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The Digital Investor

Bitcoin is dead, long live Bitcoin

What happened this month in the financial markets?

At the time the coronavirus started to expand in the rest of Europe from northern Italy, financial markets tumbled. Crypto-currencies were among the most heavily affected assets. The bitcoin price halved. On March 12, 2020, it declined by more than 40 percent! Even considering the tumultuous reputation of Bitcoin, such a drop is massive and unusual. This dramatic decline has been fuelled by the liquidation of high leveraged positions in a small market dominated by retail investors.

Was there any place to hide? Looking at traditional markets, the drop in prices has also been massive and unusual. The S&P500 and the Dow Jones indices lost more than 30 percent from their peak in about a month's time. After Black Monday on October 19, 1987, the Dow Jones recorded the second largest daily drop in its entire history[1].

When comparing the 30 percent decline in equities with the more than 50 percent decline in Bitcoin, it is important to remember that traditional assets were supported by massive injections of liquidity, increase in the quantitative easing programme, lowering of interest rates, and stock market circuit breakers, to name a few. Such instruments do not exist for cryptocurrencies. What would have happened if they had not been used for traditional assets?

When such a price action takes place, all asset classes are hit badly, independent of their characteristics. The downside correlation increases. These movements are similar to those observed in the wake of the Lehman moment in 2008.

Even safe assets such as gold did not perform well, a situation that was also observed in 2008 during the global financial crisis (GFC). It illustrates that when a major shock hits the financial markets, investors look for liquidity rather than quality. This is the reason why US Treasuries performed well during these periods of acute stress. In just a few days, the yield for the ten-year Treasury declined by roughly 100 basis points to a historical low of 0.6 percent.

Despite the exponential increase in the number of people affected by the coronavirus, financial markets have started to somehow de-correlate: the US Treasury benchmark yield rose to over 1 percent, while stocks continued to decline and Bitcoin rose to about USD 6800.

The eoconomic and financial consequences of the battle against the coronavirus

Decisions by governments to quarantine or completely isolate the population is undoubtedly a legitimate decision to limit the spread of the virus. However, it comes at a high cost for society. When business activities suddenly froze, the global economy entered a recession. In the meantime, global wealth contracted dramatically due to the deteriorating outlook and the sudden rise in the demand for liquidity, meaning cash.

To mitigate the consequences, governments are untying their purses. In the wake of the global financial crisis (GFC), fiscal policy had already been used massively to recapitalise the financial system and to foster growth. As a result, governments went into this crisis with already high levels of debt. Central banks reacted quickly to the shock, something they learned painfully during the GFC. However, they started this crisis in an unfavourable position; their balance sheets are already inflated and interest rates are very low or even negative. This gives them limited ammunition to fight the economic repercussions.

To illustrate the speed and scale of the central banks' response, the Federal Reserve (Fed) cut its target rate twice in two weeks by a total of 150 basis points to 0 percent. The size of its balance sheet, currently at USD 4.3 trillion, will exceed USD 5 trillion only as a result of the announced liquidity and quantitative easing programmes, making the Fed's balance sheet roughly as big as 25 percent of GDP. At the same time, the European Central Bank (ECB) increased the size of the asset purchase programme (QE programme) and provided additional liquidity to its refinancing programme (TLTRO).

There is no doubt that humanity will win the battle against the coronavirus. Pandemics are temporary by nature and the unprecedented measures undertaken should make the current crisis short-lived. This is why we can already prepare for the time after.

The question arises as to what the economic and financial situation will be after the coronavirus crisis. The good news is that the coronavirus does not destroy the infrastructure and is unlikely to affect existing institutions if it does not last too long. Our best guess is that the post-coronavirus world will look very much like the pre-coronavirus one.

However, the economic and financial consequences will be significant and long-lasting. Public debt will be much higher than today, and the central banks' balance sheets will be much larger. In order for these heavyweight institutions to coexist peacefully, both interest rates and yields must be zero.

