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*June 2021*

# MONTHLY AGENDA DIGITAL ASSETS - MORE THAN JUST BITCOIN

## The world of crypto

Bitcoin, blockchain and the world of crypto assets have gone from the obscure and complex realms only discussed by in the know techies to now becoming a topic discussed by many corners of society. With the value of crypto assets in circulation now well in excess of $1.8 trillion this relatively young asset class is virtually impossible to ignore and has garnered the attention of multi-nationals, institutional investors and central bankers.

So what are crypto assets and should we invest in them?

## What are crypto assets?

Crypto assets can be seen as an all-encompassing term used to describe a family of digital assets that has come to life with the creation of the blockchain technology. Digital assets include things like utility tokens, security tokens, asset backed tokens and cryptocurrencies.

1. Utility tokens such as Ethereum allow users to build smart contracts on the Ethereum blockchain network This can allow for automated settlement of transactions with swift execution and improved efficiency and quality of outcome, disrupting the traditional financial settlements process as we currently know it.
2. Security tokens represent ownership or interest in an associated real-world asset. Instead of receiving a signed subscription agreement or certificate of ownership you receive a token embedded on the blockchain which represents your interest in the asset.
3. Asset backed tokens like Tether or USDC are backed by physical fiat currency and are pegged to the value of that fiat currency. Often referred to as stablecoins, the benefit of these tokens allows users to hold their assets in the digital world without having to convert back to actual fiat currency whilst also avoiding the high volatility associated with many cryptocurrencies.
4. Cryptocurrencies like Bitcoin were initially conceived as a peer-to-peer electronic currency but in fact have become more of a store of value and are often referred to as digital gold.

**Chart 1: A New Family of Digital Assets**

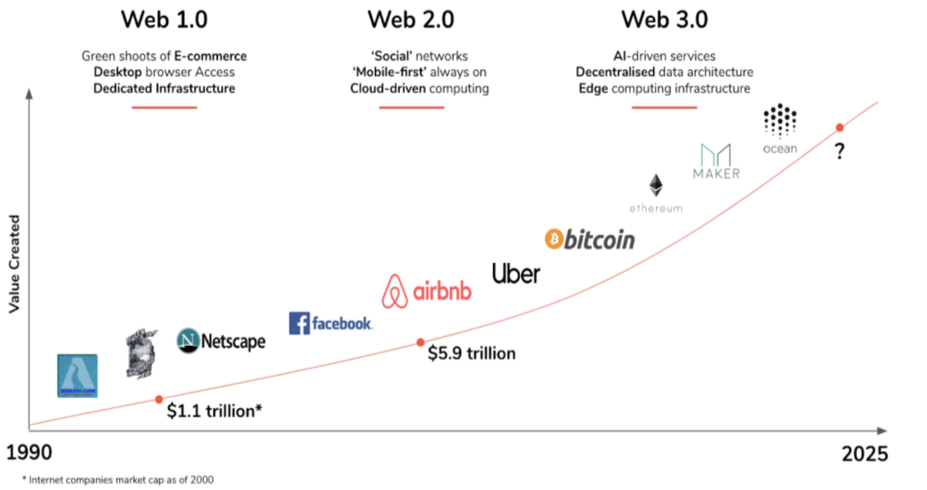
| Type | Examples | Use Cases |
|---|---|---|
| • Cryptocurrencies | • Bitcoin, Litecoin | • Aspirational Store of value (digital gold) |
| • Security Tokens | • Blockstack, T-Zero | • Alternative assets, new type of value |
| • Utility Tokens | • Ethereum, Filecoin, Compound | • Defi and decentralized applications |
| • Asset-Backed Tokens | • USDC, Diem, Tether | • Payments and trade settlement |
| • Digital Fiat Currency | • China DCEP, Boston Fed/MIT | • Cashless society, benefits distribution |

Source: Fidelity Digital Assets

What is blockchain?

The revolutionary aspects of the blockchain technology have earned it the lofty title of Web 3.0 as it has the ability to be truly transformative in how it changes the shape of the many industries.

