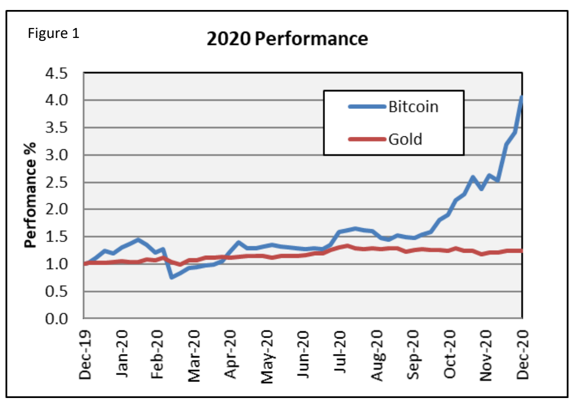
Is This the Time for Crypto?

January 2021

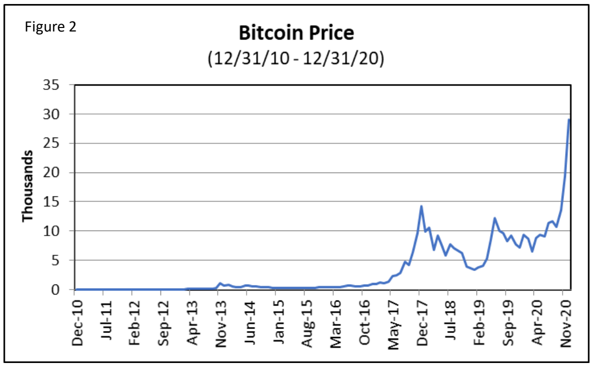
A good argument can be made that financial markets should not have behaved the way they did in 2020 given the devastation of COVID-19. As Europe and the U.S. initiated lockdowns of unknown duration, it appeared the world would come to a screeching halt with immeasurable consequences. Equity markets quickly plunged, and investors braced for a return to a Great Depression-like world. Nine months later, after deft action from the world's fiscal and monetary authorities, market reviews marvel at the year's results. Many investments delivered laudable returns including, remarkably, crypto currencies. With an impressive rally during the fourth quarter, Bitcoin appreciated over 300% in 2020. "Cryptocurrencies" have existed for slightly more than a decade with mixed acclaim and endorsement. Will the pandemic and our chaotic world cement the legitimacy of "Cryptos?"

The history of currencies is lengthy. Currencies have played a vital role in the functioning of modern economic systems. Even when societies bartered goods, exchanged items could be considered currencies because each item had a value that could be expressed in terms of another. At all times, the foundation of currency was the utility it had to someone else. Even when physical notes were introduced, their value and utility were represented by what they could purchase, which in turn depended on their credibility as a medium of exchange. In time, that credibility emanated from an issuing entity, like a central bank, which had an authority accepted by the currency's users.

Bitcoin was developed in 2009 after the economic turbulence the world experienced in 2008. The concept behind the cryptocurrency was to create an item of value that would have permanence, no individual or institution could control, was accessible to everyone and yet anonymous to everyone. In a way, bitcoin took on many of the characteristics of gold without the cumbersomeness of holding it or the exposure associated with owning it. The unique breakthrough in its creation was software technology by which a distributed ledger called blockchain could record every transaction allowing users to buy, sell, transfer or receive bitcoin anonymously and securely. To facilitate entry into the world of digital currencies, various exchanges emerged through which people could establish accounts and transact those currencies like they might do with stocks in a brokerage account.



During 2020, Bitcoin rose in price by over 300% while gold appreciated a meager 25%. [see figure 1] Does this make sense? Many price changes in 2020 strain credibility, although they warrant a bit more discussion. Bitcoin and other digital currencies have been notoriously volatile. As these currencies received attention in the mid-2010s, they experienced similar price spikes and painful declines. Over the last decade, Bitcoin appreciated enough to generate returns exceeding 215% per annum with volatility exceeding 200% p.a. [see figure 2 on next page] Meanwhile, gold returned only 3.0% per annum with volatility nearing 17% p.a. Crypto naysayers decry the impracticality of owning and using them, the absence of a backing or source of credibility, the lack of recognition by the world's monetary and tax authorities and, significantly, the widespread use for criminal activity. Early on, few institutions adopted the currencies and fewer establishments accepted them in payment for goods and services. One additional challenge was the creation of thousands of currencies, which eroded the credibility of most of them. Supporters emphasized the security of their blockchain backbone, their range of applications in the digital era and their store of value as global monetary authorities continued to debase their currencies.



