The CIO View

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Putting Wealth To Work For Generations

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The CIO View – Bitcoin and Gold

JBWere View

Both Bitcoin and gold have rallied quite sharply in 2024. For the former, product innovation and an easing of financial conditions have likely driven an increase in investor interest. For the latter, greater uncertainty about the disinflationary narrative and elevated geo-political risks may have supported recent price action. While some investors are happy to characterise Bitcoin as “digital gold”, we disagree with this assessment. Accordingly, the case to allocate capital to Bitcoin in multi-asset portfolios remains unproven, in our view.

Key Points

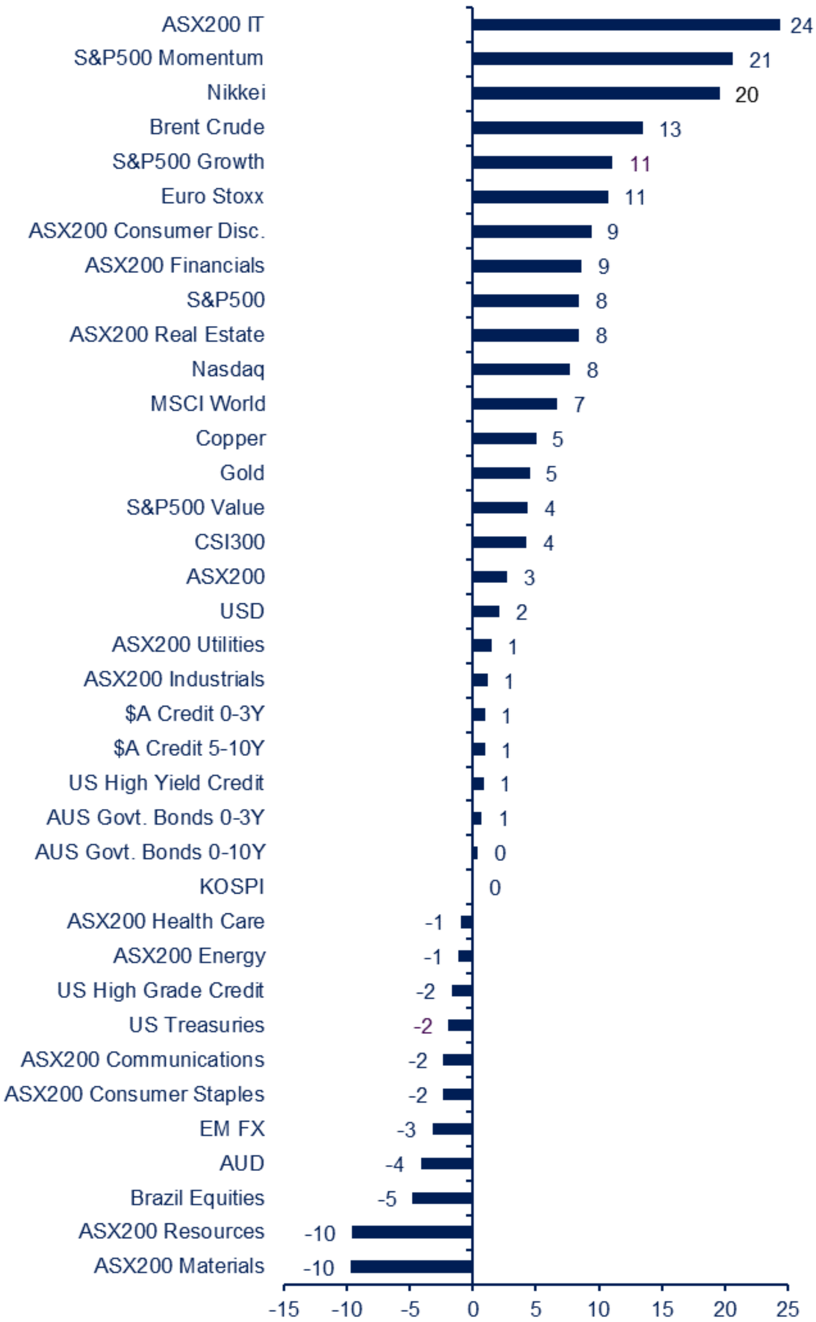
- Both Bitcoin and gold have rallied this year. Indeed, gold is up 9% in $A terms so far this year, and remains one of the better performing parts of a multi-asset portfolio. While the drivers of the gold price are well understood, the same cannot be said about Bitcoin. In part this is because it has a short and volatile history and is yet to experience the demands of a full business cycle.
- The approval of Bitcoin ETFs by the SEC earlier this year has clearly been a driver of inflows into Bitcoin. Product innovation, together with the approach of a Bitcoin “halving event”, have likely helped to support the price of late. We can also draw some tentative relationships between the price of Bitcoin and movement in broader financial conditions.
- Those who argue for the inclusion of Bitcoin into multi-asset portfolios often describe Bitcoin as “digital gold”. We take issue with this description, given Bitcoin is not a reserve asset and unlike gold, is yet to show any utility as a hedge against drawdowns in risk assets. Hence its role in a multi-asset portfolio, should it be included, will be quite different to that of gold. Readers familiar with our research will know that we have for some time been strong advocates of the role that gold should play in a multi-asset portfolio, but we believe that the case for Bitcoin to be considered as a component of multi-asset portfolios is far from justified.
- Deploying Bitcoin to portfolios might add some variety to an investor’s growth asset exposure, but it brings no income stream, doesn’t provide much diversification benefit and potentially, raises many ESG issues. For example, the Chair of the SEC described Bitcoin as “*…also used for illicit activity including ransomware, money laundering, sanction evasion, and terrorist financing.*” Sympathy with this characterisation will likely see Bitcoin fall at the first hurdle in the investment process.