**Chart 2: The evolution of the web**




Source: Fabric Ventures

Web 3.0 is seen as a leap forward from mobile, social and cloud to open, trustless and permissionless networks.

Distributed ledger

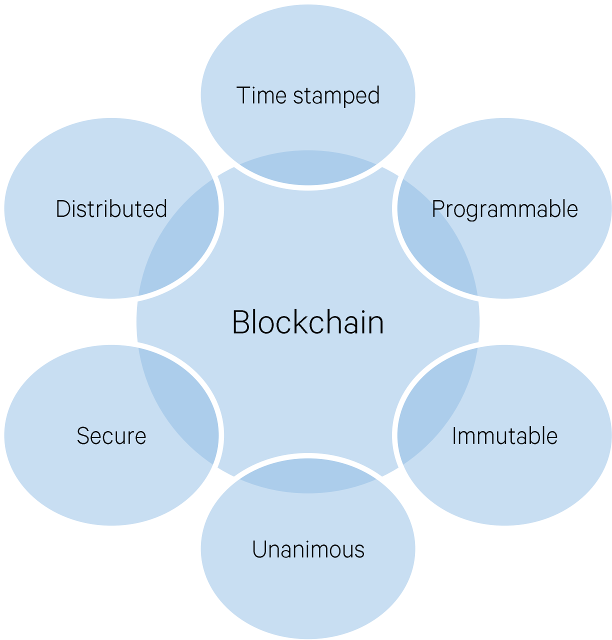
In its simplest form, blockchain is a type of distributed ledger technology that allows a transaction to be recorded without a centralised administrator, as is the case with the traditional financial system.

It has three core features that enable this. Firstly, the ledger is distributed, meaning that data is simultaneously stored and widely accessible by all network participants. Second, it is decentralised and is not controlled by any one central authority. Finally, it is immutable; once a transaction or node has been added to the blockchain it is virtually impossible to change or remove it.

Single source of truth

For these reasons the blockchain becomes the single source of truth as all information stored on the blockchain is tamperproof, resilient to attacks and accessible to all on the network.

**Chart 3: Benefits of the blockchain network**




Source: BNP Paribas AM

Blockchain for business

Described as a breakthrough and with a growing number of applications to validate its utility, blockchain is increasingly growing in user adoption. The benefits of this disruptive technology are numerous; we recently heard of a transaction where $1 billion was moved across the blockchain for a fee of roughly $25. This example highlights a couple of key benefits of blockchain - speed of settlement (on average less than one hour compared with the usual two-day settlement period in traditional banking) and cost of transacting (traditional banking charges tens of thousands of dollars for such transactions).

Driverless banking

Smart contracts will significantly enhance transaction efficiency by removing third party brokers and automating previously complex intermediated processes, in doing so reducing time and error. Some have described this essentially as driverless banking.

A consensus record

With distributed ledger technology, blockchain creates a consensus record between all relevant parties to a business transaction which is widely accessible and immutable. This will greatly improve efficiencies in how many industries operate and in practice blockchain technology has already been in use by many industries for some time now.

Supply-chain management

The IBM Food Trust is the only network of its kind to connect participants across the food supply chain through a permissioned, permanent and shared record of food system data which will greatly enhance traceability and safety for industries like fishing and farming and allow consumers to trace their food 'from bait to plate' by simply scanning a QR code. If a food safety issue is reported, it is immediately clear who is impacted and who should take action. To promote sustainability farmers, producers and other food actors can automatically digitise and easily share audits, certificates and other records, proving that they utilise and promote sustainable and ethical practices.

Content sharing fairer

In the entertainment industry, musicians and artists are turning to blockchain to make content sharing fairer for creators using smart contracts where revenue on purchase of creative work can be automatically disseminated according to pre-determined licencing agreements. In the charity space, Bitcoin-based charities like BitGive Foundation use a secure and transparent distributed ledger to give donors greater visibility into fund receipt and use.

