ZEROCAP

Digital Asset Firm
for Private Clients

Zerocap Q3 2021 Insights

www.zerocap.com

Zerocap is an over-the-counter (OTC) wealth firm for digital assets, providing deep liquidity, insured custody and yield products for clients looking to move seamlessly between fiat and digital assets.

Our global banking infrastructure and principal trading model enables fast settlement in all major currencies and OTC assets. We offer a fully insured asset environment in custody on a dollar-for-dollar basis, with a range of yield generating investment options for compounded returns.

We are the firm for private clients, family offices and institutions.

CIO note

Where Q2 saw ESG concerns and regulatory backlash out of China, Q3 has worked to shake off concerns despite volatility against increasing inflationary pressures, credit issues out of China's large property sector, and a more interested SEC in the face of retail asset flows. Leverage use on crypto derivatives was also a target globally, echoing moves in the retail leveraged FX space. As fun as a 100x leverage is on an asset with 120% annualised volatility, it's one way to decimate the retail crowd.

Despite the broader crypto market ending the quarter in the green, we saw deleveraging in September that shook out a significant slice of open interest across derivatives, affecting spot volumes for the proceeding weeks. Despite this, our OTC desk was firing toward the end of September, with lots of interest in structured products to take advantage of yield plays against heightened options volatility. I'm reminded time and time again that it pays to be a contrarian in these markets. When the crowd is getting wild – consider managing risk on the other side, and when fear is greatest – consider buying value. This was perhaps the last opportunity for a while to pick up bitcoin at US$40,000 given the velocity of unleveraged spot buying we are seeing funds and institutions.

Similarly, ethereum saw significant institutional inflows into the Grayscale Trust, signifying growing interest from the big end of town front-running ETH 2.0 and a host of potential future price drivers. On layer 1 and 2 protocols, and other industry verticals, NFT hype was the dominating force over the quarter. The NFT space is definitely approaching bubble territory here - the 'peak of inflated expectations' is near. We view NFTs as having amazing use cases in the future for the legacy world, but urge caution right now given the sheer hype behind this vertical. The DeFi sector also saw record inflows once again, growing total value locked in yield plays. A significant portion of DeFi is still weighted towards crypto native participants - to really disrupt traditional finance and banking, the space will need to move away from churning protocols through yield farming, and rather towards sustainable infrastructure plays. Terra (LUNA) is making leaps here - the most promising algorithmic stablecoin and ecosystem in our mind.

Be cautious in markets beyond BTC and ETH - we are fairly inflated. The technology adoption curve is a great model to visualise the cycle - where do you think we are now?

Have a great Q4, be safe out there!

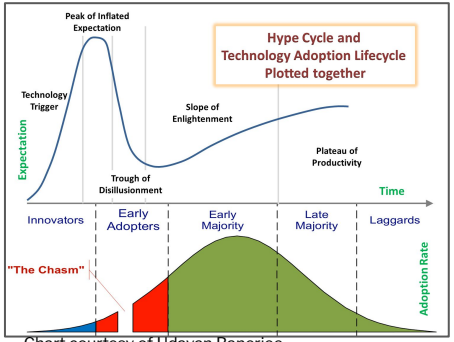


Chart courtesy of Udayan Banerjee

Cryptocurrency market performance

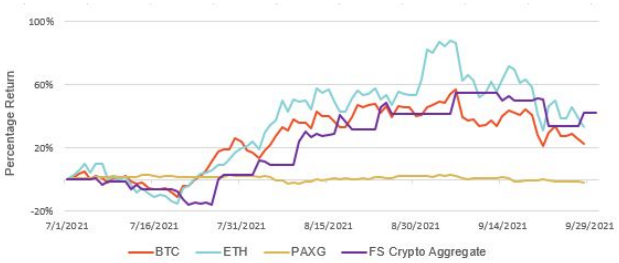
A steady recovery

BTC returned **30.6%** compared to ETH at **42.36%** over Q3. The sector had a slow start with a choppy market recovery for bitcoin in the face of a decreased hash rate due to China's crackdown on mining. Asset accumulation appeared to be the key focus for many with exchange outflows persisting. Anticipation for ETH's London hardfork drove sentiment as we moved into August with a host of protocols seeing gains off the back of the shift in outlook. By mid-September assets across the board had seen strong moves to the upside, although a significant deleveraging event caused a retest of the 40k mark for bitcoin just as regulatory concerns in the US heated up. A slew of US based crypto companies were hit with subpoenas and fines, a result of the SEC tightening its regulatory grip. The weight of the global recovery potentially stalling began to deepen correlations between the crypto market and traditional equities as inflation became the main focus for many alongside any systemic impact of the Evergrande saga. The space's seasonality has come into effect this quarter with September seeing BTC and ETH record -10.27% and -21.69% losses respectively.

