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Bitcoin: It may be time to seize the opportunity

WisdomTree Market Insights

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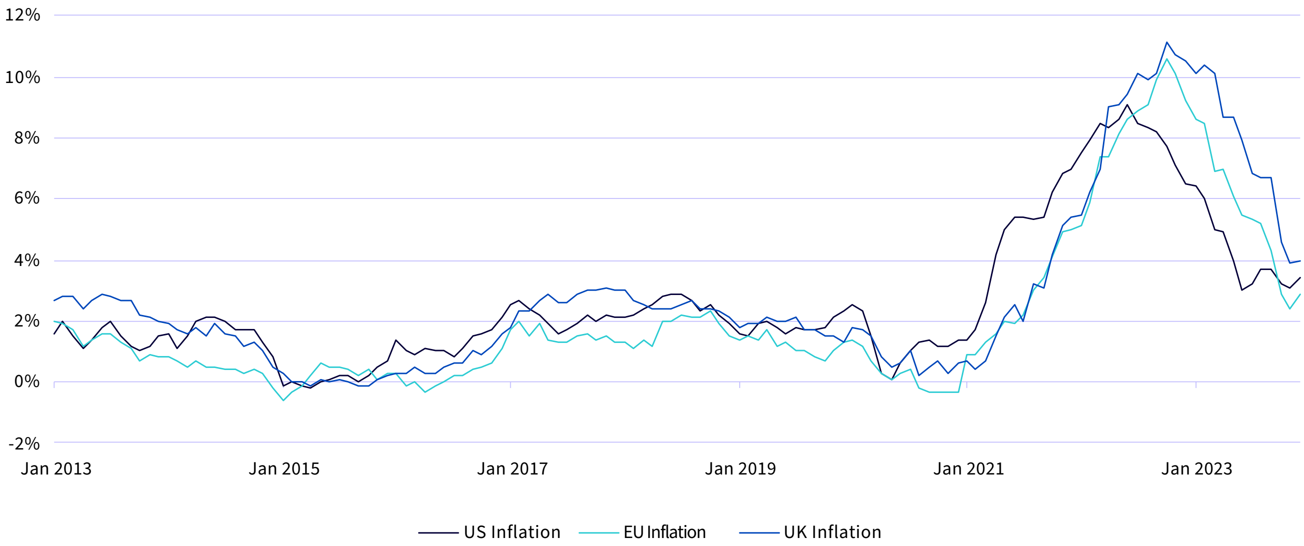
Markets and investors are always adjusting to an evolving view of the current reality. In early 2024, the environment featured several major upcoming elections alongside the continuation of a post-pandemic normal. It was particularly noteworthy that the world, largely in 2022 and early 2023, reawakened to the fact that inflation can occur in developed markets. Central banks had been rolling out quantitative easing (QE) intermittently following the global financial crisis (GFC) of 2008-09 with seemingly no consequence. Yet in the 2020s, inflation's damaging effects have been visible for all to see.

Figure 1: CPI year-on-year (YoY) in major developed markets (2013-2023)



Source: Bloomberg.

Is fiat money effective?

Fiat money represents money that has value because the issuing government says so. This contrasts with money that's backed up by a scarce resource such as gold. If we think of the British pound, US dollar, euro, Japanese yen, Swiss franc—these are all examples of fiat money. While not perfect, these currencies do seem to exhibit a certain stability and store value for their respective markets. But what about the Turkish lira? What about various African currencies? What about Argentina's currency? Currency effectiveness is one of those things that's truly in the eye of the beholder.

If we are considering whether bitcoin be viewed as a currency or as money, it's likely too early to tell. One of the things we constantly remind ourselves of is the fact that bitcoin, like gold, is not denominated in any particular country. It is, however, a bit easier to move around than gold. At a high level:

+ Bitcoin's transferability and ease of use in digital transactions could be a positive of its money-like characteristics.
+ On the other hand, bitcoin's value has been volatile over the roughly 15 years of its short history. Currency exchange rates – think dollar versus yen or euro versus pound – are certainly also volatile, but they are not as volatile as bitcoin, which has had an annualised price volatility versus the US dollar of circa 70% per year for the past 10 years.

