ZEROCAP

Zerocap Q1 2023 Report

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About

Zerocap is a market-leading digital asset firm, providing **liquidity, digital asset custody, asset management and technology** to forward-thinking investors and institutions globally.

Zerocap offers a full-service model for all your digital asset needs, served by a team of seasoned professionals with a deep understanding of digital asset technology and traditional finance.

Zerocap sets a new standard for governance and compliance in the digital asset industry, as evidenced by licensing, auditing, institutional backing and a bespoke insurance policy from Lloyd's of London.

Proudly founded in Melbourne, Australia, with offices in Melbourne, Sydney and London.

Zerocap Pty Ltd carries out regulated and unregulated activities.

Spot crypto-asset services and products offered by Zerocap are not regulated by ASIC. Zerocap Pty Ltd is registered with AUSTRAC as a DCE (digital currency exchange) service provider (DCE100635539-001).

Regulated services and products include structured products (derivatives) and funds (managed investment schemes), which are available to wholesale clients only as per the Corporations Act. Zerocap Pty Ltd is a corporate authorised representative (number 001289130) of Gannet Capital Pty Ltd (ACN 139 264 690, AFSL 340799).

CIO Note

Q1 was largely defined by the prospect of an increasingly tight monetary landscape. While January saw risk rally, February and March were predominantly negative given strong rhetoric out of the US Fed combined with the prospect of recession. By March, the cracks began to show with the fall of mid-tier banks such as Signature, Silicon Valley Bank and First Republic.

The swift introduction of the Bank Term Funding Program from the Fed and US Treasury, a way to provide support for the banking sector via claims on US Treasury bonds and Mortgage Backed Securities at face value directly with the Fed, caused some respite. Although, the market quickly saw through the roundabout greenlight to introduce an addition $4.4 trillion to the money supply with assets external to the economy rallying (GOLD +7.56%, BTC +41.26% from 11th Mar - 30th Apr).

The quarter woke many to the reality of just how difficult the position that many central banks find themselves in truly is. When choosing to juggle banking collapse (with the prospect of economic fallout), and currency debasement, the likely choice is continuing to support despite hawkish rhetoric. This risks stagflation, but presents a unique opportunity for Bitcoin's primary value proposition to shine.

Within the digital asset ecosystem, we saw mini boom and bust cycles over the quarter. The rally in BTC trickled down into lower cap assets causing some to run multiples. The Arbitrum ARB airdrop had a similar impact on the space, introducing fresh funds and siloed bubbles. Ethereum's successful Shanghai fork proved to be positive for the network with limited Beacon Chain withdrawals and sustained network uptime. Des[ite all the positives, the end of March saw a reduction in liquidity across the market, further compounded by the increase is regulatory scrutiny out of the US.

Whether the market finds itself in a counter trend rally or whether the bottom is truly in, the last three months has proven that the space is rife with opportunity despite the overarching sentiment. Moving into Q2, it is expected that we begin to see more direction out of Central Banks and regulators which will ultimately determine the medium term direction of the market.

Best of luck for Q2.

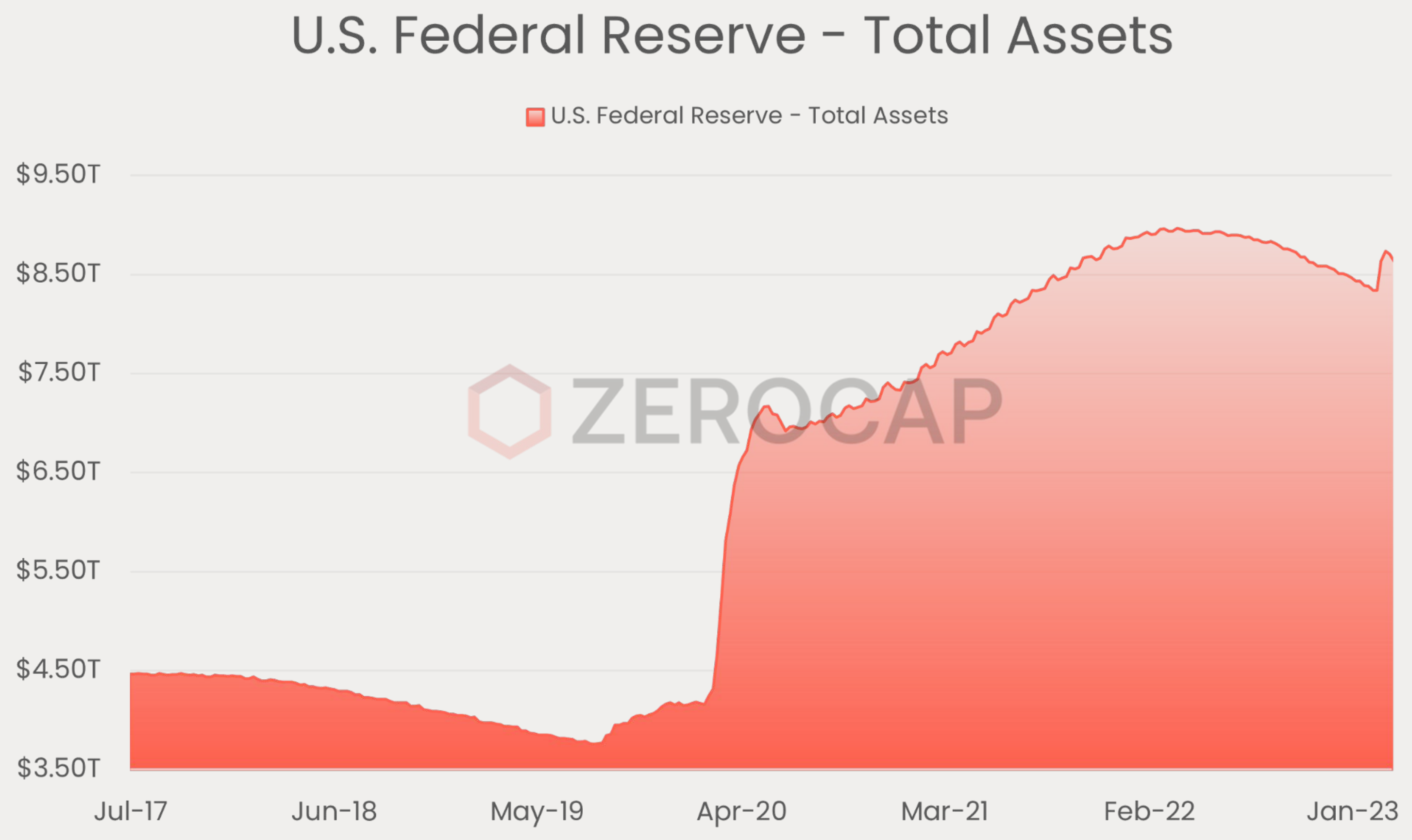
Global Macro Overview

“March Madness”
A chaotic first quarter saw regulators and central banking authorities juggle stickier than expected inflation, a normalising labour force and systemic failure within the global banking sector.

