INSIDER Weekly

- ISSUE #164, July 2020 -

Greetings and welcome to this edition of the Insider Weekly.

Thanks this week go to fellow member Barry for this shot of Zions National Park, Utah.

Ok folks this week we're doing something very different. Instead of a "normal" weekly we bring to your attention. The crypto currency Ethereum. My friends over at zerocap put forward the investment case.

Ethereum is moving again, this time driven by the future of finance. Is it ready to solve some of the greatest challenges today, or is this just another bubble ready to pop?

Preface:

Decentralised Finance - "Defi" is built upon, and powered by Ethereum. The crypto world has this protocol in its sights again after the 2017 boom and bust. However, this time - it may bring more of the world along for the ride. Covid-19, shrinking yields and the search for alternatives; Ethereum could be the technology that tomorrow's bank is built upon. What does it mean for financial markets and you as an investor? Let's dig in...

Ethereum: Powering a New Form of Finance

Ethereum.

From fairly humble beginnings to the heights of the ICO boom, Ethereum (ETH) has been on one helluva ride. This cryptocurrency is more than just a currency. It serves as a smart, programmable protocol on which to build applications, contracts and other neat things. The protocol is the platform for over 260,000 different cryptocurrencies, a few of which dominate the market capitalization of the industry, many of which are from much smaller projects. Since the 2017 ICO boom, we've been sceptical of its potential to reach these heights again. What drove massive inflows to the currency over this period was a plethora of (often shite) projects building on the protocol, and then using this protocol to raise capital from unsavvy FOMOing investors. With every transaction, ETH grew in network value, and this was reflected in its price ten-fold, awash with the irrational exuberance of the market. Will we ever see another flash in the pan like 2017 again? We are beginning to think so...

The (ka)boom

To give you an idea of the boom period - check out the following 4-years of token activity. This was almost entirely facilitated through the Ethereum protocol. We gave a snapshot of the ICO activity in our recent article, and what this meant for the space. In short, like the dot-com boom left us with the internet and some fantastic innovations, similarly the ICO boom left us with some great tech, ready for distributed and 'traditional' technology to build on. Post this boom - from early 2019 to now - the market has been shaking out the weak hands and failed projects, leaving the kind of disruptive innovation that could change the world.

In our prior article, we also looked at the differences between Bitcoin and Ethereum. This is an important point - whilst the two assets correlate in various ways, they are two different beasts. Think of Bitcoin as gold, a censorship resistant, non-sovereign store of wealth. Like gold, you won't be making thousands of transactions per day. You'll be holding to hedge against inflation or for longer-term speculative upside. On the other hand, think of Ethereum as smart-money. You can program it, attach rulesets and governance models to it, and create your own applications on its technology.

So where is the real value in ETH? Why now?

Two words: Decentralised Finance, otherwise known as "DeFi". The DeFi projects that have had their heads down building, are beginning to pop their heads up with some pretty amazing, albeit nascent, technology. DeFi is poised to eventually reach into all aspects of wealth; blockchains will support trading, lending and credit markets; providing instantaneous loan collateralization, simplifying complex relationships between assets, and ultimately, improving access whilst reducing systemic risk. All without the need for the usual financial institutions to act as intermediaries. It has always struck me as strange that I can jump on a video call from Australia to my best buddy in Canada instantly, yet it still takes 3-days to wire him some cash. We live in a digitally connected world, built on 21st century globalisation, yet I can only get a loan from an Australian bank. And it takes weeks to get approved, even though I'm sitting on healthy collateral. Imagine a world where blockchains acted as the ledger of truth, where you could borrow and lend to counterparties around the world - knowing their collateral levels and risks without having to deal with a bank? This is where DeFi is heading, and it's long overdue.

This just so happens to be at a time when Covid is wiping the floor with any kind of rational economics and yields are at all time lows or negative (for now). This is the perfect breeding ground for large cyclical shifts in the financial system. We are beginning to see it in commodities, particularly inflation hedge commodities - gold, silver, copper.

