The Case for Digital Assets

September 2021
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Human imagination is the most powerful force in the universe. It is the greatest single thing separating us from other creatures. There is no higher power. Our ability to conceive of a tomorrow that is better than today is a precondition for discovery, invention. And these two things quite naturally stack, compound. Their summation has lifted us from the Stone Age to the space station. The journey has only just begun. This should be obvious to everyone but the most hopeless pessimist.

Economically speaking, our ascent is defined by rising productivity, the spoils of which determine prosperity. In modern times, we have imagined various ways to distribute this wealth: socialism, communism, free-market capitalism. I can imagine other approaches - the Chinese are exploring one. But even within existing constructs, there are nuances. Today, capital owners collect a disproportionate share of profits relative to laborers. There is no intrinsic reason that this degree of inequality cannot persist. But in modern history it never has. And the societal stresses such inequality have produced are quite obviously manifesting, intensifying, metastasizing.

The private sector overwhelmingly sees itself as a more capable steward of research and development capital than governments. However, an examination of innovations traceable to state-funded initiatives during the past century suggests otherwise. I suspect the failure of Soviet communism led western freemarket capitalists to imagine every element of our system to be superior. I imagine someday we will regard that black and white conclusion as foolish. China’s unprecedented economic rise and breathtaking technological advances should prompt Western self-reflection. So far it has not. I can imagine this being forced upon us. Perhaps abruptly.

In fact, I can imagine many things. I can imagine almost everything, except of course, things that never cross my mind. Those are unknown unknowns, Black Swans. In my lifetime, not a single such creature has reversed human progress, let alone markets. Not for long anyway. Lehman was not a Black Swan. I worked there for seven years, and we spent most of them imagining the firm abruptly failing. Today’s pandemic is not a Black Swan either, it was a near certainty, arrival date unknown. Black Swans are generally magnificent, indistinguishable from magic - the internet, smartphones, cloud computing, quantum entanglement. The big risks are skewed to the upside, and manifest frequently. That is why we no longer live in caves. Yet periodically, our imaginations run wild with visions of cataclysms. I imagine that will never change.

This leads me to investing. Which is principally about the identification of macro mega-trends. The two dominant trends of recent decades are now obvious: breathtaking technological advance and deepening global trade. The latter was not possible in the absence of the former. And the combined impact has left the world forever changed, connecting nearly eight billion people to one another in ways previously unimaginable, allowing the instantaneous exchange of information, ideas, and new forms of collaboration. But not only that, the advance gave each curious mind access to the collective discoveries and knowledge gained since the dawn of time.

Naturally there have been other trends. Population growth has been slowing, inexorably. In developed economies, societies started to age. First Japan, then Europe. China too. And these trends have interacted in complex ways to produce a disinflationary environment that naturally favored capital owners over laborers. Governments mostly ignored this growing imbalance and its corrosive social consequences. In fact, they implemented policies that amplified the problems, reversing each economic interruption with lower interest rates, greater debt, increased leverage, and this inflated asset prices, widening inequality.

The process was reflexive in that each crisis required a more aggressive dose of the monetary stimulus that had itself contributed to the economic fragility in the first place. Such stimulus works by pulling demand from the future to the present and it therefore required no imagination to foresee that the process would ultimately deplete the former to sustain the latter. This end point was reached during the economic depression of early 2020. In response, western governments embarked on a new form of policy stimulus, issuing unprecedented quantities of bonds and then buying that debt with money created by their central banks.

For students of economic history, such a familiar policy mix is implemented when governments intend to debase the currency in which they are borrowing. This allows them to simultaneously unburden themselves from the debt that they are incurring. It is a very rational late-cycle response to a difficult predicament. Throughout history, it has been attempted countless times. And I can imagine it going more smoothly this time, at least for a period. But as an investor who makes decisions on a probability adjusted basis, it is most certainly not the way to position a portfolio. Especially not with what is discounted in traditional asset prices.

And this leads me to the case for digital assets.

Money is an illusion, perhaps the world's greatest mass delusion. Out of desire and necessity, we succumb to the hypnosis. Without money, we are lost. And while we cling to its supposed permanence, a quick survey of history tells us money is anything but. Indeed, our central bankers have stated their intent to diminish its value via 2% inflation each year, in perpetuity. Between the global financial crisis and last year's economic collapse, which is to say over twelve short years, they failed to achieve their stated goal of debasing the dollar at the desired pace. It was not through a lack of trying that they failed, but rather a misunderstanding of what money truly is.

