Investor's Outlook

Quarterly edition of investment ideas from the research experts at Francis

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Welcome to this quarter's edition of Investor's Outlook

The vision of this quarterly newsletter is to provide a high-level view of investing trends, philosophies, and practices that formulate our investment discipline.

In this issue, we're exploring cryptocurrency's transformative journey through the digital asset landscape.

Crypto's Colossal Comeback: Digital Dynamics Distilled

- After experiencing significant volatility and high-profile losses, the digital asset marketplace is maturing. The approval of Bitcoin ETFs and increased institutional adoption have marked a turning point, with total cryptocurrency market capitalization reaching approximately $3.2 trillion.
- Central banks and governments are increasingly engaging with digital assets, particularly stablecoins. These kinds of cryptocurrencies offer cost-effective international trade solutions, potentially reducing transaction settlement times and fees as well as broadening financial inclusion.
- Given the extreme volatility and high risk, limiting cryptocurrency exposure to no more than 5% of an investment portfolio is wise. Focus on established assets like Bitcoin and Ethereum, use dollar-cost averaging, and view cryptocurrencies as a small, diversified component of an overall investment strategy.

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Crypto's Colossal Comeback: Digital Dynamics Distilled

Introduction

As of early 2025, the cryptocurrency landscape has undergone a remarkable transformation, demonstrating that digital assets are more than just a flash in the pan. From its tumultuous beginnings to its current state, the journey of cryptocurrencies has been nothing short of extraordinary. Let's take a walk down memory lane, examine the present, and peer into the future as digital assets continue to evolve and, in some cases, thrive.

As illustrated in Exhibit 1, the history of cryptocurrencies is marked by extreme volatility with spectacular crashes followed by dramatic revivals. Bitcoin, the pioneer of digital currencies in a decentralized environment, has been at the forefront of this roller-coaster ride since its inception in 2009. Since their inception, both Bitcoin and Ethereum have exhibited volatility that dwarfs that of traditional financial markets, with Bitcoin's annualized volatility (as measured by standard deviation) often exceeding 60% compared to the S&P 500's typical range of 15-20%. This vicious price action has allured speculators, inspired entrepreneurs, but also put off many investors. As time has moved along, polarizing opinions about crypto and its future have often rivaled the strident tone which accompanies presidential politics.

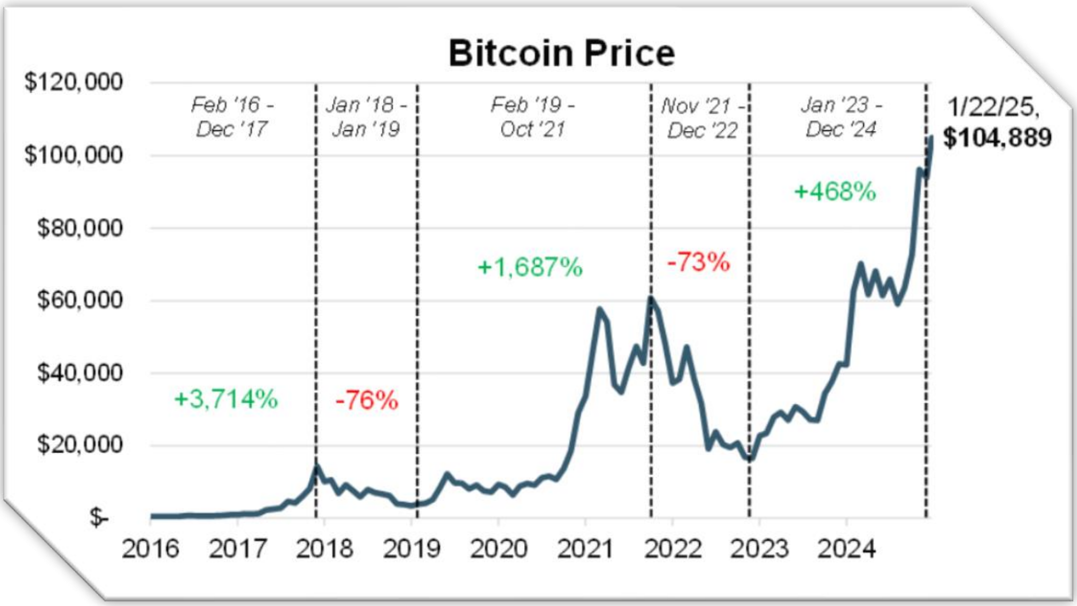
In its early days, cryptocurrency gained a reputation as the preferred medium of exchange on the dark web. The Silk Road, an online black market operating from 2011 to 2013, used Bitcoin to facilitate anonymous transactions for illegal goods and services. Countries like North Korea have reportedly used Bitcoin as a way to evade sanctions.

