Genesis Q2 2023

# Q2 Market Observations

Genesis

# Introduction

Arriving at the mid-point of 2023, the digital asset space has taken on a decidedly transitional feel awaiting the next watershed moment. Q2 saw the arrival of new players set against the prior quarter's washouts of industry stalwarts, prospective new product filings in the wake of sweeping regulatory enforcement, and fresh rulings on the judicial front that have begun to assuage chronic concerns about the statutory status of certain digital assets.

With a robust rally in prices that once more pushed bitcoin above the $30,000 threshold, the April-June period also eclipsed the anniversaries of some of the prior year's mayhem, which have begun to feel increasingly distant as progress for the industry on multiple fronts swamps legacy challenges.

Q2 was at once a valediction and a validation, bidding farewell to long-lingering gadflies and welcoming the top tier of TradFi mainstays to the fold in a pivotal shift for the asset class.


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# 1 Q2 2023 Trading Insights

## Bruhaha

Trading rhythms alone typically do not set the tone on a three-month horizon or longer. In much the same way that Q2's market activity saw an extension of established practices, a renewed focus on managing counterparty risk continued to drive client engagement as market participants evaluated firms with which to continue working after the succession of collapses that now spans crypto trading venues, banking providers and custodians.

In that vein, tri-party arrangements with various custodians and execution venues partnering for off-exchange settlement has lodged itself into the broader ecosystem as a requisite due to last year's trauma and this year's more recent disruptions. It's plausible that the tri-party arrangements will become part of the standard operating framework for many firms who wish to intermediate bilateral exposure while still accessing robust liquidity from OTC dealers and exchanges.

The preeminence of counterparty consideration foreshadows the next wave of institutional crypto adoption, which may include more advanced iterations of prime services offerings and execution and operational facilities, both on- and off-chain. In anticipation of those, the buy-side continues to trade opportunistically in the spot and derivatives market, specifically with a tilt toward exchange-cleared venues and a selective approach to OTC activity with reliable and trusted partners

Q2 saw a far more significant amount of activity than might have been expected with such range-bound markets, as BTC traded listlessly between ~27,000 and ~30,000. Global banking destabilization, exchange solvency concerns, and the resolution of regulatory battles dominated the landscape as constructive sentiment returned with the Fed's prospective pause on interest rate hikes and BlackRock's application for its institutional Bitcoin product. With the latter milestones coming to the foreground, the desk observed an increase in client activity across segments bolstered by promising developments such as the favorable Ripple ruling, the launch of offshore futures by Coinbase, and the emergence of EDX, the trading platform backed by Citadel, Fidelity and Schwab and partnered with crypto EMS Talos.

In such sideways markets, the search for winning idiosyncratic trades returned, emphasizing client dialogue. A true value-add OTC desk is generally known to provide clients with commentary, analysis, and market color; this quarter's conversations included all of that and then some, with a heavy tilt toward trade edge capture from assessing market structure, flow decomposition and thought leadership throughout the vicissitudes of the mini cycles observed during the ~90-day window.

Following the rally in March, there was a notable increase in BTC overwriting amongst longer-term HODLers, while directionally oriented asset managers purchased longer-dated lower-delta BTC wing calls to capture both the upside convexity and relatively low volatility as well as depressed basis exhibited in the market. On the back of BlackRock's ETF application, we saw a surge in bullish plays from crypto native clients who legged into shorter-dated wingier call spreads while ATM-25 delta skews were still cheap.

Alongside a clear premium being placed on execution and stability, operational capabilities became top of mind following the wind-down of certain banks. Since then, we've seen market participants clamoring to onboard with replacement banking partners as a prerequisite for stability in settlements and uninterrupted transactions worldwide. Stablecoin settlements surged, as did in-kind collateralization, and it is expected that market participants will rely on these alternative forms of financial transmission to the extent that fiat rails remain compromised in the future. The banking bruhaha also cemented a nascent predilection of many shops moving operations offshore. While a select handful of "crypto-friendly" banks in the US captured the runoff market share from legacy digital asset-oriented firms, it is becoming increasingly clear that as long as there is regulatory scrutiny without clear guidance on rules and regulations, financial services firms will continue expanding their operations abroad.

