



## CRYPTO CURRENCIES

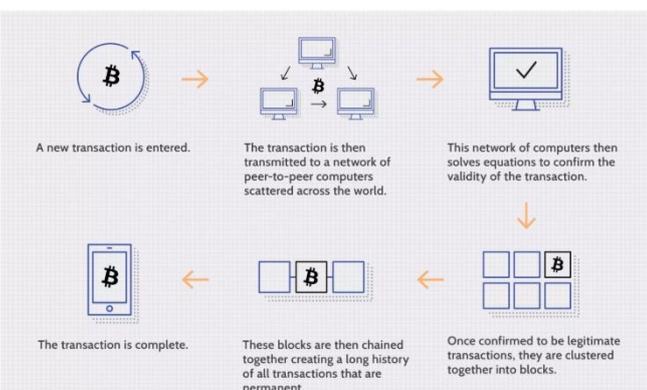
June 2021

**With the world hopefully looking toward the latter stages of the pandemic, the new ‘C’ word is shifting from COVID to Crypto. Viable medium of exchange or flash in the pan Ponzi scheme? With answers from reputable investors ranging from “Bitcoin fixes everything” to “disgusting and contrary to the interests of civilisation”, and everything in between – it is fair to say that opinions on crypto currencies and their poster-child Bitcoin, are mixed. From blockchain to Dogecoin, “to the moon” and back, this month we are exploring the world of crypto and how it will impact the financial and wider world in the future.**

Whilst an official definition is as elusive as its inventor, blockchain is the term commonly used to define the cryptography system that was designed to support Bitcoin, and that underpins all crypto currencies. Corporations and governments alike are looking to implement blockchain technology in a wide array of potential applications such as voting, legal documents and medical records.

A blockchain is a digital ledger of transactions that is duplicated and distributed across the entire network of computer systems that participate. Every time a new transaction occurs, a record of it is added to every participant’s ledger, with the transactions then verified and added to the ever-growing chain of transactions recorded centrally on the ledger.

No individual, corporation, or government controls the ledger. This is because it is distributed amongst all computers in the network, which makes it difficult or impossible to change, hack, or cheat the system, as to do so the actor would need to hack 51% of the computers or “nodes” in the network - which in the case of Bitcoin is estimated at over 100,000 nodes. Provided that the chain cannot be altered or hacked, theoretically this therefore establishes a key pre-requisite for a successful currency, that being a limited supply that is not open to forgery.



Source: Investopedia

### REGULATION

One of blockchain’s most coveted attributes is that it is a decentralised system with no government control or manipulation. It facilitates a platform of currency

validation and exchange that is autonomous, unlike the FIAT currencies such as the £, \$ or €, which are all controlled directly by central banks and therefore indirectly by government. Whilst one of its key attractions, this is also one of its weaknesses. With growing demand and usage of crypto currencies, governments around the world are becoming nervous that lack of regulation could help facilitate increasing levels of financial crime. Whilst crime fighting captures the headlines, governments are perhaps more concerned about the lack of control of crypto generally, given that intervention via central bank action has been and remains the most important policy lever available to control inflation and economic growth within established money supply. If consumers and businesses shift away from FIAT currencies to crypto, the government no longer has that control.

This month, China has banned banks and payments firms from providing services related to crypto currency transactions and banned a slew of related accounts on the Twitteresque Weibo. This, alongside Tesla reversing its decision to accept crypto as payment for their cars (more on this later) resulted in an immediate crash in prices across the crypto market, with Bitcoin at one point falling to £24,168 - a 43% drop from its peak in April. President Biden has also announced plans to require crypto transfers of \$10,000 or more to be reported to the Internal Revenue Service (aligning with cash transfers). The IRS estimates that, if approved, the crackdown could increase its tax revenue by almost \$700bn over the next decade. This is followed by more recent news that the FCA is clamping down on companies dealing in crypto currencies for failing to meet the required standards under money laundering regulations, with more than 50 companies withdrawing their application to register with the regulator altogether.

