Bitcoin, more asset than currency

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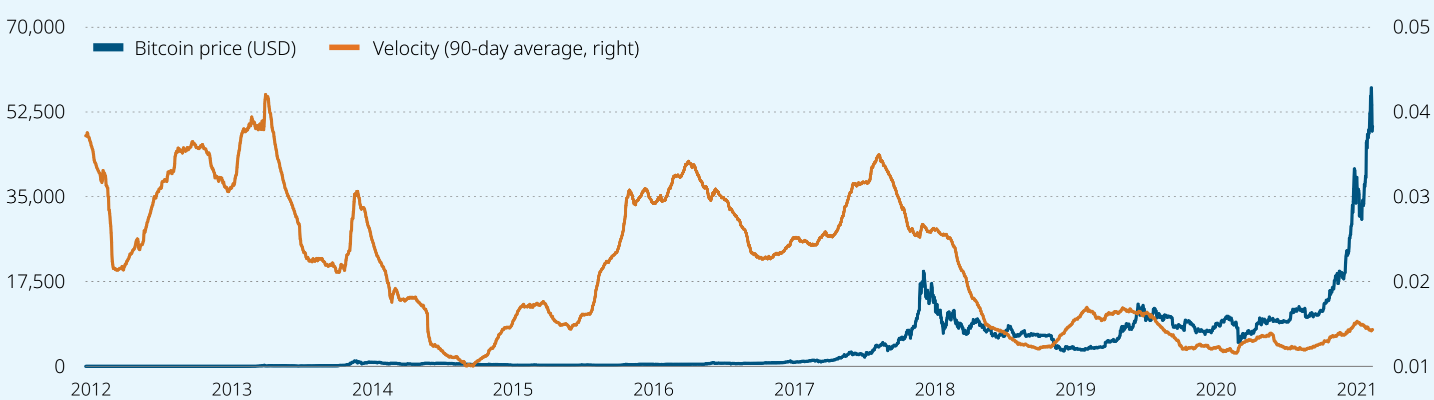
Highlights

- While Bitcoin could eventually become more common in large cross-border fund transfers, it still shows little promise as a realistic replacement for handling daily transactions.
- Its appreciation in the past year seems to be driven by its potential role as a financial asset, perhaps as a replacement or complement to physical gold.
- Long-term investors are expected to seek only limited allocations to cryptocurrencies given extreme price volatility, unclear intrinsic value, and regulatory risk.

The outlook for Bitcoin and other cryptocurrencies hinges on two key questions: will cryptocurrencies challenge government-backed currencies as a means of payment, and will investors treat cryptocurrencies as a new asset class that deserves a place in well-balanced portfolios? Much of the discourse around Bitcoin's previous melt-up in 2016-2017 focused on the cryptocurrency's potential to disrupt the traditional payments infrastructure, from cash to credit cards. That ship has mostly sailed. The "velocity" of Bitcoin, a measure of how often the stock of Bitcoin changes hands, has fallen by half since 2017 and has barely grown throughout its recent one-year bull run, highlighting Bitcoin owners' habit of holding rather than spending their tokens (Figure 1).

Figure 1 | Bitcoin's velocity has not followed its price



Source: Underlying data via Coinmetrics. Velocity is market cap over transaction value (90-day average).

Even after multiple tweaks to its blockchain technology, the Bitcoin network is still limited to below 10 transactions per second, a tiny fraction of Visa's reported 24,000-per-second capacity.[1] This scalability constraint is not easily solved and could lead to processing delays and/or high transaction fees, especially at times of peak demand. A multi-hour settlement delay and $10 fee, both of which are currently expected for a typical Bitcoin transaction, would discourage even the most techno-optimist shopper.

Mainstream adoption of Bitcoin as an alternative currency for daily transactions seems unlikely. Semi-decentralized cryptocurrencies, such as Ripple, are more promising on that front, though they also have drawbacks in terms of weaker security and higher susceptibility to regulation. Off-the-blockchain workarounds, such as Mastercard's plan to facilitate conversions from crypto to fiat currency at the point of sale, should help improve crypto's credibility but without solving Bitcoin's longer-term scalability issue. Bitcoin could gain more ground in handling large international fund transfers. With fees being independent of transaction amounts, transferring funds on the Bitcoin blockchain can be cheap and fast. Last April, during a trough in congestion, US $1.1 billion worth of Bitcoin was transferred with a 10-minute delay and a $0.68 fee.[2] Add to that its 24/7 settlement capability and its imperviousness to government intervention, and the Bitcoin network may offer advantages compared to slow-to-settle wire transfers.

