



ALPHA BOOK

DECEMBER 2022



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THE FEAR TO END ALL FEARS

More fear? Yes, please. It may be the fear to end all fears, writes Sander Kok. He believes we are witnessing the antipode of peak euphoria while the BTC price is looking attractive at the \$16,000 handle. That said, we may all agree that the near future for crypto has rarely looked more menacing, so now may not be the time to "load that musket to the brim with every last grain of gunpowder". It seems best to "split it and shoot twice." You can read all about such considerations in this month's market essay.

In this issue's deep dive, our analyst Paul Hoffman writes once more about modular blockchains and explains why their future is brighter than that of monolithic ones.

And as always, on page 4 we are holding ourselves publicly accountable for our earlier calls – whether they were good or bad. The crypto space can use some more accountability, we thought. Lifting the veil: our calls turned out well until a black swan named Sam Bankman-Fried came along.

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Appchains don't make sense, writes Dirac. He raises six fundamental objections.


KEY INSIGHTS

- ③ Although the bear case looks stronger than ever, we are currently bullish BTC and bought at an average price of a little under \$15,900.
- ③ We are seeing signs of seller exhaustion and an increased lack of weakness in BTC.
- ③ Fear levels have rarely been higher. We believe we are witnessing the antipode of peak euphoria while BTC is at juicy levels and is finding support. Peak emotions in the market tend to collapse into their counterpart.
- ③ If Grayscale is not forced to unwind their trusts, crypto will have doom dispersal on top of seller exhaustion – a potent mix.
- ③ If the worst happened and Grayscale was forced to sell their hundreds of thousands of Bitcoins and Ethers on the market, we expect the crash to leave an outsized wick on the BTC chart towards \$8,000-\$10,000. Though bad news for leveraged bulls, the event would mean a fantastic opportunity for spot buyers with money on the sideline. A Grayscale-induced crash would be a temporary problem, not a fundamental one.
- ③ Our report on monolithic, modular, and semi-modular blockchains suggests a bright future for fully modular blockchains. Our analyst is convinced that modular tech beats monolithic tech on a long enough time horizon. As to when to invest, new tech is often embraced with much excitement, which tends to wear off – particularly once the first hiccups occur. It seems best to wait for that to happen before investing, as the chances of hiccups are high with all new and ambitious projects. The price for exposure will be much lower after that happens.

PERFORMANCE CHECK: HOW DID WE DO?

Accountability isn't the most poetic of words, but we think crypto needs to hear it more often. Each month, we look back at the calls from our previous issue. We are, to our knowledge, the only research company to do so, hoping more people in the space will follow.

- 1 First, we did not see the FTX insolvency coming – just like everybody else. Once that black swan event occurred, all bets were off.
- 2 We were right to forecast that Nasdaq had bottomed and that risk was going back on. But although our bullishness was correct, the FTX debacle meant none of our targets were reached, except for SOL's.
- 3 We were correct to long SOL as the market indeed turned out to be poorly positioned for the Solana conference. Price went up 29% in a matter of days. It also was a sell-the-news event, as we had forecasted.
- 4 ETH turned out to be much stronger than BTC, as we had forecasted, but, owing to its high beta, it dropped deeper once the FTX news broke.
- 5 We were right to keep the LUNC short open as a hedge against our BTC, ETH, and SOL longs. The price dropped 53% after reaching a local high on November 5th. (We are now fully out of the short.)



CRYPTO IS WAKING UP

After a lull, November is shaping up to become a volatile month. Our market analysis discusses the bullishness that's slowly returning in crypto land. Are we in for an earth-shattering bear rally? We also talk about which assets we are long and which we are short, and what's in store from Solana. The company behind the layer 1 has information to disclose about Saga, its ambitious phone project.

In this issue's deep dive, our analyst Paul Hoffman discusses a topic every serious crypto investor should get familiar with sooner rather than later: the differences between monolithic, modular, and semi-modular blockchains. What are the trade-offs? And what does the future hold? Is now the time to place your bets?