The case against direct crypto investment

The inherent volatility of most cryptocurrencies does not reconcile with their potential use as a unit of account nor a store of value. A unit of account requires stability of pricing in order to compare the value of different goods, which is why goods are not currently priced in crypto. Likewise, many businesses would be unwilling to accept crypto as payment or hold it on balance sheet given this volatility, making it a poor store of value.

Medium of exchange shortcomings

As a medium of exchange, crypto also has its shortcomings, with few businesses willing to accept payment in digital currencies. Additionally, it has been noted that even if were to become more widely adopted, scalability issues will arise. Bitcoin, for instance, is limited to around just five global transactions per second, far fewer than that of existing networks (e.g. Visa is capable of handling 65,000 transactions per second and typically processes 1,700).

Valuation challenges

The valuation of cryptocurrencies is another key challenge to consider for investors. Most cryptocurrencies do not generate income, hence cannot be valued by conventional financial techniques such as discounted cash flows. While this is also true of a number of other assets – gold is a good example – their value can be appreciated via a discernible utility; gold has other uses, such as for jewellery. Cryptocurrencies, however, have no alternative utility and hence their value relies on the belief that their use will continue in the future; without this they could be viewed as worthless.

Correlation issues

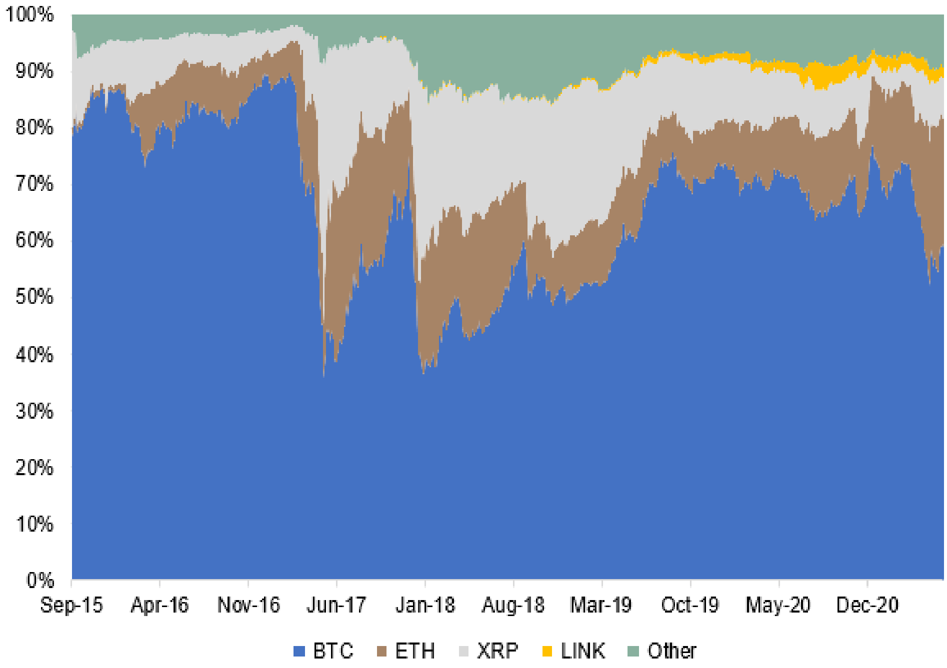
Finally, from a portfolio perspective, the addition of direct crypto investment will only enhance risk/return measures if it has a low or negative correlation with other asset classes, particularly equities. However, the evidence of this is inconclusive at this stage. In particular, cryptocurrencies experienced a sharp selloff in March 2020, in unison with the equity market and hence were not a useful diversifier through this period of market stress.

For these reasons, we would not recommend a direct investment into a crypto asset.

**The Escala Approach**

The most common argument in favour of Bitcoin is its first mover advantage and large current user base. Active user numbers, however, can be very volatile. Ethereum amassed a user base that was 80% of Bitcoin's within one year given the greater use case for its blockchain technology. If an incumbent fails to adjust to new technological advances they can quickly lose their dominant position; think Myspace and Facebook or Yahoo and Google.

