
Weekly Market Flash

Frothing at the Bit(coin)

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At least tulips were pretty to look at, on 17th century Amsterdam streets. Pets.com actually facilitated the sale of real products in its millennial heyday (at a steep loss, sure, but still). Was gold really 300 percent more glittery in January 1980 than it was in January 1979? Who knows, but, you, know, gold! Where there's a bubble, there's always something that at one time made sense, long before triple- or quadruple-digit annual returns turned the "thing" from obscure novelty to popular get-rich-quick sensation.

So what is the "thing" about so-called crypto-currencies and their most visible public face, bitcoin, which at the end of November was worth more than 1,700 percent of its value at the beginning of 2017? The crypto-currency phenomenon appears to be one of the only viable newsworthy events that can compete with Trump's tweets for air time as this oddest of years finally approaches its end. It's not our cup of tea, but as commentators on all things investment markets, we would be remiss by not giving the crypto-craze at least one column's worth of consideration.

Creation Myths

Bitcoin has been around for a scant nine years, presciently coming into the world around the same time that financial markets were falling apart in the great market crash of 2008. A mysterious figure going by the name of Satoshi Nakamoto (whose actual identity remains a mystery today) posted an arcane description of the protocols for a decentralized financial ledger technology onto an obscure mailing list for techies with a libertarian bent. The technology, called blockchain, is what bitcoin runs on much in the way that all websites run on the decentralized technology protocols that govern the Internet. Initially, bitcoins were an object of interest for only two groups of users: computer programmers, who earned rewards for solving complex programming issues ("mining" bitcoins), and shadowy denizens of the "dark web" of illegal drug traffickers and the like, who were attracted to the opaque features of blockchain through which they could trade and deal anonymously.

The Price of Everything...

Clearly, crypto-currencies' days of nerdy and shady obscurity are long gone. They are now, for better or worse, in the process of transitioning to something resembling a mainstream asset class. This week, bitcoin futures began trading on the Chicago Board of Options Exchange (CBOE) and are due to launch on CBOE's longstanding rival, the Chicago Mercantile Exchange (CME). A handful of large financial institutions are pushing the SEC for approval to launch bitcoin ETFs so that all the world can join in the fun. In a bit of sideline humor, the first ETF application earlier this year was submitted by none other than the Winklevoss twins, of Facebook notoriety. That application was denied. Fans hope that endowing the nascent crypto-currencies with the respectability of established platforms and institutions will facilitate efficient price discovery, expand the participant base and encourage liquidity.

...The Value of Nothing

Price efficiency and liquidity are noble aims, but they do not solve the fundamental question anyone planning to take a punt on crypto-currencies should ask: what exactly are they, and how should they be valued? Clearly, crypto-currencies do not bear the characteristics of either fixed income (legally binding claims to a known set of cash flows) or equities (residual nonbinding claims on company profits). They are more like commodities, perhaps, in having no intrinsic worth other than what people are willing to pay for them (bars of gold, barrels of oil and the like generate no cash flows and pay no dividends). But all commodities have specific uses in the real world, whether powering internal combustion engines or glittering from the necks of fashionable humans. Thus far, at

least, there is no convincing use case for crypto-currencies outside of those obscure digital corners where they have resided to date.

The Un-currency

Moreover, to call them currencies at all is to take very generous liberties with the meaning of “currency.” A reliable currency fulfills three specific use cases: a store of value, a medium of exchange and a unit of accounting measurement. An instrument capable of rising or falling by double digits on any given trading day falls woefully short of any of these three uses. Imagine, for a moment, that you live in a world where your home mortgage is denominated in bitcoin. How thrilled would you be to have no idea whether next month’s payment obligation would be a fraction of this month’s, or greater by a magnitude of ten or more? Until and unless these use case problems are solved, bitcoin and its ilk are no more currencies than are beads or clamshells.

Gold Standard...Not

Moreover, the claim made by some that bitcoin has the potential to be a new variation of the old gold standard is ludicrous. The argument here rests on the fact of bitcoin’s scarcity: baked into the computer code it runs on is a hard limit of 21 million bitcoins that can ever be issued. Like gold, goes this argument, the scarcity makes it a durable store of value. This argument fails for two reasons. First, bitcoin itself may be limited in maximum quantity, but there are now plenty of competing crypto-currencies out there and thus potentially no limits at all. Second, what made the gold standard work was not the inherent nature of the commodity itself but the fact that one ounce of gold was always exchangeable for a fixed amount of a national currency – the British pound sterling for most of the gold standard era – so there was never a doubt as to the relationship between a yellow rock mined from the ground and the cash that facilitated activity in the real economy. Sure, you could theoretically fix the value of a single bitcoin in US dollars or euros and call it a standard – but what would be the point?

When the Music’s Over

The most likely end to the crypto-currency craze, like those of bubbles past, will be pain for anyone left holding the bag when the music stops. But that does not mean there is no future for digital money. After all, the crash after the dot-com bubble did not arrest the rapid development of the Internet. In the case of the crypto-currencies it is the underlying technology – the blockchain distributed ledger system – that has real potential to revolutionize the world of financial payment systems. The technology is being widely studied by central banks – not as a way to decouple payment systems from national regulators, but as a way for the banks to provide better oversight to the rapidly growing marketplace for financial technology. Such oversight, of course, is radically opposite the original libertarian impulses of Satoshi Nakamoto’s protocols, which aimed instead to free money from its government monitors.

We will continue to study blockchain’s evolution, and will likely have more to say about it in future posts. As always, though, we caution our friends and clients to beware the lure of the free lunch...because it never is.

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