However, Bitcoin's meteoric rise appears to be driven more by its appeal as a potential new asset class rather than as a new form of currency. Bitcoin is far too volatile to be a reliable store of value like official currencies, exhibiting 76% volatility since it first crossed US $100 billion in total market capitalization in October 2017. Some investors foresee Bitcoin evolving into "e-gold", replacing or supplementing physical gold as a new asset class. Bitcoin does share – and could even improve on – some of gold's characteristics as an asset class. Bitcoin has a fixed supply as its blockchain caps out at 21 million tokens, protecting against debasement. The fixed number of tokens also avoids supply-side disruptions that can affect the price of physical gold. Bitcoin itself is secure, with a bulletproof blockchain. However, there have been thefts in the past in crypto exchanges, where Bitcoin can be traded for fiat money.

A typical well-diversified portfolio is likely to continue allocating a very limited weight to Bitcoin and other cryptocurrencies:

Extreme volatility with correlation to stock markets. Given its high volatility, even a small allocation to Bitcoin can have a material impact on total portfolio performance. Bitcoin also tends to move with stock market returns, reducing its diversification benefits from a total fund perspective.

Uncertain fair value. Because Bitcoin lacks cash flows and boasts diverse but uncertain use cases, different fair value models produce wildly divergent valuations. Long-term investors may have difficulty disentangling speculative moves from fundamentally based changes in market price.

Regulatory risk. Governments may crack down on Bitcoin given concerns about money laundering and illegal transfers. Tax authorities could also seek more information from investors about their Bitcoin holdings to assess possible capital gains.

Unclear winner. Gold has the benefit of a multi-century consensus as the non-fiat safe asset. There is no such consensus around Bitcoin. Bitcoin could itself become disrupted by other cryptocurrencies. As one example, Ethereum has a promising use case while its market cap is only about 1/5th of Bitcoin.

With Bitcoin's market cap approaching US $1 trillion, Bitcoin makes up close to 1% of the global public equity and fixed income market. In this context, a long-horizon investor may only wish to hold a comparably small proportion of their portfolio in a sleeve of major cryptocurrencies, recognizing that even a small weight can lead to an outsized impact on total portfolio risk and returns given Bitcoin's high volatility.

1 https://usa.visa.com/run-your-business/small-business-tools/retail.html
2 Cointelegraph, https://cointelegraph.com/news/bitfinex-made-a-11- billion-btc-transaction-for-only-068.

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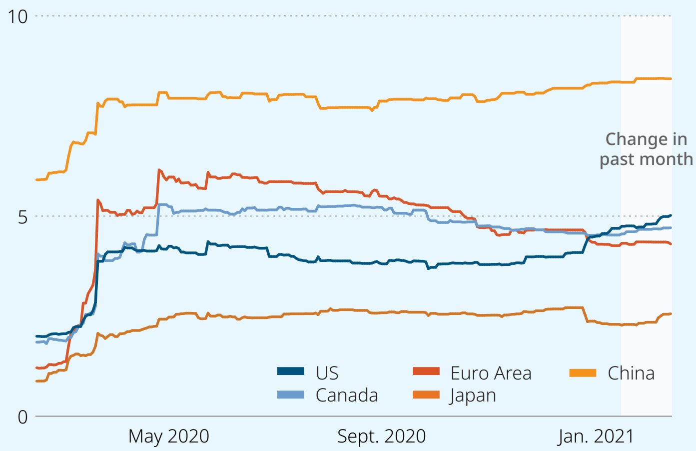
Investments

