Bitcoin - silver bullet or big bubble?

By Jacques Plaut

14 Nov 2017

Before I say anything else, let me first say this: I do not know where the price of Bitcoin is going. If you are looking for a price forecast, I'm afraid this is not the article for you. The best I can do is to tell you that it will fluctuate. Nonetheless, I hope that I will still be able to say some useful things about the value of Bitcoin, and its suitability as an investment.

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Bitcoin as an asset

The usual methods for valuing an asset are not readily applicable here:

- ## The present value of future cash flows:

  There are no future cash flows associated with Bitcoin, except the price at which you will sell it one day.
- ## Historical prices:

  The first Bitcoin was traded in 2009. This is a short history compared with, say, the 150-year history we have for oil and the 2 000-year history we have for gold (which is the asset most similar to Bitcoin). And the history we do have is not very stable.
- ## Supply/demand analysis:

  The demand and the supply come mostly from speculators, and the attitude of speculators is notoriously hard to foresee.
- ## Relative scarcity:

  The ultimate supply of Bitcoin is limited to 21-million coins. The supply of dollars is unlimited. Therefore, Bitcoin should appreciate indefinitely against the dollar. And while the supply of Bitcoin is limited, the supply of virtual currency is not. There are at least 1,100 others, including Ethereum, Gnosis, Mysterium, and my favourite: PonziCoin. Some of these have better underlying technology than Bitcoin.

Bitcoin as a currency

One could say that Bitcoin is not an asset, but a currency. Some even say that it will eventually become the world's reserve currency.

First, I'm not sure that Bitcoin will be the new reserve currency. The underlying technology is somewhat clunky and, like I mentioned, there is lots of competition from other virtual currencies. Also, people tend to value stability in their reserve currencies. One that is rapidly increasing in value will cause people to hoard it; one that is decreasing will cause people to spend. The current system of having a central bank that manages the stability of the currency by altering the supply of money, has worked quite well for a hundred years. Governments will presumably have a say in all this, and might not approve. It was illegal for US citizens to own gold from 1934 until 1975.

We normally value currencies by looking at the price history, the quality and track record of the issuing central bank, the amount of foreign reserves, the fundamentals of the sovereign, and the Big Mac Index. These are not easily applied to Bitcoin.

Tulips

Can behavioural psychology give us any insight into Bitcoin?

There have been several times in history of frantic speculation on commodities – the price of tulips in Holland in 1637, Florida real estate (1926), gold (1980), Japanese assets (1990), and internet stocks (2000), to name a few. There is always some underlying justification, or "story", at least at the start. Scarcity of bulbs, the Florida climate, gold's virtue as an inflation hedge, the wisdom of Japanese policymakers, or the internet's ability to change the world – these are the justifications that served for my examples above. The problem comes in when people stop connecting the price of the asset to any underlying economic reality. If you believe the story, no price is too high.

In the case of virtual currencies, the "story" which has captured the public imagination is blockchain technology. Blockchain technology is a way of enabling the digital transfer of money between two parties without an intermediary. The idea has lots of potential, and virtual currency is only one of many possible applications. But this does not make bitcoin worth anything, just like the existence of the internet was not enough to make Pets.com a valuable asset.

I don't know whether Bitcoin deserves to be classed with episodes like tulip mania. I see some similarities with previous bubbles, but all the signs are not yet there. For example, the abuse of debt in some form is a standard feature of any bubble, and I'm not aware that people are using it to buy Bitcoin, yet.

Three more things

1. Bitcoin is not a friend of the environment. According to one estimate, the total amount of electricity consumed by processing bitcoin transactions is enough to power 1.6-million US households for a year. Bitcoin uses more electricity

than Lebanon or Cuba.

2. Some blame central banks for the rise of virtual currencies. Because the US Federal Reserve is keeping rates low and printing money, they say, people are putting their faith in other assets. I'm sceptical of this explanation. Bubbles can happen in any interest rate environment. When the price of gold peaked in 1980, US interest rates were 14%.
3. The idea of an alternative currency is not a new thing. Before Lincoln signed the National Banking Act of 1863, the US had hundreds of currencies, issued by individual banks. They were often backed, to varying extents, by gold. Those that weren't tended to end in collapse.

Would we own bitcoin for clients?

Regulations do not currently allow this for most of our funds. But regulations aside, we are always looking for good ways to preserve capital and earn returns for clients. We do not think Bitcoin is an instrument which will enable us to do this; indeed, we see material risk of capital loss.

ABOUT THE AUTHOR

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