Japanese equities have followed 2023's gains with a strong start to 2024, despite the BoJ lifting interest rates this week for the first time in 17 years

Market summary

So far this year, growth assets continue to out-perform. Once again, the small ASX200 IT index has taken top position, registering gains of 24% year-to-date. This sector has been helped by strong gains in WiseTech (WTC), Life360 (360) and Iress (IRE). The Nikkei remains the strongest performing equity market in our subset in **Chart 1**, up 20% so far this year. Locally, the ASX200 is up 3% so far this year. Australian fixed income is holding in well relative to its US counterpart, with Australian yields holding in as US yields have moved higher. In FX, 2024 has been defined by USD out-performance, leaving AUD/USD down 4% and EM FX down 3%. Oil has been the standout in the commodity space, up 13% in 2024. In contrast, gold has risen 5% while copper is unchanged to start the year.

Chart 1: Year-to-date returns, selected financial assets (local currency); %



Source: Bloomberg and JBWere. Past performance is not a reliable indicator of future performance.

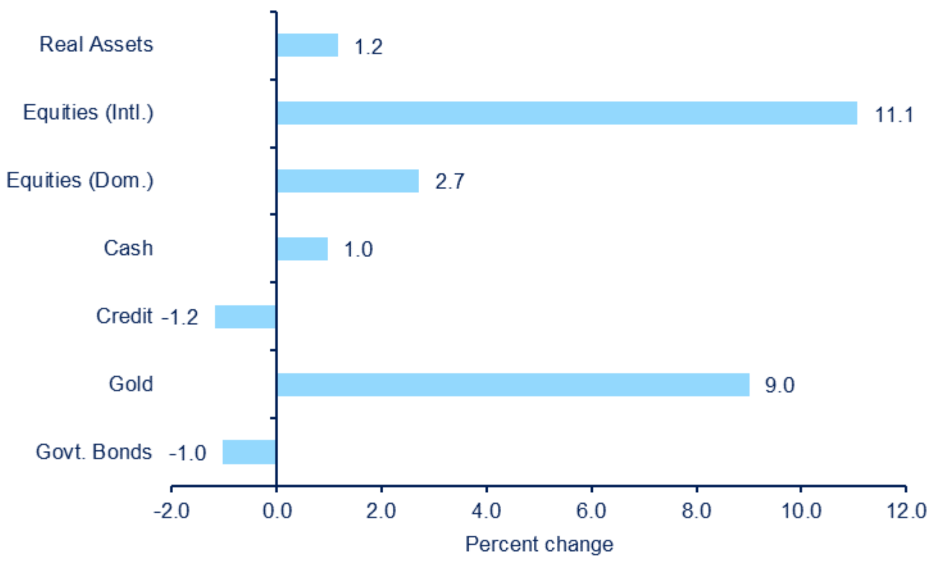
Chart 2 shows the seven asset classes we use in our Strategic Asset Allocation (SAA) ay JBWere and illustrates quarterly performance for these seven asset classes. As a reminder, the benchmarks for each asset class are as follows:

- **Cash**: weighted average of the Bloomberg AusBond Bank Bill Index (50%) and the Australian Banks' Term Deposit 1-year rate (50%)
- **Government Bonds**: Bloomberg Barclays Global Aggregate Treasuries Total Return Index, hedged into AUD
- **Credit**: Bloomberg Barclays Global Aggregate Credit Total Return Index, hedged into AUD
- **Domestic Equities**: ASX200 Total Return Index
- **International Equities**: MSCI ACWI Gross Total Return Index, AUD unhedged
- **Real Assets**: weighted average of the FTSE EPRA/NAREIT Global Index Total Return, AUD unhedged (50%) and the FTSE Developed Core Infrastructure 50/50 Total Return Index, AUD unhedged (50%)
- **Uncorrelated Assets**: we proxy using the $A price of gold

For $A multi-asset investors, global equities and gold have been the best performing assets so far

Once again, international equities are the standout performer in the multi-asset portfolio. Gold has also performed for local investors, with weakness in the AUD conspiring with a stronger gold price to deliver 9% returns this year. Fixed income indices have posted modest declines to start the year, while real assets have gained a little over 1% and domestic equities are up almost 3% for the year so far.

Chart 2: Strategic Asset Allocation – 2024 year-to-date returns



Source: JBWere and Bloomberg. Past performance is not a reliable indicator of future performance.

Bitcoin and Gold

Both gold and bitcoin have rallied since October last year

Despite a modest pullback of late, both Bitcoin and Gold have rallied significantly since October (**Chart 3**). The approval of ETFs for Bitcoin in January has clearly been a large part of this dynamic; Blackrock has reported that its Bitcoin ETF has been the fastest growing ETF in history. We are also approaching a bitcoin "halving" event (reducing the rate at which bitcoin can be mined). So easier access to Bitcoin and scarcity issues may be behind its recent surge.

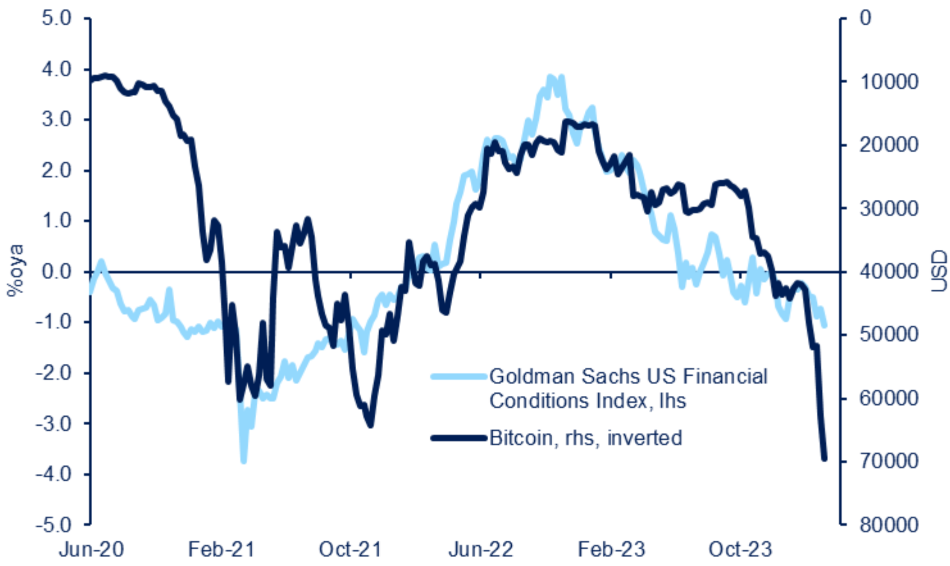
Chart 3: Bitcoin and Gold have both rallied in the past 5 months

Source: JBWere and Bloomberg. Past performance is not a reliable indicator of future performance.