Performance from 12/2010 -12/2020		
	Bitcoin	**Gold**
Total Return	215.2%	3.0%
Volatility	201.9%	16.8%

Source: Bloomberg

Over the last couple of years, a few digital currencies managed to retain sufficient attention to be traded and used by a growing number of institutions and commercial outlets. In December 2017, both the CBOE and the CME launched bitcoin futures, giving the currency a stamp of approval and enabling trading in the digital currency for institutional investors who faced legal and regulatory hurdles to access it directly. In October 2020, payments company Square announced the purchase of 4,709 bitcoins for $50 million. Square was not the first corporation to purchase bitcoins but, given the company's successful cash application, the purchase sealed a big endorsement from a leader in digital era payments. J.P. Morgan's Nikolaos Panigirtzogluo, who commented on the Square transaction in an October 13, 2020 publication, returned to discuss Bitcoin in a January 4, 2021 report. In the latter, he compared Bitcoin with gold indicating that for the market value of all bitcoin to be equal to the market value of gold, the price would have to rise to $146,000.[1] While he was not endorsing the price, various media outlets picked up his report giving the currency an additional early 2021 surge.

Panigirtzogluo's analysis attempted to provide a valuation metric for bitcoin. His comparison to gold is logical because, like gold, Bitcoin has no inherent return (no interest, no dividend, no earnings stream, no attachment to an item of value to someone else). Bitcoin has a few potential investment benefits: 1) if widely adopted, it will experience increased demand without a commensurate increase in supply (there is a limit to the number of bitcoins that will ever be created); 2) Bitcoin cannot be shorted directly because its technology does not permit sales without holdings. (The currency can be shorted using futures.); and 3) some argue it is an alternative investment uncorrelated with stocks and bonds. (This last benefit likely erodes with broader investor participation.) Still, legitimate questions arise regarding the merits of bitcoin. For an Argentine or Venezuelan citizen facing rampant inflation, instability and greedy tax authorities, Bitcoin might be a nifty idea. For developed country investors where the rule of law prevails, inflation remains well-behaved and there are many investment options, the logic of its euphoric purchase is more challenging. Gold has performed a "store of value" and "safety in the face of panic" role for hundreds of years, yet, by comparison, its price barely moved in this tumultuous year. Therefore, it would appear Bitcoin's extraordinary appreciation resulted from increased ownership, and also lots of speculative buying, leaving the unanswerable quandary, does it deserve the elevated price?

---

[1] Flows & Liquidity, January 4, 2021 and October 13, 2020– J.P. Morgan. Nikolaos Pangirtzoglou et. all.

We believe enough people and institutions will adopt bitcoin and a few other digital currencies as legitimate instruments for transactions, investment and trading. In time, authorities will also come around to supporting their use, with requisite warnings and investor protection efforts. They will also search for ways to tax, and perhaps regulate Bitcoin, eroding one of its benefits. However, we do not believe Bitcoin's price can divorce itself from the absence of inherent value and other limitations associated with its ownership and use. People and institutions have long been able to buy gold, yet that does not mean they always do. In fact, in recent years some of the largest owners of gold, the world's central banks, have been sellers. Like any asset, Bitcoin will likely find a price that has a rational relationship to its utility.

January 15, 2021

GIA Partners, LLC

At GIA Partners, credit is in our DNA. We are a bottom-up credit manager who has managed credit portfolios in virtually every part of the world's fixed income markets as well as through some of the most severe credit events in history. Additionally, our investment team has the distinction of being among the first to recognize and actively invest in global high yield and emerging markets debt.

We have a thorough understanding of fixed income investments and their role in a globally diversified portfolio, which has rewarded our clients throughout market cycles.

Gloria Carlson
Director, Sales and Marketing
212 893-7835
gcarlson@giallc.com

Arnold West
Director, Institutional Sales
212 893-7815
awest@giallc.com

Important Information