Fidelity Compass

Factors Driving the Bitcoin Conversation

Andrew Clee, Vice President, Product

Pamela Ritchie, Host

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Pamela Ritchie: Hello and welcome to Fidelity Compass. I'm Pamela Ritchie. It's been a pretty wild start to 2024 for Bitcoin. The world's first decentralized cryptocurrency broke record highs earlier this year topping $70,000 for a Bitcoin. The asset class doesn't come without its share of volatility, for sure. Where does Bitcoin go from here and how is Bitcoin changing the global marketplace ultimately, or certainly the ripples underneath it?

Happy to say that joining us here today for a comprehensive overview of Bitcoin, including how he sees the product landscape playing out through the rest of this year, is Fidelity Vice President of Product, Andrew Clee. Hi Andrew, great to see you.

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Andrew Clee: Thanks for having me.

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Pamela Ritchie: Great to have you here. We'll invite everyone to send their questions in through the next little while for Andrew. You have had amazing conversations about this for many years now and through those years Bitcoin has actually done a pretty good round trip, actually. It's been quite historic. Why don't you sort of tell us about the round trip because it's a bit dizzying actually.

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Andrew Clee: I guess if we start kind of back to where it started, it came out of the financial crisis. Original thesis, alternative to fiat currencies. Store of value, the scarce supply so it is a fixable supply, 21 million Bitcoin. I think it's probably best to kind of start in 2020 because that's probably when it hit mainstream.

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Pamela Ritchie: Sort of $17,000 up to where we've been in the last little while.

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Andrew Clee: I think it got a shock when the world shut down. You may recall, it dropped about 50% kind of in that March 2020 timeframe but then we had a huge bull run right up into 2021. It kind of peaked, actually, where we're at today. Then all of a sudden rising interest rates came, and we saw it plummet back down to the $16, $17,000 U.S. dollar level. Here we are today at $65,000.

I think what's pretty interesting is just the round-trip experience has largely been a changing narrative of what's driven those kind of rallies. There's been periods of exuberance. There's been periods of different theses from investors, what we're doing what with it. If you think about the most recent run, I think it's twofold. A is we had the ETF approvals in the United States. Not near the Canadian market, we've had them here for several years in 2020...

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Pamela Ritchie: So, that's this January. That's sort of the beginning of this year it all properly...

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Andrew Clee: Exactly, and then you also have the halving that happens in April, mid April, towards the end, I think it's April 22nd, that Bitcoin is going to halve. What that means for everyone is miners solve puzzles that clears the blockchain. That's how we actually move the coins amongst the blockchain. The miners get rewards. Currently, they get 6 ¼ coins for solving that puzzle and creating the hash or completing a block. That is about to drop to about 3 1/8 coins so not good for miners, but if you look back this is actually going to be the fourth halving and typically you see a strong run in Bitcoin prices about seven months after the halving. So, typically we're up about 40 to 50% in price. I think it's a combination where the markets say, hey, okay the SEC is approving it but we're also leading up to a halving so that's part of the [crosstalk].

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Pamela Ritchie: Scarcity story.

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Andrew Clee: Exactly. There's also the traditional argument that it's a hedge against monetary debasement. If you look at the debt that the U.S. Federal Reserve's put on since the pandemic it's actually quite a staggering number. Ever since we moved off the gold-backed standard for currencies, there's kind of looking at the world and saying there's actually nothing stopping governments from printing more money. There's that camp that's saying, you know what, Bitcoin is a store of value, a gold alternative. I think there's competing narratives in different points of time, but it's quite interesting to see. Here we are at 65,000 today.

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Pamela Ritchie: This is incredible. Let's pull on some of those narratives throughout it, also what it was. Was it a risk asset, was it something that fits more on a store of value side of investing? There were a lot of different arguments in there. Has it settled?

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Andrew Clee: It has. The way I look at it is over longer time periods, let's take five years, three years, whatever that may be, over those types of time frames the correlation to stocks, so take the S&P 500, the TSX, is about 0.2. So, anything above 0.7 we'd say, okay, that's a pretty strong positive correlation. 0.2 you're like, okay, this is a diversification asset. It's zero to fixed income. If you look at the last 12 months, it's actually negative, -0.15 to the risk assets. If I took you back to kind of, let's call it, the '21, '22 market it was highly correlated to the NASDAQ.