Typically, we have seen Bitcoin rally when financial conditions ease, or when real yields are falling (**Charts 4 and 5**).

Bitcoin appears to rally as financial conditions ease

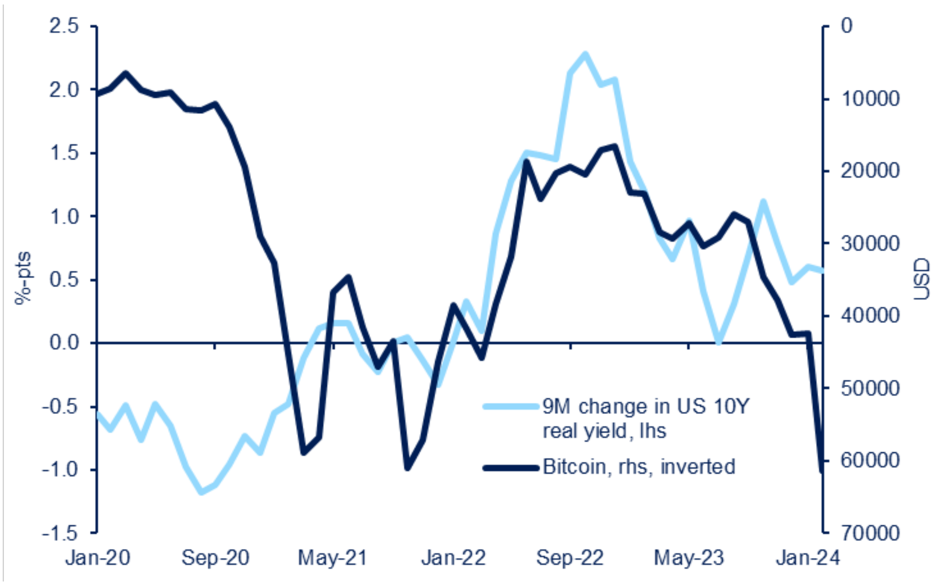
Chart 4: Bitcoin appears to rally when financial conditions loosen



Source: JBWere and Bloomberg. Past performance is not a reliable indicator of future performance.

And rallies as real yields decline

Chart 5: Bitcoin also appears to have a negative correlation with movements in US real yields



Source: JBWere and Bloomberg. Past performance is not a reliable indicator of future performance.

So product innovation, expectations around curtailed supply and easier financial conditions have all likely played their role in Bitcoin's recent rally. But given Bitcoin's short and volatile existence – which can be effectively summarised as a rally in 2020-21, a sell-off in 2022 and a rally in 2023/24) – we don't have much in the way of historical relationships to rely upon when trying to ascertain fundamental drivers of price changes.

While gold and bitcoin have both rallied together in recent months, we do not agree with the view that bitcoin is "digital gold"

