STGFM Insight

Cryptocurrencies / Digital Assets

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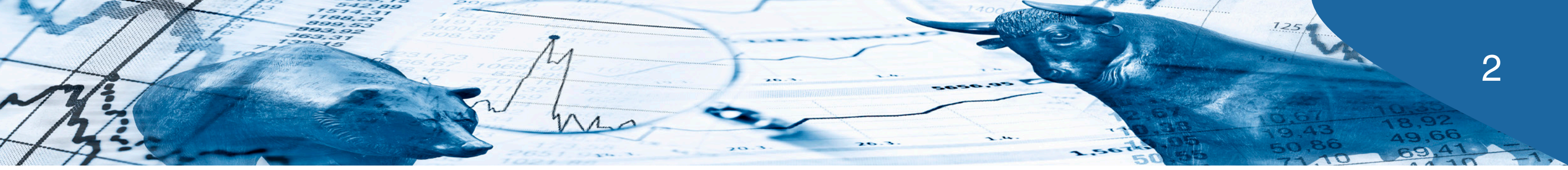
St. Gotthard
Fund Management



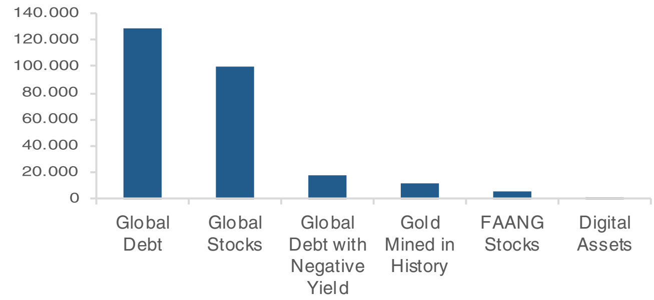
Not just a fashionable craze? More and more financial market participants are warming up to the idea that the past years have seen an emergence of a new asset class: cryptocurrencies. Many object to the relevance of code-based “currencies”, which ultimately are but long lists of data. However, recent news about major financial institutions, important market players and even high-ranking strategists accepting the potential that the distributed ledger technology (DLT) offers to us is further proof that a new asset class has come to light and that it will change many aspects of today’s financial markets going forward.

Following the boom in the years up to 2017, the hangover after the party brought with it a correction of some 85% to a level in December 2018 that was still some 16 times above the lows of Januar 2015. From there, a renewed uptrend started towards the all-time highs of late 2017. The bitcoin price just broke through its previous all-time high at 20K, leading to a market capitalization of existing bitcoins of more than USD 400bn. This may sound very high for “a simple protocol”. We take a somewhat different view: compared to other asset classes such as the global bond market, with an estimated volume of more than USD 125 trillion, bitcoin’s market cap represents a mere 0.4%.

TOTAL CRYPTO MARKET CAP IN BILLION USD

Source: www.coingecko.com

ASSET CLASS COMPARISON: MARKET CAP IN BILLION USD

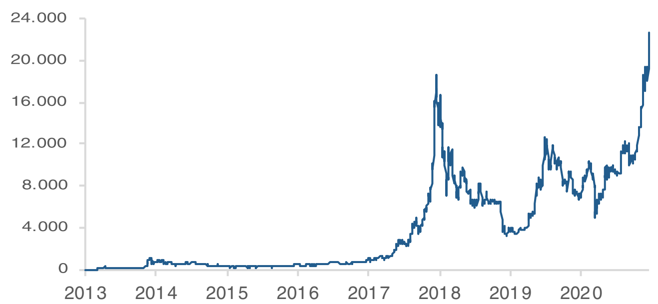


Sources: Bloomberg, ICMA, World Gold Council, www.coingecko.com

The increase in attention that bitcoin, Ethereum, and the alt-coin complex have gained can also be observed in their respective price levels, which have risen severalfold since the lows in March of this year. In this edition of STGFM Insight, we want to shed light on the asset class, while trying to offer some, if simplistic, valuation approach. As many uncertainties exist, not least due to regulation issues – in some countries, cryptocurrencies are outright banned – the presented views are only a broad sketch of whereto the journey of bitcoin and its peers could carry us.