Thinking about bitcoin in 2024, we have to recognise some of its young history to understand where we may go from here.

Do we trust the current financial system?

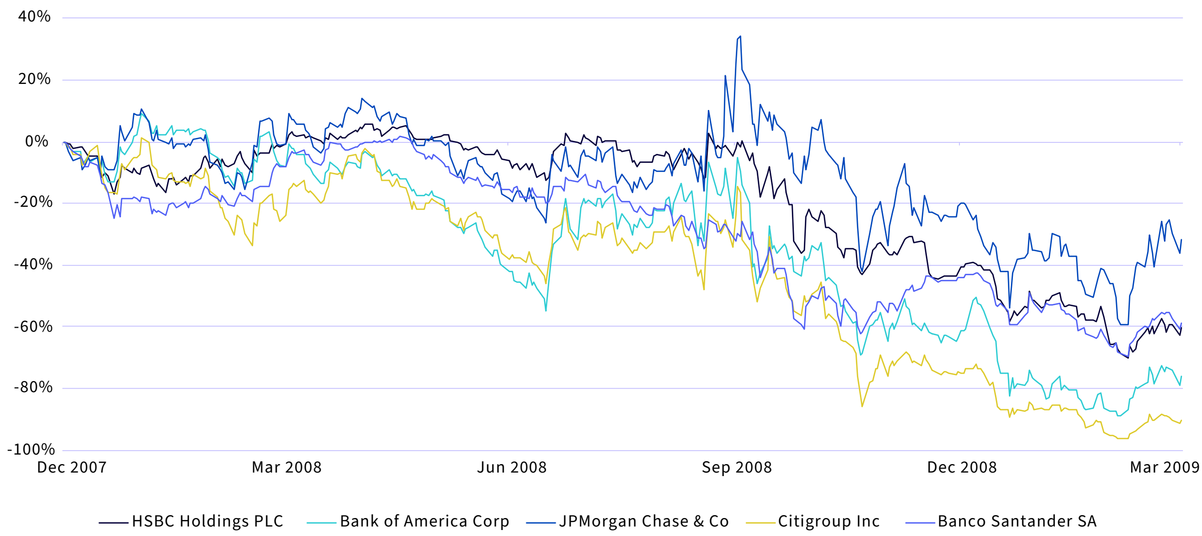
World history is subject to big events. Society will frequently have a certain perception prior to one of these big events which can completely change afterwards. The GFC was one of these big events.

Prior to 2008-09, most of the world wasn't thinking about banks. The problem with the specific nature of this crisis was that it shone a light on certain exploitative techniques and misleading tactics that were being used to encourage the use of credit across the economy. Credit is fine until the borrower can't make their payments. If a very large proportion of borrowers can't make payments at the same time, the extenders of that credit – banks, in many cases – could face a big problem.

Additionally, there were derivative securities, also packaged and sold by banks, based on these loans. When the borrowers stopped making payments, the value of these securities dropped and, since many of them were held by banks, they took a further hit. There was a narrative that the reason banks were holding so many of these securities was to 'juice up' their earnings per share and increase the bonuses of top managers. These managers should have known the inherent risk, but the incentives – frequently in the millions of dollars – did not encourage them to hold back.

The issue with all the banks doing this at roughly the same time was that, once the dominoes started to fall, the entire global financial system was at risk and governments needed to bail them out. If one or two banks fail, and we've seen some examples recently, we can weather the storm, but if all the banks fail at once, we don't know what happens to society.

Figure 2: Market cap changes of the top five banks (31 December 2007 to 31 March 2009)



Source: MSCI, Bloomberg. The top five banks are selected from developed markets and based on their market cap as of 31 December 2007. Percentages changes are calculated based on the market cap in USD.

Needing taxpayers to bail out financial institutions steered by tycoons taking excessive risks did not go down well. There was a feeling that they took these risks, made a lot of money, and faced almost zero consequences when they nearly broke the global banking system.

In 2009 conditions were ripe for something like bitcoin to enter the scene. All of these banks represented a very centralised set of actors and risks had been concentrated within these actors. A decentralised system could be particularly attractive against this backdrop. There's an interesting bit of evidence that exists in bitcoin's so-called genesis block[1] – text that is possibly being used to offer evidence of the creation of the block on a specific day.