What else? Well, just as in our previous issues, we are holding ourselves publicly accountable for our earlier calls – whether they were good or bad. Last issue's calls turned out pretty well. Nothing in Alpha Book is financial advice, but let's just say we hope you coincidentally made some money after reading our strategies and analyses. Sell the Merge, then buy back, we said. Short LUNC. It went pretty well for us. We hope you did equally well or even better.

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FEAR IS HERE

MONTHLY MARKET ANALYSIS – READING TIME: 7 MINUTES

By Sander Kok



Figure 1: Bitcoin's 3-monthly chart. We are showing the linear type to reveal the full extent of the destruction.

Fear is back in the market, dear reader, and that's great. I'm not being sarcastic. Fear this widespread always comes with the best trade opportunities and, counterintuitively, with the lowest downside risk, especially if the price has already gone down and is finding support. To any sensible trader, fear should just be another word for priced-in. Does this mean we feel comfortable enough to long? No. But our feelings don't matter. We bought a bunch of Bitcoin regardless, with 45% of our filthy fiat.

Our average entry is a little under \$15,900. We plan to add to this position if the widespread fear appears misplaced. We will reduce it if it doesn't. Before I go into details, let's look at the bear case.

The trend on the chart is still down only. Just when we could reasonably expect some mean reversion to the upside – if only on the coattails of other risk-on assets as the Fed began to sound less hawkish – FTX blew up and Genesis in its wake. Now the latter's parent company DCG is in trouble, which may lead to another DCG subsidiary, Grayscale, having to sell hundreds of thousands of Bitcoins and Ethers. And there is more. At the time of writing, the S&P recovery is losing steam as it nears resistance, Chinese production seems to remain slow due to ongoing covid restrictions, and fresh rumors of crypto contagion are now daily. Miners may soon capitulate – again. And lastly, who is left to buy? Degens had their accounts wiped long ago, while more conservative players got rinsed at FTX, the most reputable exchange that ever was. Institutionals won't touch crypto with a stick. Over the past eight days, an average of \$350 million stablecoin got redeemed *every day*, meaning less order book liquidity and less money on the sideline to bid.

You have to be sick in the head to declare yourself a bull in these conditions. The bear case is clear-cut. It is easy to understand – and therefore easily reproduced. Just check Twitter. With some poetic license, you could say the

production and shipping costs of the bear case are low, so we see it everywhere. The crypto bear case is like a Billy bookcase.

The bull case is more complex and takes a bit longer to explain. It is, therefore, less easy to reproduce, which is one of the reasons why we don't see much of it on crypto Twitter.

One reason to be bullish – or at least, to not be bearish – is fear. I started this article by saying fear is great for bulls. The more widespread, the better, especially after the price has collapsed and support is being found. If the fear is here, it is typically time to long. If the fear weren't here, it could show up, and prices would go down. If the fear is already here, at least a part of what is feared is already priced-in, meaning the current price may be unfairly low.

Fear is not the only reason we longed, though. The main reason, outrageous as it may sound, is strength – or let's call it lack of weakness. As we wrote last month, a patient's health is best measured by the suffering he can endure. The markets endured tremendous suffering even after the FTX collapse, without falling much deeper. Apart from Satoshi Nakamoto showing up, it's hard to conceive of any more hair-raising news than DCG considering unwinding Grayscale's GBTC and ETHE. Since we had already broken technical support after the FTX collapse, we should have gone down tens of percent. But all bears got was a measly 7% drop.

Why? Here is a theory. Being in crypto can be similar to being in a fight. Once you've taken a few blows, you stop feeling them. This may have been happening to whoever is still left in the ring. Even if crypto investors take more punches to the chin, they can hardly get any more scared than they are now. Neither will they have much more blood to give. Hence the measly 7%.

