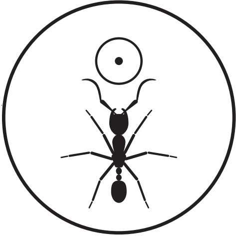

Myrmikan Research

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Return of the Winklevii

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One of the Winklevii (as the Winklevoss twins will forever be known) gave an interview this week that sent shivers through gold mining investors:

> We think that Bitcoin is like gold 2.0, so whatever your reasons for investing in gold, whether its scarcity, durability, portability, fungibility, we think that Bitcoin matches or beats gold across the board in all of those categories. It's actually not scarce, it's fixed. You can send it around like you send an email—it's a lot harder to do that with bars of gold. So, the market cap of Bitcoin right now is $300 billion; the market cap of gold is $6 trillion. We think that Bitcoin disrupts gold. We've been saying this since the market cap was $1 billion in Bitcoin. We're 300 times more correct today, and we think there's a chance we'll be 20 times more correct from here on out.

The argument is not bad. As discussed in Myrmikan's October 26 letter, Bitcoin does indeed exceed gold in every one of Carl Menger's elements of liquidity—except one: stability. The letter explains why Bitcoin can never be stable and, therefore, can have no monetary value; since it has no other claim to value, it will eventually end up at zero. But the reasons for this are admittedly subtle and far beyond the grasp of most economists, much less amateur speculators/investors.

According to a recent report by Deutsche Bank:

> 40% of cryptocurrency trading in Oct-Nov was yen-denominated. Japanese men in their 30s and 40s who are engaged in leveraged FX trading (or who used to trade but have stopped) are driving the cryptocurrency market. . . . Some major FX brokers are using the same 25x leverage limit that applies to FX trading, but there are no direct rules in leveraged trading of cryptocurrency. During the Swiss franc shock in January 2015, many retail investors not only received margin calls but also incurred losses greater than their margin balances, because forced settlements couldn't be implemented in a timely manner.

A bubble needs an increasing *rate* of speculative inflows to avoid collapse, which is why players like the Winklevii are frantically inserting the plumbing of wholesale and retail money markets into the Bitcoin network:

> We built Gemini.com, which is a licensed exchange custodian . . . it makes it easier for hedge funds to get involved—we have some of

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> the world's most sophisticated market-makers and prop trading firms already on Gemini. Phase 2 of that is trading a futures contract, which we've done with the CBOE [Chicago Board Options Exchange], that's cash-settled, which allows institutions that are already trading up in Chicago exchanges to get exposure to Bitcoin with cash and then settle out in cash; so they don't actually have to touch or feel Bitcoin, and they get the exposure to it. And I think the next phase to that would be something like an ETP or ETF product.

This scene from the Big Short explains what he's talking about:

https://www.youtube.com/watch?v=EEXTqtH-Oo4
[at 1:30]

Though institutions will be making side-bets on Bitcoin, these bets do effect the underlying market because every long futures contract requires a short. If there are no investors willing to go short, then the dealer has to create a short contract. The dealer then must balance his risk by going long the underlying commodity directly. Recall that the Bitcoin network can process only 400,000 transactions per day, which means dealers that have to make frequent Bitcoin trades would incur large expenses compared to a dealer that already has a huge amount of Bitcoin inventory on hand. This is the reason, no doubt, that the Winklevii spent $11 million of their $65 million Facebook settlement buying nearly 100,000 bitcoins at around $120 each in 2013. They can now use this inventory to backstop their dealer network.

This is extremely clever. It is not easy to sell large amounts of Bitcoin. Coinbase, the largest U.S. Bitcoin exchange, for example, allows unlimited deposits, but limits withdrawals. Right now the flows are inbound, so withdrawal limits should not matter much, yet they already have them. Imagine the scramble when everyone decides to get out.

The Winklevii, by organizing a primary dealer exchange, will have no trouble liquidating their estimated $1.6 billion (and climbing) worth of bitcoin. All they have to is take the short side of the futures contracts that institutions are buying. There is a close historical parallel.

During France's Mississippi Bubble from 1716 to 1719, Richard Cantillon (whom Murray Rothbard called the "father of modern economics") bought shares in the Mississippi Company early in the bubble, shares that would run from 200 livres to over 10,000. He then bought out his cousin's interest in the family bank and began issuing credit to speculators, taking their shares as collateral. The speculators used the credit to buy more shares, sending the price higher, which enhanced the value of their collateral, enabling them to borrow more—a classic bubble.