'Chancellor Alistair Darling on brink of second bailout for banks' – The Times, 3 January 2009[2].

Since no one knows Satoshi Nakamoto, it's impossible to say exactly why this text is there, but we can logically note that there would have been many ways to offer evidence of the block being mined on that date. The fact that a bailout for banks was referenced could be a window into a less favourable view on the matter.

1 Source: https://en.bitcoin.it/wiki/Genesis_block

2 Source: https://www.thetimes.co.uk/article/chancellor-alistair-darling-on-brink-of-second-bailout-for-banks-n9l382mn62h

Printing money: good or bad?

When we see the paper-like units of currency, it's natural to think that someone, somewhere has to be in charge of the printing. The operation of actual printing is one thing, but when we talk about printing in an economic context, we are often thinking about managing the total supply of a given currency.

There is a classic expression, 'too much money chasing too few goods = inflation'. Inflation rates can be 5-10%, like we saw in recent years in many developed countries. Inflation can also be 50%– hyperinflation. The point is that there's no upper limit, hence the importance of prudent management of the overall money supply in an economy. Zimbabwe is one of the often-cited examples of hyperinflation, where there were actual units of currency printed at the 100-trillion-dollar level (Zimbabwe dollars)[3]. It's unfortunate when things get to that point because it's really indicative that the currency is barely worth the paper it's printed on.

1971 saw an important step taken by the US government – the abandonment of the gold standard[4]. Prior to that point, a certain number of US dollars were convertible into an ounce of gold, and that gold was securely stored to back up the currency. After that point, the value of a US dollar was 'because the US government says so.' Once this step is taken, there's no longer any limitation on the US government's expansion of the overall money supply.

With the Federal Reserve Act of 1913, the US Federal Reserve (the Fed) has been in a position of effectively seeking to manage the trade-off between inflation and unemployment[5]. We don't want the economy to grow too slowly as that would mean high unemployment, but we don't want the economy to grow too quickly as that would mean high inflation. The term 'Goldilocks' is often used in terms of seeking to have it 'just right.'

The global financial crisis of 2008-09, however, brought the Fed to the forefront in a manner that had been almost unthinkable previously. The Fed, through the leadership of Chairman Ben Bernanke, created a series of programs to ease credit for the entire financial system. When we say, 'easing credit', many mechanical things can happen, but it usually leads to an increasing money supply. We went into an environment of financial easing that was largely in place for the better part of the next 12 years.

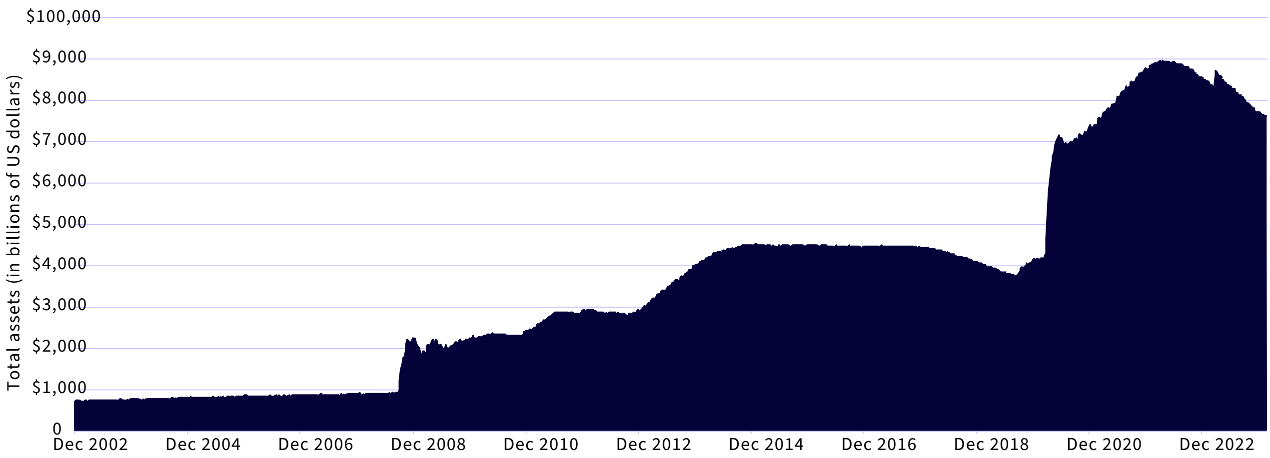
The COVID-19 pandemic, which roiled markets in 2020, took the concept of financial easing to an entirely new level. We can see that the size of the Fed's balance sheet eclipsed $7 trillion USD.