Chart 4: Bitcoin's market share has fallen over time



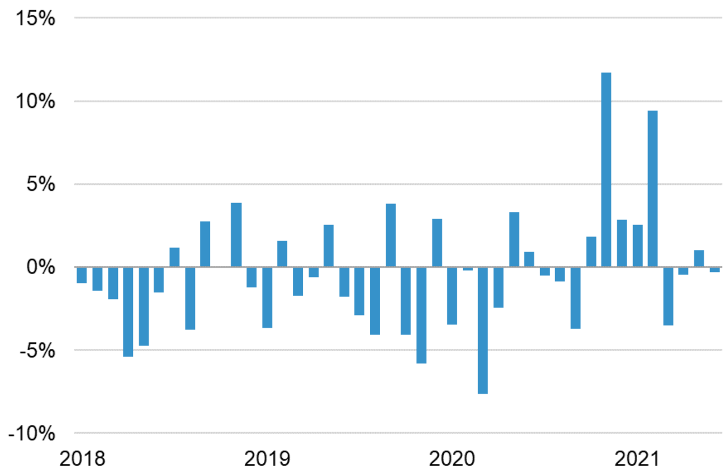

Source: Coin Metric

Key to the value proposition for crypto assets is the network effect and ability to grow its user base. As this process is very volatile in the early stages of the evolution of the industry, we believe a more risk adverse approach to investing in this space is to find the companies facilitating the transactions on the networks; the picks and shovels if you will. This would be akin the finding the Apples or the Amazons or the Netflixs that emerged from the internet revolution. On this score we believe it is still early days.

Picks and shovels approach

We do believe there will be many winners in the crypto asset space but equally there will be many losers. To provide some protection against this, we would recommend investing in a fund that has a diversified pool of potential picks and shovels of the crypto world.

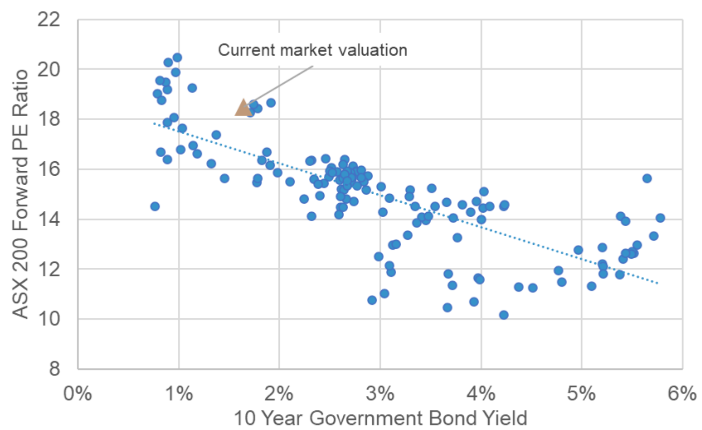
**Chart 5: MSCI Australia: Value – Growth (Monthly)**




Source: Bloomberg

The outperformance of value stocks in the Australian market has faded in the last few months after five successive months of relative gains compared to growth, from October last year through to the end of February. Value and cyclicals have received a boost from two key developments recently; initially the vaccine news in November 2020 and then a sharp rise in bond yields through February. The latter driver has been less evident in the following months, with bond yields stabilising in this time.

**Chart 6: ASX 200 slightly expensive relative to 10 year yield**




Source: Bloomberg

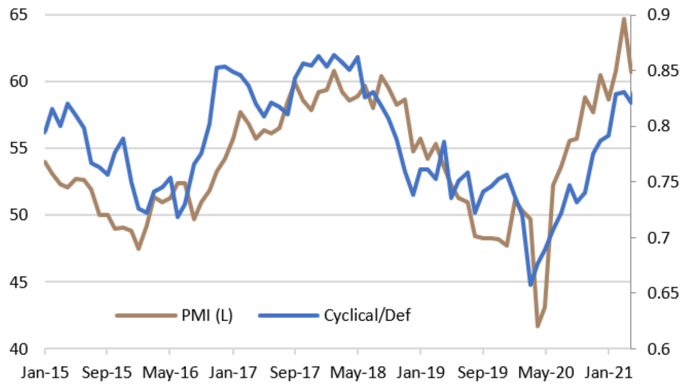
Higher bond yields are typically associated with a lower PE ratio of the equity market, as illustrated by the chart which plots monthly data over the last decade. A key risk for equity valuations this year is yields rising from the lows of the COVID crisis, hence ongoing earnings upgrades remain important in maintaining the market's momentum. Based on the bond yield/PE ratio relationship over time, the market currently looks to be slightly expensive.

