

Ahead of the curve

Week 48, 2022



Provided by

arcane
research

Market Update



Powell relief followed by diminishing volatility

- The crypto market saw more upside last week after a strong positive reaction to Jerome Powell’s speech at the Brookings Institution on November 30. In the speech, Powell indicated that the FED “could live with a more modest interest rate hike in December”, reflecting positively on the crypto market. However, Powell also indicated that rate hikes in 2023 could become higher than anticipated. The positive market response to the Powell speech suggests that macro conditions will still play a substantial part in BTC’s price discovery onwards. This week in macro is slow, with few notable events. However, next week is shaping up to become hectic with back-to-back important U.S. events, with the release of U.S. CPI numbers on December 13 and the FOMC press conference on December 14.
- Apart from the market reaction to Powell’s speech, markets stayed directionless last week, as BTC has spent the first 6 days of December floating in a narrow trading range near \$17,000. The market slowdown is reflected in severely reduced trading volumes in spot and derivatives markets, and the last month seems to have caused market participants to shy the crypto market.
- The last week has seen more clarity related to Genesis’ balance sheet hole. Per recent reports, Genesis currently owes \$1.8bn to its creditors, with the size expected to grow further. Related to crypto lenders, Nexo halted operations in the U.S. and has seen substantial outflows since the FTX collapse.

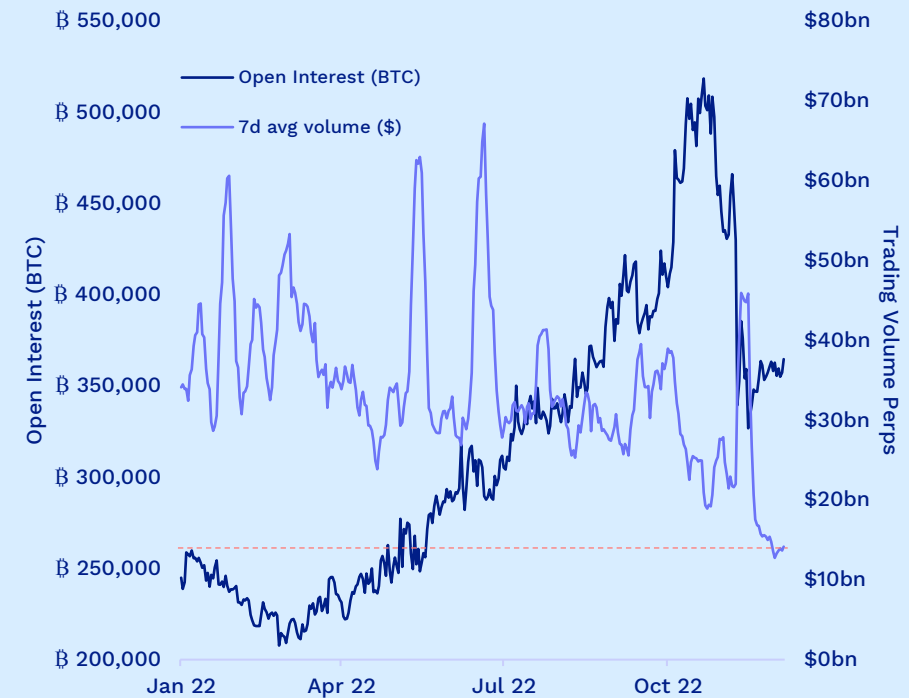
Trading activity in perps reaches multi-year lows

- Activity in bitcoin derivatives has come to a standstill alongside the rest of the market. Open interest has stabilized materially, and we note a sharp decline in trading volumes. The current aggregated 7-day average trading volume in perps sits at \$14bn and reached multi-year lows of \$12.7bn on November 30.
- Perpetual swaps are the most frequently traded BTC instrument. Perps have tended to see volumes stabilizing in the \$20-\$30bn range in previous low volatility environments after dramatic selling pressure. The current decrease in perp activity suggests that market participants have exited the market in the last month and that we might experience slower days ahead.

Short BTC ETF’s AUM remains high

- ProShares’ short ETF BITI experienced massive inflows in November, leading its short exposure to surge to new all-time highs after a daily inflow equivalent to 2,730 BTC on November 9. Inflows remained high in the following days, leading the ETFs BTC equivalent short exposure to peak at 7,890 on November 28. The ETF has since experienced substantial outflows, but the AUM remains elevated as the short exposure sits at 6,230 BTC, well above the peaks of this summer.
- Due to the structure of the ETF, BITI has yielded negative returns since its launch in June, despite BTC’s drawdown underperforming a naked BTC short by 22.24%.

BTC Perps: Open Interest (Notional) vs Trading Volume (7-day Average)



