10x Research

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Newsletter

The Real Deal on Bitcoin ETF Flows Must-Know Facts Unveiled!

Analysis:

Research | Strategy

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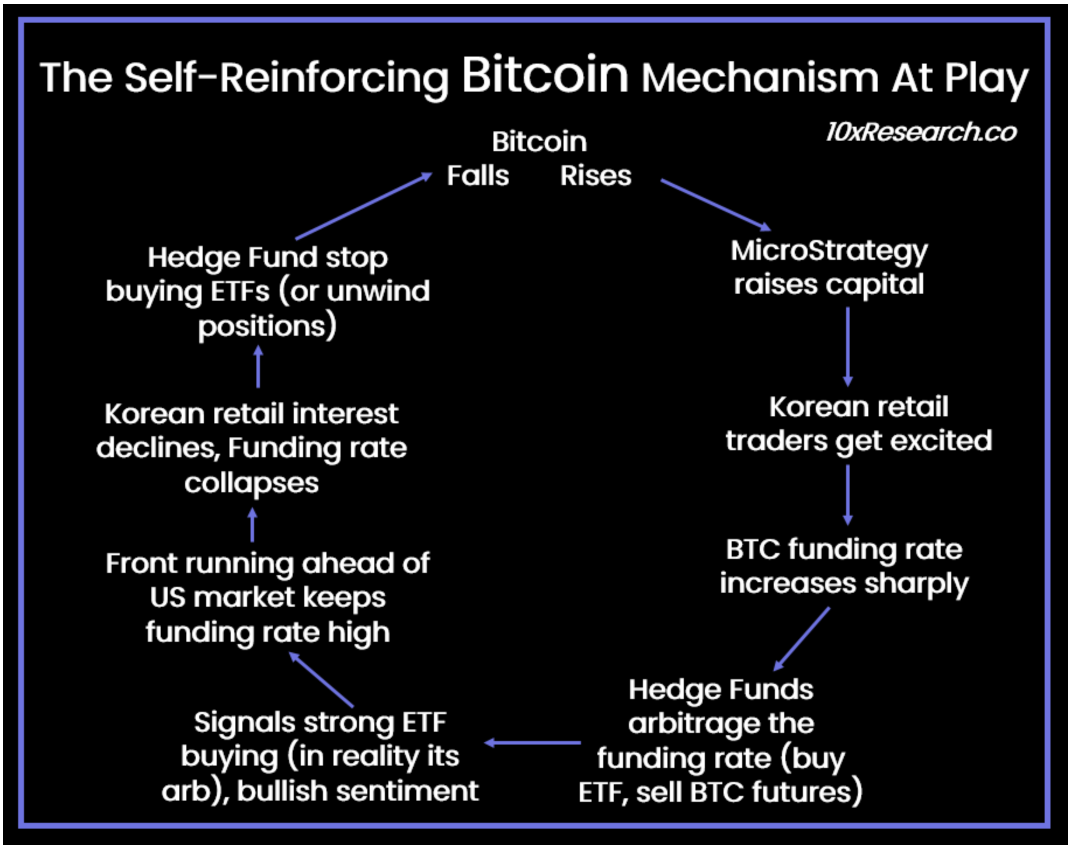
A self-reinforcing mechanism might have caused the Bitcoin rally from 50,000 to 70,000 from mid-February to mid-March. Expectations and inflows might have been artificially inflated, and the quality of those inflows might be weaker than the market currently perceives them to be.

If this is the case, Bitcoin will continue struggling to rally further.

In our report two days ago, we argued that central bankers will likely resist potential rate cuts. Indeed, last night, several regional Fed presidents pushed out their expectations for reductions, and as we argued two days ago, this is negative for Tech stocks and, ultimately, for crypto. The Nasdaq fell -1.4% last night.

Today's report is not about macro (or interest rates); it is about understanding how the self-reinforcing mechanism of Bitcoin ETF inflows might have given a wrongly interpreted bullish expectation for higher prices. This might be the most crucial concept to understand right now and might set Bitcoin's direction for the next few months.

