market notes: Crypto Yields - What's the Cost?

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12 April 2024
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4/12/24 - Marcel Kasumovich, Deputy CIO, Coinbase Asset Management

1. Action beats deliberation – that's how kids excel. Give kids a drum, and they will beat it, eventually converging to a rhythm. It's not just a metaphor – it's a vision of the future. I'm reminded of the experiment where six-year-olds, CEOs, MBAs, and lawyers are given the same materials to build a tower – and the kids outperform the adults not just because they act but because they embrace uncertainty. In today's finance, crypto is the trial-and-error kid in the traditional sandbox.

2. But even disruptive technologies like crypto mature over time. Leading asset managers like Blackrock now provide investors with onchain investment products to enhance US dollar yields. It also unleashes the power of smart contracts. Now, investors can move funds into USD stablecoin almost instantly, anytime. It's a better user experience at a cheaper cost and faster speeds. Traditional investment strategies will have to adapt to these technologies or be replaced.

3. Yet, it's early days. The entry of digital assets into the mainstream of finance is shining a bright light on early-stage inefficiencies that are opportunities for investment strategies. Consider the basic principle of foreign exchange markets – interest-rate parity. If you can earn 10% interest on a deposit in Country A, compared to 0% in Country B, then the forward price of Country A's currency must be 10% lower than that of Country B. Otherwise, riskless returns could be earned.

4. It's also a simple no arbitrage condition that doesn't hold in crypto assets. Take ETH markets. Ether yields ~3% versus ~5% for the US dollar. Interest-rate parity means the forward price of ether should be 2% stronger versus the dollar. The dollar offers a higher yield because it is expected to decline in value. Yet, ETH is priced to rise as much as 15% in the next year. That is, you may be able to earn a double-digit USD return using crypto without crypto exposure – buying ETH and selling it forward.

5. Are traditional market players missing a free lunch? No, not quite. Figure 1 illustrates the forward yield for ETH to the end of 2024 in three scenarios – interest-rate parity price, the Chicago Mercantile Exchange (CME), and the Deribit Exchange. There's a ~10% premium between the lowest and the highest, reflecting different types of risk. It's a sign that crypto markets are not yet mature – not a riskless source of income. Actively assessing these risks is the opportunity.

6. That risk assessment starts by asking simple questions. Why is there demand for ETH at higher forward rates? It's a demand for leveraged exposure. The buyer of the forward sees the implied cost of funding as low relative to the upside potential. The seller providing liquidity demands compensation for various risks, chiefly the ability for intermediaries to have enough collateral to stay solvent. Less collateral means more leverage and more compensation for liquidity providers.

7. Such analyses are an afterthought in mature markets. A convergence of standards, fluidity of cross-border capital, and long track records of intermediaries provide investors with more comfort. But in less mature crypto markets, harvesting yield requires additional risk premium. It is also a terrific portfolio diversifier. Yields are high when bullish markets are stretched. It's also unique to mature markets – credit spreads widen with rising asset prices, the opposite of traditional norms.

8. Incorporating yield from crypto markets enhances the longevity of an investment strategy. One of the biggest challenges for an institutional investor is the risk of a sudden decline in crypto assets. After all, material drawdowns are not uncommon. The inclusion of credit to an actively managed portfolio mitigates those risks. At the expense of shallower returns in a rising market, well-structured yield strategies lower portfolio risk directly and indirectly as a signal of market sentiment.

9. But not all yield is created equal. As rates rise, so too does risk. A new wave of excitement in DeFi is delivering US dollar yields in excess of 30%. There's no onchain magic wand. The liquidity provider in futures, the seller, can generate even higher US dollar yields only by taking more risk – leverage. And the introduction of leverage turns an asset owner into a renter – a market move counter to the exposure can force an unwinding at the least opportune time.

10. Crypto asset markets are maturing. Real world assets moving onchain with smart contracts used to give investors 24/7 liquidity is a window into the future. But the basic principles of finance still apply. The nascency of crypto asset markets allow investors to generate higher yields with more elaborate onchain solutions than the first steps of traditional players. Higher yields come with higher risks that need to be assessed. After all, adults still need to provide kids with guardrails.

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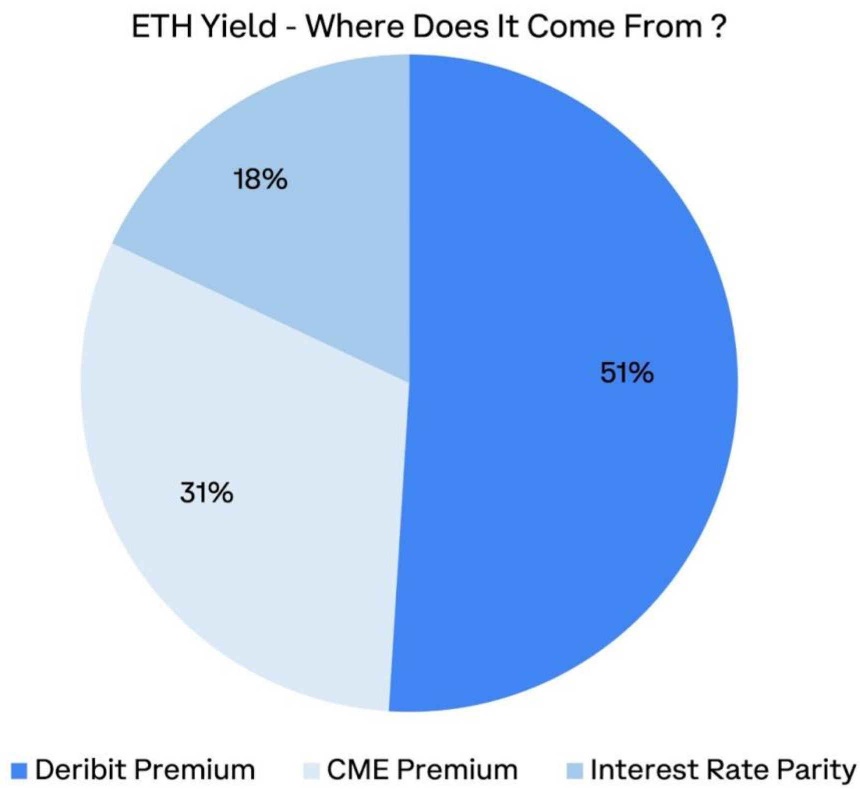
Figure 1: Follow the Yield(er)? Assessing risk



Source: CoinMarketCap.com. CME. Deribit. CBAM Calculations as of April 11, 2024 at an ETH.USD spot reference of $3,555.98. The chart shows the marginal yield implied by a theoretical interest-rate parity with the incremental yield premium in the CME futures and then the incremental yield premium implied by Deribit futures.

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