White Paper Report
Bitcoin and Bubbles: Part III

Five years ago, we wrote our first paper on Bitcoin. In December of 2017, Bitcoin was reaching astronomical heights and our clients were searching for an understanding around the hype. With its meteoric rise, to almost $20,000, Bitcoin had surpassed all other asset bubbles **(See chart on page 3).** There were many stated reasons why "this time it's different". As is often the case in an asset bubble, investors seeking to get rich quick will set high price expectations and back into the reason. Experts come out of the woodwork to explain the phenomenon. In the end, the results are usually the same. When bubbles burst, late speculative adopters get crushed. Our first paper warned of precisely that. Bitcoin quickly collapsed to $3,000. A massive decline. But that would not be the end. With a massive inflow of capital from COVID relief, speculative investors were at it again. This time pushing Bitcoin to over $60k.

In March of 2021, our clients again asked for our thoughts on this anomaly. Our second paper once again warned investors of the perils of investing in an asset that is only supported by "the greater fool theory", meaning the price goes up if you can find a willing buyer, not because of any traditional valuation metrics. We also warned that bubbles can lead prices to inexplicable heights. Those runs are intoxicating. They pull in capital that is not discerning. Once again, the bubble has burst. Bitcoin has fallen over 80% from its high. Once again, investors have taken massive losses. Bitcoins and Bubble III will look at how this incredible and historic bubble occurred, how prices got so high, and more importantly, what to make of the Crypto market now.

Megan Horneman | Chief Investment Officer
mhorneman@verdence.com
Past performance is not indicative of future returns

The Evolution of the Crypto Bubble

Our first warning on the cryprtocurrency market was five years ago when we released a white paper titled, “Bitcoin and Bubbles.” We had witnessed a nearly 1800% increase in 2017 in a product (i.e. Bitcoin) that had no fundamental value, was driven by speculation, was unregulated and had no store of value. However, in the years the followed the entire cryptocurrency market has exploded and astonishly has been referred to as the “future of money.” The universe has seen eye popping fund flows, an exorbitant amount of newly created “coins” and endorsements from famous athletes and actors. Even top banking executives left their posts for jobs in the crypto world. Crypto exchanges have been seen on billboards, advertised at sporting events and one cryptocurrency exchange even bought the rights to the name of a famous basketball arena. The momentum of the crypto market lured investors who did not want to miss out on the “next best thing” (sound familiar??). In addition, the decades-long period of low interest rates and excessive fiscal stimulus helped investors take a gamble on this new marketplace. However, the first major bear market did little to deter these gamblers (May 2021 – July 2021 when the Bloomberg Galaxy Crypto Index dropped ~50%) and now investors are witnessing a more pronounced collapse of the cryptocurrency market (Bloomberg Galaxy Crypto Index down ~80% since November 2021). Billions of dollars have disappeared, legal actions are being taken for alleged fraud and investors are frantically fleeing anything related to these “pet rocks” (as referred to by Jamie Dimon, CEO of JPMorgan Chase). **(Chart 1)**.

Chart 1

The Collapse of the Crypto Currency Market

Data is as of December 22, 2022. Source: Bloomberg Finance LP, Verdence Capital Advisors.

Megan Horneman | Chief Investment Officer
mhorneman@verdence.com
Past performance is not indicative of future returns

VERDENCE CAPITAL ADVISORS

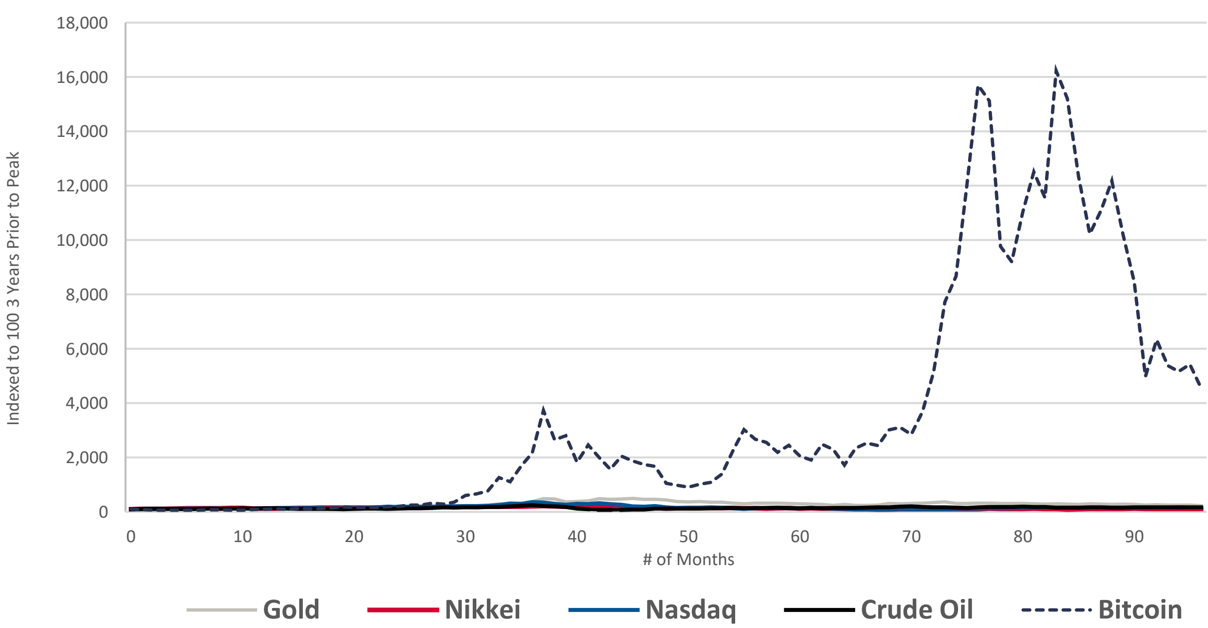
The "Crypto Winter"