It’s not all unfavourable news for crypto though. President Bukele of El Salvador has put forward a proposal to accept Bitcoin as legal tender, a move he suggests will make it easier (and cheaper) for Salvadorans living abroad to send home remittances which amounted to \$6bn in 2019—a fifth of the country’s GDP. Whilst many believe this to be a PR

stunt due to the complexity of the plans and the president's fondness for attention-grabbing manoeuvres, he believes the proposition will bring investment, tourism, generate jobs, and help provide financial inclusion to thousands outside the formal economy. The acceptance of a crypto currency as legal tender is seen by many in the industry as an important milestone toward the ultimate goal of a universal world currency.

In total there are 10,428 crypto currencies traded across 381 exchanges with a total market value of \$1,728,199,33,914. Whilst the market capitalisation of crypto assets has ballooned over the past four years, Bitcoin has remained the dominant crypto currency with by far the largest market capitalisation. The table below shows the current percentage weighting of the differing crypto assets:

Bitcoin	<b>44.98%</b>
Ethereum	<b>17.97%</b>
Tether	<b>3.84%</b>
Binance Coin	<b>3.46%</b>
Cardano	<b>3.07%</b>
Dogecoin	<b>2.60%</b>
XRP	<b>2.52%</b>
USD Coin	<b>1.45%</b>
Pokadot	<b>1.30%</b>
Uniswap	<b>0.82%</b>
Others	<b>17.99%</b>

Bitcoin has managed to maintain its position as the dominant crypto asset over time in part as a result of first mover advantage but also the fact that the price of Bitcoin tends to be more stable than other "altcoins". Bitcoin is also the most widely accepted crypto currency, with a slew of big retailers including Expedia, PayPal, and Microsoft accepting it as payment.

## HOW ARE FIAT CURRENCY GOVERNMENTS REACTING?

Most governments are adopting a different approach to El Salvador with the US, China, and the UK, among others, launching efforts to create their own central bank digital coins. The UK's currency dubbed "Britcoin" would be issued and backed by the Bank of England and would be denominated in sterling with its value tied directly to liquid assets, meaning the coin could be directly exchanged with sterling, avoiding the fluctuations seen in many of the traditional digital currencies. For industry purists, this move is seen as a threat to the core principles of crypto currencies, as central banks will continue to have control, removing the decentralised aspect that appealed to many of the early pioneers. However, with the concept of digital currencies becoming more mainstream and their threat appearing on the radar of central banks, governments will do all in their power to retain control over their national currencies. The adage 'Don't fight the Fed' springs to mind.

## THE NEXT ECH-ELON OF FINANCE OR ANOTHER SPECULATIVE BUBBLE?

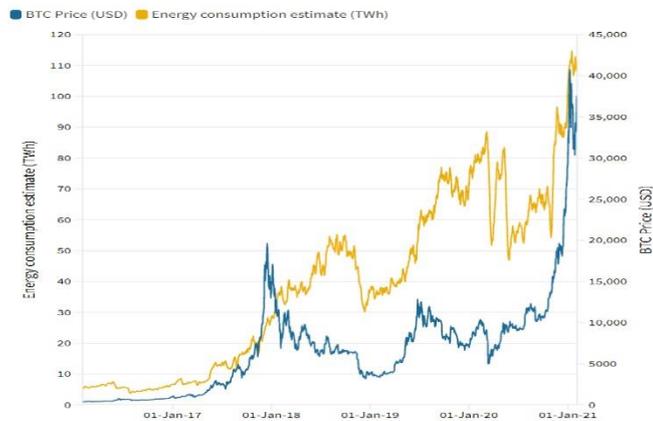
At only 13 years old, Bitcoin is still extremely early-stage, and like all nascent asset classes its lack of trade history puts it in the "price discovery" phase of its life. Unlike a company, crypto cannot be evaluated on its business prospects, earnings, or cash flow. Headlines and PR lead to herd like momentum-based investing and generally positive price pressure. Tesla accepting or no longer accepting payment for cars via Bitcoin or an announcement of new government regulations can send the price moving in either direction, a phenomenon exacerbated by the increasing use of leverage in the crypto markets. Sometimes these price movements are not in the direction many would predict, for example, when Elon Musk was due to appear on Saturday Night Live crypto currency experts expected the price of Dogecoin to rise due to his strong support for the coin but, after he and his mother joked about the coin on the show, the price dropped almost 40%! That said Dogecoin has increased 6,212% in six months, even after this sell-off. This is particularly staggering for a coin that was initially created as a joke to mock the concept and wild speculation of crypto currencies at the time – Dogecoin's success therefore the perfect encapsulation of the irony surrounding crypto.

