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market notes: ETH ETF – Second Time's a Charm.

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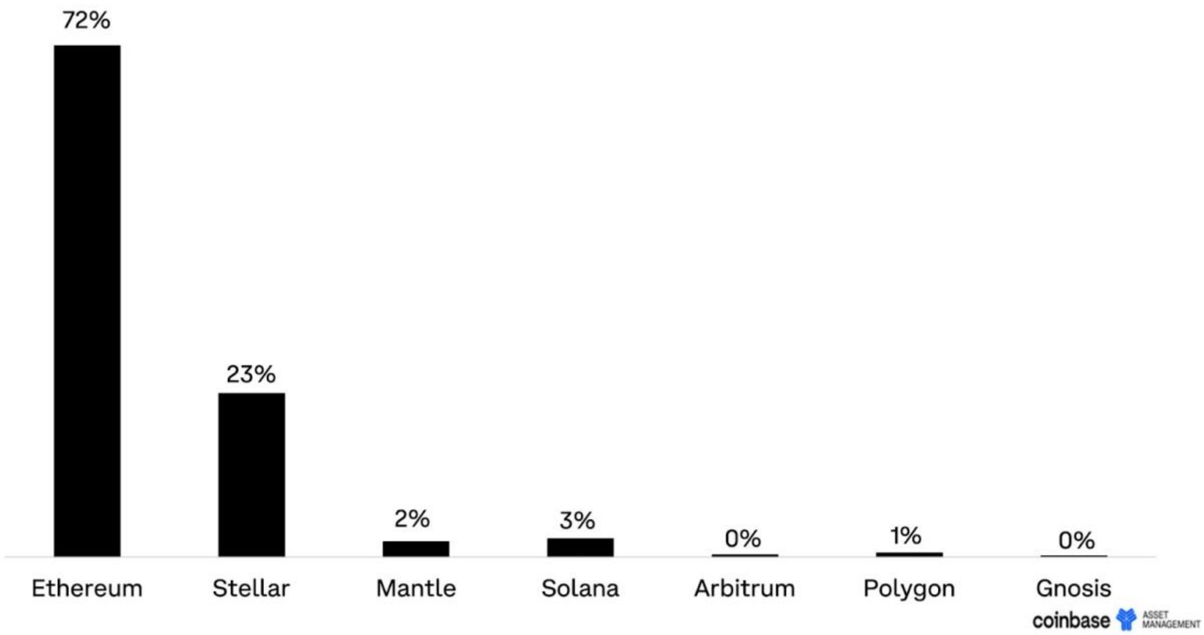
Figure 1: Tokenizing US Treasury Securities - An Ethereum-led Experience



Source: RWA.xyz

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7/19/24 – Marcel Kasumovich, Deputy CIO, Coinbase Asset Management

1. Why have US Bitcoin exchange-traded products been such a resounding success? Innovation is supposed to make things better, cheaper, and faster. Crypto technologies exemplify this principle. But wrapping Bitcoin in a traditional financial product diminishes its innovative features. The Bitcoin ETF is less liquid and less mobile than the underlying asset. The answer lies in a common mantra—analyze, don't judge.

2. ETFs serve as a comfort blanket for investors cautiously entering the crypto market. These investors prefer exposure through familiar tools with regulatory certainty rather than directly integrating crypto assets. As the world migrates to native digital infrastructure, traditional financial wrappers will eventually be replaced by

programmable baskets tailored to investors' needs. The demand for Bitcoin ETFs is the first step.

3. Will second movers like the US Ethereum ETF achieve similar success? Its features are even more limited than the underlying asset. For example, the Trusts holding ether behind the ETF will not be able to provide staking services, depriving investors of real yield and diluting long-term performance. Staking transforms ether into a bond-like security, moving it away from a passive commodity to an active asset, thus restricting its Trust-structured ETF delivery for now.

4. Enthusiasm for the Ethereum ETF is naturally dampened following Bitcoin's launch. It's a case of "been there, done that." Volatility markets offer a clear illustration, especially around known events. Before Ethereum's move to proof-of-stake, one-week volatility expectations surged to 125% annualized. With less than a week before the first day of ETH ETF trading, that metric is about half of the "Merge" event. Both upside and downside tails are priced similarly.

5. Investor sentiment is a wet noodle. Could it be oversteering to early Bitcoin ETF experiences? After all, one month after the Bitcoin ETF launch, net flows were flat as new products were offset by rebalancing away from the Grayscale Bitcoin Trust. The Grayscale Ethereum Trust, at 2.4% of ether supply, mirrors the size of the Bitcoin Trust. Investors may expect a similar flow for ether, with new demand postponed to the fall.

6. But this recent history is unlikely to reliably predict the immediate future. History shows that the market often surprises. Bernard Baruch, the original lone wolf of Wall Street, playfully opined that the purpose of the market is to make fools of as many people as possible, a classic contrarian construct. The most humbling outcome might be Ethereum ETFs becoming a resounding success from the start, forcing investors to chase prices.

7. The fundamental case for Ethereum isn't in question. If Bitcoin is the gold standard of the digital economy, Ethereum is the oil that keeps it running smoothly. Ethereum has had a bumpier ride than Bitcoin, with events like the October 2017 hard fork and the long migration to proof-of-stake. Yet, Ethereum's adaptability continues to meet the crypto economy's needs. Its network effects are undeniable—from stablecoin to real-world assets, Ethereum dominates.

8. Flexibility is Ethereum's superpower. Adoption is the focus, following in the footsteps of tech giants before it. Upgrades have diverted revenue from Ethereum's mainnet but significantly increased adoption. Active wallets have risen five-fold since early 2023 to

nearly 15 million per week. Upgrades have led to fee reductions and boosted activity on cheaper "Layer 2s," where transaction volume is over six times Ethereum's base layer.

9. Unlike the timing of the Bitcoin ETF, politics and policy are also becoming tailwinds for Ethereum's launch. Skepticism about crypto technologies is fading, replaced by demand for real-world applications. Tokenizing US Treasury Securities is an Ethereum-led experience, accounting for 74% of the $1.9 billion in tokenized assets (Figure 1). This shift is evident in Ethereum's profitability, which turned positive last year despite cheaper transactional layers.

10. What should investors do? Ethereum and Bitcoin play different roles in the crypto economy but share a common trait—long-term holders are reluctant to sell. Over 75% of ETH owners have held for more than 12 months, even higher than BTC. Fresh demand must reach a market price where long-term holders are willing to sell. This dynamic is even more powerful for ether, as it is programmed to be procyclical. Unlike almost any asset, its supply declines when demand rises.

11. The Ethereum ETF will mark yet another milestone in the integration of crypto assets into mainstream finance. A step backward in micro innovation for a future leap forward macro finance. Don't forget Baruch's Law of Markets when dismissing Ethereum's ETF potential—the second time may be its contrarian charm.

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