Inflation rates exhibited varied trends across different geographies, and sectors: United States (US) inflation declined to 5% in March, beating the expected 5.2%. A cooler print was attributed to slowing growth in food prices, and decreased energy costs across the board. The Euro Zone enjoyed a much needed drop in its rate of inflation to 6.9% vs 8.5% in February, along with Japan - declining to 3.2%, marking the lowest increase since September 2022. Whilst costs of fuel, energy and amenities appear to be normalising, food costs in Japan have soared to their highest levels since the 1980’s. The United Kingdom (UK), unveiled a red hot inflation print for March - unexpectedly rising to +10.4% vs +10.1% the month prior, disappointing domestic market participants.

Against this inflationary backdrop, central banks worldwide have continued taking various measures to combat inflation, the European Central Bank (ECB) policymakers agreed to raise key interest rates by 50 basis points in March, while the Bank of England raised its keybank rate by 25 basis points to 4.25%. The Bank of Japan remained steadfast, maintaining its key short-term interest rate at -0.10%. ECB and FED officials have emphasised the need for further monetary policy adjustments to ensure a “timely return of inflation to target levels,” with a 25 basis points rate hike anticipated for May in both the EU and US.

Broader markets, already reeling from the trials and tribulations of sustained, restrictive, monetary policy, weathered the third biggest US banking failure on record, with the collapse of Silicon Valley Bank (SVG) on March 10th. SVG was previously the 16th largest bank in the US, and was the second in a series of crypto / VC friendly banks that fell victim to strenuous market conditions in the latter half of the quarter. Silvergate, announced just two days prior to SVB’s collapse that it would be winding down its operations, Signature also being seized by regulators the weekend following.



Source: TradingView

The associated aftermath led to a $153 billion surge in lending via the FED discount window, seeing the FED’s balance sheet jump from $8.4 trillion on March 8 to $8.7 trillion a mere week later. Contagion appeared to seep into traditional financial markets with the acquisition of 167 year old controversial banking behemoth Credit Suisse, by rival Swiss bank UBS for 3 billion CHF. The landmark takeover struck debt markets, as a result of Swiss regulator FINMA’s decision to write down over $17 billion worth of Credit Suisse’s Additional Tier 1 debt (AT1’s).

In light of the recent banking developments a flight towards a new “highly liquid asset class” is unfolding, seeing the total crypto market cap breach $1 trillion USD, as numerous “Blue chip” cryptocurrencies were “bid up” - BTC printing returns in excess of +67%, Ethereum up a similar +46% QoQ. Commodities such as Oil faltered (-6.552% QoQ), on account of easing supply chain disruptions and overestimated global demand. Safe haven assets such as GOLD (+7.7% QoQ) fared better than many of the major indices, outperforming the S&P500’s +4.9% quarterly gain, and the DOW JONES’ relatively disappointing gains of +0.4% QoQ. The NASDAQ was a highlight amongst the traditional indices, ending its best quarter since 2001 up approximately +17% QoQ, on account of investors allocating positions after significant derisking occurring in the 2022 year.

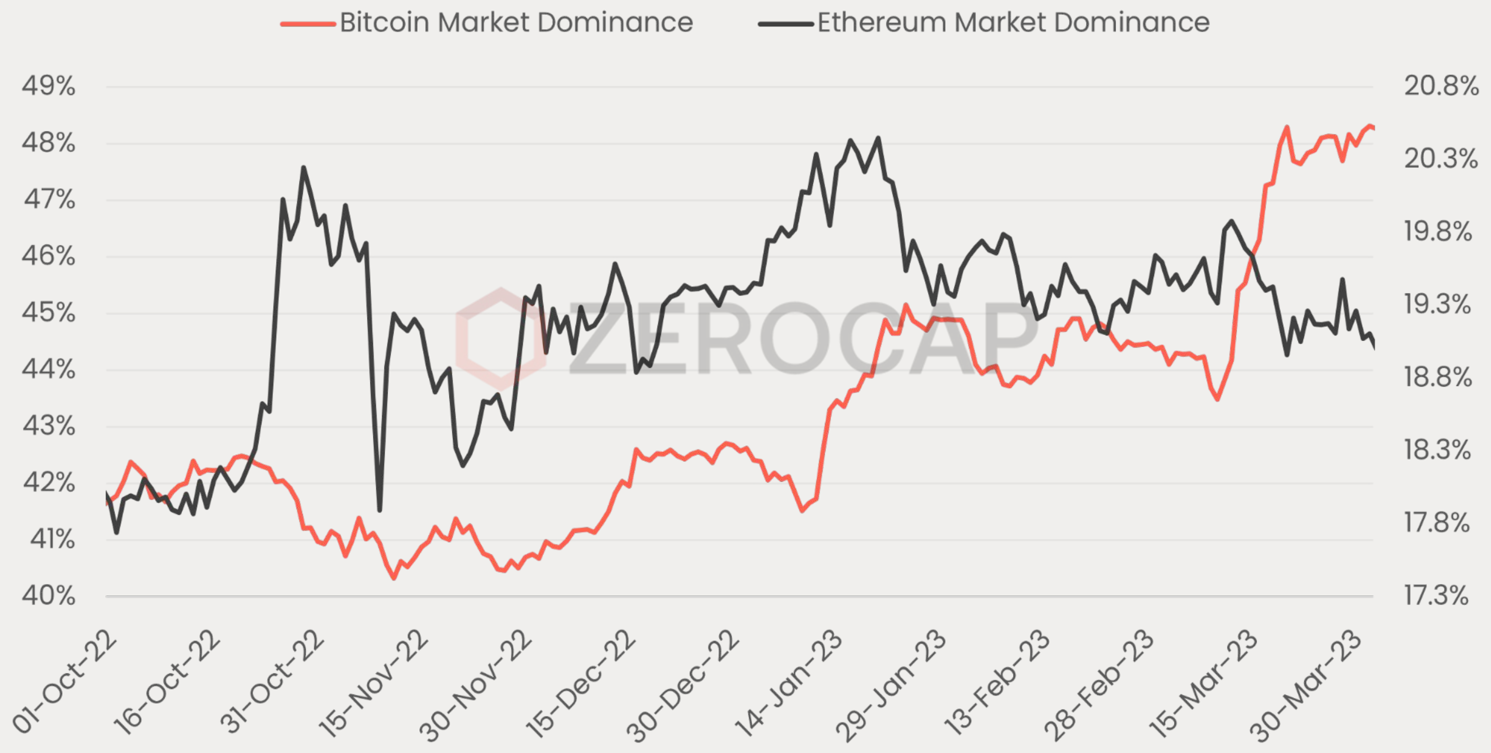
Digital Asset Markets

BTC experienced a sharp decline in 2022, which was attributed to persistently high inflation, an aggressive US Federal Reserve, volatile economic data, escalating geopolitical tensions, and the capitulation of key protocols and centralized exchanges. However, off the back of counterparty risk concerns and newfound optimism regarding alleviated hikes in the second half of 2023, BTC broke above 20k by mid-January, with the crypto market following suit.

