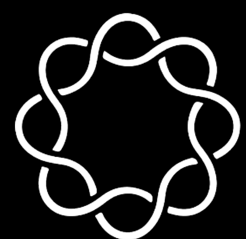
June 2020

The Institutional Argument for Bitcoin



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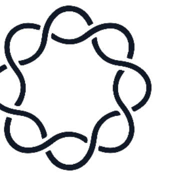
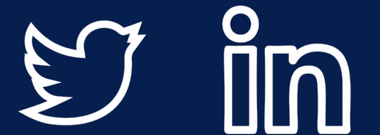


Introducing Our New Partner

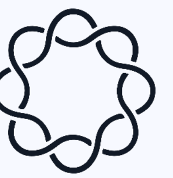
José Macedo, London Office



José brings extensive experience having previously led the advisory department at AmaZix, one of the largest digital asset advisory companies; his team worked with over 150 projects raising $1.3B, including the likes of Bancor, HDAC, Bankex, GBX and many others. Before entering the digital asset space, José was a world-class poker player and an award-winning entrepreneur, starting and successfully exiting his previous ecommerce business and earning awards such as the Duke of York Young Entrepreneur award.

José has spoken at conferences all over the world and his writing has been featured in publications such as EuroNews, Yahoo Finance, and Bitcoin.com, among others. He is also a member of the scientific committee for San Marino where he acts as its token economic expert, advising the government on how to understand, structure and regulate crypto assets. Most recently, Jose made it into Forbes 30 Under 30 for Finance.

Jose will lead Delphi's expansion into Europe alongside Piers Kicks.



Key Takeaways (Short-Term)

- The swift rebound in asset prices (most notably risk assets) since March 23rd low was initially driven by 1) the increased likelihood of a technical retracement (as has been the case in prior market crashes of comparable size) and 2) **the size and speed of global policy responses, both monetary & fiscal.** Similarly, the latest leg higher in equities was initially driven by price breakouts (~May 18th) and heightened retail trading volume; *the amount of "smart money" still largely on sidelines is important to monitor as it may serve as a positive catalyst for risk assets if fundamental expectations improve.*

- Renewed risk appetite (amid waning coronavirus fears) gave a bid to ex-US equity markets (i.e. EM, Europe), which have outperformed US large-cap peers since mid-May. This risk-on move coincided with a US dollar sell-off; many of the worst performing major currencies through mid-March's USD peak (NOK, AUD, MXN, RUB, ZAR) are among the best performing currencies since.

- We're reaching another key inflection point as policymakers weigh the cost-benefit of additional stimulus measures. Any reduction in fiscal support will be met with heavy resistance, especially from struggling SMEs and millions of unemployed; another $1T+ relief package is probable, though **demand for US government debt will be key to monitor as increased Treasury issuance ramps up.**

- The fight against deflation will likely pressure policymakers into increased (or at least continuous) "stimulus" as monetary growth and debt monetization become de facto strategies; **sovereign credit risks in both advanced & emerging economies have risen considerably alongside the probability of fiat currency debasement**.

- Fiscal policy will likely take the driver's seat amid increased corporate defaults & bankruptcies. Such policies will need to get money in the hands of those who will spend it (i.e. ordinary households) if we're to see growth & inflation pressure build as their **marginal propensity to consume (MPC) is much higher than wealthy counterparts.**

- In the short run, non-sovereign scarce assets (i.e. BTC & Gold) could be challenged by increased deflationary pressures. However, such conditions would undoubtedly force policymakers to provide even greater monetary relief, compounding our conviction in bitcoin's long-term value proposition as a hedge against fiat currency debasement.

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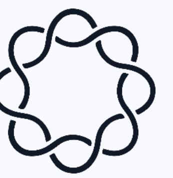

Key Takeaways (Long-Term)

- Even if we did see a miraculous “V-shaped” economic recovery, global growth was far from “booming” before COVID-19 brought the world to a grinding halt; a return to pre-COVID norms would still leave us with **burdensome debt loads, crippling inequality, and below-average growth prospects.**

- Temporary delays on debt servicing costs and government-sponsored loan programs only kick the can down the road; **we cannot solve stifling debt burdens with more debt.** Slower economic recovery will cause many businesses and corporates to default on their obligations, potentially creating a vicious feedback loop; spillover effects could weigh on asset prices as market participants flock to investable “safe havens”.

- Policymakers will be forced to use unconventional policy tools like **yield curve control,** which essentially serves as a blank check for further QE as officials shift from fixed to variable $ amount based on yield targets on specific maturities. Record high debt levels relative to economic activity (debt-to-GDP) will tip the scales toward **broad-based currency debasement** as governments attempt to shore up their economies and **reduce the real value of mounting liabilities.**

- Acute investors realizing the downside risk to sovereign debt is far greater than expected will likely lead to **significant demand for non-sovereign alternatives which stand to benefit from fiat currency debasement (i.e. BTC & Gold).** Certain asset classes and sectors are also poised to rise under such conditions – notably stocks, real estate, & precious metals – as the demand for elements of quasi-scarcity increases.

- In our opinion, the **investable asset** with the **highest potential upside over the next decade** given such conditions is bitcoin. The starting valuation of BTC (& crypto assets broadly) is a major contributing factor to its asymmetric return profile; there’s a consequential difference between the **asset class** and the **investable asset** that appreciates most.