Bitcoin's market share decreased from **46.13%** to **42.39%** over the quarter due to a surge in adoption of alternative blockchain networks. ETH's market share grew from **18.05%** to **18.17%.** Growth was likely suppressed due to the flood of liquidity incentives on alternate layer-1 chains.

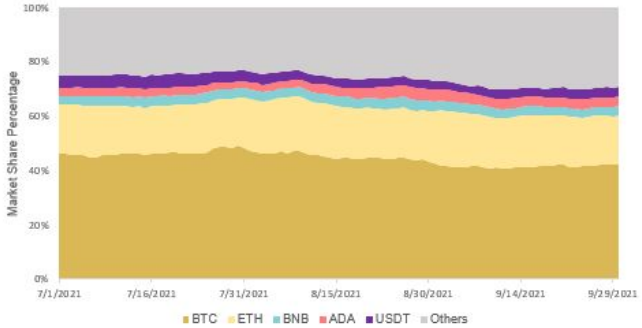
Stablecoin usage has maintained significant growth over the quarter. USDT continues to lead the pack with an added **$16.83B** minted over the quarter. We have seen a concentrated effort by Circle to promote USDC and increase access, the cause of its standout performance over Q3, adding **655.1%** to its supply.

2021 Q3 Cryptocurrency Returns



* FS Crypto Aggregate tracks the performance of 630 digital currencies, representing the market as a whole.

2021 Q3 Cryptocurrency Market Share



2021 Q3 Top 5 Stable Coins QoQ

USDT	USDC	DAI	BUSD	TUSD
$20.94 B	$3.90 B	$1.17 B	$985 M	$275 M
(+$16.83 B)	(+$3.39 B)	(+$1.13 B)	(+$968 M)	(+$121 M)
(+409.8 %)	(+655.1 %)	(+2694.4 %)	(+5669.6 %)	(+78.5 %)

Quarterly Asset Performance

Bitcoin

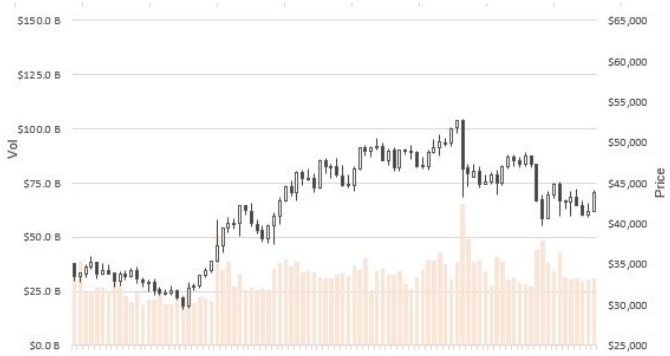
Bitcoin began the quarter recovering from a steep decline in hashrate due to the continued crackdown within China. This drop in active miners reset the asset's mining difficulty to levels not seen since May 2020, a time when BTC's price sat at only US$10,000. Investors remained divided early in the quarter, with the majority of speculators sitting on the sideline in anticipation of a more definitive move. By late July sentiment had brightened, a likely result of significant hashrate coming back online and an overtly short bias from speculators which led to over US$1B of liquidations in what was a textbook short squeeze.

Regulation and macro themes remained key focal points over Q3 with updates newsflow out almost daily on various nations' plans to integrate or alienate the asset class from their economies. The Wyden/Loomis/Toomey amendment to the US' Infrastructure Bill spurred a flurry of newsflow and positive sentiment. Despite its failure to pass, it sparked action on a crypto lobby in the US and displayed some degree of support amongst existing members of parliament, a net positive.

