FCAM
Decentralised Digital Investing

Monthly Commentary

JULY 2023 PERFORMANCE

TOTAL NET RETURN

PERIOD	FUND RETURN
1 Month	-2.11%*
Life to date	-22.51%*

*Post management, performance and entry fees. Past performance is not indicative of future performance.

The Fort Stable Fund generated a return of -2.11% for the month of July 2023. ETH traded 3.8% lower over the month closing at $1861.77. We are maintaining our core long ETH position at around 23% along with our Long 1900 September calls and long 1700 September puts. This month we will deal with three things; The macro-outlook, some legal resolution in the fundamental question that beguiles the US industry of whether a token is a security; and news out of the annual ETHCC (ETH Community Conference). Crypto was an early lead indicator for risk seeking this year, US tech stocks have rebounded however the second half of the year looks like its focus will be on the Bond market. The crypto centric positive long-term catalysts remain in play in terms of ETF applications, continued adoption, and development but the macro uncertainties may well muddy the outlook for risk assets as we move from the Northern Hemisphere summer.

Macro; Old problems replaced by new ones.

The only economic measure that has mattered for the last 12 months has been inflation. Globally the attention to inflation has been focused on fighting persistent inflation and the resolve of Central Banks, including the Federal Reserve, to move us back towards the target of a 2% annualized rate. Cash rates have been hiked at a speed not seen in modern history. The level of activity and economic growth, to date, hasn't really been impacted and equally neither have absolute employment levels. This month we may have had a signal that inflation, in the US, has indeed peaked. Historically from here there should be switch in regimes to one where the focus shifts to monitoring weaker growth and earnings and potentially then a subsequent increase in unemployment. US inflation fell abruptly to 3% in June down from 4% in May and after peaking at 9% last year. The news is good however some of the slower to adjust components such as shelter / housing that will stay elevated and energy costs remain volatile. Stripping out the more volatile components of food and energy would still have had inflation close at 4.8%.

The market expected the FED to hike again at the 27th July and they did. This brings the benchmark borrowing rate to a range of 5.25%-5.5%. At his press conference, Fed Chair Jerome Powell stressed that the central bank is seeking proof that inflation is "durably down" and noted that policymakers will take a "meeting by meeting" approach toward rates.

The narrative that currently has the most traction has been the soft landing or indeed, no landing. One where rate hikes have been enough to moderate the inflationary impulses and cause limited economic damage and indeed are at a level that's accommodative enough to see a non-inflationary reacceleration of growth. Anything is possible however historical indicators such as the extent of inversion of rate markets indicate that weaker growth, spending and employment are ahead of us.

Unemployment rates have remained very low post 2020 for a variety of reasons but that labour hoarding impulse maybe coming to an end as the headlines of job losses in different industries seem to be increasing. That said it remains anecdotal for now as the various

measures of employment activity are still relatively robust. In Australia's case incoming RBA Governor Michele Bullock has said an increase in the jobless rate from 3.6% to 4.5% is necessary to engineer a return to the central bank's 2 to 3% inflation target. The fact the RBA have "paused" indicates perhaps that think that's a likely outcome as we move towards Q4? Leading indicators are the weakness in the household sector, Retail trade volumes have declined over the past two quarters and consumer confidence is anchored at recessionary levels, the economy indeed is already showing signs of staggering under the weight of high inflation and high interest rates in a heavily levered economy.

Another cloud on the horizon that is gaining some media and pundit attention is the sustainability and cost of projected absolute debt levels and the immediate increased issuance schedule for the US treasury over the second half of the year. The US treasury is looking to issue $2trillion of long dated bonds which has seen an increase in Long end bond yields. This increase in yield is driven potentially by 2 factors: One good and one worrisome.