- The trend away from today’s Dollar Standard is likely to accelerate; like many other post-COVID developments, hindsight will likely prove the virus outbreak **served as the accelerant** - not the root cause - of such structural & secular changes.

- **Expectations** for inflation may very well turn higher long before it shows up in the data and **changing expectations drive markets.**

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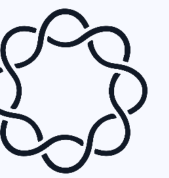

Something's Gotta Give...

It's been more than three months since the world was thrust into pandemonium over the coronavirus outbreak and, as we approach the end of Q2, it's almost eerie how divided the first six months of the year have been. Investors headed into 2020 on the back of one of the best years for financial markets in the last decade. Stocks were breaking to new highs, corporate credit was in vogue; even Treasuries and sovereign bonds were throwing off double digital annualized returns. In December, we deemed 2019 the year of the "Everything Rally", though questions around its sustainability were starting to percolate.

There's no denying the economic fallout from COVID-19 has been crippling; three months of mandated social distancing and sheltering-in-place will do that to any economy. However, if you told 100 armchair economists we'd be staring down the barrel of the worst unemployment crisis since the Great Depression, none of them would have pinned the S&P 500 within 2% of its pre-COVID all-time high. Now, to be fair, the US large-cap benchmark has become an increasingly vague proxy for the equity market at large, but nonetheless, the message seems clear: **something has got to give.**

Markets are discounting mechanisms; by and large, today's asset prices reflect future expectations for growth, profitability, etc. But, hypothetically, even if we do see a miraculous rebound in economic activity, let's not forget **global growth was far from "booming" before COVID-19 brought the world to a grinding halt.** Such a recovery to pre-COVID norms would still leave us with **burdensome debt loads, crippling inequality, and below-average growth prospects.** The structural changes required to tackle these systemic issues head-on will take years and cannot be fixed by simply throwing more money (and more debt) at the problem. Investment in infrastructure, education, and emerging technologies is a start, but our efforts must be directed at fighting the long-term trend of widening economic inequality (of which we believe decentralized networks and digital assets will become a larger part of the conversation). The most important question now is not *how did we get here* but rather ***where are we headed next?***

Quick note: *a bulk of this report was written in the weeks following the initial outbreak as the world began to grapple with its new reality. Admittingly, we did not expect the strength of the relief rally to be this extensive; our view for several weeks now has been the downside risks to asset prices greatly outweighs their upside potential. Then again, we didn't expect policymakers to greenlight over $10 trillion in monetary and fiscal support in a matter of weeks, but we digress.* ***This report is a culmination of prior work, ongoing analysis, and great speculation. We've designed it to be a tool for both the initiated and casual onlooker, trying to make sense of a world grown increasingly complex and uncertain.***

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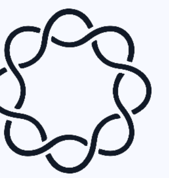


