

Bullish insights

Ethereum Update
August 17, 2022

The Merge

The final testnet merge is a two-step process starting with the Bellatrix upgrade that is expected to be complete at epoch 112,260. When the network hits a Terminal Total Difficulty (TTD) of 10,790,000, Goerli (PoA) merges with Bellatrix and on Ethereum block #58750000000000000000000000000000 the PoW chain will merge onto the Beacon chain transitioning to PoS. This is anticipated to occur somewhere between September 15 to 16.

Ice Age

The transition to PoS has long been in the works starting with the first difficulty bomb called "Ice Age". Back in 2017, the Serenity upgrade was meant to transition the network to PoS, however it was delayed with a hardfork. The difficulty bomb makes it harder for miners to mine with increased difficulty levels of puzzles under the PoW mining algorithm which in turn increases the block time. In early October 2017, miners experienced an average Ethereum block time of ~30 seconds for a couple of days until the difficulty bomb was reset to revert back to the normal ~13 seconds. Over Ethereum's history, the difficulty bomb was reset six times resulting in six hardforks.

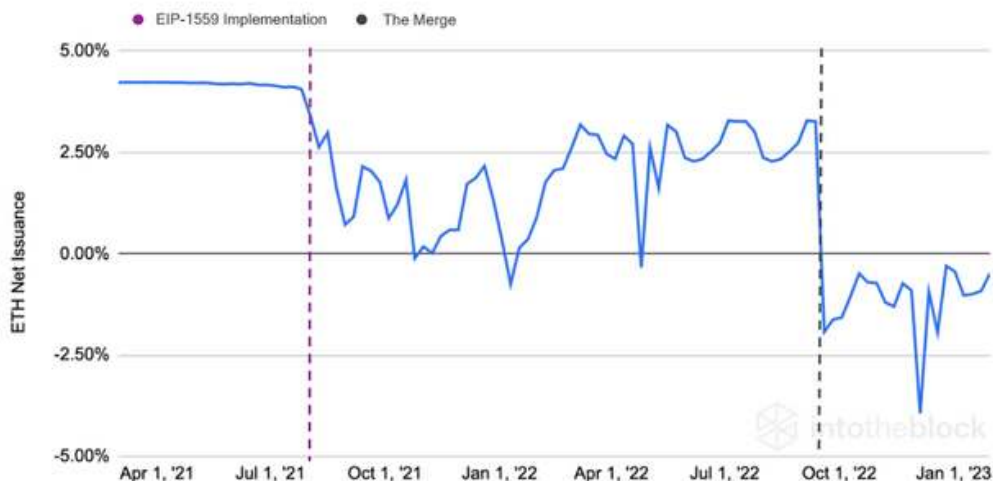
Ethereum Improvement Proposal	Hard Fork
EIP 649	October, 2017
EIP 1234	February, 2019
EIP 2384	January, 2020
EIP 3554	August, 2021
EIP 4345	December, 2021
EIP 5133	June, 2021

Ethereum's Deflationary Argument

Under PoS miners will no longer need to be incentivised, which means the amount of new ETH issued is expected to drop by ~90%. After last year's implementation of EIP-1559, ~80-85% of transaction fees were burned, resulting in more burn less mint.

Ethereum's net issuance has seen a drop since EIP-1559 and is anticipated to move into deflationary territory once the Merge goes live.

ETH Projected Deflation Post Merge



Source: Intotheblock as at July 23, 2022.

ETH Staked

As of August 16, a total number of 415,314 validators have staked 13.29mn ETH on the Beacon Chain marking an all-time high record. The staked ETH on the Beacon Chain represents ~11%, (~\$25bn) of the total supply in circulation. Under the Lido protocol, approximately 4.28mn ETH (~\$8bn) is staked on the platform yielding ~3.9% APR as of August 17.



Source: Delphi Digital, Dune Analytics (@sixdegree), Glassnode, Nansen as at 16 August 2022.

Centralised Support for PoS

Stablecoins like Circle and Tether in addition to oracles like Chainlink have expressed their support for ETHS. Exchanges however, like Binance have not ruled out potential future support for the PoW fork.

Recently, exchanges like Poloniex, Huobi, and BitMEX have expressed support for the fork and in turn enabling customer access to ETHW financial products. Bitmex for an example will be launching USDT ERC-20 futures contracts for the new forked token ETHW. Poloniex have added a swape page for users to swap their Ethereum tokens into the two potential ETHS and ETHW.

Trading Activity

There has been talks of different trading opportunities and one highlighted by Bitmex was taking advantage of centralised exchange's listing lag time compared to decentralised exchanges. They expressed that CEX's may take hours or days before PoW deposits could be enabled thus the ability for a trader to buy ETHW on a DEX (the moment the merge occurs) and selling it on CEX once listed. On-chain wallets that hold ETH may potentially be airdropped ETHW thus there may be increased demand to borrow ETH nearing the Merge as investors will want as much of the airdropped token as possible. There also seems to be speculation that the liquidity pools pairing ETHW on DEX's will be drained at a rapid rate as soon as the Merge occurs as investors may potentially scurry to accumulate ETHW to sell on CEX's.

A Zero-Sum Game

To understand why the community is torn between the fork we may need to first explore the motives behind the financial incentives it draws. Miners for one will be advocates of the fork as under PoW they have huge financial incentives to do so. Miners have paid millions in investing in mining hardware that could become obsolete once Ethereum transitions to PoS. They will no longer be able to mine block rewards and instead the incentives will be allocated to the largest stakers in the network. Traditionally, miners are rewarded for the energy expensed in securing the network as block rewards are given as compensation. They compete with other miners racing to solve computational challenging puzzles to validate a new block. However, under PoS, validators who stake a large portion of ETH are assigned validator rights and thus rewarded network fees for securing the network and validating new blocks.

The move from PoW to PoS seems to benefit the network, the environment (slashing energy consumption by 99%), as well as ETH holders but sacrificing the interests of miners, a zero-sum game.

Chandler Guo a prominent figurehead in the mining community has led a group of miners to support Ethereum's PoW post-merge. In July, he expressed "I fork Ethereum once, I will fork it again!" He has garnered support from certain exchanges although, at the same time admits that "forking ETHW will not be as easy as forking ETHC." It is unclear how defi protocols that rely on price oracles such as Chainlink will handle the forked chain, especially after Chainlink publicly announced that it would not support any PoW forks after the Merge, aligning with the Ethereum Foundation.

Remarks

The fork in our opinion is motivationally driven by miners and understandably so. The shift from PoW to PoS slashes miner revenue seemingly making their investment in mining hardware redundant. If the community truly believed in maintaining a PoW chain they could simply use Ethereum Classic \$ETC which forked from the Ethereum blockchain back in July 2016; it maintains PoW consensus. Should the Merge successfully go live on mainnet and a fork occur, we anticipate euphoria to drive volatility around ETHS and ETHW. Much like a short-lived Minsky moment isolated to ETH, the market may speculate and drive up price action but could also possibly dump once investors reach an epiphany and bullish momentum eases. We do not anticipate the new fork (should it go ahead) to meaningfully absorb ETHS dominance in the long-run. It would not be surprising to see ETH outflows from CEX's that do not support the fork closer to the Merge as speculators bet on an airdrop of ETHW. There is a potential for ETH holders to deposit their ETH to DEX wallets in order to catch a potential airdrop of ETHW then offloading it onto a CEX.



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