# Trend Following

At this juncture, the once-heterogenous ecosystem of cryptocurrency venues has begun to converge into two definitive focal points: OTC and listed trading. Within these two domains, each now entails its own taxonomical hierarchy for trading spot, linear derivatives, and, most critically for our desk, options. In that context, there were comparatively few new trends in Q2 2023, but rather a solidification and acceleration of those persistent phenomena, of which many have been flagged in Genesis' prior quarterly retrospectives.

1. **Derivitization**
   With spot market liquidity suffering[1] and spot order book depth chronically flagging[2], it has become increasingly apparent that a significant portion[3] of the future growth of crypto volumes will be in derivatives[4]. Deribit, the apex crypto options exchange, set a fresh YTD high for the number of option contracts traded in a 24-hour window as bitcoin reclaimed the $30,000 mark[5]. The second quarter also witnessed the launch of onshore institutional-sized fixed date and offshore perpetual futures by Coinbase[6]. At the time of the writing of this report, CME crypto options volumes have seen a material pickup in volume by nearly 25% to ~$1bn, even as futures trading volumes fell, boding well for a continuation of the trend that options are increasingly seen as the go-to instrument for institutional players[7].

1 **Bitcoin Liquidity Dries Up With 'Tourists' Recoiling From Chaos**, Bloomberg

2 **Trade Volume Surging to Start 2023**, Conor Ryder, CFA, Kaiko

3 CCDATA: 10 May 2023: "Derivatives trading volume on centralised exchanges fell 23.3% to $2.15tn in April. However, the market share of derivatives reached a new all-time high for the second consecutive month, with a market share of 77.6%"

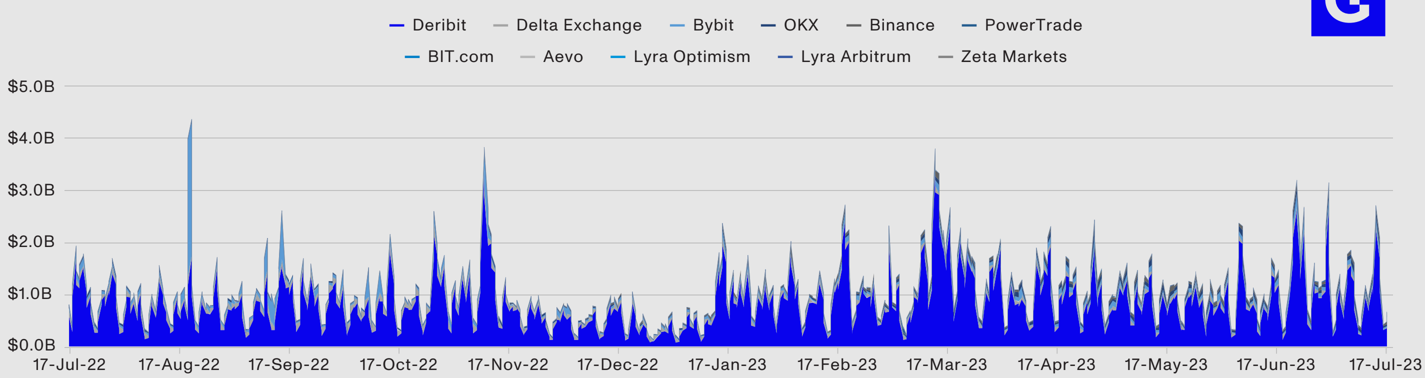
4 **Surging Demand for Derivatives Is Fueling Bitcoin's Resurgence,** Bloomberg

5 **Bitcoin Options Volume Soars Above $3.3 Billion In 24 Hours As BTC Price Sniffs $31,000**, ZyCrypto

