Volatility and Crypto ETFs

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On top of the general selling pressure on risk assets so far this year due to macroeconomic factors, two crypto-specific headlines over the past several weeks have particularly shaken the crypto market.

The first of these events was the collapse of Terra in May. The second was when major U.S. cryptocurrency lending company Celsius Network announced on June 12 that it was halting withdrawals and transfers on its platform.

These recent events have shown that liquidity is an important consideration for investors when investing in the crypto market. Cryptocurrency ETFs can provide investors with a transparent liquidity mechanism in a regulated vehicle, as well as access to institutional trading execution.

Terra

In the first half of May, the Terra blockchain, formerly one of the top blockchains by the market cap of its fundamental token (LUNA),[1] underwent a dramatic collapse. While Terra can be considered a generalized blockchain similar to Ethereum, the Terra blockchain and the ecosystem built around it focused on facilitating the supply and generating demand for its stablecoin, UST.

Stablecoin overview

Stablecoins are cryptocurrencies that aim to peg their price to that of another asset, such as a fiat currency or a commodity like gold. Most major stablecoins are pegged to the U.S. dollar.

Stablecoins can serve as a bridge between fiat currencies and digital currencies on blockchains. They can also be used as collateral on, and to provide liquidity to, various DeFi protocols. Along with the growth of DeFi, the market capitalization of stablecoins has grown significantly over the past two years.

The table below summarizes the major types of stablecoins.

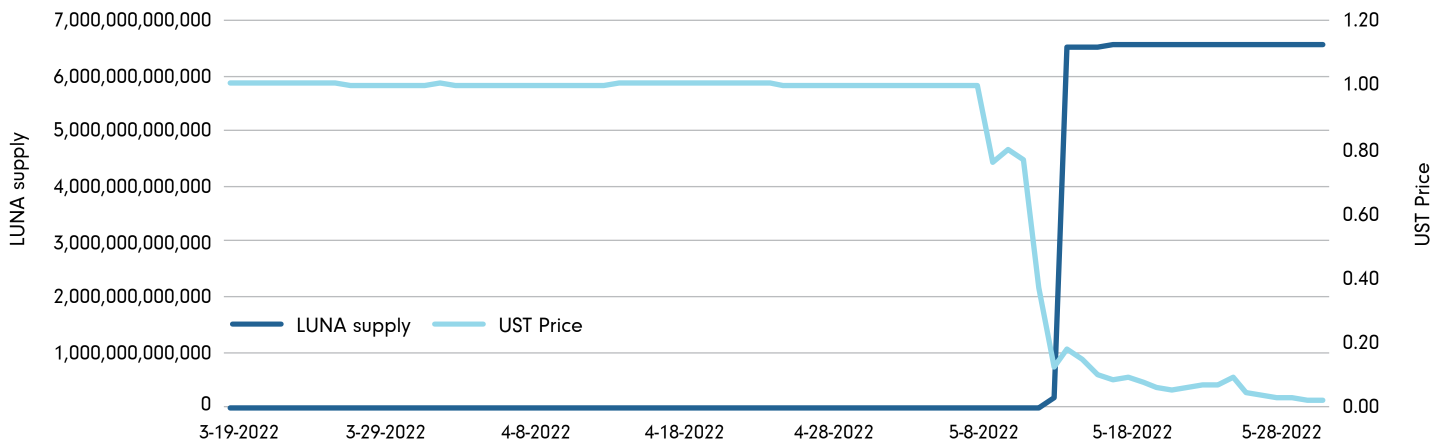
	STABLECOIN TYPES		
Collateral-based	Fiat-backed	Stablecoins are backed by fiat reserves held by a centralized institution. The number of stablecoins in circulation is proportional to the amount of fiat reserves.	
Collateral-based	Crypto-backed	Stablecoins are backed by other cryptocurrencies locked into smart contracts as collateral. Generally, there is overcolllateralization to provide a buffer against volatility in the crypto asset(s) used as collateral.	Decentralized
	Algorithmic	Stablecoins are not backed by fiat or crypto collateral. Aims to achieve price stability via algorithms that manage the supply of tokens in circulation.	Decentralized

1 The pre-collapse blockchain and token, Terra and LUNA, respectively, have since been renamed to Terra Classic and LUNA Classic. However, for the purposes of this article, Terra and LUNA will continue to refer to the pre-collapse blockchain and associated token, unless otherwise specified.

Algorithmic stablecoins, unlike fiat-backed or crypto-backed stablecoins, aim to achieve price stability without requiring large amounts of collateral. UST used a "burn and mint" mechanism to maintain its peg to the U.S. dollar. For example, if demand for UST were to fall, and its price dropped below $1 on the open market, arbitrageurs could buy UST on exchanges and mint (create) $1 worth of LUNA for each UST burned (destroyed), which they could then sell on the open market, and capture a profit. This process would decrease the supply of UST until, theoretically, its price returned to $1.