Source: Tradingview, Laevidas

Spot Market



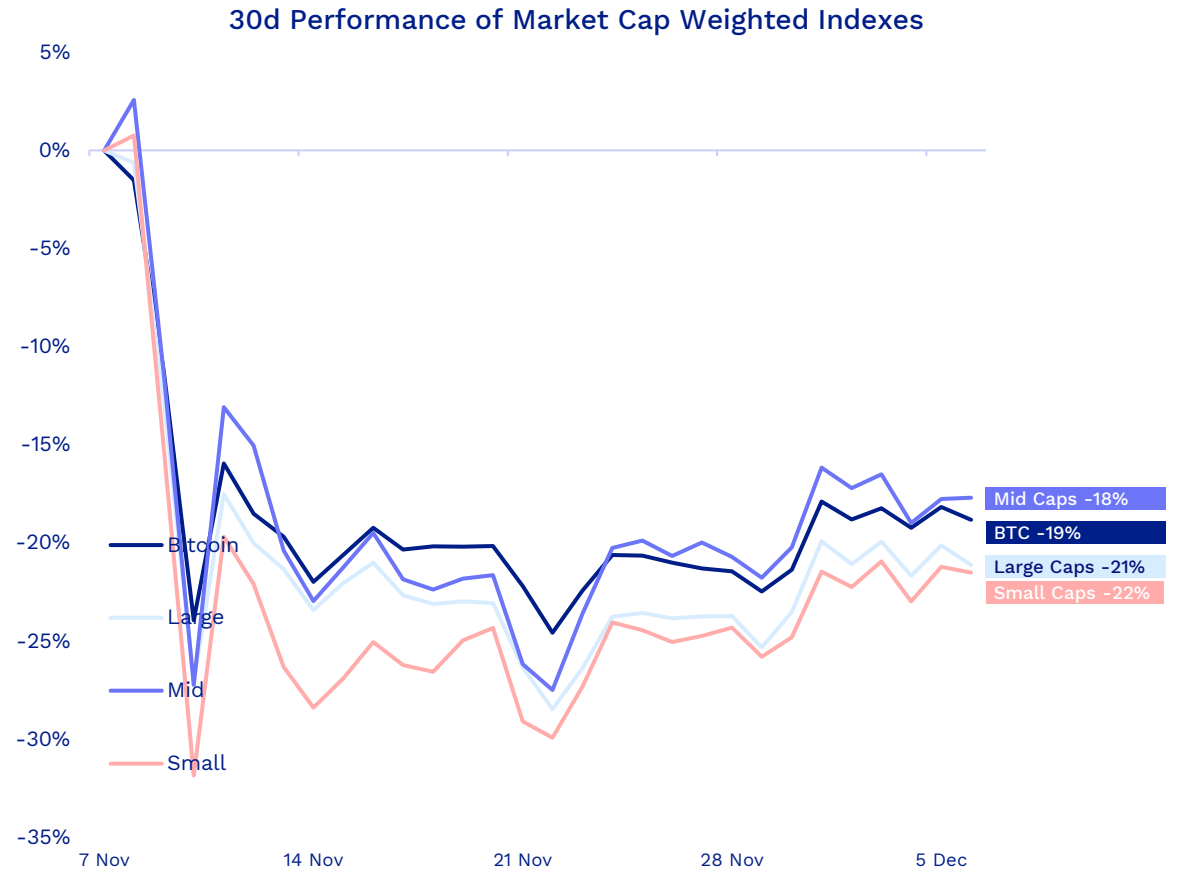
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Extremely correlated crypto market

- The crypto market has mostly traded as one coordinated organism in the last week, evident by all indexes trading in a very flat environment.
- The overall flat market is likely caused by a trader exodus following the FTX collapse, as the market trails in deep consolidation accompanied by low trading volumes.



Source: Bletchley Indexes, Tradingview (Coinbase)

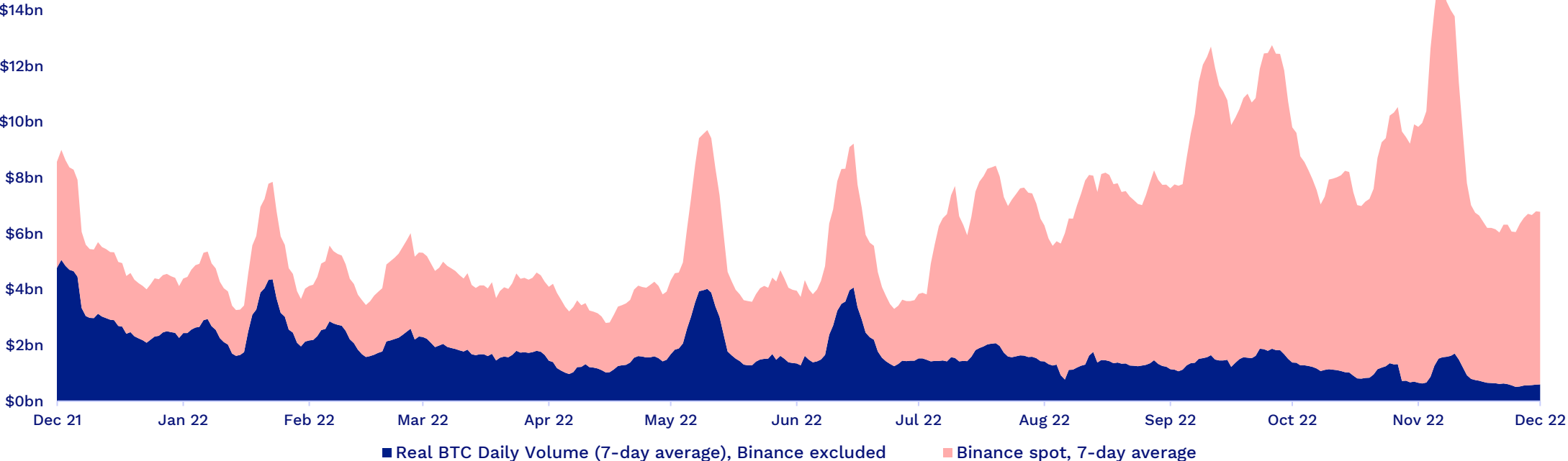


Volumes remains shallow

Volumes have fallen further in the last week as trading activity remains low. Daily trading volumes in BTC spot markets, when excluding Binance, sits 65% below the yearly average. On November 29, the 7-day average real spot volume in BTC (excluding Binance) reached \$510m, lows not seen since October 2020.

