DEFLATION, NOT INFLATION, WILL UNLEASH BITCOIN PRICES

The Federal Reserve is testing the limits of the dollar in the face of COVID-19. Fundamental data shows that these are the perfect conditions for Bitcoin to break into the mainstream.

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Introduction

Bitcoin began as a response to the global financial crisis of 2008. This ethos is captured by a message on the genesis block, “The Times 03/Jan/2009 Chancellor on brink of second bailout for banks,” commenting on a headline in The Times about the instability of the global financial system.

More than a decade has passed since the article was first published. Now, we are in the middle of yet another financial crisis.

It is still too early to predict the magnitude of COVID-19’s impact on the world economy. Nevertheless, a global recession seems inevitable. Entire industries are getting shuttered because of the shutdowns induced by coronavirus.

Factories, retailers, and restaurants will not return to full operating capacity until the epidemic ends. J.C. Penney and J. Crew, two of the largest retailers in the US, have already filed for bankruptcy. More are expected over the next few quarters. Harder hit is the airline and travel industry — people are unlikely to travel for at least another year. Less consumption has led to low energy demand, decreasing the need for oil and leading to negative crude oil prices for the first time ever. We have yet to see the true impact of coronavirus on the commercial real estate industry in the US.

Even more alarming is the pandemic’s impact on unemployment. The crisis has put hundreds of millions out of work. In the United States alone, the number of unemployed jumped to 20.3 million in April, levels not seen since the Great Depression.

To fight the crisis, governments around the world have injected unprecedented amounts of monetary stimulus into their economies. Congress has already approved a 2.3 trillion coronavirus relief package, and the number is likely to increase to 5 trillion by the end of 2020.

Retail and institutional investors are looking for shelter in fear of forthcoming inflation. Now, more than ever, it is necessary to revisit how these macro trends might affect Bitcoin and the broader cryptocurrency space.

In recent years, Bitcoin has continued to gain worldwide popularity, drawing the attention of both wall street and main street investors. The recent pandemic has only created more curiosity for Bitcoin and alternative currencies. It is still unclear whether Bitcoin will live up to its narrative as a safe haven asset. But there are some clues.
During 2019, global events, like the US-China trade war and the conflict in Iran, pushed Bitcoin prices up. This dynamic exemplified that the crypto-asset was starting to display a negative correlation to risky world events. However, when markets fell on March 12, now known as “Black Thursday,” we saw the opposite. Coronavirus inspired fear not only in equities, but also in supposed safe havens like Bitcoin and gold.

With the Bitcoin halving now behind us, we take a look at how COVID-19 has recently influenced Bitcoin’s price, examine the impact of monetary stimulus on the world economy, postulate the macro trends that might develop in the years ahead, and finally, estimate its implications on Bitcoin’s price.

United States Unemployment Rate  |  Source: tradingeconomics.com
Looking at the historical correlation chart of Bitcoin and the S&P 500 Index, we see that the correlation coefficient shows a cyclical pattern, revolving around 0. For the uninitiated, 0 indicates very little correlation. In fact, before March of this year, the coefficient had reached highs of 0.3 just twice in Bitcoin’s history.

Cash is King During a Liquidity Crisis

Historical correlation chart BTC vs S&P | Source: coinmetrics.io
However, in March of this year, the correlation coefficient rose dramatically to an all-time high of 0.6, and now hangs around 0.5. The spike in correlation is attributed to the COVID-19 market crash, which had a severe effect on all the asset classes.

The S&P 500, NASDAQ, DJIA, gold, and Bitcoin all plummeted. Investors scrambled for liquidity, and cash was their number one choice. During the market sell-off, traditional indexes had some of the worst days in history, dropping double digits.

Bitcoin also lost more than 40% in the span of two days. Some were quick to point out that “Bitcoin’s safe-haven narrative has flown out the window.”
Bitcoin and Gold quickly rebounded back to their previous levels while S&P 500 lagged behind and continues to hang well below its previous March high. Nevertheless, the clear winner during the mayhem was USD.