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Pamela Ritchie: It was a risk asset class.

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Andrew Clee: Exactly. You see it ebb and flow and I think it's the narrative changing about the drivers of this. I think the strongest argument, at least when you talk to the supporters of this space, is the hedge against monetary debasement. You have the renters if you say that like the SEC is going to approve the ETF, of course you're going to get a run-up in price [indecipherable] that landmark comes into the space. I think the strongest argument is the digital gold, the alternative there, a hedge against monetary debasement, a hedge against central banks printing press continuing to [indecipherable] as they like to say. It's quite fascinating to watch over time and it's fun to watch. A volatile asset class that is starting to get mainstream adoption I think is something that we have to pay attention to. You're starting to see institutions and government pension plans around the world start to take notice on this asset class.

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Pamela Ritchie: I want to go to a couple of things you said there. Volatility, it's a store of value, if the world becomes more volatile, which it might, we don't really know, there's lots of things happening right now, what does it do?

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Andrew Clee: It'll be interesting. As long as we have internet I think that that would be a fairly strong scenario for Bitcoin upside as you see it, as it stands today because I think that is the thesis, the original thesis as it was signed playing out. What we haven't seen is people use it as a medium of exchange. We see it around the world but not in the developed world. It's more of an investment type story.

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Pamela Ritchie: Main Street, which you also mentioned, this is an interesting one. I don't have the history that you have but I think you've mentioned before that this truly came from Main Street and then later you, along with Wall Street, decided to take it along and adopt it. Why is that important?

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Andrew Clee: Because I think, at least in the modern world, I can't think of an asset class that didn't come from Wall Street to Main Street. So, let's just rewind.

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Pamela Ritchie: It could be the one-off, literally.

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Andrew Clee: Exactly. Think about it, when we look back at the stock market, who had access to the stock market before we had electronic trading on that? It was large pensions, those institutions, and they were trading pink sheets, blue sheets. Then we invented the mutual fund. What did the mutual fund do? It provided access to Main Street to co-invest alongside other investors in a co-mingled pool of vehicles. I can take you through time and probably not a great example is mortgage-backed securities. Those kind of stand-alone in the institutional world and Wall Street packaged them up, put them out to retail in different types of products and we saw how that ended.

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But if you look at Bitcoin this is not something that started with Wall Street or Bay Street. It started with the tech community, or the early adopters as we call them, and it really started as a decentralized product. Canada offered an ETF wrapper in 2021. The SEC waited till 2024. Europe is somewhere in between the two of those depending on the jurisdiction. This is really something that started in the hands of retail and then was later adopted by the institutional model so call it Wall Street or Bay Street. I can't think of any other asset class at the top of mind where you actually saw the trading and the adoption start in the hands of the retail investor.

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Pamela Ritchie: In the hands of the retail investor because they thought that the currency debasement story was real to them? That's what it stems from so do those fit together?

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Andrew Clee: I do and I think a lot of those investors were also probably believers in physical gold. If you think about why the arguments to hold physical gold, I think you use the similar arguments of why you would invest in Bitcoin. I think when you look at that community and you say, "Why did they adopt Bitcoin?", is they probably had a theory that we were printing too much money. They may have a theory that the debt levels of governments are unsustainable. This was a piece of technology that had a scarce supply – 21 million. We know it can't go more than that. They started looking at this asset class as a hedge against, I guess we can call it fiat currencies, whether it's the stock market because that would be in significant trouble if we did have that monetary debasement or the central banks, we lost faith in them, the credibility lost so I think it started there. Obviously, as the asset grew in value you start attracting other investors. You have short-term renters, the speculators. I think the original thesis was the reason that the Bitcoin was created.

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Pamela Ritchie: We've seen recently, we don't need to go too much into sort of where markets are immediately but we've certainly seen a run-up in gold. One of the arguments, and we don't always know what central banks are doing because they don't tell us, is that central banks are in the market buying up lots of gold. I don't know if that's true or not, but does it also apply potentially to why the price of Bitcoin is going higher? None of them say yes, again, we don't know but what do you think?