With zero interest rates, the enormous national debt will be sustainable. At zero interest rates, the balance sheet assets of the central banks, which consist primarily of government bonds, will be stable. However, with zero interest rates along the entire yield curve, the stability of the financial system may well be called into question. Is the value of cash-generating assets discounted at 0 percent interest rate reasonable? What instrument will central banks use going forward if the target rate cannot be increased anymore? Are central banks independent when they are forced to keep interest rates at zero because the concern for systemic stability is primarily linked to government debt, the liquid asset par excellence that the entire financial system has to hold according to Basel III regulation?

If confidence in the institutions is challenged, the global financial structure is destabilised. The last time this happened was on August 15, 1971, when the United States unilaterally suspended the convertibility of the US dollar into gold, which meant the end of the Bretton Woods system and turned the dollar into a fiat currency, a currency without intrinsic value.

Outside money

If such a troubled period were to recur, in which currency would an investor keep their savings safe? Outside money is the answer. It is a form of money that is not liable to anyone within the economic system. Throughout history, precious metals such as gold and silver have played the role of outside money, as they have been accepted internationally as a means of payments.

It's important to note that outside money is the currency of choice used to settle a transaction where there is no trust between the two parties. This was the case thousands of years ago in long distance trading, when merchants from different countries exchanged goods for gold. This is still the case today during wars, when countries pay for imports in gold as their national currency is not accepted across the border.

Cryptocurrencies such as Bitcoin, Litecoin etc. are a new form of outside money, as they have many similarities with gold and silver. They can be used in a situation where there is no trust, they are not liable to anyone and cannot be manipulated because their supply is fixed. The supply is a part of the social construct and cannot be changed unless the majority of the community agrees. For example, although Bitcoin's cap of 21 million can be technically changed, it will not be changed as the social construct will most certainly never allow it to be changed.

They also have an additional advantage over the traditional form of outside moneys: they are easy to transport and store. Finally, they are very practical, as you can use them to buy a coffee. When did you last buy your last coffee with a gold or a silver coin?

What does the coronavirus crisis tell us about cryptocurrencies?

The total market capitalisation of cryptocurrencies shrank from USD 290 billion on 24 February 2020 to just USD 135 billion 3 weeks later, a decline of 53 percent. In cryptocurrencies, the Bitcoin price dropped from about USD 10,400 mid-February to less than USD 4000 at its lowest intraday price, only to stabilise around USD 5000 in mid-March (and at the time of this writing at USD 6350).

The two other outside money assets, gold and silver, also performed poorly. Gold declined by 13 percent and silver by 33 percent.

Outside moneys performed badly when the coronavirus shock hit Europe and the United States. The magnitude of the decline seems to be inversely proportional to the size of their market.

Despite these recent performances, outside money is a safe asset. It is safe because it has no counterparty risk and is not the liability of someone else.

Conclusion

The coronavirus has impacted our life in ways that were unimaginable a month ago! Governments have taken harsh measures to limit the spread of the virus. As a consequence, economic acitivity has been severaly affected and asset prices have dropped massively. As for crypto assets, Bitcoin has been hit even harder.

There is no no doubt that we will win the battle against the coronavirus. However, this battle will come at a cost. Public debt and central bank balance sheets will continue to increase, limiting their room of action going forward. The international monetary system may well come under pressure if confidence in these institutions wanes.

Outside money is an asset class that protects against this type of risk. Some cryptocurrencies such as Bitcoin are new forms of outside money. We are therefore confident that the value proposition of cryptocurrencies will remain intact.

Finally, native cryptocurrencies represent an integral part of the blockchain technology, which supports a wide variety of applications. One application is outside money, and Bitcoin, designed as digital gold, proposes this feature. The number of applications that this technology supports is enormous. Crypto-currencies are about more than just outside money.

The value contribution of cryptocurrencies is very topical, and we believe Bitcoin remains an attractive diversifier for portfolios.

[1] The Dow Jones Industrial Average exists since 16 Febuary 1885!

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