Crypto turmoil intensifies as major fund defaults

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The turmoil in the crypto currency market has intensified with the announcement on Monday that the prominent crypto hedge fund, Three Arrows Capital, had defaulted on loans worth a total of $670 million.

The money is owed to the digital asset brokerage firm, Voyager Capital, which issued a notice saying Three Arrows had failed to repay a $350 million loan in the stablecoin USDC as well as about $323 million worth of bitcoin.

Three Arrows’ troubles flow from the crisis in the crypto market that erupted last month when the so-called stablecoins TerraUSD and its sister stablecoin Luna collapsed leading to losses of billions of dollars.

Stablecoins were touted as providing stability for the crypto market because they were supposedly pegged to the US dollar and functioned in a way analogous to chips in a gambling casino that could be cashed in at full value. In May, however, they fell below dollar parity.

Three Arrows had invested heavily in Luna which fell to virtually zero.

As warnings of the impending Three Arrows default spread last week, attention was directed to Voyager Capital with its shares falling by more than 60 percent last Wednesday.

Following the confirmation of the default, Voyager issued a statement aimed at trying to contain fears of contagion throughout the crypto market. Overall market capitalisation has plummeted from $3 trillion last November to around $900 billion—a loss of almost 70 percent.

Voyager CEO Stephen Ehrlich said the company was “working diligently and expeditiously to strengthen our balance sheet and pursuing options so we can meet customer liquidity demands.”

The contagion fear results from widespread borrowings by Three Arrows, one of the largest crypto asset hedge funds, from a range of companies to finance its investments across a number of digital assets. There are fears that Voyager may not be the only company facing large losses.

“What’s to be seen is whether there are any large, remaining players that had exposure to them, which could cause further contagion,” Vijay Ayyar, a vice president at the crypto exchange Luno, told the business channel CNBC.

A recent article in the Financial Times noted: “The deflating bubble in digital assets has exposed a fragile system of credit and leverage in crypto akin to the credit crisis that enveloped the traditional sector in 2008.”

The crypto market has been “sold” on the basis that it provided an alternative to the official financial system which afforded protection against inflation and currency movements. It was even touted as a form of “digital gold.” But its rise over the past decade has proven to be completely dependent on the flow of cheap money from the Fed and other central banks.

Valuations were inflated by a series of complex arrangements and deals—what the FT called “financial gymnastics”—which left “huge towers of borrowing and theoretical value teetering on top of the same underlying assets.”

This inverted pyramid could be sustained so long as crypto prices kept rising, but inflation and the aggressive lifting of interest rates by the Fed has led to a fall in asset prices across the board, prompting investors to withdraw their money.

Some companies are unable to pay up. Earlier this month Celsius Network, which operates as a kind of bank for crypto currencies, announced that “due to extreme market conditions” it was pausing all operations.
withdrawals and transfers between trading accounts to place it in a “better position to honour, over time, its withdrawal obligations.”

Since that announcement its position appears to have worsened. The Wall Street Journal reported on Monday that Celsius had hired restructuring consultants from a major firm “to advise on a possible bankruptcy filing.”

The WSJ has also reported that short sellers are “ramping up bets against Tether, the world’s largest stablecoin.” Shorting involves borrowing an asset which is then sold in the expectation that its price will go down. It is then bought and returned to the lender with a profit realised on the price difference.

According to the article, the shorting has been undertaken by “traditional hedge funds” and involves trades worth “hundreds of millions” of dollars.

Tether is the most widely traded stable coin in the world and is supposedly backed by cash, commercial paper, precious metals and government bonds as well as digital tokens.

However, its foundations were shaken in the TerraUSD collapse in May when it broke dollar parity and briefly traded as low as 95 cents.

Since then, according to the WSJ, short sellers have claimed that most of Tether’s commercial paper holdings are backed by debt-ridden Chinese property developers.

The company has said “these rumours are completely false” and indicated that hedge funds were “looking to generate returns by creating arbitrage opportunities on the basis of these rumours.”

Be that as it may, the hedge funds may well be operating according to the maxim of the 19th century German chancellor Otto von Bismarck, who said he never believed the truth of any assertion until it was officially denied.

Whatever the position of individual operators in the crypto world, the plunge in market valuations is being driven by the shifts in the financial system as a whole.

While the value of the main crypto currency, bitcoin, has stabilised at around $20,000, down from near $70,000 last November, this may only be a temporary pause.

“The risk of contagion in the crypto markets remains elevated,” Marion Laboure, a senior strategist at Deutsche Bank told the FT.

“A tightening Fed will expose more crypto firms with excess credit risks by withdrawing liquidity and raising rates, which will depress the value of the coins on which many of these levered schemes depend,” she said.

It is not only the crypto market that is being impacted by the sea change in financial conditions. The tech-heavy and interest-sensitive NASDAQ index is down more than 30 percent from its record highs, with the fall in the price of significant stocks down by much larger amounts.

Shares in the television streaming service Netflix are down 75 percent from their 2021 highs. Shares in the crypto currency exchange operator Coinbase, whose public listing in April last year was accompanied by great fanfare with a market valuation of $47 billion, have plunged by 86 percent. Shares in the cinema chain AMC, once touted as a so-called meme stock in early 2021, have dropped by 80 percent.