July 2021 Newsletter

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The Rise and Fall of Cryptocurrencies

In the last twelve months investors have been witness to the exorbitant rise and subsequent inordinate fall of cryptocurrencies around the world. Bitcoin, by far the largest cryptocurrency avaible in the market, increased more than tenfold in just seven months, only to fall in excess of 50% a mere two months later. As investors take stock of the "Cryptomania" that has dominated markets, one can't help but ask the question, "Now what?"

Understanding Cryptoassets

Currently, there are over 9 000 cryptocurrencies available in the market, the more bizarre of which include Dogecoin which was started as an internet meme, Potcoin which was designed to provide a decentralized banking infrastructure for the cannabis industry, TrumpCoin, PutinCoin, UFOCoin and Garlicoin just to name a few. While these may sound like jokes, they are all legitimate cryptocurrencies with coins in circulation.

According to a March report issued by the Macro Research Board in London, Cryptocurrencies, should be considered a subcategory of digital currencies, with the following general characteristics:

- **Regulatory:** Crypto-assets are regulated exclusively by their private communities and are not policed by a central financial intermediary. As a result, the subsequent regulations are based on computers and people that ensure transparency and surety of completion of any and all transactions.
- **Legal:** Cryptocurrencies do not require legal identification in order for buying and investing to take place. As such, the identities of buyers and sellers remain totally anonymous.
- **Anti-Government:** Cryptocurrencies are described as an anti-central bank currency, and as a result governments cannot force the freezing or cancellation of crypto transactions, even upon suspicion of illegal activities.
- **Actionable:** If required, cryptocurrencies may be converted to cash through both centralised and decentralised marketplaces. The primary challenge of using a decentralised exchange is the vulnerability to fraud due to the lack of regulation.

Risks faced by Cryptoassets

It is widely accepted that the predominant risk faced by Cryptoassets lies within their most distinguishing characteristic; the lack of regulatory transparency and consistency. Due to the anti-central bank and anti-government nature of cryptocurrencies, and that crypto transactions are virtually impossible to cancel upon government request, many countries are cracking down on their policies against cryptocurrencies and, in some cases, are threatening an outright ban of possessing any form of Cryptoassets. Policymakers in China have recently restricted financial institutions from offering any services that involve cryptocurrencies, with the PBoC issuing a statement asserting that "digital currencies do not have any underlying value, prices are constantly manipulated, and they are not protected by Chinese law." In the UK, digital asset company Binance has recently suspended the ability to withdraw and deposit pounds after the crypto exchange was banned from operating in Britain. Binance forms one of the largest digital asset companies in the world, processing around $1.5tn in crypto transactions in the month of May alone.

Likewise, India has proposed a new law in March of 2021 which would ban Cryptoassets outright and would criminalise possession, issuance, mining, trading, and transferring of Cryptoassets. Enactment of the law would give holders of Cryptocurrencies up to six months to liquidate any and all Cryptoassets, after which penalties would be incurred. Even locally SARS has begun to take notice of Cryptoassets and has requested that South African cryptocurrency exchanges provide information on their customers.

Indeed, this was made no more apparent when, in the last week of June, Johannesburg-based crypto company Africrypt was apparently hacked. Investors' crypto wallets were emptied in a matter of hours to the tune of R54 billion, with the two founders of the company suspiciously disappearing to the UK within days of the scam occurring. The disappearing act is akin to that of Johann Steynberg of Mirror Trading International (MTI), who managed to pull off a multi-level marketing scheme in late 2020 and disappeared with roughly R10 billion worth of Bitcoin.

The real death blow delivered to investors in both cases came as a result of the unregulated nature of cryptocurrencies, which will preclude any form of redress for their stolen Bitcoins. In a statement made by the Financial Sector Conduct Authority (FSCA), “crypto assets are not regulated in terms of any financial sector law in South Africa and consequently the FSCA is not in a position to take any regulatory action.”