The CRB commodity index (Energy: 39%, Agriculture: 41%, Precious Metals: 7%, Base/Industrial Metals: 13%) has begun turning skyward. With inflation, this sucker will really move, bringing in what we view from a macro level as the cyclical shift to commodities and associated inflation hedges. Whilst we still see potential upside in the equity markets due to the sheer amount of capital flooding the system, we don't see improving dividend yields anytime soon in many industries. With a reduction in purchasing power, and shrinking yields, where will people turn to for diversification?

Furthermore, 46 of the world's central banks are considering launching their own digital currencies. People would be well placed to look at the risks of having your illustrious CB governors with the keys to your bank account. Heaps of fun at the moment with the money streaming in, but this comes at a cost - and it could be the loss of your control on your own capital in the long run.

Business

IMF Cautiously Approves Central Bank Digital Currencies

by Paul de Havilland Dec. 16, 201

IMF suggests a range of risks and benefits to central bank digital currencies

Source

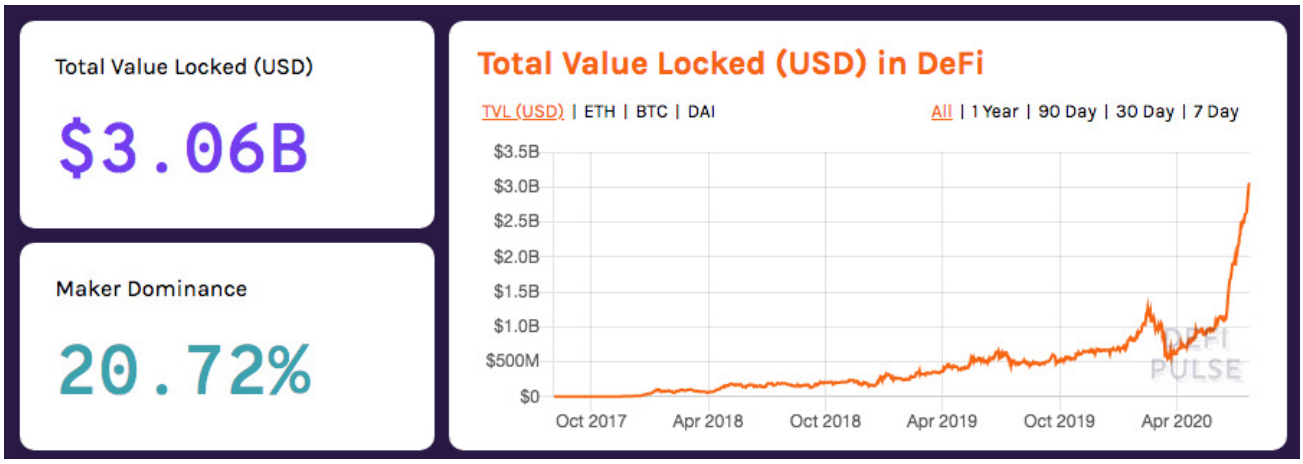
What does DeFi have to do with all of this? DeFi solves many of these problems and more.

- It allows you to have total control over your assets - to be your own bank, out of the hands of governments, central banks and ex-partners.
- It removes the friction of banking and settlements, allowing instant transactions and access to global credit markets. In other words, liquidity.
- It removes the costly layers that reduce your earn rates in yield products.
- It provides transparency around total supply dynamics of assets you are holding.

The current macro picture makes sense for Bitcoin as a frictionless and liquid store of wealth, and Ethereum as the future of finance - in a world where financial structures are being distorted like we've never seen before.

DeFi Progress

The total value locked in DeFi has just surpassed $3 Billion. A drop in the ocean compared the mainstream credit markets, and that is where the opportunity lies.



