GRAYSCALE

Hedging US-China Trade Risk with Bitcoin

A Real-Time Case Study

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*"Bitcoin is the beginning of something great: a currency without a government, something necessary and imperative." – **Nassim Taleb, Author of 'The Black Swan: The Impact of the Highly Improbable'***

Crises Are Becoming More Common and Global

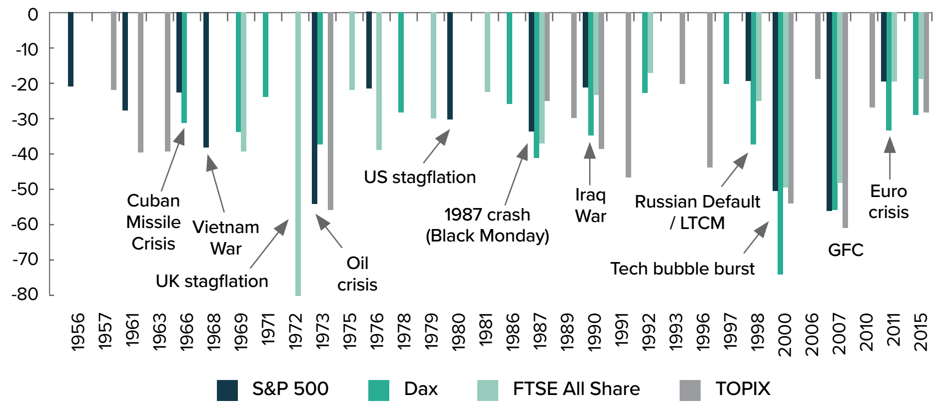
Financial crises are becoming more common and global. The below chart from Goldman Sachs identifies a long list of large drawdowns across US, European, and Asian equity markets over the last sixty years, showing just how devastating their effects can be. For example, during the Global Financial Crisis (GFC) between October 2007 and March 2009, the S&P 500 and several of its global equity counterparts lost more than half of their value, erasing decades of wealth creation and challenging our understanding of market efficiency and systemic risk.

Unfortunately, these broad-based drawdowns in asset prices happen with greater frequency than most investors realize. Now, more than ten years into a bull market for risk assets[2], it is crucial for investors to understand the dynamics of liquidity risk and the tools available to hedge before the next crisis materializes.

In this paper, we'll explore Bitcoin's potential role as a hedge against liquidity risk through the lens of five macroeconomic developments, including the recent escalation of US and China trade tensions.

1. Originally published December 2016. Updated as of August 7, 2019.
2. We define "risk assets" as those with uncertain cash flows and high sensitivities to credit and business cycles (e.g., equities, corporate bonds, industrial commodities, and commercial real estate). We define "wealth preservation" assets as those with hedged exposures to these forces (i.e., certain forms of cash, currency-hedged government bonds, gold, and in our view, Bitcoin).

FIGURE 1: **LARGE EQUITY DRAWDOWNS ARE FREQUENT AND GLOBAL**[3]



What is Liquidity Risk?

Liquidity risk is the risk of a real[4] decline in wealth resulting from (1) an imbalance in the amount of money and credit relative to debt in a given economy and (2) how exposed an investor's portfolio is to that imbalance. Generally, this imbalance can take one of two forms: deflation or inflation. When there is not enough liquidity to service debts or stimulate economic growth, the result is deflation, while too much can spur excessive inflation.

In the modern macroeconomic order, liquidity is primarily controlled via fiscal and monetary policies enacted by federal governments and central banks. How liquidity is transmitted and the mechanisms through which it will be managed (or mismanaged) has important implications for the performance of markets and asset classes, and consequently the optimal construction of investor portfolios. The truth is, most traditional portfolios lack adequate diversification to protect against liquidity risk because they are heavily concentrated in equities, which typically respond negatively to both deflationary and inflationary pressures (e.g., the Global 60/40).

When building a portfolio, it's important to keep in mind that all investment decisions are relative. For example, an equity portfolio manager may choose to allocate capital to various countries, sectors, and investment styles (e.g., value, growth, momentum) while a strategic asset allocator may choose to deploy capital across various asset classes (e.g., equities, bonds, commodities, real estate). These are typical allocation decisions that managers make in normal economic cycles as they seek to diversify their portfolios and generate returns that match or exceed a given benchmark.