Emergence of an asset class - The asset class was born in November 2008, when the seminal 9-pages long white paper was published by pseudonymous Satoshi Nakamoto, and on January 3, 2009, respectively, with the bitcoin genesis block mined. The first transaction of goods for bitcoins took place in May 2010, when two pizzas were bought for 10’000 bitcoins, today worth a triple-digit million dollar amount. Used primarily by IT specialists, bitcoin was not broadly known until towards the end of the second wave that culminated in late 2013, a larger audience started to take note. This obscure software-based, cryptologically-secured peer-to-peer network (i.e. decentralized by definition) had reached a market cap of USD 10bn. The following roughly 18 months seemed to confirm the sceptics, as the bitcoin price receded by about 80% to just above 200 USD. However, the ensuing bull market until late 2017, during which BTC went up almost a hundredfold to close to 20’000 USD, to us is evidence that cryptocurrencies satisfy a demand and hence are here to stay.

BITCOIN PRICE IN USD

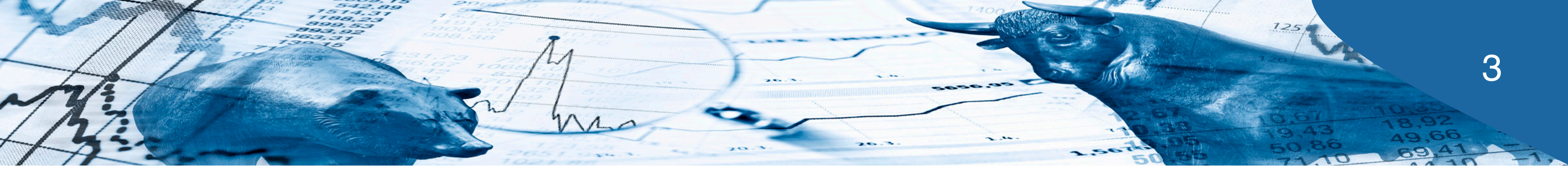


Source: Bloomberg

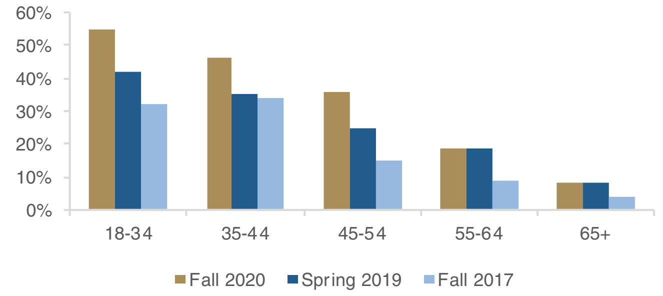
Digital gold valuation approach - Taking this argument one step further, also because many cryptocurrency advocates refer to bitcoin as “digital gold”, the total gold mined throughout history amounts to about 200’000 metric tonnes, i.e. 200 million kilograms. We know from the bitcoin protocol that the maximum amount of bitcoin supply (expected in the year 2140) is 21 million, of which roughly 18.5 million have been mined to date. Keeping things simple, there are about 10kg of gold per bitcoin in circulation. Applying, for the sake of staying conservative, a discount of 90%, this would result in one bitcoin approximating one kilogram of gold, currently trading around USD 60’000. At St. Gotthard Fund Management, we take the view that the bitcoin price could well reach these levels over the course of the coming 1-2 years. Any appreciation of the gold price (in fiat terms), by the way, would be reflected in an even higher estimate, based on this line of argument.

In recent weeks, several renowned investment strategists have drawn similar comparisons. Some even stated that, in today’s digital world, digital currencies could take the place of gold as millennials’ “receptivity” to technology and cryptocurrencies are real. A survey taken this summer in the US showed that only 3% of Baby Boomers (56-74 years old) have assets in the form of cryptocurrencies, compared to 21% in the Generation-X cohort (41-55 years) and 27% of the Millennials (24-39 years). From this viewpoint, demand for digital assets is only set to grow.

Another survey that took place in October 2020 and repeated the same questions as in the fall of 2017 and in the spring of 2019 showed an increasing likelihood of the more than 2000 surveyed persons to buy bitcoin in the coming 5 years. Across all age groups (except for the 65+ cohort), the percentage of respondents that said that it “is very or somewhat likely to purchase Bitcoin in the next 5 years” has grown, while the generational skewness remains in place over time.



