An Early Winter for the Crypto Industry

SIGNATURE GLOBAL ASSET MANAGEMENT

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As I write this piece in late December, physical winter has not yet arrived – the weather is mild, and the ground remains green waiting for the first sustained snowfall.

The crypto industry, however, saw winter's arrival a few months ago and the forecast calls for a long and cold freeze.

The “winter allegory” highlights a painful realization that the crypto industry isn’t evolving at its expected rate and companies involved in the sector will have to squirrel away cash and hibernate until conditions improve, which is likely in three to six years by Signature’s estimate.

The proof of this is in the headlines. The poster child for crypto, Blythe Masters, chief executive officer of Digital Asset Holdings recently left the firm reportedly for “personal" reasons. She had pioneered innovative new financial services such as the credit default swap while at her former employer J.P. Morgan Chase and her move to the crypto side was considered a huge validation of the future of the space. Scores of other financial executives followed her, and the siren call to the crypto side.

But the headlines from a year ago, trumpeting the billions of dollars raised in the crypto market are now playing a different tune. The new headlines, buried from the general public's view, are along the lines of the biggest Ethereum development firm ConsenSys laying off 50-60% of the firm’s workforce. Scores of others are restructuring to conserve cash or shuttering their operations as funding sources go cold. (Ethereum is an open software platform based on blockchain technology that enables developers to build and deploy decentralized applications).

Technology firms are not alone, and the slowdown is felt across the whole industry. Wall Street, once intrigued with the notion of crypto as a new trading market, has quietly frozen initiatives due to lack of traction with customers. Regulatory uncertainty from the U.S. Securities and Exchange Commission and the criminal prosecution of unsanctioned bitcoin offerings has added to the chill.

So, where do we stand as technology investors? Signature was forced to come up with a crypto thesis at the start of 2018 when our phones were ringing off the hook with exuberant crypto startups dialing for dollars.

We fortunately did not succumb to the siren call. Signature’s view was that crypto was overhyped short-term and the tokens would likely trade down to the cash cost required to produce a token.

This is exactly what has transpired as we close 2018. This was a differentiated view from bullish peers.

While we think that the general technology sector has matured from the dot.com days, we made an exception for crypto as skeptics did have a point. Crypto not only felt like the dot.com days as the technology is speculative with uncertain long-dated outcomes, but the cash burn rates and funding requirements were also similar to dot.com peers.

This anchored Signature's thesis and, absent a better one, we thought that the price of Bitcoin would also have an uncanny resemblance to the Nasdaq index during the dot.com demise. Sure enough it does, as seen in the graph below that overlays the performance of the Nasdaq during the dot.com days (1999-2001) and the price of Bitcoin today.

An uncanny similarity: Bitcoin vs. the Dot.Com days of the Nasdaq

Source: Bloomberg L.P. as at December 21, 2018.

So, it truly feels that we are now at the classic trough of disillusionment with the crypto industry as we were with the dot.com market back in March 2001. Short sellers have done so well that they are covering their positions with glee as a vision of the *sugar plum fairy* dances in their heads.

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Is crypto going to zero? Not necessarily and it feels like the e-commerce industry of 2001: namely there is merit to the technology of digital tokens but we are early and perhaps not in the proper industry configuration.

What do we mean? Well, the crypto industry was built on a decentralized model that assumed that "if you build it, people will come". But perhaps crypto is more like the loyalty point industry, which was backwards in the sense that you need a large platform of people to first support a new "currency".

This is Signature's current thesis and we think that the validation of digital tokens is best served from large platforms creating and supporting a token within their ecosystem with an audience that is already large and captive.

It is interesting to note that under an avalanche of bad news for crypto, Facebook is rumoured to be doing just that – launching its own crypto token on its WhatsApp messaging app, with a focus on the remittance market within an emerging market said to be India.

We shall see if this approach will eventually thaw out the crypto market. But this is a multi-year winter, so pile up the logs you need to keep warm in the interim because you will have to hunker down.

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IMPORTANT INFORMATION

Malcolm White is the portfolio manager of Signature Global Technology Corporate Class. Mr. White and his immediate family do not own securities in the crypto companies mentioned in this blog. Signature Global Technology Corporate Class does own securities in Facebook.

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