The Bitcoin Bubble Changes Shape

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"It looks remarkably like a bubble forming to me… Over the centuries we've seen bubbles, and this appears to be a classic case. With a bubble, you never know how far it's going to go before it comes down."
-GRANT SPENCER, Reserve Bank of New Zealand Acting Governor, referring to Bitcoin

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Up, Up and Away? It's been two weeks since we wrote on the Bitcoin bubble and whether investors should consider jumping on the train to never-never land. Our case against such action was that Bitcoin is volatile, doesn't behave like a currency, isn't backed, is extremely expensive, and could become banned.

Despite these warnings (not that the market listens to us, anyways), the price of Bitcoin continued to run hot, surging from $10,000 to $17,000 within a week.

One particularly significant development that could have a long-term impact on the price of Bitcoin was the launch of Chicago Board Options Exchange's (CBOE) Bitcoin futures contracts on Monday. Essentially, this makes it possible for investors to bet on Bitcoin without having to ~~physically~~ virtually own the cryptocurrency. However, opening the floodgates to traditional investment vehicles may not be in the best interest of broader asset classes or the market at large. In fact, as Louis Vincent-Gave, Gavekal's co-founder and the author of this week's EVA, points out, Bitcoin futures trading changes the nature of the Bitcoin bubble, with ramifications that could extend well beyond cyberspace.

With the introduction of futures trading, "Bitcoin mania" is looking increasingly like the capstone on asset inflation that has been building in recent years. Moreover, when the bubble bursts, Bitcoin could very well be the bubble that kills all bubbles.

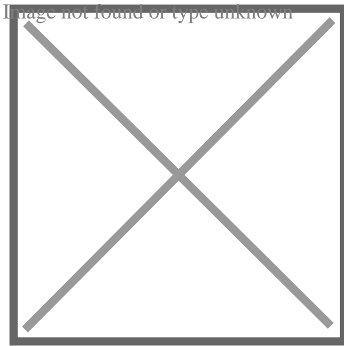
Don't see that as a possibility? Consider this statement made by Joseph Borg, securities regulator, to CNBC on Monday:

> "We've seen mortgages being taken out to buy bitcoin. … People do credit cards, equity lines. This is not something a guy who's making $100,000 a year, who's got a mortgage and two kids in college ought to be invested in."

But that's exactly what Joe and Jane Six-pack are doing – buying up leveraged positions in a speculative "currency" or futures contract that is…again…extremely volatile, doesn't behave like a currency, has no backing, has literally gone up in a vertical fashion lately, and could become banned. And it's beginning to remind some market experts (including us) of when financial institutions packaged mortgages into debt-based securities leading up to the global financial crisis.

The fear of this "mania" turning into "complete and utter madness" could further motivate central bankers to begin tightening faster and faster, resulting in what might be a very severe market whiplash.

Up, up and away? Perhaps – maybe Bitcoin is headed far higher, as its many backers claim. We don’t profess to know but we do stick with the time-proven belief that the bigger the binge, the bigger the hangover.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THE BITCOIN BUBBLE CHANGES SHAPE
By Louis-Vincent Gave

All the talk about crypto-currencies, initial coin offerings (ICOs), distributed ledgers, etc. feels a lot like discussions on carnal knowledge in a high school boys’ locker room. Everyone is talking about it. Yet almost everyone’s experience is extremely limited. And it is likely to stay that way for the time being, because for all the talk, very few of those doing the chattering are actually getting any action. So, what is there left to say about the unfolding crypto-bubble that hasn’t already been repeated ad nauseam by the financial press and the general media?

The obvious first point is that this is a bubble, not so much because of the parabolic price action (impressive as that has been), but because of the overall value now ascribed to the crypto-currency market. In our capitalist system, “things” have a value because of the “services” that they provide. So, Starbucks is worth US$83bn because so many of us are willing to fork out US$5 or so for a cappuccino made with soy milk. Or Tencent is worth US$480bn because so many Chinese people spend their waking hours playing Honor of Kings. But do crypto-currencies genuinely have US$440bn of value-added?