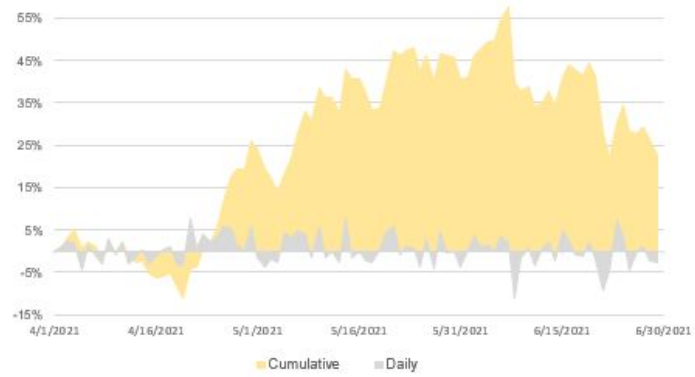
A notable shift in tone from central banks began to impact the crypto space as correlation to equities steepened and a broader move to risk-off was experienced. This shift in tone was soon followed by the largest deleveraging in the asset seen since May, resulting in ~50% of fresh open interest wiped from the market across derivatives. Weak price action in equities combined with a poor rollout in El Salvador provided the perfect catalyst for a shakeout. The recovery from this move was short lived as Evergrande contagion led investors to further limit exposure to risk assets.

Overall, the cumulative return for bitcoin over Q3, 2021 was **30.6%**. The cumulative market cap change was **$195B**, rising to **$824B** in capitalisation.

BTC Q3 Price & Volume



BTC Q3 Market Cap Change



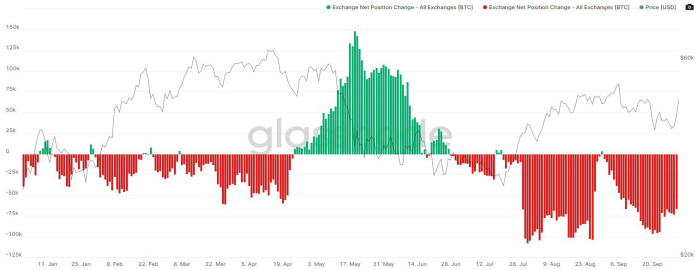
Bitcoin On-Chain

Bitcoin saw historically significant levels of outflows across Q3 as larger holders accumulated following the May correction. The inevitable implications of this level of outflows paints a bullish picture as supply on-exchange becomes limited and the BTC purchased is moved into dormant wallets. Similarly, it indicates elevated demand for the asset.

One of the most prominent news events for the industry this quarter was the mass exodus of bitcoin miners from China. The original cause of such a large concentration of hashrate in the region was the low cost of energy. Although, government and regulators quickly became aware of the immense energy usage that the mining facilities were draining from the grid, particularly in remote parts of the country. On the back of this and a national push to outlaw cryptocurrency use and its related industries, facilities were forcibly shutdown and fined. Others quickly packed up shop in fear of the same fate. Fast forward to the end of the quarter and we have seen a swift hash rate recovery, trending back towards all-time highs. By the end of August, the US had acquired 35.4% of global hashrate while Kazakhstan came in at second with 18.1%, likely a result of its cheap energy and proximity to China.

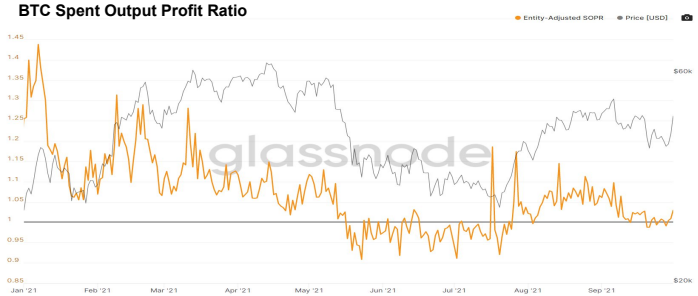
We also saw a bearish resistance on the asset's spent output profit ratio throughout July which was flipped moving into August and finally established as support in late September. The metric shows that between June and August, coins were being sold at a loss due to investor capitulation and a lack of a propensity to hold. As token value increases and coins are held back into profit, the successful support test confirms a willingness to hold. This further indicates bullish sentiment in the market.

BTC Exchange Net Flows



BTC Mean Hash Rate

BTC Spent Output Profit Ratio



Ethereum

Ethereum displayed signs of strength this quarter despite an increasing divide between those who see its long-term dominance of layer-1 volume as a given and those who believe competitors pose a serious threat to the growth and health of the network.