In late 2021, the market cap of the cryptocurrency market was ~$3 trillion. To put that in perspective, the market cap of Apple is ~$2 trillion. At one point in 2021 there were ~8,000 cryptocurrencies that were listed on CoinGecko which is the world's largest independent cryptocurrency data aggregator. However, if you asked anyone on the street they may have only been able to name four or five. Currently, there are less than 4,000 actively listed (and trading) and the market cap of the cryptocurrency market is estimated to have fallen to ~$850 billion.[1]

Now with what is being referred to as the "Crypto Winter," we are witnessing the next phase of this bubble bursting. The exchanges that handle the trading and execution of these coins are collapsing at a rapid pace.[2] The most notable bankruptcy has been that of FTX which was once one of the largest exchanges by volume and at its peak was valued at more than $30 billion. The failure of FTX and many other exchanges comes from irresponsible accounting, mismanagement of funds, leverage, a liquidity crisis and too much reliability on their own native coin. The downfall of FTX started with the slump in the value of their token (i.e., FTT) and the discovery that FTX was highly leveraged to its own coin (i.e., FTT) as well as its research and trading firm, Alameda Research. When the value of FTT collapsed, like a run on a bank, investors flocked to withdrawal their funds driving the value of the FTT cryptocurrency and the broad crypto market lower thereby exacerbating the liquidity crunch, ultimately FTX had to declare bankruptcy with over $3 billion owed to its 50 largest creditors.[3] It has not stopped with bankruptcy, we are witnessing a web of mismanagement, lies, fraud, carelessness and now criminal charges and class action suits against those who misled investors.

Putting it in Perspective: Bitcoin Compared to Prior Bubbles

Data is monthly and taken three years prior to peak in investment and 96 months after the peak.
Data for bitcoin is as of November 2022. Source: Bloomberg Finance LP, Verdence Capital Advisors.



Megan Horneman | Chief Investment Officer
mhorneman@verdence.com

Crypto Thesis Fails to Materialize

We have warned for years that regulation is one of the biggest risks to the crypto market. Its lack of regulation leaves investors helpless in a situation like FTX. There is no government backstop, no due diligence, no uniform policies, and no insurance (like FDIC insurance for banks). Furthermore, the rationale that drove investors into cryptocurrencies has failed to materialize. Let's go back and revisit the justification that was used to buy cryptocurrencies in recent years.

1. **It is an inflation hedge. Wrong!** Inflation as measured by the Consumer Price Index has increased 7% in 2022. However, this year the Bloomberg Galaxy Crypto Index is down 80%.
2. **It is the new store of value. Wrong!** To be a store of value it must be widely transactional, be completely liquid and have a stable value.
3. **It is a new currency that will supplant the U.S. dollar. Wrong!** Some believed rising fiscal deficits would leave the U.S. dollar with no value and cryptocurrencies could replace it. Well, the U.S. dollar is up almost 10% in 2022 and not only has crypto deteriorated **(Chart 2, next page)** but the volatility in Bitcoin proves it cannot be a viable currency. **(Chart 3, next page).**
4. **It is a new asset class. Wrong!** To be classified as a stand-alone asset class, the asset must exhibit certain characteristics like correlation, risk, liquidity, and a meaningful way to value the product. Bitcoin did not exhibit any of these characteristics.
5. **It is safe and not regulated. Wrong!** Because cryptos used decentralized blockchain technology some believed it was secure. Some mistakenly believed there was a regulatory outlet that would keep the cyrptos safe. However, since 2011 there has been ~$9 billion worth of cryptocurrencies stolen with the largest amount in 2022. **(Chart 4, next page).** We also cannot ignore that these crypto wallets are secured with a passcode and if you forget your passcode, there is no reset. Your coins are lost.
6. **It is anonymous**. **Wrong!** The point of blockchain technology that crypto was founded on is that it is a completely transparent ledger that anyone can access. Does not sound anonymous.
7. **Millennials and Gen Z are buying it so it must be the future. Wrong!** The lack of understanding and education taken from websites with no financial background (e.g., TikTok) left these generations with significant losses.

Regulation is one of the biggest risks to the crypto market. Its lack of regulation leaves investors helpless.

Chart 2

Crypto No Competition to the Dollar

Data is indexed since the start of the 2022 and as of December 19, 2022. Source: Bloomberg Finance LP, Verdence Capital Advisors.