During a liquidity crunch the popular choice is clear. A precipitous drop in stock markets will cause investors from all markets to move into cash. Neither Bitcoin nor gold has shown it will be able to provide shelter during a short-term liquidity crisis.

This was the case in 2008 as well. Bitcoin wasn’t around yet but here is the S&P 500 versus Gold.
The Federal Reserve and other central banks around the world are currently doing everything they can to prevent a deeper, longer-lasting economic downturn.

During the financial crisis of 2008, major central banks, including the Fed, conducted what is now known as Quantitative Easing (QE) in attempts to kickstart stalling economies. QE is the process of simultaneously injecting liquidity and pulling down interest rates. The Federal Reserve’s QE efforts in the United States added almost $2 trillion to the money supply in 2008.

This expansion of the money supply didn’t stop a recession, however. Instead, the U.S. financial crisis officially started in December 2007 and lasted until June 2009, extending over 19 months. Meanwhile, the QE program lasted until the end of 2013, expanding the Fed’s balance sheet to over $4 trillion.

During the current Coronavirus crisis, we see history repeating. The Fed is again “printing” money to save the economy.

Current projections indicate that the Fed will purchase $3.5 trillion in government securities with these newly created dollars by the year’s end. It has already printed around $2.3 trillion.

New dollars might blunt a recession, but is the strategy sustainable?

Economists and fund managers point out that Fed’s actions could lead to potential inflation.

Chetan Ahya, chief economist at Morgan Stanley, said in a note:

“We see the threat of inflation emerging from 2022 and think that inflation will be higher and overshoot the central banks’ targets in this cycle. This poses a new risk to the business cycle, and future expansions could also be shorter.”

Chris Brightman, chief investment officer and member of the board of Research Affiliates, wrote in the report:

If the Fed continues to print new money, could Bitcoin become an inflationary hedge due to its disinflationary nature?

A few powerful investors agree. Paul Tudor Jones, a famous hedge fund manager, compares Bitcoin to gold in his recently published market outlook:

“Real consumption must decline in line with the real value of output lost due to the cessation of productive activity. If today’s money printing does succeed in maintaining the nominal value of consumption spending, many more dollars will be chasing a smaller amount of goods and services. The result will be inflation.”

“Bitcoin reminds me of gold when I first got in the business in 1976. Gold had just been productized as a futures instrument (like Bitcoin recently) and had enjoyed a heck of a bull market, almost tripling in price. It then corrected almost 50% in nearly two years similar to Bitcoin’s 28-month 80% correction!”
Gold price
USD per Troy Ounces in log scale. Source: Bloomberg

Bitcoin price
USD per 1 Bitcoin in log scale. Source: Bloomberg

Gold vs Bitcoin Prices | Source: seekingalpha.com
He also argues that owning Bitcoin is a good way to defend oneself from the “Great Monetary Inflation” (GMI) that we have been seeing recently.

“But the GMI caused me to revisit Bitcoin as an investable asset for the first time in two and a half years. It falls into the category of a store of value and it has the added bonus of being semitransactional in nature,” said Jones.

Jones polled his research group asking to grade different assets based on four characteristics indicative of a good store of value — purchasing power, trustworthiness, liquidity, portability.

Even though Bitcoin came in last, it is because it is an emerging store of value. He continued:

“So that was the flavor behind some of the discussions that were had when scoring the suitability of each asset as a store of value. What was surprising to me was not that Bitcoin came in last, but that it scored as high as it did. Bitcoin had an overall score nearly 60% of that of financial assets but has a market cap that is 1/1200th of that. It scores 66% of gold as a store of value, but has a market cap that is 1/60th of gold’s outstanding value. Something appears wrong here and my guess is it is the price of Bitcoin.”

It’s worth noting, the total market capitalization of Bitcoin today is currently a mere $168 billion. This represents just ~1.8% the market size of gold at $9 trillion. If Bitcoin captures just 10% of the gold market that would bring the price of one Bitcoin to $50,000, ceteris paribus.

