WHEN BITCOIN MEETS INFLATION

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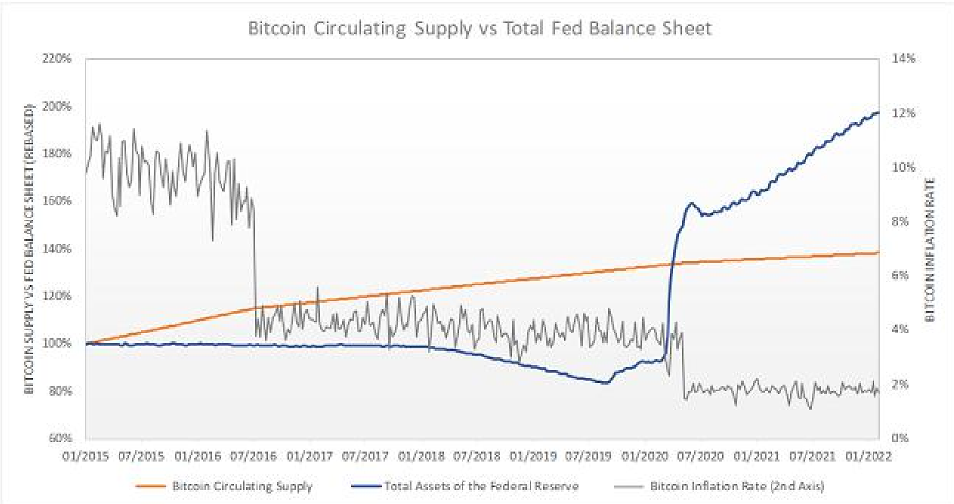
2022 is a challenging year, especially for crypto, as bitcoin approaches its correction phase in a halving cycle[1]. The crypto market started the year with price turbulence amid the Federal Reserve (Fed) raising interest rates, high inflation, and the general equity markets drop. The total crypto market cap briefly reached an all-time-high at $3trillion in early November 2021 and has dropped to $1.87trillion[2], with Bitcoin now at $41,206 (-11% Year to date (YTD)) and Ethereum at $2,883 (-23%YTD)[3]. This gives us the opportunity to deconstruct the myth that bitcoin is perceived as an inflation hedge from a technology design standpoint, and how the asset has behaved during the recent high inflationary environment. We then suggest some new ideas on how stablecoins and staking could be used as an alternative solution.

Technologically speaking The Bitcoin protocol is codified to be deflationary. New bitcoins are mined using computing power, and the mining rewards are predetermined– the reward halves every four years, hence the new supply of bitcoin halves – making bitcoin's issuance schedule consistent and predictable. Currently, over 90% of bitcoins are already in circulation (?18,989,550[4] as of 21st March 2022), and the max supply is capped at 21 million. Bitcoin's inflation rate, calculated as the percentage of new coins issued divided by the current supply, is currently at 1.8%[5] per annum (PA) and is scheduled to decrease after the next halving around March 2024.

Figure1: Compare Bitcoin Circulating Supply against Total Assets of the Federal Reserve (Rebased)



Source: Glassnode; FederalReserve; WisdomTree; 2nd March 2022.

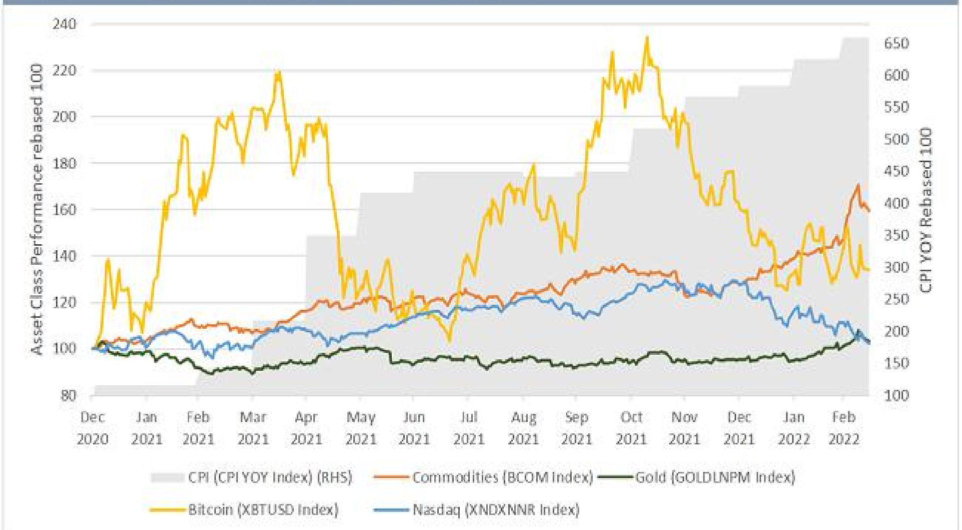
Historical performance is not an indication of future performance and any investments may go down in value.

Technologically speaking, bitcoin should be a good inflation-hedging instrument, but why didn't the price behave accordingly in recent markets?

