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Market update

Market update: Coronavirus

Abstract

As the coronavirus disease spreads, economies slow and global financial market sold off. Bitcoin price has dropped substantially.

We think the significant price drop is due to a combination of factors. In our view, the most important is that crypto-market is dominated by retail investors, some of them with leveraged positions. The drop in price caught many of them off guard and forced them to sell.

The bitcoin value proposition remains intact and the blockchain technology underlying the crypto-currency proved solid. As diseases are temporary by nature, all assets that were hit are likely to recover ultimately. Finally, bitcoin halving is to take place in May this year and will likely support the price.

Economic and financial situation

The coronavirus[1] has spread rapidly and broadly around the globe. At the time of writing, more than 130 thousands people are infected in cl 126 countries. Death toll is reaching 5000 people.

To limit contagion, various measures have been taken. Schools have been closed, large people gathering have been forbidden leading to cancellations of festivals and sport events, cities, and even countries have been quarantined. President Trump has decreed a 30-day ban on travel from more than two dozen European countries to the US.

We welcome all these measures that are set to curb the exponential spread of the coronavirus. While it is too early to evaluate their success, they have negatively impacted economies and financial markets.

According to the Purchasing Manager Index (PMI), an economic indicator used to gauge economic activity, the Chinese economy experienced a sudden halt. The index dropped from a healthy 51.1 in January to 40.3 in February, the lowest recorded level since the beginning of this survey in 2004. The level of 50 marks the limit between expansion and recession.

Other economies have not been impacted as negatively as China so far according to the PMIs. It is no surprise that the next release will indicate a worsening of the global economic outlook.

In line with these developments, asset prices have moved significantly. Crude oil price halved since the beginning of the year to roughly USD 30 per barrel, the Volatility Index (VIX) reached almost 70, a level not seen since the Global Financial Crisis, the S&P 500 entered into a bear market with the biggest daily loss since Black Monday, and corporate spreads for both investment grade and high yield bonds have exploded. The magnitude and the speed of these movements illustrate the severity of the crisis.

Risky assets have been hit hard. What about safe assets? At USD 1570 an ounce, gold remained broadly unaffected by the coronavirus. US treasuries on the other hand performed strongly. The benchmark 10 year Treasury yield moved by 100 basis points (bps) to a historical low of 0.6% in the wake of the unexpected Federal Reserve 50bps rate cuts before increasing again thereafter.

In the meantime, bitcoin, which is often perceived as a hedge against adverse developments dropped from USD10,400 mid-February to USD 5800 at the time a writing, a drop of approximately 50%.

Crypto-market situation

Did bitcoin fail to deliver what it promised?

Bitcoin and more generally, crypto-currencies, are a new form of asset class as their determinants[link1] are not those used to value traditional assets. Bitcoin, to mention the most prominent one, is a decentralised and censorship resistant store of value and means of payment. It is thus closer to gold than to government bonds.

Gold and government bonds, both risk-free assets, did not behave similarly in the wake of the coronavirus. Gold price has remained broadly unchanged while US government bond price have increased massively. The reason for these two different behaviours is that they are not risk-free in the same way.

Gold is a safe asset that protects against monetary depreciation, whether domestic (inflation) or international (currency depreciation) and loss of confidence in institutions. This is the case because it is “outside money”, i.e. a form of money that cannot be manipulated by governments and central banks. It is also an international unit of value that is acknowledged worldwide, wherever you go, gold has value.

US government bonds are safe assets as they provide liquidity to the global financial system. Liquidity is what financial intermediaries, companies and households need when asset prices plummet and the economy is hit negatively. This is the reason why US government bonds have been in high demand and why the European Central Bank is providing additional liquidity facilities to financial institutions so that they can then provide it to the real economy.

Bitcoin is closer to gold than to government bonds. As confidence in institutions is high, people do what government say and investors trust central banks. There is no need for outside money. However there is need for liquidity.

Secondly, there is evidence that retail leveraged positions have been closed due to the bitcoin price collapse, adding further downward pressure on bitcoin.

Thirdly, institutional investors categorise crypto-currencies as alternative investment, a high risk pocket. It is clear that in the case of asset price and liquidity shock, crypto-currencies are sold as any other non-core risky asset.

Finally, the crypto-currency market is small. Bitcoin market cap is slightly more than \$100bn, while gold is \$7.5tn and US government debt (notes, bills and bonds) is about \$20tn! As the depth of the crypto-currency market is small, so is liquidity

Conclusion

The sudden and broad spread of the coronavirus has surprised everyone. Policy makers try to limit the contagion. In the meantime, economic activity dropped and financial market acted accordingly. As far as bitcoin is concerned, it experienced its first crisis and revealed its true nature. As digital outside money, bitcoin is a new asset class in a small market with limited liquidity. As we see the current financial shock as a liquidity shock primarily, bitcoin and gold are not assets designed to protect against that risk.

[1] or covid-19.

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