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market notes: Orderly Capitulation?!

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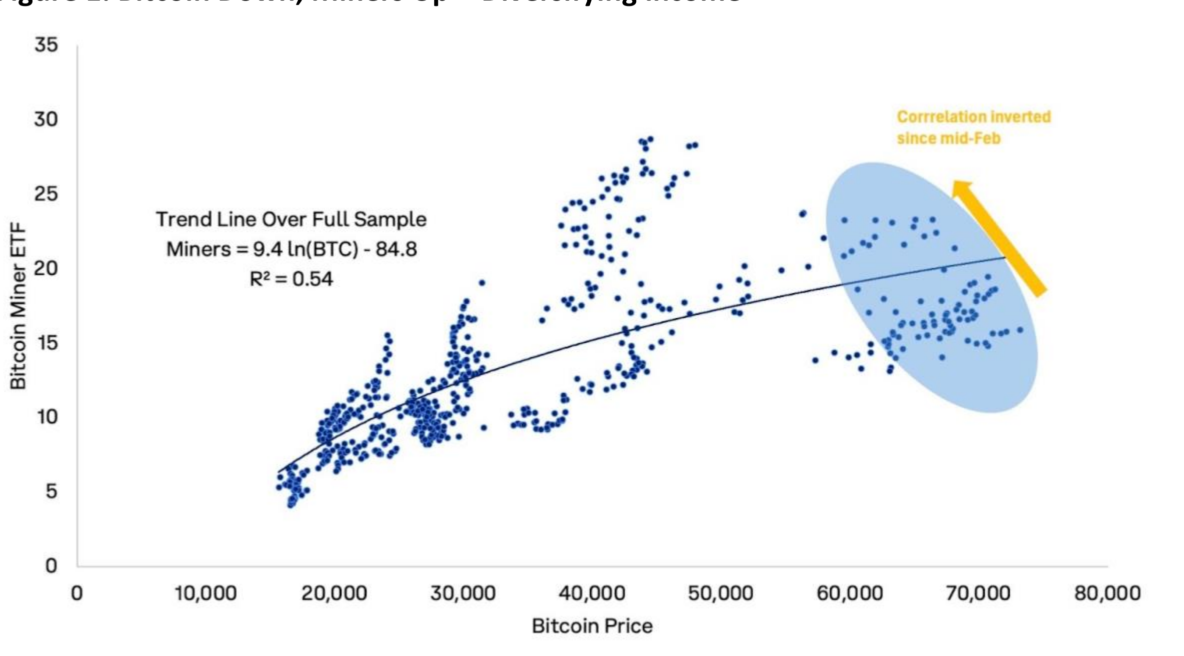
Figure 1: Bitcoin Down, Miners Up – Diversifying Income



Source: Bloomberg LP. CBAM Calculations.

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7/12/24 - Marcel Kasumovich, Deputy CIO, Coinbase Asset Management

1. An orderly capitulation? Bitcoin miners seem to think so. Recently, the hashrate—the computing power behind Bitcoin transactions—experienced its most significant decline since the FTX events. This drop, coupled with a fall in Bitcoin prices, screams capitulation. But interestingly, there are no signs of distress. Volatility is low, and there are no reports of counterparty strains. This "boring" capitulation could be a positive sign for the market's predictability and growth.

2. After all, capitulation isn't the issue. The real challenge for investors is analyzing outcomes and taking calculated risks. Fear of the unknowns in the crypto market slow adoption. What if the next price drop reveals an unseen fragility? This uncertainty is why crypto assets carry a high-risk billion premium compared to traditional assets—investors are compensated for these unknowns. Until crypto assets find stability, gains and losses can be dramatic.

3. Bitcoin miners are at the core of that stability. But miners' behavior is different from previous cycles. Despite the recent downturn, the hashrate is nearly three times higher than the lows of the FTX downturn. Instead of reducing computing power as Bitcoin rewards halved, miners increased production capacity before the current sharp decline. This is the root of the "orderly

capitulation." And liquidity was ample, with our Digital Financial Conditions Index topping at 84 out of 100 in June.

4. Capital availability is also clear in equity markets. Publicly traded miners have raised more than $2 million this year, which is roughly 2% of their total value. Miners are also becoming less correlated with Bitcoin prices. Since mid-February, the correlation between Bitcoin and the Bitcoin Mining ETF has averaged –18%, compared to +79% over the previous two years (Figure 1). Rising demand for data centers driving miner value, led by Artificial Intelligence.

5. Mining is a maturing marketplace. Back in 2009, a personal computer could mine a maximum of 3,000 Bitcoin a day. Today, mining difficulty is 80-trillion-times higher, competing for 6% of the remaining Bitcoin to be produced even though most of the current mining fleet will soon be obsolete. This evolution reflects institutional optimism about Bitcoin's future value. Just as personal computers became redundant for mining, large-scale mining operations must also adapt.

6. One adaptation is increased diversification of revenues. Miners are achieving this through cloud computing, AI support, and hosting services. These are to be utilized when Bitcoin is less profitable. Companies like Bitdeer, early adopters of this trend, have outperformed their peers. Bitcoin hedging strategies are also making miners more attractive by reducing earnings volatility and improving access to capital. It's not all about Bitcoin, after all.

7. The next step in the journey is deeper crypto capital markets. Today, crypto capital markets are dominated by MicroStrategy, the largest public holder of Bitcoin. While miners aim to smooth earnings, MicroStrategy is doubling down on Bitcoin, borrowing at low rates unsecured to buy more. Before exchange-traded products, this was a way for investors to gain exposure and for credit experts to earn yield without directional market risk.

8. More sophisticated underwriting will follow. Traditional finance models, like waterfall cash-flow structures used in real estate, are migrating to the digital economy. Institutional investors aim to meet return targets, so holding non-yielding assets like Bitcoin or gold is challenging. Investing in higher-yielding infrastructure tied to the crypto ecosystem is more attractive, especially if cash flows can be structured to meet investor risk tolerance. We've developed such models.

9. According to Doug Wilson, our credit portfolio manager, "the creation of the onchain 'Bitcoin bond' is a leap forward in integrating traditional finance with the digital economy." Doug created the "Bitcoin bond" in 2022, tiering cash flows across senior, junior, and equity tranches. The senior debt tranche yielding 12%, and the junior tranche at 18%, are fully covered by cash flows since then. The higher risk Bitcoin flows are accruing to equity holders. It's not a concept—it works.

10. Investors are waiting for real activity in the market. And it's happening. Digital asset infrastructure is integrating with traditional markets, evidenced in the diversification of Bitcoin mining into broader data centers. This maturity will lead to more sophisticated capital market

activities on better blockchain technologies like our "Bitcoin bond." Stay tuned as we continue to innovate and, hopefully, coin a better term than "orderly capitulation."

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Bitcoin mining poses unique risks that could lead to loss of capital investment. Risk factors include the inability to grow hash rate as a function of limited computing power, the cost of acquiring new miners as affected by global supply chain issues, the value of bitcoin mined not exceeding associated mining costs, market volatility of the asset, and the reduced generation of revenue due to bitcoin "halving". Bitcoin mining may also be impacted by increasing compliance and legal costs as the industry is subject to emerging regulation.

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