In February, the possibility of extended hikes was reaffirmed, leading to a pullback in BTC and other risk assets as investors de-risked. Regulatory imposition, such as a probe into Paxos Trust Company by New York regulators in mid-February, became a temporary concern for some investors. However, economic data and shifting inflation narratives overshadowed most space-specific stimulus.

BTC showed signs of dislocation in the latter part of Q1. In March, Silvergate bank faced regulatory scrutiny, Silicon Valley Bank capitulated, and USDC experienced a de-pegging event. Initially, fear drove prices downward, and BTC re-tested the 20,000 level. However, with the Fed stuck between a rock (systemic collapse) and a hard place (hyperinflation), they made the decision to unwind a significant portion of their QT by increasing the size of their balance sheet by ~$300 billion.

BTC vs ETH - Market Dominance



Source: TradingView

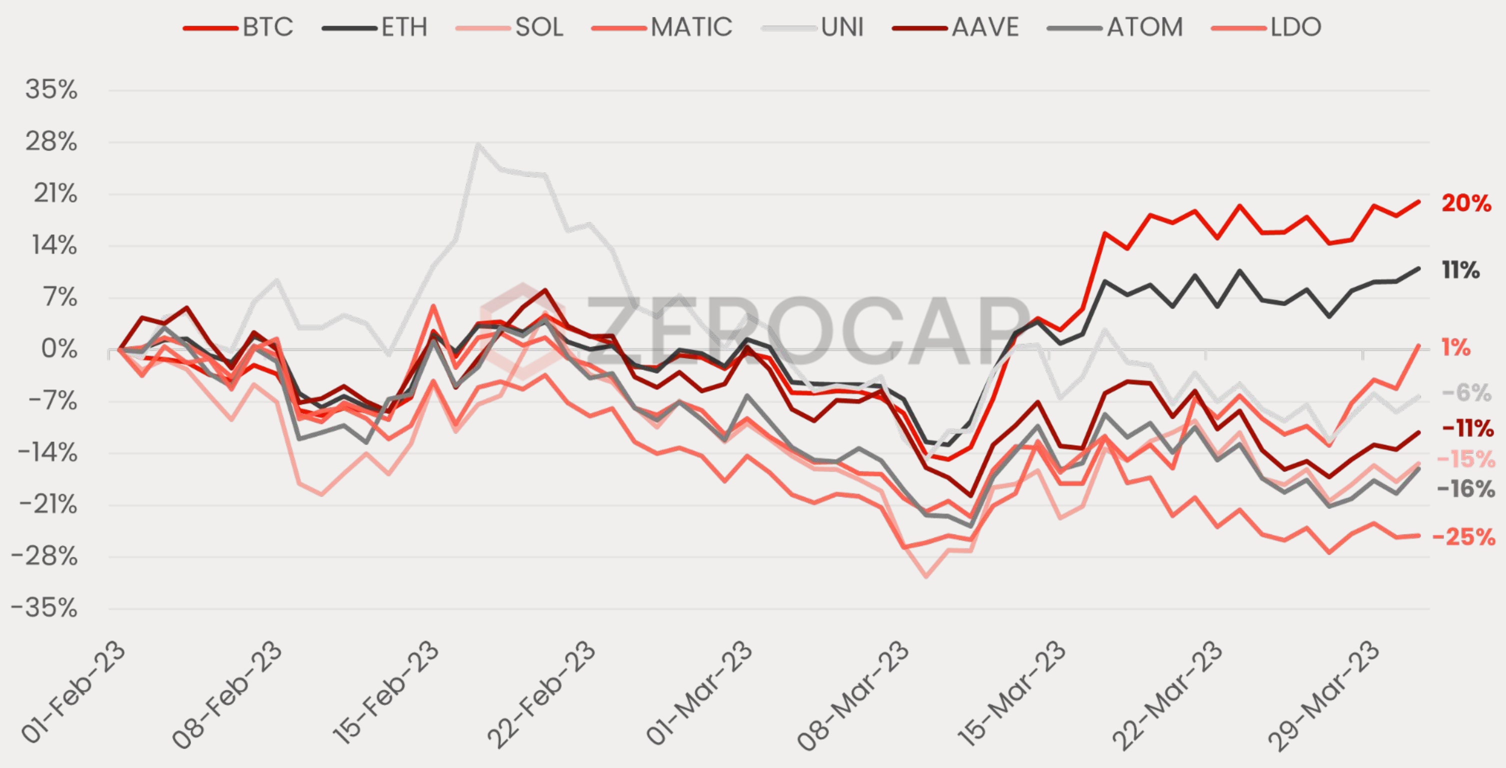
Digital Asset Markets

Through all the turmoil, BTC stood out from the crowd, breaking correlation to equities in a meaningful way and tracking as a flight to safety asset, similar to gold. While BTC's co-dependency to risk assets ticked higher off the back of heightened macro uncertainty during late March, BTC's unique qualities as a highly mobile bearer asset made it a hedge against balance sheet expansion, banking woes, and traditional portfolios. BTC's market capitalisation dominance shows that much of Q1's market strength has been primarily led by BTC.

While BTC outperformed ETH since the beginning of February and throughout March, it's worth noting that ETH's performance was relatively healthy compared to the broader market. Specifically, ETH returned +20% between February and April, while MATIC, SOL, and ATOM returned -1%, -15%, -16%, respectively, during the same period. Additionally, some DeFi assets like UNI and AAVE suffered -6% and -11% each.

Although BTC remained the clear leader, ETH's overall outperformance was likely attributed its highly anticipated Shanghai Upgrade which was scheduled for April 12th. This upgrade, which will enable staked ETH withdrawals, represents an important milestone in ETH's roadmap and is expected to shift market dynamics with increased capital availability.

