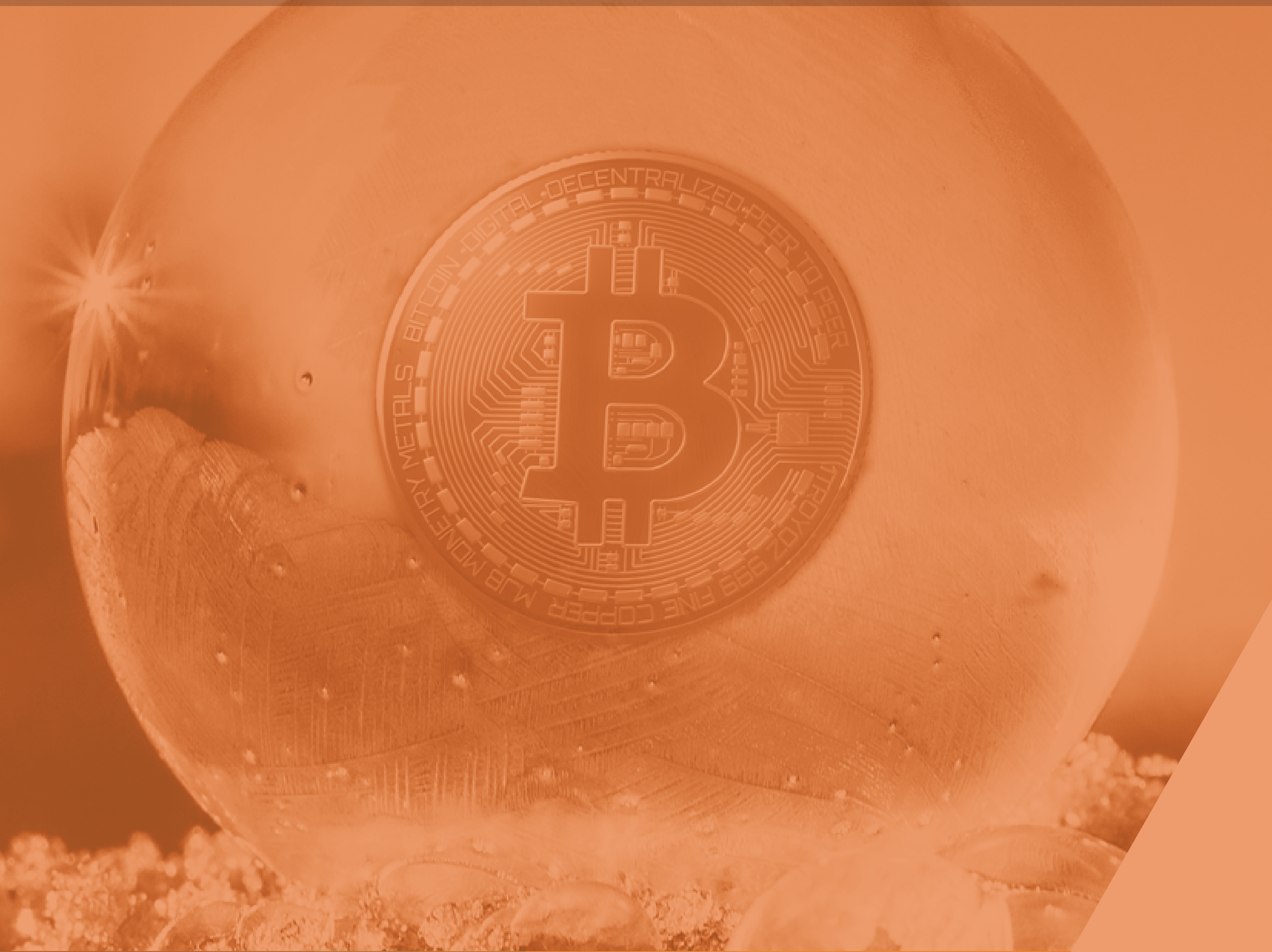
AGN Global Business Voice: Business Alert

Making sense of Cryptocurrencies: Part #4
It's all about the value - new gold or fool's gold?



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It's all about the value - new gold or fool's gold?: Part #4

HOW DID WE COME TO BE HERE?

There was once a time before Bitcoin...in the late 90's there was Digicash, B-Money and Bit Gold. Then the emergence of blockchain inspired pseudonymous person(s) "Satoshi Nakamoto" to scribe the 2008 white paper *"Bitcoin: A Peer to Peer Electronic Cash System"*, proposing a number of solutions to problems of earlier crypto-evolutions.

As the title suggests, Bitcoin was intended as a commercial tradable currency that everyone could use day-to-day to pay for all manner of goods and services. As we have explored in previous editions, there is a way to go to achieve that vision, mainly due to price volatility. But was it ever conceived as a vehicle for capital appreciation? With a total market capitalisation approaching US$1.4tn[1] across the crypto-population, equivalent to the annual gross domestic product of countries like Australia and Spain, it's difficult to imagine it didn't go through someone's mind.

