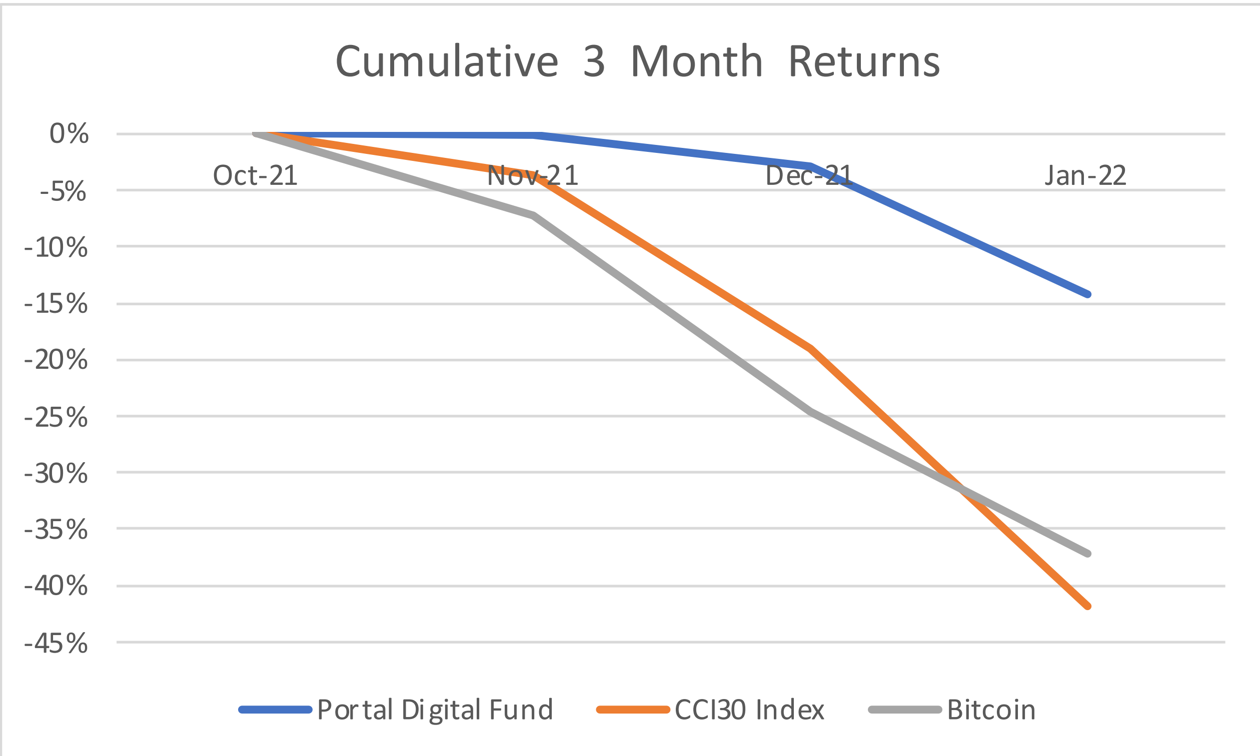
PORTAL
DIGITAL FUND

January 2022 Market Commentary

Introduction
January continued the risk-off environment that began in mid-November 2021 across all asset classes. As we stated in our "Portal 2022 Outlook" report we believe that *"Inflation is being vastly underestimated – rates are going to rise much faster and higher than expected, increasing volatility across all asset classes!".* This played out as expected and the high growth tech stocks and DeFi assets in particular are feeling the brunt of the selloff.

Contagion
This risk-off sentiment spread through to the cryptocurrency and digital asset markets which are now down -42% in the case of Bitcoin and -37% for the CCI30 Index from the start of November to the end of January, whilst the Portal Digital Fund is down -14.3% over the same period, in line with our targeted volatility mandate of 1/3rd of the downside.