Many investors have accordingly balked at the notion of participating alongside the currency of choice for the contraband wares and clandestine operations, and many still do today.

Perhaps the truest test for crypto occurred in 2022 as the Federal Reserve embarked on rapidly raising the Fed Funds rate to fight off inflation. This choked off the easy capital available to support the crypto industry. Not only did Bitcoin plummet 64% in that year (74% since its then all-time high in November 2021), but the crypto world was also rocked by some high-profile collapses that shook investor confidence. In May that year, the Terra Luna ecosystem, led by the controversial and outspoken Do Kwon, imploded, wiping out billions in market value almost overnight. This was followed by the spectacular fall of FTX, one of the largest cryptocurrency exchanges, in November 2022.

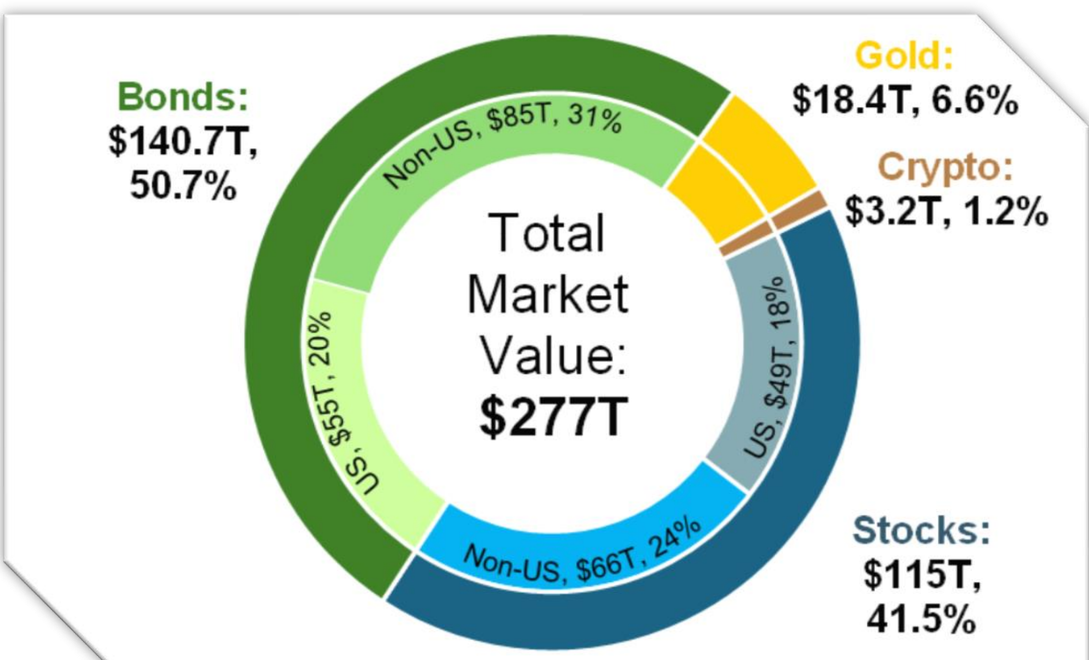
Crypto's Colossal Comeback

Exhibit 1 – Volatility of Bitcoin



Sources: Bloomberg, Francis LLC chart design and return calculations.