Source

These numbers do not include centralised credit markets within the crypto industry - which are essentially traditional lending models (master loan agreements, centralised 'bank' like functions) that facilitate institutional borrowing and lending of digital assets. When we include this type of lending, we are heading north of $10b annually, and growing at an insane rate.

DIGITAL ASSET LENDING SNAPSHOT
2020 | Q1 Insights

Summary Statistics

- 2020 Q1 Originations: $2.0B
- Originations ITD: $6.2B
- Total Active Loans as of Mar 2020: $649M
- Reached $1B+ in Active Loans on Feb 14, 2020

Robust Growth – Major $1B Milestone

Genesis Capital's Quarterly reports

The demand is growing for these services, and it's only a matter of time before institutional growth spills over from centralised credit markets to DeFi credit markets. Furthermore, and of greater opportunity, is traditional investors beginning to use this space for yield generation.

Let's give you some tangible insights into some of the products across centralised and decentralised finance products - both of which present a bullish case for Ethereum.

Earn up to 12% p.a on USD holdings

DAI APR Rates	See more DAI rates	
Compound	7.68 % APR	FLAT
nüo	6.43 % APR	FLAT
δY/δX	5.58 % APR	FLAT
AAVE	3.17 % APR	FLAT
fulcrum	1.34 % APR	FLAT

USDC APR Rates	See more USDC rates	
nüo	10.6 % APR	FLAT
BlockFi	8.6 % APR	FLAT
Compound	1.68 % APR	FLAT
fulcrum	1.28 % APR	FLAT
δY/δX	0.87 % APR	FLAT
AAVE	0.51 % APR	FLAT
coinbase	0.15 % APR	FLAT

How is this possible when the USD benchmark rate is at 0.25%?

There are various factors and requirements driving the digital asset credit space. Primarily - short/medium and long-term funding requirements by institutions in an effort to hold core digital asset positions whilst deploying additional capital for immediate opportunities.

Genesis Capital identifies 3 primary use cases from their institutional borrowers.

1. Operating Working Capital
2. Speculating / Hedging
3. Trading / Arbitrage

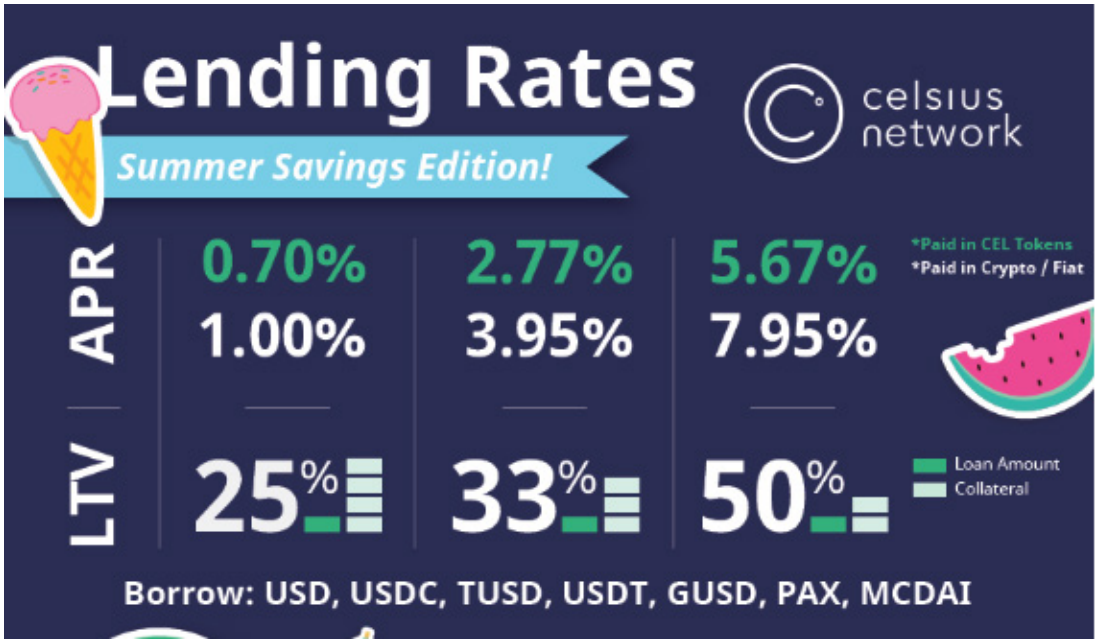
Advantages of borrowing against their underlying collateral include:

1. Maintaining exposure in core holdings, as part of their investment or liquidity mandate
2. Ability to hedge downside risk without deploying additional capital
3. Tax efficiency through triggering liquidation events

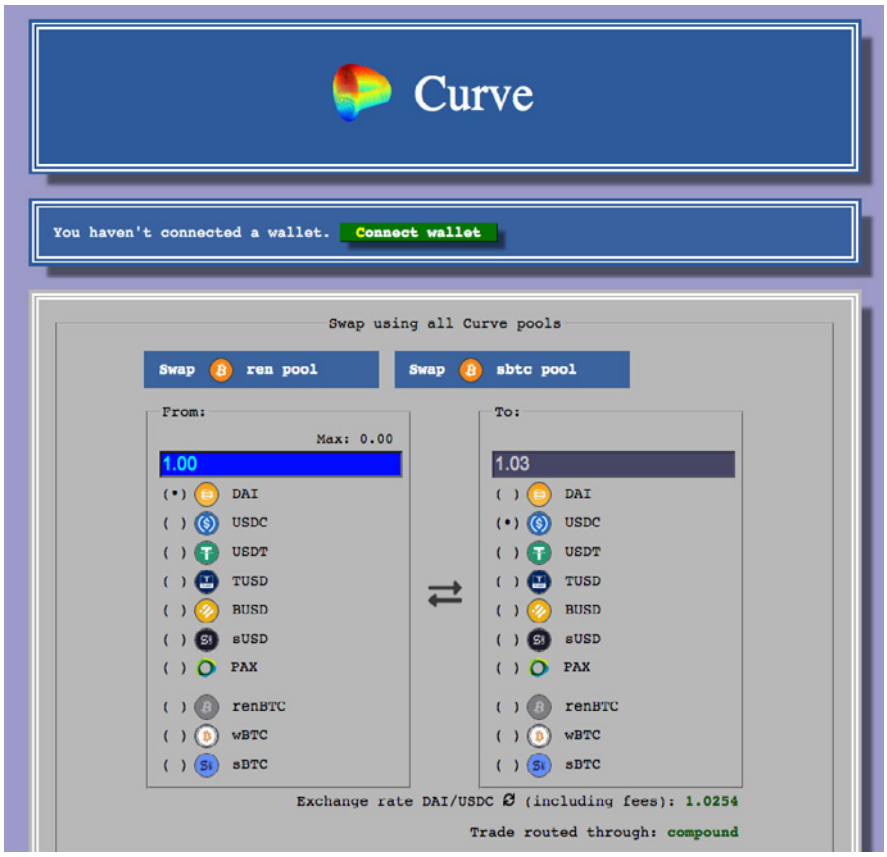
Loan rates are high as a function of the volatility of the underlying asset and the direct application of these loans. Unlike a bank that takes a very large intermediary spread between depositors and borrowers, the digital asset credit market connects borrowers and lenders with significantly less layers.

This means more interest for you as the lender, and less comparative interest for the borrower.