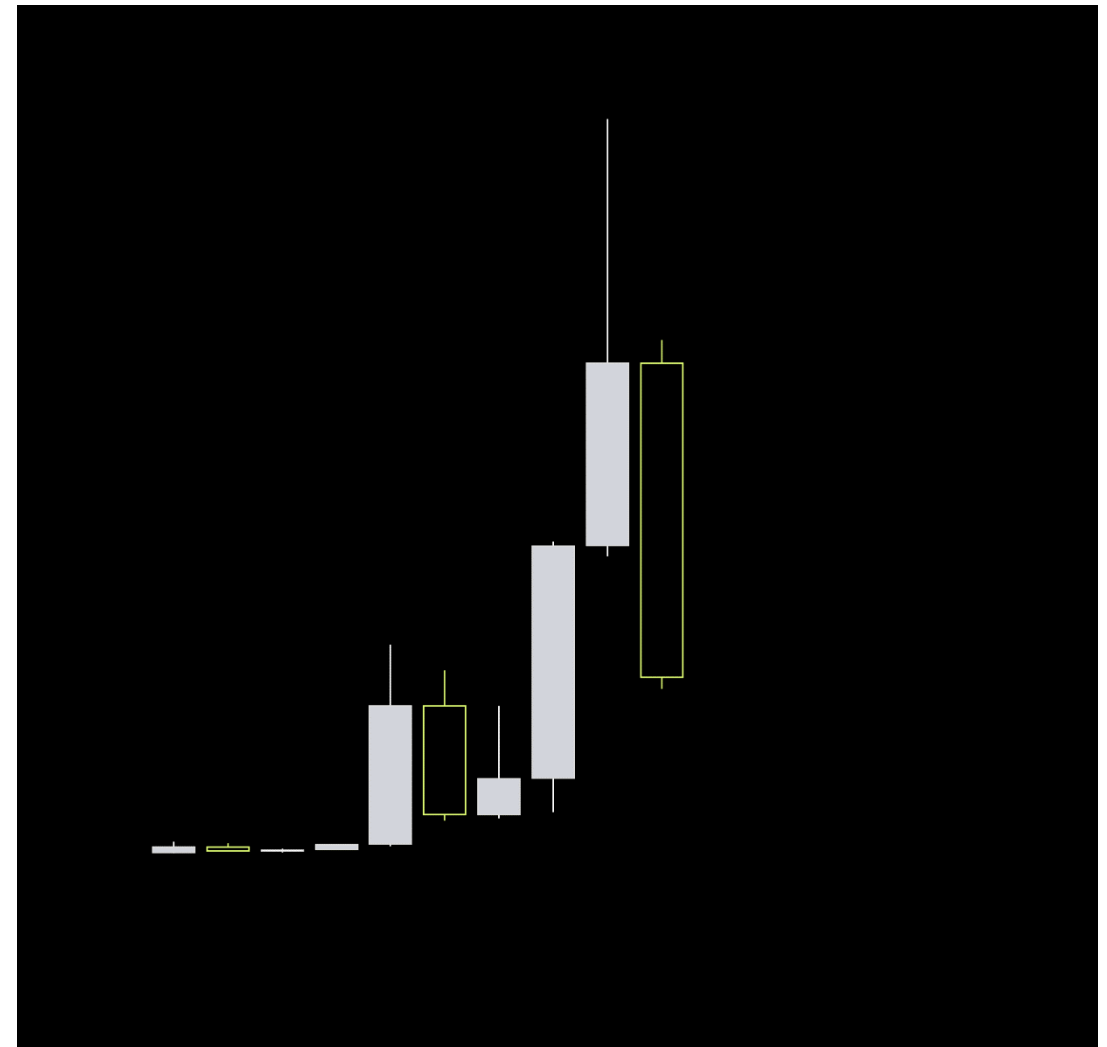


Figure 2: Connoisseurs will recognize this modern art masterpiece as BTC's yearly chart.

