
BITCOIN & CRYPTO: FRAUD OR THE FUTURE?

Wisdomtree EU
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Few issues divide well-respected investors as much as cryptocurrency. To hear many classic “value” investors tell it, crypto is Bernie Madoff with the added dimension of wasting electricity and facilitating seedy criminal activities. Others, including many famed macro investors like Paul Tudor Jones¹, Stan Druckenmiller², and Dan Loeb³, believe we are in the early innings of a new transformative asset class—one which will cut out the traditional rent-seeking financial middle men, directly connect economic actors and expand financial services to the far reaches of the globe. The range of predicted outcomes is staggering.

The further we dig into the crypto ecosystem, the complexity (and potential) becomes apparent. Whatever your initial impression, a ~\$2 trillion asset class should be approached with interest, respect, and humility.

Warren Pies, Co-founder and Strategist at 3Fourteen Research, aims to answer four discrete questions:

1. Is Bitcoin a Ponzi scheme?
2. Does Bitcoin threaten the US Dollar?
3. As speculators, what is the most interesting aspect of Bitcoin?
4. What are our preferred Bitcoin risk management/timing tools?

In a May article⁴ for the New York Times, Krugman racked his brain wondering “why are people willing to pay large sums for assets that don’t seem to do anything?” In the final analysis, Krugman concluded that Bitcoin was a Ponzi scheme powered by “technobabble” and “libertarian derp.” Essentially, **the Ponzi scheme argument boils down to Bitcoin having no true “use case.”**

From our perspective, crypto-blockchain technology more broadly—has a number of potential use cases. Yet, the core Bitcoin use case is wealth mobility. More specifically, Bitcoin seems to be the perfect instrument for cross-border transfer of large sums of wealth. It is no coincidence that China and other countries utilizing capital controls dominate Bitcoin mining globally (chart below). Where there is wealth trapped behind capital controls, Bitcoin demand will be close behind.

History is filled with examples of assets that derived value from their ability to

clandestinely transfer wealth across borders. Diamonds, artwork, precious metals, rare books and other “collector’s items” all act as stores of value that can surreptitiously cross jurisdictional boundaries. Bitcoin is the logical evolution of this demand.

Consider the following:

- Proof of work ensures Bitcoin cannot be forged.
- At a \$750 billion market cap, liquidity abounds.
- Digital transportation makes even diamonds comparatively cumbersome (\$10 million of gold weighs just under 500 lbs).

Countries with capital controls—like China, India, and S. Korea— have been at the vanguard of Bitcoin suppression. Anyone who fails to see a legitimate use case for Bitcoin has not put themselves into the shoes of a citizen of such a jurisdiction. In developed markets, stable banking and property rights are taken for granted. Across the globe, however, these conditions remain the exception.

Does Bitcoin threaten the US dollar?

Others impart supernatural power to Bitcoin and argue that if allowed to grow, it will overtake the US Dollar. The upshot is that Bitcoin is too dangerous to the US government and, thus, will be snuffed out by regulators. We disagree with both views. As stated, we see legitimate use cases for crypto. However, there is virtually zero chance that crypto displaces the US Dollar.

Rather than viewing Bitcoin as competition against the US Dollar and fiat currencies⁵, we think it is more properly viewed as competition against (or an adjunct to) gold. In fact, unintuitively, we view Bitcoin as supportive of the US Dollar. If Bitcoin facilitates asset leakage from more draconian jurisdictions (e.g. China), then these assets must find a new home. Countries with stable currencies and strong private property rights should benefit from these Bitcoin-facilitated outflows. In other words, the end goal is not to convert the Chinese Yuan into Bitcoin, but to get it into a more stable jurisdiction of choice. Bitcoin is a conduit for these transactions. Attractive markets (like America) are the destination.

