FCAM
Decentralised Digital Investing

Monthly Commentary

MAY 2023 PERFORMANCE

TOTAL NET RETURN

PERIOD	FUND RETURN
1 Month	-0.76%*
Life to date	-20.97%*

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

The Fort Stable Fund achieved a return of -0.76% for May 2023. This result was influenced by the decline in the price of ETH, which traded poorly throughout the month, ending lower at $1900. The decrease in implied volatility in ETH options was significant after the crypto markets failed to make further gains, as concerns over the US regional banking situation stabilized somewhat.

The market narrative in May was characterized by differing factors. Equities performed reasonably well, driven by the success of Large Tech and AI plays. However, participation was limited, reflecting persistent fears regarding the economy, global interest rate trends, and the resolution of US debt ceiling negotiations, which were only finalized late in the month.

During this month, we began staking our ETH on the network following the successful Shappella upgrade. Notably, the total ETH staked has surged, despite the Shapella hard fork from the previous month, which now allows for withdrawals from staking. Currently, more than 2.9M ETH has been staked or is queued for staking, representing a 15.9% increase compared to pre-Shapella levels. As of now, approximately 18% of the total ETH supply is staked or in the activation queue waiting to be staked. Given the low yields on fiat-backed stable coins like USDC, which continue to hover around 2%, staking ETH to earn *4%-5% while contributing to network security appears to be a sensible opportunity. We have maintained our long ETH exposure at 19%.

* The projected earning yield of staking ETH is 4-5% per year. This is based on the current staking reward rate of 5%, which is subject to change. The actual earning yield may be higher or lower depending on a number of factors, including the price of ETH, the number of ETH staked, and the length of time staked.

Macro back in the driving seat.

Central banks around the world are in a difficult spot. They are trying to navigate the main issue of our time, how to tame inflation, without causing a recession. Equally they are attempting to reign in excess liquidity that has flooded the financial system over the last few years that has distorted Asset Markets.

The only solution to inflation a central bank has is to maintain higher interest rates to slow underlying demand. However, this will also slow economic growth and increase unemployment, this equally dims the outlook for risk assets and capital creation. The fear of recession is what is impeding risk seeking, there are quite a few pundits that believe we are probably already in a recession even without a significant uptick in unemployment.

The current state of the world with elevated fixed asset prices and wealth inequality caused by money printing and consequentially persistent inflation is impacting perceptions of the sustainability of the existing system. Some are concerned that the dollar could be replaced as the reserve currency, while others are more worried about the debt ceiling and the sustainability of government benefits which we get to shortly. Regardless of where you sit in this argument it does feel like we are reaching the end of the current playbook of credit growth and positive demographics driving GDP and productivity.

In the United States, inflation is still running at 4.9%. Core inflation, which strips out more volatile food and energy costs, is closely watched and remains stubbornly high. It dipped slightly in April to 5.5% year on year but has barely moved since the end of last year.

The Federal Reserve raised interest rates by 25 basis points in May, and there is a growing consensus that the Fed may look to pause from here. However, history tells us that a "hawkish pause" (verbally indicating that there is a risk of further hikes while holding them steady) is a precursor to them cutting rates. It does feel this time around the FED and Jay Powell will persist with rates higher for longer to slay the inflation dragon, ensure their legacy and to try and break the nexus between asset prices and central bank liquidity.

Inflation elsewhere globally also remains elevated. The UK is still running at 10.1% and the Bank of England only expects it back to 5% by the end of the year. Australia also saw rate hikes in May even as inflation eased.

The upshot of all of this is that the central banks will need to remain vigilant, keep rates elevated, and hope that they can navigate the knock-on effects of their actions.

Unintended consequences of higher rates.

US Regional Banks:

There is a "Bank Walk" underway as opposed to more conventional Bank Run.. Money has been leaving the US regional Banking system to perceived safer vehicles and structures such as Money Market Funds. As we indicated last month the crisis in the US that started with Silicon Valley Bank (SVB) and has since moved onto other more conventional banks with what were perceived as better balance sheets. SVB's collapse was the first major bank failure in the US since the financial crisis of 2008, since then we have seen other west coast banks go into liquidation and this month First republic Bank which is a Blue Chip bank in the space, was sold to JP Morgan facilitated by the Regulators to avoid a collapse. Many Regional Banks are still in precarious positions with their equity largely wiped out, while the noises of imminent collapse have died down many of them are going to find it hard to be viable.

As we flagged last month rapidly rising interest rates caused the value of assets held by regional banks to decline, many have a large portion of their investments in what are termed Hold To Maturity buckets that can be impaired in value but aren't saleable without approval and will mean the bank takes losses. While there a backstops in place now to deal with the high levels of uninsured deposits the solutions are stop gap in nature. As a result, many regional banks have been forced to raise their borrowing costs, and have tightened their lending standards. This in turn has made it more difficult for businesses to obtain loans, and has raised concerns about a possible credit crunch.