Empirical evidence

The current inflation rate is around 7.9% in the US, 5.8% in the Euro Area, 6.0% in India, and 5.5% in the UK[6]. Geopolitical risks have pushed energy and commodity prices even higher, suggesting a likely continuation of higher inflation further into 2022. Different asset classes have reacted differently to this renaissance of inflation, highlighted in figure 2. Interestingly, bitcoin's price has not followed other inflation-hedging instruments like Gold or Commodities, neither has it appeared in high correlation with risk assets like tech stocks.
This contradicts the widely cited narrative of bitcoin being an "inflation hedge," a place to put your money when fiat is losing real-world value. What could be the possible explanations?

Figure 2: Asset Class Returns January 2021 - March 2022 Rebased



Source: Bloomberg; WisdomTree; 1 January 2021 – 15 March 2022.

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1) A nascent asset class with a short track record

Bitcoin was only created in 2009 and its mainstream adoption didn't start until 2019[7]. During this period, the global developed economies haven't seen much inflation to test how it would react to such conditions. 2021 was the first time where bitcoin was put to the test in a high inflationary environment. Traditional inflation hedging assets like gold, commodities, and real assets, have all been through several inflation cycles, this gave them the time to attract investors and establish themselves as inflation-hedging instruments. This is important, because it takes time for investors to be convinced an asset is value-preserving.

Bitcoin, as a nascent market, differs to other traditional assets like gold/commodities, especially in areas like:

- **Retail vs institutional participation:** The bitcoin market is still dominated by retail investors

- **Derivative instruments:** Fewer hedging solutions for bitcoin; derivatives trading volumes are much lower than traditional assets

- **Regulatory guidance:** The regulatory framework on crypto is evolving

- **Product availability:** There are fewer regulated financial products (i.e. funds/exchange traded funds (ETFs)) available for investors to access.

- **Market infrastructure:** such as settlement, prime brokerage, quality data provider, etc

These factors mean that the bitcoin market is at a fundamentally different development stage to traditional assets. It is nascent and at this stage, the asset has just begun to be adopted by large institutions.

These are reasons why Bitcoin and other cryptoassets are demonstrating "growth-in-value", liquid venture capital (VC) characteristics at this current stage. As the market continues to mature, Bitcoin's "store-of-value" characteristics may become more apparent and this is where bitcoin could become a more traditional inflation-hedging instrument.

2) High inflation is not the only factor impacting 2021/22 global markets

2021 is too short a period to assess whether bitcoin is an inflation hedge. The global market hasn't seen a high inflationary environment like the current one since 1982[8]. Besides inflation, there are geopolitical factors, the post-covid economic recovery and other macro factors driving the assets' performance. Indeed, this may be the reason why gold, as a traditional inflation hedge, did not react until 2022 to high inflation.

There are other challenges unique to crypto in 2021/22, namely regulation shifts, i.e. China's blanket ban on crypto; and social media influences, e.g. Elon Musk tweets. These factors have also impacted the price of bitcoin and cryptoassets alike, adding to the price volatility.

Via these two lenses, investors can now understand why bitcoin has not acted as an inflation hedge in the recent market conditions. Bitcoin's price history still paints a 30-day rolling volatility of 75.35% annualised[9].

Another idea

For investors hesitant of crypto's volatile nature, another idea is to consider using stablecoins to obtain staking yield as inflation hedge. The idea is that these cryptocurrencies like Tether (USDT) and USD Coin (USDC) are created to peg to US Dollar, therefore their value stabilises around $1. Staking allows investors to deposit their crypto for certain activities such as providing liquidity and forming the lending pool. In return, the investor is rewarded, currently at 8.3% PA for USDT and 7.2%p.a. for USDC[10], much higher than the traditional currency strategies under current market conditions.

However, several risk factors play into account when putting your crypto at stake: market risk – coin value deviates from $1; collateral risk - quality and liquidity of the reserve assets i.e., commercial papers, lockup periods, counterparty risk, loss/theft and so on.

Outside stablecoins, other cryptoassets like Solana, Cardano, Avalanche, are also popular options for staking, and there are recognised wrapper solutions such as a Solana staking exchange traded product (ETP) acting as a one-stop solution, where investors can outsource the crypto trading, custody and staking process to the ETP issuer while benefiting from the enhanced performances from staking. The staking rewards on these Proof-of-Stake assets are normally much higher compared with stablecoins, as the staked coins have the functional role to validate transactions on the blockchains, generating utility for the network.

Bottom line

Investors habitually invest in gold, real estate, commodities, and other real assets to protect against future inflation. 2021 created a set of complex market conditions, which provided the opportunity to introduce bitcoin and other cryptoassets as a potential investment idea. This nascent asset class introduces a liquid VC-like growth potential for investors to access the disruptive blockchain technology. As more use cases develop and institutional adoption continues at log speed, crypto assets like bitcoin will grow to stabilise and could potentially act as an effective 'store-of-value' solution in the future.

Sources

[1] WisdomTree Market Outlook March 2022: https://www.wisdomtree.eu/-/media/eu-media-files/other-documents/research/market-insights/wisdomtree-market-outlook-model-portfolios.pdf

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[9] CoinGecko, WisdomTree; 8 March 2022

[10] https://www.stakingrewards.com/earn/tether/, 21 March, 2022.

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