Cryptos’ Many Damocles’ Swords

The famed “sword of Damocles” dates back to an ancient parable popularized by the Roman philosopher Cicero in 45 B.C. In Cicero’s version of the tale, a tyrannical king named Dionysius II remains utterly unhappy, despite his wealth and power. As the story goes, one day, a court flatterer named Damocles showers the king with compliments and remarks how blissful his life must be. The king responds by offering Damocles an opportunity to switch places for one day so that Damocles can taste his good fortune firsthand. Eagerly accepting the proposal, Damocles is showered with lavish food and goods, but just as he is starting to enjoy his time on the throne, he notices that King Dionysius hung a razor-sharp sword from the ceiling, suspended only by single strand of horsehair. For the rest of the story, the courtier rightfully fears for his life, which makes it impossible to indulge in the fleeting opulences of his short-lived time on the throne.

This parable later became a common motif in medieval literature and was more recently and famously used in a speech by President John F. Kennedy during the Cold War when he stated: “Every man, woman and child lives under a nuclear sword of Damocles, hanging by the slenderest of threads, capable of being cut at any moment by accident or miscalculation or by madness.”

The phrase “sword of Damocles” is now commonly used as a catchall term to describe a looming danger. In the context of this week’s newsletter, Evergreen Gavekal’s partner Louis-Vincent Gave points to the many threats facing the cryptocurrency space. Despite its meteoric rise in the first quarter of the year, the world’s first cryptocurrency, bitcoin, went from going “to the moon” by mid-April to losing over half of its value by mid-June. In April, this newsletter published “Bitcon No More,” highlighting the merits of the digital coin, but stating that we believed the asset looked overextended and would sell off on a near-term basis.

Speaking of bitcoin as an asset class, Goldman Sachs recently published a fascinating report called “Crypto: A New Asset Class?” Inside the paper, cryptocurrency analysts and financial experts are asked a simple question that you can probably infer from the name of the publication. Not unexpectedly, the experts shared divided opinions on what the future holds for cryptocurrencies.

As you will read below, our esteemed colleague sits on the side of the fence that believes many cryptocurrencies, including bitcoin, are facing a perilous future. But, the biggest risk he sees facing the cryptocurrency space might surprise you. Without giving away Louis’ punchline, a small hint is that the threat looms on the other side of the Pacific. For those that tracked market news this week, the risk comes from the same “republic” that is plotting to crack down on certain international tech securities listed on US exchanges. But more to come on that in next week’s newsletter…

Since peaking in mid-April at US$63,500, bitcoin has almost halved in value, making a series of lower highs and lower lows (see chart below). For such a high-beta asset, this roll-over is interesting given that risk assets such as equities have powered on to new highs. Behind thispull-back lies an apparent shift in narrative. In recent months, the mass media's take on crypto-currencies has shifted to their use by criminal hackers holding corporates like Colonial Pipelineto ransom, and their gluttonous energy consumption. So has the overall environment for cryptos materially changed?

Cryptos are a hard-to-pigeonhole asset class. A decade into their development, they are used in very few transactions, and so are not a currency. Yet neither are they a commodity, as they cannot be used to make consumption goods. If anything, cryptos are a perpetual zero-coupon bond, whose future supply is limited (unlike current government bonds!). This, in turn, may help explain some of their volatility. After all, 30-year zero coupon bonds are by far the most volatile instrument in the fixed income universe, so imagine the volatility on a perpetual zero coupon bond: the first hint of structurally rising interest rates could decimate the asset class. And yet rising rates are not the only threat to the past decade's bull market in all things crypto.

Another worry is that the bigger a market becomes, the more money it must attract for prices to keep pushing higher. Now, in a world where the Federal Reserve and European Central Bank are pumping around US$3trn a year into their combined economies, this concern could perhaps be brushed away. But what if central banks start to revisit the rationale behind their liquidity injection programs? Or worse still, what if rising prices, notably for energy, become a liquidity drain. In such an environment, crypto-currencies may struggle to attract the marginal dollar.

Now, a quick look at liquidity inflows, and outflows, into cryptos, most notably into bitcoin, shows that investors often use tether as a halfway house for taking positions. Could such operations also be a Sword of Damocles hanging over the crypto space? For while the issuer of tether claims that every coin is backed by a range of reserve assets, the value and quality of those "reserves" have repeatedly been questioned. And of course, if tether's backing does come to be doubted, any mass withdrawal could resemble a bank run. Except this would be a bank run with no government back-stop. On a related note, UK authorities last weekend stopped Binance, a prominent cryptocurrency exchange, from operating in Britain and on Monday, Binance customers in the UK lost access to a major payments gateway.

But perhaps the biggest threat to the crypto space is the upcoming launch of the digital renminbi, potentially in time for the Beijing Winter Olympics in February 2022. This will see the introduction of a new currency whose payment and savings functionality could quickly garner a billion users. This matters because a lesson of recent decades is that in our platform-driven world, there are very few silver medals and even fewer bronzes. Instead, we live in a "winner takes all" environment. Being second to Facebook, Google or Amazon has simply not been a very attractive proposition.

With this in mind, will there be a future for bitcoins, or dogecoins, or any other decentralized coin once savers in Shanghai, Caracas, Athens, Paris or Miami can keep savings in a renminbi wallet and use it to buy goods on Alibaba, or services on Tencent? Will the launch of the digital renminbi be the death knell for other digital currencies?

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