Bitcoin v Market - Cumulative Returns

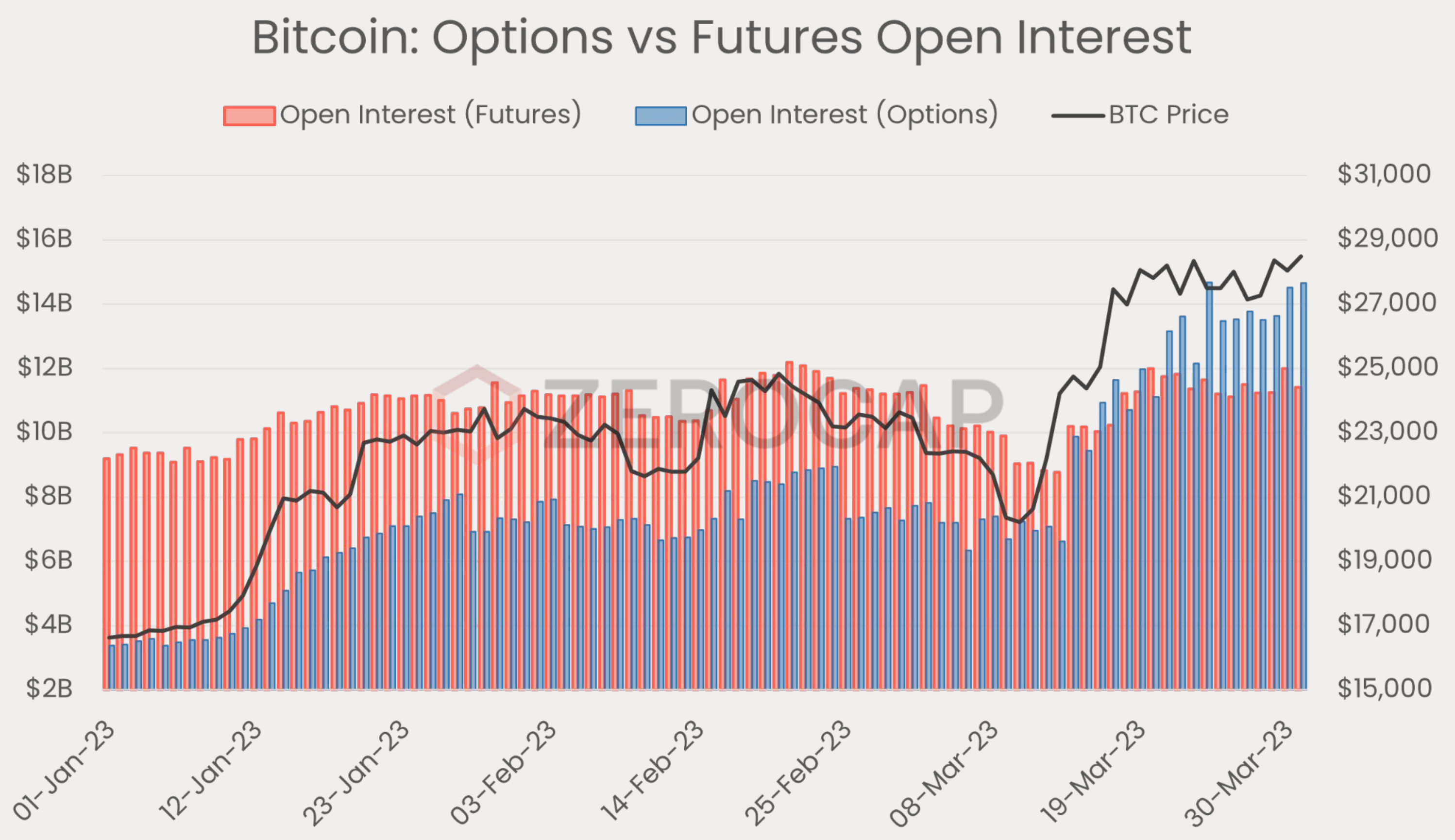


Source: TradingView

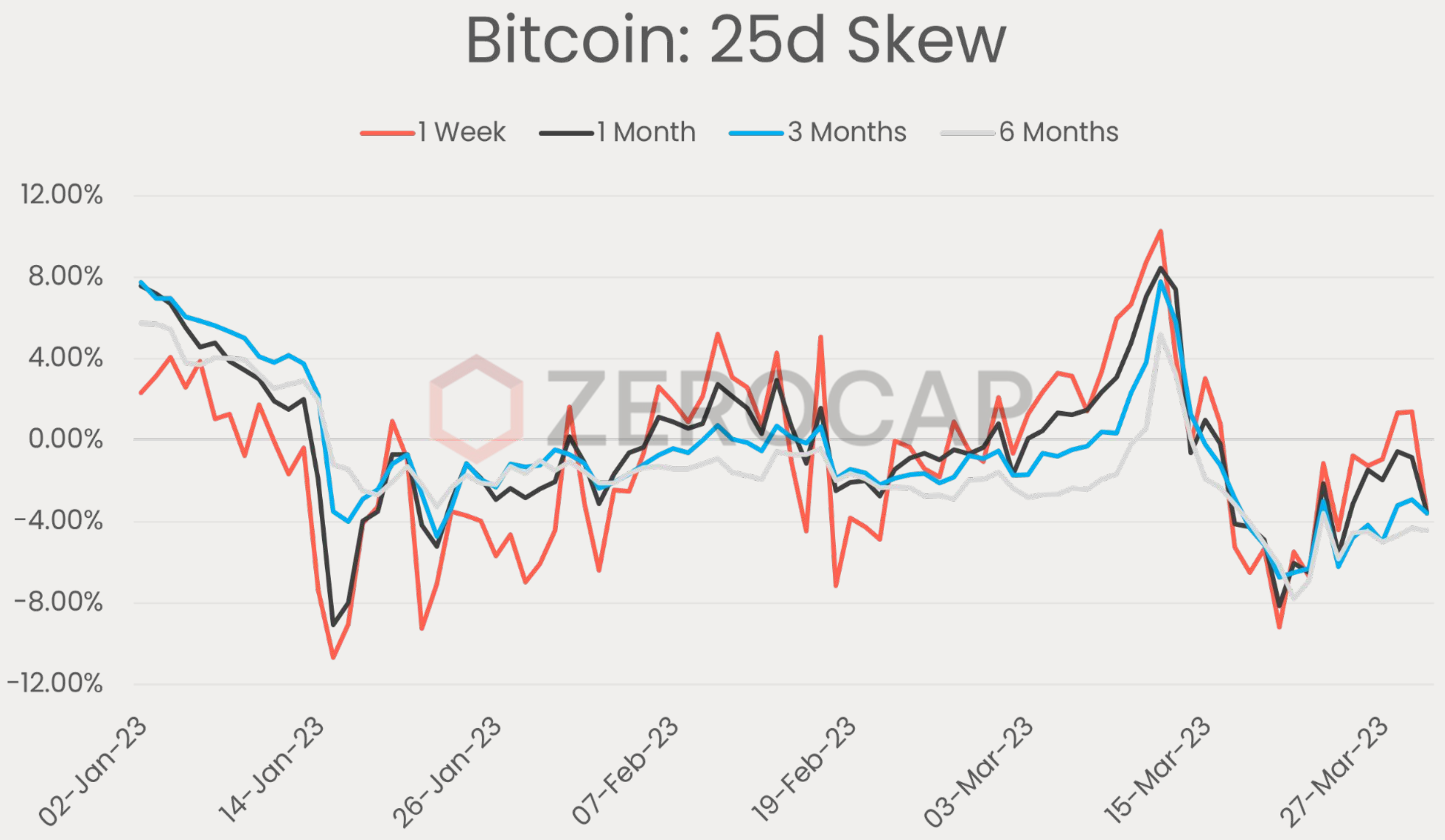
Derivatives

In the options space, we saw a return to higher implied volatility (IV) after a downturn in vol at the back-end of 2022. In contrast to the prominent trend in 2022, we saw IV trade higher as the Bitcoin spot price rallied; which was the opposite for the majority of last year. This trend was exacerbated by the large moves that we saw at the beginning of January and mid-March. The increased correlation between spot price and volatility positively echoed into put-call skew, with calls being bid over puts for the majority of the quarter as sentiment rebounded after a turbulent Q4 for crypto-assets. It's worth noting that the recent SVB collapse in March was the only instance that truly tested this trend and similar collapses could potentially lead to an opportunity in the case of further downside, where volatility may come cheap, and we witness a marked reversion in risk assets that break the downward trend.