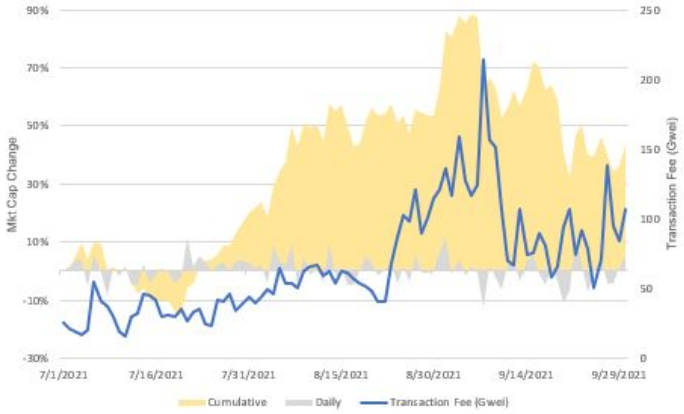
The London Hardfork was the key fundamental driver going into Q3 due to its significant adjustment to the network's tokenomics. EIP-1559 introduced a burning mechanism with the intention to make ETH a deflationary asset and create more predictable gas fees, further driving investment incentive. The upgrade also integrated key foundations for the future release of ETH 2.0, the proposed savior to the network's high gas fees. Price ultimately rallied in the weeks preceding and following the successful fork.

As we moved into August, NFT hype well and truly set in with multiple headlines detailing 1,000 x flips in a matter of days for certain projects. Opensea recorded a record $3B+ in trading volume with an estimated $215M in fee revenue. The influx of activity on the network caused a spike in gas fees with some users paying thousands of dollars in gas to mint, list and or sell their NFT. While congestion was a significant factor, we also saw a rise in front-running as smaller fish were priced out of art drops and whales took advantage of their large capital base.

Arbitrum One (a layer-2 scaling solution on Ethereum) also had its successful mainnet launch this quarter, swiftly surging to $1.5B in TVL in a matter of weeks proving itself as a strong competitor to Optimism and Polygon. This near-instant inflow was partly fueled by incentives schemes on the chain, although it displays the value of an Ethereum secured network with reduced fees. The cumulative return for ether in Q2 was **42.36%**. The cumulative market cap change was **$107B**, reaching **$353B** in capitalisation.

ETH Q3 Price & Volume

ETH Q3 Market Cap Change & Gas Fee



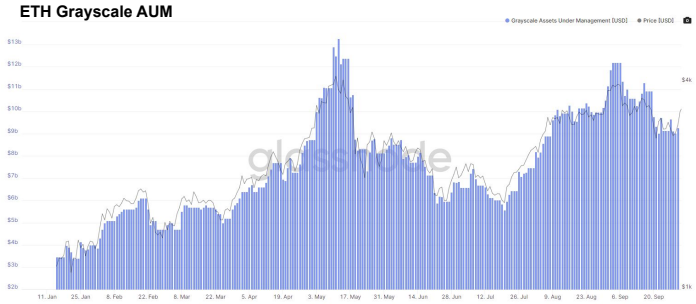
Ethereum On-Chain

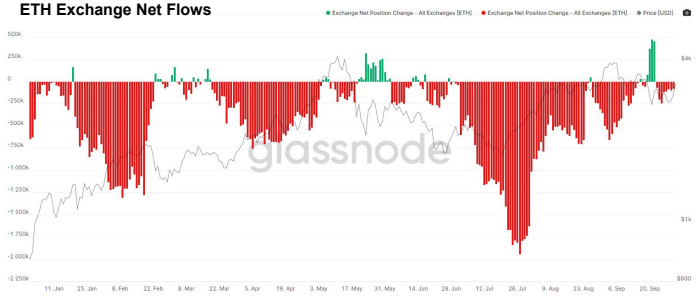
Ethereum saw volatility in its cumulative active addresses over the quarter due to a number of factors. Anticipation of the London hardfork was building across July, with spikes in activity recorded directly in the lead up to its launch. At the same time, the market was experiencing what is now known to be the 'lows of the May' capitulation for the asset. As sentiment was increasing, so were the decentralised exchange volumes, credit loaning and borrowing of assets on-chain. Ultimately, users were repositioning for what they successfully forecasted was another run-up.

The volume of inflows into Grayscale's ETH Trust turned heads over Q3 as institutions piled into the asset. This is indicative of a broader shift in focus across the quarter to more nuanced assets beyond Bitcoin as investors and asset managers dive down the crypto rabbit hole and attempt to position themselves ahead of the curve. It is worth noting that AUM grew alongside price throughout August following the successful London hardfork and overall positive news coverage of the network.

Exchange outflows dominated in late July, a result of leading investors preparing to take advantage of a successful fork. Interestingly, we saw a sharp decline through August leading to a mixed September. As we moved through the quarter, momentum behind ETH slowed, predominantly due to a lack of newsflow and the rise in success of alternative chains.

