WHEN BITCOIN MEETS INFLATION

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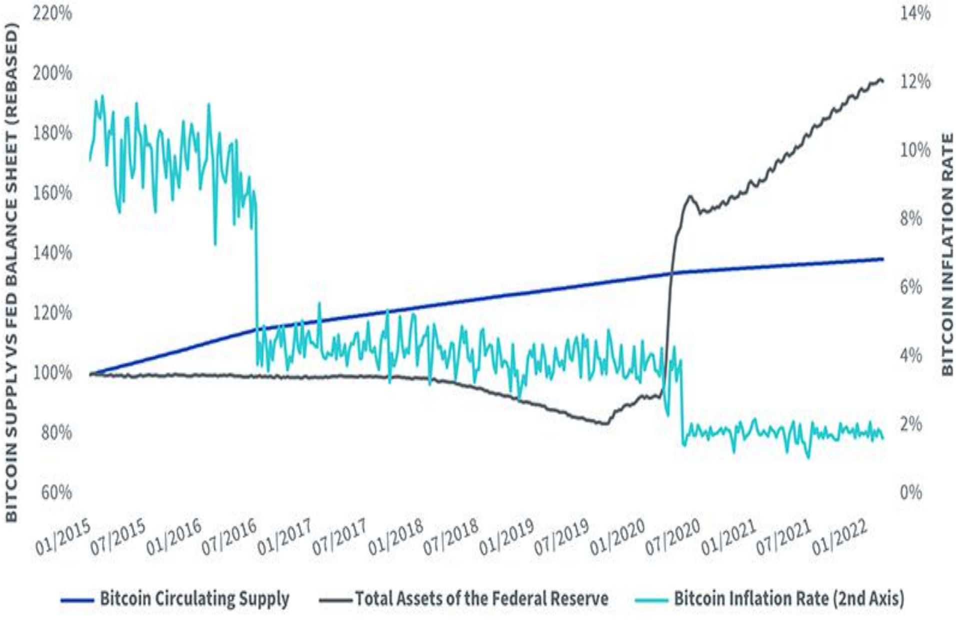
2022 is challenging, especially for crypto, as bitcoin approaches its correction phase in a halving cycle. Crypto markets started the year with price turbulence amid the Fed raising interest rates, high inflation and the general equity market's drop. The total crypto market cap briefly reached an all-time high of $3 trillion in early November 2021 but has dropped to $1.87 trillion[1], with bitcoin now at $41,206 (-11% YTD) and ether at $2,883 (-23% YTD)[2]. This gives us the opportunity to deconstruct the myth that bitcoin is an inflation hedge from a technology design standpoint and look at how the asset has behaved during the recent high inflation environment. We then suggest some new ideas on how stablecoins and staking can be used as an alternative solution to combat inflation in a portfolio.

Technologically Speaking

The Bitcoin protocol is codified to be deflationary. New bitcoins are mined using computing power, and the mining rewards are predetermined—the reward halves every four years; hence, the new supply of bitcoin halves—making Bitcoin's issuance schedule consistent and predictable. Currently, more than 90% of bitcoins are already in circulation (18,989,550[3] as of March 21, 2022), and the max supply is capped at 21 million. Bitcoin's inflation rate, calculated as the percentage of new coins issued divided by the current supply, is currently at 1.8%[4] per annum (p.a.) and is scheduled to decrease after the next halving around March 2024.

Figure 1: Compare Bitcoin Circulating Supply against Total Assets of the Federal Reserve (Rebased)



Sources: Glassnode, Federal Reserve, WisdomTree, as of 3/22/22.

