Crypto's Race Against Time

One of the things that makes the crypto world so interesting is that the whole movement is supported by a great unanswered question. There's this unfulfilled promise behind crypto, one that happens to be really consequential to our economy, our institutions and our way of life. The question is this: will crypto fulfill its ultimate promise and become the centerpiece in a new financial world order? Serious stuff. No wonder crypto has so captivated our collective attentions.

I am starting to believe that the answer to this question is going to come down to a kind of race against time. There are two forces out there that are ever-present threats to the ultimate viability of crypto:

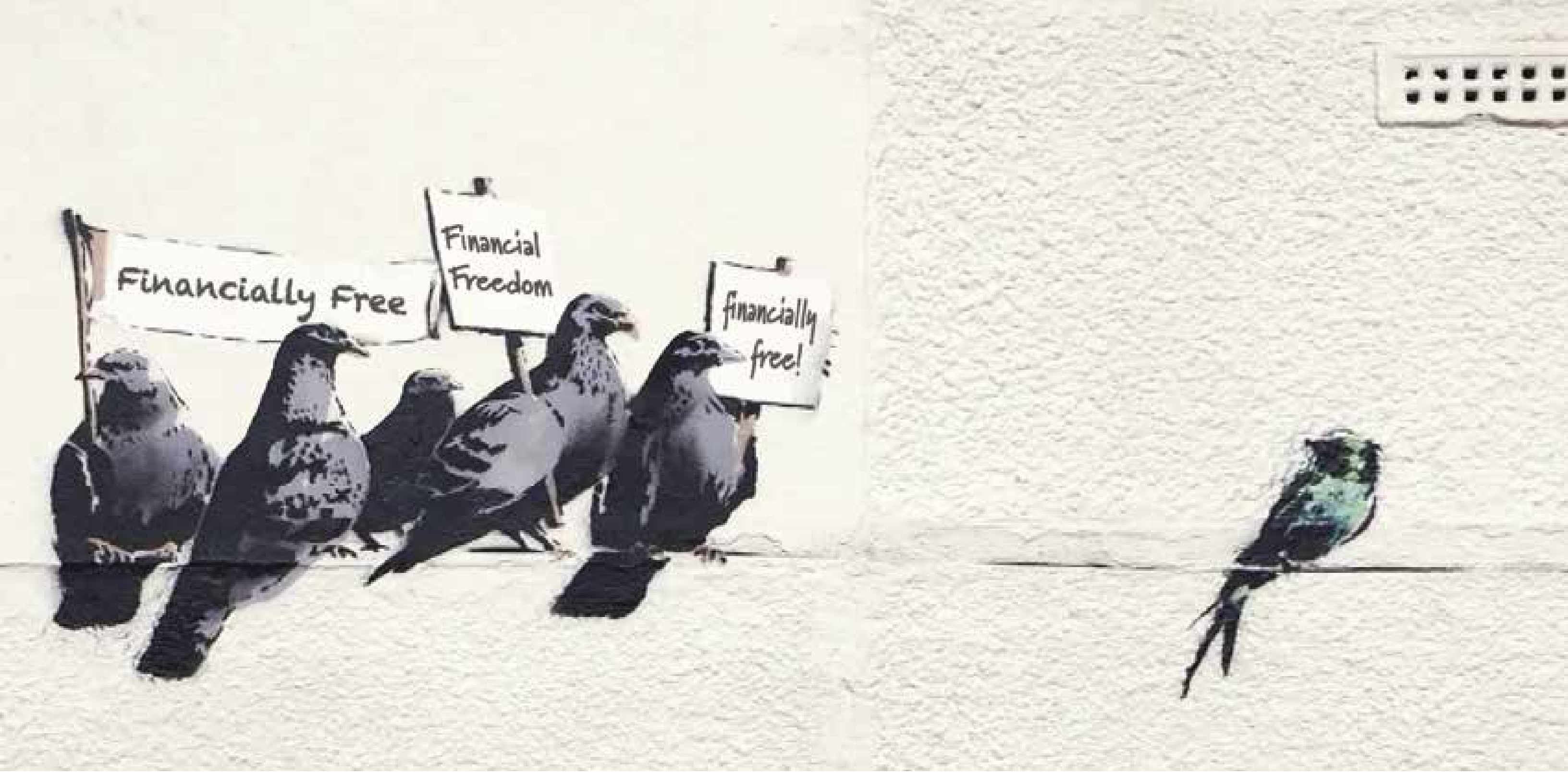
1. The threat of regulation and
2. The risk of some kind of speculative self-implosion.

