Making sense of bitcoin price increases

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Bitcoin pushed past $40,000 for the first time having run up over 265%1 since October 2020 and over 430%2 in the last 12 months, making it one of the best performing assets of 2020.

People often ask why has it moved this much? What's it worth? This is a hard question to answer for anything but harder still for bitcoin given the early stage of its life, its complicated ecosystem and the lack of an agreed fundamental valuation approach.

One answer is that if the price is going up, there are more buyers than sellers at a given price level – the better answer is that we're seeing constrained supply and increased demand being driven by a range of overlapping factors. In this blog, we'll have a look at some major factors that may be involved in this trend:

1. Structural supply reduction: The halving

On May 11, 2020, the bitcoin reward for mining blocks was halved. Given the nature of a bitcoin mining business, they consume resources priced in fiat currency (hardware, power) and generate bitcoin and they are consistent and natural sellers. The halving has reduced the supply and this puts upward pressure on price as people look to buy. For further insights, see here.

There is also an interesting valuation model based on this, called "stock-to-flow"3 which is used to assess the price of bitcoin by treating it as a store of value asset, such as gold, and determining value based on supply characteristics – the price has followed this surprisingly well.

2.Supportive central bank policy: Continued Quantitative Easing ("QE")

The devaluation of fiat currency4 is one of the prime investment rationales put forward for bitcoin and one that has resonated with investors around the world. In much the same way as gold, an asset with a fixed supply is likely to serve as an excellent inflation hedge as central banks print money at unprecedented rates in response to the events of 2020. As a result, bitcoin is finding its way into more and more people's investment portfolios.

3.Increased confidence: Recovery post Q2 2020 crisis

Bitcoin was hit by the 2020 market sell-off, as were all assets but it bounced back quicker than everything else. This was important for the cryptocurrency as many sceptics said it would fail at the first crisis; 2020 seemed to prove that sentiment was wrong, at least for the most recent crisis.

4.Social Proof: Consistent headlines of institutional adoption

Institutional adoption has come thick and fast in 2020. Not just in the investment space but also with corporates starting to hold bitcoin as part of their corporate treasury. Notably in 2020, Square Inc. bought $50mn, Galaxy digital bought $125mn and MicroStrategy Inc bought a massive $625mn. These are all listed companies and not crypto startups5.

Additionally, Paypal entered the crypto space announcing in October 2020 that it would allow payments in bitcoin. Having bitcoin used in this way, and by these companies, provides people with the confidence it is here to stay. Another interesting idea is that major purchases by large company treasuries also constrain supply as these are typically long term holdings. That said, the recent price moves may have thrown their portfolios out of balance so we may see some selling in the near term, but let's see.

5.Momentum or Fear Of Missing Out (FOMO)

This may be the oldest reason for anything. Investors pile into an asset while it’s on the way up and this is true for bitcoin more than any other asset class, especially when it is retail investors.

These five factors paint a picture of constrained supply and factors that support demand or, more accurately, make people feel comfortable to take advantage of it. Less supply + more demand = Price increases.

1 WisdomTree, Bloomberg. Data from 1st October 2020 to 7th January 2021.

2 WisdomTree, Bloomberg. Data from 1st January 2020 to 7th January 2021.

3 The Stock to Flow (SF or S2F) model is a way to measure the abundance of a particular resource. The Stock to Flow model is generally applied to natural resources and it attempts to value bitcoin in a way similar to other scarce assets like gold and silver.

4 Fiat money is government-issued currency that is not backed by a physical commodity, such as gold or silver, but rather by the government that issued it. The value of fiat money is derived from the relationship between supply and demand and the stability of the issuing government, rather than the worth of a commodity backing it as is the case for commodity money.

5 https://bitcointreasuries.org/

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