What a Stablecoin’s Troubles Mean for Crypto Investors

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Stablecoins are supposed to be the part of the cryptocurrency market that is immune to the wild swings in value that have characterized assets such as Bitcoin.
But the nosedive this week of one of the industry’s leading stablecoins is a reminder that many of the complex financial structures that emerged during crypto’s historic bull run have yet to be tested in leaner times.

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TerraUSD (known by the ticker symbol UST), one of a handful of stablecoins engineered to maintain a market price of $1, has fallen substantially off that mark. The unwelcome turbulence has wiped out billions of dollars in value. It has also had spillover effects for other cryptocurrencies struggling to maintain investor confidence after a monthslong decline from last year’s all-time highs.

Campbell R. Harvey, professor of finance at Duke University’s Fuqua School of Business, says the situation amounts to a “painful lesson” for people who invested in UST or its infrastructure. He says the turbulent market helped reveal issues with the system that may not have been apparent during boom times.

“Think of this as a stress test,” he says. “If the market hadn’t fallen, it might fall next year.”

When investing in cryptocurrency, or any risky asset, it can be helpful to take a long-term view of the market. For example, if you’re investing on a 20-year time horizon, it might not matter whether something is worth less now than last week — or even last year.

However, it’s also worth considering whether the factors that led to a crypto crash change your long-term point of view about your investment.

While the crypto market had already seen drawdowns as U.S. policymakers hit the brakes on growth amid rising inflation, UST’s high-profile flop has only added to the pressure.

The fallout has been pronounced because of the increasingly interconnected nature of the decentralized finance, or DeFi, system that has developed around crypto.
What happened

- UST’s developers created another cryptocurrency, called Terra (Ticker: LUNA), to help maintain the value of the stablecoin. Ideally, holders of UST can trade it at any time for an equivalent amount of LUNA.
- But LUNA tokens, unlike UST, have a price that is determined predominantly by market conditions. This worked fine when investors were confident in LUNA’s value. But as the market declined and some users dumped large amounts of UST, investors generally lost confidence in the value of LUNA tokens.
- In recent months, UST’s developers had also bought billions of dollars worth of Bitcoin to further support the stablecoin’s value. Then, as the crisis deepened, they moved to sell some of that Bitcoin, exacerbating the overall selloff in the crypto market.

By Wednesday afternoon, LUNA’s market price had dropped below $2, down from an April high above $115. Meanwhile, UST had not come close to regaining its “peg” to the U.S. Dollar.

What’s next

The creators of UST have pledged to restore the system to working order in hopes of recovering some of the market value their protocol has lost.

“Terra’s focus has always oriented itself around a long-term time horizon,” Do Kwon, founder of UST creator Terraform Labs, wrote on Twitter Wednesday. He noted that UST had recovered from another loss of its peg last year. “Short-term stumbles do not define what you can accomplish. It’s how you respond that matters.”

Whether Kwon and his team will mount a successful comeback is unknown, but this week’s events may continue to reverberate around the crypto space. U.S. regulators already had their eye on stablecoins, and the scrutiny could grow more intense.

Harvey, of Duke University, notes that UST had an unusual mechanism to maintain its peg to the dollar algorithmically without having a large amount of collateral in place to guard against big market swings. Some other stablecoins, such as USDC, are backed with actual cash reserves, and some have large amounts of other crypto assets to back them up.

Jon Wu, head of growth at Aztec Network, a crypto privacy protocol, says it’s possible that someone could solve the issues that have emerged with UST. But he also says it’s worth considering the potential harms of a repeat occurrence: “Is it worth the amount of risk it presents to the entire ecosystem?” he asked.
Bill Birmingham, chief investment officer at Osprey Funds, which specializes in crypto assets, says this week’s events also highlight the opportunities for growth in a space developing on the fly. “The cycles of innovation in crypto are so fast,” he says. “The ability to create something, test it in the market and see if it fails or succeeds are unlike anything we’ve seen.”

The author owned Bitcoin, LUNA, and UST at the time of publication.

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