Three Questions to Manage the "Micro-Macro Mess" That Hit Cryptoland This Week

Bitcoin Suisse Research

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Micro Question: “What is the deal with this UST/LUNA crash on the Terra blockchain?”

- UST is an algorithmic stablecoin. It maintains its peg to the USD by burning or minting a second token, called LUNA. 1 UST can always be burned for 1 USD worth of newly minted LUNA. Under normal circumstance, the mechanism creates arbitrage incentives in both directions to keep the price of 1 UST close to 1 USD.
- However, extreme valuations reveal a design flaw: very low prices of LUNA close to and below $1 lead to ever more LUNA being created, and thus to inflation. Under normal circumstances, LUNA inflates and deflates its value to constantly repeg UST. But if LUNA approaches the $1 range, the design flaw kicks in. In other words, investors witnessed hyperinflation that lasted only 24h and brought LUNA from $60 down to under $1.
- While the design can explain how it happened, it is unclear what or who triggered the process (e.g., Anchor saw outflows of 4.6B UST over 7 days). It is possible that the UST stablecoin got attacked in a way similar to how fiat currencies can be attacked (famous example: George Soros, the GBP, and Black Wednesday).
- Not all stablecoins are created equal. At the moment, it looks that UST/LUNA could be an isolated incident of a flawed algorithmic stablecoin with little contagion effect onto non-algorithmic stablecoins with asset-backed designs like USDC, DAI, etc.
- The “Luna Foundation Guard” used large amounts of BTC to protect the UST from falling further. While that ultimately failed, the large-scale selling put pressure on the Bitcoin price, too.

Read more:

- Today’s Weekly Wrap of 13.05.22 (forthcoming)
- Decrypt “Algorithmic Stablecoins” (April 2021)
- Decrypt “Stablecoins – Navigating Crypto Volatility” (September 2019)
- Our next Decrypt will cover stablecoins, different types, and what to consider when using them, including a more detailed analysis of the UST/Luna incident.

Macro Question: "Crypto was supposed to be an uncorrelated space – and now, all crypto is deep in red, too.

Why is that? And why should I not panic?"

- We are currently experiencing extraordinary times: record-high US inflation caused by a tremendous increase in US money supply M2, US interest rates on the rise, an ongoing war in Ukraine aggravating supply shortages and price increases, and all that amidst a legacy of unresolved supply chain issues from COVID. These macro trends create a risk-off environment, in which investors tend to reduce their risk exposure across markets, not just crypto.
- Continued high inflation is leading to increased prices of many assets from food, and energy, to stocks and crypto assets. The US FED (as the globally dominant currency player) is keen to curb high inflation by hiking interest rates (by 50bp on 4 May). These hikes make "safer", fixed-interest investments like bonds become more attractive, and investors move out of assets perceived as risky, like stocks or crypto. This has been leading to red numbers in many risk assets, not only crypto, during this week (9-13 May).
- In such an environment even investors who planned to hold may feel significant pressure when prices are falling beyond a certain pain point (e.g., margin calls). Such sells plus automated stop-loss sell orders may cause cascading price declines.

So, the question is: What is **your time horizon** when investing?

Short-term view: short-term all kinds of things can happen, and it is impossible to predict the market short term. Trading for short-term gain always faces this challenge and even crypto does not rise all the time.

While the DeFi space offers great short-term opportunities through new products and narrow markets, these very aspects represent risks on the technology and/or market side.

Long-term view: While it is impossible for Bitcoin or Ethereum to escape such strong market sentiments in the short-term, fundamentals prevail in markets long-term.

In the case of Bitcoin, none of its fundamental properties has changed: no inflation (max. supply of 21M of which 90% are mined), resilient network (survived China ban), conservative technical development (low-risk approach to new features), and growing adoption by governments, institutions, and individuals. Similarly, Ethereum, although they postponed the "Merger" once more, does not give any indications that there are major issues, neither on the technology nor ecosystem side. Development and innovation continue.

In fact, if the investment horizon is long enough, the current market situation can offer the opportunity to grow positions with a reduced average price paid ("dollar-cost averaging"). However, it is important to do your own research when selecting coins/tokens for investment because, as we are currently witnessing with LUNA/UST, there are circumstances that result in a total loss of your investment.

Question: When bottom?

Impossible to predict. While on a micro level, the LUNA/UST sell-off may cause a cleansing in parts of the DeFi space (which is positive in the long-term), the macro trends mentioned above will not disappear anytime soon and influence all markets.

While past performance is no guarantee for future performance, Bitcoin’s properties that made it the best performing asset of the last decade, are still in place and there is little reason to believe it will not rebound. The drawdown in May 2021 was larger than this week (c.f. Monthly Returns) and falling to USD 20’000 would require to touch Bitcoin’s 4-year moving average, something that only happens rarely, last time in April 2020 when COVID-19 hit.

Finally, if you hold ETH, staking for the Ethereum 2.0 migration offers an opportunity to generate regular income instead of selling.

Recommended further reading:

Paradigm – Surviving crypto cycles
Coinbase - How-to-minimize-your-losses-during-a-falling-market