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Andrew Clee: I'll make two comments. I think gold would have had a stronger run than we've seen if Bitcoin didn't exist.

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Pamela Ritchie: Interesting.

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Andrew Clee: When you kind of look at the charts kind of comparing gold versus M2 money supply, there's an argument that gold should be stronger than where it is today. It's very difficult to prove but I think gold may have lost some of its shine because of Bitcoin. Those that call it digital gold may be diverting assets towards Bitcoins rather than the physical gold or precious metals. I do think it's taken away some of that lustre from gold, but I think you're spot on that this is part of the run that we've seen so far.

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Pamela Ritchie: It could be in there as well. The ETFs, the story, the run-up obviously until January, they were offered... What did you notice after that? Tell us your comments as you watched maybe the month of January unpack itself in this space. Obviously, people got in on the rumour so-called and sometimes out on the other side. It was a fascinating story to actually watch what it held. People wanted it.

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Andrew Clee: It was a buy the rumours sell the short-term news because we did see that the ETF came. What's important to remember is the Grayscale Bitcoin Trust was trading at a huge discount and they were also very expensive. What I wanted to watch play out was would the demand for the new ETFs outstrip the redemptions that never really were going to come to close the gap because when you have a closed-end fund trading at a discount there is no arbitrage mechanism for market makers to bring that discount back to the NAV. We knew that there was going to be a structural outflow just by design of the closed end converting to the ETF. When we were internally talking about it, we kind of were just debating, I said, I actually think that Bitcoin is going to fall in price because I don't think demand can outpace what it would take to close that discount on the conversion of the Grayscale closed end fund to the ETF. That's effectively what you saw because they were getting redeemed every day and that was a structural weakness on price. That had to happen because ETFs' open supply of units means that there should never be a premium or a discount or there's an arbitrage opportunity.

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That was very short lived and I was really, really surprised by how much demand came in to the other ETFs. If you look at Fidelity and iShares in the U.S. those are monsters. I was also very, very shocked that once that discount and the outflows stemmed from the closed end how much money was going in daily into these ETFs. Just for context, Bitcoin trades about 5.5 to 6 billion a day of U.S. dollars. It's a decent sized market. At peak ETF flows, the ETFs getting up 15, 20% of daily trading volume. When an ETF takes subscription, they have to buy that that same day. Our ETF in Canada, if we take money in from a market maker, we're going into the spot market and we're buying [indecipherable] Bitcoin. It's no different than the U.S. That number has somewhat settled. Let's say on average the U.S. and Canadian ETFs are taking in 300 million. That's 5% or so of daily volume. That's sustainable. When you have ETFs being 20% on the demand, obviously there was some pressure on a scarce asset class that was pushing prices higher. It's just fascinating to watch how much money they raise and how quickly they raise it. I think that was the surprise out of the whole thing.

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Pamela Ritchie: It's really interesting to sort of sit here and watch what has happened and also where it is now. Canada was offering this, Fidelity specifically, three years ago.

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Andrew Clee: Three years ago, 2021.

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Pamela Ritchie: Regulations changed and it was available. Some of the round trip was followed through that period.

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Andrew Clee: It was. I think it was February, maybe end of January they announced it, but I believe the launch was in February 2021. Bitcoin was probably trading 55, somewhere in that range. My memory's dating me here but we launched it just in time to see an all-time high at the time. It kind of peaked towards the end of 2021 and then we saw it go down to, let's call it $60,000 USD. So, the ETFs have gone round trip. Ethereum is not necessarily the same story. If you think about the Fidelity Ethereum ETF, when we launched that that was actually near the lows of where the crypto winter was. I think the important thing here is crypto is incredibly volatile. When you're thinking about including in a portfolio there's different ways to thinking about it. We take a risk-based approach and considering the correlation benefits, I touched on that earlier, but I think it's starting to mature as an asset class.

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Pamela Ritchie: That was what I was going to ask you. We've been watching sort of the maturation of an asset class.

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Andrew Clee: The volatility is starting to come down relative to history. I think that's just kind of a law of large numbers thing, when you have something that kind of starts in the dollars, that's where it did. You hear the story of the guy who traded 100 Bitcoins for a pizza pie.