The slowdown in market activity is also evident in derivatives. BTC perps have seen trading volumes plunge to \$14bn, mirroring the stagnant activity seen in spot markets.

Real BTCUSD Daily Volume* (7-day average)



Source: Tradingview

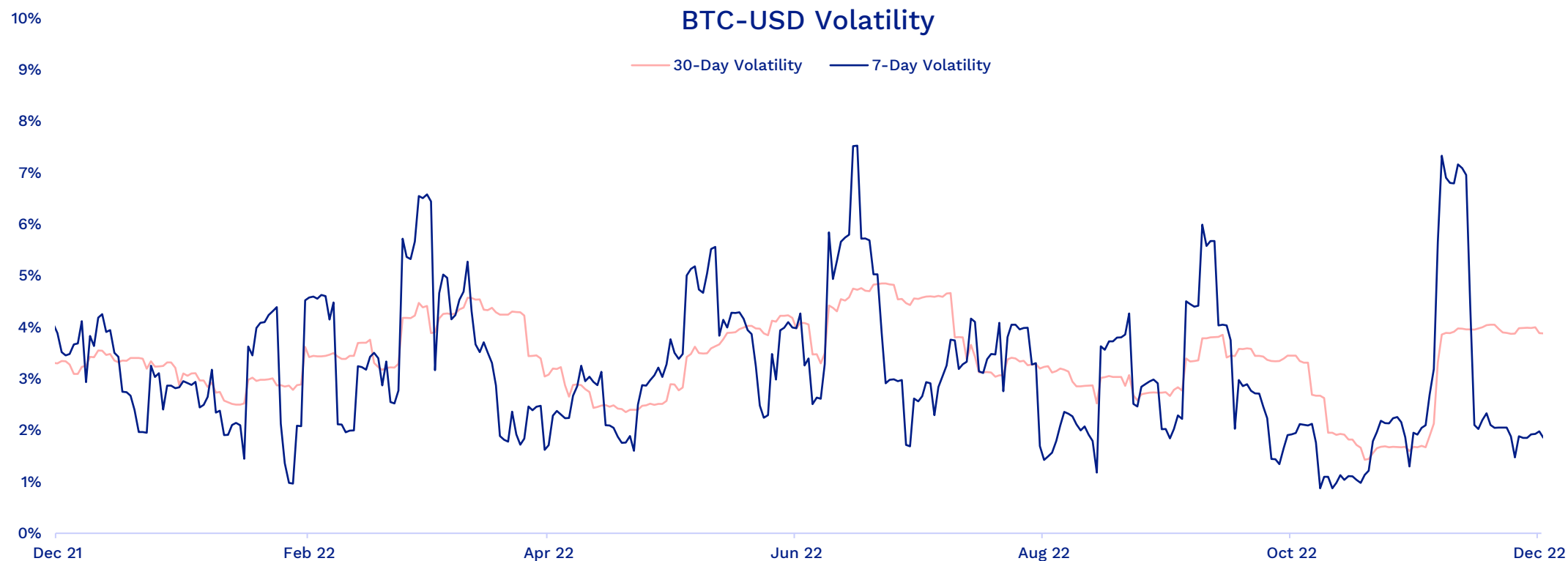
*Includes Bitwise 10 exchanges and FTX



Volatility slowdown

The 7-day volatility in BTC remains at 1.8%, as BTC has stabilized within the \$15,500 to \$17,500 trading range. November 30 saw a push higher in BTC from \$16,500 to \$17,000, but prices have since flattened completely in a narrow trading range between \$16,800 and \$17,100.

There are few obvious volatility catalysts in the near term. Still, unexpected contagion-related developments may shake up the market, while next week's U.S. CPI release and FOMC press conference may cause BTC to move.



Source: Tradingview (Coinbase)