Notably, in March, Open Interest (OI) on Deribit surpassed the combined OI of BTC-related derivatives, marking a first since the creation of these instruments. Aggressive call buying during Bitcoin's ascent to $30,000 influenced Options OI. The OI in futures markets notably dropped in November 2022 and has barely recovered despite positive price action in recent months. Arguably, this is due to firms reducing their counterparty risk given recent events, and may have led to potential unwinds to proprietary strategies across all venues, such as the futures basis.



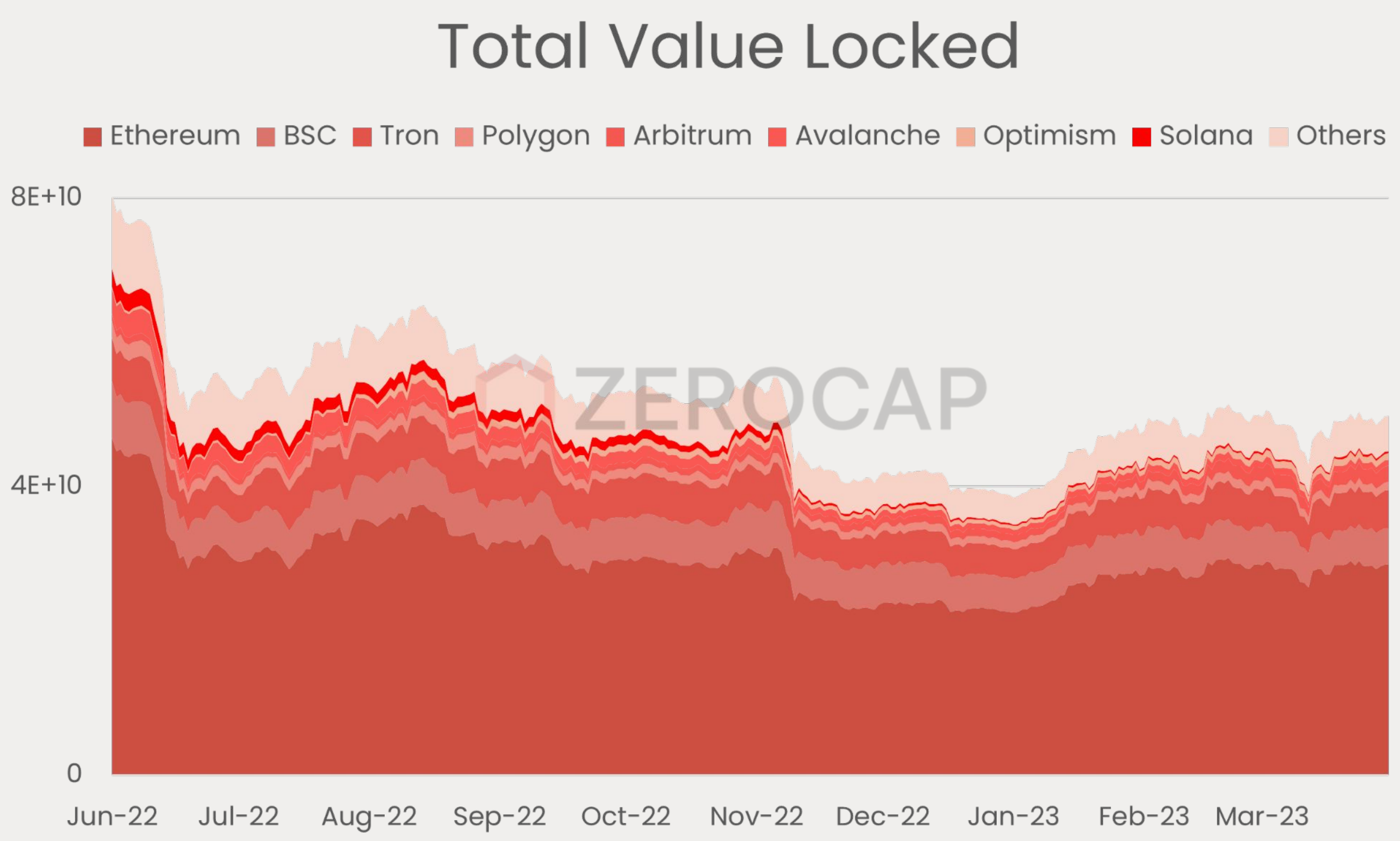
Source: Coinglass



Source: Derebit

DeFi

Opening the quarter with US$38.7 billion total value (TVL) locked into smart contracts within the wider blockchain ecosystem, this value increased to US$49.8 billion, reflecting a 28.7% growth QoQ. Certain chains contributed to this growth more than others; namely, Ethereum, Arbitrum and Optimism. The growth of DeFi over the past quarter can be fundamentally attributed to particular narratives in the space. These include the layer 2 narrative, seeing Arbitrum and Optimism soar in TVL as well the liquid staking narrative, resulting in Lido's TVL nearly doubling QoQ. In the case of Lido, with the Shanghai upgrade nearing, Q2 will determine whether or not it continues to maintain its dominance over other decentralised applications when ranked by TVL.



