



Q1 Crypto Market Framework

Outlook for the
coming quarter

January 18, 2022

Introduction

2021 was the year bitcoin and crypto truly went mainstream.

But the story of crypto adoption is no longer just about bitcoin as digital gold and decentralized finance (DeFi).

Crypto now encompasses a broad range of technologies and infrastructure through NFTs in areas including art, culture and virtual gaming, new payment rails and mediums (stablecoins), and the future of work and organizations (DAOs). While Bitcoin and Ethereum were both up an impressive 60% and 397%, respectively, several cryptoassets were up +1,000% (eg Dogecoin) and a staggering +10,000% on the year (eg Polygon, Solana, Avalanche).

While 2021 left few still arguing that crypto will “go away”, the December sell-off that continued into the new year raised questions over the sector’s near-term prospects.

In this updated Q1 Crypto Market Framework we discuss our view of current market conditions and the forces that may shape crypto markets in the coming months. We also highlight the role social media played in driving some of the dizzying crypto price action, as well as provide an overview of the key regulatory topics and calendar for the coming months.

Our Q1 Market Framework

Looking ahead to 2022, here on the desk at Blockchain.com, we have our eyes on a number of different indicators and themes. While there are many outlooks available, the below is a summary of our market view for the coming quarter.

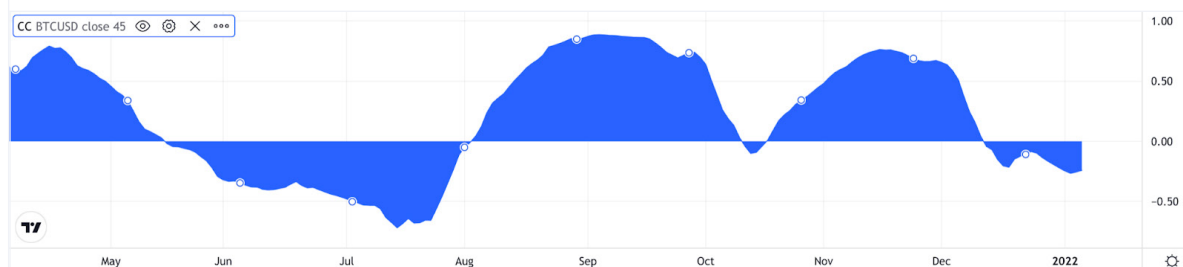
Theme 1: Bitcoin (BTC) still matters

Perhaps the most under-appreciated and under-reported story in crypto has been BTC taking market share from gold. In our view, BTC's viability as a credible alternative to gold has gone from a fringe idea to common knowledge amongst market professionals over the course of 2021.

Unlike the many other interesting narratives driving crypto, which are forward looking and speculative around future use cases and adoption, BTC as "digital gold" and a core reserve asset now looks to be a settled point.

We believe that an increase in BTC's correlation to gold—and a decrease (or even change of sign!) in BTC's correlation with equities—is now quite possible (Figure 1). We look for this especially in the case of a further re-rating of equities lower - as we see a strong likelihood that allocators will continue flows to BTC irrespective of the level of equities. We see such allocation flows as likely to persist as long as macro uncertainty favors hard asset allocation.

Fig 1. BTC/SPX rolling 45 day correlation, watching for further downtrend, especially if equities sell off more



Source: [TradingView.com](https://tradingview.com)

Given uncertainty in the path of future economic conditions and Fed actions, a new policy mistake in either the deflationary or inflationary direction is possible. While the market lately assumes BTC is largely a risk-on asset, we see BTC—a liquid, non-counterparty dependent asset—as ultimately representing a hedge against both runaway inflation AND a deflationary risk-off environment, just as gold does. We see the market as likely to focus more on this idea over the quarter.

With "Bitcoin dominance" (an imperfect but rough approximation of BTC market cap as a % of total crypto market cap) at the lows (Figure 2), we are keenly looking for a turn there. We are also highly intrigued by the relationship between BTC pricing and

measures of macro volatility, in particular the MOVE index (fixed income volatility), where the recent divergence seems unlikely to persist (Figure 3).

Fig 2. BTC Dominance, last 5 years - at the lows, watching for a bottom



Source: [TradingView.com](https://tradingview.com)

Fig 3. BTC price (green) vs BofA MOVE index, last 15 months. If BTC is a hedge against macro volatility, the recent price divergence may not persist



Source: [Bloomberg Finance](https://www.bloomberg.com)

On the supply side, we note the ongoing reduction of exchange balances in BTC and ETH, and the increase in stablecoin balances. Load outs have persisted throughout 2H21 despite the bearish price action. If allocation inflows do continue we see a residual risk of a supply crunch driving price action materially higher in both BTC and ETH (Figure 4). Finally, the persistence of large stablecoin balances on exchange suggests ample liquidity to us, and in our view reduces the risk of Fed tightening

driving a liquidity drain sufficient to create disorderly downside price action, at least for the next few months.

