ELEMENT

Our Weekly Thoughts

ELEMENT DIGITAL ASSET MANAGEMENT

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At press time, the price of bitcoin is hovering around the $7.3k level, down roughly 2% since yesterday. The entire digital asset space is following in lockstep with 47 out of the top 50 names by market cap seeing low single digit red moves today. In the past week, the entire space is down 6% and trending lower. It doesn't seem like this bearish move is the result of a particular catalyst. Rather, the market feels like it is continuing to normalize to a fair value price given the lack of a marginal buyer and the lack of any real structural changes that would warrant a local maximum in the near term. Technical analysis indicate that we could be due for some sustained weakness if bitcoin doesn't rebound in a meaningful way. So traders and risk managers may be be adjusting exposures ahead of a perceived drawdown. Let's also not forget that all eyes are on a particular mainnet launch this weekend. It's quite possible the risk being reshuffled around is to accommodate for an event that what will likely turn into an interesting case study on how to fund and develop a product in a controversial way (we will also be watching closely). Anyway, here are some of our other observations for the week:

1. This is not your grandfather's market. We say that in jest of course. But let's face it. Seasonality is a factor that cannot be ignored. If you played the market in 2018 as you did last year, you are likely in the red by double digits. Last year was a bubble. Returns were parabolic. Buy and hold at anytime of the year made anyone look like a genius. This year was the correction. This year saw meaningful amounts of capital move to the short side. This year the marginal buyer is yet to show up to the party. It is a completely different market from what we had even just 6 months ago. This market needs not just intelligent speculation but also diligent risk management (something we focus on daily). One way to do that is by observing factors that are simple to understand but difficult to capture given structural data quality limitations with primary data sources. We have found that employing statistical methods like volatility targeting or risk parity can be valuable in a market that behaves somewhat trendless in the medium term. Conversely, in a market that exhibits a great deal of trend (read: momentum), these methods are less effective and can even dampen a rolling Sharpe ratio. That's why it's paramount to tailor any investment strategy to the current state of the marketplace.

2. A major disruption to traditional markets <u>will</u> impact the price of bitcoin. The bitcoin network came into existence in the beginning of 2009, at the height of the global financial crisis. Embedded in the genesis block was a line of text: "The Times 03/Jan/2009 Chancellor on brink of second bailout for banks." This line of text refers to an article published by The Times, the newspaper of record for the United Kingdom, and hints that Nakamoto's motivation behind creating bitcoin was due to the fallout from the financial crisis. For all of bitcoin's and all other cryptocurrencies' existence, the world has experienced a fairly homogenous market environment of moderate and sustained growth across almost all developed world economies, low inflation that has persistently been below central bank inflation targets, and accommodative central bank monetary policy. This environment has persisted for nearly 10 years (with some small short-lived exceptions) and has resulted in strong returns across asset classes, including cryptocurrencies. The current economic expansion is already the second longest on record for the United States. However, the market environment will eventually shift as there is little to no slack in the labor market, inflation measures are reaching central bank targets, and monetary policy normalizes.This raises the question of how bitcoin and other cryptocurrencies will fare under alternative market environments. The limited history of cryptocurrencies and the homogenous nature of the market environment over the past 10 years means that relying on empirical data reveals little clues. Therefore, we can only take a first principles-based approach. Due to the decentralized and trust-less nature of cryptocurrencies, any shift in the market environment that is preceded by a geopolitical crisis that threatens the stability of institutions or the banking sector could be a market environment in which bitcoin thrives. The limited empirical data supports this view — bitcoin had strong single day gains in response to both Brexit and Donald Trump's presidential win. Bitcoin has also responded favorably in response to the recent political crisis in Italy which has caused Italian sovereign bond yields to spike to their highest levels in years and again called into question the viability of the European Union.

3. It pays to pay attention to the gamblers. Even though the uninformed spectator would argue that buying bitcoin is a total moonshot gamble (Hi Mom), those of us with skin in the game know otherwise. We understand the potential of the technology and the value of decentralization in many industrial verticals. No, we are not gamblers. There are however some real gamblers in the marketplace. We're talking about the participants that lever up with perpetual swaps on Bitmex, margin trading on Bitfinex or futures trading on OKEx. We're not talking about the hedgers or the professionals. We're talking about those whose sole trading strategy is the equivalent of playing daily Fantasy games with constant vig. Why does it make sense to monitor margin activity? Because with any levered bet, a mark to market that moves out of the money will trigger a collateral event. This could lead to a margin call, followed by a position liquidation. We speculate that this aforementioned liquidation is done somewhat aggressively, with market orders that rip through bids and asks. And this violent price move can manifest into continued market drift. In other words, sharp high prices result in continued moves higher while sharp lower prices result in continued weakness. That's why it pays to pay attention to the gamblers.

4. It also pays to look under the hood. By 'hood', we mean what's happening on the blockchain. We find it valuable to look at more usage-driven metrics in attempts to determine the status of the market. Daily Bitcoin transactions, for example, have regressed from a high of 499k transactions in December 2017 to 144k transactions as of yesterday. The last time we reached these levels for more than a one-day blimp was recently in April 2018, and prior to that in November 2016 (when Bitcoin's price was $714). Likewise, the number of unique addresses used on Bitcoin's blockchain has declined from a little over 1 million in December 2017 to 333k on May 28th, which was last seen in July 2016 when the price was $680. While this decline in usage is partially due to the fact that merchants, payment processors, and online gambling sites are now accepting other altcoins, it cannot fully explain that substantial of a drop in volume. Looking at these metrics obviously doesn't mean that we expect Bitcoin to fall to sub $1k any time soon, but it does show us that we are firmly in a bear market until we come across a catalyst powerful enough to reverse the momentum upwards. That being said, there is a light at the end of this bear market tunnel. As prices continue to drop and excitement in the investor community wanes, we find that it will become harder and harder for new (read: underdeveloped) protocols to raise money. Moreover, fewer companies will want to raise startup capital in ETH as their runway declines with falling prices. While this sounds like negative news, what it means is that we will instead see a likely trend of companies seeking outside VC investment to first build their technology, and then approach the public for a crowdsale to reach scale. This both increases the credibility and feasibility of projects, which in turn is critical for new capital inflow to this space.

5. Spreading FUD is an absolutely toxic behavior that needs to be eradicated. The constant proliferation of FUD ("fear, uncertainty, doubt") is an unfortunate reality that exists in our space. With social media, it seems as though anyone can be a Jim Cramer or a Bill Ackman. Anyone can prop up a position with a viral tweet or start throwing falling knives with a carefully worded subreddit post. We at Element Digital Asset Management however do not subscribe to this mentality. Hopefully by now you've noticed that the kind of content we piece together is a little different from what goes viral in the cryptosphere. We dedicate a good deal of our time to produce what we like to believe is very thoughtful and high quality. This content stems from our understanding of the space and our continued curiosity for what we don't know. Our continued thirst for truth. We believe one can only interpret truths the scientific method way. We pride ourselves on our ability to make good observations, develop theses, run analyses and learn from the results. We try to rely more on that process for investment decisions as opposed to relying on untested speculation or rumor mongering. We also like to think that the way in which we think about this world, while it doesn't always translate into a sensationalist headline, is what an investor with **actual** skin in the game would value. Because that is who we are and that is what we value.

Thanks for reading everyone. Questions or comments, just let us know.

Portfolio Management Team
ELEMENT DIGITAL ASSET MANAGEMENT

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