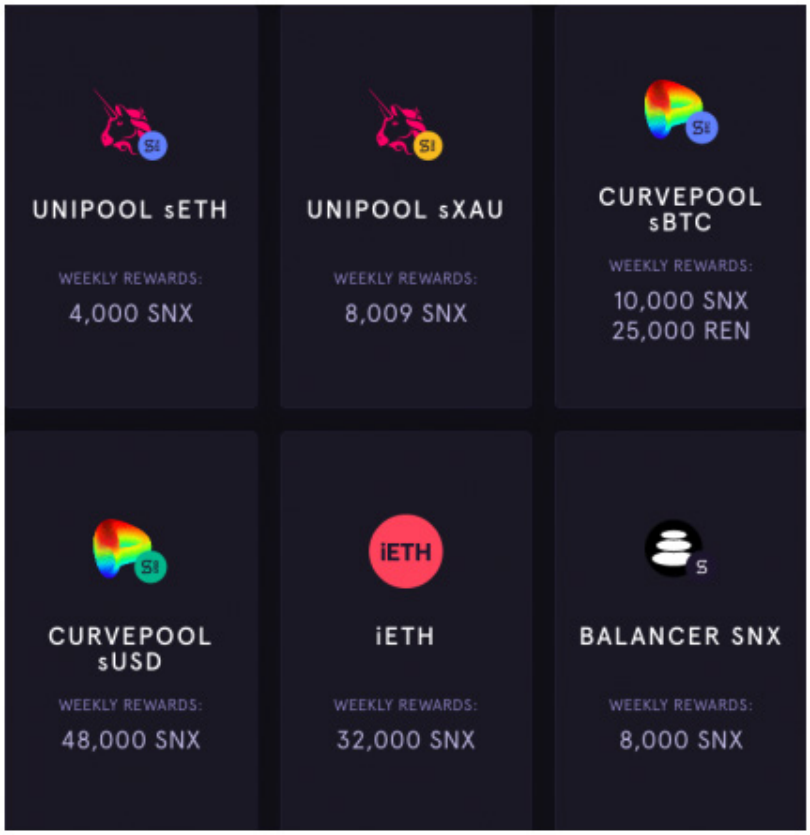
Have a portfolio of digital assets, and borrow against them
Want to have your cake and eat it too? Well you can. Hold a portfolio of assets for longer-term growth, and borrow against them – as low as 1% when overcollateralized.



Become a liquidity provider, or 'yield farmer'
Yield farming, as it has become known in recent months, is the practice of providing liquidity (USD token or Crypto Asset) on a DeFi platform, earning yield for doing so and still being able to borrow against your collateral. This is fairly risky at the moment as the DeFi platforms are still largely in 'launch' phase, but the theory behind them is sound. Investors can move between a variety of tokenised USD formats - USDT, USDC, DAI to ensure that they are earning the most yield. Some assets pay more than others depending on the environment. To exchange between assets, investors could go to a centralised exchange, or they could jump on a decentralised platform like Uniswap or Curve Finance (sporting a website reminiscent of the mid 90's), and access pools of liquidity. This reduces slippage, and improves pricing. The swap occurs on an over-the-counter (OTC) basis. In a traditional OTC market like FX, large banks and market makers provide these pools of liquidity, which eventually arrive to the average retail investor when they make an overseas purchase.



Harnessing DeFi in this scenario removes the large balance sheet requirements of Prime Brokers and all the additional intermediary layers in between. It literally connects pools of liquidity with takers of liquidity. To incentivise adding liquidity onto these pools, variable incentives are paid, from in a variety of different digital assets. Yield Farming is the process of adding and taking liquidity from these pools to maximise interest payments. It's a brilliant incentive model: capital flows where it's needed most. Economics at its finest.



SNX rewards for providing liquidity on other protocols, via Mintr

All these rewards/yields are paid in ERC-20 tokens, AKA tokens running on the Ethereum network.

Start a bank
Yep - this is where it'll land up. Not yet, but sooner than you may think. A frictionless bank, instant, censorship resistant, truly yours. The tech has some way to go, and there will be hacks, losses and failures along the way. But think of this as the beginning of a new kind of bank, where only you have the keys to your vault.

Investment Case
There are 6 key tenets to our investment case on Ethereum.

1. The macro case
We've covered the macro case, which has partly justified us entering now and not in 6-months when the DeFi projects are really kicking some volume.