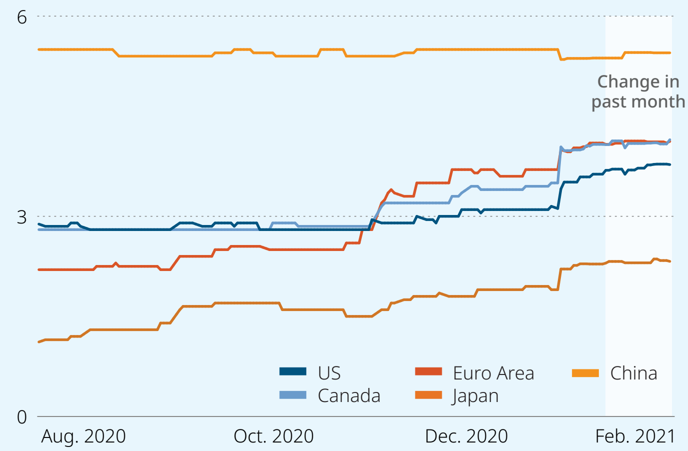
Global macro update

- Inflation expectations rose in the **United States** in recent weeks, as Democrats decided to fast-track their stimulus plan through the budget reconciliation process. Expected to reach the legislative finish line in late March, the stimulus could push inflation above the Fed's 2% target.
- Growth expectations for **Canada** inched up in February. Climbing oil prices mean higher capital investments and exports, while Biden's $1.9 trillion stimulus plan should have positive spillover effects for Canada's economy.
- **Euro Area** inflation is expected to be much higher than previously thought. The phasing out of a sales tax holiday in Germany and a rise in energy prices should push prices up by around 1.3% in 2021. We don't expect inflation concerns to jeopardize plans for monetary and fiscal stimulus.

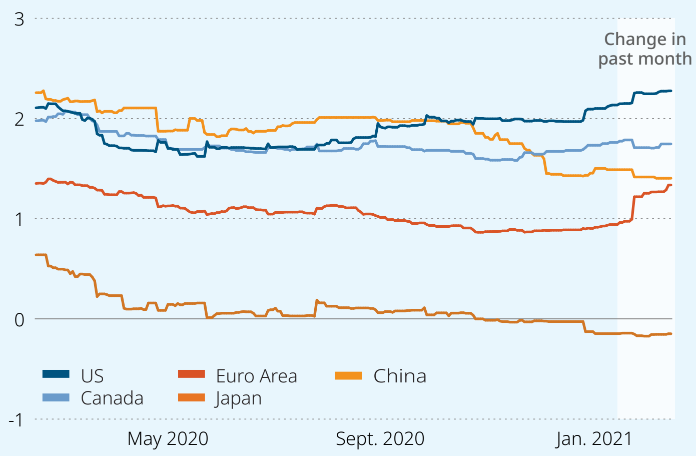
2021 real GDP growth forecast (%, consensus)



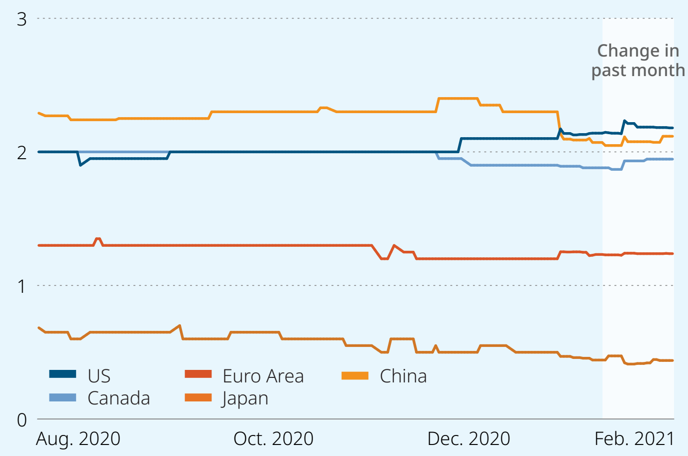
2022 real GDP growth forecast (%, consensus)



2021 inflation forecast (%, consensus)



2022 inflation forecast (%, consensus)

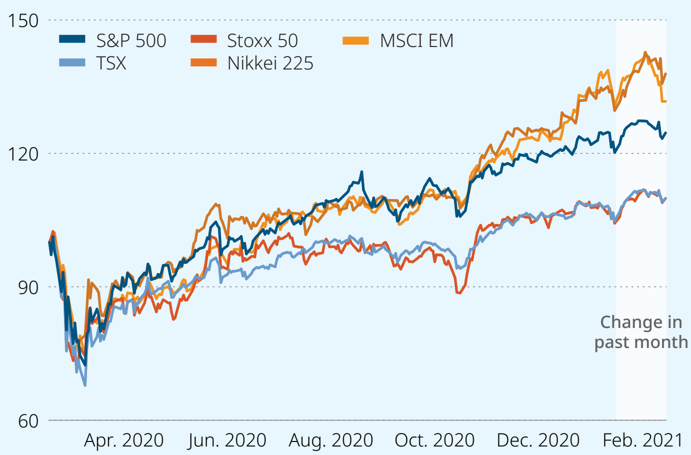


Source: 2021 forecast survey from Consensus Economics, 2022 forecast survey from Bloomberg, as of February 28, 2021.