Source: DefiLlama

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Non Fungible Tokens (NFTs)

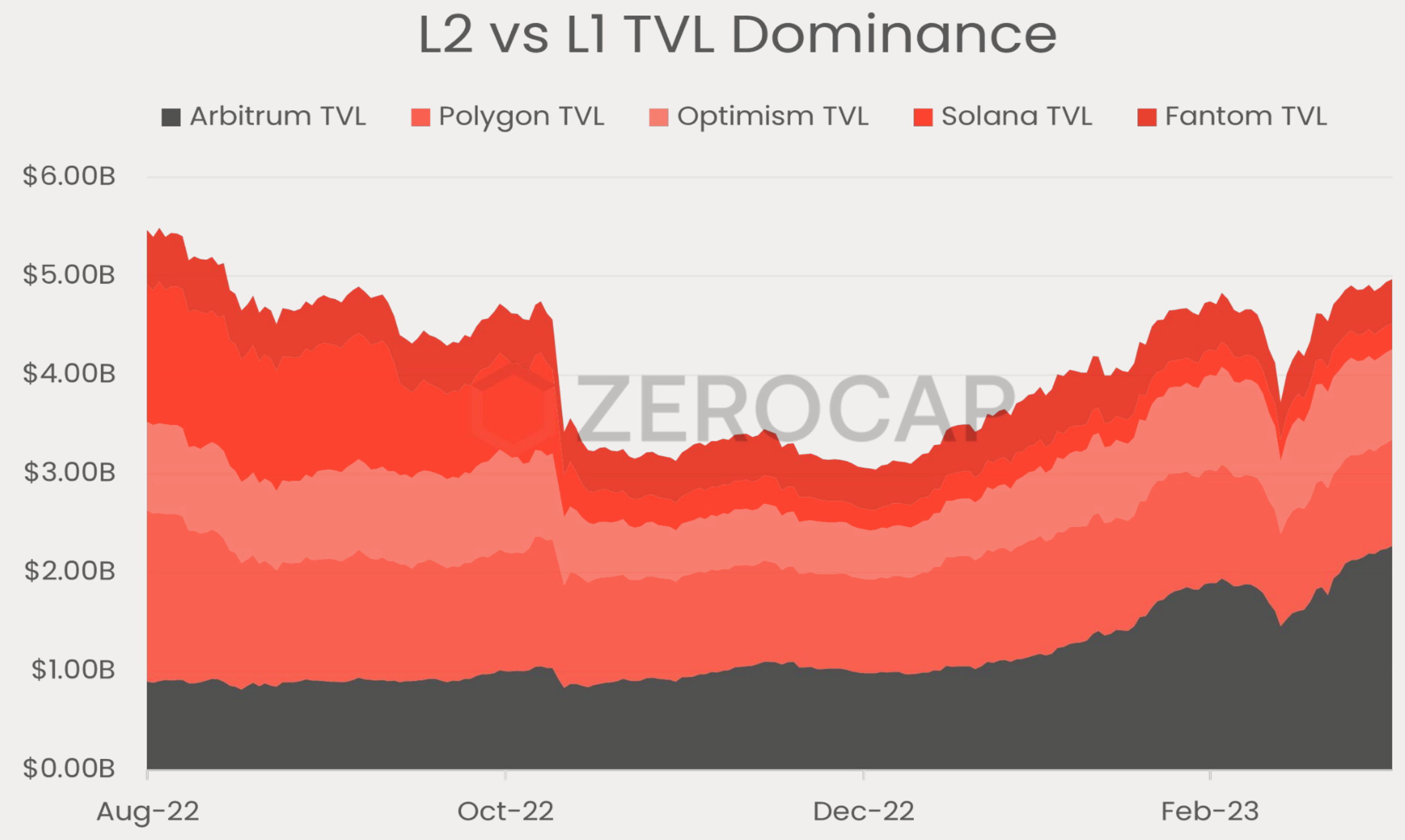
This quarter, developers publicly displayed the ability to inscribe NFTs on the Bitcoin blockchain, sparking a new narrative in the NFT space. This development has broadened the NFT market by offering an alternative to Ethereum-based NFTs and attracting high-profile artists and collectors. Additionally, it has fueled discussions about the potential of Bitcoin's programmability and its evolving role in the world of digital assets. To capture this growing market, many collections existing on other chains like Ethereum and Solana have looked to expand to Bitcoin. For instance, Magic Eden launched a marketplace for Bitcoin NFTs and Yuga Labs released a Bitcoin-based collection of NFTs.

Layer 2s

The long awaited and hyped Arbitrum airdrop took place in Q1, eventuating in 1.275 billion ARB tokens being airdropped to over 625k users. Accordingly, the average allocation per claimant is 1,859 - worth over US$2k. Whilst this highlights the profitability of participating in the big airdrops, it further propelled Arbitrum ahead of alternative layer 2 protocols, including Optimism and ZkSync. Subsequent to the airdrop, ARB tokens are able to be used as liquidity on the rollup platform; this resulted in the network's TVL growing 129.6% from US$980 million to US$2.25 billion QoQ.

Despite Arbitrum seeing more success throughout the first quarter of 2023, the second most adopted Optimistic rollup, Optimism, began moving towards its vision of a 'superchain'. Coinbase announced it would be launching Base, its own OP Chain using Optimism's OP Stack - a composable layer upon which unique layer 2s can be released that leverage the underlying technology of Optimism. This can be analogised to how Cosmos' software development kits (SDKs) enable developers to efficiently launch their own layer 1 blockchain without all of the common overhead work. Optimism as a base layer accrues value from these OP Chains. It is likely that as more companies look to move off-chain to on-chain, they consider modular networks that enable them to spin up their own layer 2.

As well as Optimistic rollups making strides, zero knowledge (ZK) rollups have similarly been picking up traction throughout this quarter. The majority of the companies building ZK rollups remain focused on launching a zkEVM - a layer 2 rollup that leverages ZK proofs for batching transactions, yet remains compatible with the Ethereum Virtual Machine (EVM).



Source: DefiLlama

zkEVM's allow developers to easily port smart contracts from Ethereum onto the rollup, ergo enabling these protocols to make use of the scalability benefits of layer 2s without requiring a rewrite of each contract. Both zkSync (now rebranded as zkSync Era) and Polygon launched their zkEVMs this quarter, with other announcements relating to this technology being made. One such example relates to the Immutable zkEVM - a new EVM-compatible zk-rollup powered by Polygon's technology that supports the Immutable platform.