A normalization of the US yield curve, that is long end rates sitting higher than cash rates on the more sanguine economic outlook we highlighted above but also pushed higher by the camp who are fearful of the markets ability to absorb this higher than expected issuance schedule. The last concern that the market has started to train some focus on is the annual cost of servicing the stockpile of debt having increased to over $1 trillion per annum. This now ranks higher than the US defence budget in terms of annual expenditure. The cost of the fiscal support that the US economy has received post covid is likely to only increase from here and it has a few concerned about Bond markets.

So, in summary: the inflation fever seems to have broken. For now, there is a narrative that the FED and central banks globally have managed the soft landing however the jury remains out on this hypothesis. Globally there are still numerous disruptive influences from a Chinese economy that is stalling to potential issues with food security out of Ukraine and increases in energy prices. Notably European and UK growth looking very anaemic and Australia seems to be softening. Interest rate markets are at odds with the expectations of the FED and other central banks who indicate they expect that rates will remain elevated for some period of time.

Markets counter to this narrative is seen through the pricing some aggressive cuts by the end of Q1 2024. That scenario one assumes is pricing an expectation of a significant growth headwind. Where has this left digital assets? Higher rates at the margin attracts capital away from speculative and productive activities, so the opportunity cost to add an incremental dollar into crypto is higher than it has been for a long time. Crypto and digital asset catalysts will need to come from a narrative other than macro it seems.

Court rulings; Progress but we really need policy.

There has been a long running court case between the SEC and Ripple Labs that dates back to 2020. The crux of the case is that the SEC alleges that the XRP (Ripple Token) is a security and was issued illegally. There was a preliminary ruling that was made during the month that probably added a little clarity and buoyed the market briefly. One thing that is apparent and pleasing is that the courts are engaged enough with the digital assets space to see nuance.

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Historically the Howey Test has been the catchall to punish all kinds of nefarious actors that the SEC didn't like, a cudgel to beat the scammers and Ponzi operators. The fact that the US courts are prepared to take the time to engage with digital assets and come up with nuanced views is pleasing. It shows that they can recognize that there is merit to digital assets and the technology that its built on can be revolutionary for capital creation and innovation. While not yet a trend we also have a report commissioned for the UK government by The Law Commission earlier this month also which indicated that digital assets such as cryptocurrencies and non-fungible tokens (NFTs) do not fit within the traditional categories of personal property but should be classified as a "third thing". The first is personal property "things in possession" (eg Gold / Art) the second is "things in action" (debt / shares in company), the commission proposes a third thing of digital assets.

Back to the Ripple case which has not been decided however this summary judgement is issued by the judge before anyone has argued their facts. They make the judgement ahead of the case and indicate that "given all you have presented this is where I see things" this can change but rarely does in cases such as this. When we get a final result, we are likely to see the case contested in higher courts, so while the case has been going on for 3 years already and costing tens of millions its likely to go on for a quite a while longer and cost a great deal more.

The focus was on 2 rulings. 1. The original fundraising where the incorporated company approached large institutions and gave them tokens in return for start-up capital – this was the offering of a security and as such was an unregistered security. The issuers of the token are likely to be fined heavily under this ruling. It was (1) an investment of money, (2) in a common enterprise, (3) with the expectation of profit, or (4) to be derived from the efforts of others. The second ruling was that Tokens that are purchased on exchanges are deemed not to be securities for the new holder. These include the instance of original purchasers in the ICO selling the tokens to a new purchaser on an exchange or the treasury or Ripple programmatically selling down their withheld tokens. The argument here is the new owner doesn't buy them with a view to participating in a common enterprise with the expectation of profit. This last ruling is important because it identifies that digital assets are "different" and that's what buoyed XRP and other tokens, it also increased the value of Coinbase shares as a large part of the SEC case rests on charging them with listing unregistered securities. This news makes it clear (currently) that airdropped tokens would avoid all the issues that XRP has, they are tokens that are issued as a reward to the users of a protocol or product.

The ruling also shoots down something called the embodiment doctrine. This legal doctrine states that tokens embody the original contract for ever and always. This ruling unequivocally states that the tokens do not necessarily "embody" the contract just as orange groves or their oranges didn't embody the contract when sold in Howey which is our historical test case. The Token by itself isn't a security the token when it is accompanied by the actions of an issuer, promoter and financial obligations equals a contract… without those when it's listed on an exchange it's that "third thing" … just a token.