The successful launch of EIP-1559 was not without great benefits to the network despite the slowing interest in ethereum, with over $1B dollars worth of ETH burned between the fork completion and September 15th. As the quarter progressed, the number of deflationary days for token supply only increased.





Decentralised Finance

Ethereum DeFi faced a turbulent quarter as liquidity siphoned out to NTFs, and low yields in blue chip protocols remained subdued due to incentive programs on layer-2s and alternative chains. Decentralised exchange volumes remained elevated across multiple chains, primarily fueled by a distrust for centralised entities and the “if it's not your keys, it's not your crypto” attitude. This was further amplified by a crackdown on crypto trading in various countries with the standouts being China and Korea.

While spot trading limitations were minimal globally, we also saw a concentrated effort to limit the trading of derivatives, specifically with leverage use. The Asia Pacific region received the brunt of the limitations with Binance even restricting trading in Australia. This comes off the back of heightened regulatory scrutiny for the company. On the back of this, we saw decentralised trading platforms such as dYdX record explosions in trading volume with over $540M in open interest at the end of Q3 and a peak of $3.6B in 24 hour trading volume, surpassing Coinbase on September 27th.

Lending platforms and yield-farming took a hit on Ethereum as gas fees remained too elevated to profit meaningfully. With this being said, $1B+ in liquidity incentives drove a migration and subsequent boom on other layer-1s such as Solana, Avalanche and Fantom. This surge allowed smaller protocols to gain a meaningful user base upon launch by offering elevated yields, although a large portion of projects experienced pump and dumps as APYs dropped and early movers pulled funds. With multiple blue chip projects such as Aave and Maker adding services to other chains and layer-2s, the DeFi landscape looks as promising as ever. The key focus now remains on how these Ethereum alternatives maintain their user base and continue to progress the sector. Overall, the DeFi sector recorded **$178B** in TVL at Q3 close, an increase of **$62B**.

ETH Total Value Locked

ETH Total Uniswap Liquidity

Emerging Themes

Layer-One Wars

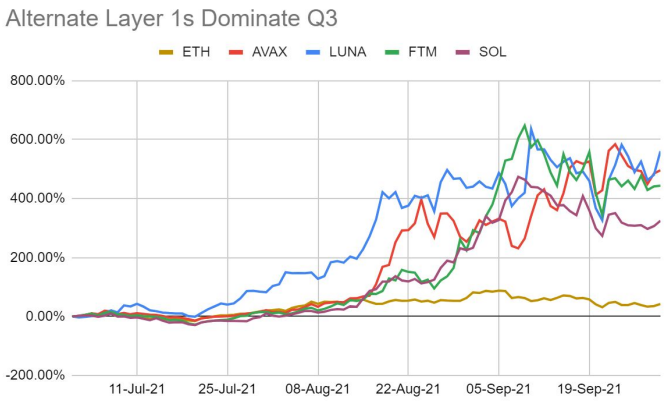
The worsening transaction capacity of Ethereum's network has incentivized crypto users to explore other blockchains. Many of the competing ('layer one') blockchains saw an explosion of adoption and value in Q3. While the ethereum token grew 42% in value during the quarter, this was dwarfed by that of its competitors such as Terra (561%), Avalanche (496%), Fantom (444%) and Solana (323%). The latter three all announced attractive incentive programs for their users during the quarter. Fantom for example, rallied over 22% on August 30 after announcing an incentive program involving over $296 million worth of FTM tokens for its users.

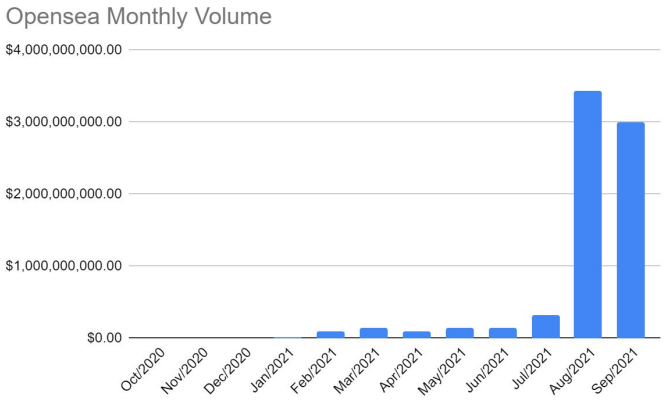
Stable Assets

Negative newsflow surrounding the incumbent fiat-collateralised stablecoins (USDC and Tether) - including tightening regulation and the anticipation of countries launching their own centrally backed digital currencies (CBDCs) - has diverted attention to a more decentralized approach to stablecoins. A large reason for the surge in Terra's native token (LUNA) would be the increasing adoption of its stablecoin (UST - an algorithmic stablecoin). UST has a far more decentralized approach to the mainstream models and has the potential to weather the tightening regulations.