Priced for Perfection

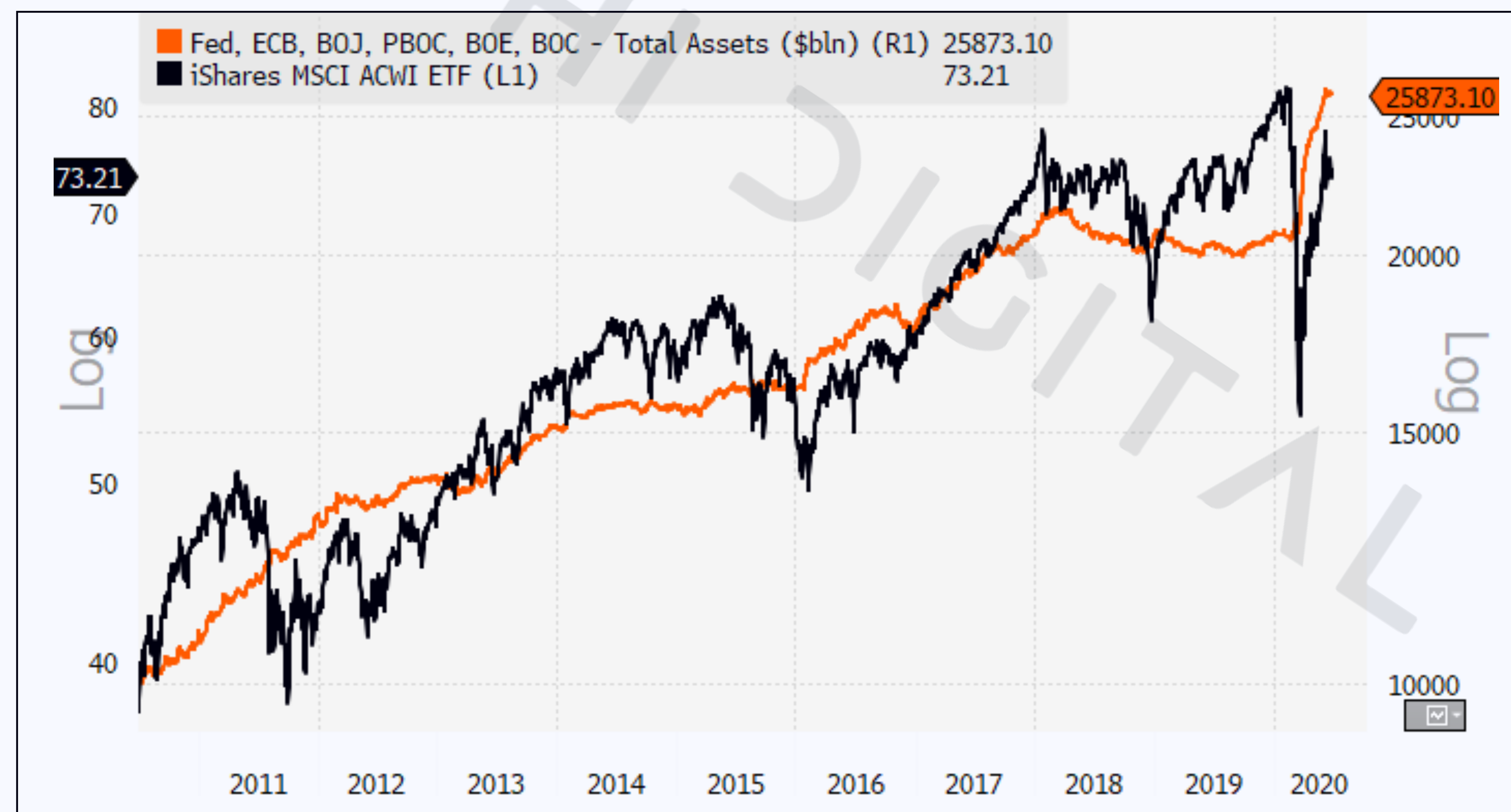
In the long run, we foresee fiat currency debasement as all but inevitable. However, timing such structural changes can be incredibly difficult; after all, attempting to perfectly time markets has destroyed more careers than it's made. It's no secret the rebound in asset prices, most notably risk assets, has been swift and extensive. However, at this juncture, it appears markets are somewhat priced for perfection; the sustainability of the latest uptrend is becoming increasingly dependent on a "V-shaped" recovery while the near-term prospect of "pre-COVID growth" seems to be more elusive by the day.

The size and speed of the market's recovery has been matched only by the magnitude of the policy response, but we're far from out of the woods. While some of the support programs only recently launched, others are getting close to their expiry. **We are likely on the cusp of another inflection point as policymakers decide whether to scale back relief efforts in the face of improving (but still dire) economic data.** Many of these public programs aim to curb the economic fallout from mass layoffs and lost income, so their continuation remains critical to a sustained recovery.

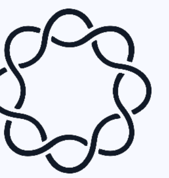
Financial headlines also rarely give a complete picture; underneath the surface there's a litany of problems we still face. Small-and-medium-sized enterprises (SMEs) are going bankrupt at a record pace. Sales and cash flow have dried up for many businesses dependent on foot traffic and "social closeness" like retail and restaurants.

In the case of the latter, much (if not all) of that foregone revenue is simply gone; there isn't pent-up demand to make up for lost nights out.

Major Central Bank Total Assets ($bln) vs. All-Country World Index



Source: Bloomberg, MSCI, BlackRock



"Haves" vs. "Have Nots"

Meanwhile, corporate giants have managed to take advantage of the public debt markets; **US investment-grade corporate debt issuance recently breached $1.2 trillion in 1H 2020, surpassing last year's total in less than six months** as companies take advantage of the Fed backstop. Renewed risk appetite has also opened the door for riskier borrowers with US companies in the high-yield market raising funds at the **fastest monthly pace on record in June.** The disparity between the **"haves" and "have nots"** will cause **further consolidation across a whole host of industries** (tech, airlines, big retail, etc.) as large players scoop up smaller, struggling peers. The sustainability of renewed demand for risk assets is questionable at best if and when policymakers step away from the table, taking large swaths of stimulus with them. If anything, large-scale debt monetization and the expansion of eligible asset purchases (e.g. high yield corporate debt) has **encouraged moral hazard among both borrowers and investors who have grown to count on policymakers as a backstop for asset prices.**

US Investment-Grade (Left) & High-Yield (Right) Debt Issuance ($bln)

$1,500 $1,400 $1,300 $1,200 $1,100 $1,000 $900 $800 $700 $600 $500
$1,141 $888 $860 $1,084 $1,134 $1,198 $1,312 $1,335 $1,411 $1,240 $1,219 $1,257
2009 2010 2011 2012 2013 2014 2015 2016 2017 2018 2019 2020

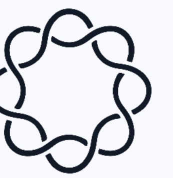
$60 $50 $40 $30 $20 $10 $0
$28 $14 $36 $25 $36 $21 $47 $31 $4 $29 $40 $57
Jul-19 Aug-19 Sep-19 Oct-19 Nov-19 Dec-19 Jan-20 Feb-20 Mar-20 Apr-20 May-20 Jun-20

Source: Bloomberg

The Great Accelerant:

COVID-19

The Eye of The Storm



It isn't far-fetched to say we're facing one of the biggest economic threats of our generation. The economic damage of COVID-19 and accompanying global policy responses intensified the challenges facing overly indebted nation-states and accelerated the timeline for such tail risks. **Excessive corporate borrowing, complex global supply chains, and US dollar hegemony** are just a few of the critical vulnerabilities the coronavirus outbreak exposed, the totality of which have yet to be seen.

