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market notes: Centralized Decentralization!?

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2/16/24 – Marcel Kasumovich, Deputy CIO, Coinbase Asset Management

1. February 14 is a special day. "I Love Free Software Day" gives a different reason for loved ones to celebrate all over the world. I know, if it's free, you're the product. Nonsense. "Free" software dates back to the 1950s when it was included with computing hardware as a matter of common sense. Drive adoption, engage great minds, and make even better products. Hardware is costly, and what is built on the basic software is transformative. That's the value.

2. Only, it is not how we organize.

3. LibreOffice, Linux, Firefox – these are all free, open-source software that have stood the test of time. But their market shares are barely noticeable. SEC Chair Gensler explains it for bitcoin, which is "not decentralized because finance tends toward centralization since antiquity." But it's beyond finance. ChatGPT was built to be decentralized and not-for-profit. It is centralized, for profit, and its 180 million users in three months is the fastest new network expansion ever.

4. Society self-selects into centralization.

5. Are crypto technologies following a similar path? It's not that society doesn't value decentralized tools. The internet is a smashing success. It's about how the technologies are employed. Take crypto's entry into exchange-traded funds (ETFs). Inflows to the new funds have totaled more than $10 billion, one of the fastest launches. Those buyers could have engaged in bitcoin long before. The ETF is a familiar, comfortable, and centralized onramp.

6. It also changes the way we think about the current cycle. This is an institutional cycle now – the first crypto has experienced. Around 11% of bitcoin is held by a narrow number of institutional players, a list and size that is growing by the day. Mainstream companies are leveraging decentralized technologies to create compelling user experiences – the ETF is the most primitive of those. It will also force us to evaluate market dynamics in a different light.

7. Availability of data is the beauty of blockchain. In a cycle where decentralized activity was dominating trends, that data was a valuable signal to investors. Those signals are blunted by centralization. Through the sharp rise in the price of bitcoin, onchain activity has been lousy, new active bitcoin users are sluggish, and Lightning Network nodes have been stale. These were reliable bearish investor signals in the previous cycle. Not now.

8. The pipeline of user experiences is strong despite weak onchain activity. Price signals are still working. Crypto winter led builders to build, and there's a powerful pipeline to be unlocked in this institutional cycle. Take Taproot Assets. Introduced in October 2023, the tool allows funds to be deposited on the Lightning Network for instant movement. It's attractive for existing assets, like stablecoin, and new ones, such as foreign exchange.

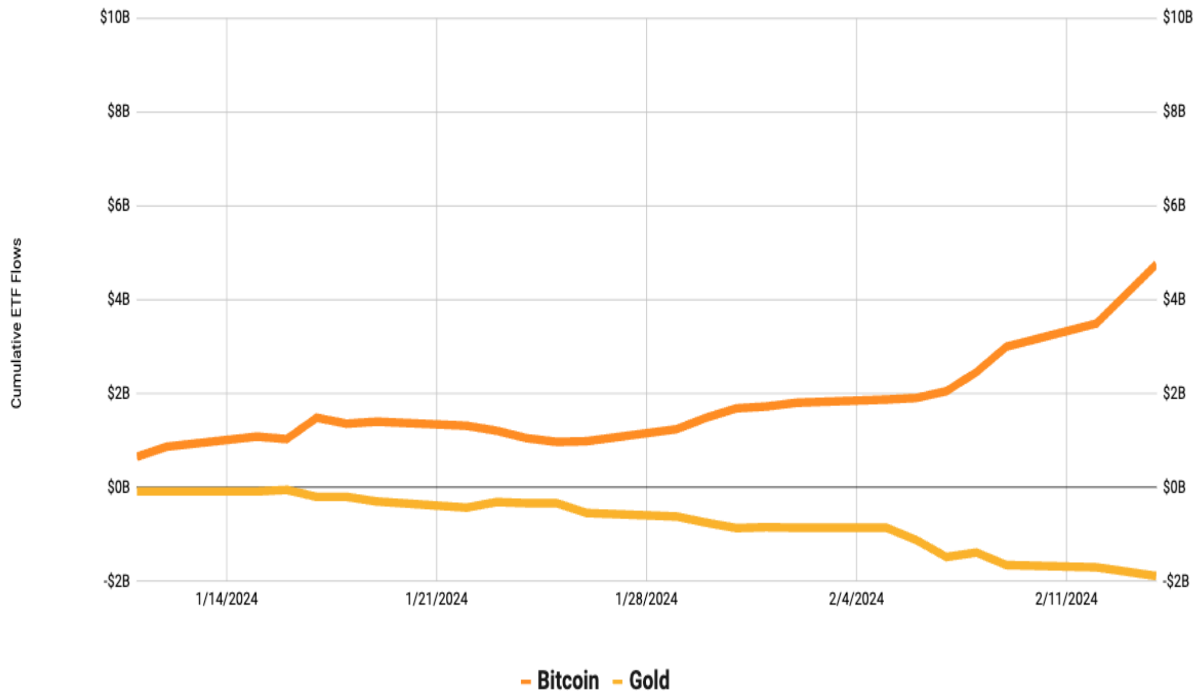
9. So goes the art of investing. One minute you have a reliable market signal, the next starts its decline to redundancy. But core principles are irrevocable – like supply and demand. Onchain data reveal 69% of bitcoin owners have held positions for more than a year, near record highs. With a fixed bitcoin supply, new buyers have to find the price where old owners are willing to sell. This is the case for asymmetric upside as bitcoin moves into mainstream portfolios.

10. Does it mean the price is always right? Surely not. These demand and supply dynamics can generate huge gains in bitcoin – but to sustain them, they have to be for the right reasons. It is the struggle between technical and fundamental analysis. Why bitcoin enters portfolios matters. Price must meet the expectations of new demand. What do investors expect? A store of value with technological upside that drives the marginal cost of financial transactions to zero.

11. Narratives can be persuaded by price. Speculative bubbles are deeply entrenched in financial markets – especially for long-duration assets like technology. So, we look to market-based signs for evidence of excesses. Interestingly, there are none, even after the rapid appreciation of bitcoin. Volatility markets are balanced and the slope of the forward curve, a simple indicator of leveraged demand, is boring compared to the last cycle of leverage.

12. Centralized decentralization may be the most ironic unlock. Users like it, gravitating to the familiar. Regulators embrace it, as activity moves to spot markets with visible participants that allow transactions to be surveilled. But what of a decentralized future? It's alive and well. The market is sending a lot of love – love for the technology, the rules-based approach, and the merit-based inclusion. User experience will decide whether in centralization, we trust.

Figure 1: Bitcoin ETF – Independent Inflow!



Source: Bloomberg L.P. CBAM Calculations.

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