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Hiking rates to kill inflation has led to this potential blockage in what is the lifeblood of the US economy, small to medium sized enterprises, right now there is no "crisis", rather its just a challenge to the existing banking model and the channel through which financing can be provided.

Central Banks as we have indicated only have one tool, that is the cost of money. They are pulling on that handle knowing full well its ineffective at best and destructive at worst. There will be consequences and the central banks have deemed these as more favourable that persistent and self-sustained inflation.

Debt crisis and the death of the Dollar.

While the current issue of the US debt ceiling is largely resolved the sustainability of the trajectory of spending and debt the economy is running is not. The US debt ceiling is a statutory limit on the amount of money that the federal government can borrow. It was created in 1917, during World War I, as a way for Congress to have more control over the government's spending. The problem is that it has turned into just another political tool with neither political side looking to reform the process, to that point the ceiling has been raised 79 times since it was created. The challenge ahead for risk markets is that the Treasury are likely to issue $1.1T to replenish their coffers, this increased issuance is competition to risk assets and likely to draw money away.

Another of the issues worth highlighting is not only the sustainability of absolute debt levels but the increased cost of interest payments particularly with rates higher.

The US Congressional Budget Office (CBO) projects the following:

- Annual interest costs will rise to $1.4 trillion in 2033.
- Last year the federal government spent about $1.3 billion per day on interest payments (2022) by 2033, the nation will spend about $3.9 billion per day.
- As a percentage of GDP costs would nearly double from 1.9 percent of GDP in 2023 to 3.6 percent in 2033.
- The previous high for interest relative to GDP in the post-World War II era was 3.2 percent in 1991; that ratio would be exceeded in 2030 under CBO's calculations.

In a keynote speech to a USC graduating class famed investor Stan Druckemmiller brought the situation into stark relief. While this speech was US specific the message in his address is applicable to many western nations including Australia. With the demographic trends the promised and existing support structures in pensions and healthcare will be overwhelmed by increased demand as Baby Boomers age out of the workforce and the tax base shrinks.

A few facts

- US government debt grew from $15T to $31T today. If you account for what the government has promised it will pay people in terms of social security and Medicare there are credible estimates that the present value of that debt approaches $200T.
- So what needs to happen to taxes or spending to address this ? – this is referred to as a fiscal gap… to close that gap, which sits at 7.7% of GDP, a 40% increase in all Federal taxes collected, or, an immediate and permanent cut of 35% in federal

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- One of the key tools used to sustain growth and in turn boost asset prices has been the expansion of the FED's balance sheet. The various QE's were initiated with the expectation that they would be temporary, we have had one aborted attempt to reduce that balance sheet and are currently attempting another reduction. The balance sheet of the Fed today stands at just below $9T, or 10 times as large as before the financial crisis in 2008.

There are versions of this narrative running in many economies from Australia to the EU and even in China where the demographics and tax base are problematic. The promises made will be hard to honour without some exceptional productivity / growth boost. Free energy or the growth of AI are both touted as potential game changers but the timing on both and political will to embrace them is uncertain. This in turn raises questions on the dominance of the USD as a reserve currency, which has created a narrative that digital currencies can have a role in anew world order.

Lets get the last part out of the way. Its pretty unlikely that BTC or other digital asset will take that of role of global currency in our lifetimes, the USD dominance may wane and decline but the chance of complete demise is low for a variety of reasons. There is a move to reduce reliance on the USD as a means of transaction for exports between nations in some parts of the world, particularly those unfriendly to the US. For example China, Russia, Brazil and middle east nations have been transacting their respective commodities in domestic currency, indeed even BHP have transacted Iron Ore denominated in RMB and are looking at utilizing blockchain technology. This is where the crossover of the above engages with digital assets and blockchain technology. An alternate system of transacting outside the existing system and structure that is likely going to need to evolve and change, potentially with disruptive outcomes.

The world sits at an interesting juncture. We are likely coming to the end of this interest rate hiking cycle, while we have maybe one to two more hikes to properly ensure we kill off the threat of inflation the reality is that global growth will struggle from here with the high cost of interest. The risks of recession remain elevated, the narrative of soft or no landing seems unlikely to us. In the face of persistent inflation central banks will want to hold rates at current levels as long as they can, but we know from history from the moment that central banks pause they are normally 6-9 months off cutting rates again.

Where does this leave digital assets? The macro backdrop is the only narrative that really matters now and the next catalyst for a bullish move in risk assets is reliant on a rate cutting cycle, which seems unlikely to commence quickly. The debt ceiling issue has been resolved and kicked well down the road so that tail risk has dissipated however the large issuance of bonds and bills by the treasury will draw capital away from all other assets including digital. There remains hope that the regulatory situation will become clearer with bills being prepared to be presented to the US house and congress in June. The expectation we have is that the markets will remain trading sideways for the foreseeable future.

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