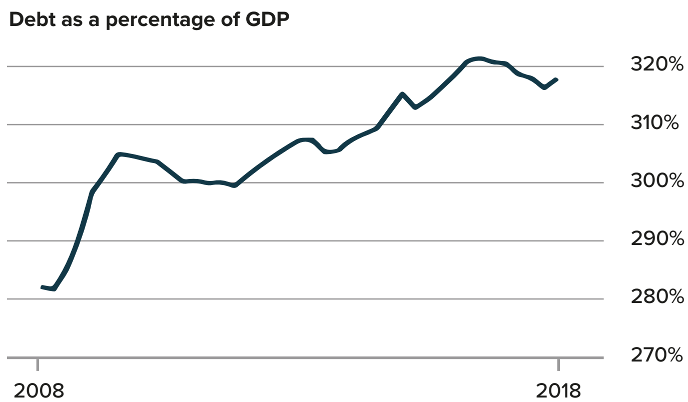
However, in a liquidity crisis, capital allocation decisions change. Investors make choices between holding risk assets with uncertain cash flows and

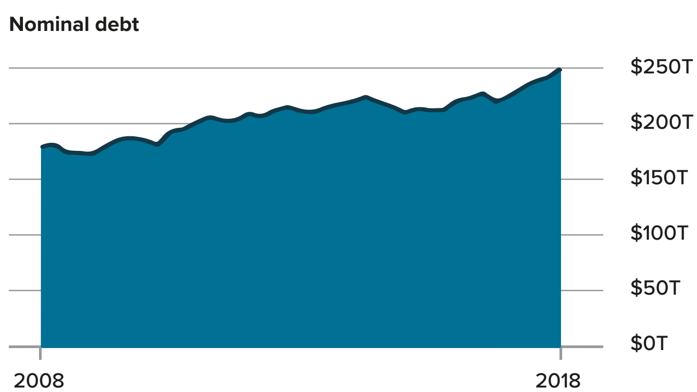
3. Source: Datastream, Bloomberg, Goldman Sachs Global Investment Research.
4. Real prices are adjusted for general price level changes over time, i.e., inflation or deflation. Nominal prices, sometimes called current-dollar prices, measure the dollar value of a product at the time it was produced. Source: Federal Reserve Bank of St. Louis.

high sensitivities to credit and business cycles (i.e. , equities, corporate bonds, industrial commodities, and commercial real estate) versus wealth preservation assets with hedged exposures to these forces, including the currency devaluations that often follow (i.e., certain forms of cash, currency-hedged government bonds, gold, and in our view, Bitcoin).[5] Time and again, we've witnessed risk asset correlations converge, reducing diversification benefits when investors need them most.

A key component of liquidity risk is that it scales non-linearly with the amount of leverage in the financial system. This is particularly important within the context of our current economic environment, since global debt is at an all-time high of roughly $250 trillion and debt-to-GDP is over 300%.[6] Despite muted volatility across global markets in recent years, the looming risk of a liquidity crisis is also high.

FIGURE 2: **THE WORLD'S $250 TRILLION DEBT**[7]





5. Source: Bridgewater Associates: The All Weather Strategy: Transitioning to the Safe Portfolio in a Depressionary Environment. http://sdcera.granicus.com/MetaViewer.php?view_id=4&clip_id=75&meta_id=9141.
6. Source: Bloomberg. Global Debt of $244 Trillion Nears Record Despite Faster Growth. January 15, 2019. Chibuike Oguh and Alexandre Tanzi. https://www.bloomberg.com/news/articles/2019-01-15/global-debt-of-244-trillion-nears-record-despite-faster-growth.
7. Source: Bloomberg. The World's $250 Trillion In Debt: the World's Post-Lehman Legacy. September 13, 2018. Brian Chappatta. https://www.bloomberg.com/graphics/2018-lehman-debt/.