We argue the economic consequences of worldwide lockdowns and mandated social distancing have and will exacerbate issues for debt-based economies. In addition, although we've seen a considerable pullback in the dollar recently, the contraction in global trade coupled with greater monetary growth abroad is likely to keep a bid under USD. Given the dollar's importance, **there are few threats to The System more prevalent than a stronger buck;** it threatens to wreak havoc on indebted developing countries and crush a recovery in global growth at a time when most major economies have plunged head first into recession.

In the short-term, deflationary pressures like falling demand, collapsed commodity prices (e.g. oil), and a contraction in global trade are likely to outweigh any inflationary counterparts. This effectively causes a dollar "short squeeze", lowering the supply of dollars (especially USD exports to EMEA who are dependent on the American consumer) at the same time general flight-to-safety sentiment increases demand for USD to meet margin calls and debt obligations (we got a taste of this in March). Demand for dollars (and dollar liquidity) is setting up the greenback for one last act where economic deterioration abroad propels the global reserve currency higher relative to its fiat peers, adding to the aforementioned headwinds.

Decreased spending, increased debt defaults and elevated unemployment are all consequences of a strong USD. We believe this will have dramatic consequences for both advanced and developing economies, **increasingly driving the conversation around finding an alternative reserve currency (or basket of currencies) to serve an increasingly interconnected economic system.**

In the long-term, we believe the size of the fiscal relief packages required combined with the increasing burden posed by off balance sheet liabilities (mainly pension obligations, Medicare, Social Security) will see the cycle reverse, resulting in broad-based currency debasement. Akin to a wrecking ball, the same forces that drove it to deflation will reverse towards inflation; a strong dollar weakens the US economy just as debts from coronavirus and off-balance sheet liabilities soar, **forcing the US to monetize its debt, raising risk premia on its bonds and initiating the inflationary cycle.**

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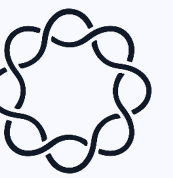

The “New Normal”

Pockets of optimism have crept back into markets as news trickles in of states and countries taking steps to reopen their largely idle economies. We all know the longer the world stays locked up, the deeper the economic pain will be. But simply lifting the lockdowns doesn’t mean the global economy will come snapping back. The beauty of the digital age is **seamless access to real-time information** like the current number of deaths or the growth trajectory of confirmed cases in any given country. Citizens are turning more and more to credible sources they can trust rather than relying on political leaders who downplay or even misinform the public of the severity of this health crisis. Put simply, **if businesses reopen** per government guidance, **there’s no guarantee their customers will follow suit.**

The economic recovery in the aftermath of COVID-19 is likely going to be slower and longer than many initially anticipated, which could very well add to deflationary pressures in the intermediate term (more on this to come). Additionally, resurrecting domestic business does not change the protectionist attitudes adopted by many countries fearing foreign contagion. While this rhetoric has subsided in recent weeks, it does not guarantee key trading partners won’t roll back such restrictions if another wave of the virus outbreak takes hold (as we’re already beginning to see). As such, these “early mover” countries could be left with pre-COVID inventory levels without the accompanying consumer bases.

Critical issues within global supply chains exposed by the global lockdown likely only serve to accelerate the de-globalization trend as domestic production of vital resources and equipment ramps up; greater emphasis on domestic versus foreign production will also drive up the odds of major currency wars as political leaders shy away from local currency strength in favor of globally competitive industries.

If the situation doesn’t wind up being as dire as some predict, the immense backstop policymakers created for financial markets (including riskier assets like high yield corporate bonds) has worsened the moral hazard around increased debt loads and the debt burden shift from the private sector to the public sector is well underway. **Again, the coronavirus outbreak (and subsequent responses to it) serves as the accelerant - not the root cause - of what likely comes next.**

In the words of the great Bob Dylan, “the times they are a-changin’”. We will survive this, there’s no doubt about that. But the world will not be exactly as we left it, nor will the public’s perception of money and the role of the nation-state.