Derivatives

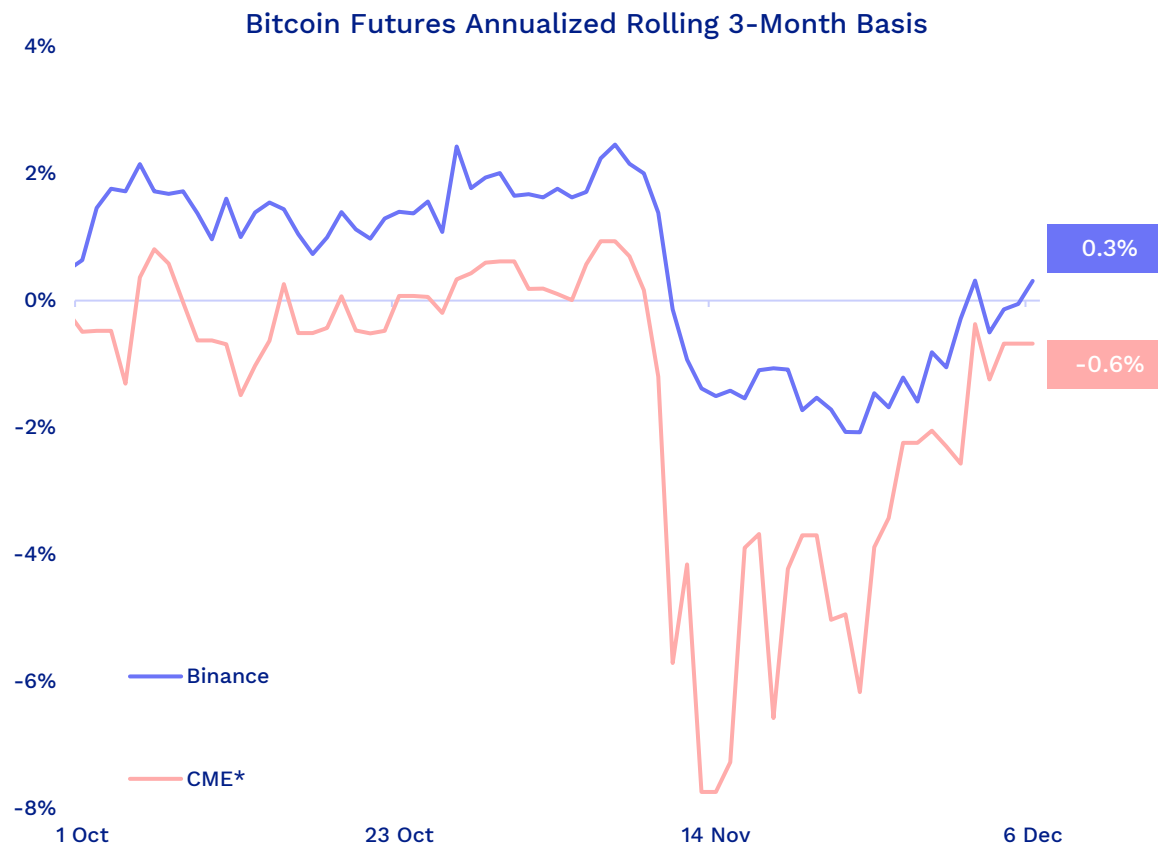


Futures trading on par with spot

- The 3-month futures basis on CME has climbed further over the last week as futures prices now align more closely with spot prices. The recovering futures basis on CME may be partly explained by shorts being covered, evident by recent ETF flows.
- In the offshore market, we note that the futures basis on Binance has neutralized, trading slightly above spot for the first time since November 10, indicating that the sentiment is gradually improving.

Futures term structure still in sharp backwardation

- While the futures basis is gradually recovering, the CME's futures term structure remain in backwardation, indicating that institutional traders remain cautious.



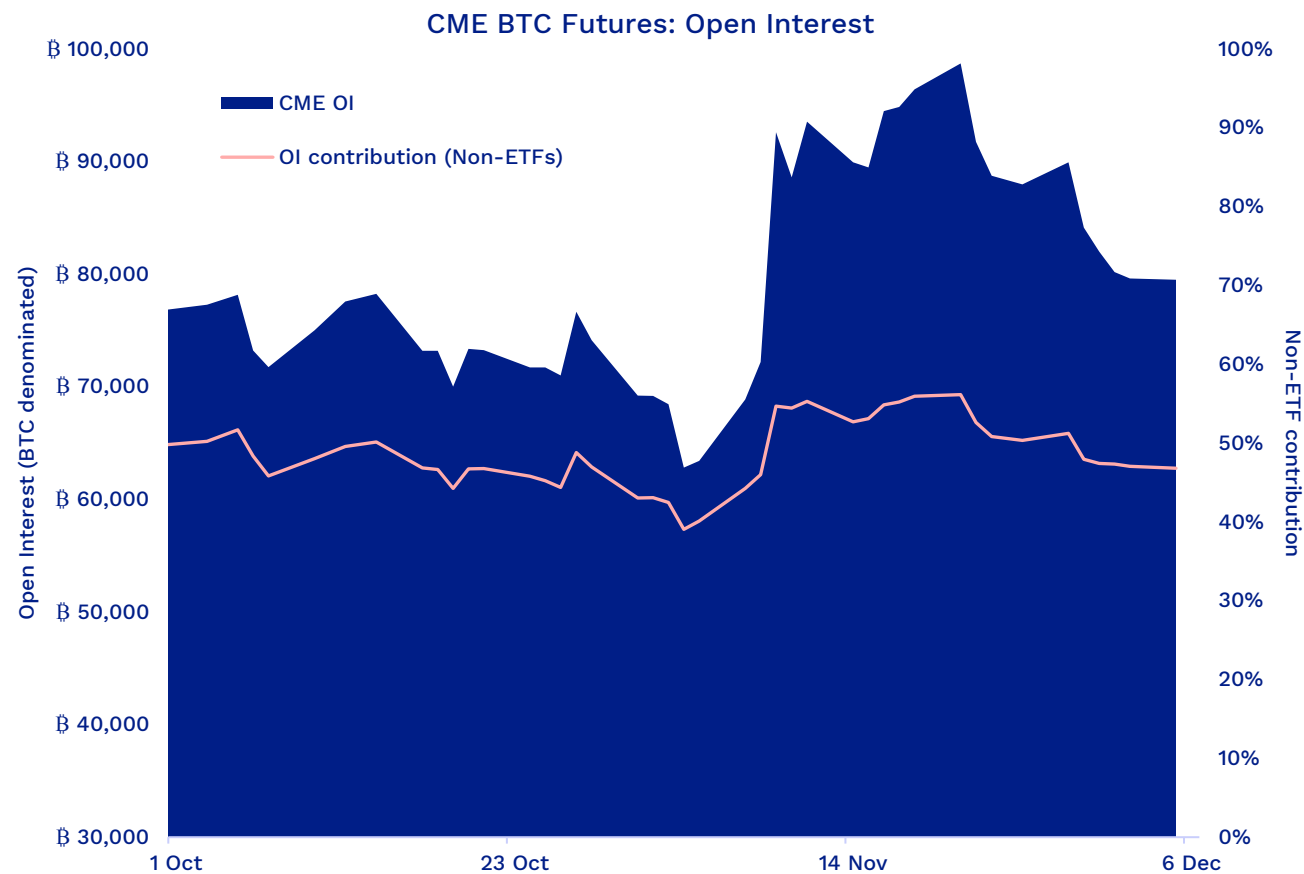
Source: Skew, Laevidas, Tradingview, CME

*Closed Saturday - Sunday



CME's BTC OI declines further

- CME's open interest has fallen further this week to 79,000 BTC after reaching a new all-time high of 98,725 BTC on November 21.
- Outflows from BITI explain parts of the reduction in OI, but direct activity, unrelated to ETF flows, has been the most significant contributor to the decline, as the non-ETF contribution to CME's open interest has fallen from 50% last week to 47% today.
- The "active market participant" contribution of 47% is still substantially higher than the 39% level reached on November 3 but aligns closely with levels seen throughout Q3, 2022.

