coinbase ASSET MANAGEMENT

market notes: Picks and Shovels

Investors are attentive to "big caps" in this cycle. It's a pick-and-shovel strategy to capture the megatrends in tech innovations – crypto included.

01 March 2024
Marcel Kasumovich
Coinbase Asset Management

Investors are attentive to "big caps" in this cycle. It's a pick-and-shovel strategy to capture the megatrends in tech innovations – crypto included.

market notes: Picks and Shovels
03/01/24 – Marcel Kasumovich, Deputy CIO, Coinbase Asset Management

1. **Be optimistic**. Winston Churchill remarked that "a pessimist sees the difficulty in every opportunity; an optimist sees the opportunity in every difficulty." Last cycle's decline in crypto valuations was akin to an economic depression. The optimists saw that removing the harmful parts of the crypto economy made it stronger. The technologies that survived proved their resiliency. And the most valuable cryptos, like big companies in the stock market, are leading the recovery.

2. FTX was the end of the beginning. People were afraid that a major failure in one part of the system would cascade to everything else in the crypto economy. Pessimism prevailed. Solana was deemed guilty by association with FTX, an error in investor judgment. Systemic risks don't wait to be revealed – they happen after a shock or not at all. And they didn't after FTX. Markets stabilized. Bitcoin has almost tripled since then, outpacing the 229% gain in the Coinbase Broad Index.

3. Don't sweat the small stuff. The world is undergoing a period of profound change, with new technologies improving intermediation and content that dominate our daily lives. Rather than speculating on application winners and losers, investors now demand the fundamental technologies that make the crypto economy work. And those are the big caps, with Bitcoin, Ethereum, and US dollar stablecoins accounting for roughly three-quarters of total market capitalization.

4. Buying big market capitalization, resiliency may be common across equities and cryptos. After all, bitcoin's uptime is 99.99%. But it's also an invitation to reinforce supply differences between the two. NVIDIA's competitors are rapidly expanding investment in the same technologies. Companies like Huawei are quietly investing tens of billions of dollars into chip manufacturers that over time will revert semiconductors back to their qualities of the previous cycle – a commodity.

5. Crypto big caps are the foundational security layer. The competition is more with the tools integrating into those base layers, resembling the ubiquity of the internet rather than a processing chip. Since their January approval, new ETFs have bought roughly ~330,000 bitcoin. That's 6,705 bitcoin per day compared to 900 of fresh supply paid to bitcoin miners. Where does the rest come from? The market has to find a price that encourages longer-term holders to take profits.

6. The demand-supply dynamics resemble a rocket ship in price. But like a rocket ship, it is fuel temporarily expended to find a new orbit. What is the appropriate value of technologies that

aim to secure financial and non-financial intermediate in the future? That is what the market is extrapolating to. The big caps will find a new, stable orbit at much higher prices. Then, institutional investors can shift attention to the applications built around that stability.

7. Cyclical assets will be cyclical. There's no escaping that law of markets. Bitcoin is a commodity and its cost of production is the simplest anchor for evaluating its cyclicality. Figure 1 shows the price of bitcoin against its historical production cost. It's a natural cyclical floor. The further that bitcoin's price moves from its cost of production, the more that price is reflecting a longer horizon view and non-commodity forces that trade more like tech beta. It demands discipline investing.

8. Today, production costs are sending a warning sign. Bitcoin's price is 1.75-times higher than its cost of production, or nearly 2 standard deviations greater than the average of the past year. But the "bitcoin halving" next month, where miners will earn half of current rewards and see a near doubling of production costs. What we are seeing is the typical runup of bitcoin prices into that halving event. Today's signals of cyclical excess are a mirage – they will disappear with the April halving.

9. Bitcoin is the gold standard for the crypto ecosystem. Investor attention on picks and shovels is a lesson learned from the previous cycle – some struck gold in the rush of the 1800s, but all of them needed picks and shovels. It is a strategy that can endure a cycle, weather the downturns. But there is no substitute for discipline. Even the sellers of key inputs to the gold mining had to be alert to when the rush would fizzle. And those inputs to production are often more subtle than it seems.