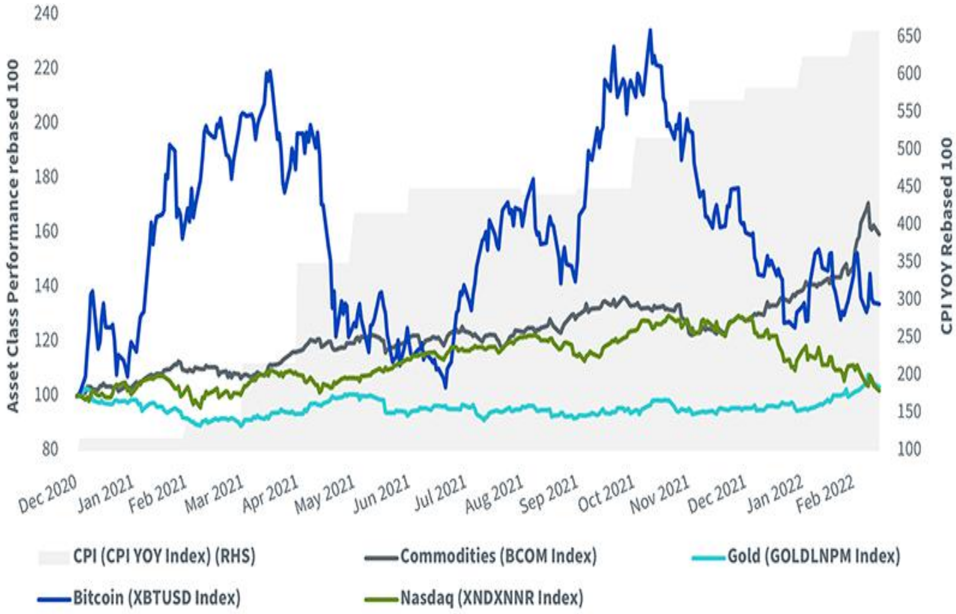
Technologically speaking, bitcoin should be a good inflation-hedging instrument. So, why didn't the price behave accordingly in recent markets?

Empirical Evidence

The current inflation rate is around 7.9% in the U.S., 5.8% in the euro area, 6.0% in India and 5.5% in the U.K.[5] Geopolitical risks have pushed energy and commodity prices even higher, suggesting a likely continuation of higher inflation further into 2022. Different asset classes have reacted differently to this renaissance of inflation, as highlighted in figure 2. Interestingly, bitcoin's price has not followed other inflation-hedging instruments like gold or commodities; neither has it appeared to be highly correlated with risk assets like tech stocks.

This contradicts the widely cited narrative of bitcoin being an "inflation hedge," a place to put your money when fiat is losing real-world value. What could be the possible explanations?

Figure 2: Asset Class Returns January 2021 – March 2022 Rebased



Sources: Bloomberg, WisdomTree, 1/1/21–3/15/22. Historical performance is not an indication of future performance. You cannot invest in an index.

For definitions of indexes in the chart above, please visit the glossary.

1. A nascent asset class with a short track record

Bitcoin was only created in 2009, and its mainstream adoption didn't start until 2019.[6] During this period, the global developed economies did not see much inflation to test how bitcoin would react to such conditions. 2021 was the first time that bitcoin was tested in a high inflation environment, whereas traditional inflation-hedging assets like gold, commodities and real assets have all been through several inflation cycles where they had time to attract investors and establish themselves as inflation-hedging instruments. This is important because it takes time for investors to be convinced that an asset is value-preserving.

Bitcoin, as a nascent market, differs from other traditional assets like gold/commodities, especially in areas like:

- **Retail vs. Institutional Participation:** the bitcoin market is still dominated by retail investors.
- **Derivative Instruments:** there are fewer hedging solutions for bitcoin; derivatives trading volumes are much lower than traditional assets.
- **Regulatory Guidance:** the regulatory framework on crypto is evolving.
- **Product Availability:** there are fewer regulated financial products (e.g., funds/ETFs) available for investors to access.
- **Other Market Infrastructure:** such as settlement, prime brokerage, data availability, etc.

These factors mean that the bitcoin market is at a fundamentally different development stage than traditional assets. It is nascent, and at this stage, the asset has just started to be adopted by large institutions.