A New Way to Hedge

What makes Bitcoin such an exciting financial technology and investment opportunity is that it has a distinct set of properties unlike any other asset. Through this unique mix of properties, Bitcoin has the potential to perform well over the course of normal economic cycles as well as liquidity crises, especially those involving currency devaluations. These properties are as follows:

- ***Store-of-value*** characteristics similar to real assets like gold, with hard-money attributes like immutable scarcity. (For more, see our previous paper, *Bitcoin & the Rise of Digital Gold*). **(Positive in Liquidity Crisis)**
- ***Spending*** characteristics similar to cash. Today, you can spend bitcoin with over 100,000 merchants worldwide including Whole Foods, AT&T, Microsoft, Overstock.com, Expedia, PayPal, and Dell to name a few. Bitcoin also has trading pairs with every major fiat currency, making it a ubiqitous medium-of-exchange. **(Positive in Liquidity Crisis)**
- ***Growth*** characteristics of a new technology as real applications for blockchain technology and decentralized digital assets continue to emerge and create value, stimulating further demand. **(Positive in Economic Cycles)**

With continued adoption, Bitcoin represents a transparent, immutable, and global form of liquidity that can provide both wealth preservation and growth opportunities. As a result, we believe it deserves a steady strategic position within many long-term investment portfolios. While Bitcoin may not be appropriate for all investors based on their investment mandate or market microstructure limitations, some may see the benefit of adding an allocation to their portfolios.

A Real-Time Case Study: US-China Trade Tensions Escalate (May 5, 2019 – ?)

Though trade tensions formally began between the U.S. and China back in 2017, the dispute escalated in the mid-2019 starting on May 5, when U.S. President Donald Trump announced a tariff increase on $200 billion of annual Chinese imports – from 10% to 25%.[8] In response, Beijing announced its own series of retaliatory tariffs (from 10% to 25%) on $60 billion of American goods. As trade talks formally resumed at the G20 summit in June, it seemed plausible that a U.S.-China deal could be reached; however another round of unproductive negotiations followed. On August 1, Trump announced that the U.S. would impose a new 10% tariff on an additional $300 billion worth of Chinese imports, effective September 1.

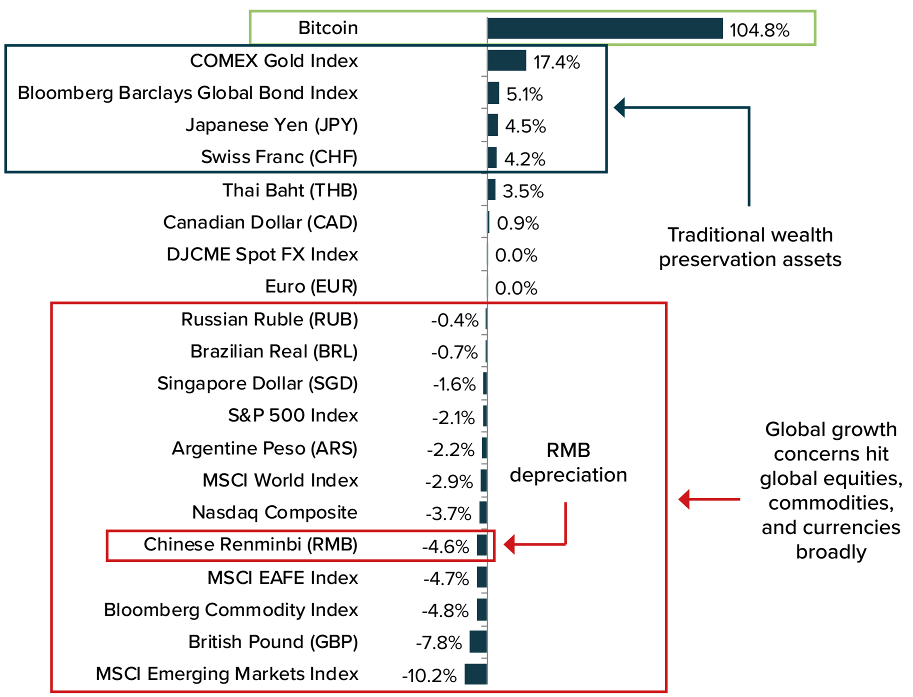
Given that the U.S. and China are currently the two largest single-country economies in the world (representing more than $35 trillion in annual GDP or roughly 40% of the annual global economic output), the recent escalation

