Too Big to Ignore — What's Driving Crypto's Recent Volatility

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IN THIS ISSUE, WE DISCUSS:

>> The crypto market has been rocked by a series of difficult headlines recently, including bans on mining activity in China and increased regulatory pressure in the U.S.

>> These developments appear challenging on the surface but are actually good news in disguise. They are paving the way for the next phase of the crypto bull market.

>> Expect more headlines, particularly around regulatory activity. As long as regulators keep crypto on an even footing with traditional finance, however, crypto will continue to grow.

It's been a bumpy few weeks in crypto.

The Bitwise 10 Large Cap Crypto Index is down 48% from its all-time high, achieved on May 8, 2021. Although it's still up 286% over the past year — making crypto the best-performing asset class in the world over that period — the pullback has been real, and painful.

Unlike past market pullbacks, this one hasn't been driven by flagging "animal spirits" or technical factors. Rather, it's been catalyzed by fundamental developments with real implications for the future.

In the past two months we've seen:

- **A Chinese crypto mining ban:** As part of a broader anti-crypto push, China enacted ***severe restrictions on crypto mining***, effectively banning it throughout the country;
- **A Chinese crypto trading crackdown:** China also ***tightened restrictions on crypto trading***, particularly on platforms that offer retail investors high degrees of leverage;
- **Rising environmental concerns:** A tweet from Elon Musk ***pushed concerns about bitcoin's environmental impact*** to the forefront, potentially delaying institutional adoption;
- **Crypto & ransomware:** A ***major crypto-paid ransomware attack*** shut down gas pipelines across the East Coast, raising regulatory risks.

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These are material topics, and, with more mainstream attention than ever, have become focal points for the media. But while the headlines make many skittish, for those of us who have been in the industry for a while, these are actually bullish developments and necessary parts of crypto's maturation.

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For example: mining concentration levels in China have long been an existential concern for bitcoin. China's mining ban, while destabilizing in the short term, is a welcome catalyst for a rapid migration of mining power out of China. Long-term, it will ***make the crypto market more resilient***.

Similarly, reducing leverage on overseas exchanges will lower future volatility and make crypto more acceptable to U.S. regulators. At the same time, the recent attention to bitcoin's environmental impact has already motivated the industry to invest in carbon offsets and renewables, and a full review by institutional investors will show that ***bitcoin is increasingly net-positive for the environment***. Finally, ***the bitcoin bounty paid in the Colonial Pipeline attack was quickly tracked and seized by law enforcement***, providing visceral evidence that bitcoin is actually bad for crime.

As Benjamin Graham once said: **In the short run the market is a voting machine, but in the long run it is a weighing machine**. For now, the short-run vote is moving against crypto, but the long-term weighing of these developments is strongly positive.

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THE GREAT U.S. REGULATORY AWAKENING:

The remarkable thing about the above headlines is that, while they are driving the short-term crypto news cycle, they aren't even the biggest development in crypto right now. That award goes to what I call "The Great U.S. Regulatory Awakening" — a deliberate and synchronous effort by every major regulatory agency in the U.S. to grapple with the question of how to regulate this disruptive space.

Over the past eight weeks, we've seen:

- **U.S. Treasury:** U.S. Treasury Secretary Janet Yellen said that ***a new framework is needed for crypto*** and that ***the current U.S. framework is not "up to the task."***
- **Securities and Exchange Commission:** SEC Chairman Gary Gensler declared that the U.S. is "***behind the curve on crypto regulation***" and that ***new regulations are needed around how crypto exchanges function***.
- **OCC:** The interim head of the Office of the Comptroller of the Currency (OCC) announced plans (at the ***urging of the American Bankers Association***!) to reconsider recently adopted pro-crypto regulations, including rules that allow federally chartered banks to custody cryptoassets.

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- **Federal Reserve:** Vice Chair Randal Quarles said that the Fed is creating an "***interagency sprint team***" with the OCC and the FDIC to put new crypto regulations in place.
- **CFTC:** A new commissioner of the CFTC argued that ***new rules are required to govern the decentralized finance space***, and railed against emerging risks.
- **FDIC:** The Federal Deposit Insurance Corporation announced a formal "***Request for Information and Comment on Digital Assets***," laying the groundwork for a new approach to supporting "responsible innovation" in crypto.
- **IRS:** The U.S. Treasury proposed new rules that would require all crypto transactions ***in excess of $10,000 be reported to the IRS***.
- **U.S. House of Representatives:** Maxine Waters (D-Calif.) ***organized a Democratic Congressional working group on cryptocurrencies*** to "do a deep dive on [the] poorly understood and minimally regulated industry."
- **U.S. Senate:** Elizabeth Warren (D-Mass.) called crypto "***a Wild West***," and argued that ***the U.S. needs to confront crypto threads "head-on."***

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One might ask: what's driving all this new regulatory activity?

