Bitcoin – Asset, Currency or Mirage

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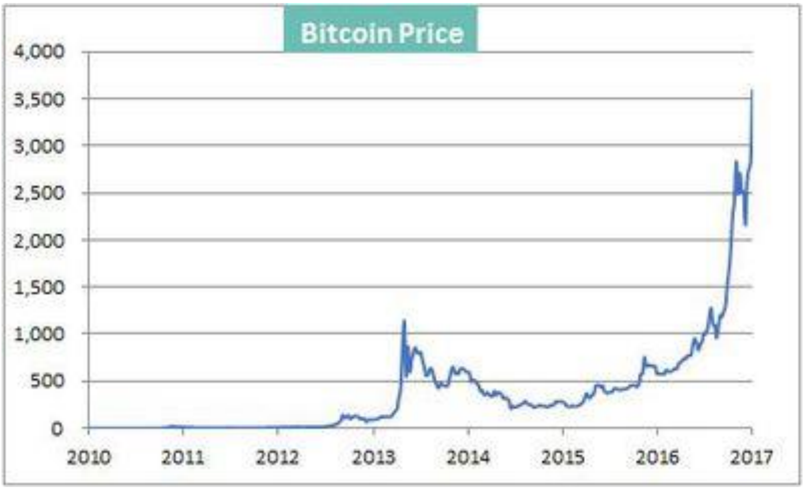

With the price of bitcoins going stratospheric, we thought subscribers would welcome a view, and indeed some of you have already been asking for such a view.

The chart highlights the dramatic rise in the price of bitcoins since its introduction as a digital currency in 2010. But, don't let the chart either entice you or fool you.

An understanding of what constitutes 'Sound Money' is more important here than any understanding of technology. People have traded with each other in goods and services since time began. Paper money and credit facilitates trade, but to be accepted as payment such money or credit must be trusted and have intrinsic value.

We receive payment for our goods and/or services and we lodge our payment into the banking system. We trust the banks to safeguard our money. Yes, this trust was broken in 2008 and led to bank runs all over the developed world. But central banks stand behind domestic banks. And in 2008, central banks stood behind domestic banks in the US, UK, and in the Eurozone. In the Eurozone, the ECB provided all the liquidity banks needed and depositors' monies were safeguarded. The system was tested to the core, but it did survive, albeit at a price, and with old lessons having to be relearned.

But what backs the central banks? Governments, of course! A sound banking system and a country's currency is underpinned by the government's ability to raise revenue through taxes, not just today, but into the indefinite future. In the vast majority of times, your bank deposits represent 'Sound Money'.

Within the banking system, it makes complete sense that the borrower should pay for the use of the savers capital and that you, the saver, get a return on your savings that at least matches inflation i.e. your money is a store of value. However, as new paper money can be created at will, paper monies have not always acted as a store of value - think of the German Reichsmark after WW1 and, more recently, the Argentinian peso and the Zwimbabian dollar - all worthless as a store of value due to the fact that their governments spent recklessly and printed money in huge quantities to try and pay for that spending.

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In this light, it is easy to understand the allure of gold as a store of value. Gold is also a medium of exchange that needs no banking system. With deposits in a bank, your assets are secure only so long as the bank is secure. In other words, when you lodge your savings with a bank you get an I.O.U. in return. You are dependent on the bank making good on that I.O.U. Not so with gold. If you buy gold with your savings you have an asset, not a liability (an I.O.U. is a bank liability).

As gold has been in demand as jewelry for thousands of years, there is a base demand for gold. And as it currently costs *circa* $820-850 on average to get an ounce of gold out of the ground, gold has intrinsic value. If you come back in twenty years, there'll be a price for your gold, and over the millennia, due principally to the fact that new gold supplies are limited, the gold price has matched inflation; gold has been a better store of value than most paper currencies over the millennia.

But, as the supply of gold cannot be increased at the same pace that trade expands, gold's problem as a medium of exchange in trade has been that there was never enough of it around to facilitate the settlement of faster expanding trade. But, as a store of value, gold stands above all paper currencies.

Bitcoin is a digitally created currency and is in limited supply. Some, therefore, suggest it is similar in nature to gold. But, unless there's some intrinsic value in bitcoin currency, comparing it to gold is simply self-serving. None of us in GillenMarkets fully understands the blockchain technology that supposedly verifies payments made with bitcoins on the Internet. But, unless that technology is going to lead to some revenue flow for owners of bitcoin currency, bitcoin has no intrinsic value, but rather is simply a new medium of exchange for settling trade in goods and services. Yes, it operates outside the banking system - like gold – but, so what?

When we settle for goods or services using credit or debit cards are we not using digital currency? It seems to me that we are. And there's a cost - the facilitator i.e. Visa or Mastercard, among others. But, ultimately they are part of the wider banking system.

If bitcoin and blockchain technology lower the cost of settling trades then they represent a positive development. But, the Internet itself was a revolutionary development, yet it makes no money for anyone. Rather, it has changed our lives, lowered costs in many areas, increased choice and spawned new innovations. If bitcoin is going to revolutionise trade settlement then its supply should not be restricted, but rather should be expanded at the same rate as trade. That being the case, why would its price rise other than to offset inflation, similar to the price of gold.

So, have bitcoins any value? When you own them can you earn a return on them? Our current understanding is no. Do you have counterparty risk? Yes. Can the amount of bitcoins be increased at will? Not at present, but new cryptocurrencies are cropping up regularly so does it really matter if each separate one is limited if there's no control of the supply in general? It would not appear so. Unless you know the answers to these 'Sound Money'

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questions, you should avoid bitcoin as an investment proposition. Fans of bitcoin seem to be placing all their faith in the fact that bitcoins are strictly limited in supply. So what? A limited supply means very little if an item has no intrinsic value. The Dutch learnt the lesson of intrinsic value in the late 1600s when Tulip-mania took over. The only intrinsic value tulips had then (and now) was the cost of production, but the Dutch forgot that for a few years, and lives were ruined in the too often human pursuit of riches without effort.

Most likely, we are simply witnessing a speculative development where the limited supply of bitcoins is leading to higher prices as the demand to own them multiplies, with these higher prices bringing in more speculators who drive the price still higher. Was that not what drove house prices in Ireland to daft levels in the early to mid-2000s? Easy access to mispriced credit (loans) created demand for property which resulted in still higher prices which led to more demand for credit until the bubble fell on its own weight? If bitcoin is a novel way to settle trades outside the banking system then why limit the supply?

If more knowledgeable, tech-savvy subscribers have a better understanding of the bitcoin phenomenon, we will welcome your views. If we have misunderstood the bitcoin revolution we stand ready to change our view. As economist John Maynard Keynes once said *"if the facts change, so do I - what do you do, sir?"* Humility is an essential tool for survival in the investment game!

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