With that lack of weakness in mind, let's look at the modern art masterpiece on the right (Fig. 2). Connoisseurs will recognize it as BTC's yearly chart. We can agree that it doesn't inspire any lust for shopping. But who in their right mind would sell here if they believe in Bitcoin's long-term value proposition? Mind you, that drop is 77%. The question is particularly relevant for long-term investors. Mathematically, Bitcoin can fall another 99.9%, but realistically, how much deeper than today's price? Bitcoin's narrative as an immediate inflation hedge has thus far failed. But that's far from enough to declare it



Figure 3: Although it is much too early to call any decoupling, BTC's correlation with the S&P broke on November 28 and stayed broken up until the time of writing. It is worth keeping an eye on.

legally dead. Neither is the inflation hedge narrative Bitcoin's only value proposition. And equally important, the air left the bubble long ago; there is less and less for shorters to profit off. We will likely see new big shorts if sentiment changes. But those big shorts would be short-lived.

In fact, if you believe Bitcoin will come back as it did before – where would you buy if not around these levels? Lower, you say. Because of DCG. That makes sense. There is a small chance DCG's Grayscale unwinds its GBTC and ETHE trusts, and Bitcoin and Ether will drop like a brick. This is fair – in that calamitous scenario, you would get to buy BTC for \$8k-\$10k. But is that a reason not to buy here, as well? Why load that musket to the brim with every last grain of gunpowder if you can split it and shoot twice or thrice? I am not trying to convince anyone – this is to show how market participants might start to think as we build support by not going down or even by going up. Those who aren't on board now may come on board later. This is particularly relevant if you take into account the large chance that Grayscale does not unwind its trusts. In that case, we'll have doom dispersal on top of seller exhaustion. A potent mix. At the risk of sounding like an altcoin moonboi: that's rocket fuel.

One could object that macro should also look decent. Sensible as that may sound, I disagree. Idiosyncratic momentum would be strong enough if the above came to pass, especially if correlations with legacy markets continue to drop (Fig. 3). Only if macro looks nothing short of horrendous precisely during the days of any good Grayscale news do I see it mess things up. But if macro doesn't give us anything worse than the bleakness we're already used to, crypto bulls should finally see their coins mean revert to the upside.

Will we reach all-time highs? Absolutely not. For that, we do need macro to clear up. But \$24k-\$25k shouldn't be out of the question. That would be the

top of the channel we were stuck in last summer when contagion fears finally abated (Fig. 3). We can see BTC reach those levels if the Grayscale problem is solved. If it doesn't get solved but doesn't turn out to be as bad as it seems now, the pre-breakdown level of \$19k will likely be the best bulls can hope for. If BTC closes convincingly above that resistance, I expect more conservative buyers to step in.

To summarize, we bought long-term spot based on lack of weakness, ultra-high fear levels, and lucrative R:R. In the coming months, we will need to remain nimble enough to exit our position if any bad Grayscale news hits and be particularly vigilant during US hours. After all, it is unwise to hold onto a long-term investment if you can get out when market-shattering news hits. We also need to realize that finding out we are wrong does not merit hitting the panic button if the price has already reached much lower levels by then. Panic is -EV. Sure, if Grayscale unwinds its trusts, we are in big trouble, and short-term traders would instantly take the price much, much lower. But those sellers would trade on a short time horizon. Investors and spot traders would only want to sell in order to buy back lower, and derivative traders would eventually have to close their shorts by longing. It will be a temporary problem, not a fundamental one.

For that reason, if Grayscale doom came upon us, I expect the crash to leave an outsized wick. Lots of leverage will be wiped, not just on centralized exchanges but also in DeFi. It will be a spectacle to behold and a fantastic opportunity for those with money on the sideline. Hence that "mere" 45%. We want to keep enough dry powder in case providence treats us with a generous wick.

Another reason is the plethora of other bearish catalysts that may be upon us. The current spinetingling threat of contagion probably won't stop with

DCG. Nexo and Crypto.com could be next. And then there is good old miner capitulation (Fig. 4), which is always around the corner in times like these. The chart below shows a bearish cross on the hash ribbons, which typically indicates capitulation will be with us anytime, on top of the current sell pressure from miners.

More fear? Yes, please. Bitcoin is at juicy levels, and we are witnessing the antipode of peak euphoria. ♦ Sander Kok



Figure 4: A bearish cross on the hash ribbons typically indicates miner capitulation ahead.