The main claim to economic value-added of the bitcoin/ledger revolution is the elimination of intermediaries, whether banks, transfer agencies, or even venture capital funds. Take ICO funding as an example. It is estimated that this year some US$2.6bn of VC funding found its way to various start-ups through the issue of ICOs; coins that are in essence backed by the future earnings of a company, instead of by the taxation power of governments. This is a game-changer. But is it enough of a game-changer to justify a surge to US$440bn in market cap in such a short period of time?

Put it this way: to most people, it would seem that the purpose of Amazon is also to destroy the various intermediaries that still survive in the capitalist system. Perhaps not financial intermediaries, as the distributed ledger revolution promises to do, but commercial intermediaries. And while Amazon today also boasts a chunky market cap of US$560bn, it took

two decades to get there, rather than a single year.

Would that not seem a more reasonable pace of growth for the cryptocurrency universe? If only because people's patterns of behavior, especially when it comes to money, take a very long time to evolve? As Charles likes to say, "people change spouses more often than they change banks". Therefore, won't moving large numbers of transactions from the real world to the ether take a whole lot longer than today's distributed ledger enthusiasts anticipate? Especially since wider adoption will run into its own challenges, not least of which is much greater electricity consumption. Indeed, mining and transacting bitcoin is extremely energy-intensive; so much so that it is estimated that today's "bitcoin use" around the world consumes about as much energy each day as Ireland. In time, this could present a hurdle to further growth.

For now, however, the biggest hurdle to widespread bitcoin adoption has to be Gresham's Law. This is the idea that a "good" currency is chased out by a "bad" currency, as people hoard the good currency and use only the bad one for day-to-day transactions.

To illustrate this, imagine a pothead who bought himself a bag of marijuana for one bitcoin two years ago (for let's face it, early adoption of bitcoin was heavily concentrated among purchasers of illegal substances). Our dope-fiend is now looking back and thinking, "darn it! that bag cost me US$17,000".

This surge highlights a simple point: any currency is first and foremost a means of exchange. And a currency with an annualized 30-day volatility of over 100% cannot genuinely be considered a means of exchange!

But all this talk of a bubble leads me to one simple observation: **this "bitcoin bubble" is completely unique, and unlike anything else I have witnessed in my career.** There are two reasons for this:

1. **This is the first bubble where an exponential rise in price does not trigger a consequent increase in supply.** Consider the 1999 internet bubble by way of comparison. The more internet stocks rose, the more friendly investment bankers came knocking on everyone's door to flog ever more paper of ever-diminishing quality. But today, the more bitcoin rises in price, the more it encourages new companies to fund themselves through ICOs, coins that are then often used to purchase bitcoins, whose own supply remains highly constrained regardless of underlying valuation or market pricing.
2. **This is the first bubble in my career that has inflated almost entirely without any increase in leverage.** At least until now, I have not heard of anyone trading bitcoin on a margin account.

For these two reasons, it might almost be possible to conclude that the bitcoin bubble doesn't matter, at least from a macroeconomic standpoint. The lack of leverage means that if and when the bitcoin bubble implodes, the economic repercussions will be limited and there will be few "ripple effects". Indeed, our clients may remember that Gavekal likes to classify bubbles aseither "productive" (when capital pours into productive assets such as railways, or telecom lines)or "unproductive" (when capital pours into scarce assets, like modern art, gold, or land inJapan). In a nonproductive bubble, when the implosion happens the economic system is leftwith neither more nor less land, gold, or Van Goghs than it started with. In a productive bubble,the implosion means that assets usually change hands to a new set of owners who canmaximize the revenue from the investments made.

