DIGITAL ASSETS VS GOLD

Which is the better inflation hedge?

CMC MARKETS CONNECT

INTRODUCTION

In 2022 CMC Markets Connect, a leading global provider of institutional trading and technology solutions, hosted a panel debate to answer the question, “can digital assets ever replace gold as an inflation hedge?” Held both as an in-person event with more than 100 attendees and simultaneously live-cast over the internet attracting a further 350 delegates from across the globe, a highly experienced audience of cryptocurrency professionals delivered a session that proved both engaging and highly insightful.

Chaired by Camilla Boldracchi, Institutional Services Team Leader at CMC Markets Connect, the panel included Shazia Azim, Partner, Financial Services Consulting Leader at PwC UK; Mel Tsiaprazis, Chief Commercial Officer, Bitstamp; Eva Lawrence, Chief Operating Officer, Arcane Crypto; and Michelle Chivunga, CEO and Founder, Global Policy House. An all-female panel was invited to mark one part of CMC Markets’ celebration of International Women’s Day.

Perhaps unsurprisingly, with such a diverse range of backgrounds, opinions were divided over the state of evolution of cryptocurrencies – even the legacy Bitcoin – and to what extent this will impact its ability to act as an inflation hedge. Taking inspiration from the session, we offer our take on five key questions which remain front of mind for many who are trying to understand the fundamentals of digital assets.

The Crypto market is still a young industry. It's difficult to look at market cycles in that space, given the limited data available when you compare it to something like gold.

Eva Lawrence
Chief Operating Officer

There is a big community-driven agenda behind NFTs as it allows us to become more creative in the space to create better value that is accessible and inclusive.

Michelle Chivunga
Global Policy House

As Cryptocurrencies become more regulated, investors' confidence about the price behaviour will increase. I think you will see it act more as an inflation hedge over time.

Mel Tsiaprazis
Chief Commercial Officer

The more advanced Digital Assets get, the more environmentally friendly they will become and the more inefficiency they will cut out.

Shazia Azim
Partner, Financial Services Consulting Leader

WHY ARE CRYPTO ASSETS FAILING TO BEHAVE LIKE GOLD IN THIS HIGH INFLATION ENVIRONMENT?

The growth of digital assets has taken place at an extraordinary time for economic policy globally. Interest rates – and consequently inflation – have both been artificially low for the past decade, allowing the majority of asset valuations to inflate significantly. There was no shortage of speculation that when the inevitable happened and inflation did start to move higher, this new asset class would itself become a fantastic store of value itself. Bitcoin was very much in focus here with its indelible ledger of ownership conferring security along with its finite supply meaning that it shared many of gold's attributes. Yet, over the last 12 months, the price of BTC/USD is little changed and there's certainly no suggestion that in terms of a wealth store it's anywhere close to behaving like a precious metal.

However it's important to consider how these digital assets – even the legacy players like Bitcoin – are still incredibly young when considering the bigger picture. Gold has been used as a wealth store for 3,500 years, whilst cryptos are only now starting to gain any traction at all with the more established intuitions. There's also that fundamental asset price inflation for the last decade that needs to be considered – are digital assets currently fairly priced?
Whilst the performance of this new generation of assets may have defied the best estimates of many when it comes to what should have happened this time round, there's plenty of reasons to buy into the idea that future inflation spikes will see cryptos truly shine.

WE HEAR ENOUGH ABOUT THE ENVIRONMENTAL IMPACT OF MINING BITCOIN. IS THIS WARRANTED AND HOW DOES IT COMPARE WITH THE SOCIAL COST OF MINING GOLD?

Media headlines here have certainly been brutal in recent years, pointing out that the energy consumption necessary to mine bitcoin and run the accompanying blockchain is now equivalent to that used by the entire population of countries like Norway or Thailand.
There's no escaping from the fact that it is an energy intensive process and estimates have suggested that the electricity bills account for as much as 75% of income. Whilst there are some plays to use renewable energy for bitcoin mining – something that is incredibly lucrative once you start harnessing surplus energy that would otherwise be wasted – the clampdown by China on bitcoin mining served up a major blow here.

Indeed, estimates calculated by Digiconomist (https://digiconomist.net/bitcoin-energy-consumption/) shows that the production of one bitcoin generates 334 tonnes of CO_2 whilst mining the equivalent amount of physical gold generates just 16 tonnes of CO_2.