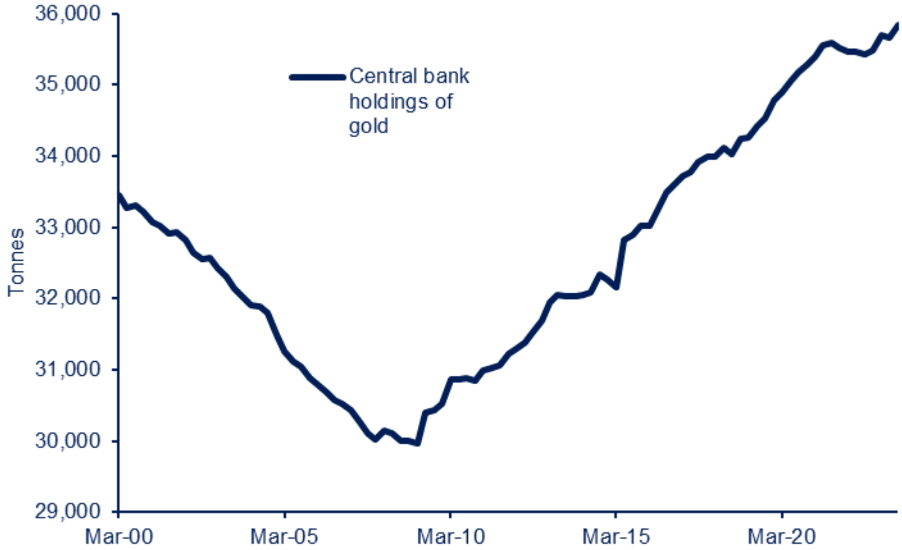
Another reason for Bitcoin's rally is likely to be some investors' perception of Bitcoin as the digital version of Gold. Indeed, at least in the last 2 years, the price action in Gold and Bitcoin have been quite similar. However, we should importantly note that while there might be some positive correlation between the price of Gold and the price of Bitcoin, the latter runs close to four times the realised volatility of Gold. So in risk-adjusted terms, the rally is not truly comparable (ie, Gold has out-performed). Perhaps more importantly, **we do not hold the view that Bitcoin is "digital gold"**. Gold is a reserve asset and has historically worked well as a hedge against drawdowns in risk assets. Bitcoin possesses neither of these characteristics, and so we would be cautious about reading too much into similarities in the price action of gold and Bitcoin.

What about gold? As noted, it too has had a strong performance of late (**Chart 3**). In the short-term, often gold rallies when **1)** investors are worried about inflation; **2)** investors experience increased risk aversion (for example, geo-political concerns); **3)** real interest rates fall or **4)** the USD weakens.

Over a longer-term horizon, we have noted in prior research that gold can be the beneficiary of structural de-dollarization flows and currency debasement. Indeed, the structural bid for gold by central banks was one of the key underpinnings to our call a few years ago that gold should be added to multi-asset portfolios as part of the Uncorrelated Strategies asset class.

> *Rising central bank holdings are a structural and long-term source of demand for gold, in our view, and further cement gold's status as a reserve asset*

Chart 6: Central bank holdings of gold increased in the wake of the financial crisis, and have started to increase again in recent years



Source: JBWere and World Gold Council. Past performance is not a reliable indicator of future performance.

Data from the World Gold Council show the steady accumulation of gold by central banks in the post GFC environment, but also a further increase in recent years (**Chart 6**). In terms of other shorter-term drivers of gold, we note that inflation expectations have started to rise again (**Chart 7**). And it would be fair to assume that some investors are worried about geo-political developments. US real 10Y yields are still 50bp lower than their peak in October, which is likely helping to support gold prices too.

Chart 7: Short-term measures of inflation expectations have risen of late in the US

Source: JBWere and Bloomberg. Past performance is not a reliable indicator of future performance.

Regular readers will know that we have advocated for a modest allocation to Gold in the Uncorrelated Strategies component of portfolios for a number of years. We would be hesitant to add to the allocation while Gold trades above US$2000/oz, but think it worthwhile considering adding to the allocation should Gold correct sub US$1800/oz.

What about Bitcoin? We wrote a few years ago that we didn't believe the elevated realised volatility of Bitcoin warranted addition to the portfolio. For example, since

Bitcoin offers no income stream to investors, nor appears to have utility as a hedge against drawdowns in risk assets

It does not appear to rank favourably on ESG criteria

2020, Bitcoin returns (in $A) run just over 5 times the realised volatility of Gold returns (in $A). **We also noted that it was hard to discern what sort of asset it was, given its strong positive correlation to other growth assets**. Indeed, the correlation coefficient between monthly returns in the Nasdaq and Bitcoin is 0.46, while the correlation coefficient between monthly returns in Gold and Bitcoin is 0.21 (using data from Feb-19 to Feb-24). So over the past 5 years, returns in Bitcoin have behaved more like a growth asset than an uncorrelated asset.