Exhibit 2 – Market Capitalization of Cryptocurrency vs. Liquid Assets



Sources: Stock and bond market values obtained from SIFMA and current as of 6/30/24, Cryptocurrency value obtained from cryptomarketcap.com as of 2/7/25, Gold value from econovis.net based on data from World Gold Council/World Bank and current as of 12/31/24.

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Crypto Chaos Spurs Regulation

The second order effects of these debacles brought down hedge funds and locked-up high yield lending programs offered by exchanges like Gemini with billions lost or inaccessible for over a year. These events led to increased calls for regulation and left many wondering if crypto was nothing more than the proverbial house of cards. While these entities challenged traditional business norms in nearly every regard as they ascended, their subsequent failures reinforced a cold, hard truth: despite the groundbreaking technological power of cryptocurrencies, they still had to operate under constraints applicable to the real business world.

Fast forward to early 2025 and much has changed. Regulatory clarity is emerging, and institutional adoption and product advancements have ushered in a new era for digital assets. The approval of Bitcoin ETFs in the United States marked a significant turning point for cryptocurrency adoption, allowing traditional investors to gain exposure to Bitcoin through familiar investment vehicles. This development led to increased institutional participation and record highs for Bitcoin with massive inflows.

In a surprising turn of events, the Trump administration, now back in office, has shown interest in adding Bitcoin to the U.S. Treasury reserves. This move, while controversial, has lent further acceptance to Bitcoin as a long-lived asset, though many debate whether it truly has any theoretical value.

> ***As time has moved along, polarizing opinions about crypto and its future have often rivaled the strident tone which accompanies presidential politics.***

Crypto's Evolving Narrative

The recent outperformance of cryptocurrencies has left some skeptics confounded, with even some long-time critics rethinking their prior conclusions. The narrative of crypto as a purely speculative asset is gradually giving way to one that recognizes its potential role in a diversified portfolio. As illustrated in Exhibit 2, cryptocurrency has now grown to just slightly over 1% of all the major liquid investable asset classes.

Some consider cryptocurrencies, such as Bitcoin, as a hedge to inflation but the relationship between Bitcoin's price and inflation is complex and evolving. The correlation between the two tends to be more pronounced in emerging economies with historically high inflation rates like India. Recent studies on that topic have shown a positive correlation between Bitcoin prices and inflation expectations, particularly in the short to medium term. However, the correlation is not consistent across all time periods or markets and is less defined on the home front. Given that there is only 15 years of data to evaluate, it is problematic to draw firm conclusions until more time passes. While Bitcoin has shown resilience during times of high inflation expectations in fiat currency markets, its price is also subject to other factors such as market sentiment, regulatory changes, and broader economic conditions.

Real Case Business Uses for Crypto

Looking ahead, the integration of digital assets into the global financial system appears set to accelerate, with central banks, governments, and corporations all playing significant roles. Many central banks are in various stages of researching, developing, or implementing Central Bank Digital Currencies (CBDCs).

One of the more talked about uses of cryptocurrency is found in the form of stablecoins, cryptocurrencies designed to maintain a stable value relative to a reference asset such as the U.S. dollar or the euro.

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Financial Disruptor: Stablecoins

These have emerged as a promising solution for reducing costs and facilitating international trade, offering significant advantages over traditional cross-border payment methods. It's anticipated that using stablecoins for remittances could reduce costs by up to 80%, with average fees ranging from 0.5-3.0% of the transfer amount.