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Pamela Ritchie: I remember that. Someone bought a Christmas tree with it at some point too.

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Andrew Clee: Where we are in just seeing the futures markets, the ETF markets, institutional interest in it, that generally leads to decreasing volatility. But if you look at it it's still the 2-year standard deviation, let's call it the average standard [indecipherable] over two years it's about 4X of gold. It's still incredibly volatile but it is less than we have seen historically. It's really interesting, volatility counts to the upside, too. When prices go up, you're taking the vol; when prices go down, you're taking the vol.

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Pamela Ritchie: Talk a little bit about the futures market because the futures market is an interesting thing. Everything that you talked about that was in January was the spot story. Futures markets are kind of rocketing.

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Andrew Clee: They are. I think that's where the speculative interest sits. I think Jurrien Timmer was on here chatting with you about it. If you were to be a short-term renter of it and can do it and leverage or however you may choose to do it, the futures makes a lot of sense. It'll be really interesting to see what happens if the price was to unwind because the futures market. It's also important to remember that the futures market is a hedging tool for a lot of the market makers that are making markets in these ETFs. Let's assume in aggregate there's $300 billion a day traded in Bitcoin ETFs. That means that there's $300 million of hedging activity that's sitting on the other side of that.

Some of the market makers can hedge with physical. That's in Canada and the US. Some of the larger market makers that may be bank-owned may be prohibited from trading in physical spot. So, you know that they're actually going to use tools that could be ETFs directly, it could be the futures market but there's also hedging activity that happens in there. It's really going to be interesting to watch what is renting and speculative versus what's actually structural and demand from a hedging relationship. I think there is some optimism in the futures market that we do believe would be short-term or speculative in nature.

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Pamela Ritchie: What do you think of this question coming in? Thank you for sending it in as well. You're welcome to send a couple more in throughout this. How much of the Bitcoin run is influenced by the influx of AI and semiconductors, perhaps the spending within there? I don't know, do you connect all that together?

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Andrew Clee: The interesting thing about that is, we're now talking about mining, so in order to be a good miner you have to have the best technology. The improvement there has obviously seen drastic improvement in the way that we mine. As I touched on earlier, essentially what miners are doing is they're solving a puzzle to complete the block and they get the reward for doing it. What's important to remember is that as you get more miners in, so let's just assume more miners are buying better technology through the form of semiconductors, the problem just gets harder to solve. They have a targeted time to complete a transaction within the block they're solving the problem. You invite more miners or more competition or increased power in AI or semiconductors all that happens is that the problem gets more difficult to solve. We're solving to a time we're not solving...

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Pamela Ritchie: It [crosstalk] the price, actually.

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Andrew Clee: It does to a degree. What happens when you go through halvings is because the reward is now less... I just touched on it. You're going to go from 6 ¼ to 3 1/8 reward. Because a lot of these miners take on debt to fund the investment in the technology they need to do it, we probably would see some people wash out here where they can't sustain their debt levels because the reward's now half of what it was leading up to the halving. What that means is all that's going to happen is as the competition decreases is the problem gets easier to solve. So, we're still solving for the time, we're not solving for the complexity of the puzzle. Generally, what happens is as those weak hands or the overlevered hands of the mining get washed out through the less lucrative rewards is they'll sell all that technology and you'll actually bring in new miners because they'll buy that equipment at a discount. As you kind of go through that bankruptcy or whatever, I have an asset in the form of these semiconductors or these computers.

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Pamela Ritchie: They'll be sold at auction like everything else.

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Andrew Clee: Sold on auction, 80 cents on the dollar or whatever that may be, whatever the current price is. Eventually you'll see the mining ramp up again, puzzles become more complex but it washes out the weak hands, the strong hands prevail and then you bring in a new flux of capital. We've done this now three times. The fourth one will be coming up on April 22nd is the estimate right now. It'll be interesting to see what happens. Generally, what happens in halvings it's bad news for miners, rewards are less so they get hurt a little bit through this. Typically, what you see is Bitcoin appreciate about seven months after. That's just historical. There's been different macro narratives at play pretty much every single time we've done this. It happens about every four years. If you think about the last one it was the pandemic so completely different narratives than what we have at play today, different interest rates, different geopolitical climate. Time will tell but it is an exciting event to watch out for.