However, this provides a one dimensional assessment and fails to take account of the other highly toxic pollutants such as cyanide and mercury which are generated in the extraction and refining process of physical gold. This can be especially problematic amongst what are euphemistically called artisanal miners, but are in all reality operating on the fringes, often without proper regulation or oversight. Concerns have also been raised with regard to the terms that worker are employed under and whilst multinational mining corporations will have CSR policies in place to ensure fairness, again it's those operating on the sidelines that have been thrust into the spotlight. Tens of thousands of children are reported as working in the small scale mines in Africa, Asia and South America.
(https://www.ilo.org/ipec/areas/Miningandquarrying/MoreaboutCLinmining/lang--en/index.htm)

TO WHAT EXTENT SHOULD DIGITAL ASSETS BE CONSIDERED A SAFE HAVEN AND HOW ARE INSTITUTIONS CHANGING THEIR VIEWS HERE AS THEY BECOME MORE MAINSTREAM?

Digital assets are becoming increasingly legitimised every day, although challenges are still present. Storage security has become way more sophisticated and the ability to trade over standard systems have also developed well, but digital assets still have some way to go before they can be considered truly mainstream. Pricing and valuation issues continue to deliver a major limitation, but arguably it's regulatory uncertainty that poses the single biggest threat right now.

Central Banks are getting onside and indeed some smaller economies have now adopted cryptocurrencies as legal tender, with El Salvador being the first in September 2021.
Institutions are also gradually upping their exposure to the asset class, although for the vast majority these still remain as comparatively tiny holdings, although adoption rates here are reported as now accelerating. Perhaps the proverbial elephant in the room however is governments and central banks having to relinquish control of monetary policy.

Digital assets right now still only represent a tiny fraction of global wealth. Estimates suggest they collectively have a total value of around $2 trilion, whilst the total value of gold is reportedly in the region of $12 trillion. However as this market balloons – it's tipped to quadruple over the next five years – the challenges presented in a legislative framework will only grow further. Once major governments present more cohesive plans over adoption, assuming these are supportive then even the most prudent of institutions will have little reason not to start adding to holdings here.

NFTS. MISUNDERSTOOD, MISPRICED OR JUST AHEAD OF THEIR TIME?

Non fungible tokens remain something of an enigma to many, and perhaps that's of little surprise given they are a rather abstract concept. And there's certainly been a degree of misunderstanding, with many thinking they only apply to the ultra-high value items. In one high profile instance, Twitter co-founder Jack Dorsey turned his first tweet into an NFT and sold it for $2.9 million. Just over a year later in April 2022, when offered at auction the highest bid was just $280. That alone seems to underline how they are both misunderstood and mispriced. However it's worth bearing in mind that these products remain in their absolute infancy with the first NFT transaction taking place in 2015, some six years after the first bitcoin was mined.

Care probably needs to be taken to ensure that this innovative construct doesn't become marginalised.

Time will hopefully act as the most important component in ensuring they find their correct purpose and can be fully adopted. Work already underway has shown that comparatively low value content can be converted into NFTs and then sold to readers, potentially cracking the micropayments challenge which the publishing industry has been battling with for the last two and a half decades. Other applications have seen the tokenisation of everything from bottles of wine to property, whilst the Proof of Attendance Protocol allows users to create an indelible record of learning, events and experience. Delegates at the recent CMC Markets Connect event discussing whether digital assets could be seen as an inflation hedge were each able to claim an NFT showing their attendance. Ultimately this sub-class of assets is still finding its footing and exciting times lie ahead – even if that does mean a few wrong turns or false starts are seen in the process.

CRYPTOS AS A STORE OF VALUE. AS WE EMERGE FROM AN UNPRECEDENTED PERIOD OF QE, HOW SHOULD THIS BE FACTORED INTO VALUATIONS?

There are two distinct points here which need to be considered. Perhaps on the most simplistic level it's a case of considering what gives any asset the utility of being a value store, and that's going to be dictated by how easy it is to use this as a medium of exchange. Whilst the wider acceptance of cryptocurrencies is gradually increasing, challenges remain especially in terms of understanding fair value – something that is especially evident if attempting to translate back into fiat currency. Given the heightened levels of volatility we continue to see across digital assets, until more of the "supply chain" itself is priced using cryptos then this is going to remain something of a challenge.

From an economics perspective, the issue is fundamentally different. Asset valuations have been inflated globally by long periods of low interest rates, something that is especially true for those investment vehicles that offer a yield. A blue chip stock consistently delivering a 6% p.a. dividend becomes an obvious pick if bond yields are at or close to zero, but as interest rates normalise, the picture becomes somewhat different. Non-yielding crypto valuations haven't been inflated directly by this factor and whilst there may have been a degree of read-across, the theory at least would be that the downside pressure that ought to be exerted on yielding assets as interest rates rise shouldn't apply to cryptos.