**Chart 7: ASX 200: Sector performance**


Source: Bloomberg

The Australian equity market has had a strong first half of 2021, generating double digit returns approaching 30 June. Sectors that are more cyclical in nature continue to lead the way, including financials, materials and consumer discretionary. Only two sectors have declined year to date, being the interest rate sensitive IT and utilities sectors, though the former has rebounded significantly over the last several weeks.

**Chart 8: Cyclicals may have peaked with US manufacturing activity**




Source: Bloomberg

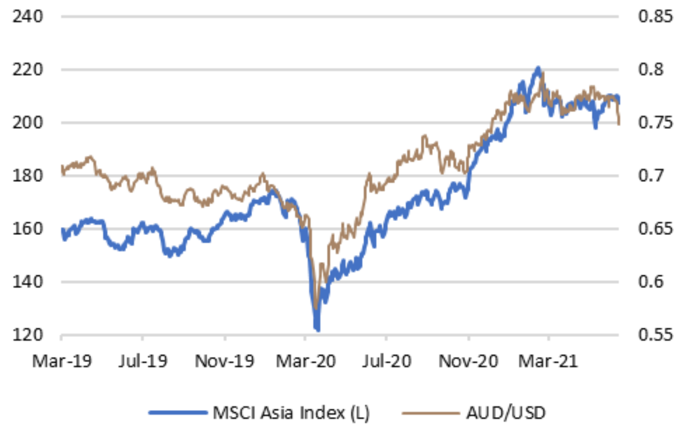
The US Federal Reserve began the discussion of reducing the amount of monthly bond purchases this month. The move should not have been a surprise given the strength in the economic indicators of late.

Post the announcement from the Federal Reserve, cyclicals began to sell-off in favour of defensives.

Some of these stocks are also under pressure as the stronger dollar weighs on commodities, even as declining yields help bond proxies such as utilities.

An equal-weight gauge of cyclical versus defensive sectors has now fallen to the lowest since February. Materials are by far the worst S&P 500 performer in the past month.

**Chart 9: Follow the Aussie – a weaker AUD coincides with weaker Asian equities**




Source: Bloomberg

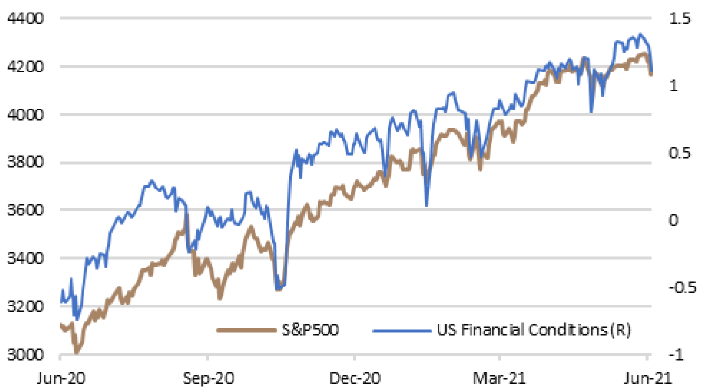
Despite the stronger employment report in Australia, downward pressure remains on the Australian dollar driven by the stronger USD.

Tapering of bond purchases by the US Federal Reserve takes a big weight off the shoulders of the greenback.

The resulting downward pressure on the Aussie dollar bodes ill for Asian equities if past relationships hold.

This would be consistent with a weakening in commodity prices associated with a weakening of activity in emerging markets.

**Chart 10: Taper talk tightens financial conditions and weighs on equities**




Source: Bloomberg

While US financial conditions still remain at levels that are very accommodative, it is the change in conditions that matters most for financial markets.