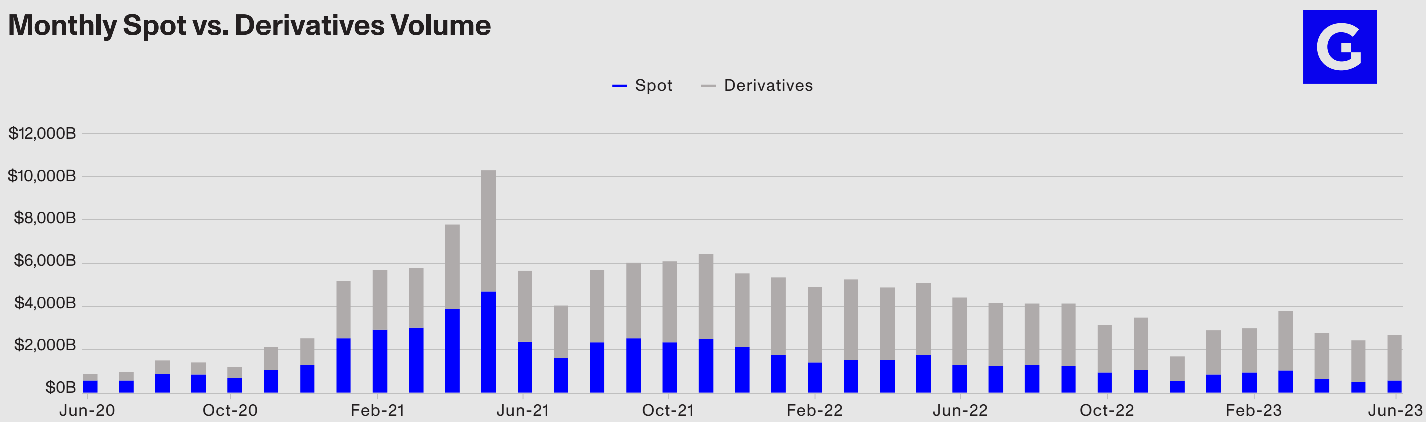
6 **Institutional-sized Bitcoin and Ether futures contracts launching on Coinbase Derivatives Exchange**, Coinbase

7 **CME Bitcoin (BTC) and Ether (ETH) Options Volume Rose to $940M in July: CCData**, Coindesk