Chart 3

Bitcoin More Volatile than Equities

Data is as of December 20, 2022. Source: Bloomberg Finance LP, Verdence Capital Advisors.

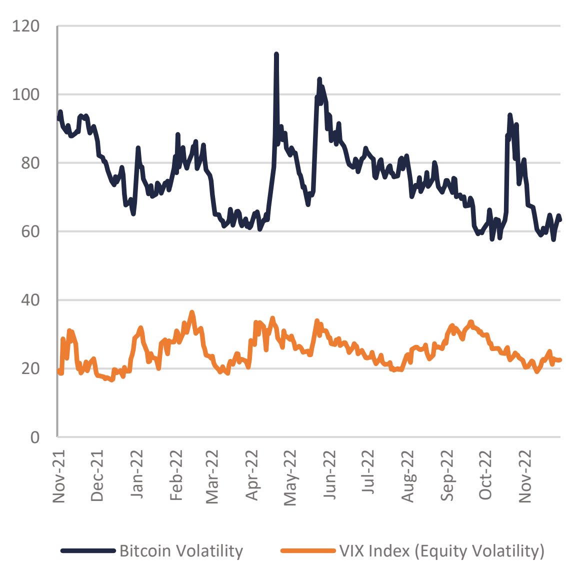
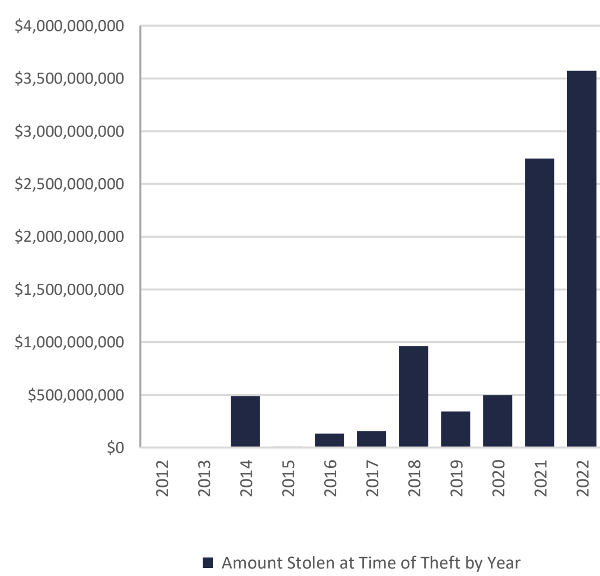


Chart 4

Theft of Crypto Becoming Common

Data is as of December 16, 2022.

Source: www.comparitech.com/crypto/biggest-cryptocurrency-heists/, Verdence Capital Advisors.



Blockchain May be What Emerges as the Clear Winner

The technology behind the crypto craze has always been what has value, the blockchain. Blockchain is a decentralized database that stores information in a digital format and strings it together to form a chronological chain. Once the chain builds up (as new data comes in it creates a new block that is linked to the old blocks) it cannot be edited, deleted, or destroyed. The use of blockchain allows data to be held away from a centralized location and reduces the risk of human error in data entry. While blockchain has primarily been used in the crypto experiment it has tremendous potential to change the way businesses operate. For example, a company can utilize blockchain for inventory management. IBM is using blockchain technology to show every step of food processing so consumers can truly track “from farm to fork” the food they are consuming (called IBM Food Trust).[3] Shipping can become more efficient with less error if we migrate to a blockchain as opposed to a complex network of computers. If we utilized blockchain technology in the voting system, it could reduce the risk of voter fraud.

Our View

We continue to highly discourage investing in cryptocurrencies. What we have seen this year is greed and the fear of missing out overriding reason and fundamental analysis. Crypto is speculative and has no foundation. Investors are simply pinning their hopes on the misperception that there will be another buyer. Unfortunately, those buyers are not emerging. We realize the cryptocurrency world has evolved to a level that governmental agencies cannot ignore it and it will likely be around in some form. However, the future of regulation will dictate what this industry will look like over the next decade. With the high-profile bankruptcy of FTX we expect regulation to be a major issue in 2023 for the crypto world. It is likely that regulation will scare off speculative investors, some committing fraud or using the crypto market for terrorism, drug trafficking and other illegal activities. As the dust settles, we do believe the positive that will come out of this experiment will be a widespread adoption of blockchain technology. Blockchain has ways to improve efficiencies in business and we will continue to monitor the development of this technology and how investors may benefit.

Disclaimer:

1. https://www.washingtonpost.com/business/2022/12/18/crypto-winter-ftx-collapse-bitcoin-prices/
2. https://www.washingtonpost.com/business/2022/12/18/crypto-winter-ftx-collapse-bitcoin-prices/
3. https://www.cnbc.com/2022/11/21/collapsed-crypto-exchange-ftx-owes-top-50-creditors-3-billion-filing.html
4. https://www.ibm.com/topics/blockchain-for-business

Megan Horneman | Chief Investment Officer
mhorneman@verdence.com

VERDENCE
CAPITAL ADVISORS