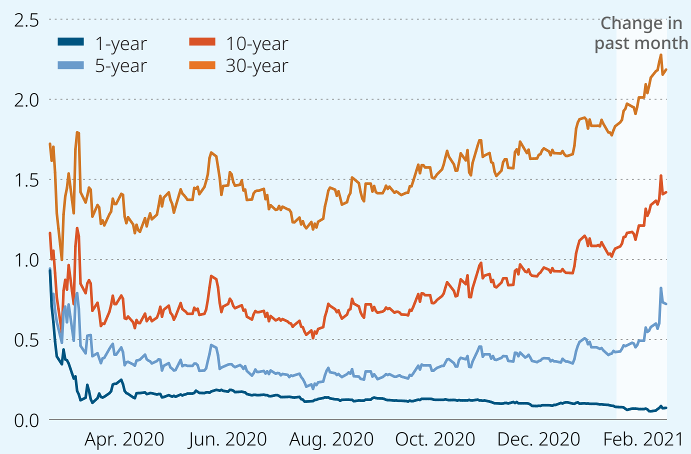
Capital markets update

- **Japanese stocks** outperformed other equity markets in February, driven higher by positive earnings surprises across a broad range of mostly cyclical industries, notably energy, real estate and consumer discretionary.
- The **US yield curve** steepened significantly in February, the long end driven higher by rising growth and inflation expectations, the short end depressed by expectations that Treasury will fund the Biden stimulus from its cash reserves.
- **Oil prices** climbed in February amid strong demand and global inventory drawdowns, contributing to the appreciation of the commodity-linked **Canadian dollar** relative to its US counterpart.

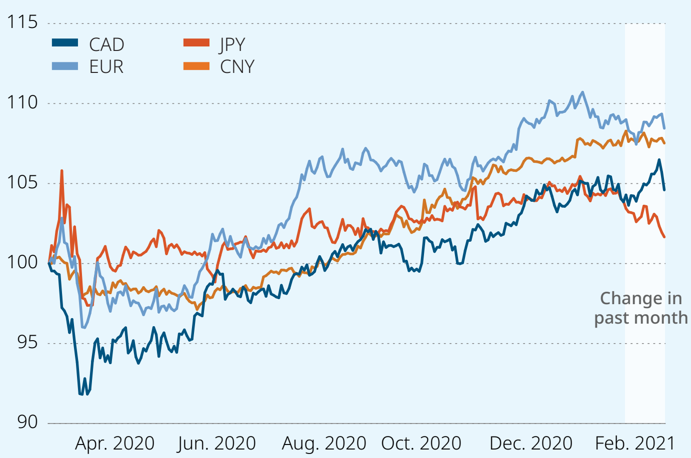
Equity indices (one year ago=100)



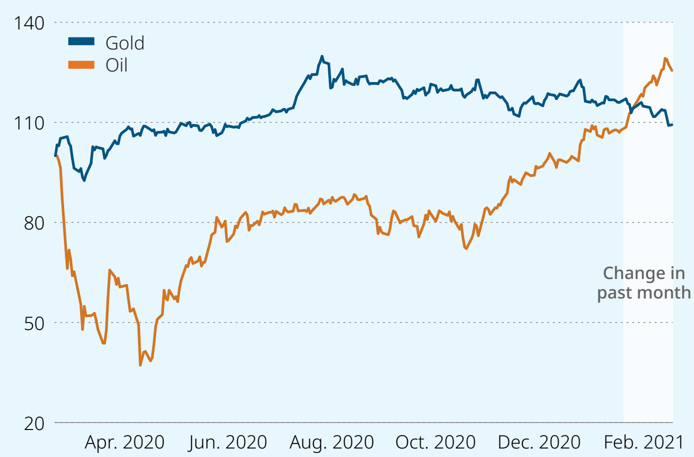
US Treasury yields (%)



Currencies (relative to USD, one year ago=100)



Commodity prices (in USD, one year ago=100)



Source: Via Bloomberg as of February 28, 2021.