The change in tone from the US Federal Reserve this month, indicating it is considering reducing the amount of bond purchases each month, represents a move towards less accommodative financial conditions.

Not surprisingly, US equities reacted negatively to the news having been sustained on a diet of cheap, easy credit for so long.

**Chart 11: US yield curve flattening as market looks to rate hikes**


Source: Bloomberg

Reverberations from the Fed meeting extended to reflation trades. The US yield curve is flattening as investors position for a mix of policy tightening and slow growth. The market is re-calibrating the so-called 'right tail' risk of persistently high inflation. If the Fed is willing to tighten rates sooner than expected, the risk of runaway inflation is significantly reduced.

The pricing in of a U.S. tightening cycle is challenging earlier expectations that the Fed will let inflation run hot. The yield curve flattening is the most since market turmoil last March, no doubt exaggerated by an unwinding of steepening bets.

The Bank of England could be next to signal a more hawkish stance, with more than a full 15 basis points rate hike now priced in for next August.

**Chart 12: RBA balance sheet keeps expanding ($b)**

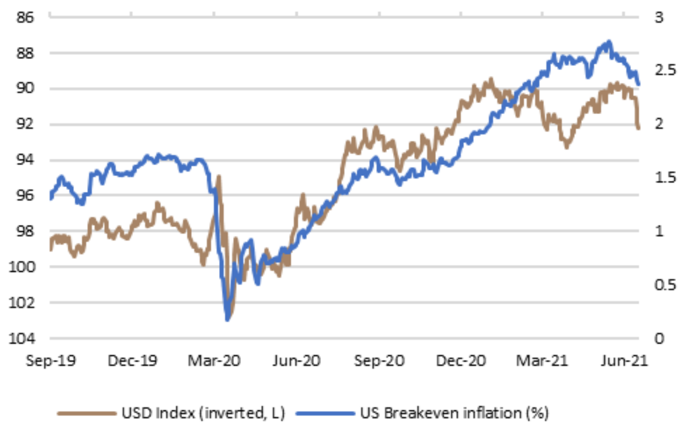

Source: Bloomberg

The Reserve Bank of Australia is due to meet next month to decide whether to extend the three-year yield target on government bonds and on a third tranche of longer-dated bond buying.

The RBA balance sheet has doubled in size over the past 12 months as it stepped up it purchases on government bonds.

This share pales in comparison to the Bank of Japan which owns almost half of the Japanese government bond market.

**Chart 13: Falling market expectations of inflation associated with a higher USD**

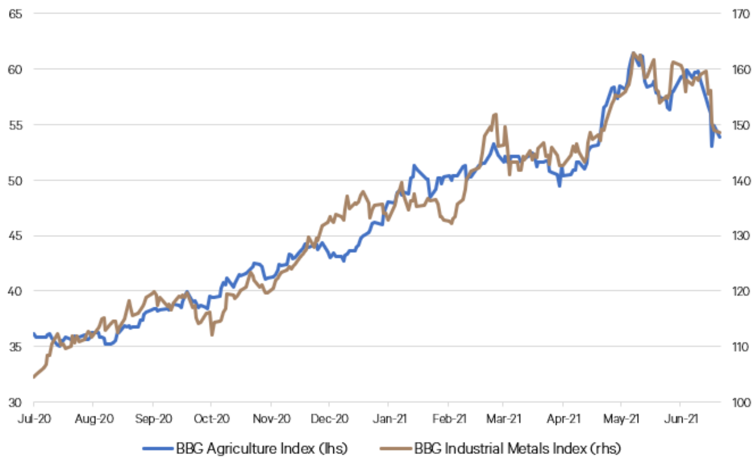



Source: Bloomberg

Inflation bets are falling out of favour, evident in the Bloomberg Commodity Index having its worst day since last April.

Markets are forward-looking, so even though the Federal Reserve has only just begun to talk about reducing bond purchases, the market has moved a couple of steps ahead in starting to price in a rate hike. This is providing support for the USD which in turn is weakening market-based expectations of inflation.