DEEP DIVE | BLOCKCHAIN TYPES

READING TIME: 8 MINUTES | By Paul Hoffman

Monolithic blockchains, modular blockchains, and layer 2s are 2022's crypto buzzwords. But what is a monolithic blockchain, and how is it different from a modular blockchain? Isn't a modular blockchain just a monolithic blockchain with a layer 2? In this article, I unpack these concepts and review how they relate. I propose a more closely defined and specific definition of monolithic and modular blockchains, and I propose that a blockchain with a layer 2 stack is not a modular blockchain but a semi-modular blockchain. I will also briefly describe the Celestia blockchain and demonstrate that a native modular blockchain has properties a semi-modular blockchain does not own. This fact underlines the important differentiation between a modular and semi-modular blockchain. Finally, I will provide an actionable investment thesis regarding modular blockchain architecture.

Bitcoin is a monolithic blockchain. It means that consensus, the execution of transactions, and the blockchain data all live on the base layer. Every single transaction, including the mining and broadcasting, happens within the main Bitcoin blockchain architecture.

A modular blockchain is fundamentally different. It is designed so that separate elements of the architecture – say the consensus and data availability logic – occur in one part of the architecture, and other logic occurs in another. This design allows for high transaction throughput, for example.

A semi-modular blockchain is a blockchain such as Ethereum, which was initially designed as a monolithic blockchain, but with the addition of a "layer 2", has taken on certain aspects of a modular blockchain. This is because

certain elements of the architecture do not live on the main chain. However, given that the main chain, also known as "layer 1" still encompasses all the required blockchain architecture, Ethereum should be considered a semi-modular blockchain. I will touch on this point in more detail below.

The blockchain trilemma

First, to demonstrate the significance of monolithic, modular, and semi-modular blockchains, layer 2s and blockchain architectural design, let's come to grips with the blockchain trilemma. This term was coined by Vitalik Buterin and describes the fact that every blockchain must weigh the importance of three fundamental principles: scalability, security, and decentralization.

Summarizing: scalability refers to how much a network can grow in the future while maintaining similar transaction speed and output. Security is about how safe a blockchain is against hacking or social coercion (controlling >51% of the network), and decentralization refers to how many nodes/miners can effectively contribute to the safety of the blockchain.

Let's touch on a few examples. Bitcoin is very secure and highly decentralized, but it is very slow. It is secure and decentralized because everyone can run a node and because the total computing power allocated to Bitcoin is considerable (it's in fact the most powerful computing network in the world) and because of this high level of decentralization and

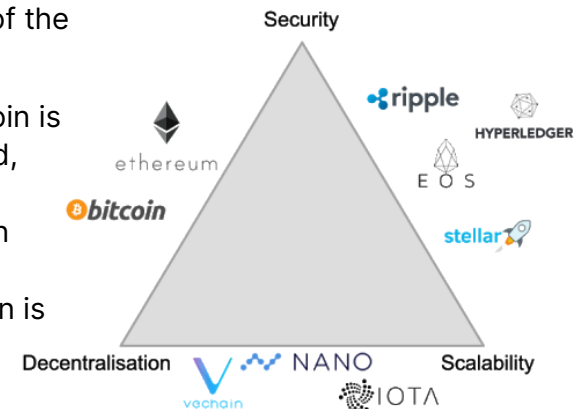


Figure 5: The blockchain trilemma is not new, as you can tell by this nearly five-year-old image. (Courtesy Quai Network.)

computing power allocation, it is practically impossible to 51% attack or socially coerce.

The downside to Bitcoin is that it's slow and thus not scalable. Its network gets congested as usage increases. This scalability issue is equally real for Ethereum. By extension, the lack of scalability comes with the same downside. Whenever the demand for Ethereum transactions grows, the network becomes slow and expensive – the latter caused by the increased competition for block space. Hence it does not scale.

A network such as Solana, on the other hand, is highly scalable and secure, but many times more centralized. Its scalability and security come from its Proof-of-History consensus protocol. Long story short, such a consensus protocol makes the blockchain very fast, but it requires a lot of computing power. Given the setup costs to fulfill this requirement, Solana's decentralization is vastly inferior to Ethereum's.