Either one could destroy crypto. Don't believe the hype you see on Twitter. Despite what these Bitcoin fanatics are saying, I don't think there is anything inevitable about this at all. We've already seen a major world power—China—move very aggressively against cryptocurrency. Predictable perhaps but certainly not the last we'll hear on this. Cryptocurrency is a direct threat to state power and a challenge to the most powerful entrenched interests in human history—i.e. big banks and the Wall Street.

My own working hypothesis is that the world seems to be evolving to a kind of bipolar situation where in some places citizens will retain financial freedoms and in others they will not. Cryptocurrency is at the core of this. Thus far, America seems to be content to allow cryptocurrencies to exist so long as their citizens pay taxes and, of course, don't use it break any pre-existing laws. The Chinese, on the other hand, are pursuing a different strategy based on the idea of a Central Bank Digital Currency (CBDC).

In many ways a CBDC sounds like a good idea. With it, you could instantly stop all financial crime and money-laundering. You could ensure that everyone pays their taxes. Regulation would be easier—you could just stop people from buying products or services with a flick of a switch. It would make it easier to distribute stimulus funds, welfare benefits or even Universal Basic Income. Gosh, with a CBDC you could even execute the crazier aspects of Modern Monetary Theory like Bernanke's idea of helicopter money.

But a CBDC is also incredibly dangerous. Imagine a world in which the government has complete, instantaneous knowledge of your every financial move. Think of the kind of power that would give. What do you do if the government decides to just take all your money? Or freeze your accounts? Anyone who has ever had their credit card or bank account turned off because of a fraud knows what this might feel like. There's perhaps no more potent instrument of state power ever imagined than a CBDC.



Here's the interesting thing, if my theory plays out and we do see the emergence of a world split along the lines of free personal finance versus state-controlled finance, I think crypto becomes that much more valuable. Think about it—what does it signal when a state decides to ban crypto? Doesn't it just basically prove the whole point? States that ban crypto are doing so precisely because they are afraid of the freedoms it provides to the individual. For huge segments of the global population, financial freedom will become this increasingly scarce, sought-after thing. And like all desirable things that become scarce, its value will increase. Crypto will benefit from this so long as it remains an effective outlet and expression for financial freedom.

So, in my opinion, regulation isn't so much the threat right now. It might even be an opportunity. In fact, intelligent regulation—yes, I know those two words don't usually go together—could be a big positive for crypto by reducing some of the fear associated with the industry. To be sure, regulation could someday be an existential problem but that would take a pretty dramatic reversal of political sentiment here in the US and the rest of the democratic world. That leaves us with the other big risk: the possibility for speculative overreach.

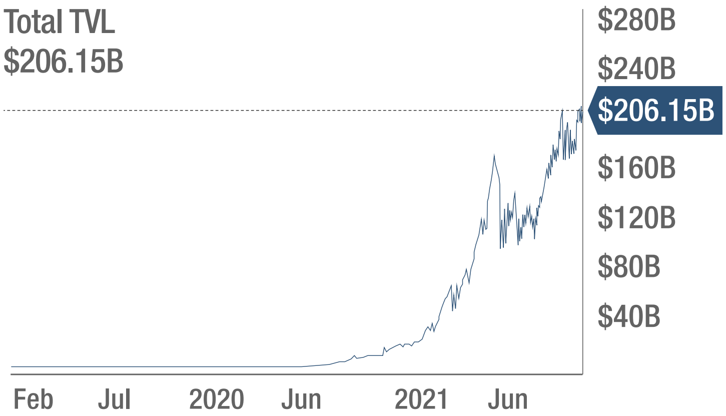
Disclaimer: Before we get too far into this, remember, I am someone who is already long crypto and both very bullish and optimistic about the long-term potential here. Don't cancel me just for suggesting there might be some problems with and downside to crypto! Look, I just don't want to allow myself to make the mistake of refusing to consider the other side of this trade.

In my mind there is no question that the biggest risk to the crypto story is that it destroys itself in some kind of speculative self-implosion. Like it or not, speculation is absolutely rampant in the industry, as-is shady and morally questionable behavior. And it's not the obvious stuff like money-laundering, hacks and ransomware that are the problem. The real problem is that we're seeing a lot of the fraud-like behavior normally associated with things like Jordan Belfort's penny stock schemes. We're seeing insider trading, frontrunning, and other forms of market manipulation. We're seeing excessive leverage. In other words, the crypto world today probably feels kind of like the stock market of the 1920's before we had the Securities Act, investor protections and the SEC.

Crypto's race against time is essentially a question of whether it can become sufficiently useful in the real world before it destroys itself via speculative mania. Today there are three important fault lines we need to keep a very close eye on: DeFi, NFTs and Stablecoins.

