DIGITAL ASSETS OUTLOOK

Wisdomtree EU
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Rising interest rates likely to put pressure on digital asset prices

It is likely that as long as the Federal Reserve (Fed) continues to raise interest rates, digital asset prices will be under pressure. However, at the same time, a large amount of developer activity is taking place, and several large institutions are getting ready and preparing for the next bull market in digital assets. The ecosystem continues to expand beyond Bitcoin and Ethereum but these two assets continue to represent over 50% of the approximately $1 trillion industry[1].

The US 10-year Treasury (UST) yield, a risk-free rate[2], stood at close to 4%[3] in mid-October and rising interest rates, we believe, have impacted the Decentralised Finance (DeFi) industry particularly hard. DeFi was a popular category in late 2021 and early 2022 but has since suffered and DeFi yields have dropped in many cases to below the 10-year UST. Higher DeFi yields are still possible but require complex strategies and more risk-taking.

Ethereum upgrades, cross-chain bridge solutions and NFT-IPR in focus

After a successful move from Proof-of-Work to Proof-of-Stake the Ethereum network will continue to grab headlines in 2023. The near-term future upgrades include the unlocking of Ether that has been staked creating a yield of 4-6% for the owner of staked Ether and "Sharding"[4] which will enable scalability and will potentially also address the high gas fees (transaction fees). Ethereum will potentially be a deflationary asset going forward as new Ether is expected to be issued less (miners no longer receive Ether rewards) and as the Ethereum Improvement Proposal (EIP-1559) implemented in August 2021 led to a proportion of gas fees being burned and permanently removed from the token supply. An area we continue to monitor is the potential centralisation of the network validator community and the threats of censorship this could pose to the ecosystem. Although over 422,000 validators were securing the network pre-merge, four of the largest ones (Lido Finance, Coinbase, Kraken and Binance) controlled over 60% of the Beacon Chain[5].

The digital assets industry, as it is based on code, still continues to suffer from hacks and network attacks and many of them have taken place in cross-chain bridges. We expect to see significant innovation and development activity in this area to make different blockchains interoperable with each other. Two main types of solutions being developed at the moment are cross-chain solutions built directly into the consensus layer of protocols and generalised cross-chain messaging solutions built on top of cross-chain bridges.

We see significant potential in non-fungible tokens (NFTs) in the area of brand and community tokenisation. We are already seeing many creative industries adopting NFTs in the hope of unlocking value in intangible assets, creating digital communities and potentially creating a shared-ownership business model where users of networks can benefit from value accrual in communities and brands. Clarification is needed, however, with intellectual property rights (IPR) of NFTs. At the moment, many issuers of NFTs retain full ownership of the commercial rights to NFTs and this might not be appropriate for all use cases. For the industry to flourish, we believe, it is necessary to address the issue of IPR and be clear about what commercial rights, if any, the buyers of NFTs receive when purchasing the tokens.

Digital assets regulation finally taking shape and paving the way for institutional investors

Digital assets regulation is finally taking shape both in Europe and in the US. This will pave the way for institutional investors who need regulatory clarity to start investing in the ecosystem. In Europe, the Markets in Crypto-Assets (MiCA) regulation is in its final stages of being crafted and will become law across the European Union in 2024 overruling all existing national laws covering crypto markets. In the US, the Lummis-Gillibrand crypto bill called “Responsible Financial Innovation Act” is a first attempt at creating a regulatory framework for the digital assets industry. It is not yet known when, or if, this bill will become law in the US. Both bills focus heavily on regulating the stablecoin market.

Stablecoins are pegged in value to government-issued fiat currencies and could become a bit like modern-day money-market mutual funds easing the transactions between the traditional and digital assets industries. However, there is still some opacity in terms of what kind of assets actually back these stablecoins today. For stablecoins to serve their purpose as a bridge between traditional and digital worlds, they should be backed by cash, Treasury bonds or similar cash-like instruments and not by commercial paper, for example, which is much riskier to hold.

Sources

[1] Source: CoinMarketCap

[2] US 10-year treasury bond is considered “risk-free” as it is highly unlikely that the US government would go bankrupt

[3] Source: Bloomberg

[4] Sharding refers to the act of splitting the network’s data into smaller portions to enhance capacity and improve scalability

[5] Beacon Chain is the Proof-of-Stake blockchain that was created pre-Merge to run in parallel with Ethereum’s Proof-of-Work blockchain

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