

Is Bitcoin the New Gold Standard?

By: Henry Pizzutello, Chief Investment Officer

While we have already laid out our investment thesis for bitcoin as an asset class worthy of inclusion into an investment portfolio, there are still many who have seen the meteoric price increase of the last six months and determined that this is a “bubble” waiting to burst. Interestingly, the price of bitcoin has been burst no less than three times in the past ten years. Each time it has moved higher afterwards due to increasing utility and demand. Bubbles are not supposed to do this — they are characterized as such so that they cannot gently deflate and must burst, never to return.

Gold is traditionally thought of as an inflationary hedge, but its price has declined this year in the face of increased inflationary fears, and especially relative to the price of silver. In fact, in terms of silver, the price of gold has dropped almost 50% since COVID started last year. While gold has some industrial value, and silver even more so, their primary value is in the eye of the beholder as a store of value during inflationary periods. The market price does not justify significant intrinsic value, and while the same may be said of any currency, there is no government standing behind precious metals. The same can be said of bitcoin.

A better way to factor a valuation is to look at the relationship between gold and treasury bonds. Generally, treasuries outperform gold when markets are not concerned about inflation, while gold outperforms when there are inflationary concerns. However, currently both gold and treasuries are falling, even though there is widespread concern regarding future inflation as a result of the pandemic related government stimulus, which is considered to be potentially inflationary. Meanwhile, bitcoin has been making new highs.

If investors are truly worried about the long-term buying power of government-issued currencies, then gold should be rising in price, as it is perceived to be a store of value. One theory is that bitcoin has emerged as an alternative “anti-fiat” asset. It has gained popularity given the rise of anti-government sentiment that has been seen globally over the past few years and has been one of the central themes of all digital currencies since inception.

Bitcoin’s performance over the last year is more directly aligned with movements in bond yields. As yields have risen, so has the price of bitcoin. The implication is that the digital currency is benefitting from the belief that inflation is coming. While there is significantly more volatility in the price of bitcoin than gold, the fact remains that the price of bitcoin is acting the way gold should be in the face of impending inflation expectations.



Bitcoin and gold are both inflation-sensitive, but gold tends to outperform in economic downturns. In contrast, bitcoin seems to outperform during a stronger economy, even when the yield is rising. This is where we see global economies today, which helps to explain the differing price movements, as well as the overall resilience of equity markets. Bitcoin seems to be positioned as a better store of value against currency devaluation rather than gold. It has been designed so that the supply of new coin will reduce over time, and greater usage will continually skew the supply/demand dynamic upwards. While bitcoin will have more volatility and price declines than gold, the ever-limiting supply/demand dynamic means that one has to hold significantly less of the asset to achieve the same or even better protection. For gold to achieve the same inflation or devaluation protection as bitcoin, one would have to 4 or 5 times the amount, which can be a significant drag on overall portfolio performance.

Are Markets Entering the Irrational Exuberance Stage?

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We are now past the one-year anniversary of the March 23, 2020 market low. While the market has staged an unprecedented recovery since then, it is more important to look at what to expect going forward. The only historical comparisons to this recovery are the first 12 months off the 1982 low (+58%) and the first 12 months off the 2009 low (+69%). One of the things that must be taken into account in looking at these strong bounces off low points is how the second year of the recovery plays out. In the second year, performance tends to be more in line with historical averages and it tends to be more volatile as well. It is interesting that much of the move last year did not make sense to many people. Today, the picture is much clearer and the questions that investors were concerned about (economic growth, pandemic, U.S. election) are in much better focus now. However, the market performance is much more restrained and choppy — witness how the tech-heavy Nasdaq has struggled until recently, and the Russell 2000 has lagged the S&P and the Dow.

The chart below shows market performance following bear market lows for the past 60 years. You can see that the second-year returns are positive and generally above average historical performance, but there is more volatility associated with them, as seen in the third column.