Recently, however, UST did not manage to avoid what is known as a "death spiral," a well-known risk related to algorithmic stablecoins. Essentially, UST got caught in a loss-of-confidence vicious circle that saw drops in the price of UST, causing more LUNA to be minted, leading to declines in the price of LUNA, leading to further UST sell-offs and price declines.

LUNA (CLASSIC) SUPPLY AND UST PRICE



Source: Messari.

Within a few days, the supply of LUNA went from under 350 million to more than 6.5 *trillion* as the price of UST tanked.

Following the de-pegging of UST, LUNA dropped to $0 within a week, despite efforts by the Luna Foundation Guard (LFG), a non-profit organization established to support the Terra ecosystem and safeguard the stability and adoption of UST, to stabilize the peg. For background, in the months prior to the collapse, the LFG had been accumulating bitcoin and other crypto reserves intended to serve as a collateral reserve to bolster the stability of UST's peg. In the aftermath of the collapse, LFG revealed that in its attempt to maintain the peg stability of UST, it had almost entirely depleted its bitcoin reserves, from around 80,000 bitcoin to 313,[2] contributing to negative price pressure on bitcoin at the time. On May 11, the price of bitcoin fell below $30,000 to its lowest level since July 2021.

Even though UST failed, it's important to remember that there are different types of stablecoins that operate via different peg mechanisms. There are other major stablecoins, namely those that are fiat-backed or crypto-collateralized, that can be used to support liquidity and DeFi activity in the crypto ecosystem. Although UST was the largest *algorithmic* stablecoin prior to its collapse, it was not the largest stablecoin overall: right before the de-pegging, its market cap was around $18 billion, compared to around $80 billion for USDT and $50 billion for USDC. USDT and USDC, both fiat-backed stablecoins, remain the top two stablecoins by market cap and have continued to hold their peg.

2 https://twitter.com/LFG_org/status/1526126703046582272

Celsius

On June 12, crypto markets came under further pressure as U.S. cryptocurrency lending company Celsius Network halted withdrawals and transfers on its platform due to "extreme market conditions", having experienced a rise in redemptions in the wake of the Terra collapse and overall market volatility. This move strengthened rumours of the platform's insolvency.[3] In a posted memo, Celsius stated that it was taking this action to "stabilize liquidity and operations" while it "takes steps to preserve and protect assets." Following Celsius' announcement, crypto prices dived the next day, with bitcoin falling below $23,000, extending a sell-off sparked by the release of U.S. inflation data on June 10, the previous Friday.

Crypto lending businesses like Celsius have gained in popularity over the last couple of years. A crypto lender is analogous to a bank, in that it allows users to deposit their cryptocurrency and earn yield. Crypto lenders generally offer higher returns on deposits than traditional banks, with Celsius offering an annual return of up to around 18%,[4] by deploying user tokens into various DeFi protocols or by lending out tokens to investors and companies for speculation, hedging or other purposes. However, crypto lenders are not subject to the same levels of regulation as traditional banks in terms of transparency, risk management practices, etc., and do not generally have protections such as government deposit insurance.

Celsius' potential insolvency may have repercussions for the broader crypto market, as the firm has deployed significant amounts of assets on multiple DeFi protocols. If it goes into liquidation, the unwinding of its positions could have knock-on effects that result in further price decreases and liquidations for other DeFi users, as well as further eroding confidence in crypto infrastructure. The extent of the impact of Celsius' financial situation on the broader DeFi market remains to be seen. This episode will likely increase scrutiny on investor protection and systemic risks with regard to financial products offered by crypto platforms.

Benefits of an ETF vehicle

Exchange-traded funds (ETFs) can provide investors access to liquidity and price discovery during volatile times, although there are potential risks and drawbacks associated with gaining exposure to cryptocurrency via an ETF vehicle. For example, ETFs may be subject to tracking error, which is the difference between the return an investor receives and the return of the index the ETF is attempting to replicate. ETFs incur fees and expenses (see disclaimer for more detail).

Volatility-inducing events such as the ones outlined above are part of the growing pains and evolution of a still-emerging asset class. Going forward, the value propositions that blockchain technology aims to present – such as decentralization, transparency, and accessibility – may drive further adoption and growth of cryptocurrencies and the blockchain ecosystem.

For investors who believe in the long-term potential of cryptocurrencies, and who wish to maintain exposure to the asset class, crypto ETFs such as Fidelity Advantage Bitcoin ETF (FBTC) can provide investors with a transparent liquidity mechanism in a regulated vehicle, as well as access to institutional trading execution.

3 https://cointelegraph.com/news/celsius-exodus-320m-in-crypto-sent-to-ftx-user-withdrawals-paused

4 https://celsius.network/earn

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