2. Hype
This is the other part justification for entering now. We are hearing rumbling noises - beginning to form as they did in the very early ICO days. Just before mania hit. Whilst we don't want to hit the trade due to FOMO, the last thing we want to do is have a strong thesis and miss a solid entry because we were slow. And I'd rather be in the trade with good foundations, even if the trigger is the madness of the crowds.

The fact that Forbes is already picking this up is concerning. But it's important to understand that Ethereum is the second order consequence. I fear the crowds will initially hit the latest DeFi project tokens, that will ultimately drive volume in Ethereum through transactions. This will not be an immediate move, but one that is likely to follow.


Forbes Billionaires Innovation Leadership Money Busi

10,890 views | Jun 22, 2020, 08:50am EDT

DeFi Yield Farmers And Crypto Investors Are Raking In 100%+ Annualized Yields

Leeor Shimron Contributor
Crypto & Blockchain
I write about the intersection of technology, economics, finance, politics, and crypto.

3. Ethereum is essentially an ETF of DeFi projects
Let's take a look at DeFi market capitalization and which protocols they are built on.

DEFI PULSE	Name	Chain	Category	Locked (USD) ▼	1 Day %
1.	Maker	Ethereum	Lending	$707.4M	8.29%
2.	Compound	Ethereum	Lending	$569.1M	3.18%
3.	Aave	Ethereum	Lending	$557.1M	13.82%
4.	Synthetix	Ethereum	Derivatives	$505.4M	0.63%
5.	Curve Finance	Ethereum	DEXes	$332.9M	9.98%
6.	Balancer	Ethereum	DEXes	$281.4M	8.42%
7.	WBTC	Ethereum	Assets	$131.8M	15.82%
8.	InstaDApp	Ethereum	Lending	$120.7M	4.77%
9.	Uniswap	Ethereum	DEXes	$72.0M	1.21%
10.	Flexa	Ethereum	Payments	$57.1M	-2.62%
11.	dYdX	Ethereum	Lending	$34.4M	5.79%
12.	RenVM	Ethereum	Assets	$26.2M	0.78%
13.	mStable	Ethereum	Assets	$25.1M	9.58%
14.	Bancor	Ethereum	DEXes	$21.6M	1.09%
15.	Set Protocol	Ethereum	Assets	$15.7M	7.63%

Of the top 15 market cap projects in DeFi, every single one is built on Ethereum. Even if half of these fail, some will survive, jump on market share and still generate significant value for Ethereum. When in doubt, buy the ETF right?

4. Lending / Credit markets
We've touched base on superior yields through DeFi platforms, and the associated volume and demand through the Ethereum protocol. Further to this, these platforms and markets will see increasing interoperability further growing the ecosystem. For example, various DeFi lending platforms are already seeing integration that allows frictionless use between them.

5. Trade flows, speculative flows and stablecoin use
The majority of stablecoins are built on Ethereum. We've been interested in the rise in stablecoin use - which are essentially tokenised versions of fiat or an asset. USD backed stablecoins are backed by a true USD. They have advantages over the average USD - in terms of yield generation (outlined previously) and transaction speed.

Dollar Tether's (USDT) market cap has just hit $10b - making it the 3rd largest crypto by market cap.

We are pretty dialled into the crypto OTC markets, and often gain 'insightful' off the cuff knowledge. Where is this stablecoin demand coming from?

"China" as Trumpy puts it.

China's demand for Tether has been growing exponentially - used for trade flows, and recently, capital flight out of Hong Kong. One of our Asian-based liquidity providers told us that over 75% of their business is executing USDT for on behalf of Chinese customers, from offshore Renminbi and Hong Kong dollars.

We also see a marked increase in stablecoin use when we get volatility and contango in the derivatives markets. Stablecoins are a great way to margin positions and shift positioning. Given the rise in the Bitcoin derivatives markets, we see this continuing.