Fig 4. Aggregate exchange balances of BTC and ETH, last 1 year - strong load-outs in Q421 despite bearish price action may indicate ongoing allocator inflows and setting up a possible supply crunch?



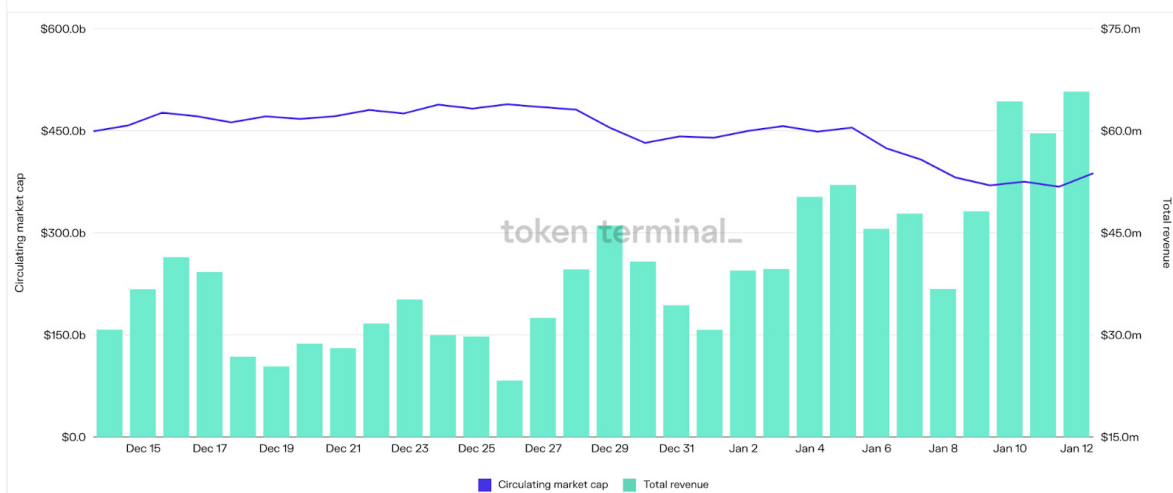
Source: [CryptoQuant](#)

To summarize:

- BTC is *unique* in the crypto ecosystem as a proven reserve asset and definite winner of its particular use case
- Looking for sign of increased macro hedge narratives around BTC driving flows given risk of policy mistakes
- Watching for correlation breaks – namely declining correlation to equities and increasing correlation to gold
- Tightening supply dynamics could matter at some point if inflows persist
- Risk of downward gap seems reduced given large undeployed stablecoin balances - should keep volatility low

Theme 2: Ethereum - scaling on Layer 2 and the path to proof-of stake, enough to surmount macro pressures?

Incredibly, ETH network fees are now \$35-\$65m daily. Of course, with Layer 2 (L2s) (eg Polygon, Arbitrum, etc.) now paying ETH for security, this cost of using ETH is likely going in one direction.



Source: [token terminal](#)

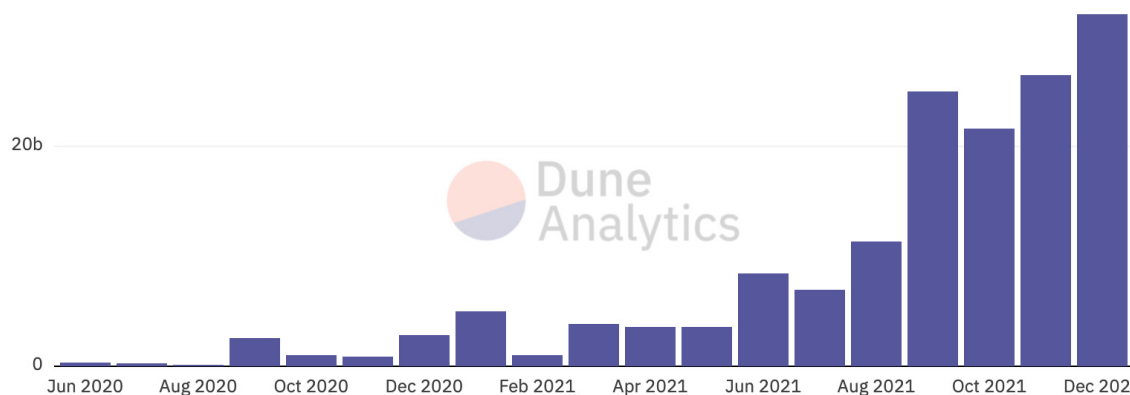
Of course it can be argued that this is a function of ETH's success, but it also cracks the door wide open to competitors, as we have seen over the last year especially. It is absolutely crucial for the ETH ecosystem to make L1-L2 switching completely seamless, in order for ETH to perpetually dominate the smart contract wars.