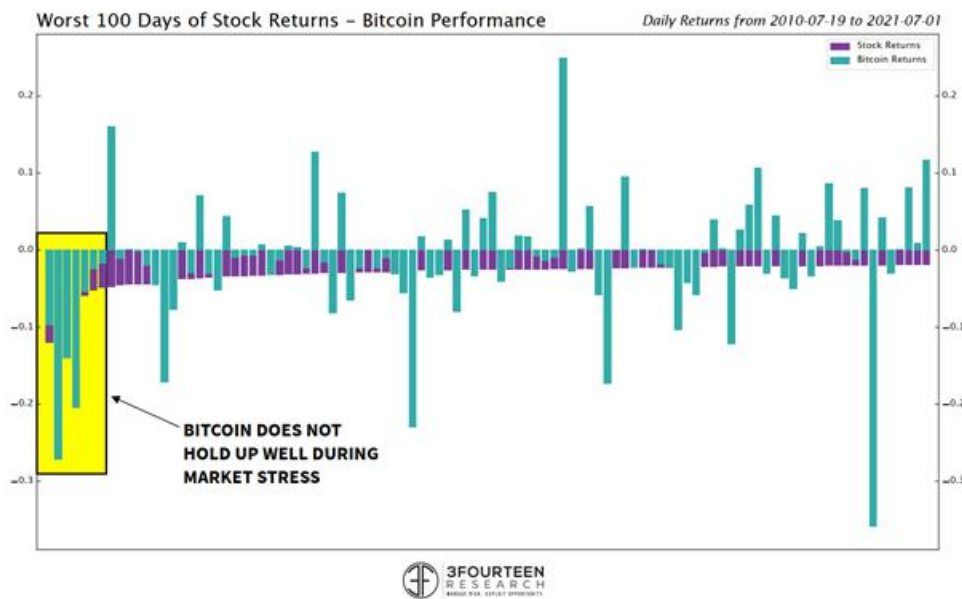
Does this mean we see no regulatory risk? No. With an emerging asset class, there is always the risk of a regulatory misstep. However, regulation in general should not be feared. Rather, regulation equals acceptance. Regulation clears the path for institutional adoption. While crypto is inching closer to this outcome, it is not completely there yet. In any event, we view Bitcoin as a net negative for countries that impose strict capital controls on their citizenry and a net positive for more laissez faire⁶ jurisdictions. Bad regulation is a risk, but proper regulation would facilitate mass adoption.

Broadening Adoption

As speculators, Bitcoin interests us because it is a new asset undergoing mass institutional adoption. It is quantitatively interesting due to its portfolio diversification benefits (low vs to other major assets), short-term trend following properties, and long-term mean reversion character. In short, it marches to its own beat with a secular tailwind at its back.

While Bitcoin is generally uncorrelated to other assets and could possibly boost portfolio returns, there is no evidence that it provides any hedge to equities.

We plot the 100 worst equity days (purple bars) and Bitcoin's returns (blue bars) on these days. Bitcoin was down on 61 out of these 100 days, and on the absolute worst days (far left) Bitcoin loses big.

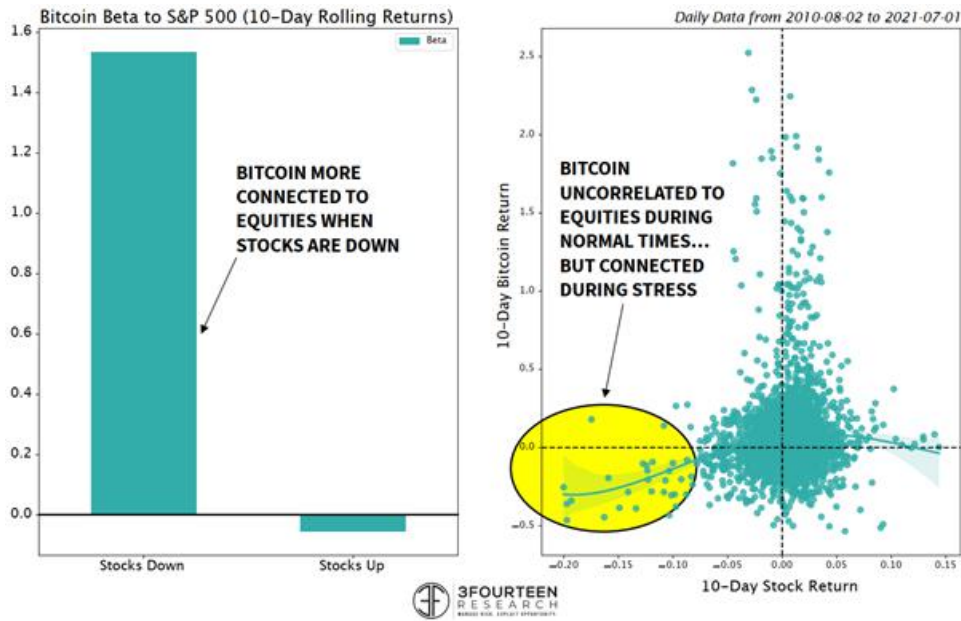


Worst 100 days on the S&P 500. Source: 3Fourteen Research.