Yet regardless of demand, the most crucial element of any crypto currency is the credibility of the limit to its supply, as already mentioned. History is littered with examples of currencies destroyed by massive issuance of new money leading to hyper- inflation and value erosion. See the German Weimar Republic and Zimbabwe as examples. If there become any uncertainties about the credibility of the blockchain to protect and therefore limit supply of a currency then regardless of demand, the house of cards will fall.

## ENVIRONMENTAL IMPACT

Bitcoin mining, the process of validating transactions that are to be added to the ledger, involves computers solving complicated mathematical equations. In return for this work, the miner is given a small amount of Bitcoin to compensate. As profits and competition grow, and as coins become harder to mine (this is the way the system works), the computational power of these mining operations grows to exceptional levels, with electricity consumption to match. This has led to estimates that Bitcoin's electricity intake exceeds 110 TWh – consumption that ranks it in the top 35 countries in the world or approximately equivalent to The Netherlands. This would be fine in places such as Iceland that use 100% renewable energy but with 65% of Bitcoin mining currently operating from China, their heavy

reliance on coal power makes Bitcoin's carbon footprint massive. As concerns around the world's carbon impact grows and the popularity of an ethical investment approach increases, many investors have now stepped away from Bitcoin (including Elon Musk) citing its environmental impact. This could be a structural demand problem for Bitcoin in the future.



Source: Coinmetrics and Cambridge Bitcoin Electricity Consumption Index

## COINCLUSION

At the time of writing Bitcoin is up 20% YTD (despite the recent crash) and a staggering 270% over a calendar year. Crypto currency prices have shot-up over the last decade - famously, two pizzas paid for in 10,000 Bitcoin 10 years ago would cost £270m given the value of Bitcoin today! However, these astonishing returns come at a price when more recent retail investors chase highly speculative returns only to experience price drops of 40% or more due to, say, a comment from Elon Musk.

Purists though will point to similar crashes when Bitcoin dropped from \$19,000 to \$7,000 towards the end of 2017 before recovering strongly as evidence that, while certainly volatile, prices are booming over time and that you should 'BTD' (Buy The Dip) and then 'HODL' (Hold On for Dear Life).

Crypto is here to stay for now but whether all or any of Bitcoin, Ethereum, Litecoin, Monero, Dogecoin and others will survive remains uncertain. However, the blockchain as a mechanism has many other positive applications (such as data and internet security) and government and corporate adoption/interest has further proven this. Investing in Blockchain rather than crypto could be the better route for those willing to take the plunge. It's the equivalent of selling picks and shovels rather than prospecting for gold yourself - much more of a sure thing but probably less exciting.

If adopting the 'prospecting for gold' approach, deciding on which crypto currency to invest in can be compared with choosing between Amazon.com and Pets.com but without the possibility of assessing underlying corporate fundamentals. The price for being wrong could be 100% of what you invested so sitting on the side lines and accept a

lingering sense of 'FOMO' (Fear Of Missing Out) is the sensible approach and one that we adopt, but taking a gamble that your coin of choice will emerge victorious is certainly more fun, if you are prepared to accept the risk.

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