Exhibit 1: Our Self-Reinforcing Bitcoin Mechanism At Play Framework



Source: 10x Research

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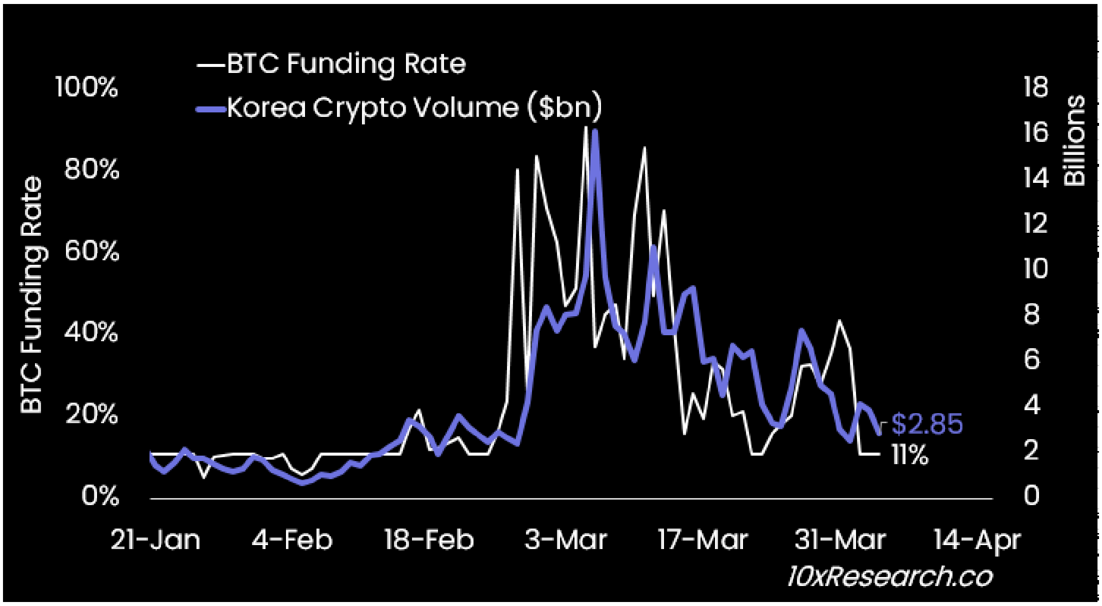
Most investors were surprised when Bitcoin sold off in January, as the outflows from Grayscale's GBTC were more significant on some days than other ETF issuers' new inflows. Commentary from investment advisors and allocators was nearly non-existent that they would indeed allocate capital into those Bitcoin ETFs. Blackrock held a mini buy-side conference in their NY office in late February to revive their clients' interest. Stronger ETF inflows followed.

But it might have been MicroStrategy's various capital raisings that started this rally. MicroStrategy bought $155m worth of Bitcoins from mid-February as an ongoing process. Then, on March 4, the company announced a $600m convertible debt offering that was quickly upsized to $700m.

A few days later, MicroStrategy closed and completed another $800m debt offering. The proceeds were used to buy Bitcoins, and MicroStrategy's shares rallied. At one point, the shares traded at a 120% premium to their Bitcoin holdings or +80% relative to the price of Bitcoin based on regression analysis. The shares have remained mainly overvalued while news flow around MicroStrategy has been quiet.

Exhibit 2: BTC Funding Rate is significantly correlated to trading volumes in Korea



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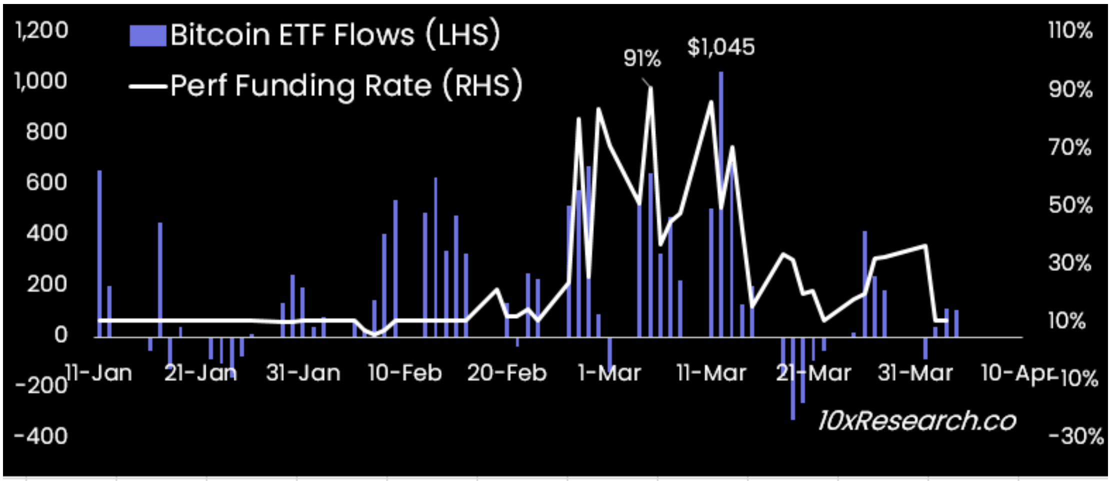
Those Bitcoin buy orders from MicroStrategy's capital raising signaled the exuberant period of this bull market, and trading volumes among the influential Korean retail traders exploded from $3bn to $16bn – twice the US$ volume of the Korean stock market. This caused perpetual funding rates for Bitcoin futures to explode from +10-15% to 50-80%. Of course, other retail traders are at play, but the data set allows us to single them out.

Those funding rates brought in hedge funds, who were willing to arbitrage those funding rates by buying (likely) Bitcoin Spot ETFs and selling those futures (basis trade). There is indeed a noticeable correlation between ETF flows and high funding rates. CME data indicates that although hedge funds were already short 8,000 contracts when the ETFs were launched, their short position has doubled (increase by $2.7bn) vs. $+11bn of ETF inflows.