PROPENSITY TO PURCHASE BITCOIN IN THE NEXT 5 YEARS

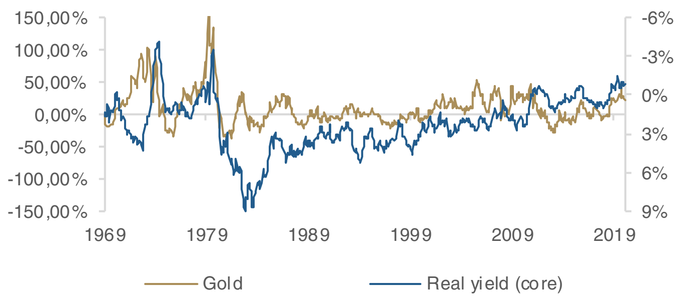


Source: The Harris Poll

The case for alternatives to fiat currencies in general - After forty years of falling inflation rates, major central banks continue to support the real economy with wide open liquidity taps. Considering the built-up money supply and the publicly stated intentions to keep the taps open until inflation really picks up, a sudden weening off must not be expected. However, this "generosity" by central banks has led to a structural shift in nominal interest rates: the average yield to worst of global bonds has moved to below 1% p.a., while the outstanding value of negatively yielding bonds currently stands at USD 18 trillion (18'000 billion). Considering inflation, i.e. the loss of purchasing power, amounting to 1-1.5% at this point (and expected to rise significantly in the medium term), investing in bonds on a real basis leads to losses.

During times of negative real yields, that is nominal interest rates below rates of inflation, non-yielding investments such as gold all of the sudden shine in a different light: since 1968, when real 10-year US Treasury yields were negative, gold returned more than 15% annually, compared to less than 1% when real rates were above 3.5%. An equal line of reasoning may be followed in the case of bitcoin which does not yield anything as well. Taking the argument one step further, with the announced bond yield suppression on behalf of central banks, real yields will stay negative for a long time, in our view. This bodes very well for demand for alternatives to fiat currencies such as precious metals or the cryptocurrency complex.

GOLD PRICE AND REAL YIELDS



Source: Bloomberg

It's not all about bitcoin - Bitcoin, the oldest and by far biggest cryptocurrency in terms of market capitalization, currently makes up roughly 66% of total cryptocurrency market capitalization. Having commenced the asset class in 2009, dominance was at 100%, but started to fall below the 95% level only in early 2017. In the ICO craze of 2017, when numerous new "coins" were brought to market (via initial coin offerings, ICOs), bitcoin's market capitalization share of the total cryptocurrency market capitalization had dropped to below 40%, but since has recovered.

Considering the many new DLT projects that have spawned in the past years, progress is being made on many fronts as we write. Various potential applications of DLT in many business areas such as the Financial Services Sector, Healthcare, Insurance, Real Estate, Music, Logistics and Supply Chain have already been tested and are only at the beginning of showing the blockchain technology's potential. While the ICO craze of 2017 lacked in many cases viable projects, many companies have started putting the technology to daily use, and many more will follow. Institutional infrastructure is being built at an ever faster pace; companies such as DBS or Fidelity, to name but two, are for instance paving the way for better custody and trading experience in the field of financial markets.

BITCOIN DOMINANCE

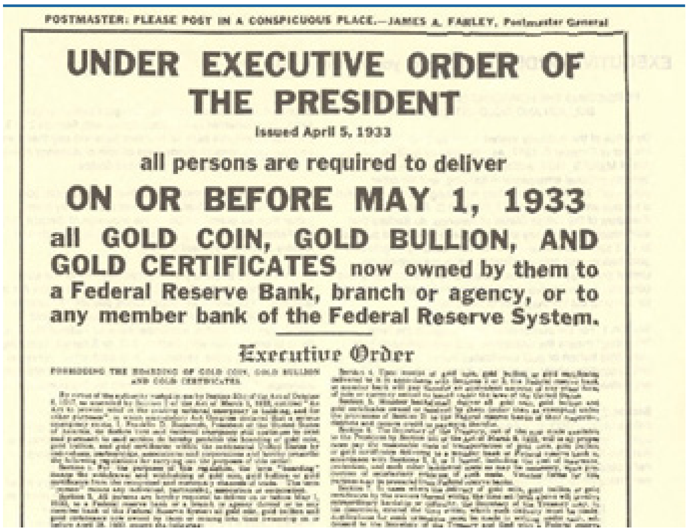
Source: Bloomberg

Who said cryptocurrencies do not offer yield? The term "Decentralized Finance" (DeFi) currently is a hot topic among crypto circles. DeFi means an experimental form of finance that does not rely on central financial intermediaries such as brokerages, exchanges, or banks, and instead utilizes smart contracts on blockchains, the most common being Ethereum. The tokens utilized in many projects offer participants the possibility to lock their own tokens (or "stake") in order to make the blockchain more secure – for a return, financed by transaction fees and/or the mining of new coins. Staking yields in some cases amount to more than 10% p.a. Increasing adoption of a given coin or token should lead to price rises relative to fiat currency, therefore the two main return drivers are at work for investors, income and capital gain. We can see huge potential for many projects in the different areas of activity (lending, song royalties licensing, or simply smart contracts in general) and have personally invested in certain projects.