To put this perspective into numbers. Solana currently sits at just over 4,400 transactions per second and 2,094 validators. On the other end of the spectrum, Ethereum has more than 422,000 validators but averages out at roughly 10 transactions per second. Transactions on Ethereum can cost up to \$20 (currently \$0.80), while Solana's are a mere \$0.00025.

The Solana and Ethereum comparison demonstrates that monolithic blockchain architecture has to weigh the importance of scalability, decentralization, and security, given that one may come at the cost of another.

Enter Layer 2

A solution to the blockchain trilemma is introducing a second layer to the monolithic blockchain. You could consider this a second blockchain running

on top of the first blockchain. (This is not 100% factually correct, but it helps build a mental map of the layer 1/layer 2 architecture and the relationship between these.)

Adding a second layer is desirable because the layer 2 can have different blockchain trilemma priorities. The first layer can prioritize security and decentralization, while the second layer can prioritize speed. Take Ethereum's layer 2 solution Arbitrum, for example, which is capable of 4,500 transactions per second but has no built-in decentralization mechanism. However, the combination of Ethereum as a layer 1 (decentralized and secure) plus the Arbitrum layer 2 (scalable) effectively does away with the blockchain trilemma. The layer 1 and 2 architecture combo is simultaneously decentralized, secure, and scalable – no trilemma.

There are, however, two significant trade-offs. First is the concept of the bridge. A bridge is what connects the layer 1 to the layer 2. To use the layer 2, you must first send some crypto tokens from the layer 1 to the layer 2. Then, once you've finished working on the layer 2 and wish to use the tokens again on the layer 1, you must send them back. The sending back and forth takes time – on Ethereum, bridging from the layer 2 to the layer 1 takes up to a week. In a world where time is money, this is not desirable. Bridging is also a confusing and challenging user experience.

The second issue is ecosystem fragmentation. Arbitrum isn't the only layer 2 on Ethereum; there is also Optimism, dYdX, Loopring, and a host of others to consider. And given that some applications live on the Ethereum main chain, and others live on Arbitrum or Optimism, the Ethereum ecosystem is more fragmented than if all applications were to live on the main chain. This fact is significant because fragmentation is undesirable in a world where network effects determine the success of a digital product.

Therefore, a layer 2 solution is not the ultimate solution; it is essentially a band-aid for monolithic blockchain architecture. To be clear, I am not discrediting the impressive work done to build layer 2s; the point I'm making is that adding a layer 2 to a monolithic blockchain does not make it a modular blockchain outright and comes with real downsides, contrary to what some have argued.

The native modular blockchain

A native modular blockchain is a blockchain that is built from the ground up with modularity in mind. What do I mean by modularity? Remember that Ethereum has a second layer? Well, a module is a type of second layer, the key difference being that it's directly integrated with the layer 1. This integration means there is no need for a bridge between the layer 1 and the module. In addition, the modules can communicate directly, which means the ecosystem isn't fragmented.

Finally, because the native modular blockchain is built from the ground up as a modular blockchain, it is not encumbered by legacy architecture. To understand the significance hereof, I will briefly explain three more concepts – execution, data availability, and consensus.

First execution. Whenever someone puts a transaction through or engages with a smart contract it must be executed. On a monolithic blockchain, this happens on the main chain. On a modular blockchain, this happens in a module. The result is a much "lighter" layer 1.

This lightness, in turn, affects data availability and consensus. For a blockchain to reach consensus, all the nodes on the blockchain must have access to the latest data (hence data availability). And given the fact that the layer 1 without the execution element is much lighter, data is propagated

throughout the network faster. This makes a modular blockchain much faster than a monolithic blockchain (and potentially more decentralized).

Furthermore, because the modular blockchain layer 1 can focus exclusively on data availability and consensus, and the modules themselves on execution, each component (module and layer 1) can be optimized more effectively for their respective tasks, which again allows for more scalability, and potentially decentralization and security.

