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market notes: Comeback Stories– Bitcoin, Trump, and…?

Bitcoin, Trump, and the art of the comeback—2024 is a year of second chances and big returns. The stakes are high as these unlikely bedfellows step back into the spotlight, each hoping to redefine the game.

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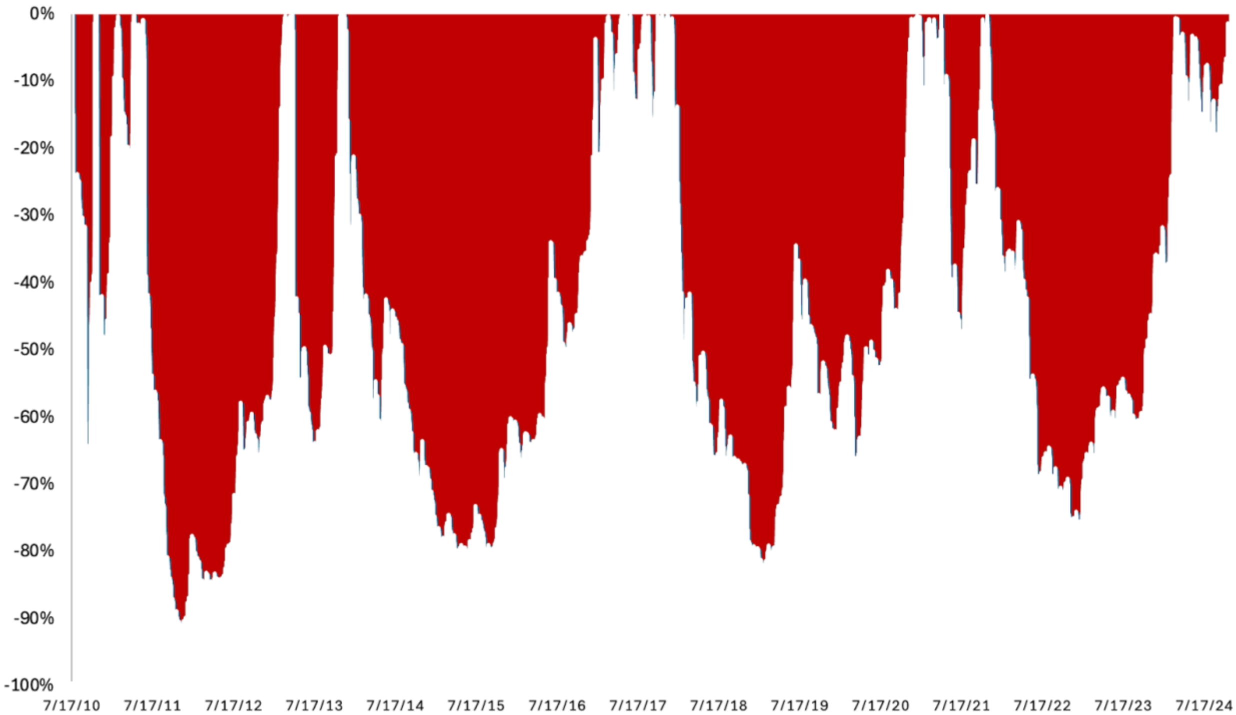
Figure 1: Where's My Volatility? Bitcoin Drawdowns From ATHs



Source: Glassnode. Week Onchain Number 44.

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11/08/24 – Marcel Kasumovich, Deputy CIO, Coinbase Asset Management

1. Comebacks. They captivate us, rekindling our faith in resilience and second chances. In the 2024 US election cycle, finance has its own comeback story: Bitcoin. Once dismissed, Bitcoin is now poised for a resurgence, challenging traditional assets and reminding us of its unique staying power. Bitcoin's potential revival could reshape perceptions and redefine the financial landscape. And in an era craving stability, will these comebacks set the stage for the new strategies that institutions are seeking?
2. (Spoiler alert—yes, it sure does.)