NFT Boom

NFTs took a major leap in Q3. Speaking to this was the exponential rise in OpenSea volume. Most prominently CryptoPunks, which have seen total sales volume of over $1.5 billion. Visa bought CryptoPunk #7610 for $150,000 (a bargain compared to CryptoPunk #7252 which sold in August for a whopping $5.3 million). While some may view these hefty sale prices as being bubble territory (which we agree are very extended right now), it is likely that digital images are just the start of a broader NFT revolution. NFTs are likely to become a household name as they hold far more utility than just digital imagery. Use cases will include gaming, event tickets and real estate.





Macro Overview

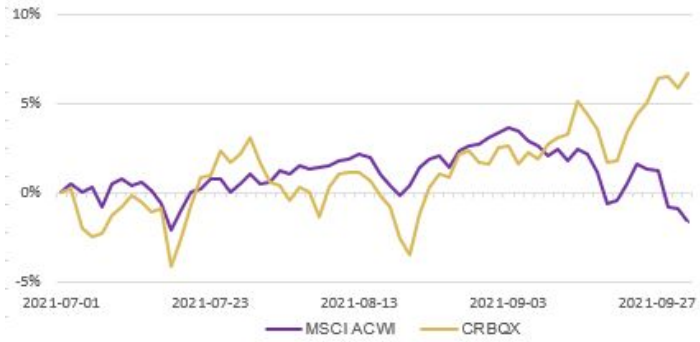
Economic and market Update

There were a number of macroeconomic and geopolitical concerns weighing on asset markets in Q221. Producer and manufacturing cost inflation concerns are pushing bond yields to higher levels across the globe. In the US, ten-year treasury yield shifting above 1.5% as PPI for August reaching 8.3% YOY, in addition to a potential US default on its government debt, exacerbated by the political back and forth between congressional parties. At the same time, Chinese manufacturing PMI dropping below 50 for the first time in 18 months, generating fear of global stagflation risk rising.

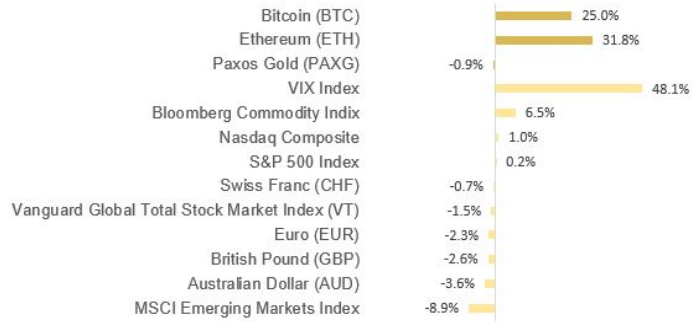
Global geopolitical risks were also elevated with Japan and Germany electing new government leadership, EU members dissatisfied with AUKUS peg against China, and Taiwan's request for aid from Western nations against elevated pressure from the PLA's military exercise across the strait.

Chinese property developer Evergrande Inc failed to service several USD offshore bond coupons in time. At the same time, the spread of credit exposure had dampened market sentiment across all emerging markets (a second developer, Fantasia, also missed coupon payments). Evergrandes' listed shares were suspended following a drop towards the lowest level since its IPO 11 years ago. EM credit spreads blew out while the RMB weakened against major currencies.

MSCI ACWI vs Commodities quarter term cycle



2021 Q3 Multi-Asset Class Performance



S&P 500 vs Commodities long term cycle

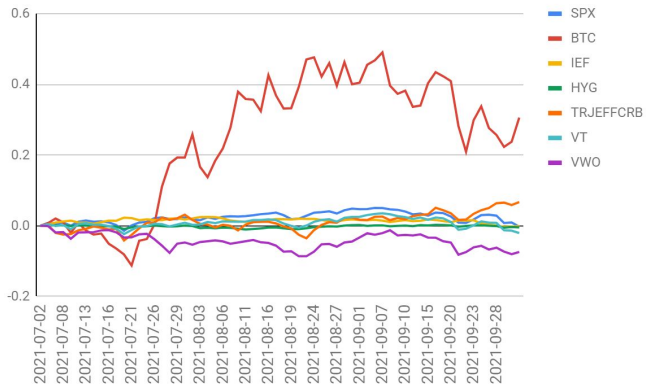
Economic and market Update (Continued)

The US Federal Reserve announced their intended tapering timeline as November 2021, bringing to light the beginning of the end to the world's most extraordinary stimulus program. Despite the ECB remaining neutral to slightly dovish on interest rates, the Bank of England surprised the market with a hawkish tilt; in light of increasing inflationary concerns, the market is now pricing in official interest rate normalisation to begin in Q122. Domestically, the interbank market is now pricing the RBA to begin its asset tapering by 2022.