Historical performance is not an indication of future performance and any investments may go down in value.

On days equities are down, Bitcoin's market beta is 1.5. On up days, Bitcoin's beta is slightly negative. Finally, the scatter plot (bottom right) compares 10-day returns for stocks and Bitcoin.

During periods of equity extremes (especially on the downside) Bitcoin seems to follow the mood of the market.



Source: 3Fourteen Research

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So, Bitcoin is no equity hedge. Why, then, has it managed to receive the label of an “uncorrelated” asset? Two reasons: First, most days, Bitcoin and the stock market move independently. It is only really during periods of acute stock market stress that the relationship shows up (see the first chart). Given the systemic nature of the equity market (i.e. equity market stress infects almost every other asset), this is not surprising. Second, Bitcoin can go through its own periods of stress, or exuberance, without seeming to impact the stock market.

Tactical Indicators

Academic research is emerging, and our testing confirms that traditional trend-following strategies work well as crypto risk management tools.

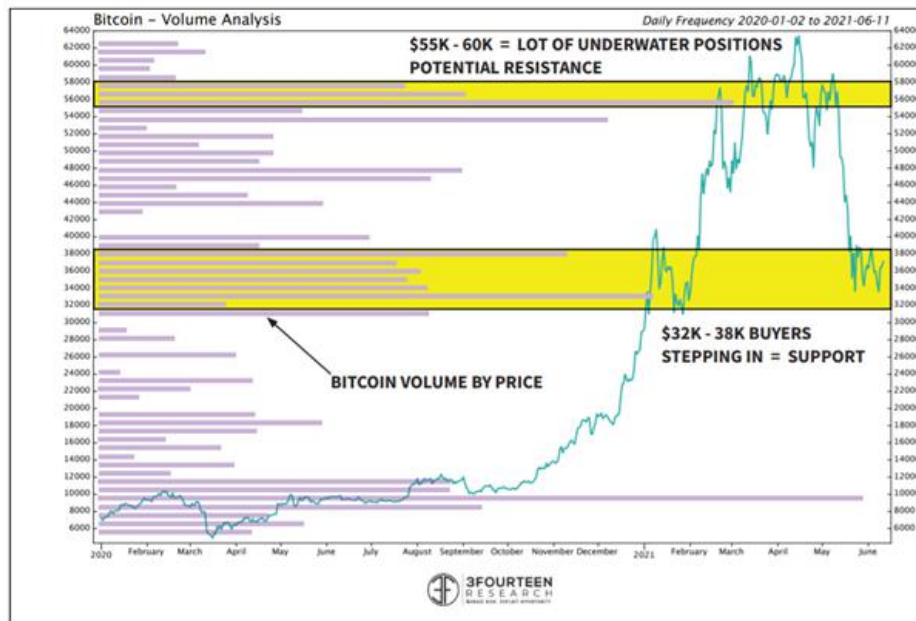
For tactical investors, 314 Research is providing some new modelling work that can help cut drawdowns substantially and preserve upside.

Underlying this model is a mix of:

- Trend Breadth
- Time series slope calculations
- Raw momentum and

- Flows into and out of Bitcoin as determined by its cumulative volume

In our testing, we have found Bitcoin responds to flow and volume data. One way we use volume data is to calculate the amount of volume that has taken place at different prices. This is known as "volume by price." In the chart below, we calculate Bitcoin's current volume by price. At present, we see a large volume block in the \$32-\$38k range acting as support. If Bitcoin is able to bounce from current levels, the volume block at \$55-\$60k is likely to act as resistance.



Source: 3Fourteen Research.

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Sources

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- <https://www.bloomberg.com/news/articles/2021-03-01/bitcoin-btc-billionaire-investor-dan-loeb-says-doing-deep-dive-into-crypto>
- <https://www.nytimes.com/2021/05/20/opinion/cryptocurrency-bitcoin.html>
- A fiat currency is a national currency that is not pegged to the price of a commodity such as gold or silver. The value of fiat money is largely based on the public's faith in the currency's issuer, which is normally that country's government or central bank.
- Laissez-faire is the policy which is based on the idea that governments and the law should not interfere with business, finance, or the conditions of people's working lives

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