We are keeping close tabs on the competition amongst smart contracting platforms for market share. At a high level we still think the core tension is between ETH scaling solutions on Layer 2, versus alternative Layer 1s. In order to track the success of Layer 2 scaling, one metric the desk is observing closely is the total percentage of ETH gas fees paid attributable to Layer 2.

MONTHLY Ethereum gas spent to settle/proof L2 activity on ethereum

(Arbitrum+Aztec+DeversiFi+BobaNetwork+DyDx+ImmutableX+Loopring+Optimism+Metis

A.+PolygonHermez+Sorare+ZkSwap+ZkSync)



Source: [Dune Analytics](#)

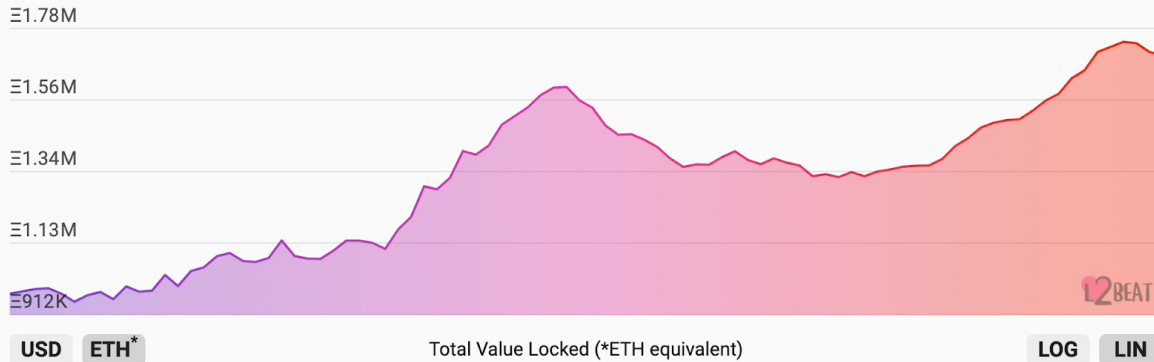
In addition, L2 total value locked (TVL) is of course a useful barometer, and is near its all-time high in ETH terms.

Overview

TVL: **\$5.74B**
-0.67% / 7 days

15 Oct 2021 – 12 Jan 2022

30D 90D 180D 1Y MAX



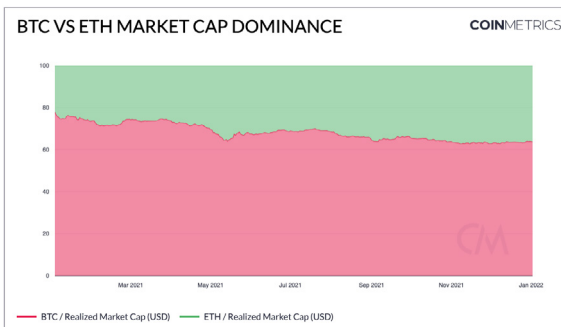
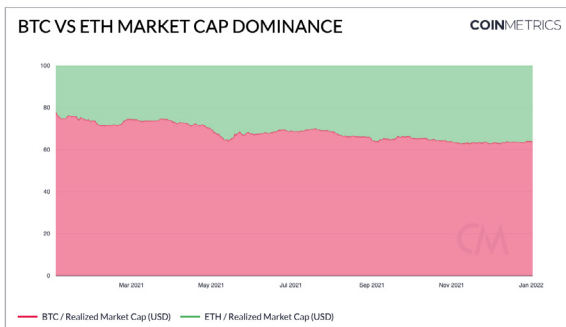
Source: [L2BEAT](#)

There are high expectations for ETH transitioning from the current energy intensive Proof of Work consensus algorithm to Proof of Stake by Summer of 2022. As we move closer to that date, price action is likely to be volatile, but a successful on-time transition could lead to a swift move higher, as the market looks to price in the additional deflationary nature of ETH 2.0.

This is likely to be a narrative which allows ETH price action to be determined somewhat independently of broader markets. A failure to deliver, however, could be very negative and cause significant instability relative to traditional assets / BTC.