Q321 also saw a change in tone for global portfolio allocation bias. The quarter began with a remaining correlation level across risky assets, but this had shifted by the end of September. The exit in stocks and bonds saw a shift towards money flow into digital assets, with global players such as Brevan Howard, KKR and Steve Cohen's Point72 entering cryptocurrency investments. In asset manager Fidelity's client survey of US and European institutional investors, 84% said they are interested in gaining exposure to digital assets. The latest report by Bank of America states that they are "bullish on digital assets and blockchain technology.

China's crackdown on cryptocurrency activities onshore in anticipation of the PBoC's Central Bank Digital Currency launch created a migration of platforms offshore. Despite this, the recent dip in cryptocurrency prices had actually induced a rise in hodler percentage, resulting in a major push towards Put to Call ratio flipping and forcing prices higher and faster.

Intermarket Cumulative Return



This chart maps the performance of cross asset markets represented by global and EM stocks, Commodity prices, Treasury bonds and High Yield Corporate debt.

Market Index:
SPX: US S&P 500 index

BTC: Bitcoin / USD

IEF: iShares 7-10 year treasury bond ETF

HYG: iShares High Yield Corp. Bond ETF

TRJEFFCRB: Refinitiv/CC Commodity Research Bureau Index

VT: Vanguard Total World Stock Index ETF

VWO: Vanguard Emerging Markets Stock Index ETF

Derivatives

Futures

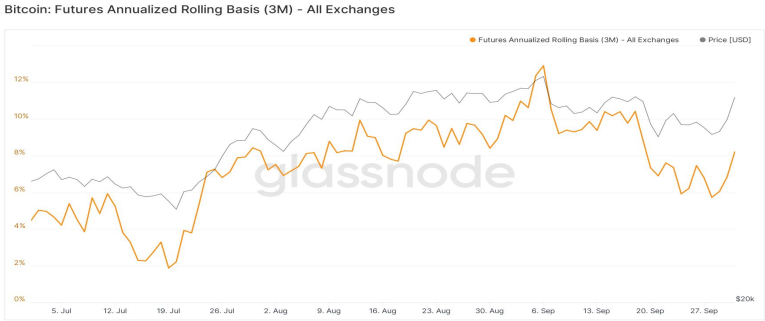
Basis arbitrage opportunities were scarce at the beginning of Q3, with lower spot prices in both BTC and ETH forcing a compression of the futures premium. The positive roll-down began to rise by the start of September; BTC basis reached around 13% p.a. at its peak, while ETH peaked at approximately 15% p.a. for quarter-end maturity contracts.

Perpetual funding rates tracked spot price movement for the quarter, beginning in negative territory and spiking higher during early September trading before settling down near par to end the quarter.

Options

Options implied volatility remained elevated throughout the quarter but still tracked spot closely. Both BTC and ETH implied vols briefly traded below 100% during the start of Q3 but pushed towards 120% by early September. Realised volatility failed to justify the high implied volatility, making long options plays expensive. Risk Reversal trades became a popular strategy during the first push towards 50,000 level on BTC. By selling an OTM, downside PUT to finance the upside CALL provided less carry roll-down cost until the spot leg pushes higher eventually. Unfortunately, this strategy also created downside negative gamma risk, which saw heavy selling of spot/futures during the mid-September selloff. As a result, downside protection demand increased as BTC price traded towards 40,000, generating a bias towards PUT versus CALL options.