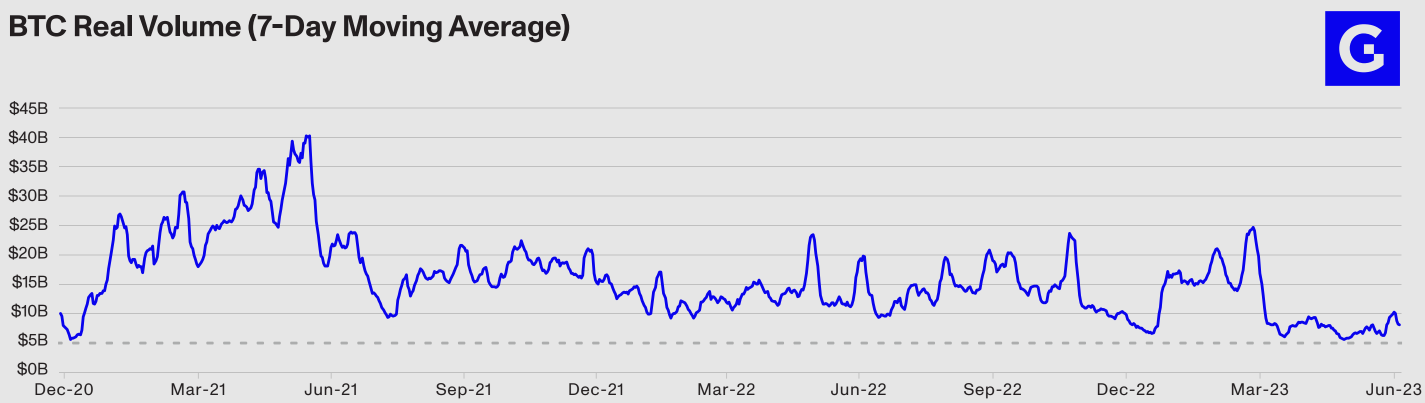
**Global Crypto Options Volumes**




**Source:** Laevitas




**Source:** CCData




**Source:** Messari, Kaiko

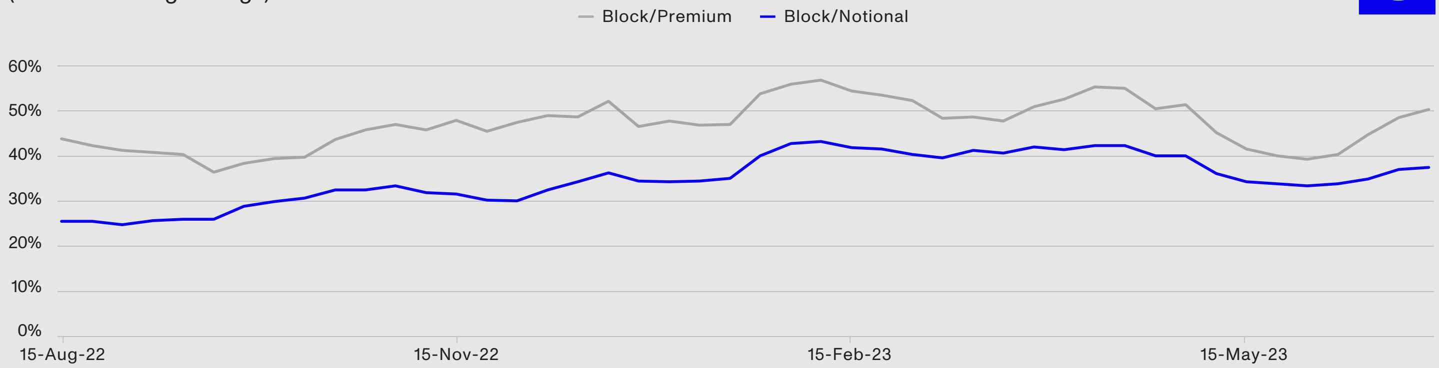
2. **Institutionalization**
   Just as crypto mainstays like Coinbase rolled out new offerings, Q2 also heralded the arrival of an establishment armada which appears now to be docked on the shores of this asset class. We view this development as the omen of a bright future that foreshadows a restoration of access, a proliferation of fresh products/services, and an unblocking of legal logjams. All of which will contribute meaningfully to the texture of a marketplace that, by the numbers, has been sizing up as a secular consideration. Block trade volumes, a proxy for institutional grade activity, have been rising relatively unabated for some time. The prospective ability to express views on crypto majors through one or more spot-based ETFs managed by household TradFi names like BlackRock and Fidelity alongside a spot-trading venue (EDX) supported by them (and their peers) is likely

to contribute to burgeoning volumes and broadening participation amongst larger-sized allocators. Between US Pension funds, 401ks, and Hedge funds alone, sits roughly $50T in capital that can hopefully soon gain exposure to Bitcoin via a spot based BTC ETF. The introduction of ETFs has in the past proven a meaningful catalyst for further price appreciation in the underlying asset. Such was the case for assets previously considered 'fringe,' from junk bonds to emerging market debt and precious metals, which now form a core part of most macro portfolios, for which index and ETF access product is now rife and which experienced a material appreciation post-ETF launch. If those patterns hold for bitcoin, a modest allocation by such institutions could fuel a return toward all-time highs, or beyond. Market participants appear to agree; with sizable purchases of medium-term call options on bitcoin throughout the last weeks of Q2 and, as of the time of writing, the first month of Q3. There's also been no shortage of sellers of bitcoin downside, who seem undaunted by the prospect of delays in ETF approvals or lags in adoption rates thereafter. It's also worth noting that, similar to those aforementioned asset classes, a secular decline in volatility across both bitcoin and ether, for which the relative price of optionality neatly converged in Q2, has certainly boosted the affordability of options as a tool for directional leverage.