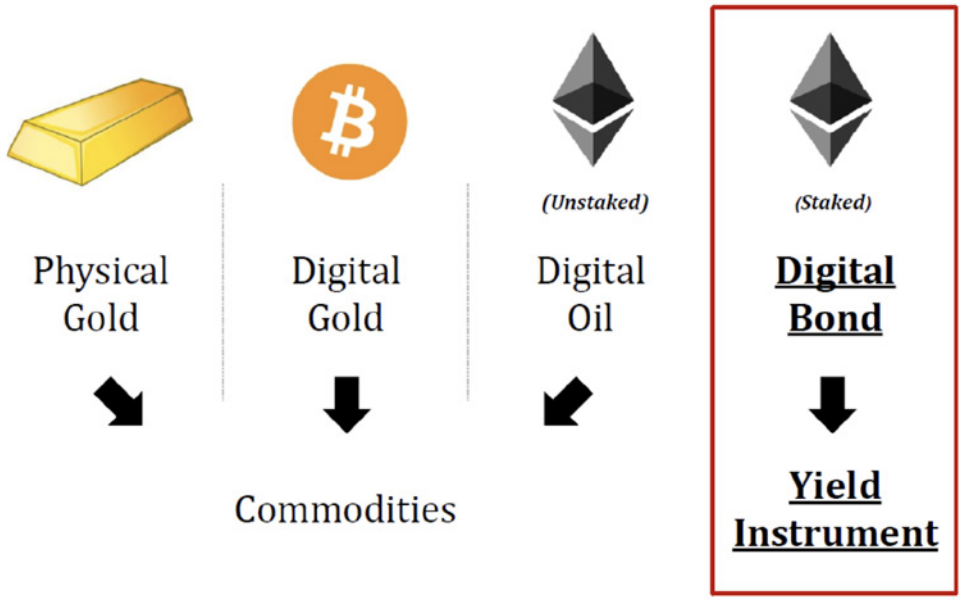
6. Staking - ETH as the digital bond

Stefan Coolican from Ether Capital does a great job of getting to the crux of this argument. Ethereum currently runs on a proof-of-work model. Ethereum miners around the world are incentivised to solve mathematical problems, and are rewarded with Ethereum for doing so. The mechanism's purpose to secure the network, and validate transactions on the blockchain. It's virtually unhackable, however very power intensive. For this reason, amongst others, Ethereum is moving to a proof-of-stake model.

Proof-of-work computing power at one miner.

Proof-of-stake allows Ethereum holders to 'stake' their Ethereum. It essentially involves locking your Ethereum up in a liquidity pool, and earning rewards for doing so. The staked assets within this pool act as a disincentive to incorrectly validate falsify transactions or harm the network. Such activities risk losing the staked collateral.

With the credit markets we've referenced previously, you are ultimately relying on counterparties to act responsibly. In the staking environment, you are pooling capital in a node and essentially adding value to the network itself. Staked ETH has no counterparty risk, only protocol risk. This turns it into an intrinsic yield instrument. This is kind of a big deal, and will likely encourage inflows and limit outflows.



We are pretty excited about where this is all going. It is the foundation of a new form of finance, one that is poised to do great things in the coming years. As I'm writing this conclusion, ETHUSD is flying through $300.

Keep a measured head, and zoom out a little. Still a long way to go.

Further to this point, there are some big cyclical intermarket shifts occurring right now. I'd urge everyone to play it cool, position size accordingly and be prepared for some scary moments along the way. It's never a straight line up, and we all need to approach nail-biting moments with poise. Because it's all part of the plan! Best of luck with the journey, we are only just getting started.

Jon is the Cofounder of Zerocap, a digital asset execution firm utilised by high net worth and institutional clients, and founder of Vesper Capital, a multi-strategy prop firm specialising in FX.

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As always, thanks for reading and being part of Insider.

Sincerely,

Chris MacIntosh

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