S&P Performance 1st & 2nd Year Following Bear Market Low			
<u>Bear Market Low</u>	<u>1st Year Off Low</u>	<u>2nd Year Off Low</u>	<u>2nd Year Max Drawdown</u>
10/22/1957	31.0%	9.7%	-9.2%
6/26/1962	32.7%	17.4%	-6.5%
10/7/1966	32.9%	6.6%	-10.0%
5/26/1970	43.7%	11.1%	-11.0%
10/3/1974	38.0%	21.2%	-5.1%
8/12/1982	58.3%	2.0%	-14.7%
12/4/1987	21.4%	29.3%	-9.2%
10/11/1990	29.1%	5.6%	-6.8%
10/9/2002	33.7%	8.0%	-8.8%
3/9/2009	68.6%	15.7%	-17.1%
3/23/2020	74.9%	?	?
Average	42.2%	12.7%	-9.8%

As equity markets continue to make new highs, investors are asking, “When is the equity market bubble going to burst?” more and more frequently. We all know what happens to a bubble in real life — it gets larger and larger until it ultimately pops. In the investment world, a bubble is defined as an asset class with an unsustainably high price that will ultimately “burst” and fall back to more normal values. However, a high price does not by itself signify a bubble condition; there are a number of factors that should be evaluated in order to make that determination. While there are numerous factors that may be considered, taken together, these four factors have been reliable indicators of previous market tops:

- Current prices are high relative to historical measures
- Current values reflect unsustainable future expectations
- Concentration in equity exposure is high relative to historical levels
- Market sentiment is overwhelmingly positive

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	Roaring 20's 1926-29	Dotcom Era 1999-2000	Financial Crisis 2007-2008	Current Market 2020-2021
Current price relative to historical	HIGH	HIGH	AVERAGE	ABOVE AVERAGE
Future Value Expectations	HIGH	HIGH	AVERAGE	AVERAGE
Equity exposure	HIGH	HIGH	ABOVE NORMAL	AVERAGE
Market Sentiment	HIGH	HIGH	ABOVE NORMAL	ABOVE AVERAGE
Interest Rates	HIGH	HIGH	HIGH	LOW

Based upon the aggregate measures in the table above, we are not yet in bubble territory. However, underneath the hood, there is a very big divergence across different sectors in the overall indices. Companies in sectors, like emerging growth technology, measure as being extreme in terms of bubble conditions. However, while the overall market capitalization of technology companies has increased (particularly emerging technology companies), the number of “bubble-level” valuations is less than half of what it was during the 2000 technology crash. This makes a crash scenario much less likely.

Prices Relative to Historical Levels

Current market price valuations place in roughly the 80th percentile, which means that valuations have been lower 80% of the time. While this seems somewhat ominous, it must also be taken into context. Market valuations have been at this level previously and have not crashed. The two most oft compared periods to the current market have been the 1929 Great Depression and the 2000 technology crash. Both of those valuation levels were in the 99th percentile, and we are not close to that level. More important is the relative valuation of equities to interest rates. In 1929 and 2000, 10-year rates were close to 6% compared to the 1.65% of today. On a relative basis, equities are still much cheaper than the fixed income alternative.

Are Current Values Reflecting Unrealistic Growth Expectations?

While economic growth has been strong, it is also coming off the extremely low levels caused by the pandemic shutdown. Expectations are for continued strong growth globally, as the combination of coordinated central bank stimulus efforts and continued low interest rates have provided a runway for growth to continue. One potential issue that has come to the forefront recently is the specter of inflation caused by the rapid increase in global debt levels. While inflation is something to be considered, it is also important to note that the advancements in global technology have been deflationary and will continue to be in the future. Additionally, in the U.S., the effect of inflation is much less pronounced on markets than previously. Twenty years ago, energy made up more than 20% of the S&P capitalization — now, it is less than 5%.

Level of Equity Concentration

While it should follow that market tops are characterized by heavy inflows into equities, the reverse was true in 2020 and has continued into 2021. Equity mutual fund flows have been **negative for 10 of the past 12 months** while fixed income flows have increased and money market funds have shown massive increases. There is a lot of money sitting on the sidelines, which is contrary to what would be seen in a market top.

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How Broadly Bullish Is Sentiment?

The theory says that the more bullish the sentiment, the more people have already invested, so the less likely they will invest more and the more likely that they will sell. Aggregate measures of sentiment place the current market in the 80th percentile, which is just above the top of the “normal range” of 50%-75%. Once again, the sentiment is heavily concentrated in the high growth technology sectors rather than most stocks. The outperformance of the Russell 2000 over the Nasdaq over the past six months underscores this point.

While this analysis does not provide a total answer to the question of when a market will ultimately go through a correction period, as is inevitable, it does give some context as to how extreme the potential “bubble valuation” may be. As the factors above have shown, we are in a higher-than-normal absolute market valuation, which is made more realistic by the current relation to low interest rates. Many times, this has been rectified by rolling corrections in different overvalued sectors throughout the overall markets without a major correction taking place.