3 Source: https://en.wikipedia.org/wiki/Zimbabwean_dollar#:~:text=The%20100%20trillion%20Zimbabwean%20dollar,new%20currency%20code%20of%20ZWR.

4 Source: https://www.federalreservehistory.org/essays/gold-convertibility-ends

5 Source: https://www.federalreserve.gov/aboutthefed/section2a.htm

Figure 3: Evolution of the US Federal Reserve balance sheet over time



Source: Board of Governors of the Federal Reserve System (US), Assets: Total Assets: Total Assets (Less Eliminations from Consolidation): Wednesday Level [WALCL], retrieved from FRED, Federal Reserve Bank of St Louis; https://fred.stlouisfed.org/series/WALCL, 18 February 2024.

It was notable that from 2009 to 2020, financial conditions through Fed policy were quite easy. Inflation didn't really occur, at least with how it's officially measured. After the monetary expansion of the COVID-19 pandemic, inflation definitely occurred.

Had the US stuck with the gold standard, it would have been much harder to expand the monetary base in response to these crises. Ultimately, many think that this would have created greater short-term pain during the events, but the aftermath would have had a healthier, less 'inflation-prone' financial system.

Bitcoin: An alternative system

Bitcoin's design allows it to address concerns stemming from the centralisation of risk at banks, particularly the larger systemically important banks, and to address the risk of governments easing monetary conditions and expanding money supplies, which lead to rampant inflation.

Instead of the Fed functioning to supply money to banks and banks supplying money to businesses and individuals, a mining process exists to create bitcoin. The government is effectively outside the loop of money creation.

The bitcoin protocol has previously defined exactly what the supply of bitcoin will be and the amount that will be created at any given point in time, up to a total of 21 million bitcoin being created in roughly 2140. Recession or expansion, it doesn't matter; the supply of bitcoin is the supply of bitcoin and how we feel about it doesn't matter.

Figure 4: Trade-offs on different monetary characteristics (gold vs. fiat vs. bitcoin)

Traits of money	Gold	Fiat (US dollar)	Crypto (bitcoin)
Fungible (interchangeable)	High	High	High
Non-consumable	High	High	High
Portability	Moderate	High	High
Durable	High	Moderate	High
Highly divisible	Moderate	Moderate	High
Secure (cannot be counterfeited)	Moderate	Moderate	High
Easily transactable	Low	High	High
Scarce (predictable supply)	Moderate	Low	High
Sovereign (Government issued)	Low	High	Low
Decentralised	Low	Low	High
Smart (programmable)	Low	Low	High

Source: https://cryptonews.com/guides/why-do-bitcoins-have-value.htm. **Historical performance is not an indication of future performance and any investments may go down in value.**

What is value?

Investors are attracted by the potential for future returns. If a higher risk is properly balanced against a higher potential for future returns, it's possible that the investment could make sense for an investor. How the investor makes this decision can be a distinct mix of art and science, which has evolved over time.

+ Dividends have a long history. The idea of the dividend is that the shareholders are the owners, and the dividend represents a proportional share of the profits.
+ In the 1990s and early 2000s, the prospects of technology were too exciting to wait for profits, so the market – for a time – traded a lot more on potential and a lot less on profitability. The extreme manifestation of this market psychology led to the tech bubble.