Similarly, if just a fraction of today’s institutional funds move a small percentage of their assets into Bitcoin, the price of one Bitcoin could quickly reach $50,000 to $100,000.

The argument Jones makes to move into Bitcoin as a hedge against inflation is valid. However, we might not see inflation in the very near term as a direct result of today’s monetary expansion. There are a few more steps in between.

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<tr>
<td>2</td>
<td>Fiat cash</td>
<td>54</td>
</tr>
<tr>
<td>3</td>
<td>Gold</td>
<td>62</td>
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<tr>
<td>4</td>
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Grading assets by their ability to store value | Source: seekingalpha.com
While the long term effects of monetary expansion logically suggest risks of inflation, the concern in the near term is actually quite the contrary; the culprit is deflation. The consumer price index, a gauge of inflation, is at one of the lowest levels it has been in the past decade.

The Fed is Concerned About Deflation, Not Inflation

Source: Consumer Price Index - Bureau of Labor Statistics
There are yet to be any indications of immediate inflationary growth. Concurrently, since the last recession, corporations have been taking advantage of low interest rates and have been borrowing heavily.

Today, our corporate debt is at the highest level it has ever been, nearly $10 trillion.

To put this into perspective, our nation’s GDP in 2019 was $21.43 trillion. Our corporate debt alone is nearly 47% of U.S. annual GDP.

Over the past ten years, corporations have been borrowing money at record levels for stock buybacks to drive stock prices up. Stock prices have gone up, management and investors have taken profits, but the debt still sits on the books of the nation’s largest corporations.

Interest rates are currently near zero with no room to move lower. At the same time, coronavirus will continue to drive down consumption. This will drive down prices, and in turn, corporate revenues.

So with corporate debt at record highs and revenues shrinking to unforeseen levels, the cost to repay these loans will be exceedingly high in real terms. Corporations will have no fresh money to finance the pyramid scheme.

This would lead to cascading bankruptcies—when big corporations fold, they will also take down smaller ones that rely on them. Unemployment continues to rise, foreclosures ensue, credit markets tighten, money velocity slows, and productivity drops. The end result is a contraction in overall economic output and productivity.

In the near term, if we see significant deflation, more and more investors will want to hold U.S. dollars rather than park their wealth in risky investments. Bitcoin, may in fact continue to be relegated to the class of highly speculative investments with a nice story.
A Failure of the Federal Reserve and Other Central Banks

We’ve previously discussed how the Federal Reserve has undertaken an unprecedented “printing” of money. In reality, the Federal Reserve doesn’t actually “print” money, it also doesn’t “spend” any money.

The job of the Federal Reserve is to lend money when it needs to increase the money supply in the economy. The U.S. government does the actual shopping. As established under the Federal Reserve Act of 1913, the Federal Reserve does not have the power to actually spend.

The money that it lends to the U.S. government can be spent by the government, but it needs to be paid back, eventually. But with government debt at levels unseen since the Great Depression, and tax revenues down due to unemployment and lowered economic output, it’s likely that a balanced budget will not be achieved anytime in the near future.

Our government won’t have many options left.

Taking this one step further, Congress does theoretically have one more move. Congress can vote to amend the Federal Reserve Act so that it takes on the liabilities of the U.S. government and actually “prints” money and “spends” it directly to pay our nation’s bills.

This way the government would never have to pay the money back.

This is, of course, unprecedented in U.S. history, but these are unprecedented times. Such an action could, in theory, lead to a complete loss of confidence in the U.S. dollar where one dollar truly has even less economic basis than it did before.

People would not want to hold dollars anymore and would rather hoard goods and barter. The end result is hyperinflation. This may sound extreme, but so does a national quarantine for two months—yet, that just happened.

This scenario has in fact occurred countless times in history when governments are not able to repay their debts. This happened in the 18th century when the House of Bourbon issued worthless coins during the French revolution.

It happened in China during the 1930s when Chiang Kai-Shek couldn’t repay the country’s debts and allowed the central bank to do so. The Germans also did this at the end of WWII. More recently, in most central and Latin American countries.