Additional considerations, such as the surveillance sharing arrangements ("SSA") underlying those ETFs' applications reflect material progress in the peace process amongst regulatory contenders. Therefore, it's hoped that the arguments over legal jurisdiction and classification may, to some extent, be finally settled. Clarity on landmark cases such as the Ripple ruling will further add to confidence to the view that: this is an asset class with permanence and not a fly-by-night proposition without roots.

## BTC Option Blocks as % of Total Deribit Volume

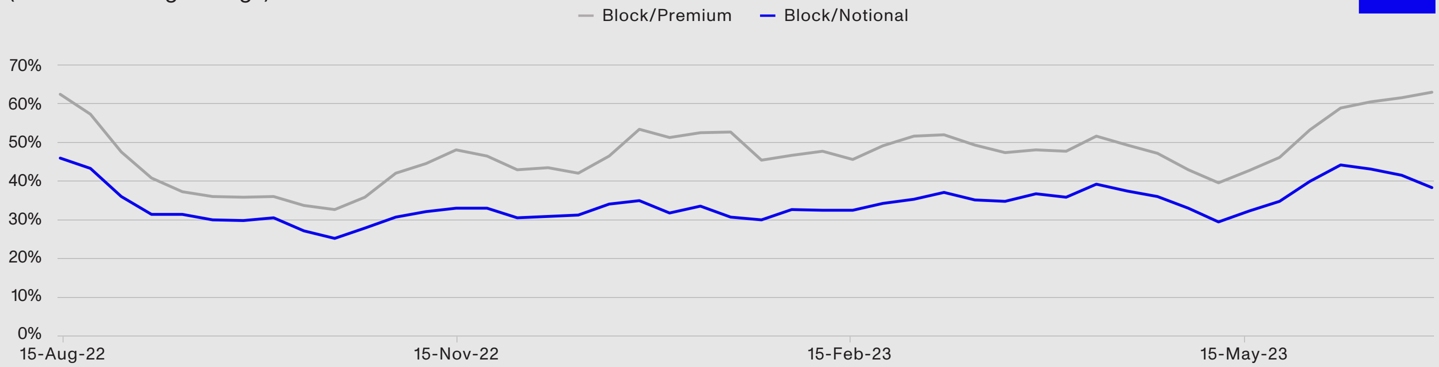
(1-month moving average)




**Source:** Amberdata

## ETH Option Blocks as % of Total Deribit Volume

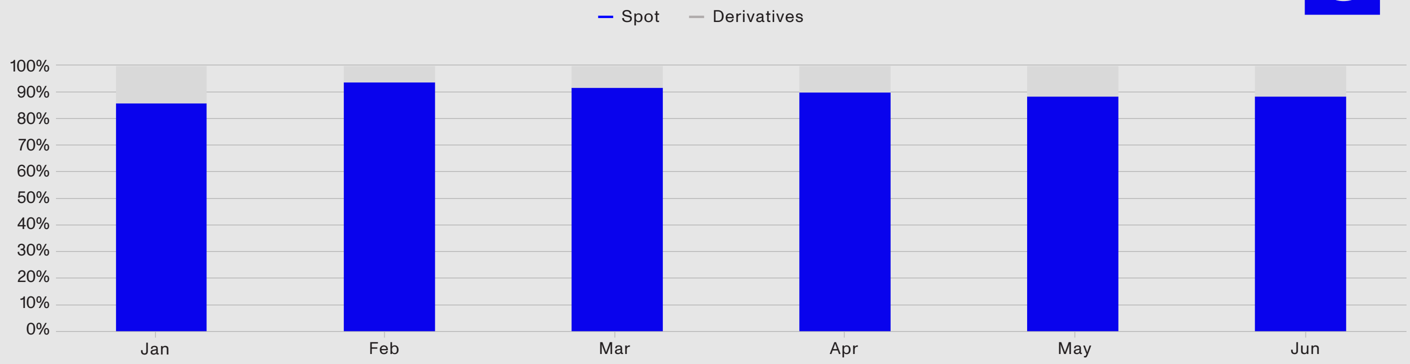
(1-month moving average)




**Source:** Amberdata

As we have mentioned in past reports, a robust crypto derivatives market can usher in institutional adoption on a global scale. The crypto options market volume for the first half of 2023, while growing feverishly, was still only ~10% of underlying spot volume. As a corollary, the notional volume of equity options in the US exceeded the notional traded value of the underlying equities in 2021 for the first time. If following this TradFi trend, the crypto options market has room to grow 10-fold from current levels.