3. It's been two years since the lows in crypto asset markets, marked by the FTX leap to default. Waves of the previous cycle still ripple through current trends. The crypto ecosystem is far stronger now, having exposed and rapidly shed its weakest links. The core building blocks of the digital economy—Bitcoin, Ethereum, and stablecoin—survived and now thrive, with technologies inoculated against speculative hubris. The resultant features of the cycle look nothing like the ones before it.

4. Consider three elements. Bitcoin's share of the crypto economy has risen steadily from the FTX lows, to 59% from 38%. April's halving of Bitcoin rewards to miners failed to boost prices as in the past, weakening revenue. Yet, the competition to mine bitcoin increased to all-time highs. Meantime, fiat stablecoin assets were unaffected by the rise in market interest rates that could have led to a rapid capital outflow. In fact, it was the banking system, not the technologies, that posed a risk to stablecoin in March 2023.

5. Resilience builds credibility. Resilience means longevity, and institutions build on innovations expected to be lasting. There are obvious ways to see this. On the regulatory side, great efforts are being made to bring crypto into the mainstream like common market rules introduced across the EU. On the market side, mainstream companies are embracing crypto from payments to gaming. Institutions don't spend resources on tools that don't last—the network effects become self-fulfilling.

6. We are all familiar with the splashy institutional announcements around crypto. But the subtleties of the financial plumbing are even more interesting. Take derivative markets, for instance. Open interest measures the total number of unsettled positions in the market. That is, for every long there is an equal and offsetting short position. In the recent past, there has been a surge in open interest to new highs. Typically, this would be indicative of leveraged speculative excess. But the details tell a different story.

7. A rise in open interest itself isn't telling. As markets mature, it's only natural for their size to grow. It's the behavior that matters, and that's where reports like the Commitment of Traders shine by breaking down open interest by the type of trader. Substantial directional exposure by speculative traders is a warning flag, as they are highly sensitive to short-term market movements. It's the root of rapid unwinding in momentum trades—speculators gradually build leverage on a price trend, and shed on its reversal.

8. It could be a cautionary crypto tale. After all, Bitcoin's price hit new highs and so did its open interest. But it's not. In fact, speculative traders—hedge funds—are running record net short exposures. Hedge funds aren't directionally bearish. They see arbitrage opportunities as a more effective use of capital, being liquidity providers to satisfy rising asset management demand. It's a sign of institutional maturity—a deeper pool of asset managers and hedge funds working symbiotically to satisfy new investor demands.

9. These micro dynamics are crystal clear in macro markets. Take the Bitcoin “basis”—the difference between the futures and spot prices that reflects the cost of leverage. Think of the percentage differential as the Bitcoin “interest rate.” In 2021, Bitcoin, open interest, and interest rates all surged. It was a clear and present danger that speculative long demand was driving prices. In contrast, interest rates are remarkably stable today. The rise in open interest and prices reflects institutional depth, not speculation.

10. The rise in institutional depth is clear in the volatility dynamics. Figure 1 illustrates Bitcoin’s drawdowns from all-time highs, which have greatly lessened in both depth and duration in this cycle. Now, markets display a similar pattern in 2020-2021, with crypto retracing to highs in early 2021, only to slump again. However, market microstructure bears no resemblance to that period—one dominated by speculative hubris. Volatility, especially downside, is being compressed as Bitcoin matures to an institutional asset.

11. Why is downside volatility declining? Investors are more alert to the risks of the past, and asset management demand is maturing to structure more carefully against those risks. This will naturally lend itself to actively managed products. It may start with the big three—Bitcoin, Ethereum and stablecoin. But value propositions through blockchain applications—like Polymarket that functioned superbly through the US election—will naturally broaden appetites and scale.

12. Bitcoin’s dominance today underscores its staying power, a comfort zone for new investors. But the broader appetite for stability hints that other innovations and comebacks are on the horizon. As this cycle matures, crypto’s evolving resilience aligns with the tenacity seen on the political stage—signaling its potential to reshape global finance. It’s still early, and the real risk may lie in underestimating crypto’s tailwinds amid increasing US regulatory clarity.

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