risk-seeking, arbitrage opportunities take the other side.

7. But that's not Bitcoin futures. In Bitcoin, commercial hedgers – like a miner – are comparatively small. Commercial traders account for less than 10% of total positions today, a market size of only $1.94 billion. A rise in commercial futures' interest through miner rewards and fees would be an unlock for the market. Until then, futures markets are financial players – asset managers, hedge funds, and small traders.

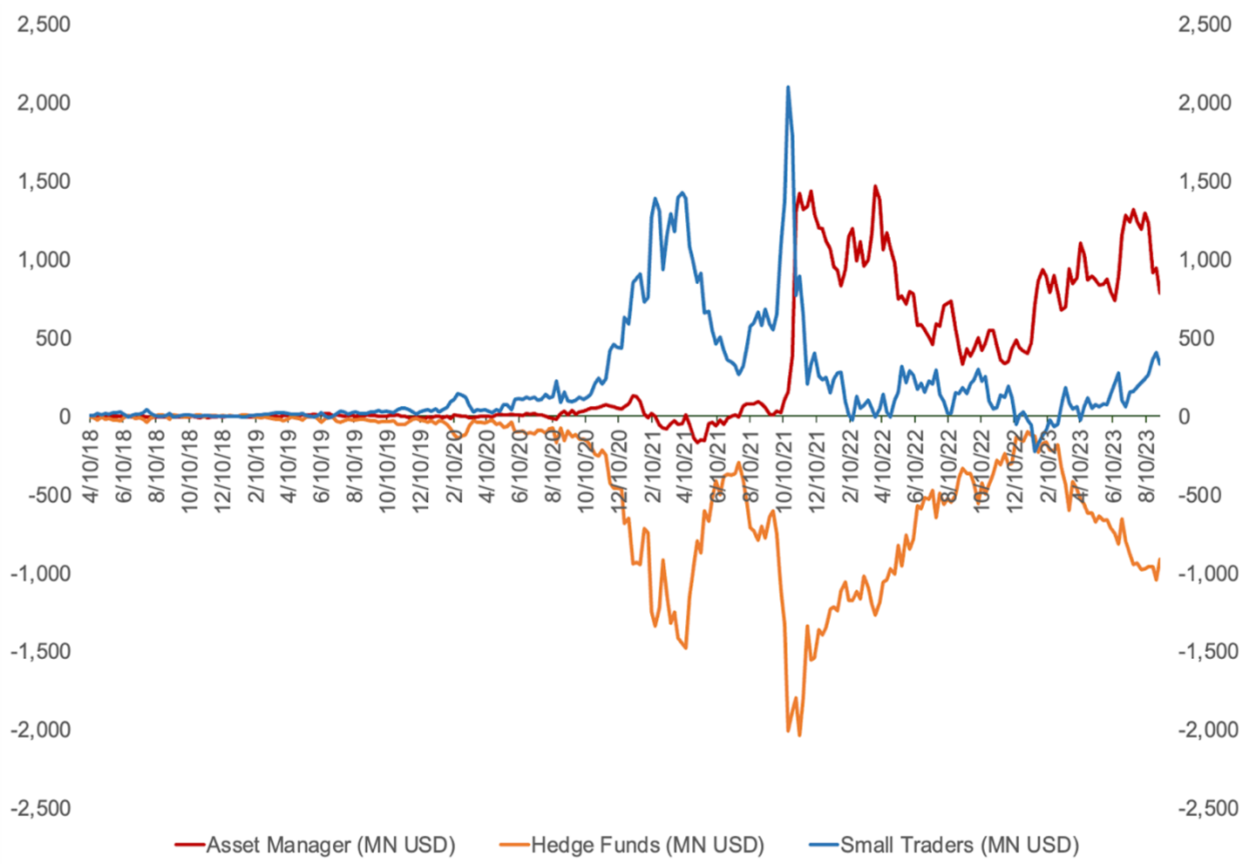
There are two key lessons for investors.

8. **First, hedge funds are the risk-reducing players in bitcoin futures**, not the risk-seeking one in traditional markets. Their role is entirely as a liquidity provider, having mostly run net short bitcoin exposure since its inception (Figure 1). Arbitrage is motivating hedge fund engagement. Asset managers and smaller traders are the investment signal. And when investment demand is too strong, a steeper Bitcoin futures curve delivers the added yield hedge funds demand. High crypto yields are a sign of market imbalance – it shouldn't happen.

9. **Second, quick increases in positions for asset managers or smaller traders is a warning** of a trend reversal. It speaks to the motivation of these traders — directional exposure. Fast increases in positions often lead to steep curves, too. They are confirming signals. November 2021 was the quickest increase in asset management exposure, coinciding with the launch of a Bitcoin futures ETF. When exposures are extreme, it's asset managers and small traders tipping the long-bitcoin boat. It leads to contrarian market signals – but only over short horizons.

10. Today, Bitcoin futures markets are calm, like broader indicators. Positioning across different trader types is small and the futures curve is flat, confirming balanced risk-taking. It's not a surprise. After all, futures are a focus for financial players whose interest is piqued by volatility more than the underlying asset. Still, the unconventional breakdown of Bitcoin futures gives us another risk management tool, attentive to asset managers and small trader activity. The low level of risk in futures markets is sending a green light to risk-takers.

Figure 1: Futures by Financial Traders - Hedge Funds Are Volatility Reducing?!



Source: CFTC [COT Report](). USD calculation based on the price of bitcoin. A metric of correlation between the bitcoin of bitcoin and net exposure for asset managers and smaller traders identifies six past periods of excess risk. These led to sharp trend reversals in a one-month period. Contrarian risk reversals are sharp and end quickly.

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