These are the reasons why bitcoin and other crypto assets are demonstrating a "growth-in-value," liquid venture capital (VC)-like character at the current stage. As the market continues to mature, bitcoin's "store-of-value" character may become more apparent, and bitcoin could become a more traditional inflation-hedging instrument.

2. High inflation is not the only factor impacting 2021/22 global markets

2021 is too short a period to assess whether bitcoin is an inflation hedge. The global market hasn't seen this high of an inflation environment since 1982.[7] Yet, besides inflation, there are geopolitical factors, post-COVID-19 economic recovery and other macro factors driving asset performances. Indeed, this may be the reason why gold, as a traditional inflation hedge, did not react until 2022 to the high inflation.

Besides, there are other challenges unique to crypto in 2021/22, such as regulation shifts—e.g., China's blanket ban on crypto—and social media influences—e.g., Elon Musk's tweets. These factors, among others, have also impacted the prices of bitcoin and other cryptos, adding to the price volatility.

Via these two lenses, investors can now understand why bitcoin has not acted as an inflation hedge in recent market conditions. Bitcoin's price history still paints a 30-day rolling volatility of 75.35% annualized.[8]

Another Idea

For investors hesitant about crypto's volatile nature, another idea is to consider using stablecoins to obtain a staking yield as an inflation hedge. The idea is that these cryptocurrencies, like USDT and USDC, are created to peg to the U.S. dollar; therefore, their value is intended to stabilize around $1. Staking allows investors to deposit their crypto for certain activities, such as providing liquidity and forming the lending pool. In return, the investor is rewarded, currently at 8.3% p.a. for USDT and 7.2% p.a. for USDC[9], much higher than the traditional currency strategies under current market conditions.

However, several risk factors come into play when putting your crypto at stake: market risk—coin value deviates from $1; collateral risk—quality and liquidity of the reserve assets, e.g., commercial papers; lock-up periods; counterparty risk; loss/theft, and so on.

Outside stablecoins, other crypto assets like Solana, Cardano and Avalanche are also popular options for staking. The staking rewards on these proof-of-stake assets are normally much higher than stablecoins, as the staked coins have the functional role of validating transactions on the blockchains, generating utility for the network. However, risks also exist in staking these assets.

Bottom Line

Investors habitually invest in gold, real estate, commodities and other real assets to protect against future inflation. 2021 created a set of complex market conditions that provided the opportunity to introduce bitcoin and other crypto assets as a potential investment idea. This nascent asset class introduces a liquid VC-like growth potential for investors to access disruptive blockchain technology. As more use cases develop and institutional adoption continues at low speed, we believe crypto assets like bitcoin have the potential to grow to stabilize and could act as an effective "store-of-value" solution in the future.

[1] https://coinmarketcap.com/charts, 3/21/22.

[2] https://www.coingecko.com/en/categories, 3/21/22.

[3] https://coinmarketcap.com/halving/bitcoin, 3/21/22.

[4] https://studio.glassnode.com, 3/8/22.

[5] https://tradingeconomics.com/country-list/inflation-rate-?continent=g20, 3/11/22.

[6] Based on SegWit and Taproot adoption trend; data available via glassnode.com.

[7] https://tradingeconomics.com/united-states/inflation-cpi#.

[8] CoinGecko, WisdomTree, 3/8/22.

[9] https://www.stakingrewards.com/earn/tether/, 3/21/22.

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There are risks associated with investing, including the possible loss of principal. Crypto assets, such as bitcoin and ether, are complex, generally exhibit extreme price volatility and unpredictability, and should be viewed as highly speculative assets.

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DEFINITIONS

Cryptocurrency : a digital or virtual currency that is secured by cryptography, which makes it nearly impossible to counterfeit or double-spend.

Federal Reserve : The Federal Reserve System is the central banking system of the United States.

Interest rates : The rate at which interest is paid by a borrower for the use of money.

Inflation : Characterized by rising price levels.

Volatility : A measure of the dispersion of actual returns around a particular average level. .