So if for now, we assume price action in Bitcoin is more like a traditional growth asset than an uncorrelated asset, **should we substitute some exposure to conventional growth assets for Bitcoin? The first point to note is that there is no income stream that comes as a consequence of holding Bitcoin**. This is an important distinction, especially for portfolios that are structured to maximise income. On current forecasts, we see long-run income forecasts for real assets at ~4%p.a., domestic equities ~5% p.a. and international equities ~2%p.a. Total return for these assets includes the income forecast and the capital gain. But for Bitcoin, the total expected return is thus capital gain only. And unlike other asset classes, where we can use modelling based upon economic and market fundamentals to determine both the long-run expected capital gain and income flow, we have nothing at present to anchor our future return expectations for Bitcoin.

On this point, we think it interesting to note recent analysis by J.P. Morgan. They assume an implied total $ allocation to Bitcoin in investor portfolios the same as that of Gold in vol-adjusted terms. Dividing this total $ allocation to Bitcoin by the number of available units of Bitcoin suggests a "fair value" price of $45k, some ~30% below current levels.

The second point is the ESG aspect of Bitcoin. While many investors focus upon the environmental impact of Bitcoin mining (energy consumption), we would draw readers' attention to the SEC Chair's comments on Bitcoin earlier this year (see ***here***)**:**

"*Though we're merit neutral, I'd note that the underlying assets in the metals ETPs have consumer and industrial uses, while in contrast* ***bitcoin is primarily a speculative, volatile asset that's also used for illicit activity including ransomware, money laundering, sanction evasion, and terrorist financing***." (our emphasis)

For most investors, ESG focused or otherwise, an asset regarded as "used for illicit activity" by US regulators is probably not worthy of consideration for inclusion in a portfolio.

In summary, the introduction of Bitcoin ETFs has clearly made access to this financial instrument easier for many investors, both retail and institutional. In that regard, it removes one previously difficult (and often expensive) hurdle to the introduction of Bitcoin to a portfolio. **But there are still a number of key decisions investors need to make considering Bitcoin's place (or otherwise) in a multi-asset portfolio**. These are:

- Where in the portfolio should Bitcoin be housed? Is it a growth asset or a digital version of gold (ie, an uncorrelated asset)?
- Does it matter that Bitcoin does not provide investors with an income stream?
- What are the ESG consequences of including Bitcoin in a portfolio?
- How much should the investor allocate to Bitcoin given its strong positive correlation with risk assets; what, if any is, the diversification benefit?
- Are the risk-adjusted returns from including Bitcoin in a portfolio attractive enough to warrant the lack of income and potential ESG issues?
- How does an investor assess fair value for Bitcoin?

When compared to Gold, the investment thesis for Bitcoin is in our view, far more challenging. We discussed the rationale for an allocation to gold in multi-asset portfolios two years ago in detail ***here***, but we re-iterate the key points:

In our view, the investment thesis for gold is far more compelling, compared to Bitcoin

- Historically, gold has held its own as a hedge against major drawdowns in risk and thus provides some insurance benefit to portfolios;
- The fair value price of gold can be determined by fundamental drivers (such as real yields, money supply growth and structural demand flows);
- Gold should not be viewed as a commodity, but rather, a reserve asset (unlike crypto-currencies); and
- Our backward looking analysis suggests that optimal allocations to gold in a multi-asset portfolio are consistently in the 5-10% range, suggesting it offers true and proven diversification benefits to portfolios.

To conclude, we observe that the recent rally in Bitcoin has once again spurred discussion about whether it demands an allocation in multi-asset portfolios. Those who argue in the affirmative on this issue often describe Bitcoin as digital gold. We take issue with this description, given Bitcoin is not a reserve asset and unlike gold, is yet to show any utility as a hedge against drawdowns in risk assets. Hence its role in a multi-asset portfolio, should it be included, will be quite different to that of gold. Accordingly, we believe that the case for Bitcoin to be considered as a component of multi-asset portfolios is far from justified. Deploying Bitcoin to portfolios might add some variety to an investor's growth asset exposure, but it brings no income stream and potentially, raises many ESG issues.

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