We are already seeing precursors of this today with the COVID-19 related special purpose vehicles that allowed the Fed to buy up junk bonds, and soon, maybe even shares of “zombie” companies.

Monetary expansion, or “money printing” by central banks around the world are reaching unprecedented levels due to COVID-19. A reopening won’t change much. It will merely reshuffle who owes who. The printing will continue on with brazen austerity.

Citizens around the world will begin to question the staying power of their national currencies as the words “quantitative easing” become less foreign a concept. This may take years to develop, depending on which road our nation’s leaders decide to take, but it’s difficult to find a clear path that avoids it.
Beyond Price, Fundamentals Point to Bitcoin

Given the macro-economic reality, the long-term fundamental picture for Bitcoin is stronger than ever. Demand for Bitcoin has been rising since the halving. On-chain activity is also recovering, adding credence to sustained demand.

Supply on exchanges is currently at the lowest it has been for the past 12 months, showing that investors expect Bitcoin to appreciate in price. In turn, these investors are pulling their coins off exchanges.

Supply on Exchanges vs Bitcoin Price  |  Source: Santiment.net
Token Age Consumed, (a metric that gauges whether long-term or short-term investors are moving their tokens) also remained relatively constant. This phenomenon can also be understood by the term “Bitcoin Days Destroyed.”

The spikes in Token Age Consumed in 2019 followed market downturns. But currently, there are no spikes. It seems like long-term investors are holding onto their coins.
The Mean Coin Age is also currently at its all-time high, which means that a greater proportion of Bitcoin holders view it as a long-term investment, rather than a vehicle for speculation.

In fact, the Mean Coin Age has been growing since the origin of Bitcoin, and we expect it to increase into the future.
Looking at the holders distribution, we see that new retail investors are entering the market. The number of holders that own up to 10 Bitcoin is also increasing. The hype around the halving brought many new investors to the crypto ecosystem.
Large holders are more conservative, however. They were increasing their positions up to 10,000 levels, but now they are either waiting, or decreasing, the number of Bitcoins they hold. During April, we’ve seen a spike in large Bitcoin holders (1,000 - 10,000 coins), and many of them are still holding BTC.

Source: Santiment.net
The data available today shows that the risk of hyperinflation is still low in the near-term. Yet, modest inflation combined with flat growth could push investors to exit equities and enter gold and other safe havens.

Nevertheless, sudden shocks to the stock market will lead investors to seek shelter in fiat, leading to a strong dollar in the short-run. As conditions cool, money will then flow to gold.

However, with gold already at all-time highs, both institutional and retail investors are growing curious about other forms of inflationary hedges to protect themselves against the long term risks of inflation. This is where Bitcoin comes in.

The case for Bitcoin as an alternative over gold is growing rapidly. Bitcoin is an ideal store of value because of its programmatic scarcity, censorship resistance, usability as a medium of exchange, and storage cost effectiveness.

The fundamental metrics underlying Bitcoin’s value as money are growing month-after-month, and soon this value will be clear to everyday investors. From an investment standpoint, the disproportionate risk-return tradeoff of investing in Bitcoin will lead logical fund managers to begin asking “why not” rather than “why.” Finally, if the price of Bitcoin rises, it will raise all ships in the cryptocurrency waters, just as we have seen it in previous cycles. Bitcoin is the gateway into the crypto rabbit hole that sparks interest in what a decentralized, non-sovereign, digital world might look like.

Money is a belief system. As fiat currencies depreciate, investors will watch Bitcoin rise, year after year, and perhaps decade after decade. Observation will soon become belief, and Bitcoin will become money, giving digital assets their chance at underpinning the global economy.

The road to a new belief system will come from a disbelief in an old system and the emergence of a new and better system. Given an alternative, people won’t stand for another failure in the financial system, like what the U.S. experienced in 2008 — or what the country could go through in the years ahead. Big banks won’t stand the test of time, but Bitcoin very well could.

Disclosure: The author of this report holds Bitcoin and other cryptocurrencies.
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