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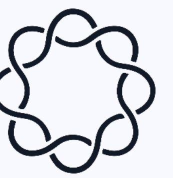
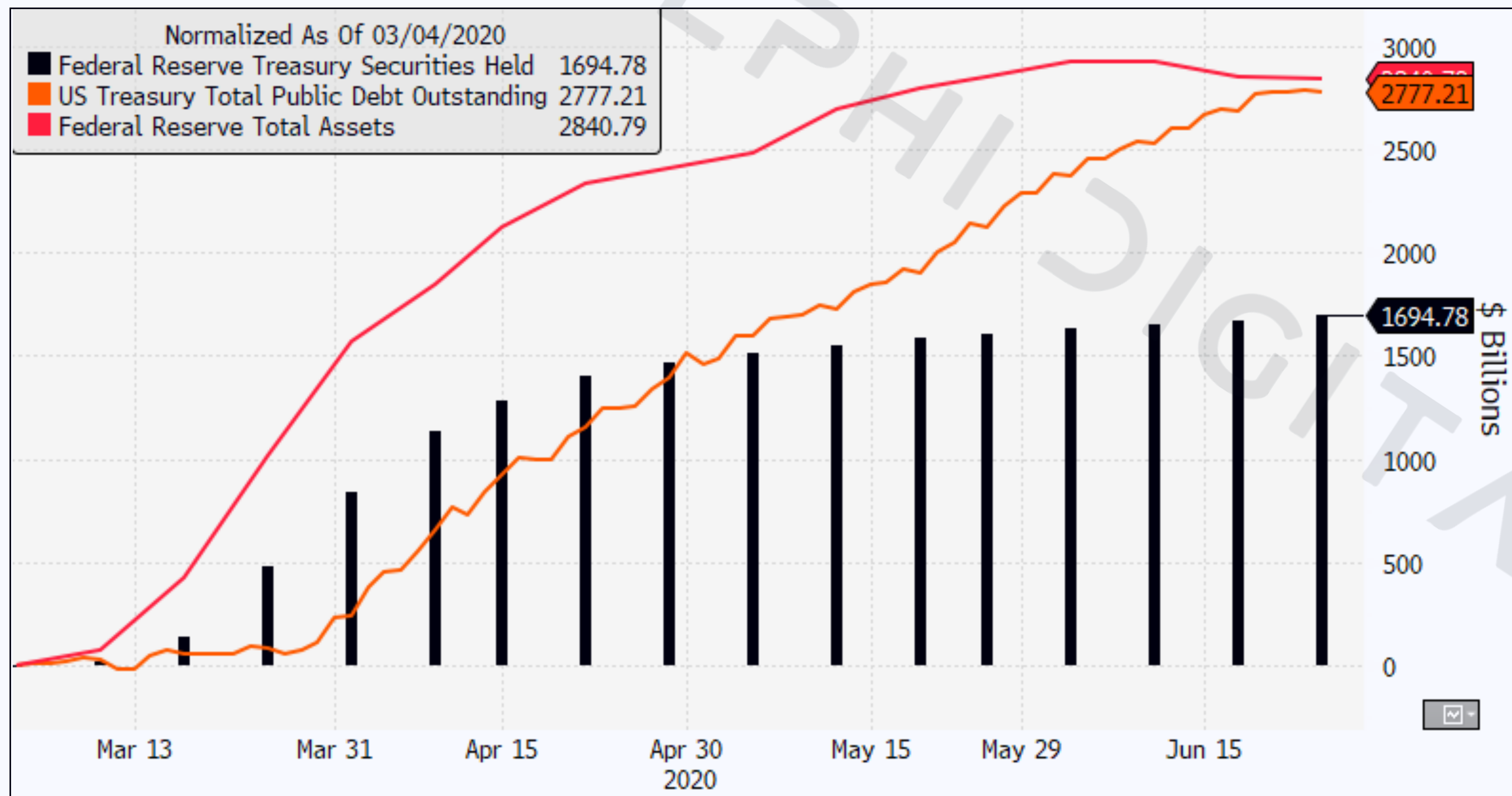
It's All About the Benjamins



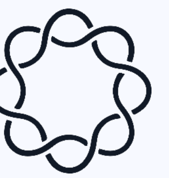
It's critical to understand the time horizon over which this is all expected to play out. The bigger picture issues stem from the nature of the fiscal response to COVID. Relief funding to date is attempting to **plug a gaping hole in the global economy;** it's not being deployed for real productive investment. As a result, debt-to-GDP is on pace to explode to record heights as economic activity attempts to recover. The problem is we've passed the point of "responsible" debt levels; **each incremental dollar of new debt has become less productive,** and that was before a global pandemic showed up. The United States continues to run sizable federal deficits, though this is unlikely to be detrimental to the dollar in the immediate term, especially if demand for "safer" assets remains elevated. However, over the long run, **the increase in additional Treasury supply will likely put substantial pressure on the greenback, especially if aspiring global superpowers back up their latest anti-dollar rhetoric in favor of an alternative reserve currency,** thus thwarting the demand for dollars.

US Treasury Public Debt Outstanding vs. Fed Treasury Holdings & Total Assets (Normalized)