10. It's easy to observe that AI hogging chip demand and lack of bitcoin supply response leads to sharply higher scarcity premiums. Think bitcoin has a power problem? NVIDIA will sell ~3.5 million of its most powerful chips this year. Each chip consumes roughly the same amount of power as the average US household. The power needs are the equivalent to a 3% increase in US households – a reminder that real world infrastructure is still a critical part of the problem.

11. There lies the tension. Just as the distribution of financial wealth has been wildly uneven in recent decades, basics that we take for granted, like power, will be under more pressure to be rationed. How do you dissuade power consumption to redirect it to other sources? By pricing lower-value users out of the market. And if that doesn't work, expect a return to brownouts seen during the mainframe days. And power prices will power bitcoin's rising trend.

Figure 1: Anchoring Bitcoin to Production Costs

Coin Metrics.Bloomberg LP, Coinbase Asset Management Calculations.

Disclaimer

This communication, including any attachments, is intended only for the use of the addressee and may contain information that is confidential or otherwise protected from disclosure. Any unauthorized use, distribution, modification, forwarding, copying or disclosure is strictly prohibited. If you have received this communication in error, please delete this message, including any attachments, and notify the sender immediately. The information and any disclosures provided herein do not constitute a solicitation or offer to purchase any security or other financial product or investment and is not intended as investment, tax, or legal advice. Unless otherwise noted, all information is estimated, unaudited and may be subject to revision without notice. Past results are not indicative of future results.

This communication may contain statements of opinion, including but not limited to, Coinbase AM's analysis and views with respect to: digital assets, projected inflation, macroeconomic policy, the market adoption of digital assets, and the market in general. Statements of opinion herein have been formulated using Coinbase AM's experience, research, and/or analysis, however, such statements also contain elements of subjectivity and are often subjective in nature. In addition, when conducting the analyses on which it bases statements of opinion, Coinbase AM will incorporate assumptions, which in some cases may be shown to be inaccurate in the future, including in certain material respects. Nothing in this communication represents a guarantee of any future outcome. Information provided reflects Coinbase AM's views as of the date of this communication and are subject to change without notice. Coinbase AM is under no obligation to update this communication, notify any recipients, or re-publish the content contained herein in the event that any factual assertions, assumptions, forward-looking statements, or opinions are subsequently shown to be inaccurate.

This communication may contain statements of opinion, including but not limited to, the author's analysis and views with respect to: digital assets, projected inflation, macroeconomic policy, and the market in general. Statements of opinion herein have been formulated using the author's experience, research, and/or analysis, however, such statements also contain elements of subjectivity and are often subjective in nature. In addition, when conducting the analyses on which it bases statements of opinion, the author(s) will incorporate assumptions, which in some cases may be shown to be inaccurate in the future, including in certain material respects. Nothing in this presentation represents a guarantee of any future outcome. The author(s) are under no obligation to update this document, notify any recipients, or re-publish the content contained herein in the event that any factual assertions, assumptions, forward-looking statements, or opinions are subsequently shown to be inaccurate.

Certain information contained in this Communication constitutes "forward-looking statements," which can be identified by the use of forward-looking terminology such as "may", "will", "should", "expect", "anticipate", "target", "project", "estimate", "intend", "continue" or "believe" or the negatives thereof or other variations thereon or comparable terminology. Forward-looking statements made in this communication are based on current expectations, speak only as of the date of this communication, as the case may be, and are susceptible to a number of risks, uncertainties and other factors. Assumptions relating to the foregoing involve judgments with respect to, among other things, projected inflation, the regulation of digital assets and macroeconomic policy, all of which are difficult or impossible to predict accurately and many of which are beyond our control. In light of the significant uncertainties inherent in the forward-looking statements included herein, the inclusion of such information should not be regarded as a representation to future results or that the objectives and plans expressed or implied by such forward-looking statements will be achieved.

Certain information contained herein may have been obtained from third party sources and such information has not been independently verified by the author(s). References herein to third parties are for illustrative purposes and are not an endorsement or recommendation for products or services. No representation, warranty, or undertaking, expressed or implied, is given to the accuracy or completeness of such information. While such sources are believed to be reliable, the author(s) do not assume any responsibility for the accuracy or completeness of such information.

The information and any disclosures provided herein do not constitute a solicitation or offer to purchase any security or other financial product or investment and is not intended as investment, tax, or legal advice. Unless otherwise noted, all information is estimated, unaudited and may be subject to revision without notice. Past results are not indicative of future results.