Cantillon perceived when the share price was nearing its apex and proceeded to sell not only his shares but also the collateral of his customers. When the share price collapsed, Cantillon bought back the now worthless shares to cover his short position and then moved to collect the full amount of the debts owed to him by the bank's clients. Cantillon became a multi-millionaire (when that really meant something) and died in mysterious circumstances fifteen years later.

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Like Cantillon, the Winklevii have positioned themselves as the most liquid player in the bubble, enabling them to liquidate their own position and go short when the time is right, if they have the wit. But the time is not yet ripe. "We've seen mortgages being taken out to buy bitcoin. … People do credit cards, equity lines," said the president of the North American Securities Administrators Association this week. As long as the price of Bitcoin increases more than the interest owed on these credit lines, it seems a good trade, and credit will continue to pour into the bubble—especially when an ETF becomes available. A Bitcoin ETF will allow retail speculators to use the margin capacity of their stocks held in their brokerage accounts, capacity that will expand along with Bitcoin prices.

Unlike every previous bubble in history, Bitcoin prices do not generate a supply response. Real estate bubbles cause overcapacity in real estate; government bond bubbles bring government spending and huge supplies of new government bonds; but the quantity of Bitcoin increases at a steadily slowing pace. And the higher its price runs, the more it seems to validate price targets of hundreds of thousands or even millions, enticing those who own Bitcoin to take them off the market. These dynamics could send Bitcoin's price significantly higher even from here, but the final price target will remain zero, or at most curiosity value, such as $100 trillion Zimbabwean notes, which now sell as curiosities for $90 each!

Calling the top of a bubble is no easy task, especially in this case. Normally a bubble pops shortly after cash flows of the speculative investments go negative. In other words, high real estate prices bring forth overcapacity, rents fall, operators cannot meet their interest payments and default, banks collapse. Those on the inside of the market have a good view of when cash flows start going negative and can get out.

In the present case, Bitcoin does not generate any cash flow, and there is no overcapacity to observe. Instead, the inflection point will come when those taking out mortgages and credit card and margin loans must sell to meet their interest payments, which will knock the price down, generate margin calls, knock the price down further, and topple the whole structure. Banks will suffer not because they are exposed to Bitcoin directly, but because the man who loses his mortgage advance to the Winklevii will be unable to make his mortgage payment. At present, the bubble by itself is surely too small to threaten the banking system. But, like subprime housing, the Bitcoin bubble could perhaps already act to trigger the unwinding of other bubbles. This potential will grow along with the mania.

Even if it not possible to observe the deleterious economic effects of Bitcoin directly, there are indirect consequences that are visible. Nvidia, a computer that manufactures Bitcoin mining computers, has seen its share price run nine times in the past two-and-a-half years and now sports a market capitalization of $133 billion. *The Wall Street Journal* reports that Michael Poutre, a stock broker once suspended by the FINRA and recently the CEO of a boutique jewelry designer, saw the shares of his new vehicle, Crypto Co., rocket from 1 penny a share less than three months ago to $478 currently, making his stake worth $3.9 billion (putting Mr. Poutre solidly into the Forbes 500 list). The *Journal* also notes that:

> A tiny Nasdaq biotechnology-equipment company changed its name in October to Riot Blockchain Inc., and its shares were up almost 10-fold

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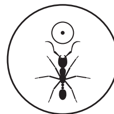
> by Tuesday's high, before dropping back a bit. British microcap On-Line PLC said in late October that it would add "Blockchain" to its name, and its shares more than quadrupled in a day on the news.

Readers will recognize these signs as phenomena that occurred toward the end of the internet bubble. The Winklevii had better hurry up with that ETF.

For gold investors, as is normally the case, patience is the key. Gold always does badly during credit bubbles, which tend to grow over long periods of time. Gold then soars in the very sudden busts. But patience is difficult. It is not easy to lose money when the crowd is making it (Dennis Gartman, for example, announced on Thursday that he is selling his gold position). That is the nature of contrarian investing.

Many bubbles end with one last spike higher, such as in 1999 and 1929. The Bitcoin phenomenon is likely the last flourish of Bernanke's bubble. When all the credit money in all the bubble markets in all the world finally panics into gold, the results ought to be spectacular.



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