Ultimately what the market overlooked last year in terms of focusing on 'ETH killers' is that all of the contenders will have to go through the same scaling pains as ETH eventually; which is why the L2 and 2.0 success/failure stories are absolutely critical milestones for crypto.

In addition, the much debated 'flippenings' (e.g., Ethereum's total market value surpassing Bitcoin's, Solana surpassing Ethereum, etc. etc.) becoming a reality will be significantly influenced by whether Ethereum can pull off its scaling challenges in 2022.



Source: [Coin Metrics](#)

Making Sense of Crypto Twitter

In its most fundamental role, social media is a cost-effective tool for communication. Platforms such as Telegram facilitate the day-to-day operations of most crypto institutional trades. Beyond transactional purposes, social media cultivates community in the space. Discord has formed the natural meeting point for many crypto and NFT projects, offering exposure and engagement not only with the project itself but to the developers behind it.

Generally, community engagement forms herding behavior, which in turn influences market prices. Perhaps the most instrumental channel in driving endorsement is Twitter.

As an epicenter for industry talking heads to incite the market, 'crypto Twitter' is considered a key resource amongst traders. Through the communities own native language and humor (ie memes), insight and price predictions can be deciphered.

To help navigate this space, NFT artist @punk6529 has shared [a helpful thread of crypto Twitter acronyms and abbreviations](#).

Q4 tweets that moved the market



Zhu Su ▲
@zhusu

...

Ethereum culture suffers massively from the Founders Dilemma. Everyone is already far too rich to remember what they originally set out to do. Perhaps a bear market is needed to remind them, or perhaps we must build elsewhere, but this is what it is--nothing new under the sun.

Fig 5: CEO and founder of Three Arrows Capital Zhu Su (@ZhuSu) shared his opinion on the Ethereum network in a tweet posted on November 21st, 2021.

The price of ETH dropped almost -8% (-7.9%) in the proceeding 48 hours, with November 21st's highest price of \$4,422.49 dropping to a low of \$4,069.77 on November 23rd.

Source: [Yahoo Finance](#)



Willy Woo
@woonomic

Contour map of every bitcoin at the price they last changed hands between investors. Huge price validation between \$50k-\$60k.

#Bitcoin 📈 as a \$1T asset class IMO is now cemented; hard to see it dropping below this zone.

This data is @glassnode's URPD visualised.

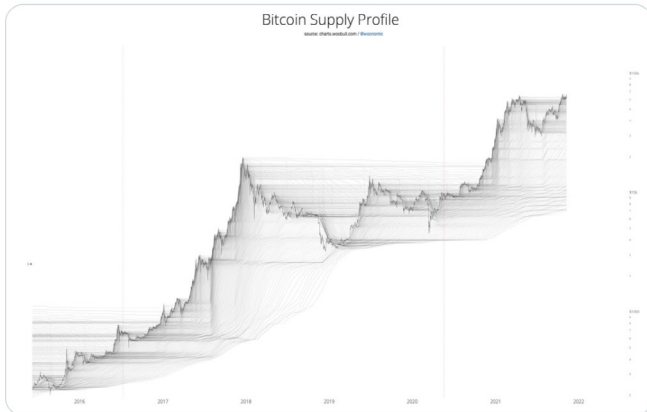


Fig 6: Trader Willy Woo (@willywoo) speculated on the 2022 Bitcoin market in a tweet posted on October 16th, 2021.

The price of BTC gained 4% over the course of the next 48 hours, with October 16th's lowest price of \$60,206.12 rising to a high of \$62,614.66 on October 18th.

Source: [Yahoo Finance](#)



Will Clemente
@WClementeIII

I'm always going to keep it real with you guys. We have spent almost a week now below STH cost basis.

Still not a bull until \$53K is reclaimed. I'm not a giga bear, just cautious until shown otherwise.

Bear confirmation would be a failed underside retest.



Fig 7: One of crypto's youngest analysts Will Clement (@WClementeIII) speculated on short-term holders vs long-term holders in a tweet posted on December 10th, 2021.

The price of BTC gained almost 8% (7.87%) in the proceeding 48 hours, with December 10th's lowest price of \$47,023.70 rising to a high of \$50,724.87 on December 12th.