Since we last wrote, Bitcoin's price fluctuated around +/-6% and returned to around US$34,000 – but is that high or low? Aiming to demystify cryptocurrencies and put things in layman's terms, this 4th in our short series of Global Business Voice Alerts gets into the reeds of the valuation issue.

Let's go straight for the jugular – are cryptocurrencies a valuable credible investment? Certainly, they offer no rights or entitlements like a conventional stock or share, or a financial instrument like a derivative. In all these cases, the investment infers ownership of some right to assets or future profits. Of course, there are instances where those assets and future profits do not fulfil expectations or even turn negative, but even so they exist in terms of enforceable legal rights, and value flows from that.

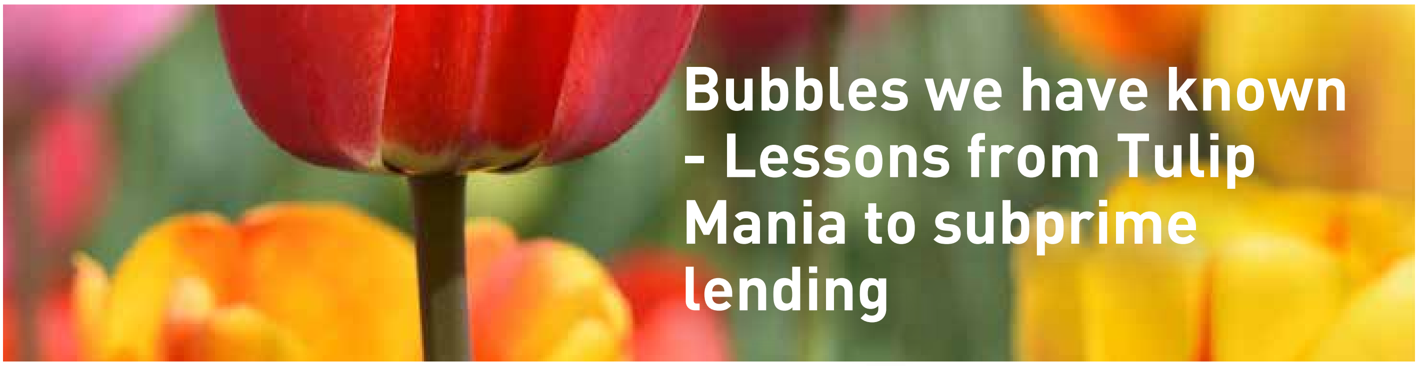
With the possible and partial exception of stablecoin, a cryptocurrency gives no such entitlements, other than to the electronic token itself; not even to the technology, intellectual property or blockchain on which it exists. Nassim Taleb, financial guru and author of The Black Swan, would have us believe it's a transparent and open Ponzi scheme – using the funds of new investors to provide a return to existing investors. Certainly, it is a zero-sum game, in that there is no

[1] *Coinmarketcapital.com, 5 July 2021*

mechanism in any cryptocurrency to generate wealth from within the system. Could that explain why some current investors make so much noise about why it's such a great thing, and invite detractors to "enjoy being poor"?

If it's difficult to see intrinsic value as an investment, what about as a currency? Aren't conventional currencies simply valueless tokens that are nevertheless exchanged for value on the basis of confidence and stability? The big difference is that a conventional currency is backed by the covenant of a central bank - in effect a buyer of last resort. So, unlike a cryptocurrency, there is always somebody (theoretically at least) that will purchase your token. Covenants for sure vary in credibility, and especially if the money supply is not controlled or the quality of the economy is doubtful. But essentially a central bank's covenant is backed by the entire economic activity and natural resources of its defining geopolitical territory, including the legal right to raise value through mechanisms like taxation, and potentially even defend it with the use of force. It may be a little esoteric and tricky to understand, but it's rather more substantial than a number on a decentralised ledger, even when it's verified by a blockchain.

So if cryptocurrency does have value as a currency, it can only be based on what value another unobligated party might feel inclined to give for the token. But why would they give any value at all? Could cryptocurrencies just be a bubble or a hoax? It can be informative to look at some famous bubbles of the past.



Bubbles we have known - Lessons from Tulip Mania to subprime lending

In Holland during the early to mid 1600s, speculation drove the value of tulip bulbs to extraordinary levels. Starting as a middle-class obsession with colours and varieties, the market got out of hand as speculators began buying tulips with leverage, using credit instruments to buy more than they could afford, pushing prices still higher in the face of limited supply. Ultimately, rare bulbs were selling at six times the Dutch average annual salary, and a few were worth as much as US$750,000 in today's values. However fashionable or unique, prices got out of all proportion to anything that could be attributed to the tulips themselves. By 1637, prices were falling as tulip producers simply couldn't keep up with demand. Those who had purchased bulbs on credit had to liquidate, which fuelled further price drops, and many investors and tulip traders were bankrupt.