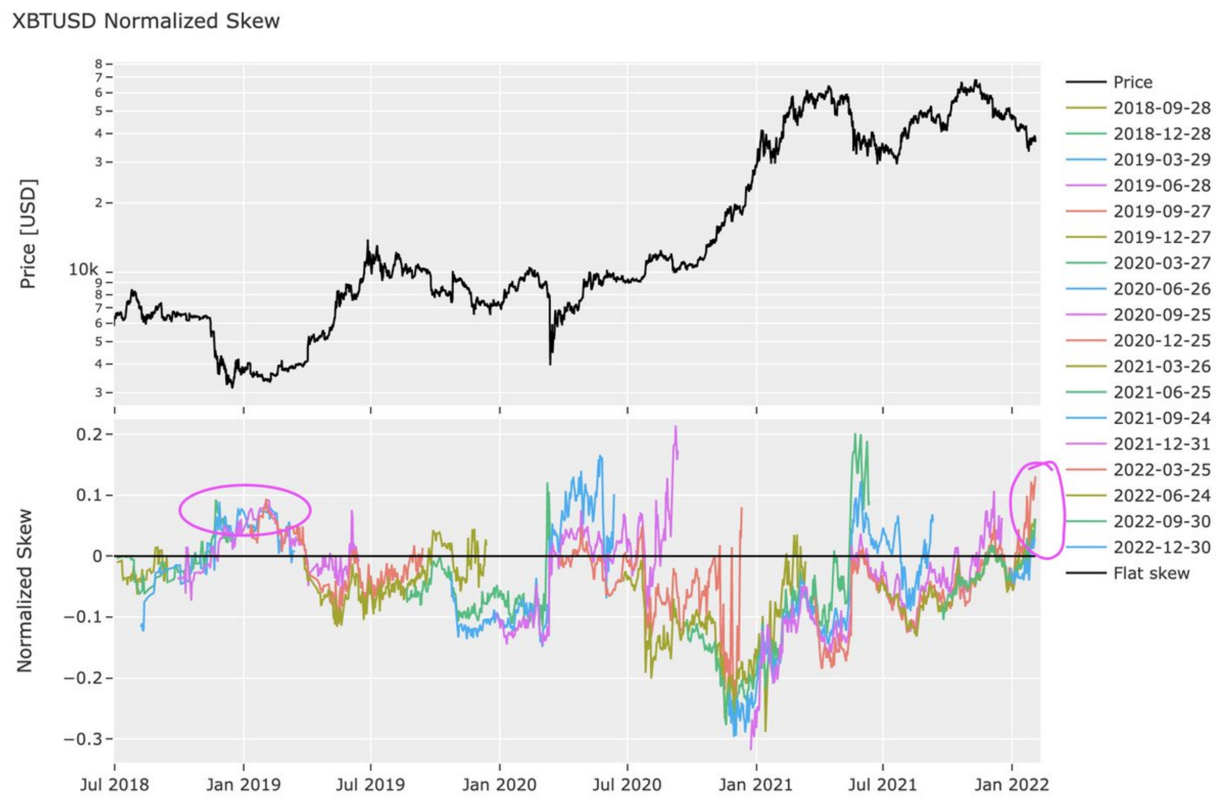
This is as large a drawdown as we saw in May through July 2021, however, here are large differences in the underling factors in both corrections. The correction we saw in May was due to crypto-specific factors, most notably China banning cryptocurrency miners and the threat of increased regulation in the USA via the proposed Infrastructure Bill.
In this instance, the underlying support and factors that have been driving the structural growth in the digital asset space have actually improved over the past few months, most

notably driven by Facebook rebranding to Meta and now Apple investing in the Metaverse, and Google appointing a dedicated Digital Asset team to look for investments in the space. The general news flow is positive, and although we expect further regulation and tax this means that this space will become more regulated and thus more accessible as it affords investors better protection.