Source: [Yahoo Finance](#)

Table 1: US Crypto Regulatory Calendar for January-April 2022

January	<ul style="list-style-type: none"> U.S. Treasury issues interim guidance for the controversial crypto “broker definition” as directed by the Infrastructure Investment and Jobs Act (IIJA). A formal notice and comment rulemaking process will follow later in the year. FinCEN is allegedly considering revisiting its controversial Requirements for Certain Transactions Involving Convertible Virtual Currency or Digital Assets rulemaking which addresses transactions involving non-custodial wallets. Timeline is currently unclear but they are rumored to be restarting the entire process from scratch. The Federal Reserve (Fed), Office of the Comptroller of the Currency (OCC), and Federal Deposit Insurance Corporation (FDIC) initiate their joint “crypto-asset roadmap” per their November 23 announcement. We do not know if these will take the form of notice and comment rulemakings like the Treasury instance above, they could simply be supervisory guidance statements with no chance for public comment. If they are rulemakings, it’s highly likely there will be separate rulemakings for each of the six subcategories delineated in the roadmap.
February	<ul style="list-style-type: none"> US Treasury begins formal rulemaking process on IIJA broker definition provisions, forty-five day timer to file comments begins. FinCEN non-custodial wallet comments due mid-month, forty-five day timer for reply comments begins (if rulemaking is issued in January). Fed/OCC/FDIC comments due if option to comment is given, forty-five day timer for reply comments begins. The Federal Reserve issues its Central Bank Digital Currency (CBDC) report. The Fed has said concretely that this report will invite public comment, forty-five day time to file comments begins.
March	<ul style="list-style-type: none"> The White House is allegedly considering revisiting its crypto-related Executive Order which slipped for about three months the first time around, so we may begin to see more heat and light around this in March. US Treasury IIJA broker definition comments due, forty-five day timer for reply comments begins. Federal Reserve CBDC report comments due, forty-five day timer for reply comments begins.

It's worth noting as part of the above that for all of the noise from and attention on the Securities and Exchange Commission, crypto is entirely absent from the agency's [current regulatory agenda](#). This can change but SEC Commissioners Hester Peirce and Elad Roisman recently [issued a statement](#) criticizing Chairman Gensler's lack of attention to the space, saying "...the Agenda—through its silence on crypto—signals that the market can expect continued questions around the application of our securities laws to this area of increasing investor interest. Such silence emboldens fraudsters and hinders conscientious participants who want to comply with the law."

Table 2. US Crypto Regulatory Topics in Focus

Stablecoins	<ul style="list-style-type: none"> US regulatory attention to stablecoins will continue and possibly intensify, with the Financial Stability Oversight Council (FSOC) saying in its annual report that it is prepared to move forward on regulating the space if Congress doesn't pass comprehensive legislation. The Federal Reserve's report on a U.S. central bank digital currency (CBDC) is "ready to go" and will be out "within the next few weeks" according to Chairman Jay Powell. The Fed moves slowly (this report was originally supposed to be released in September 2021) so there's a chance it slips into February or March.
DeFi	<ul style="list-style-type: none"> US regulators and lawmakers are just beginning to focus on DeFi, with SEC Commissioner Caroline Crenshaw recently saying DeFi presents both "a panoply of opportunities" and "risks and challenges" for regulators. Expect regulators to solicit public comment on the area to fact find and better inform their approach.
DAOs	<ul style="list-style-type: none"> Regulatory attention to decentralized autonomous organizations will likely come primarily from state governments. We've recently learned that Utah intends to pursue a series of bills which will in part create a Wyoming-like DAO regime.
NFTs	<ul style="list-style-type: none"> Some of the largest companies in crypto have decided to go big on non-fungible tokens which will inevitably attract increased regulatory attention. We've also heard that the debate around the impact of NFTs on copyright and other intellectual property protections could begin to heat up next year, so look for regulators you might not usually consider in the crypto space (such as the U.S. Copyright Office) to potentially get involved.

BTC Spot ETF	<ul style="list-style-type: none">The Securities and Exchange Commission rejected spot Bitcoin ETF proposals from both VanEck and WisdomTree in Q4 2021 while extending its review of two other proposals from Grayscale and BitWise to February 6th and 1st, respectively. While the argument that Chairman Gensler is “running out of excuses” has some merit in our view, approval may not provide the same price catalyst as we saw around the first futures-based ETF approved in October.
<i>SEC v. Ripple</i>	<ul style="list-style-type: none">Ripple CEO Brad Garlinghouse has said he expects that SEC v. Ripple will reach its conclusion next year. This is a complex and time consuming legal proceeding so it’s difficult to estimate when we may see a verdict, but the decision could have a profound impact on the SEC’s authority to regulate crypto.

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institutional@blockchain.com

www.blockchain.com/institutional

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Find out more about

Blockchain.com

Blockchain.com Q1 Framework by



Charles McGarragh

CSO & Head of Markets

Charlie@blockchain.com



Garrick Hileman

Head of Research

Garrick@blockchain.com