Let's start with Defi. The real-world commercial promise here is enormous. Our banking sector has become very unwieldy and increasingly frustrating. Who in their right mind wants to go to a bank branch to try to conduct business? Or a car dealership to finance a purchase? Or try to send money overseas from a Western Union? These consumer experiences are legitimately terrible. There are huge opportunities in everything from payments and remittances, to consumer loans and credit cards, to auto and home loans. It's hard to imagine an industry in more need of disruption and innovation.

DeFi Staking is Growing Exponentially



Note: "TVL" stands for Total Locked Value and is a representation for essentially how much money has been staked in the various DeFi protocols.
Source: Defi Llama

But, while the industry is making progress and attracting a lot of VC capital, all that Defi amounts to today is a series of technologies that enable people to speculate in cryptocurrency. DeFi protocols today are all about facilitating liquidity in emerging crypto. So, with the DeFi that exists today you can lend and borrow crypto (see e.g. MakerDao, Compound, Aave, dyDx). You can trade crypto tokens on automated exchanges using smart contrast (see e.g. Uniswap). You can create and trade derivatives (see e.g. Synthetix)...

Look, there's no question these are exciting developments but, at the end of the day, what's happening here is that people who already own crypto are using DeFi apps to try to earn yet more crypto. If you look back to the end of the chain in a typical yield farming transaction there's no connection with the real economy. It's just someone with existing crypto holdings who is willing to "stake" that crypto (i.e. lend it out in exchange for interest) in order to facilitate the liquidity of yet another crypto token. To me, this kind of feels like what Wall Street was doing with all the CDO's and CLO's back in 2007. Yes, there are all these elaborate financial products and they all look and sound really sophisticated but in the end all that's behind them is a bad loan (or in this case a highly volatile crypto asset).

Let me just reiterate something. I am not a DeFi hater. I'm actually really excited by the potential here but at this moment in time DeFi isn't helping people get loans for houses and cars or helping investors bypass Wall Street's established (rigged) structures. It's simply facilitating speculative activity within the established crypto community and this is dangerous. From what I can tell there's so much cross-staking and cross-collateralization here that a big enough incident (like an outright fraud or hack) could blow the whole thing up. This is something to consider and monitor closely.

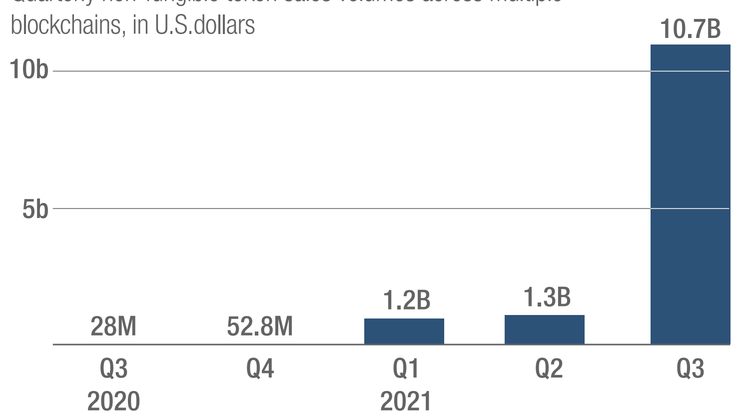
What's happening with NFTs is similar in a sense. It sort of looks like a giant modern manifestation of the Tulip Bubble. People are buying and selling jpeg files that are basically instantly and endlessly replicable for enormous sums. One funny account on Twitter compared this whole thing to the equivalent of a Star Registry. While there is ample historical precedence to the human propensity for collecting (see e.g. baseball cards, stamps, coins, Beanie Babies…etc.) and establishing subjective valuations for art that seem to make no sense (remember that Maurizia Cattelan piece that amounted to a banana tapped to a white canvas that sold for $120K at Art Basel in 2019), I find myself feeling worried about what I'm seeing here.

Of course, it's always hard to know (and maybe impossible) when you are in a bubble. But there's no doubt that there are signs of speculative mania here. Just the other day a new NFT projected dropped called MekaVerse and was up 30x by the end of the day. Not even the internet stocks circa 2000 could trade like this! Celebrities are flocking to the space in droves and anyone involved with NFT's is quick to very publicly signal (advertise) their participation in the movement. If you don't have an NFT as your Twitter profile picture, are you even relevant?

NFTs are clearly having a moment as well

NFT Sales surge to %10.7 billion in Q3 - DappRadar

Quarterly non-fungible token sales volumes across multiple blockchains, in U.S.dollars



Note: DappRadar is a company that tracks on-chain NTF sales across multiple blockchains including Ethereum, Flow, Wax and BSC.
Source: DappRadar

We have already seen one high-profile insider trading and frontrunning case. With the amount of speculative money flowing into this space this is to be expected, I guess. It's a classic case of using confidential information improperly (by the way, illegal with regular securities). An employee at OpenSea (an NFT auction site with a $1.5B valuation) was buying NFTs just before they were going to be publicly listed on the auction site, knowing that what usually happens when they hit the auction site is their price rips higher. Smart but problematic. There's no doubt in my mind that this is happening at scale.