8. Source: BBC. US to review China intellectual property policies. August 19, 2017. https://www.bbc.com/news/business-40982032

and prolonged nature of this conflict could pose significant contagion risks to the global economy and financial markets.[9] In fact, the IMF released a report evaluating the impact of the high-stakes disagreement, stating "the latest [trade] escalation could significantly dent business and financial market sentiment, disrupt global supply chains, and jeopardize the projected recovery in global growth in 2019." Moreover, they cite that "consumers in the U.S. and China are unequivocally the losers from trade tensions."[10] This is an important detail considering that consumption represented roughly 68% of GDP in the U.S. and 76% in China in 2018.[11] Disruption to the core driver of aggregate demand in these economies could significantly hamper global growth, potentially producing a domino effect of negative consequences that result in a liquidity squeeze.

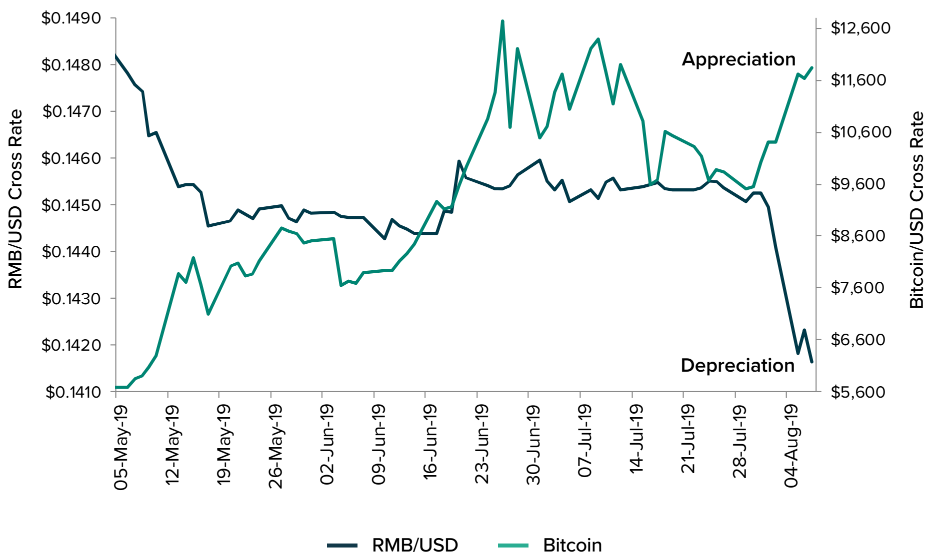
While the risk asset drawdown is still in its very early stages, Bitcoin is on the rise as these risks are just beginning to show up in other asset and currency prices. Since Trump first announced the tariff hike in May, Bitcoin has generated a cumulative return of 104.8% through August 7, versus an average of -0.5% for the twenty other asset classes, markets, and currencies below during the same period.

FIGURE 3: **US-CHINA TRADE TENSIONS ESCALATE**[2]
MAY 5, 2019 – AUGUST 7, 2019



9. Source: IMF. IMF DataMapper: GDP, current prices. April 2019. https://www.imf.org/external/datamapper/NGDPD@WEO/OEMDC/ADVEC/WEO/JPN/FRA
10. Source: IMF. IMFBlog: The Impact of US-China Trade Tensions. May 23, 2019. Eugenio Cerutti, Gita Gopinath, Adil Mohommad. https://blogs.imf.org/2019/05/23/the-impact-of-us-china-trade-tensions/
11. Source: Federal Reserve Bank of St. Louis. Shares of gross domestic product: personal consumption expenditures, Q1 2019. https://fred.stlouisfed.org/series/DPCERE1Q156NBEA.
Source: CNBC. Final consumption accounted for 76.2 pct of China's 2018 GDP growth, exports a drag. January 20, 2019. https://www.cnbc.com/2019/01/20/reuters-america-final-consumption-accounted-for-76-point-2-pct-of-chinas-2018-gdp-growth-exports-a-drag.html.
12. Source: Bloomberg. Performance of Bitcoin is based on the daily values of the Bloomberg Bitcoin Price Index (USD). Drawdown periods are defined based on a proprietary indicator measuring peak-to-trough declines of global risk assets.

