

The FTX Bezzle

By Louis Vincent-Gave

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Almost 70 years ago, John Kenneth Galbraith explained that during a bull market there is a period when an embezzler enjoys his ill-gotten gains, but the victim does not yet know he has lost out. Think of rich Europeans who invested with Bernie Madoff, and spent their summers in Saint Tropez and their winters in Saint Moritz believing Madoff was compounding their assets at a steady 12% a year. While the “bezzle” was on, the economies of Saint Moritz and Saint Tropez hummed along nicely, and the world seemed better off. In this interval, there were two engines of “unfounded” economic activity: Madoff bought watches, yachts and holiday homes, while the investors he was conning continued to spend as if their balance sheets were still rock solid.

Picking up on Galbraith’s observation in his 1978 book *Manias, Panics And Crashes*, Charles Kindleberger observed that once the bezzle implodes, the bull market gives way to the “age of lawyers,” characterized by the introduction of rafts of new regulations.

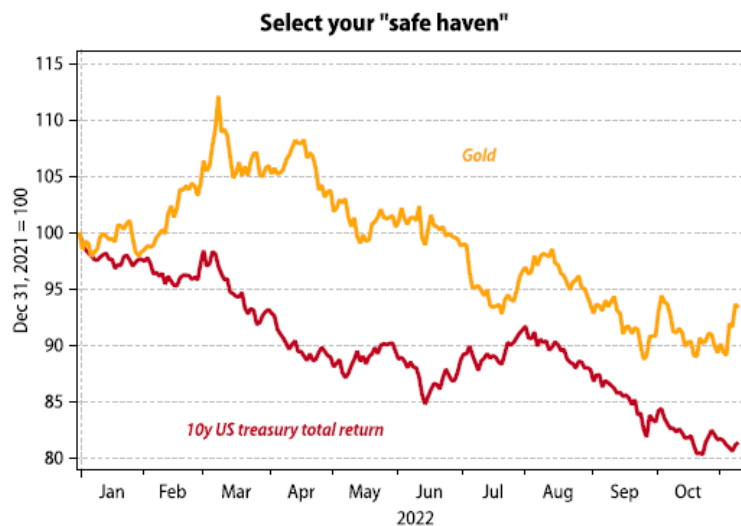
Neither Galbraith nor Kindleberger would have been surprised by recent developments in the crypto space, which have seen the implosion of FTX, one of the higher-profile intermediaries. All the signs were there: the supermodels, the record donations to politicians, the naming of sports stadiums (the Houston Astros baseball diamond was renamed Enron Field in March 2000, exactly five months before Enron’s share price peaked and 15 months before the company declared bankruptcy).

Now, the sudden implosion of FTX leaves investors to ponder a number of questions:

- **Was that it?** Warren Buffett famously said that it is only when the tide goes out that you discover who has been swimming naked. As the least regulated part of the financial markets, the crypto space was always the most likely to see outright frauds. But investors need to consider that the bull market in the broader tech space over the last decade has also been pretty epic.

Judging by the history of past bull markets, it would be surprising if FTX is the only bankruptcy of this downcycle. The age of the lawyer has now started, and as another veteran investor, Dennis Gartman, likes to say “there is never just one cockroach.” The bull market in stupidly-valued assets is over, and for these assets, the risk remains to the downside.

- **What should we make of the rally in US treasuries?** For the first time in a couple of years, US treasuries have rallied on the back of bad news; finally, government bonds appear to be benefiting from a risk-off bid. Still, this risk-off bid has to be assessed against the backdrop of recent selling; for the month of November, the 10-year US treasury is still delivering negative returns. Contrast this with gold, which after a record seven consecutive months of negative returns has now bounced 5% on the back of the crypto implosion.



- **The US dollar is not benefiting from a safe-haven bid** as the crypto space implodes. In fact, over the past few days, the euro has moved back above parity, and the yen now trades at ¥146 to the US dollar. Is the market sensing that the exposure of the crypto bezzle is a fundamentally deflationary development that may allow the Federal Reserve to start sounding a lot less hawkish?
- **Will the FTX wipeout trigger selling elsewhere?** Growth investors will not remember 2022 fondly. First there was the slump in Chinese tech stocks. Next came the collapse of loss-making Nasdaq darlings. Then, one after another the big-tech quasi-monopolies thought immune to broader macro conditions all fell (except for Apple). Throughout this period retail investors continued to double down by buying tech ETFs and other high-growth vehicles. Will the FTX implosion (right at the start of the US “tax loss harvesting season”) now be a cathartic moment—the point at which retail investors decide to take losses rather than average down on losers?
- **Will foreign investors start to worry about the propensity of the US to breed scandals?** As an investor focused largely on emerging markets, I am often asked by Americans how I can be comfortable allocating capital to markets where the potential for scandal is so great. Usually I answer: “You mean scandals like LTCM, Enron, Worldcom, Madoff, Bear Stearns, Lehman and AIG?” Now add FTX to the list (yes, I know FTX was founded in Hong Kong, incorporated in Antigua and headquartered in the Bahamas, but for all intents and purposes it was a US business).

The fallout from the FTX implosion will go far beyond its immediate capital destruction (which itself is a deflationary event, as are all bezzle reveals). For months to come, investors will fret that there are other bezzles out there waiting to be discovered. This will make access to capital all the more challenging for the capital-constrained. And it will further reduce animal spirits, with a consequential impact on the velocity of money.

As a result, FTX will amplify a number of trends that have been emerging over the last year: the outperformance of value over growth, the implosion of negative-cash-flow business models with all the knock-on effects that entails (for example, as start-ups lose funding, Google and Facebook lose advertising revenue), and the gradual shift from the US to other markets. In this regard, the FTX implosion is yet another sign that the US may just not be the “cleanest dirtyshirt” everyone assumes it to be (see [Looking For A Hiding Place](#)).

Checking The Boxes

Our short take on the latest news

Fact	Consensus belief	Our reaction
US wholesale inventories rose 0.6% MoM in Sep , versus 1.4% in Aug	Less than expected growth of 0.8%	Inventory rebuilding is over; the concern now is fading demand
UK RICS house price balance fell to -2% in Oct , from 30% in Sep	Below 19% expected; first negative reading in 28 months	Higher mortgage rates and cost of living are weighing on the UK housing market
Swedish industrial production by value rose 4.1% YoY in Sep , versus 2.4% in Aug	N/A; private sector production value rose 5.0% YoY, versus 4.3%	Rising costs and falling euro-zone demand will be a drag going forward
Mexican CPI rose 8.4% YoY in Oct , versus 8.7% in Sep	Rise less than 8.5% exp.; MoM, CPI rose 0.6%, same as Sep; core CPI rose 8.4% YoY, versus 8.3%	Fall mainly due to base effects; sequential inflation holding up; Banxico to remain hawkish

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