Here's Why Cryptos Plunged on News from China

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It’s been an astonishing week in the crypto markets, with two major stories dominating the lines.

As readers of *Exponential Investor* will know, companies are increasingly turning to initial coin offerings (ICOs) to raise finance, instead of conventional share sales. These have led to some pretty outlandish valuations. Just over a week ago, we saw the first billion-dollar valuations for post-ICO firms.

The two “unicorn” companies (OmiseGO and Qtum) have seen astonishing rises in the value of their coins, after raising relatively modest sums at ICO. This has given ICO investors a paper return of over 40x and 55x, respectively. Neither of these firms even has a working product, and I would not be at all surprised to see a substantial correction in their valuations.

This whole scenario feels rather like the dotcom bubble, which ended in a nasty crash. However, the music’s still playing, so don’t feel like it’s too late to join the party – but be careful. We’ve given you plenty of warning about the huge profits to be made – and the risks.

Despite this bullish news, the past fortnight has not all being plain sailing.

China is flexing its muscles in the cryptocurrency space, and that’s had a huge impact on markets. Firstly, the Chinese government has banned ICOs completely. This ban is not only forward-looking, but also retrospective. Companies who’ve been involved in ICOs have been commanded to return investors’ money. This is not only catastrophic for the firms involved, but has also served to stoke the fires of a panic on the bitcoin markets – causing a $400 price drop, in mere minutes. This crash was seemingly triggered by reports that China was about to close down the country’s crypto exchanges completely. These rumours now appear to be incorrect – but policy could of course change, and that’s why the market’s on a hair-trigger.

When an asset class is as volatile as crypto, there’s always a position to trade – and something to write about. You should be aware of the “hype cycle” – just because something’s generating coverage doesn’t mean it’s useful or valuable. If you’d like to read more about my views on hype in this market, check out my beef with bitcoin.

What’s the underlying story here?

China’s economy is obviously a behemoth. Despite the country’s importance, it’s difficult for Westerners to fully appreciate the influence and perspective of the Chinese government. Our cultures are very different; it’s difficult for outsiders to interpret the nuances of an administration operating in a system so different from ours.

To gain an insight into why cryptocurrencies are spooking the Chinese government, it’s necessary to have an understanding of how Chinese society works. Without delving into the detail of what makes China unique, we can regard the country broadly as we would any other authoritarian regime.

Such countries often have a range of features in common – such as restricting media freedoms, and jailing dissidents. From an economic point of view, powerful bureaucracies tend to engender corruption. Powerful, unaccountable officials take every possible opportunity to pilfer money, and look after their associates.

While China has made moves to tackle this problem in recent years, it’s still wallowing in the lower leagues of transparency indices. Despite 300,000 people falling foul of a corruption crackdown, it’s widely believed that those linked to senior levels of the party machine are still enjoying the fruits of their connections. This is known as the “tigers and flies” issue – and the tigers are typically assumed to have an easier ride. After all, it’s easy for corrupt bigwigs to deflect attention from their own graft, if they’re delivering the scalps of lowly minions.

This concentration of wealth in the hands of well-heeled but nervous plunderers leads to widespread capital flight. People with questionable wealth are keen to place it beyond the reach of the authorities in their home country – both for safe-keeping, and to disguise their crimes. Furthermore, as a regime prone to capricious changes of policy and favour, China can be a risky place to operate in. Rising stars can quickly fade, if it suits the party’s elite. Of course, a little fear is always useful for ensuring discipline.

As such, many Chinese are keen to place not only their wealth, but also their families, outside the country. That’s one reason why countries such as the UK have seen such an influx of Chinese middle-class money into housing and education – as successful and well-connected Chinese citizens seek a safe-harbour country. Cryptocurrencies are just one more tool that light-fingered or fearful Chinese can use to move their wealth beyond the reach of their government.

As you may be aware from the existence of the so-called "Great Firewall of China", the Chinese state is very keen to exert exacting control over what its citizens see and do online. In fact, the country has the largest bureaucracy in the world, dedicated to policing the internet. It appears that trading crypto isn't necessarily going to fall within its definition of acceptable for long – and that might is hard to fight.

Because of the unreliability of Chinese news, word of mouth (including social media) is an important way of conveying information. This fulfils a different role than it does in the West, where the media is generally trusted (albeit with occasional reluctance). The power of the Chinese government, coupled with the tightly controlled media, makes China a particularly fertile place for rumours.

Last week's $400 bitcoin flash crash is a good example of how such rumours can spiral out of control, and spook markets. Nevertheless, it's not unreasonable for investors to be jittery. As India's cash clampdown showed, governments trending towards authoritarianism get keener to control money flows.

China's moves to stop ICOs, and rumoured moves to control bitcoin, make perfect sense in the wider context of Chinese policy. Having a form of wealth which is outside government control is both a challenge and a snub to an all-powerful government. This is not simply about conventional economic policy instruments. More importantly, it's about the freedom of individual Chinese citizens, acting en masse, to participate in capital flight to territories beyond the reach of their government – often with pockets full of pilfered cash.

As you can see from the political vista we've discussed above, I doubt we've heard the last from China on bitcoin. The country's policies and rumours will continue to move crypto markets, and investors of all stripes should be aware of the potential impact of such moves on the wider economy. Any with exposure to crypto, both direct and indirect, needs to be well-versed in the influence of China on this space. If you're looking to acquire expertise in cryptocurrency, you'd be well advised to start with Sam Volkering's guide. Our offers in *Exponential Investor* don't last forever, and I suspect this one will soon be withdrawn. So if you're looking to profit, act now – or you may well regret it.

What are your thoughts on China and crypto? Please let us know: andrew@southbankresearch.com.

Best,

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