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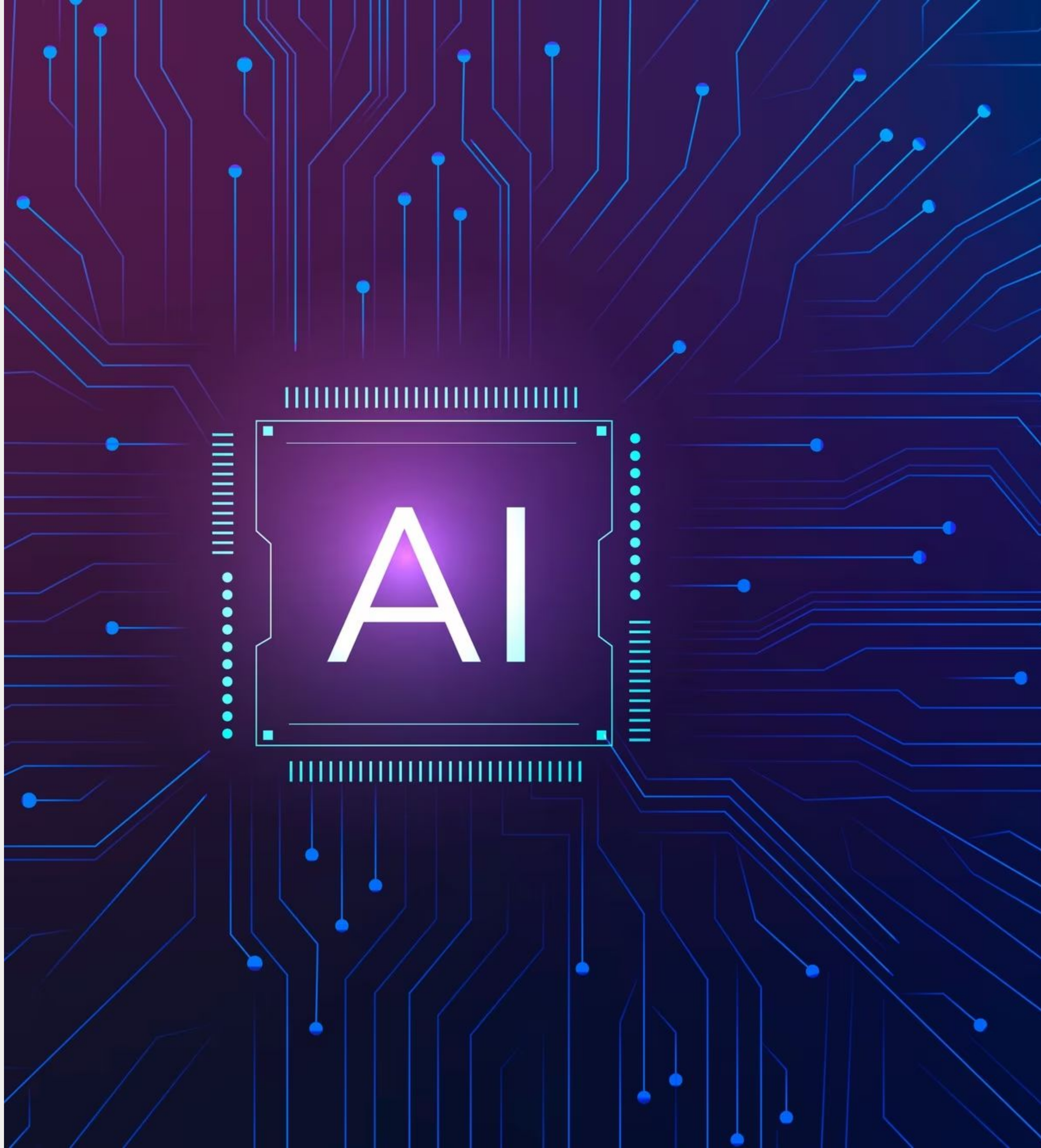
Technology

With less attractive, yet sustainable yields being offered within the DeFi space, many eyes are turning back to the fundamental technology underpinning cryptocurrencies: blockchains. One team at the forefront of the upcoming innovations within the ecosystem is EigenLayer. EigenLayer presents an approach to address the challenges of trust in the cryptocurrency domain by enhancing the accessibility to Ethereum's inherent trust, staking, and decentralisation mechanisms through leveraging its diverse set of validators. The protocol enables Ethereum validators to opt into supplementary slashing condition sets, thereby enabling them to utilise their staked ETH for the support of novel use cases such as data storage and oracle services. Consequently, Ethereum validators can engage in and reap benefits from a diverse range of decentralised applications.

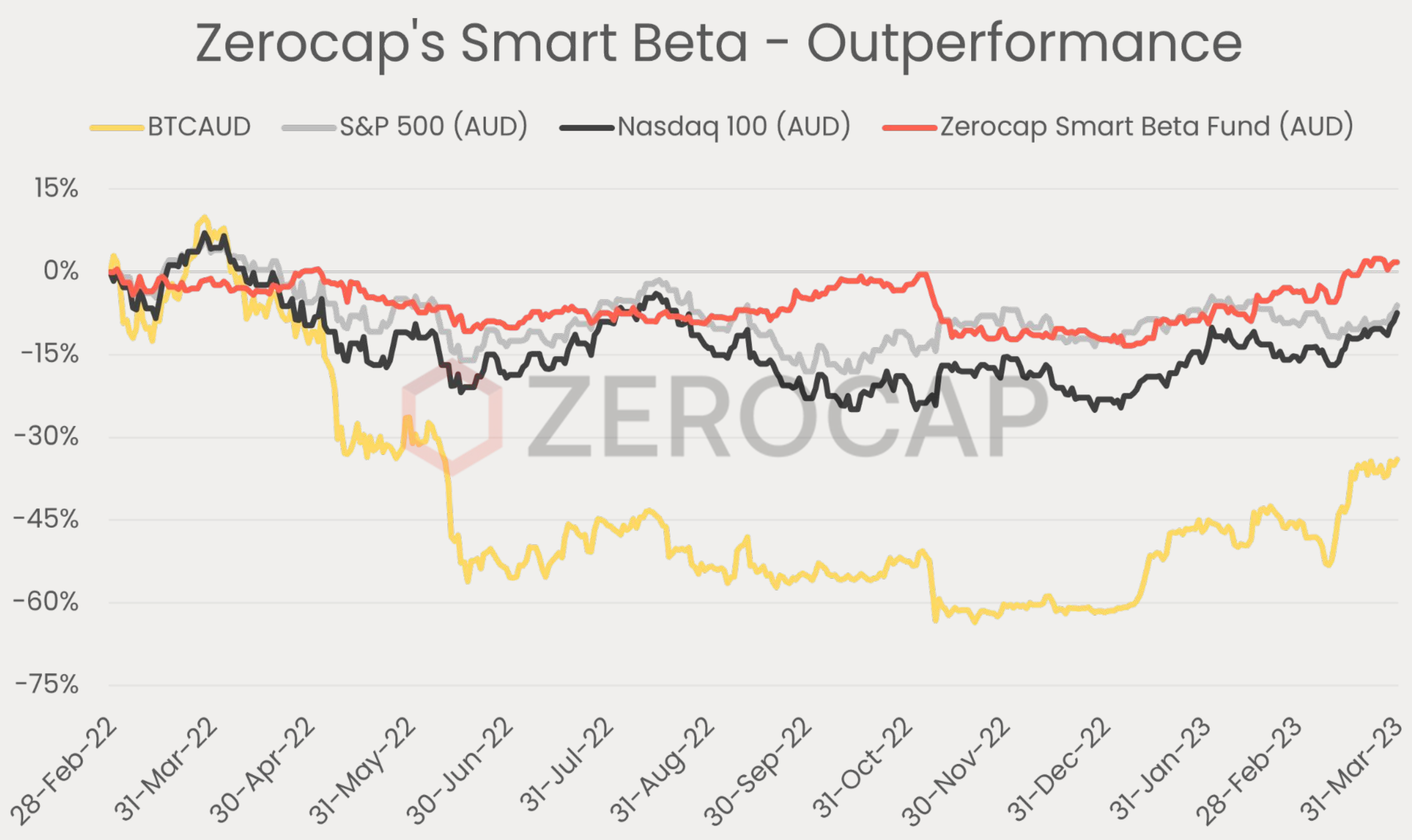
Like most industries during Q1 of 2023, with the launch of artificial intelligence (AI) chatbots, like ChatGPT, the cryptocurrency industry saw a pivot of many protocols to integrate this technology in some capacity. Previously existing AI-related tokens experienced a significant surge driven by growing interest in AI technologies and potential applications. While it's uncertain if AI tokens will become the next metaverse bubble, their capacity to positively impact the crypto industry nevertheless remains. Presently, it appears these trends are purely based on speculation and hype; companies are, however, leveraging this narrative, evidenced by Fetch.ai's raise of US$40 million in late March.