Finally, an important thing to note is that a modular blockchain can circumvent the blockchain trilemma in the same way as the monolithic blockchain can. However, instead of the monolithic's layer 2s, it is the modular blockchain's individual modules that work the magic.

To help make sense of this theory crafting, here is an image of the Celestia blockchain (right). It does a good job of encapsulating the modular blockchain architecture vs. the monolithic architecture (left).



Figure 6: The Celestia blockchain (right) vs. monolithic architecture. (Courtesy: Celestia.)

Note that on the monolithic blockchain, consensus, data availability, and execution all happen on the layer 1, which is intentionally drawn thicker to represent the higher load. Contrast this to the modular blockchain, which has a much sleeker, lighter layer 1 architecture.

Implications

As I have demonstrated, monolithic blockchains with a layer 2 are not modular blockchains. They are semi-modular blockchains at most. The key differentiator is the overall blockchain architecture which allows for the separation of execution, consensus, and data availability. The implications of this novel architecture should not be understated.

Native modular blockchains also enable fully integrated ecosystems of connected yet independent blockchains, each running on their own execution (virtual machines, if you will). Modularity promises increased transaction throughput and potentially higher levels of decentralization and security. Additionally, each module, including the main consensus and data layer, can be upgraded without affecting other elements of the modular ecosystem – true modularity.

Modular blockchains hold incredible advantages over monolithic blockchains. It is a technological breakthrough that I strongly advise you to pay attention to. I must stress, though, that the modular blockchain architecture is yet to be battle tested. We have seen novel blockchain technology – typically bridges and smart contracts – get hacked (socially or technically) countless times, and I firmly believe that a novel concept such as native modular blockchain architecture will experience some growing pains.

Investment thesis

For anyone wondering what I will do to position myself for this technology in terms of financial exposure, I will play a patient game and look for exposure a few weeks to months after release. New tech is often embraced with a lot of excitement, and when that wears off and the first hiccups occur, chances are the price for exposure will be much lower. I give this strategy a high probability of occurrence.

I ascribe a lower probability to the architecture becoming a success with quick and genuine adoption straight out of the box. However, if I'm wrong about this analysis, and key metrics do demonstrate adoption, I will look to increase exposure more quickly. In the long run, I am convinced that modular tech beats monolithic tech.

As always, key players (and their respective token unlock schedules), tokenomics, and business development will play a decisive role when it comes to the question of which modular blockchain project merits exposure. In subsequent articles I will assess several of these in more detail. ♦ Paul Hoffman

UPCOMING EVENT RISK FOR DECEMBER

December
1

FOMC

Federal Open Market Committee: Statement, Rate, and Press Conference

December
2

UNEMPLOYMENT

US Unemployment Rate Released (previous: 3.7%; expected: 3.7%)

December
9

PPI

US Producer Price Index Print (expected: 0.2% m/m; core 0.0% m/m)

December
13

CPI

US Consumer Price Index Print (expected: 0.4% m/m; core 0.3% m/m)

December
14

FOMC

Federal Open Market Committee's economic projections, statement, funds rate, and press conference

December
23

PCE

US Core PCE Price Index m/m. (This is the Federal Reserve's primary inflation measure.)

CRYPTO TWITTER SAYS

"Appchains don't make sense and are rarely a good idea: a quick thread.

Appchains have been an emerging narrative, especially with the chatter around unichain.

However, do appchains fundamentally make sense? I'll make a quick argument that the answer is no.

Argument for appchain is usually based on one of two ideas: 1. Sovereignty: optimize L1 execution environment in order to best serve an app's needs (e.g. DEX swapping). 2. Collapsing Externalities: Force things that used to negatively affect users (MEV, etc) to be neutral.

These are reasonable goals. I'll first argue against unichain and then against appchains more generally.

The case for unichain is primarily premised on collapsing externalities. <https://medium.com/nascent-xyz/the-inevitability-of-unichain-bc600c92c5c4>

The focus is on 1. Swap Fees 2. Tx Fees 3. MEV hidden fees.

