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4/5/24 – Marcel Kasumovich, Deputy CIO, Coinbase Asset Management

1. What's the next crisis? Viewing the world through a macro lens after enduring numerous shocks makes people believe they can foresee future events. That's why I'm asked the question, having survived or, at times, thrived in those periods. But each situation is unique. Ask ChatGPT and you'll get a list showcasing a recency bias – supply chain disruption, pandemics, and climate change. Machines are a terrific screen for where to spend your time. If the machine can do it, you shouldn't.

2. Today's investor playbook is to hold a "cash umbrella" to protect against the rainy day. Assets in US money market funds are in excess of $6 trillion, up nearly 20% since the middle of 2023. This surge in cash holdings is precisely what occurred in the 2008 financial crisis and the 2020 pandemic (Figure 1). Investors didn't predict crises, naturally. Rather, the rise in imbalances and asset valuations has begged for a more defensive stance. And the patience with cash holdings paid off.

3. Based on recent history, investor behavior often equates "crises" with "deflation." What's an investor to do when defensive? Taking refuge in cash can be easily rationalized by a deflationary mindset. Real short-term interest rates are too high and will crumble when something breaks. Investors then migrate out of the risk spectrum after a sharp decline in asset valuations. That the US dollar tends to rise sharply in those environments is a bonus. Forget that past. It's history.

4. The battle against deflation has been won; the next crisis is inflationary. After all, the policy responses to the deflationary crisis were the gateway for surging government debt. No intricate economic theory is needed to appreciate the choices: either implement unparalleled fiscal austerity of spending cuts and tax hikes or address debt ratios with inflation that grows the nominal tax base and lowers real spending. These are political decisions, not proactive policy choices.

5. Cash remains king – for now. It proved effective in the pandemic in 2020, during swift policy rate hikes in 2022, and is ratified now by the US dollar trading near all-time highs against other sovereign currencies. But episodes are more interesting than time. Thousands of dull data points can console analysts, only for a few episodes to dismantle comfortable logic. And when episodes demonstrate powerful differences from historical norms, it's time to consider a changing world.

6. The yield curve is one of them. An inverted yield curve is rare. It is associated with tighter credit conditions and is a reliable precursor of bad financial and economic outcomes. Why lend longer term when you can earn more by making short-term loans to the government? Yet, this logic is

broken. The US yield curve has been inverted longer than any period, investor cash holdings have increased by record proportions, and asset valuations from crypto to cars have skyrocketed.

7. The March 2023 banking crisis is another. No liquidity? No problem. The policy response left little to chance. In Switzerland, the government merged UBS and Credit Suisse, providing both liquidity and fiscal support. In the US, a systemic risk exception was invoked to protect all depositors, a tool only used in the 2008-2009 period since its creation in 1991! Though already outsized, Fed policy also targeted more liquidity to the banking system rising ~$600 billion or ~20% from 2023 lows.

8. Left unchecked, the inversion of the curve and financial strains would have seen the deflationary impulse investors were waiting for. It didn't happen. It didn't happen because of a deeply entrenched policy response that is inflationary. How can you be certain your deposits will be returned? Because a central bank can make it so. Those holding cash should take no comfort in that declaration – only banking reform is a durable solution. And that's not happening, either.

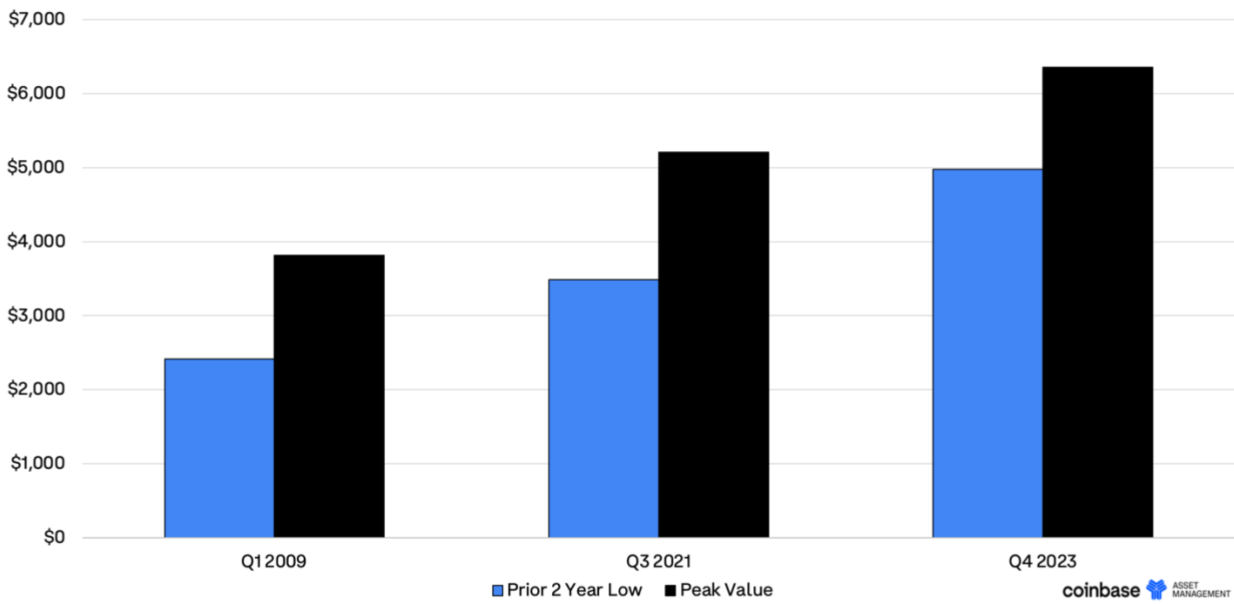
9. It's not that banks got magically better in a year. It's the nature of blunt policy tools – they supported strong big banks more than weak small ones. Small US banks hold more than twice the commercial real estate loans than large ones, one of several concerns to depositors. Cash assets for small banks, including support from the Fed, are ~9% of total assets, up from ~7% in February 2023. The cash buffer for large banks – who don't need it – is nearly 2-times small banks.

10. Inflationary policies are set to support the weakest links. Sure, there was a dip in risk assets in the 2023 banking strains. Investors weren't certain of the policy responses. But its brevity was the story. The swift recovery highlighted which assets were most valuable – ironically, those least in need of support, like NVIDIA, gold, and bitcoin. Valuations of resilient assets rose so fast that sidelined investors were deterred by higher valuations — keeping cash balances high.

11. Thus is the feeling of markets being "flush with liquidity." It's a fact. There is a hunt for new nominal anchors with cash losing its appeal. Deflationary crisis leads to a downward spiral in asset prices – inflationary crisis is the opposite. Bitcoin is entering the mainstream of assets under consideration. When in doubt, be reminded of countries with preexisting inflationary imbalances – like Turkey, where bitcoin is up more than 3-times against the lira in the past year.

12. Don't ask the machine what to do – common sense and courage are the ingredients to tomorrow's portfolio.

Figure 1: Cash, Cash and More Cash – US Money Market Assets (USD billions)



Source: Board of Governors of the Federal Reserve System. CBAM Calculations.

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