Bitcoin Annualised rolling basis (3m)



Ethereum Annualised rolling basis (3m)

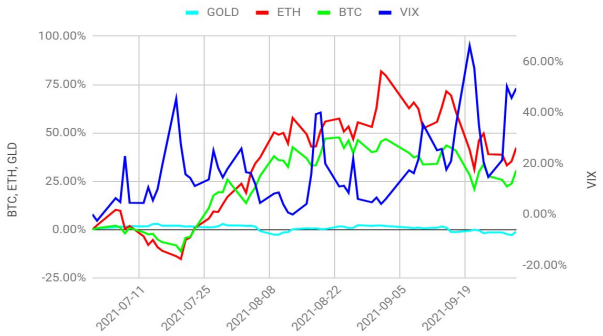
Portfolio Analysis

Despite entering into the summer holiday break of the Northern hemisphere, volatility across most asset classes was elevated in Q321. Headline media alerts relating to credit risk, geopolitical events and rising bond yields generated fluctuations in market prices across stocks, bonds, commodities, and cryptocurrencies. The VIX index broke through the 20 level resistance, reached a high of 25.71 before settling at 23.14. In comparison, the index closed at 15.83 at the end of Q221.

There was a clear holding patent for long-term investors of BTC and ETH, while news media announced new DeFi protocols, leading to fluctuations in the price of Zerocap's DeFi Index basket. Our in-house investment subcommittee on products decided to maintain the existing portfolio constituents while employing the same Relative Weighting Allocation methodology to optimise allocation to thematic growth of this vertical. Given the elevated implied volatility for the quarter, variance controlling products such as the Zerocap Bitcoin Parity fund outperformed the underlying assets for the quarter on a risk adjusted basis.

By the end of Q321, there was an obvious large move in the institutional space toward mass portfolio allocation to crypto assets. The correlation between bonds, stocks and commodities began to diverge against digital assets. As central banks in developed economies start the normalisation of interest rates and unwind extraordinary stimulus measures, digital assets have emerged as a must-have in optimising asset allocation as we enter the final quarter of 2021.

Quarterly performance vs risk (volatility)



Portfolio products:
ZDS: Zerocap DOT Staking

70-30: Zerocap BTC/ETH 70/30 portfolio

DeFi: Zerocap DeFi Index

ZBT: Zerocap Bitcoin Trust

ZBP: Zerocap Bitcoin Parity Fund

Zerocap Fund Performance

Zerocap Fund Performance

On the back of heavy crypto-tailwinds throughout late July and August, all of our products ended Q3 in-the-green.

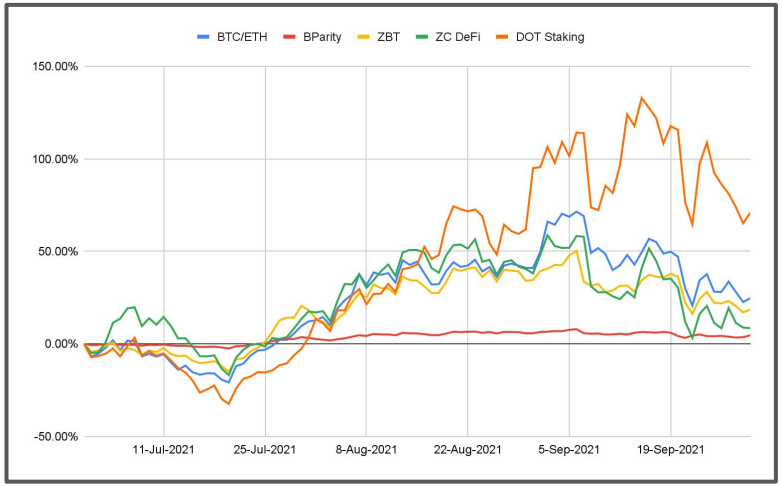
DOT Staking

The outperformance of our DOT Staking product (70.95%) plays to the growing sentiment and excitement surrounding the proof-of-stake (POS) protocols. The superior transaction capacity of their POS consensus mechanisms has contributed to the increasing support for altcoins such as DOT. Zerocap is excited to capture more of this market space as we roll out further staking products for the POS networks (such as Ethereum 2.0 and Cardano).

BParity

Our BParity product was designed to reduce volatility, whilst maintaining the beneficial portfolio effects of bitcoin . September has historically been a difficult month for bitcoin - over the last 5 years it has been a red month. BParity has demonstrated an ability to maintain resilience against volatility.

Product	Q3 Returns
BTC/ETH	24.68%
BParity	4.61%
ZBT	18.55%
ZC DeFi	8.51%
DOT Staking	70.95%



	Historical September BTC Returns	
	BTC	BParity
2017	-8.69%	-1.50%
2018	-5.95%	-0.94%
2019	-13.52%	-2.63%
2020	-7.55%	-1.41%
2021	-7.07%	-1.07%

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