Taking each in turn:

1. swap fees will still exist and will be of a similar total level on appchain, so we can consider these unchanged

2. Tx fees are quoted at 23.5bps per trade on Ethereum. This is the wrong benchmark given rollups reduce these fees to be very small...

...so I view this as a red herring.

3. MEV can be reduced but likely not eliminated. The infrastructure will also be newer and less transparent. The MEV being captured by the native token holder does not benefit the end user, only the token holder.

More generally, for a DEX appchain, you have three choices:

1. Trade native assets on your appchain (a small set of things)
2. Trade assets bridged to chain (less secure)
3. Trade assets on other chains via cross chain swapping (slower, more latency! Re introduces MEV)

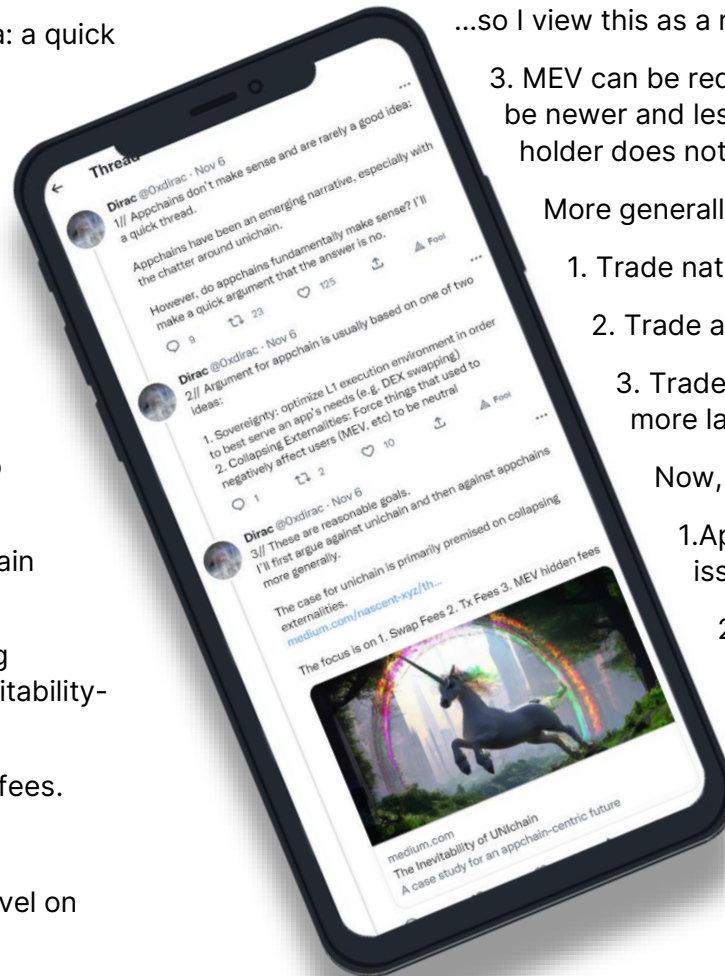
Now, the argument against general appchains (not just DEXs).

1. Appchains require actual bridges, and inherit all of the issues. Unlike L2s which are trust minimized bridges.

2. Lose Composability: no more atomic transactions between different apps!

3. Lose scope: you are restricted to assets/use cases on your chain else you have to make some other tradeoff. Fragment liquidity too.

4. Poor security: using native token for security introduces reflexivity. As your app is used less, it becomes less secure...



...= issues from giving native asset a special risk position (Mango hack, Terra, etc)

5. May have to redevelop simple infra like block explorers, dev tools, etc

6. Centralization: appchains will likely be decentralized validation but centralized upgrading, sequencers for MEV

so do appchains ever make sense?

app specific L3s often make more sense than appchain L1s. Many of the benefits with less tradeoffs.

Other things that make sense: ecosystem chains like Sei or Osmosis which are chains dedicated to a specific general use line DeFi..."

—Dirac (@Oxdirac)

Dirac works for GoldenChain and for UXD Protocol.

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We're hiring! Shoot a message to sander@captur.fi if you believe you can write the best analyses out there.