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What all of this shows is that the SEC is fighting the current battle with weapons from the last war. We need legislation that reflects the evolution of technology and hopefully as courts continue to struggle to carve a path using the existing legislation it highlights further the need to create more appropriate regulatory framework. In the US there is growing moderate, reasonable group of bipartisan lawmakers, judges and regulators that believe securities laws as they stand aren't fit for purpose. Regions such as HK, UK, Singapore, and Dubai adopting regimes that are progressive is a good start but given the role that the US plays in capital formation and creation there is a need for law to be passed here to truly resolve the impasse.

ETH conferences – Genuine progress and signs of scalability.

Ethereum smart contract deployments are still growing at a rapid clip, an increase of over 64% Q/Q compared to Q1 2023 and 277% Y/Y compared to Q2 2022. The resurgence from Q2 2022 and continued growth from last quarter is a healthy signal that Ethereum development velocity is increasing. There is a saying in crypto that "Bear markets are for Building" and that does appear to be playing out as participants are less distracted by the price action and more focussed on creating an infrastructure that's properly usable and scalable for all its intended applications. This narrative is further developed by the feedback coming out of the Annual ETH community convention held in Paris. There were product announcements made that are impressive but the trajectory and development of scaling solutions and the focus on robust architecture are what we were most impressed and heartened by.

A few highlights –

Scalability:

Products have been built before the foundations were secure. The costs of transacting were for many applications too high and the speed to slow which lead to poor user outcomes. With any innovation there is always an element of building iteratively which sees sometimes imagination getting ahead of reality however what we are seeing now is that by the time the next bull market rolls around, there will be no shortage of compute and cheap storage for Web3. The community was updated on next upgrade called "Dencun" which was confirmed to be executed by the end of the year. This hard fork introduces a significant scalability upgrade in EIP4844 (aka protodanksharding). This upgrade turbocharges Ethereum rollups, also known as layer 2's, with access to a new cheaper form of block-space on the L1. This long-awaited upgrade allows these L2s to finally become the most scalable versions of themselves. Having safely deployed the move from development where we are approaching theoretical minimums of crypto-economic resource costs. It's not just Ethereum either, many different protocols are all approaching their final forms. Developers have minimized the cost to access whichever resource they're optimizing for that being either decentralization, security or scalability (it's been a while since we mentioned the trilemma !).

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Product development:

One of the most successful products in DeFi has been UniSwap, a DEX (decentralised exchange). While initially built to run on Ethereum its now evolved to work across multiple chains. The product allows users to swap tokens in a unique manner via an AMM (Automated Market Maker). Uniswap announced an upgrade that was reflective of the extent of development of chains and processes, The upgrade is called UniswapX. It's a free-market competition-based order fulfilment protocol to facilitate best-possible decentralized order execution. It's also created a process to work across chains, i.e. you have one token on Chain 1 (Etheruem) and want Token B on Chain 2 (Solana) and it optimises who can give the fastest and best rate? With the number of chains hosting Uniswap deployments expanding, the complexity of routing of orders and the dilution of liquidity is a problem that's conceivably been solved with this upgrade. Five years ago this kind of complexity was a pipe dream the knowledge and imagination of simply allowing order execution and fulfillment to be done off-chain, with the minimum-viable-proof being made to ensure correctness improves usability by a significant multiple.

There were numerous other advancements also announced at ETHCC, (click the link below to read about the main ones) many of them nuanced and highly technical. The upshot however is that the networks are strong enough now to be truly scaled across the multitude of potential use cases that are being developed. The regulatory outlook while cloudy moves daily closer to some sort of regulation that can be worked with. The macro backdrop remains the unknown currently but is a challenge for all assets classes equally.

https://www.bankless.com/ethcc-2023-announcements?ref=bankless.ghost.io

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