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DGAM Trading

# Week Ending Jan 25

| | 1/25/2022 | 1/18/2022 |
|---|---|---|
| BTC | 35500 | 42376 |
| ETH | 2430 | 3160 |
| BTC Implied Yield (Qtly) | 5.5% | 5.5% |
| BTC 1M Implied Vol | 75% | 53% |
| BTC 7 Day Realized | 108% | 37% |
| BTC 1M 0.5 std dev skew | -9% | -2% |

Hi All,
The email tease is “the Suwalki Gap”. Allow me a confession: I only learned what the Suwalki Gap is a few hours ago. I recommend you check out Dr Pippa Malmgren’s article and she is a good Twitter follow, too (as is her father, Harald). She points out that while Ukraine is all over the news, the endgame is focused ultimately on the Suwalki Gap. This makes for a great metaphor. Are the markets making you look in one direction while the real story is elsewhere? This is hard to tell, of course. Markets are very smart and if they tell a different story than the news, then that is worth investigating.

Right now digital assets are very correlated to other risk assets, i.e., stocks, and this has been widely reported. Furthermore, inflation has been in the news. That BTC and digital assets more generally have been both correlated to stocks and falling at the same time inflation is rising, has emboldened skeptics to mock digital assets. But are we missing the bigger picture? Are we missing the Suwalki Gap?

Digital Assets remain a small market. Money flows from larger markets are going to overwhelm any fundamentals going on. This is true for money flows in and out. This is just like any other emerging market. I’ve mentioned Pettis’s book (The Volatility Engine) before and it is particularly relevant for this week. First, money flows out of financial centers overwhelm fundamentals and often drive them. Second, the mechanics of leverage matter as much or more than fundamentals in the short term.

Current correlation is more about monetary policy tightening. Or, to be more accurate, that fiscal policy is replacing monetary policy. This was likely going to happen anyway but covid-19 pushed what was originally spoken about as MMT into full effect. Interestingly, I see far fewer mentions of MMT any longer. Apparently “it” is just assumed now. If this shift continues and I believe that it will, it has the most fundamental impact on investing. Ultimately it means that the economy will take center stage rather than financial assets. Which also means that real interest rates will rise after declining since the 1990s. Rising real rates is not constructive for hard assets. Even if we see actual inflation, rising real rates will be a curb on the price appreciation of hard assets. It

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is the market acting as a discounting mechanism of the future rather than an observer of the present.

Beyond macro considerations, I find the most interesting story in crypto derivatives is that volatility is incredibly muted. Realized volatility has crossed over 100% and ranges are quite high. I was on a telegram conversation where someone asked for a straddle run. With just under 4 days to go, the Friday AM straddle on Deribit was about $2200 after having a one day range of over $5000. It also then proceeded to drop $1000 in a matter of about 30 minutes. Saying a straddle is cheap and converting that into positive PnL are two very, very different things.

Generally this week lines up well for volatility. We have the backdrop of, well, the Suwalki Gap plus the end of a 2 day FOMC meeting tomorrow. Meanwhile, there remains the threat of continued margin call activity. And, to be clear, I'm not confining movement to downside risk. After making such an aggressive move down, it seems to me that a counter trend move could be very sharp. The driver for such constrained option prices appears to be a combination of very popular option selling generally plus option vaults allowing crypto specific option selling from a global supply of money searching for income. Option selling, at least by retail, is viewed as a practically riskless form of "yield". Combined with a far, far smaller options market in crypto makes for option prices that are 1) constrained and 2) insufficiently large to overwhelm the dynamics of the underlying market. Please note that I am not saying they don't impact – QCP has a nice thread on its increasing impact. Still, it is not like traditional finance where the derivatives market is a multiple of the spot market. Unfortunately, I can't recall where I saw the stats. At any rate, feel free to @ me and reply telling me how wrong I really am. I will listen and have been known to, on occasion, learn something new. But I think the stats support this view.

Best,

Ari

Chartbook



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