Source: Bloomberg, US Treasury Department, Federal Reserve

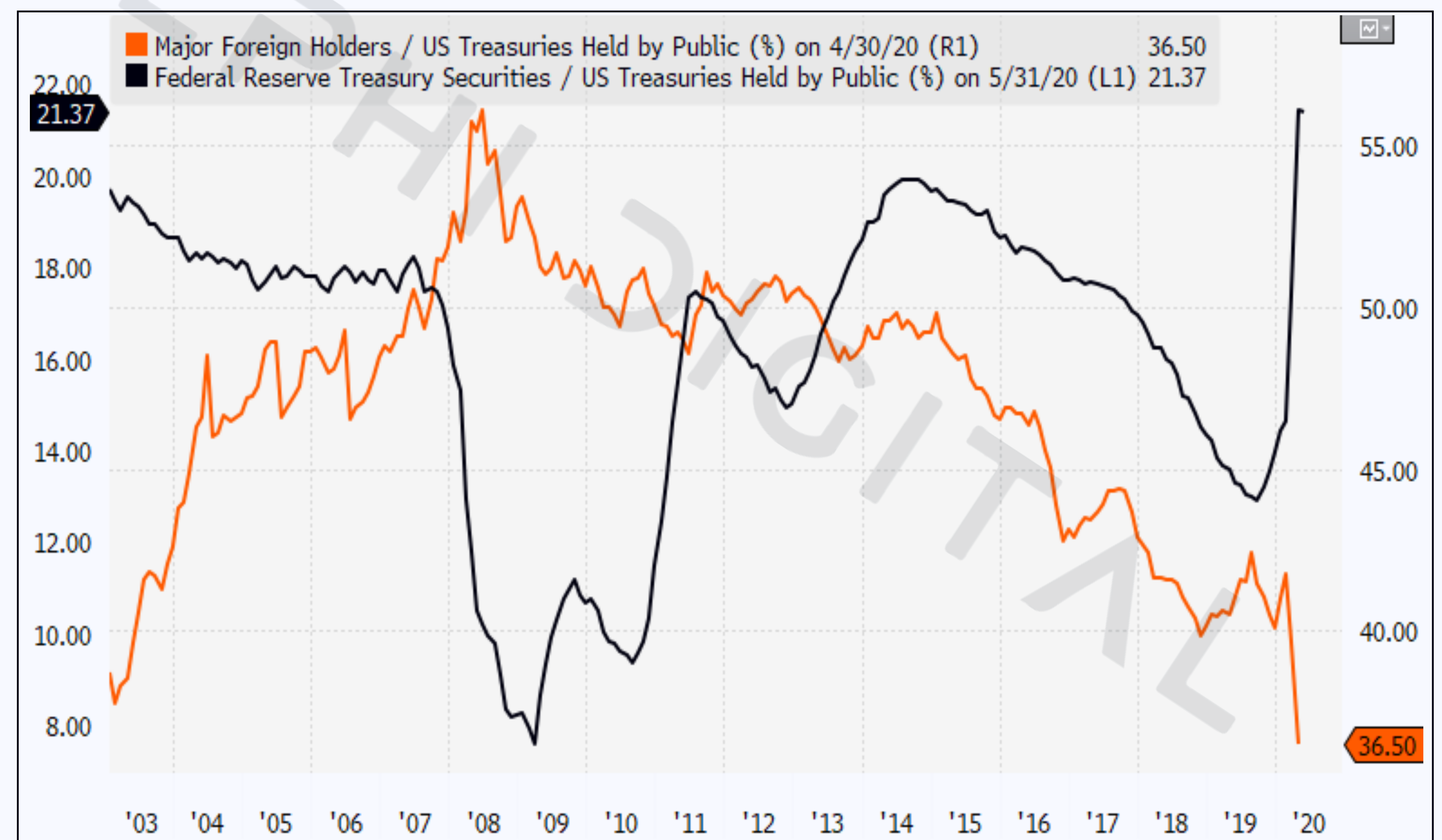
The Confidence Game



In our view, **foreign demand** for dollar-based assets, most notably Treasuries, is **likely to weaken** as coordinated efforts between US monetary and fiscal policymakers curtail confidence in the government's ability to service its mounting debt obligations. This trend is already underway with demand for Treasuries among foreign central banks starting to wane in recent years, **putting the onus on domestic institutions and private investors to make up the shortfall.** So far, this trend is largely attributable to a handful of nation states, notably countries like China and Russia, but the seeds are sown for broader disdain towards financing an evergrowing US national debt load. Policymakers recognize the potential risk of foreign institutions selling Treasuries in size, which is a key reason the Fed wasted little time expanding its repo facilities to several major foreign central banks to allow for Treasury holdings to be posted as collateral for dollar funding. Yet such efforts only belabor the point that the dollar is too integral to the global financial system; ironically, **it is its dominance and strength that will lead to its untimely downfall.**

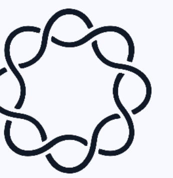
The US consumer, hamstrung by deflationary pressures and impaired balance sheets, will unlikely be unable to make up the difference, **forcing the Fed to have to print and monetize excess debt issuance.** Consequently, the Fed has made it crystal clear it is willing to do whatever it takes to keep financial markets and credit conditions intact despite the long-term consequences of its actions. Eventually, we expect holders of said Treasuries to begin discounting inflation and questioning whether negative real rates adequately compensate them for currency risk. They will thus demand increasingly large risk premiums, raising interest rates and consequently debt burdens, further weakening the economy and necessitating more monetary growth.