FIGURE 4: **RMB VS. BITCOIN SPOT RATE (USD)**[13]
MAY 5, 2019 – AUGUST 7, 2019



There are significant shifts taking place in monetary, fiscal, and trade policies around the world that will likely impact global markets well into the future. While we don't know when or at what levels the current drawdown will end, it is clear that the challenges faced by politicians and policymakers will be difficult to manage given the complexity of our global financial system. Bitcoin could be a useful tool in helping investors insulate their portfolios from any failure to manage these problems effectively.

13. Source: Bloomberg. Performance of Bitcoin is based on the daily values of the Bloomberg Bitcoin Price Index (USD).

About Grayscale Investments, LLC

Grayscale Investments is the world's largest digital currency asset manager. With a proven track record and unrivaled experience, we give investors the tools to make informed investing decisions in a burgeoning asset class. As part of Digital Currency Group, Grayscale accesses the world's biggest network of industry intelligence to build better investment products. We have removed the barrier to entry so that institutions and individual investors can benefit from exposure to digital currencies. Now, forward-thinking investors can embrace a digital future within an institutional grade investment.

Grayscale is headquartered in New York City. For more information on Grayscale, please visit, www.grayscale.co or follow us on Twitter @GrayscaleInvest.

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Investors should be aware that Grayscale is the sponsor of Grayscale Bitcoin Trust (BTC), Grayscale Bitcoin Cash Trust (BCH), Grayscale Ethereum Trust (ETH), Grayscale Ethereum Classic Trust (ETC), Grayscale Litecoin Trust (LTC), Grayscale Horizen Trust (ZEN), Grayscale Stellar Lumens Trust (XLM), Grayscale XRP Trust (XRP) and Grayscale Zcash Trust (ZEC) (each, a "Trust") and the manager of Grayscale Digital Large Cap Fund LLC (the "Fund"). The Trusts and the Fund are collectively referred to herein as the "Products". Any Product currently offering Share creations is referred to herein as an "Offered Product". Information provided about an Offered Product is not intended to be, nor should it be construed or used as investment, tax or legal advice, and prospective investors should consult their own advisors concerning an investment in such Offered Product. This report does not constitute an offer to sell or the solicitation of an offer to buy interests in any of the Products. Any offer or solicitation of an investment in a Product may be made only by delivery of such Product's confidential offering documents (the "Offering Documents") to qualified accredited investors (as defined under Rule 501(a) of Regulation D of the U.S. Securities Act of 1933, as amended), which contain material information not contained herein and which supersede the information provided herein in its entirety.

The Products are private investment vehicles. Shares of Grayscale Bitcoin Trust (BTC), which are only offered on a periodic basis, are publicly quoted under the symbol: GBTC. The Products are not subject to the same regulatory requirements as exchange traded funds or mutual funds, including the requirement to provide certain periodic and standardized pricing and valuation information to investors. The Products are not registered with the Securities and Exchange Commission (the "SEC"), any state securities laws, or the U.S. Investment Company Act of 1940, as amended. There are substantial risks in investing in one or more Products. Any interests in each Product described herein have not been recommended by any U.S. federal or state, or non-U.S., securities commission or regulatory authority, including the SEC. Furthermore, the foregoing authorities have not confirmed the accuracy or determined the adequacy of this document. Any representation to the contrary is a criminal offense.

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Note On Hypothetical Simulated Performance Results

HYPOTHETICAL SIMULATED PERFORMANCE RESULTS HAVE CERTAIN INHERENT LIMITATIONS. There is no guarantee that the market conditions during the past period will be present in the future. Rather, it is most likely that the future market conditions will differ significantly from those of this past period, which could have a materially adverse impact on future returns. Unlike an actual performance record, simulated results do not represent actual trading or the costs of managing the portfolio. Also, since the trades have not actually been executed, the results may have under or over compensated for the impact, if any, of certain market factors, such as lack of liquidity. Simulated trading programs in general are also subject to the fact that they are designed with the benefit of hindsight. NO REPRESENTATION IS BEING MADE THAT ANY ACCOUNT WILL OR IS LIKELY TO ACHIEVE PROFITS OR LOSSES SIMILAR TO THOSE SHOWN. PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE RESULTS.