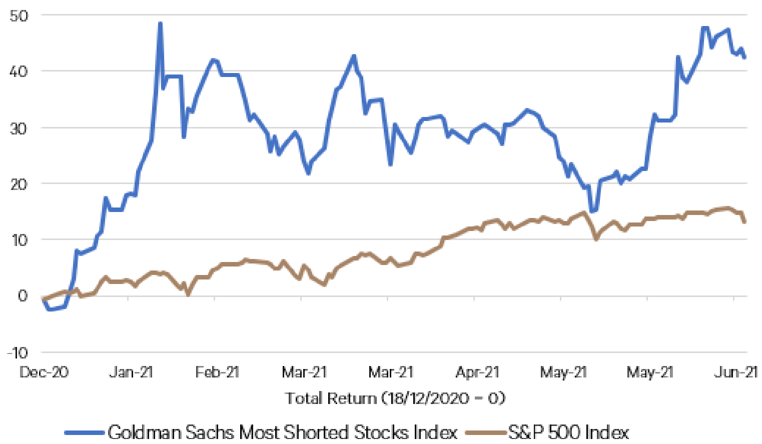
### Chart 14: Commodities fall on China and Fed talk




Source: Bloomberg

The commodities markets have pulled back in recent weeks as Chinese government entities roll out a swathe of measures aimed at cooling runaway commodity prices, including restrictions on speculative trading practices and releasing government controlled stockpiles. The sell off in many industrial metals and agriculture commodities was accelerated by indications from the US Federal Reserve last week that tapering would begin sooner than markets had expected. The Bloomberg Agriculture Index is down 12% since mid-May, with components like soybeans down 16%, whilst the industrial metals complex is down 9%, with copper falling 12% from recent highs.

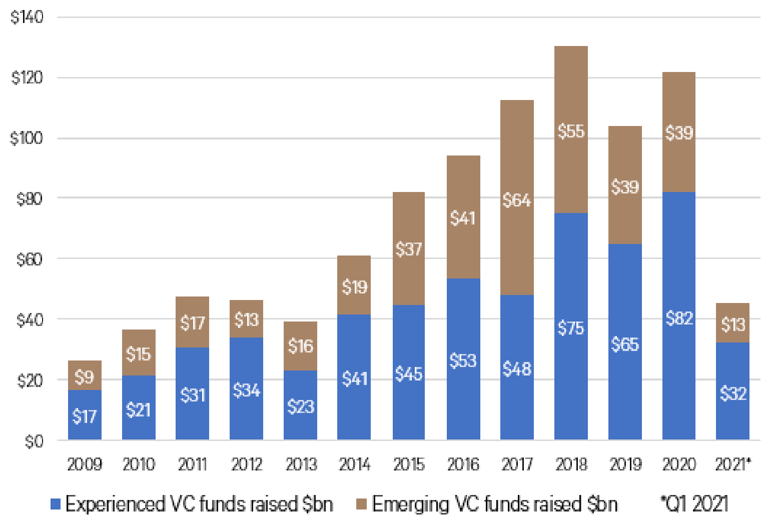
### Chart 15: Hedge Fund short pain




Source: Bloomberg

Hedge fund short bets continue to hurt many of the industry's biggest managers. An index tracking the performance of the 50 most shorted names in the broader Russell 3000 Index has outperformed the S&P 500 by some margin on a rolling 6 monthly basis. With ample liquidity flooding into equity markets and a continued surge in retail trading, market valuations on many stocks have been stretched to record levels, hurting those hedge funds with particular focus on short bets against stocks with prices disconnected from fundamentals.

### Chart 16: Venture Capital focus on experience managers




Source: Pitchbook

Whilst most private markets asset classes saw a slow down in total assets raised for full year 2020, venture capital (VC) was the one area that continued to see year on year growth with $121 billion in new capital raised. 2021 has gotten off to a similarly strong start with $45.6 billion raised in just the first quarter. With record amounts of capital to deploy, investors have continued the recent trend of allocation higher amounts to experienced managers with longer track records in the VC space. 71% of capital raised in Q1 '21 was allocated to tenured VC managers vs just 43% in 2017.

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