+ Few inventions have shifted the world on its axis to the same degree as the iPhone in 2007[6]. It effectively created a new way for software to provide value through a myriad of mobile applications. If the number of iPhone (or in general smartphone) users kept growing, the value of the 'application economy' kept growing. This is a major reason why in 2024 Meta's Facebook platform has more than 3 billion global monthly active users[7]. There's of course the assumption that the giant centralised company, in this case Meta Platforms, can monetise that massive user base. Historically, this has meant various types of advertising. In future, this could change to something else, but it remains clear that massive audiences are valuable.
+ It's possible that the way in which value is exchanged across these applications and platforms will evolve, and digital assets will represent the fuel of this evolution. Currently, the biggest platforms are effectively controlled by the biggest companies who collect fees in traditional currency within their respective platforms. Digital assets allow for the exchange of value on a more peer-to-peer basis without involving any large intermediary. Much is made of Apple taking a large slice of transactions made on applications obtained through its app store. It's a good example of a centralised actor being a party to a transaction for a fee and, in a world of digital assets, this may no longer be needed.

Even if it initially seems like digital currencies or digital assets like bitcoin are a bridge too far from what we currently think of as mainstream, we should turn our attention to Blackberry. If we look at the chart of Blackberry's (Research in Motion) market capitalisation, the reason that it rose as fast as it did was not purely the value of the current device—there was a commonly accepted view that the device would be used for a lot more things in the future. When the share price dropped swiftly in its later years, after it was clear that Blackberry was going to lose to Apple and other smartphone providers, it was dropping based on the perception that the Blackberry device had lost all its future possibilities and potential.

6 Source: https://en.wikipedia.org/wiki/IPhone_(1st_generation)#:~:text=The%20iPhone%20(retroactively%20referred%20to,States%20on%20June%2029%2C%202007.

7 Source: https://www.demandsage.com/facebook-statistics/#:~:text=How%20many%20people%20use%20Facebook,of%20billion%20daily%20active%20users.

Figure 5: Research in Motion's market cap exemplified the loss of future potential

Source: Bloomberg.

Before the Blackberry, there were certainly executives at Nokia and Motorola looking at the new device thinking—no way! Everything looks obvious with the 20/20 vision of hindsight, and anything truly disruptive looks to be on the border of impossibility in the moment.

Why now?

When we think about bitcoin's potential in the 2020s, our attention is drawn to a few things, some of which we have already mentioned:

+ Bitcoin is ultimately a network and few networks have contributed a total value greater than $1 trillion in our history. While volatile, the network has hit and sustained this value for at least a few days, on a few occasions (at the time of writing).
+ The COVID-19 pandemic led to unprecedented levels of money printing. As we emerged from the disease, many markets experienced levels of inflation that had not been observed since the early 1980s.
+ Bitcoin mining does require electricity to solve the proof-of-work protocols, but in the 2020s we are experiencing developments in renewable energy that can help to ease some of this burden.
+ There is a huge market for global remittance payments and using banks or other centralised actors can be expensive.
+ There is a huge application economy within our respective smartphones and using bitcoin for decentralised exchange of value could obviate the need for massive companies taking a cut from transactions within these ecosystems.

+ In certain countries where the rate of inflation is high on a week-to-week basis, transferring salaries directly into bitcoin could represent a better store of value than currencies that are rapidly depreciating.
+ Bitcoin has demonstrated that the protocol works, given the technology itself hasn't failed since inception.

Is it easy to use a relatively new asset class?

Nothing in investing is easy. We all gather the available information, come up with our best understanding, and do the best we can – recognising that no one knows the future with certainty.

If we compare the price appreciation of bitcoin over the past 10 years, no other asset classes come close. Even if we adjust for volatility – which is high – the return is still strong enough that the Sharpe ratio of bitcoin's price appreciation has outpaced all other established asset class options[8]. It doesn't mean that the next 10 years will look like the last 10. We know that past performance is not indicative of future returns. We think that bitcoin warrants analysis and consideration alongside other assets within any institutional due diligence process. It may not always be suitable, but in 2024 and beyond, we believe this can be based more and more on the results of analysis, as opposed to policies that in the past would have precluded the analysis from being done.

8 Source: WisdomTree has looked across publicly available investments in such things as equities, bonds, and commodities and noted that from 2013 to 2023 (10 years), bitcoin's price appreciation has been roughly 50% per year whereas nothing else has come close to that. We'd note that there is no guarantee that the next 10 years looks anything like the past 10.

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