The hypothetical simulated performance results are based on a model that used inputs that are based on assumptions about a variety of conditions and events and provides hypothetical not actual results. As with all mathematical models, results may vary significantly depending upon the value of the inputs given, so that a relatively minor modification of any assumption may have a significant impact on the result. Among other things, the hypothetical simulated performance calculations do not take into account all aspects of the applicable asset's characteristics under certain conditions, including characteristics that can have a significant impact on the results. Further, in evaluating the hypothetical simulated performance results herein, each prospective investor should understand that not all of the hypothetical assumptions used in the model are described herein, and conditions and events that are not accounted for by the model may have a significant adverse effect on the performance of the assets described herein. Prospective investors should consider whether the behavior of these assets should be tested based on different and/or additional assumptions from those included in the information herein.

IN ADDITION TO OTHER DIFFERENCES, PROSPECTIVE INVESTORS IN A VEHICLE SHOULD NOTE THE FOLLOWING POTENTIALLY SIGNIFICANT DIFFERENCES BETWEEN THE ASSUMPTIONS MADE IN THE HYPOTHETICAL SIMULATED PERFORMANCE RESULTS INCLUDED HEREIN AND THE CONDITIONS UNDER WHICH A VEHICLE WILL PERFORM, WHICH COULD CAUSE THE ACTUAL RETURN OF SUCH VEHICLE TO DIFFER CONSIDERABLY FROM RETURNS SET FORTH BY THE HYPOTHETICAL SIMULATED PERFORMANCE, TO BE MATERIALLY LOWER THAN THE RETURNS AND TO RESULT IN LOSSES OF SOME OR ALL OF THE INVESTMENT BY PROSPECTIVE INVESTORS:

FOR EXAMPLE, EACH TRUST WILL HOLD ONLY ONE DIGITAL ASSET, WHEREAS THE HYPOTHETICAL SIMULATED PERFORMANCE RESULTS ARE INTENDED TO SHOW HYPOTHETICAL PERFORMANCE OF AN INVESTMENT MULTIPLE DIGITAL ASSETS. IN ADDITION, THE GENERAL MARKET DATA USED IN THE HYPOTHETICAL SIMULATED PERFORMANCE RESULTS DO NOT REFLECT ACTUAL TRADING ACTIVITY AND COULD NOT BE REPLICATED BY A VEHICLE IN ITS ACTUAL TRANSACTIONS. If actual trading activity was executed at levels that differed significantly from the general market data used in the hypothetical simulated performance, the actual returns achieved would have varied considerably from the results of the hypothetical simulated performances and could have been substantially lower and could result in significant losses.

IN ADDITION, THE HYPOTHETICAL SIMULATED PERFORMANCE RESULTS DO NOT ASSUME ANY GAINS OR LOSSES FROM TRADING AND THEREFORE DO NOT REFLECT THE POTENTIAL LOSSES, COSTS AND RISKS POSED BY TRADING AND HOLDING ACTUAL ASSETS.

The hypothetical simulated performance results do not reflect the impact the market conditions may have had upon a Vehicle were it in existence during the historical period selected. The hypothetical simulated performance results do not reflect any fees incurred by a Vehicle. If such amounts had been included in the hypothetical simulated performance, the results would have been lowered.

AS A RESULT OF THESE AND OTHER DIFFERENCES, THE ACTUAL RETURNS OF A VEHICLE MAY BE HIGHER OR LOWER THAN THE RETURNS SET FORTH IN THE HYPOTHETICAL SIMULATED PERFORMANCE RESULTS, WHICH ARE HYPOTHETICAL AND MAY NEVER BE ACHIEVED. Reasons for a deviation may also include, but are by no means limited to, changes in regulatory and/or tax law, generally unfavorable market conditions and the Risk Factors set forth below.