The answer is: crypto has become too big to ignore.

Over the past year, crypto has moved from a conversation taking place on the edges of the retail investing landscape to something that is front and center for every major financial entity in America and the world.

We've seen: ***several macro hedge funds publicly invest in crypto***; the first ***publicly traded companies put crypto on their balance sheets***; conservative investors like ***insurance companies add crypto to their general accounts***; Wall Street giants like ***BlackRock*** and ***JPMorgan*** embrace crypto; ***PayPal roll out crypto-buying capability to 200+ million Americans***; ***Morgan Stanley***, ***Wells Fargo*** and other large brokerages greenlight crypto exposure; ***public pensions*** test the water; and most recently, ***a sovereign state (El Salvador) embrace crypto as legal tender***. Meanwhile, decentralized finance projects like ***Uniswap*** and ***Aave*** emerged to process billions of dollars in transactions a month; ***Coinbase went public*** with a $60 billion valuation; and firms like ***MSCI started developing crypto indexes*** driven by institutional client demand.

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Against this thrum of activity, regulators are being forced to act. Uncertainty is getting addressed. Crypto has a reflexive distrust of regulation, and so these actions have raised concerns. But as long-term investors betting on the future of crypto, this new regulatory activity is exactly what we need.

If crypto is going to move into the mainstream, we need ever-better AML/KYC. If institutions are going to own crypto en masse, we need ever-clearer tax reporting. And if large numbers of Americans are going to use decentralized finance apps some day, we require bright lines that projects can't cross.

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Adding regulatory clarity will bring more investors into the space and speed productive development activity, while helping the industry avoid pitfalls and dead ends.

Of course, there are risks that regulators will overreach. But historical precedent suggests that calmer heads will win out.

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In fact, over the past few years, we've seen U.S. regulators take a remarkably progressive and positive approach to the crypto market, which has helped drive the bull market. Steps like ***the SEC identifying ethereum as not being a security***, the ***IRS providing clear and positive guidance on crypto taxation***, and both ***states*** and ***the OCC*** clearing the way for regulated crypto custodians have been acts of regulatory courage that have helped this industry grow. Regulators recognize that crypto is a dynamic driver of economic growth — just look at ***the amount of VC raised by crypto firms in the past year***, or ***Andreessen Horowitz's new $2.2 billion crypto VC fund*** — and they do not want to damage the U.S.'s position in an important area of economic growth.

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It's an exciting moment. Crypto has grabbed people's attention. The big players are on the field. Now it's game on, and I'm very bullish on what's ahead.

ABOUT BITWISE:

Bitwise Asset Management is the world's largest crypto index fund manager, with over $1.2B AUM as of March 31, 2021. Founded in 2017, the firm is known for managing the world's largest crypto index fund, the first “DeFi” crypto index fund, and pioneering products spanning Bitcoin, Ethereum, crypto-focused equities, and other exposures. Bitwise focuses on serving investment professionals, financial advisors, institutional investors, and high net worth individuals, providing partnership, education and research. The team at Bitwise combines expertise in technology with decades of experience in traditional asset management and indexing — coming from firms including BlackRock, Blackstone, Facebook, and Google, as well as the US Attorney's office. Bitwise is backed by leading institutional investors and asset management executives and has been profiled in Institutional Investor, CNBC, Barron's, Bloomberg, and The Wall Street Journal. For more about Bitwise, visit ***www.bitwiseinvestments.com***.

ABOUT MATT HOUGAN:

Matt Hougan is one of the world's leading experts on crypto, ETFs, and financial technology. He is the Chief Investment Officer for Bitwise Asset Management, the world's largest provider of cryptocurrency index funds. He was previously CEO of ETF.com and Inside ETFs, where he helped build the world's first ETF data and analytics system, the leading ETF media site, and the world's largest ETF conference. Matt is co-author of two publications for the CFA Institute Research Foundation: “A Comprehensive Guide to Exchange-Traded Funds” and “Cryptoassets: The Guide to Bitcoin, Blockchain and Cryptocurrencies for Professional Investors.” He is a crypto columnist for Forbes, a three-time member of the Barron's ETF Roundtable, a member of ETFdb's ETF Hall of Fame, and the eighth person to receive a Lifetime Achievement Award from ***ETF.com*** for contributions to the ETF industry.