What we'll be watching in March

March 3: Canada 2020 Q4 GDP release

- Economists expect annualized real GDP growth of 7.5% in 2020 Q4, bringing annual 2020 growth to -5.4%.[3]
- Q4 growth expectations increased recently, as retail sales and employment numbers for the end of 2020 came in stronger than expected. A strong reading for Q4 would suggest that the Canadian economy has become more resilient to Covid restrictions, boding well for the first half of 2021.

March 17: Federal Open Market Committee (FOMC) policy decision

- We expect the US Federal Reserve's policy-setting committee will keep the Fed funds interest rate at 0-0.25 and likely maintain the current pace of asset purchases.
- Congress passing Biden's ambitious $1.9 trillion stimulus plan before the FOMC meeting could stoke inflation expectations, but Fed officials have already stated that they don't view Biden's plan as excessive, nor that rising yields will push them to taper their asset purchases.

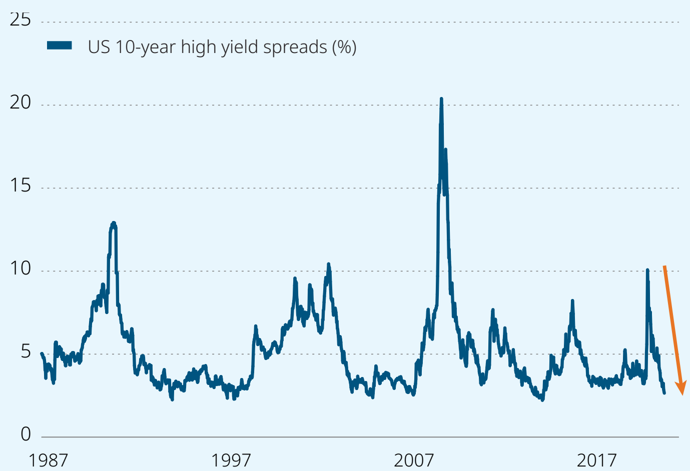
March-end: AstraZeneca concludes US vaccine trial

- AstraZeneca should soon conclude its US vaccine trial. Unambiguously successful results would open the door for its vaccine's fast approval in the US, accelerating the economic recovery.

Emerging theme

- **High yield corporate credit spreads** have now tightened below their 2019 trough. In only five years since 1987 have US high yield spreads reached lower levels than those of February 2021.
- Bankruptcies and defaults have been few and far between compared to other crises in the past. **Unprecedented policy support** for struggling firms, both fiscal and monetary, has allowed them to stay afloat. Investors could be pricing in similar implicit government backing in future crises, explaining the tight spreads, unusual at this point in the economic cycle.
- Vaccination delays, resistant virus variants and a hasty removal of public support are serious **risks to corporate solvency,** especially for the many firms that have borrowed heavily since last March.
- Tight spreads are a challenge for **income-oriented investors**. Their search for yield could lead them outside of US financial markets, accelerating portfolio outflows and spurring USD weakness.