Exhibit 3: BTC Funding Rate Exploded from late Feb to mid-Mar, so have ETF inflows



Source: 10x Research

Roughly 25% of the ETF buying might have been from funding arbitraging the funding rate with CME futures alone. More meaningful shorts (basis trades) might have been put on through perpetual futures. The key point is that those Bitcoin ETFs are likely accepted as collateral by those hedge funds' prime brokers and can offset some of the futures margin requirements.

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From a signaling perspective, while it appears that there have been strong net inflows into the Bitcoin ETFs, this flow might have been offset through futures selling as the funding rate (for perps) or the futures premium (for CME futures) was sufficiently high for hedge funds to put on delta neutral (buy BTC, sell BTC futures).

As ETF flows are reported daily but futures are not (and are less analyzed), the market has perceived those flows as bullish without realizing that this is only one side of the trade, whereas the other side (futures) is less visible. This explains why most returns have come during European trading hours (front-running the ETFs as long as ETF flow remains strong) and NOT during US trading hours when ETF buying occurs, and ETF buying is offset by futures selling.

When MicroStrategy announced their second convertible bond offering on March 14, not only did Bitcoin prices peak as this self-reinforcing mechanism came to an end, but also the funding rates (or premium for CME futures). With collapsing funding rates, the Bitcoin ETF inflows have almost stopped, and Bitcoin has lost its upside momentum.

Since March 15, net inflows have been only $345m (in total). With funding rates currently at (or less than) 10%—only twice the level of Fed Funds rate (interest rates)—the risk premia that funding rate arbitrage offers might be too shallow for hedge funds to put on more trades, which then causes this lack of ETF inflow buying that the market is currently puzzled about.

However, this ETF buying flow, primarily driven by basis trade arbitraging hedge funds and not by institutions for their long-term holdings, might not come back, which could adversely affect the price of Bitcoin.

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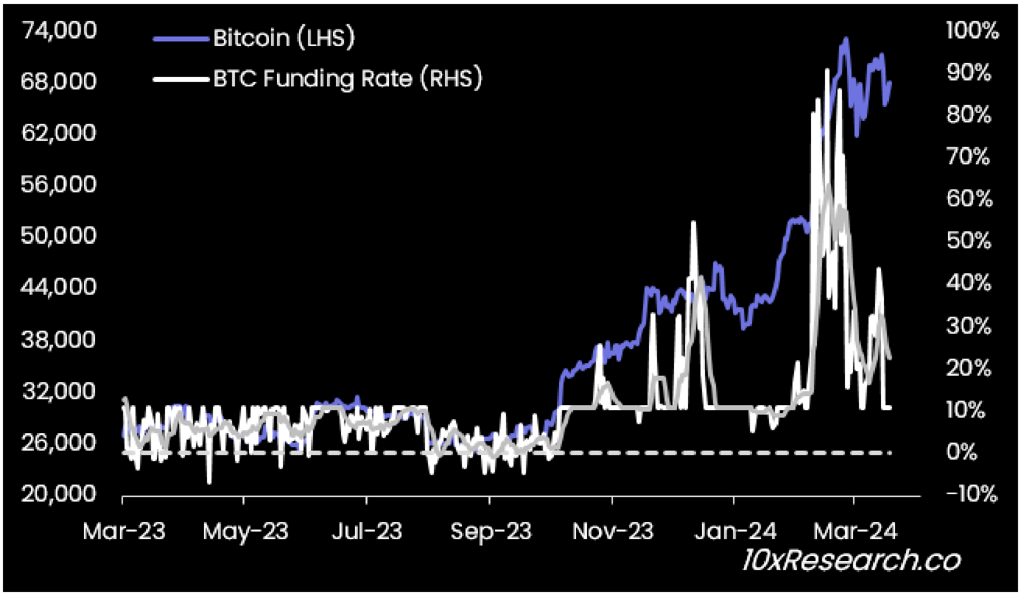
The circle of this self-reinforcing mechanism closes when hedge funds are no longer worth having those arbitrage trades in their books (<20% annualized funding rates due to a lack of Korean retail trading activity). This could occur when the monthly CME futures rolls occur (end of each month), with position unwinding likely to be noticed a week or so before. With the short Easter Holiday week, we saw those ('unexplainable' ETF outflows) occurring a bit earlier - and Bitcoin sold off.

While this is our theory based on our interpretation of the data, we are arguing that Bitcoin ETF inflows have (nearly) stopped as the funding rate no longer offers sufficient arbitrage opportunities. This sets off animal spirits in the opposite direction as flows are no longer interpreted bullishly. The self-reinforcing mechanism will likely continue to lead to low ETF inflow data (if not outflows) as trading volumes and the funding rate remain low.

Exhibit 4: BTC Funding Rate Blew Out (Bullish) - But Has Now Collapsed (Bearish)



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