Certain Risk Factors

Each Vehicle is a private, unregistered investment vehicle and not subject to the same regulatory requirements as exchange traded funds or mutual funds, including the requirement to provide certain periodic and standardized pricing and valuation information to investors. There are substantial risks in investing in a Vehicle, including but not limited to:

- **PRICE VOLATILITY**
  Digital assets have historically experienced significant intraday and long-term price swings. In addition, none of the Vehicles currently operates a redemption program and may halt creations from time to time. There can be no assurance that the value of the common units of fractional undivided beneficial interest ("Shares") of any Vehicle will approximate the value of the digital assets held by such Vehicle and such Shares may trade at a substantial premium over or discount to the value of the digital assets held by such Vehicle. At this time, none of the Vehicles is operating a redemption program and therefore Shares are not redeemable by any Vehicle. Subject to receipt of regulatory approval from the SEC and approval by the Sponsor or Manager, as applicable, in its sole discretion, any Vehicle may in the future operate a redemption program. Because none of the Vehicles believes that the SEC would, at this time, entertain an application for the waiver of rules needed in order to operate an ongoing redemption program, none of the Vehicles currently has any intention of seeking regulatory approval from the SEC to operate an ongoing redemption program.

- **MARKET ADOPTION**
  It is possible that digital assets generally or any digital asset in particular will never be broadly adopted by either the retail or commercial marketplace, in which case, one or more digital assets may lose most, if not all, of its value.

- **GOVERNMENT REGULATION**
  The regulatory framework of digital assets remains unclear and application of existing regulations and/or future restrictions by federal and state authorities may have a significant impact on the value of digital assets.

- **SECURITY**
  While each Vehicle has implemented security measures for the safe storage of its digital assets, there have been significant incidents of digital asset theft and digital assets remains a potential target for hackers. Digital assets that are lost or stolen cannot be replaced, as transactions are irrevocable.

- **TAX TREATMENT OF VIRTUAL CURRENCY**
  *For U.S. federal income tax purposes, Digital Large Cap Fund will be a passive foreign investment company (a "PFIC") and, in certain circumstances, may be a controlled foreign corporation (a "CFC"). Digital Large Cap Fund will make available a PFIC Annual Information Statement that will include information required to permit each eligible shareholder to make a "qualified electing fund" election (a "QEF Election") with respect to Digital Large Cap Fund. Each of the other Vehicles intends to take the position that it is a grantor trust for U.S. federal income tax purposes. Assuming that a Vehicle is properly treated as a grantor trust, Shareholders of that Vehicle generally will be treated as if they directly owned their respective pro rata shares of the underlying assets held in the Vehicle, directly received their respective pro rata shares of the Vehicle's income and directly incurred their respective pro rata shares of the Vehicle's expenses. Most state and local tax authorities follow U.S. income tax rules in this regard. Prospective investors should discuss the tax consequences of an investment in a Vehicle with their tax advisors.

- **NO SHAREHOLDER CONTROL**
  Grayscale, as sponsor of each Trust and the manager of the Fund, has total authority over the Trusts and the Fund and shareholders' rights are extremely limited.

- **LACK OF LIQUIDITY AND TRANSFER RESTRICTIONS**
  An investment in a Vehicle will be illiquid and there will be significant restrictions on transferring interests in such Vehicle. The Vehicles are not registered with the SEC, any state securities laws, or the U.S. Investment Company Act of 1940, as amended, and the Shares of each Vehicle are being offered in a private placement pursuant to Rule 506(c) under Regulation D of the Securities Act of 1933, as amended (the "Securities Act"). As

a result, the Shares of each Vehicle are restricted Shares and are subject to a one-year holding period in accordance with Rule 144 under the Securities Act. In addition, none of the Vehicles currently operates a redemption program. Because of the one-year holding period and the lack of an ongoing redemption program, Shares should not be purchased by any investor who is not willing and able to bear the risk of investment and lack of liquidity for at least one year. No assurances are given that after the one year holding period, there will be any market for the resale of Shares of any Vehicle, or, if there is such a market, as to the price at such Shares may be sold into such a market.

- **POTENTIAL RELIANCE ON THIRD-PARTY MANAGEMENT; CONFLICTS OF INTEREST**
  The Vehicles and their sponsors or managers and advisors may rely on the trading expertise and experience of third-party sponsors, managers or advisors, the identity of which may not be fully disclosed to investors. The Vehicles and their sponsors or managers and advisors and agents may be subject to various conflicts of interest.

- **FEES AND EXPENSES**
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