Major Foreign Holders vs. Federal Reserve US Treasury Holdings (% Total)



Source: Bloomberg, Federal Reserve

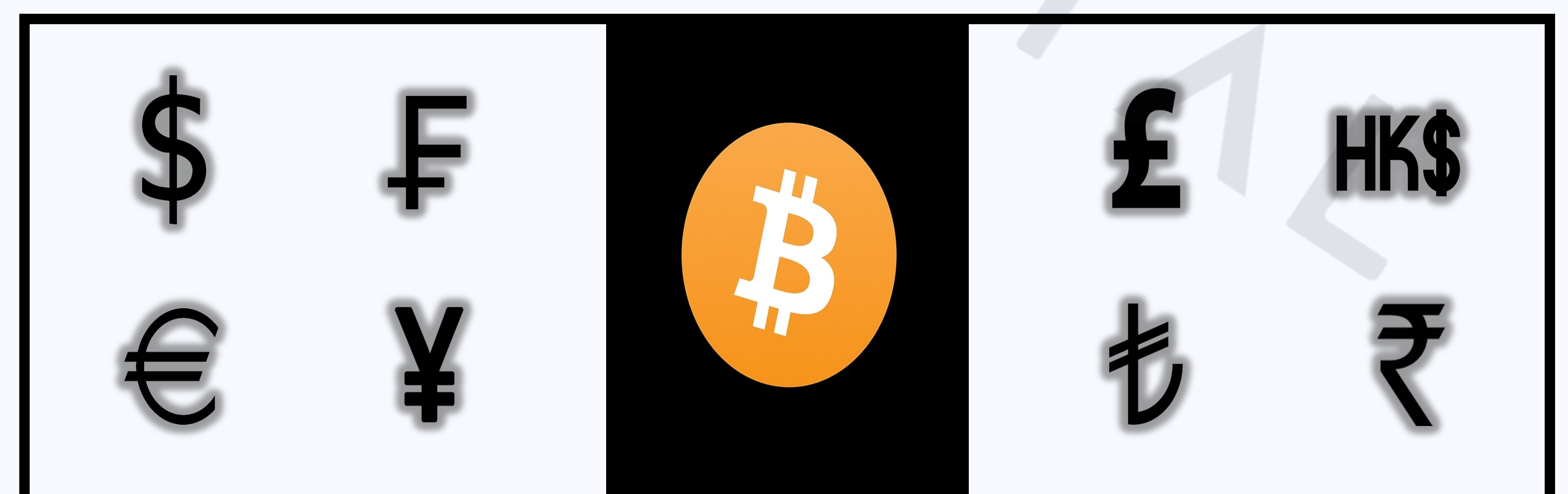
The Backdrop for Bitcoin



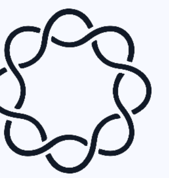
But policymakers aren't finished yet; they still have "plenty of ammo" left to combat the long road to recovery, which in the short run isn't a huge concern. However, there are **psychological limits to deficits and mounting debt obligations,** which eventually will drive away foreign and domestic investors and will put more onus on the Fed to soak up any excess Treasury issuance in order to keep rates low. This can turn into a vicious feedback loop as the US is forced to issue more Treasury bonds to service this massive debt load. **Enter broad-based fiat currency debasement, stage left.** Lower economic growth prospects coupled with massive deficits reduce the likelihood we can simply grow our way out of this. Without a pragmatic plan to reign in and reduce these debt burdens, the **US faces a material headwind in currency debasement risk.** Now, to be clear, the US dollar (and dollar-based instruments like Treasuries) is still the safest house in a bad neighborhood; in fact, we expect it to strengthen even further from here. Ironically though, **it is the dollar's strength, not its weakness, that will accelerate the world's move away from today's Dollar Standard.**

Which finally brings us to Bitcoin. Sure, one could argue bitcoin isn't backed by anything, but to say it has no value implies an incomplete understanding of how BTC is perceived and valued. In our view, bitcoin's long-term value proposition is supported by growing demand for a non-sovereign, censorship resistant, digitally native asset with a predetermined, hard-capped supply. Therefore, we could argue **its current value is backed by the demand for an apolitical speculative asset that may or may not turn out to be one of the world's most valuable safe havens.** While the immediate future remains murky, we argue the long-term outlook for uncorrelated, non-sovereign assets like bitcoin and gold grows stronger by the day. We expect demand for such assets to increase as these risks become more apparent and believe gold and bitcoin's market share of the global safe haven pie will increase; **unlike sovereign bonds, neither is tethered to fiat nor do they bear similar credit risk.**

Both gold and bitcoin are well positioned for such conditions; the former holds an impressive multi-millenia track record though we argue bitcoin boasts several key advantages over gold, which will become ever more evident in a world characterized by **rising geopolitical tensions, deteriorating trust in institutions, de-globalization and demographic trends driving adoption for digital assets.**