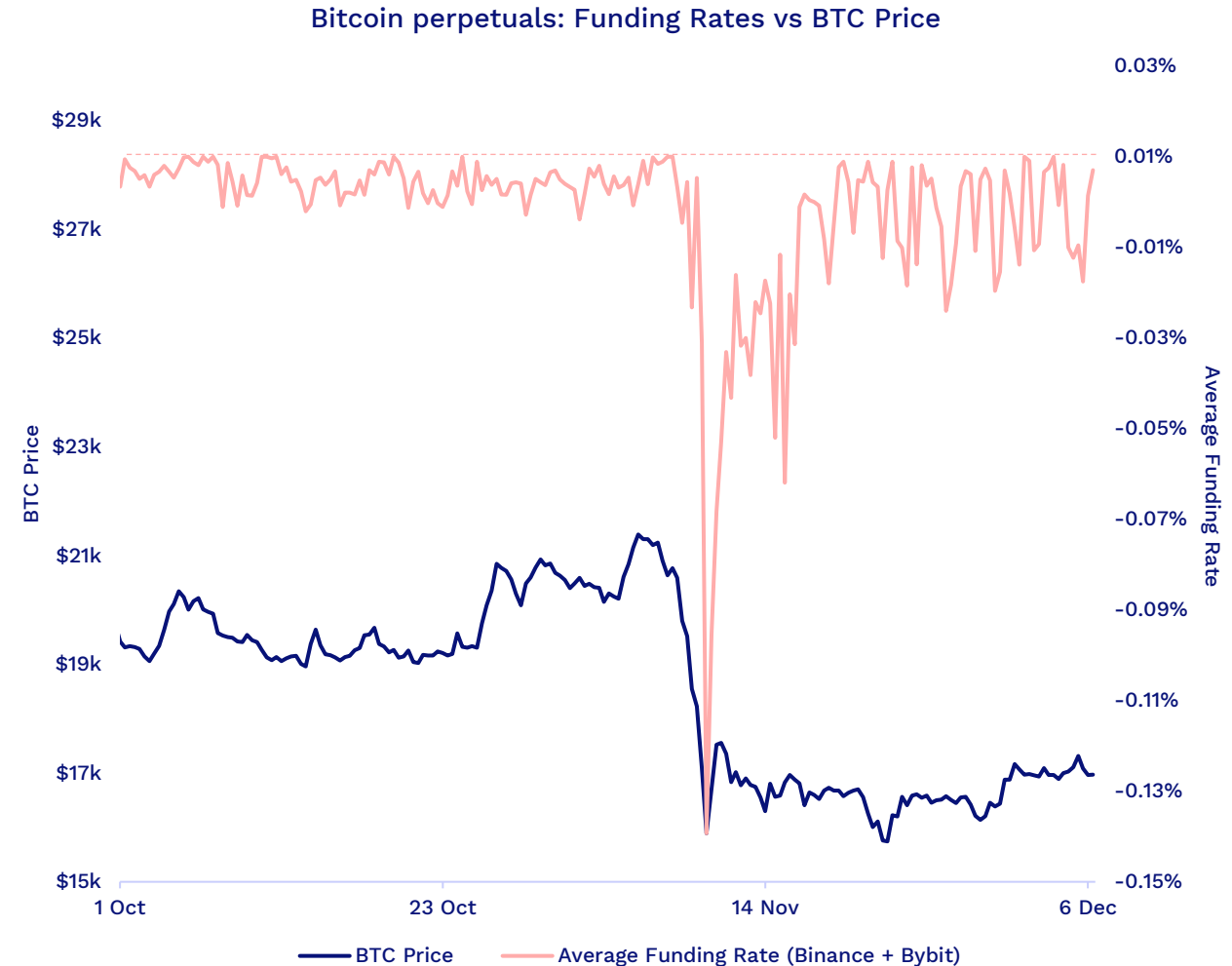


Source: Coinglass, ProShares, Valkyrie, VanEck



Funding rates oscillating near 0%

- Funding rates have oscillated around 0% in the last week, reaching neutral terrain multiple times, as the market structure is showing signs of normalizing.
- Nevertheless, trading activity in perps remains low, evident by volumes reaching multi-year lows (page X) and open interest stagnating.
- Thus, the recovering funding rates seem to be caused by muted organic activity and occur as the market, in general, remains in an unusually slow state.