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Pamela Ritchie: We're just days away from it at this point. Tell us just a little bit about the driver/use cases. We talked about buying a pizza and a Christmas tree sort of in jest there but in a much more serious way some countries with unsustainable levels of inflation and currency debasement that they're dealing with are absolutely using it as a currency.

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Andrew Clee: If you're looking at the developing world or the emerging world, places with very high hyperinflation or very weak central bank policy that have issues with currency management you have seen an adoption of Bitcoin as alternative to the local currencies. That makes a lot of sense. The same reason that you would have bought gold as a store of value in that, but they actually are in some cases using it as a medium of exchange. We talked about the incredible volatility of 4X gold, but the volatility of Bitcoin is actually less than some of the emerging market currencies that we're seeing today. That local population is saying, you know what, this is a store of value, I also can use it as a medium of exchange.

If you take El Salvador for example, they adopted it as legal tender. So, it's starting to see the medium of exchange but if you look around the developed world, I would say the vast majority of them are either buy and hold investors because of the thesis we touched on earlier, the monetary debasement as you get central bank activity or government spending, and then you have the speculators that are saying this is a volatile asset class, there's money to be made here if I have a view on a short-term trade, they're also involved in it but they're taking it purely as an investment thesis and not as a medium of exchange.

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Pamela Ritchie: That's really interesting. Maybe this will be one of our final questions: the idea that it's come from a retail place or from Main Street into Wall Street, take that a bit further. Is there a lot of money sitting on the sidelines, real money not hot money, that just hasn't gotten in yet?

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Andrew Clee: Well, yeah. I think this just goes back to how difficult it was to access. You saw the Bitcoin ATMs inside convenience stores before we had the ETF. Those still exist. I can't imagine people walking in ... just so everyone realizes what happens historically is if you bought a Bitcoin in, call it 2013, there was actually a store at King and Spadina in Toronto. It was the Bitcoin store. It was created by Vitalik Buterin who invented Ethereum so incredibly wealthy individual that kind of created the queen of cryptocurrencies, if you'll call it that, in Ethereum. They were selling Bitcoin through an ATM and you bought it, put your debit card in and it spat out a piece of paper and it had your wallet address. It's like, do I have a real Bitcoin here? I can't see it. It's literally on a receipt.

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Pamela Ritchie: It's like going back to [crosstalk].

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Andrew Clee: It was a pretty wild time. Then you had the exchanges come and we had a lot of blow-ups. We had fraud. It's well known. It was a really big hassle where a lot of banks wouldn't let you send money to certain exchanges. It was a really hard set-up. You saw the ETFs come and I think that speaks to the demand and the growth we saw there. It was just access, it was a hassle, there was a risk, I was too lazy to do it. I don't know what the argument is. I'm sure it's all of the above but you saw a lot of people that were interested in crypto that never got around to it now do it very easily through their online brokerage or their financial advisors. I think there is a lot more.

Anecdotally, we've been having conversations with some very high net worth individuals that say, hey, the ETFs now here, similar to the institutional side, the ETFs now here, I couldn't hold a physical bitcoin before but now I can hold the ETF. I do think that we've seen some come off the sidelines but there's still this whole area of the world that has very large amounts of cash that is just starting to realize that the access to secure through an ETF, it comes with the regulatory protections, institutional quality custody, institutional quality trade execution. I think there is a whole other side of the market that's now starting to look at it that hasn't come in yet.

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Pamela Ritchie: Andrew Clee, Vice President of Product at Fidelity. We will be thinking of you on April 22nd, for sure. Thank you for joining us here.

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Andrew Clee: Thank you.

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Pamela Ritchie: Andrew Clee joining us on Facility Compass. Thank you for joining us. As always, if you have any suggestions for future topics, guests that you'd like to see here on the show, please go ahead and share those ideas with us. In the meantime, stay tuned for more Fidelity Compass webcasts in the weeks ahead.

Thanks for joining. I'm Pamela Ritchie.