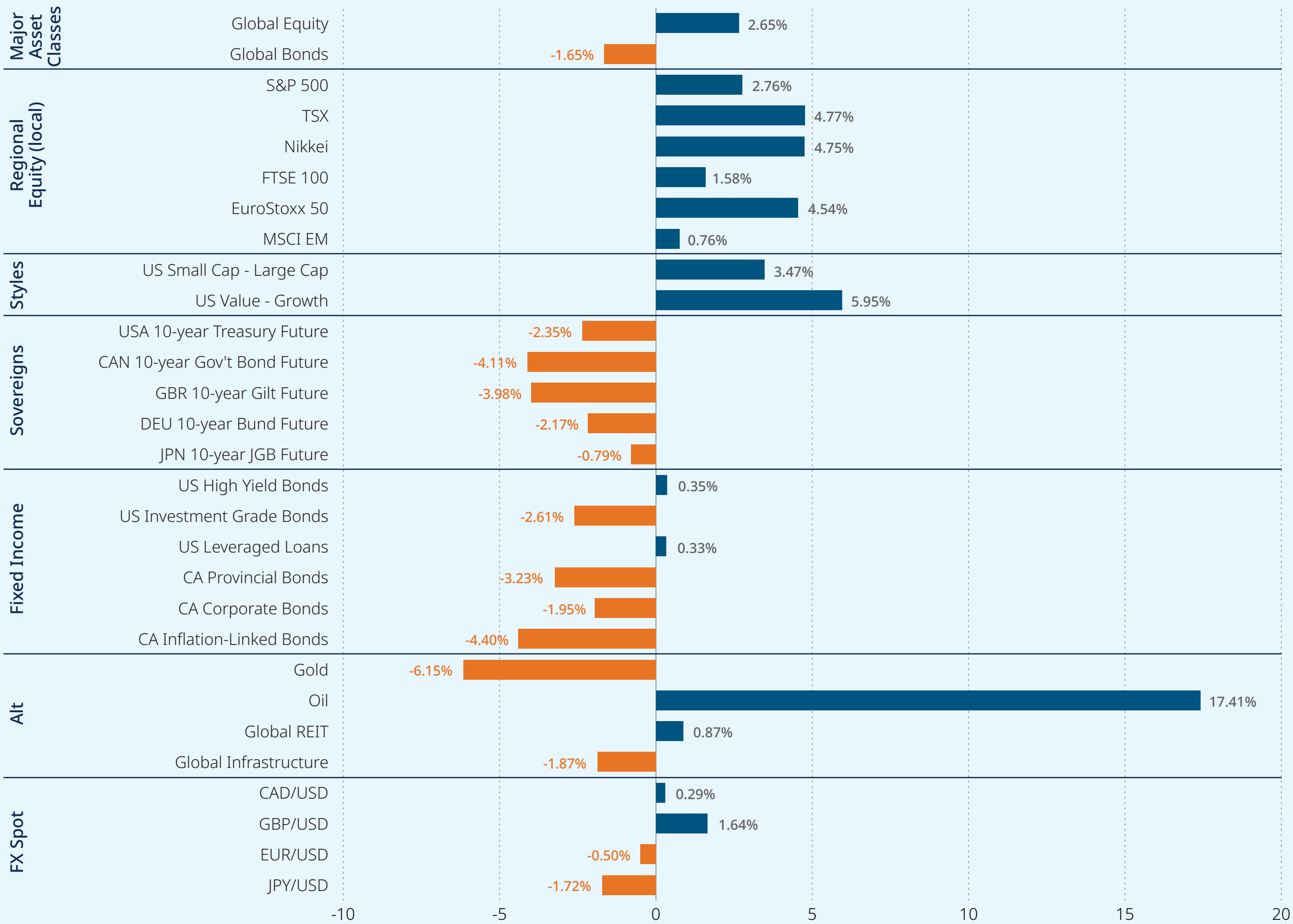
High yield spreads have tightened below pre-crisis levels



Source: Barclays 10-year US high yield spread index via Bloomberg as of February 25, 2021.

3 Bloomberg's survey of economic forecasters as of February 25, 2021.

Appendix:
Capital market returns in February



Source: Market data from Bloomberg as of February 28 2021. Index returns are for the period: 2021-01-31 to 2021-02-28. In order, the indices are: MSCI World (lcl), BBG Barclays Multiverse, S&P 500 (USD), TSX Composite (CAD), Nikkei 225 (JPY), FTSE 100 (GBP), EuroStoxx 50 (EUR), MSCI EM (lcl), Russell 2000 - Russell 1000, Russell 1000 Value - Russell 1000 Growth, USA 10-year Treasury Future, CAN 10-year Gov't Bond Future, GBR 10-year Gilt Future, DEU 10-year Bund Future, JPN 10-year JGB Future, BAML HY Master II, iBoxx US Liquid IG, Leveraged Loans BBG (USD), Provincial Bonds (FTSE/TMX Universe), BAML Canada Corp, BAML Canada IL, BBG Gold, BBG WTI, REIT (MSCI Local), Infrastructure (MSCI Local), BBG CADUSD, BBG GBPUSD, BBG EURUSD, BBG JPYUSD.

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