Another shady practice that seems to be rampant is another classic form of market manipulation. Let's say you buy an NFT at minting, want to make a huge profit selling it and have a questionable moral compass. Well, what you can do is create one anonymous account to buy it from your original account at a higher price. Then another and another—all with your own money—until finally the price action looks so compelling that an actual third party comes in and buys it from you for a tidy profit.

With or without shady behavior, the NFT market is a vulnerable place. The whole thing could go up in smoke in a second, like the tulips, simply because valuations are based entirely on human subjectivity. I think ultimately there is something real at the core of the NFT boom. In this emerging AR/VR metaverse world, people are going to want to express their identities in just the same ways that we do in the real world and NFTs are a way to do that. I just worry that the whole thing might crash before the metaverse really takes off.

NFTs may present as this exciting new development in art, expression and personal (digital) identity, a way finally to break the hold of the centralized gatekeepers. There is indeed a revolutionary nature to the whole thing. With NFTs, artists are not so beholden to galleries, producers, labels…. You name it! However, what's happening today looks more like a bunch of get rich schemes than genuine artistic revolution. To be sure, there are some examples of real NFT art but right now these are the exception. You cannot ignore NFTs because there is just too much promise here but be careful not to get caught in its speculative schemes and fevers.

Finally, let's talk about stablecoins. Again, like with DeFi and NFTs, stablecoins have great commercial promise. They have the potential to help in the on/off-ramps between crypto and fiat (which is still a mess) and could be a very useful tool for DeFi and smart contracts in any industry really. Given the volatility in crypto today, it's difficult to intelligently structure real-world contracts and financial products. It's hard to know the value tomorrow let alone months or years from now. Remember from last month all those people who made headlines buying real estate with Bitcoin back in 2017—those were really bad trades! You don't want to structure a contract in Bitcoin, for example, assuming the value is $50,000 per Bitcoin and then wake-up on the day when the payment is due and have Bitcoin be worth half that or two times that. Well, you might but you see the point. Volatility makes smart contracting in crypto challenging.

I think this is one area where the regulators are right to be concerned. The stablecoin protocols are presenting themselves to the market in a very different way than a typical crypto project and should be treated (regulated) accordingly. Here's the point: with the promise of stability comes responsibility. If you are going to keep a peg at one-for-one with the dollar or gold or whatever than you better have one-for-one backing with appropriate collateral. While I have no idea whether any of this is true, there are a lot of rumors out there suggesting that many of the stablecoins are not really backed appropriately.

For example, stories surfaced recently that Tether, the biggest stablecoin out there, had some exposure to Evergrande debt in its supposedly safe collateral. Tether, of course, has denied this but the point is that we don't know. This is where the problem arises. A stablecoin is vulnerable in just the same way as a bank to a good-old-fashioned run (even more so because they don't have the protections of the FDIC and the Fed). What would happen if people suddenly lost faith in the reliability of a Tether? What if everyone tried to cash in their Tether at the same time (which being a digital thing, could actually happen much easier than in the old days) and Tether actually had a bunch of bad collateral? Tether could go to zero pretty quickly. Now imagine if Tether was serving as the backbone of a bunch of DeFi and smart contracts when this happens. What happens to these contracts if Tether is at zero? It doesn't take much imagination to see the potential for a catastrophic cascade effect.

There are rumors out there that this bad collateral story could be even worse than Tether supposedly owning some Evergrande debt. I saw some stories that suggested that some of the stablecoins are using Bitcoin and other cryptocurrencies as collateral (remember these are incredibly volatile) and also lending back and forth between each other to try to manage the flow of entries and redemptions. If any of this is true, stablecoins could be the most dangerous fault line in the whole industry.

So what's the takeaway from all this? Given what we're seeing in DeFi, NFTs and stablecoins, the whole crypto world seems to be locked in this increasingly dangerous race against time. The question is: will crypto blow itself up before it becomes useful enough to the real-world? Crypto is already both real (hard not be with a $2T market capitalization) and useful. But to be really useful to the global economy, to be revolutionary it has to survive this moment in time where it's potential utility still far exceeds its actual utility and where it's promise is still ultimately in the future. It has to overcome the gamblers, grifters and fraudsters. It has to move beyond the speculative era and enter a new, more serious and productively focused phase. In other words, crypto needs to grow-up. ▫