The Bitcoin Advantage

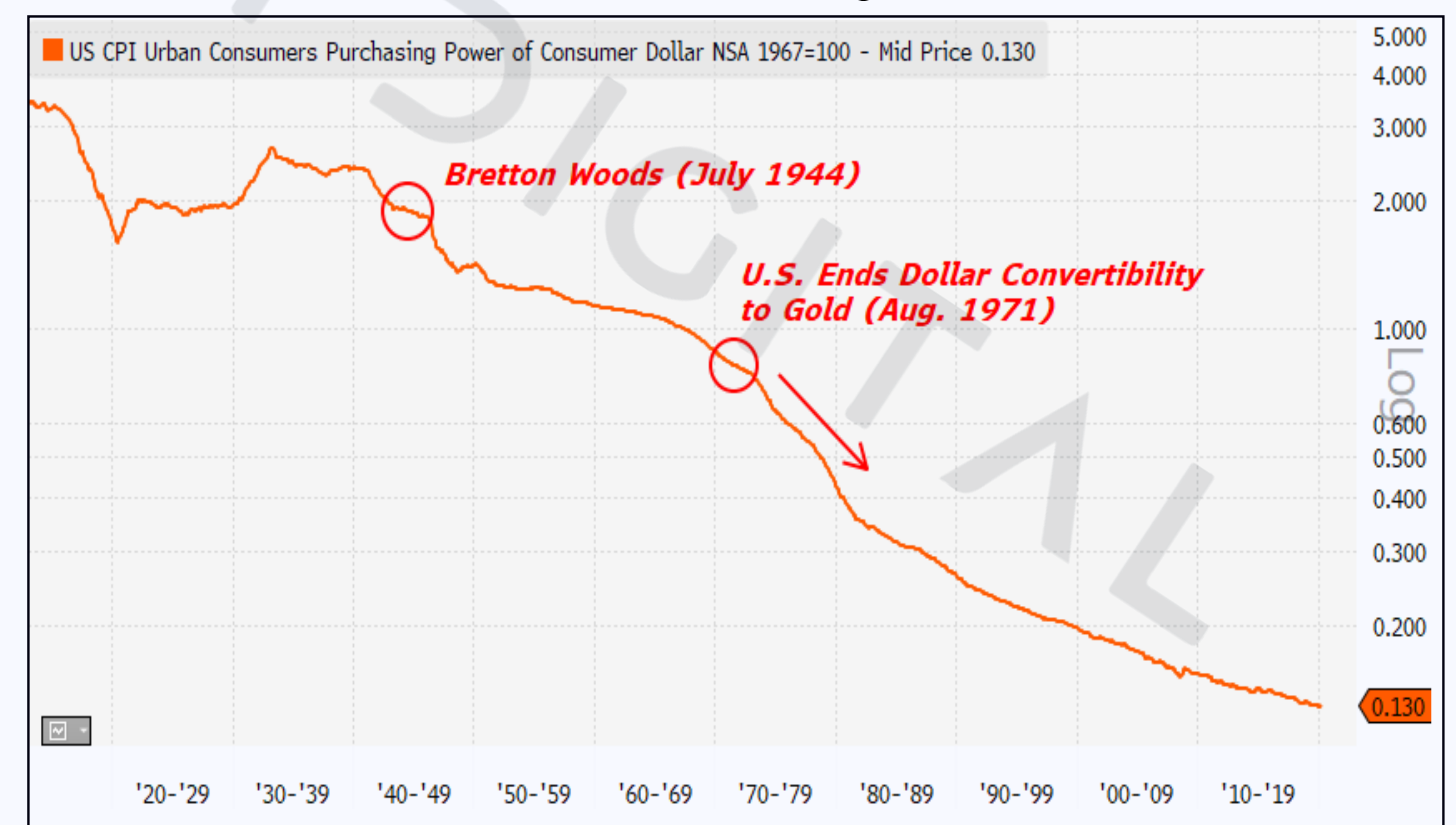


We believe bitcoin is an extremely attractive alternative to consider in the context of a multi-asset portfolio aiming to maximize risk-adjusted returns. Ironically, some of bitcoin's most attractive characteristics happen to be those in which it receives the most criticism for. For example, it's common knowledge that bitcoin's volatility is notably higher than most asset classes (though recently that notion has been challenged by violent price swings in a few markets i.e. crude oil). However, **inherent in BTC's asymmetric return profile is the expectation for greater price fluctuations** compared to other assets as **volatility works in both directions;** higher upside volatility requires exposure to its downside twin.

While all other currencies rely on trust in a sovereign, which can issue it at will, Bitcoin is entirely non-sovereign, with trust in the nation state backing the currency being replaced by trust in the underlying code and consensus. As nations are increasingly incentivized to weaken their currencies, socializing the losses in order to relieve unmanageable debt burdens, Bitcoin will enable citizens to opt out of the status quo by voting with their money. Bitcoin, at its most primitive level, represents the ultimate check on monetary and fiscal authorities by providing a **non-sovereign, censorship resistant, digitally scarce alternative** to today's monetary system. **In a world of fiat abundance, digital scarcity reigns king.**

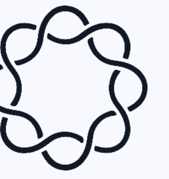
The US – like many countries – will find itself awash in mounting obligations, including enormous off-balance sheet liabilities that aren't even accounted for in standard debt-to-GDP calculations, implying higher taxation in the future. Increased capital mobility, however, could make tax rate hikes more difficult this time around compared to prior periods like the 1930s. If the wealthy catch wind of higher taxation - especially those in the top percentiles - their immediate reaction will likely be to try and get as much wealth out of the government's purview as legally possible. Most of this money could wind up in offshore accounts or real assets (e.g. gold, real estate), but a portion of it very well may find its way into bitcoin given its non-sovereign, censorship resistant nature.

US Dollar Purchasing Power



Source: Bloomberg, Federal Reserve

Disclosures



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