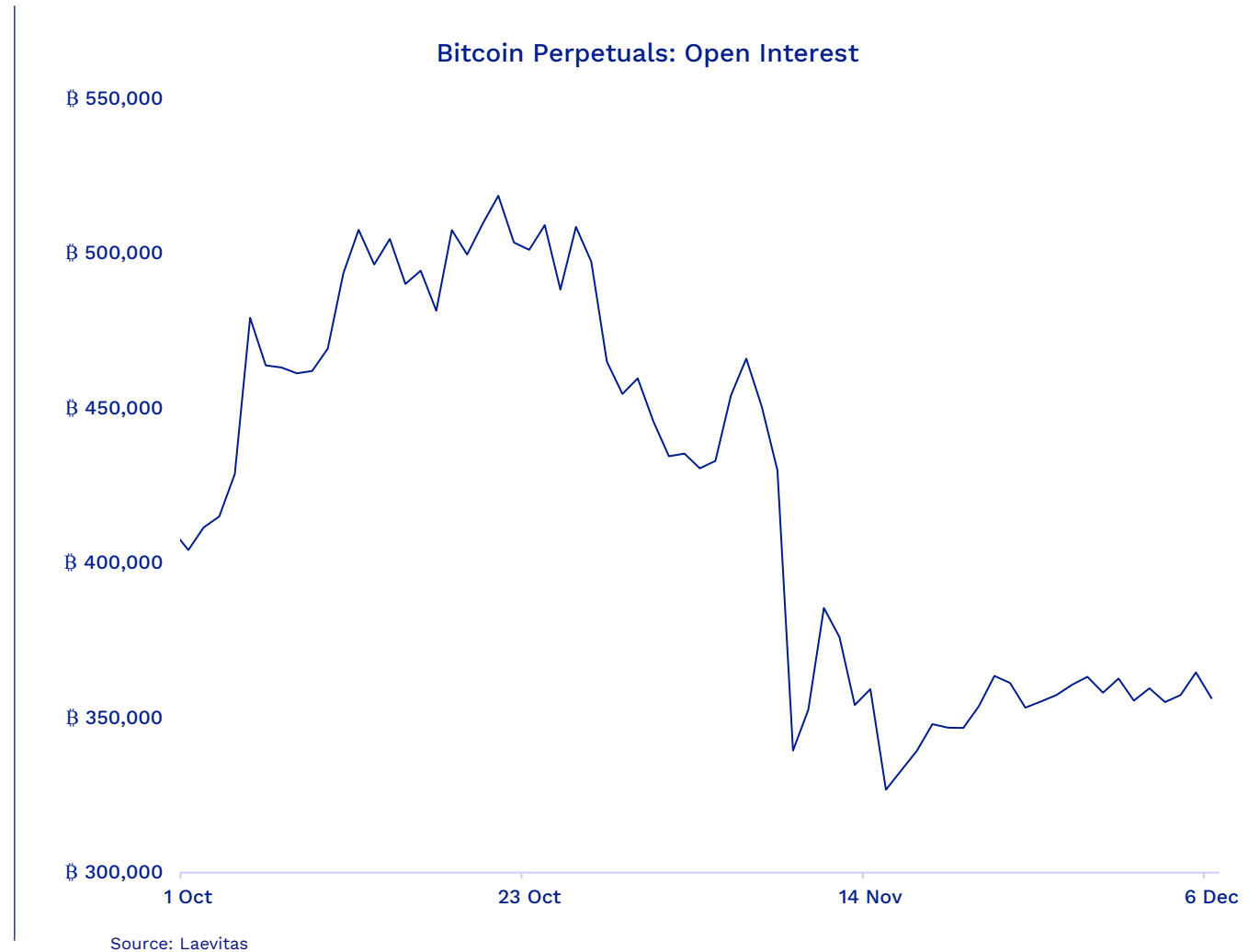


Source: Bybit, Binance, Tradingview (Coinbase)



No changes in perp OI

- Open interest in BTC perps has remained flat near 360,000 BTC in the last week, with no noteworthy changes as market activity dwindles.



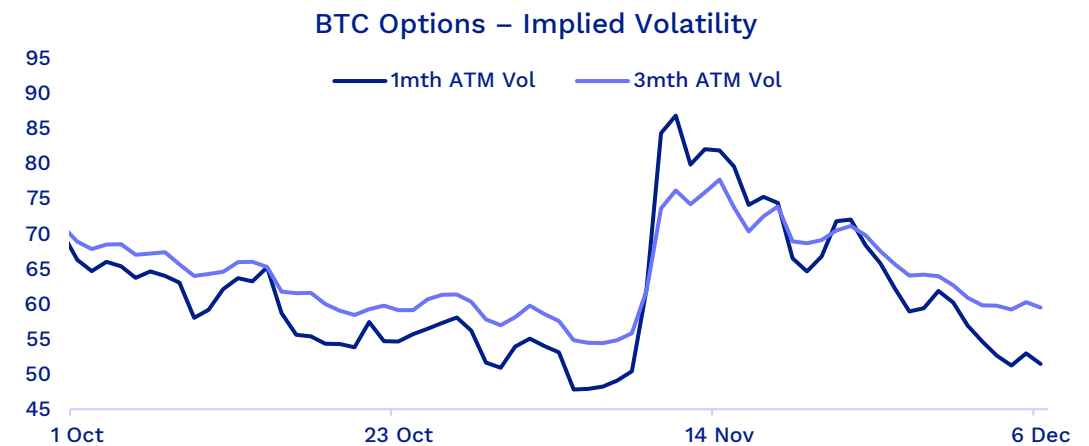
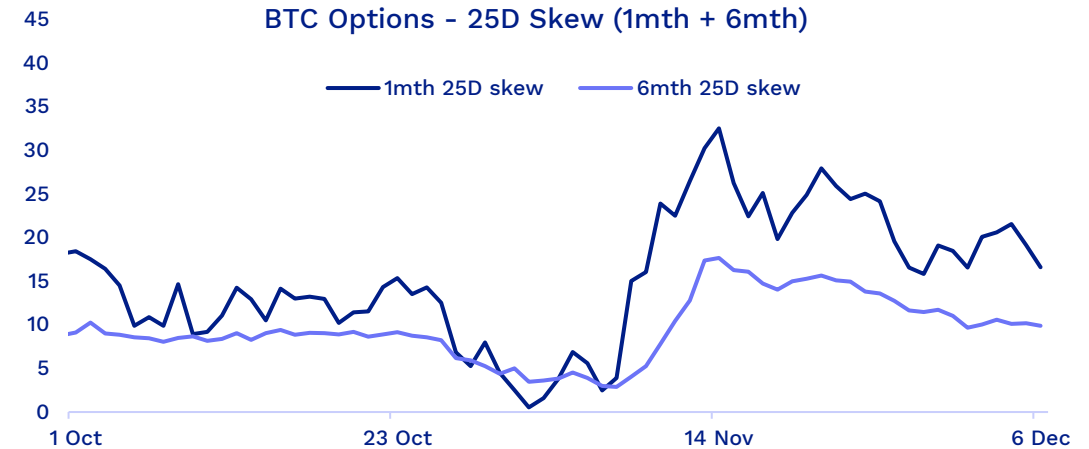
Bitcoin options: Still high demand for downside protection