Quantifying the Risks

In assessing the overall market risk globally, it's not the known risks that cause markets to meltdown, but rather the unknown risks. Markets are forward predictors meaning they tend to focus on rolling earnings driven by the supply and demand for commodities, goods and services 12 months out. Initially inflation and interest rate expectations were underestimating this risk, as per our year end outlook report. This has now been priced in with markets globally, particularly high growth tech counters and pharmaceuticals having dropped as much as 50% in the past 2 months. *(At the time of writing the CCI 30 was up 21% for the first 8 days of February)*

In my experience, the markets tend to give you maximum pain in the early part of the cycle change and so now that everyone is bearish and positioned for continued market weakness, we expect the markets will show resilience and recover. As the saying goes: "you can't sell to sellers any more than you can buy from buyers". The sellers have sold and although there will be some speculators that attempt to short the markets, I expect we are set up for a real short squeeze in the next few weeks as current skew from normal levels are extreme. We see high put skew (put vol > call vol) usually during and after big panic driven events and this is as high as it's been since late 2018 and so all the downside is being priced in by investors, who are ;positioned for further weakness, not a rally..[1]



[1] https://twitter.com/JSterz/status/1489189038326226947?s=20&t=jHzDiAoQdb5ZOHbqfvRXVQ

A Reset of Interest rate Expectations

Last week Wednesday's ADP National Employment Report numbers showed that the US economy lost -301K jobs in Jan versus an expected growth of +180K jobs. Many investment banks have scrambled to revise their forecast lower as well, with Goldman Sachs projecting a loss of -250K jobs vs the market's expectation of +125K.

A soft jobs number has reduced fears of aggressive rate hikes from the US Federal Reserve. This means inflation pressure is not as strong on the wage front. That would give the Fed more breathing room to tighten policy at a gradual pace. It is important to recognise that this is supply driven inflation, which is relatively easy to resolve, not demand driven which burns much hotter and for longer. The excess liquidity and low interest rates will be here for the foreseeable future.

The Structural Bull Market Remains Firmly Intact

We need to look past the short-term volatility and assess if the underlying drivers of the market are still indeed intact. From our perspective, DeFi continues to gather pace and gather momentum as it disintermediates the traditional financial business models by taking advantage of new technological possibilities to reduce transaction costs in exciting ways. We believe we are at the beginning of a real structural shift, and we expect the coming months to bring a flood of new and exciting tokens.

Studying financial history enables one to discern both long-term trends in prices and revolutionary changes in markets. Applying financial history to the future, I expect this crypto winter soon to pass and be followed by a spring in which DeFi defies the sceptics to unleash a financial revolution as transformative as the e-commerce revolution of Web 2.0.

A really concise argument is provided by Permian Capital Management's December 2021 Monthly Letter:
"Let's think of it from this perspective: Crypto networks are subject to Metcalfe's law which states that the value of a telecommunications network is proportional to the square of the number of connected users of the system (n2). Facebook, for example, is not a valuable network if there is just one person in the network. If that person invites friends to join the network and then they invite their friends, we start to experience exponential growth. If the value of a network is the square of the number of users, the price rapidly accelerates as people join the new network and invite their friends. From 2013 to 2022 the number of Facebook monthly active users increased from 1.2 to 3 billion or an increase of 250%. During that same time Facebook's market capitalization increased over 1,200% to one trillion dollars.

Right now, Ethereum, the largest crypto network, has 8.2 million users and is increasing 280% per year at a current valuation of $260 billion. What happens to Ethereum's market cap when it hits one billion users? Per Metcalfe's Law the valuation is the square root of the number of users. If the goal is to invest in networks that will increase 10,000% in market value, would you rather invest in Facebook or Ethereum?"

Conclusion

This drawdown has been driven by an overreaction to the impending restrictive monetary policy with the belief that the Fed will raise rates much quicker than market initially expected. Given that inflation is due to supply chain issues and the economic data points to a very anaemic global economy mean that the Fed won't be able to hike as aggressively as the market is currently pricing without causing a severe recession.

In December and January, smart Contracts and DeFi was hit the hardest as this sector trades furthest out on the risk and liquidity curve. Nothing has changed the thesis around DeFi disrupting TradFi and in fact we expect that this disintermediation will gather momentum. Many of these tokens are down north of 50% and now offer great entry prices given their strong outlook.

We've seen +50% drawdowns in crypto many times before. Disruptive, high-risk / high-reward assets invite volatility, and we believe as investors with thesis conviction and a long-term outlook always benefit the most.

We acknowledge this was a tough month at the end of a tough quarter, but we reiterate our commitment to being responsible stewards of your capital while balancing the risks inherent to investing in a new asset class.

Kind regards

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