The other characteristic of bubbles is how they are financed. Bubbles financed by debt have wide-ranging repercussions, and can often trigger a decade-long hangover. Bubbles financed by equity are typically worked out fairly quickly; the equity just moves to a new set of owners without too much long-term drag on the economy's structural growth.

So, until now, one could almost conclude that the bitcoin bubble should not be of much concern to most investors, as its scope to have a negative impact on economic growth is very limited. However, the question now has to be whether this is about to change with the launch today of the CBOE's bitcoin futures contracts (and next Monday of a rival contract on the CME). Now, thanks to futures, investors will be able to take on leveraged bitcoin positions. In turn, that may mean that a future sharp downturn in bitcoin could have repercussions for other asset classes.

From what I gathered at a recent CBOE meeting on the launch of bitcoin futures, investors will have to post 35% margin against their bitcoin positions. Now I am not a futures trader, nor would I claim any expertise in clearing operations. But with this lack of expertise fully disclosed, 35% margin seems to me to be ridiculously low given the volatility of the underlying. After all, in recent weeks we have seen bitcoin go up and down by almost that much in less time than it takes Congressman Conyers to get undressed. So, what would happen if, say, bitcoins were to fall by more than half over the course of a few hours? The exchange would issue margin calls to cover its liabilities, and investors would find that they are suddenly liable for losses far beyond their initial margins. In essence, an account holding some bitcoin futures, some S&P 500 and some US treasuries could be forced to liquidate bond and equity positions to fund its bitcoin loss.

The launch of bitcoin futures marks a profound shift for the world of crypto-currencies. It brings them out of the shadows and into the open. But the open may not prove the warm and friendly place that the current bitcoin price seems to anticipate. However one cuts it, bitcoin futures trading will now change the nature of the bitcoin bubble, with possible wider ramifications that extend far beyond the world of a few technogeeks exchanging virtual baseball cards with one another...

OUR CURRENT LIKES AND DISLIKES

No changes this week.

LIKE

- Large-cap growth (during a correction)

- International developed markets (during a correction)
- Cash
- Publicly-traded pipeline partnerships (MLPs) yielding 7%-12% (we like them even more after their recent correction)
- Intermediate-term investment-grade corporate bonds, yielding approximately 4%
- Gold-mining stocks
- Gold
- Select blue chip oil stocks (wait for a pull-back after their recent strong run)
- Mexican stocks (at lower prices after this year's robust rally)
- Bonds denominated in renminbi trading in Hong Kong (dim sum bonds)
- Short euro ETF (due to the euro's weakness of late, refrain from initiating or adding to this short)
- Intermediate municipal bonds with strong credit ratings

NEUTRAL

- Most cyclical resource-based stocks
- Short-term investment grade corporate bonds
- High-quality preferred stocks yielding 6%
- Mid-cap growth
- Emerging stock markets, however a number of Asian developing markets, ex-India, appear undervalued
- Select European banks
- BB-rated corporate bonds (i.e., high-quality, high yield)
- Investment-grade floating rate corporate bonds
- Long-term Treasury bonds
- Long-term investment grade corporate bonds
- Intermediate-term Treasury bonds
- Long-term municipal bonds
- Emerging bond markets (dollar-based or hedged); local currency in a few select cases
- Solar Yield Cos (taking partial profits on these)
- Large-cap value
- Canadian REITs (on a pull-back after a healthy recent run-up)

DISLIKE

- US-based Real Estate Investment Trusts (REITs) (once again, some small-and mid-cap issues appear attractive; also, some retail-exposed REITs look deeply undervalued)
- Small-cap value
- Mid-cap value
- Small-cap growth
- Lower-rated junk bonds
- Canadian dollar-denominated bonds (the loonie is currently overbought)
- Short yen ETF (in fact, the yen looks poised to rally)
- Emerging market bonds (local currency)
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- Floating-rate bank debt (junk)
- US industrial machinery stocks (such as one that runs like a certain forest animal, and another famous for its yellow-colored equipment)

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