Skews still suggest a high demand for downside protection

- Skews remain in positive terrain, aligning with last week's observations, as options traders are still willing to pay a premium for downside protection. Overall, the bearish sentiment in options remains strong.

Implied volatility returns toward pre-FTX levels

- As volatility has declined in BTC, implied volatility has followed suit. The 1mth implied volatility currently sits at 51, near the pre-FTX meltdown lows. The 3mth IV has also fallen considerably, trailing below 60, nearing pre-FTX meltdown levels.
- While the market structurally seems to move into a stagnant stage, declining IVs may represent an interesting opportunity related to straddle trades.



Source: Laevidas



The Deep Dive



Slowdown in BTC perps

Trading activity in perps reaches multi-year lows

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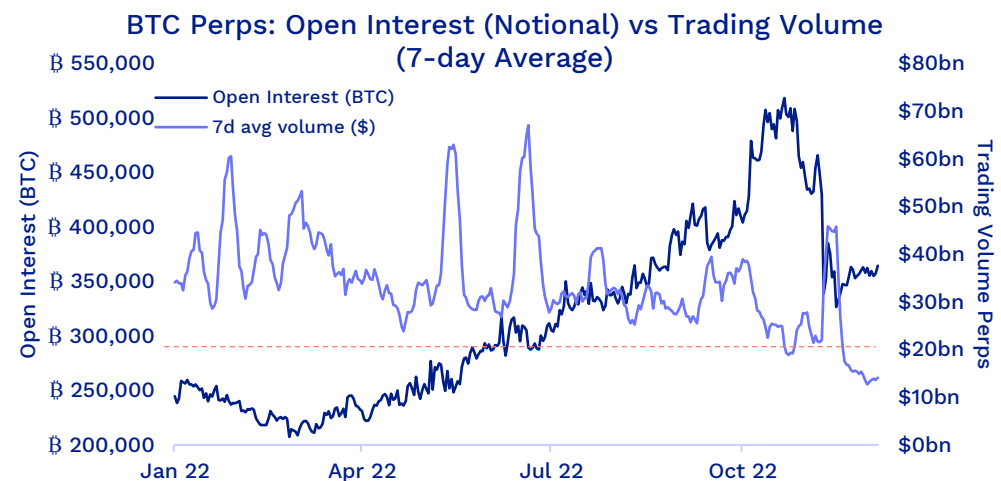
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The falling trading volumes in perps may also be caused by declining trust in centralized offshore exchanges following the fall of FTX. This also aligns with exchange balances declining from 2.5m BTC to 2.3m BTC in the last 30 days. A decline of 7.93% in the last 30 days, the largest relative decline in BTC exchange balances since January 2015.

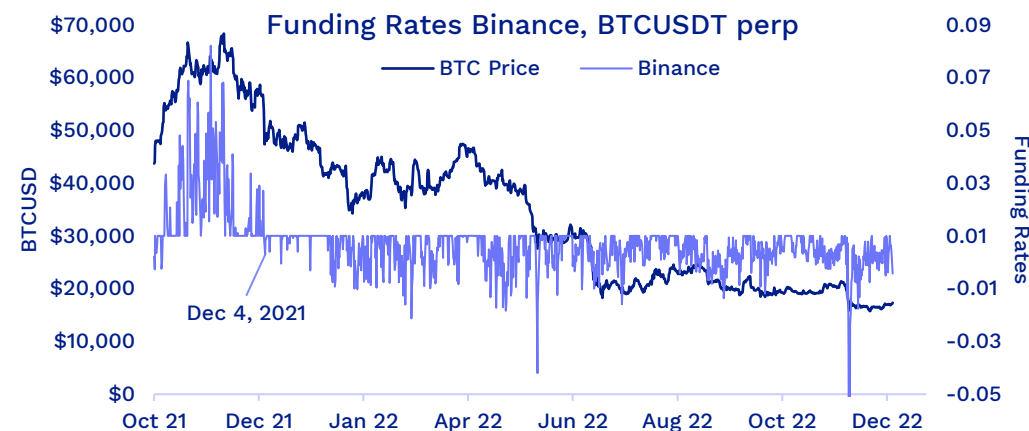
One year of funding rates at or below neutral

Funding rates have now been neutral to below neutral for an entire year. The previous record-long duration of funding rates at or below neutral levels lasted for 2.5 months, so this is clearly uncharted territory for BTC perps. Nevertheless, as we have illustrated previously, the funding rate regime has still benefitted the short side since the peak of the bull market, unlike what we saw on BitMEX in 2018.