Money is not real. It never has been. It never will be. It is our collective faith in the meaning of money that gives it value. Not even gold is real as a form of money. But for thousands of years, people have had collective faith in the useless yellow metal as a store of value, and at times, a medium of exchange. Naturally, something else equally useless could have served the purpose. But gold is scarce and for reasons we may never fully understand, we placed our collective faith in it. Even still, we unearth more each year. The pace of its extraction rises through time, increasing supply and thus debasing its value by 1%-2% per year, in perpetuity. As extraction technologies advance, that pace can quicken. We produced 2,470 metric tons of gold in 2005 and 3,300 metric tons in 2019. Within decades, we will surely extract gold from asteroids.

Bitcoin mysteriously appeared in 2009. A Black Swan. The technologies that in aggregate were combined to form the Bitcoin blockchain were not especially new or spectacular. But like all Black Swans, together they formed something revolutionary, the future. Some saw Bitcoin early and devoted their careers to it. Others punted around and profited. Some bought and held, becoming millionaires, billionaires. I saw it as so obviously the future of money that governments were unlikely to let it exist for long, lest they surrender their power of seigniorage. Instead, they would coopt whichever digital form of money became dominant and then destroy the private system that had developed it.

There is no such thing as certainty, so there was always a possibility that Bitcoin and the digital assets that followed would be allowed to coexist in a world of digital dollars. Initially, that path appeared narrow. As the years passed, it has widened. The broadening adoption of Bitcoin and Ethereum, along with the innovative companies that are rapidly developing the blockchain ecosystem make it more difficult for governments to simply destroy these private systems. It is becoming easier to imagine a world where they are permitted to flourish alongside digital dollars, revolutionizing finance in ways that lay beyond the horizon. It is in our national interest to allow this. To embrace it, encourage it. And lead the world by example.

Nothing is without risk. And the risk to these assets is not simply that governments destroy them. It is possible that unknown flaws in their structure result in a failure that shakes faith in their value. Or that a massive theft raises sufficient alarm that investors abandon the asset class. Or it may even be that the ease with which new digital assets can be created will mean that we will fail to collectively concentrate faith in any single one, leaving many, each of little of value. I can imagine all these risks manifesting, although in every case, the risk is receding due to one of the most interesting features of digital assets. Reflexivity.

Most people still view digital assets as worthless. They are not wrong. In the aggregate, digital assets can be created just as easily as the Federal Reserve credits banks with digital dollars, which is to say that they can be created at no cost and in unlimited amounts. But imagine if one or two digital assets were to be selected as the object of our collective faith, just as gold and silver were once picked from the periodic table. And now imagine that unlike gold and silver, these digital assets are of finite supply and are the only such objects of that sort in a world of infinite fiat. It is not hard to imagine that such assets will become very valuable.

Bitcoin has no reference value. This makes it profoundly unique. No matter how its price rises or falls, the pace of production follows a preset path, halving every four years until 2140 when the last of the 21 million Bitcoins will be mined - for all eternity. When the price of gold rises abruptly, production increases. The same holds true for oil, copper, condos, equities, bonds, everything in an infinite universe. If the Bitcoin price rises 10x or 100x, production will not increase. Period. And this creates one of the more fascinating inversions in today's inverted world: an asset that has finite supply, but no intrinsic value, could become priceless, if only we imagine it so.

I can imagine how faith first formed in the value of gold. Its unique color, density and malleability allowed people to hold it and trust in its authenticity. True faith must be tested, repeatedly, tirelessly, mercilessly, and survive the assault every time. The great stories of antiquity, across all cultures, explore faith for a reason. It appears to be central to who we are. Elemental. Without it we are lost. Blockchain technology has introduced a way for humans to build faith in a new system that until recently was unimaginable. It is otherworldly, residing in the cloud, and becomes stronger, increasingly resilient, the more of us interact with it. As it becomes these things, it grows more valuable. And this then draws more people to it, reflexively.

As people interact with such a novel system, it is natural that weaknesses are exposed. Their faith is shaken, some turn away. But others contribute ingenuity, investing in improvements; the means of storage become more secure, the code more robust, untrustworthy participants are removed, good money chases bad money out, use cases expand. As these forces interact in infinitely complex ways, our faith in the system rises, pushing digital asset prices beyond equilibrium. Sometimes wildly. This has happened to Bitcoin six times since it appeared. It has recovered from each boom/bust, growing stronger, more resilient. With every cycle, it has attracted more brilliant and ambitious entrepreneurs who see it as a technology platform that along with Ethereum will form the future of money, finance, and wonderful things we have yet to conceive.