This cost-effectiveness extends to businesses, potentially decreasing operational expenses associated with cross-border transactions and currency conversions. By treating money as digital information on a ledger, stablecoins enable near-instantaneous settlements, bypassing numerous intermediaries and making international transactions as simple as sending an email. This efficiency not only streamlines trade processes but also enhances liquidity, allowing businesses to react swiftly to market opportunities without traditional banking delays. Real-world applications are already underway, with companies like SAP testing cross-border USDC payments and Argentina-based Agrotoken enabling farmers to convert crops into commodity-backed stablecoins.

Furthermore, stablecoins have the potential to improve financial inclusion in international trade, providing access to digital assets and financial services for individuals and businesses in underserved regions with just a smartphone and an internet connection. However, it's important to note that challenges remain, including regulatory uncertainty and the need for further technological development. As the stablecoin network evolves, it is likely to play an increasingly crucial role in facilitating more efficient and cost-effective international trade, potentially modernizing the global financial landscape.

For investors considering how to approach this asset class, it's important to view cryptocurrencies in the context of the broader investment landscape. As of early 2025, the total market capitalization of all cryptocurrencies is approximately $3.2 trillion, which is still small compared to global equity markets ($115+ trillion) or the gold market ($18+ trillion). Given the still-speculative nature of many cryptocurrencies and the fact that they constitute no more than 2% of investable liquid assets, it's recommended limiting exposure to no more than 5% of an investor's total portfolio.

Investors now have several options for gaining exposure to cryptocurrencies, including self-custody through hardware wallets, regulated exchanges like Coinbase and Gemini, and cryptocurrency ETFs. When considering investment strategies, treat cryptocurrencies like other long-term investments, focusing on major assets like Bitcoin and Ethereum.

Among the most popular ETFs, investors have poured billions into the iShares Bitcoin Trust (IBIT), Fidelity Wise Origin Bitcoin Fund (FBTC), and the Grayscale Bitcoin Trust (GBTC). There are many other flavors of ETFs where leverage is employed to amplify long or short exposure to cryptocurrencies, but they are not recommended for hopefully obvious reasons.

Dollar-cost averaging can help smooth out price volatility over time, and viewing cryptocurrencies as one component of a highly diversified portfolio, similar to how some investors hold gold or other precious metals, can be a practical approach.

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Crypto's Institutional Journey

As we conclude our exploration of the evolving cryptocurrency landscape, it's clear that while risks remain, the range of potential outcomes has narrowed. The regulatory environment is improving, leading to increased adoption and integration with traditional financial systems. The rise of stablecoins and potential CBDCs is contributing to the further dollarization of the global financial system. Indeed, one way to think about cryptocurrency is its ease in facilitating more trade around the world in US dollar terms, which has great appeal for those in places like Argentina and elsewhere where inflation and unstable central bank policies have ravaged citizen's wealth time and again. In fact, we tend to see this as one of the strongest secular drivers of demand for cryptocurrencies as they can be an efficient way for the citizens around the globe to gain access to US dollars.

Grasping the dynamic nature of cryptocurrency's influence is crucial, while potential hazards persist. For instance, the recent advances in quantum computing could just as well be the "disruptor to the disruptor" to blockchain as crypto was to financial services.

For now, love 'em or hate 'em, cryptocurrencies are here to stay. While they may not replace traditional financial systems entirely, or could be the next building block which is itself disrupted, they are nevertheless carving out a significant niche in the global economy. For investors, the key is to approach this new asset class with caution, thorough research, and a clear understanding of both the potential rewards and the inherent risks.

Crypto's Colossal Comeback: Digital Dynamics Distilled

What's Important for Investors to Consider?

- *Cryptocurrencies' market cap ($3.2T) is small compared to global equities ($100T+) and gold ($18T+); limit exposure to 5% of portfolio due to speculative nature.*
- *Investors can access crypto via hardware wallets, exchanges, or ETFs; focus on major assets like Bitcoin and Ethereum for long-term investment.*
- *Treat crypto as part of a diversified portfolio, similar to precious metals; use dollar-cost averaging to manage volatility.*
- *Love 'em or hate 'em, cryptocurrencies are here to stay.*

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