Compared to today's financial market infrastructure, blockchain technology offers much quicker settlement of trades, for instance. In summary, the decentralized nature of DLT in general will change the face of the financial industry (and many other business areas) profoundly, in our view. For this to happen, the respective tokens and coins will be increasingly adopted and hence see much more capital inflows in the coming years.

What will the regulators say? One major counterargument to investing in cryptocurrencies is the risk of outright government bans or of such stifling regulation that makes the use of cryptocurrencies virtually impossible. This misgiving runs counter to the very basic characteristic of DLT: its decentralized nature. There is a possibility that bitcoin will be prohibited to hold. After all, Executive Order 6102 by Franklin D. Roosevelt in 1933 forbid US citizens "the hoarding of gold coin, gold bullion and gold certificates", which remained in force until late 1974. We take the view it is easier to hide a list of numbers and letters than gold.

EXECUTIVE ORDER 6102 (1933)


POSTMASTER: PLEASE POST IN A CONSPICUOUS PLACE.—JAMES A. FARLEY, Postmaster General

UNDER EXECUTIVE ORDER OF THE PRESIDENT

Issued April 5, 1933

all persons are required to deliver

ON OR BEFORE MAY 1, 1933

all GOLD COIN, GOLD BULLION, AND GOLD CERTIFICATES now owned by them to a Federal Reserve Bank, branch or agency, or to any member bank of the Federal Reserve System.

Executive Order

FORBIDDING THE HOARDING OF GOLD COIN, GOLD BULLION AND GOLD CERTIFICATES

Source: www.wikipedia.org

The introduction of stringent Anti-Money-Laundering (AML) regulation has clearly become an obstacle to cryptocurrencies' promise of unfettered flow of data. However, processes have been set up that allow for cryptocurrency accounts at well-regulated banks (such as in Switzerland and elsewhere), while major market players such as Paypal now offer its 327 million clients to engage into bitcoin transactions. Apart from that, there have been a variety of investment product launches that allow investors to participate in the rally without the need to engage into handling wallets and the connected risks. More is here to come from the institutional side as well. Bitcoin is not a currency in the meaning of a medium of exchange, but rather a store of value. Thus, it is worth as much as others are to pay for it – in a world of constantly rising fiat money supply, the demand could well continue to grow significantly. We often hear the argument on behalf of the crypto industry that there is always a lot of talk to regulate digital assets in the US. We would like to ask the question that, if a regulator wants to ban crypto, would it really spend much of its time and resources on regulating it first?

Central bank-issued digital currencies (CBDC) - Another proof of growing adoption of the DLT concept are the experiments of central banks in connection with the establishment of digital currencies by themselves. First projects and Proofs of Concept (PoC) have already been completed, e.g. these days with the participation of the Swiss National Bank (SNB). While exponents of the SNB have refused to signal any plans of adopting any form of CBDC in the future, the mere fact of the central bank's interest and active involvement (as well as the Bank of International Settlement's, by the way) to us shows that regulatory bodies have woken up to this new, exciting technology.

As any potential CBDC would be linked one-to-one to existing fiat currencies such as the US-dollar or euro, we doubt that they will replace existing cryptocurrencies with a different (and more limited) supply mechanism than the bloated and further expanding fiat money supply that we have witnessed in the past 20 years. The basic notion of alternative store of value will not apply to CBDC. Moreover, many citizens will not like the prospect of having every single citizen's monetary transaction stored forever on a government server, so there is much opposition to a pure CBDC-based currency system to expect, in our view.

CONCLUSION

- A new asset class is emerging, although at about USD 650 billion, its size does not compare to that of traditional asset classes such as fixed income (125 trillion), equities (100 trillion), or even gold (12 trillion).
- We are convinced that we will see a further catching up, notably due to more institutional investors warming up to the crypto complex.
- Were one to compare total bitcoin supply with total gold stocks ever mined, while applying a discount of 90% to bitcoin, the price target for bitcoin would be somewhere around USD 60'000, assuming constant gold prices.
- The basis for the new asset class, the distributed ledger technology, is truly revolutionary: the concept of thousands of computers storing a copy of the same information, while constantly exchanging the latest transactions among them in a decentralized manner in real-time via the internet, in essence assures decentralized trust, as these records become unalterable and are hence impossible to forge.
- Should we start to detect inflation to propel higher, we foresee an even bigger inflow into this new asset class as many digital assets may well be considered alternative stores of value.

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