As people poured their energy into this new system, its promise extended far beyond a simple alternative to digital dollars. This has drawn new investors, innovators, and with each addition, it becomes more difficult for the government to destroy the system. Rather, the incentive to allow this new technology to coexist alongside digital dollars grows. As investors observe these trends emerge, they become more willing to invest, and as they do, it becomes harder still for the government to tear it down. The process is also reflexive. And this creates yet another great inversion in today's inverted world: an asset that has no intrinsic value becomes increasingly safe to hold the more its price rises.

This leads me back to investing, which is about considering risks versus rewards, assessing the probabilities of many possible outcomes, and the myriad paths to get there. But good investing also involves thoughtful portfolio construction. The longer-term trends and policy choices that led to today's combination of highly valued risk assets and negatively yielding risk free assets, leaves today's dominant portfolio construction highly exposed to a singular risk. Inflation. And in yet another inversion, investor portfolios are most exposed to the precise outcome that governments are aggressively trying to produce.

Today's dominant portfolio consists of stocks and bonds. Bonds yield less than at any time in human history. Stocks are near the highest ever multiples. So, in a world where investors must achieve 7% annual returns to avoid insolvency, they leverage portfolios, amplifying gains, losses too. Unfortunately, at these yields, bond gains are unlikely to offset equity losses in a recession. During an inflationary period, bonds suffer, and history suggests this then causes equity losses. In a recession accompanied by inflation, portfolio losses are catastrophic. Most people cannot imagine that. But it is not as hard as you might think. An inflationary recession can happen when people lose faith in fiat.

Having spent over a decade failing to create inflation, governments recently embarked on a dramatic shift to overt monetary/fiscal coordination on an unprecedented scale. The pandemic provided the catalyst for politicians to temporarily support this new policy paradigm. But monetary/fiscal coordination on this scale is difficult to reverse. As discussed earlier, such coordination accompanies every monetary debasement. It would be unwise to bet this one will fail. Even if a new austerity sweeps our deeply divided government and causes another economic collapse, the call for more aggressive debasement will return immediately. In greater force.

Faith is not something that is lost in a smooth line. It is gained slowly, arduously and lost abruptly. And so, it may be that policies now in place will appear appropriate, even prudent, for some time still. I can imagine that, just as easily as I can imagine the opposite. But it is hard to imagine the long-term trend of ever more aggressive policy stimulus failing to achieve its inflationary objectives now that governments are unconstrained by the fear of monetary/fiscal policy coordination. And what is attractive about the addition of digital assets to a portfolio is that they help mitigate this debasement risk without requiring you to pay negative carry while waiting.

But digital assets not only help mitigate downside risks in a portfolio, they also provide exposure to the promise of humanity's latest Black Swan, a new technology that has only just begun to reshape money. And that is the final inversion in today's inverted world, because only in such a strange time can you make a highly convex, bullish bet on the promise of a brighter future that simultaneously protects you from suffering the severe consequences we face for our poorly managed past.

And with each passing day, a rising number of the world's smartest people contribute to the body of work that in aggregate enhances faith in these new digital systems. They do so without seeing one another, knowing one another's name, location, or needing a common tongue. What they share is a common faith. And they cooperate in ways that a few short years ago were simply not possible. They improve upon the code that surrounds these assets. They build the architecture and interfaces that integrate these systems with the incumbent financial players, while simultaneously creating new products, features. And on top of assets like Bitcoin and Ethereum, they build second layer applications that improve functionality, speed, efficiency, usability. This ensures that far into the future, digital asset innovations will continue to appear, making tomorrow look better than today.

We all try to imagine how far something can rise, and how far it can fall. The latter is easy. Every digital asset can theoretically fall to zero, though it is terribly hard to imagine that they all will. It is much easier to imagine that in a world where fiat can be created without limit, and where the practical uses for these digital assets continually increase, their values can rise many, many times. Surely the value of Bitcoin can surpass that of gold. Owning these assets is a mere toehold to the future, a deposit on the view that everything we know about financial intermediation and its relationship to centralized policy will change in ways we cannot yet foresee. Holding these assets over the long-term aligns yourself with the macro megatrends of technological advance and currency debasement, both of which appear to be accelerating. And naturally, where this all leads, and to what valuations, will be determined by our collective imagination.

Good luck out there,

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