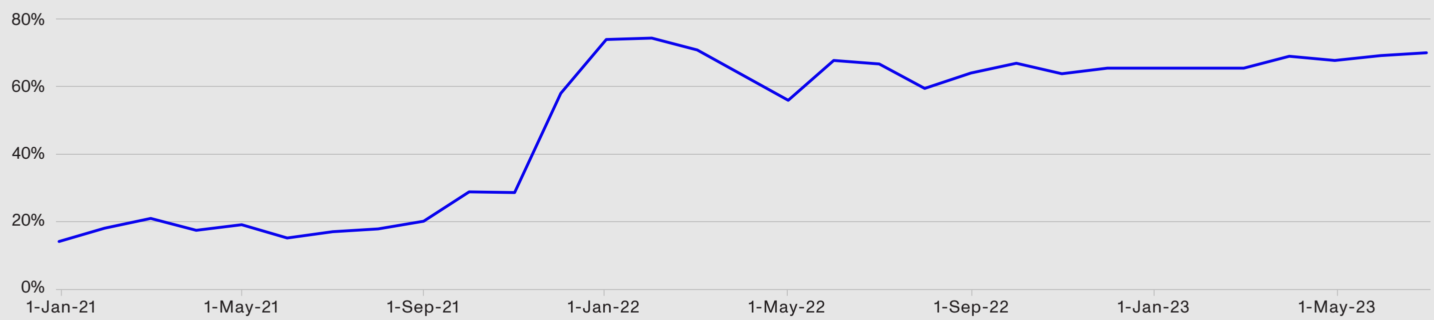
## 2023 Crypto Spot and Options Notional Volumes




**Source:** Laevitas

3. **Commoditization vs. Specialization**
   The market has become increasingly bifurcated between low edge, smaller vanilla flow and transactions at an institutional scale, often occurring under the auspices of a high-touch framework. Genesis has been trading an ever-greater percentage of our volumes via deliberately structured, sizable trades with some of the industry's largest participants, both crypto native and TradFi alike.

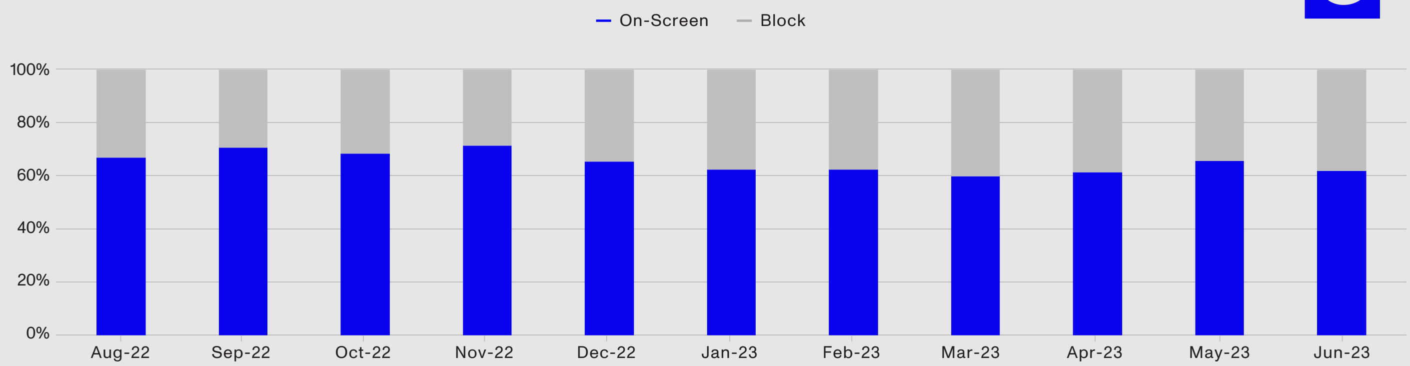
## BTC Multileg Option Blocks as % of Total Notional Traded