And it is a history that repeats itself. 100 years later, there was the South Sea Company bubble on the London markets, in which famously Sir Isaac Newton was amongst those to lose fortunes. More recently the 1980s saw the Japanese real estate and stock market bubble, then the ".com" bubble in the 90s and subprime and global credit crisis of a dozen years ago. As Mark Carney, former Governor of the Bank of England[2], commented; this keeps happening, it is in the nature of markets,

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[2]*https://www.bbc.co.uk/programmes/m000py8t*

and especially of unregulated markets, a bust will follow a boom. *History shows that even the best and brightest are taken in by speculative promises well ahead of any reasonable measure of economic worth.*

It is on the face of it difficult to make the case for cryptocurrency somehow being "different this time". But let's try looking at it another way, thinking of cryptocurrency as the new gold.

A golden haven against inflation?

Especially now that inflation concerns are increasing as governments have swelled money supplies to fund their pandemic responses, some have promoted cryptocurrency as a hedge against inflation. Like the traditional gold, and unlike conventional ("fiat") currencies, the cryptocurrency supply cannot be inflated by governments. So is there value in cryptocurrency as a safe haven?

There are some similarities between cryptocurrency and gold; both have a limited supply existing substantially independently of the regulations of any nation government, both can provide a degree of anonymity and are (to an extent at least) readily marketable. The main argument in favour of cryptocurrency over gold is its mobility – gold is physically difficult to move, and in quantity potentially easy to detect. The mobility of cryptocurrencies can be highly attractive, for example to actors who accumulate wealth offshore and do not wish to repatriate it.

However, it is inescapable that cryptocurrencies have dependencies that gold does not, and notably on the continuity and integrity of the computer algorithms in which they exist. Gold on the other hand, once physically secured, is practically indestructible and has no dependencies or maintenance requirements. Gold also has value for alternative uses, for example in industrial, medical and aesthetic applications, alongside any value as simple wealth storage. It seems we quickly default back to the general issues of physical assets with alternative uses vs. crypto assets without.

At the end of the day, the point is moot and untested. Cryptocurrencies are a recent innovation and have existed only in periods of relatively low global inflation, so far at least. When the US posted higher than expected inflation figures on 12 May 2021 there wasn't a rush to Bitcoin. Gold rallied for the rest of the month, rising around 7.5%, whilst Bitcoin fell 12% the day Elon Musk tweeted Tesla would no longer accept Bitcoin. And for now, that would appear to be the only clear answer. The price volatility of cryptocurrency surely disqualifies it for use as a safe haven, from inflation or otherwise. And that is perhaps the defining limitation for now - price volatility is presently a fatal flaw for cryptocurrencies. But why, or indeed where, that price would settle is not clear to see.

Conclusions – is there any golden future?

Based on valuation fundamentals and lessons from history one might conclude the probability is cryptocurrency prices are not sustainable, and that an almighty busting of the cryptocurrency bubble must come. But of course, the billion (or perhaps trillion) dollar question is when? And who will be left holding the baby when the music stops? Small retail investors, where the hardships are individual, or larger institutions where the damage could be more systemic?

Alternatively, perhaps a new and different future for cryptocurrencies is beginning to emerge. They have finally got the attention of authorities – intervention is now emerging in major economies. But at the moment, checks and balances in one territory simply tend to displace activities into another. So how long will it be before regulators seek international agreement about control of the cryptocurrency space? This certainly seems possible given that several major economies are considering launching their own state backed cryptocurrencies (Central Bank Digital Currencies – CBDC's).

Could some of the present cryptocurrency breed make the transition to CBDC's, perhaps along similar lines to how Spotify and Amazon moved from disruptors to market leaders? And if so, does this impute a capital value - would proven platforms and infrastructures have a value over setting up from scratch? But if so, how much, and who would benefit in a decentralised system? Perhaps one day central banks could even compete to become a cryptocurrency's backer, manoeuvring to offer coin holders the best price.

The benefits of backed and stable CBDC's initially sound attractive. It would give real time economic monitoring, with the ability to clamp down on bad actors and speed up the deployment of economic policy levers. But far from a utopian situation, they would also yield unprecedented levels of personal data, and would effectively bank the 'un-banked'. Provided you like and trust your government, there are some creditable outcomes. But others will see Orwellian implications in the wings, with the prized features of anonymity and regulatory freedom being relegated to history.

Perhaps this is as far as the present debate can go. Will we get the other side of the coin entirely from what was intended by "Satoshi Nakamoto" back in 2008? Or more cynically, could these be the unintended consequences of setting out to chase the tulip effect?

AND FINALLY IN THE SERIES 'MAKING SENSE OF CRYPTOCURRENCIES' ...

Having covered the subject from mining to the environment, from practicalities in use to the philosophy of valuation, inevitably we are left with as many questions as answers. But perhaps at least better questions than we had at the start.

In our final Part 5, we will be sharing the views of some leading experts within the AGN membership on the subject. What do we tell the clients?

Sources*: Money Week, The Financial Times, BBC, The Guardian, The Independent, Cointelegraph.com, Coinmarketcap.com, Investopedia, Wikipedia.*

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