While the observation of the prolonged state of this bearish funding rate regime presents limited actionable insights, it is telling of the longevity of the negative sentiment in the market. Despite the funding rate regime of the last year, shorts have yielded a cumulative funding rate of 4.5% since December 4, 2021, due to funding rates tending to stabilize near neutral territory as sell-offs quiet down.



Source: Tradingview



Source: Binance, Tradingview (Coinbase)



Short BTC ETF's AUM remains high

During the turbulence in Mid-November, ProShares' short ETF experienced massive inflows, leading its short exposure to surge to new all-time highs after a daily inflow equivalent to 2,730 BTC on November 9. Inflows remained high in the following days, leading BITI's short exposure to grow to an equivalent of 7,890 BTC at its peak on November 28.

However, inflows have turned into outflows in recent days. On November 30, BITI experienced outflows equivalent to 860 BTC. Similarly, December 1 saw 760 BTC worth of outflows. This is the third and fourth largest daily outflows from BITI since launch, and the outflows might be caused by the stabilizing BTC price. Additionally, most of the inflows since November 9 have been unprofitable as the spike in inflows coincided with BTC bottoming.

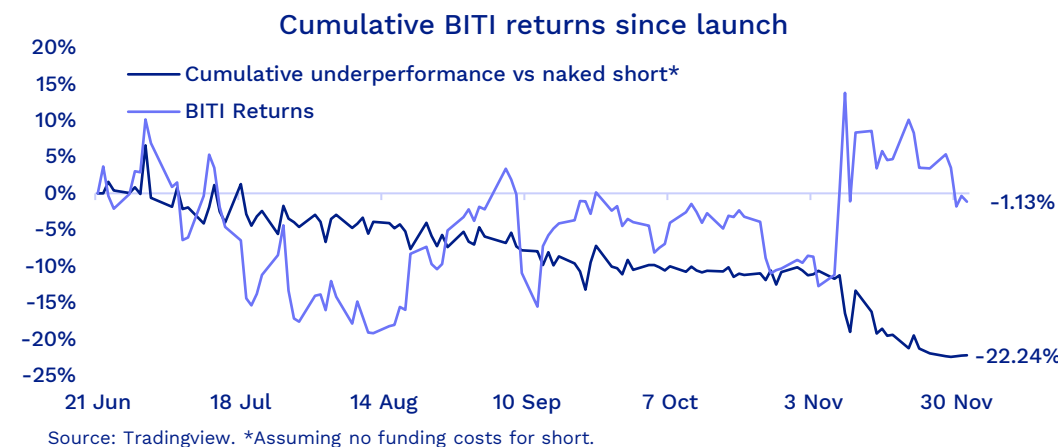
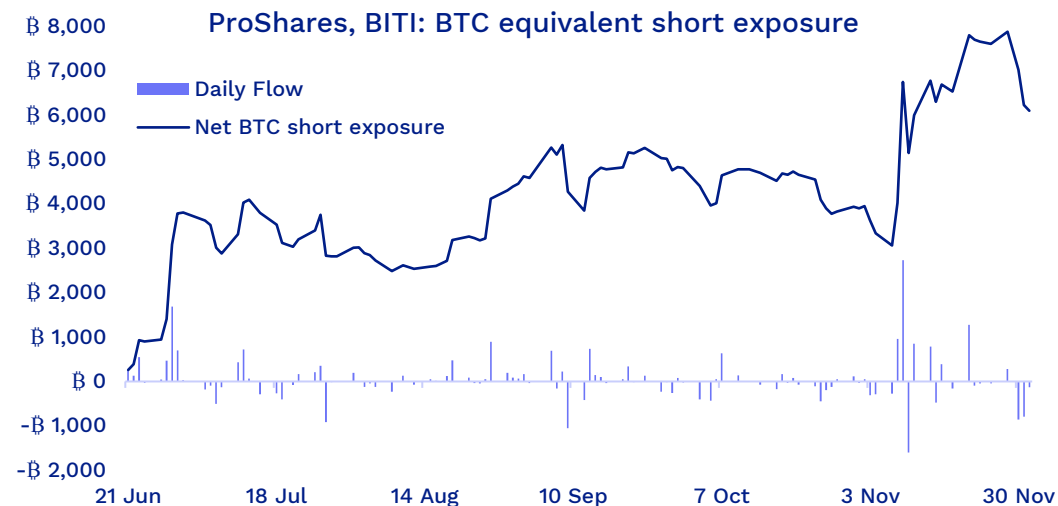
Inflows to the short ETF tend to occur amidst peak market fear, and we have previously noted a pattern of BITI's AUM peaking near BTC bottom depths. This could suggest that countertrading extreme BITI flows could be a promising trading strategy.

BITI return negative since launch, despite a significant BTC price fall

An important caveat to BITI is the daily costs related to BITI and its structure. The fund seeks a return equivalent to the -1x return of BTC on a single day. Over time, the daily BTC returns will hurt the BITI holder, and compound effects of slight underperformance day over day during periods of volatility will lead to significant underperformance. This makes BITI a bad alternative for long-term exposure.

Since BITI's launch, BTC has declined 21% from \$20,700 to \$17,200. If a trader entered BITI at the launch date and held it long-term, the investor would be slightly in the red, seeing negative returns of -1.13%, underperforming a naked BTC short by 22%.

There are costs associated with naked shorting BTC through alternative venues as well. However, the costs tend to be negative, as funding rates tend to approach their neutral 0.01% level. For instance, a BTC/USD perp short on Binance would've yielded 1.6% in excess return due to funding rates. Still, offshore exchanges introduce counterparty risk and uncertain funding rates. Additionally, U.S. retail traders are barred from using them to trade, which might explain why traders flock to BITI during uncertainty.



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