**Source:** Paradigm

That is reflected in the overall proportion of our volumes that are bilaterally negotiated prior to execution, often with a highly bespoke degree of dialogue and analysis. This allows clients to customize the expressions of their views in a way specifically tailored to their mandates and needs. It's also evident in overall market evolution, such as the growing share of option blocks that now trade as multileg packages, which provide payoff profiles that reflect the distinctive demands of various pools of capital being put to work in crypto.

**Screen Trading vs Block Trading (ETH + BTC Notional)**




**Source:** Amberdata

This has placed an added burden on market makers, who must handle outsized, concentrated flows from such corners, whereby the risks of zero-sum interactions may increase. According to an exhaustive analysis conducted by industry peers, there may be negative expected value for blindly providing liquidity absent requisite conditionality on knowing the absolute magnitude of flows in advance and intimately understanding multi-player game theoretic dynamics, including pre-existing strike risk in the market and simultaneous taker activity.

4. **Macrofication**

More so than at any time in crypto's brief history, clients now rely on digital asset trading instruments to express non-idiosyncratic views on various outcomes. These range from macroeconomic vectors like inflation and growth to policy-driven considerations like interest rates and debt limits, including cross-asset plays on crypto vs. equity or commodities and digital asset volatility vs. traditional asset vol. Moreover, there is a growing awareness that crypto now constitutes a measurable share of worldwide economic activity, even if only by proxy.

For instance, Russia has ascended to the #2 rank[8] in global hash rate[9]– effectively monetizing otherwise unsaleable natural gas via proof of work mining. Similarly, the recently announced joint venture between Abu Dhabi's Zero Two and Marathon Digital[10] has formally cemented the presence of a premier Sovereign Wealth Fund within the

8 **Russia has risen to second place in the world in cryptocurrency mining**, Kommersant

9 **Russia Becomes World's Second-Largest Crypto Miner**, The Moscow Times

10 **Marathon Teams Up With Abu Dhabi's Zero Two for Middle East's First Large-Scale Immersion-Cooled Bitcoin Mining**, CoinDesk

digital asset ecosystem. With the supposition that such mining could eventually lead to the holding of crypto on the balance sheet of one of the world's wealthiest monarchies, Bitcoin has lobbed a counterpoint to the prevailing invective surrounding digital asset use in developing economies which often rely on crypto in some measure to keep the wheels of commerce greased (such as West Africa, Latin America, MENA, and North Asia).

# Conclusion

The second quarter of 2023 may be remembered as the moment the establishment commenced its veritable land grab for crypto. Yet strangely, it has also been characterized by a material degree of apathy from a wide swath of industry participants. With the landmark announcements of fresh spot-based ETF applications by some of the world's largest asset managers, a watershed judicial victory, and the drumbeat of new trading venues and products offered by marquee TradFi and crypto-native shops, there were plenty of catalysts for fresh cyclical highs. Instead, we saw a tendency toward skeptical reception from several respected crypto pundits, which jived with a market that appeared eager to fade a breakout higher.

The digital asset space has long defied conventional expectations about how and when mass adoption may hit, and so too has it hampered projections as to when bull (or bear) markets begin and end. With major's prices ostensibly well supported just below the key psychological thresholds of 30,000 and 2,000, these figures have been ascribed a degree of importance akin to lines of demarcation to a certain extent.

But the reality is that they are numbers, perhaps take profit targets for tactical players, buy-in limits for momentum-driven investors, or merely technical heuristics for those who find the occasion to draw the lines higher or lower on any given chart. The truth is in the statistics about volumes, volatility, margins, price trends, and the breadth of participation. When viewed with an elongated perspective, Q2 2023 appears, therefore, to be affirmative in most respects.

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The firm offers sophisticated market participants an integrated platform to trade digital assets, creating pathways to benefit from market opportunities while increasing capital efficiency for counterparties.

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