Zerocap Highlights

Smart Beta Bitcoin Fund

Zerocap's Smart Beta Bitcoin Fund crossed its high watermark last quarter. It is positive since inception whilst Bitcoin is down -34.1% over the same period. The Fund's objective is to maximise benefits from Bitcoin's return profile while minimising volatility - and thus losses during market downturns. The Fund is also outperforming traditional assets with the S&P 500 Index down -6.1% and Nasdaq down -7.4% during the same period.



Marex Partnership

Zerocap and Marex Solutions have teamed up to launch credit-rated crypto structured products, providing professional investors with exposure to digital assets while managing risks. These products include Principal Protected Notes, Autocallable Barrier Reverse Convertible Notes, and Call Option Spreads. They offer reduced risk, diversification, and potential outperformance - all with S&P Global investment grade credit ratings. The products will be ISIN listed as private placements on the Vienna exchange and accessible via Bloomberg and private banking platforms. Zerocap will initially launch three credit-rated products to cater to different market conditions and investor outlooks.

MAREX

How to Get Started

To sign up and start trading, visit: ZEROCAP.COM/SIGNUP

To discuss how digital assets fit into
your investment strategy, contact us at:

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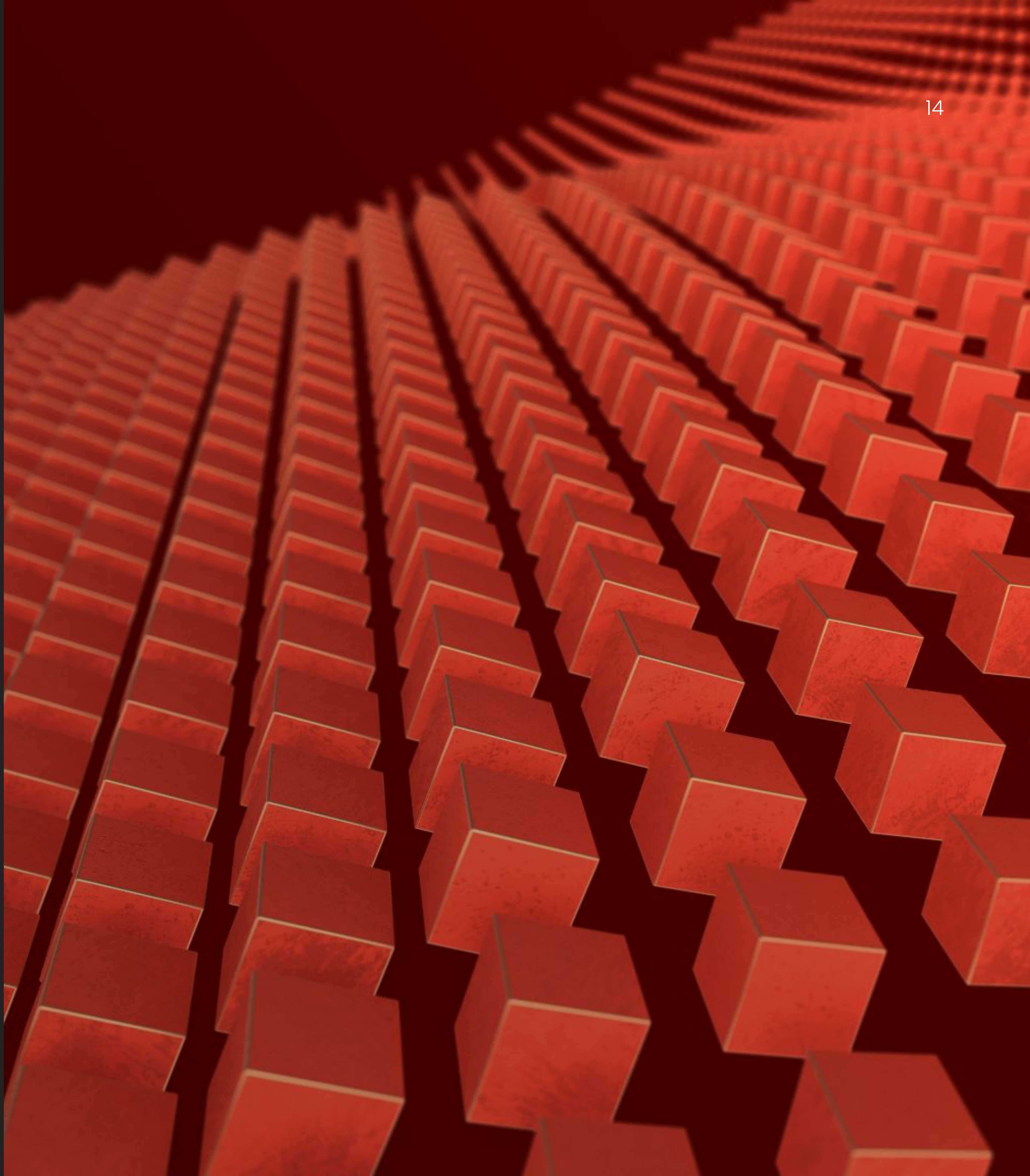

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