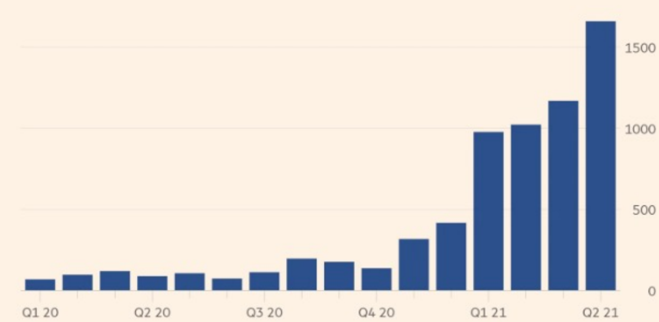
The environmental concerns surrounding the mining of Cryptocurrencies also remains a considerable threat. Bitcoin alone generates an annual carbon footprint of nearly 40 million tons of carbon dioxide, comparable to the total carbon footprint of countries such as New Zealand, Norway, and Argentina. Despite positive progress being made in this area, the exponentially increasing energy consumption required to mine and maintain crypto coins remains a long-term environmental risk.

Cryptoassets in Investment Portfolios

Despite the many risks and regulatory impediments faced by Cryptoassets, one cannot disregard the fact that investors have made truly staggering sums of money off the back of these decentralised finance (DeFi) investments. As a result, many investment management companies plan to significantly increase their holdings of Cryptoassets going forward. Hedge funds in particular have shown a marked interest in the potential gains offered by Cryptoassets, particularly given the recent price falls. In a recent survey conducted by Intertrust of 100 global hedge funds averaging $7.2bn in assets, the average chief financial officer expects to hold about 7.2% of their assets in cryptocurrencies within the next five years. This, however, stands in distinct contrast with many traditional asset managers who are far more wary of the inherent volatility experienced by digital currency returns, as well as the uncertainty surrounding regulation. Morgan Stanley, in a recent report, stated, “For the moment, crypto investments remain limited to clients that have a high risk tolerance and, even then, investments are typically a low proportion of investable assets.”

Trading in cryptocurrency markets has boomed

Monthly volumes on major exchanges ($bn)



The Block legitimate volume index
Sources: theblockcrypto.com, CryptoCompare
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Bitcoin vs. Gold

With the growing acceptance of Bitcoin and Cryptoassets in the investment universe, investors have begun to look for alternatives to holding gold as the fiat currency in their portfolios. When comparing the investment opportunities exhibited by gold and Bitcoin, Troy Gayeski, the chief investment officer and senior portfolio manager at SkyeBridge Capital stated “We’re going to stick to Bitcoin and crypto because we just think there’s more upside. While there’s more volatility, you’re going to capture a little bit more juice than you will in gold from that same phenomenon”. Gayeski is not alone in his thinking, particularly given the current inflation outlook in the US and the ballooning levels of government debt. In another statement, Gayeski noted that “All fiat-currency alternatives [Bitcoin], which have all gone through fairly recent substantial corrections, are in a much better place now to handle that eventual taper and gradual slowing of money-supply growth, than they were as they were making higher-highs after higher-highs.”

Both gold and Bitcoin have undergone significant price swings in the last six months, which has led many leading Wall Street Bankers to debate whether cryptocurrencies are indeed siphoning demand away from bullion. Goldman Sachs have proposed that the two assets can exist together in a portfolio, however Citigroup has stated that gold is “losing lustre” to cryptocurrencies. Elon Musk, arguably the most outspoken and widely followed advocate of Cryptoassets, has stated that he supports cryptos over all other forms of currencies, whether paper or fiat.

As economists debate whether markets are on the cusp of another commodity super-cycle, we may too be entering into the era of Alternative Currencies. Whatever one’s view on cryptos, investors can be assured that the asset class is here to stay and over time may indeed become a far more common allocation within investment portfolios.