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A look inside cryptocurrency’s wild ride

By Gene Walden, Senior Finance Editor | 06/14/2022

Cryptocurrency: Is it a currency? Is it an investment? Is it an inflation hedge? Is it a whole new and improved way to execute transactions?

Questions continue to swirl around the viability of cryptocurrencies like Bitcoin. But one thing is certain: it continues to proliferate into the public consciousness thanks to a slew of TV commercials, cryptocurrency mobile apps, and even grocery store cryptocurrency kiosks.

About 34 million Americans own cryptocurrency as of 2022, up from about 10 million in 2019.[i] Worldwide, crypto ownership grew from about 106 million to 295 million in 2021, according to Crypto.com, which projects that worldwide crypto ownership may reach about one billion people by the end of 2022 – although that projection may be somewhat optimistic due to crypto’s recent slump.

Yet, amidst all the hype and user growth, cryptocurrency prices continue to be extremely volatile. After reaching a high of more than $67,000 in November 2021, Bitcoin has steadily dropped to about $22,000 as of June 2022. While Bitcoin is often considered to be a hedge against inflation or other investments, that has not been evident in recent trading. As stocks and bonds declined in price over concerns about inflation in 2022, cryptocurrency fell even faster and further than any of the key market exchanges.

Cryptocurrency has been slow to gain traction as a means of exchange because of that volatility and the steep learning curve for consumers and businesses. While it remains a highly speculative investment, cryptocurrency is far from dead. Despite its flaws and extreme volatility, crypto has some strengths that could keep it on the forefront of the financial markets well into the foreseeable future.

(To learn more about cryptocurrency, see: **Bitcoin – Bonanza or fool's gold?**)

What's the draw of cryptocurrency?

While cryptocurrencies such as Bitcoin are designed to be used as a form of money, crypto transactions make up just a fraction of total financial transactions. As of 2022, there are about 250,000 to 300,000 Bitcoin transactions per day worldwide, while Ethereum – another popular cryptocurrency– has grown to more than one million transactions per day.[ii] By comparison, there are approximately one billion credit card transactions per day.

Most cryptocurrencies are touted as "decentralized" currencies with no state central bank to issue it or oversee it. Transactions are verified in a distributed public ledger known as a blockchain. A key feature of blockchain is that it records all transactions and can never be altered. Your balance – the sum of all cryptocurrency purchases and sales – would always be accurate.

Bitcoin is the most popular cryptocurrency, with about $500 billion in market capitalization as of June 2022, followed by Ethereum with a market cap of about $200 billion. Ethereum is more than just a store of value, but rather a decentralized blockchain platform designed to offer smart contracts, programmable money, and decentralized applications.

Nearly 20,000 cryptocurrencies have been created,[iii] and about half of those have already been abandoned.[iv] Taken together, Bitcoin and Ethereum comprise approximately two-thirds of the $1.2 trillion market cap (as of late May 2022). The top 10 cryptocurrencies make up about 85% of the market cap, and 99% of all crypto value is in the top 1% of coins.[v]

Limiting currency bloat

Bitcoin was designed to serve as a long-term hedge against inflation. A key feature of Bitcoin that has helped attract a broad following is the limitation that only 21 million units can ever be put into circulation. Since an increasing supply of dollars is a key cause of inflation, the creators of Bitcoin attempted to curb that inflationary pressure by putting a cap on the total number of Bitcoin units in circulation.

By contrast, central banks of sovereign nations have the authority to issue an unlimited amount of currency.

To understand the significance of maintaining a stable supply of currency, you need look no further than the growth of the U.S. money supply. According to the Federal Reserve, the M2 money supply – which is made up primarily of all physical cash in circulation, checking and savings deposits, and money market funds – grew by about 30% from January 2020 through March 2022 – and has grown nearly five-fold since January 2000, from about $4.6 trillion to nearly $22 trillion.

That means nearly five times as many dollars are chasing a relatively static supply of goods and services, which tends to trigger inflation. But as more dollars are being poured into the economy, the supply of cryptocurrencies like Bitcoin remains stable. That means that a quickly rising supply of dollars are chasing a fixed number of Bitcoin units. Theoretically, that should drive up the dollar value of relatively static cryptocurrencies like Bitcoin. However, so far, there has been no reliable correlation between inflation and the value of Bitcoin.

Cryptocurrencies have not performed as either an inflation hedge or a market hedge. Instead, the crypto market has performed more like a levered tech stock than a bar of gold.

Unlike Bitcoin, Eth (the name of the Ethereum currency) does not have an explicit maximum supply; however, it is created according to a predictable schedule which makes inflation expectations predictable. Furthermore, recent protocol changes require small amounts of Eth to be destroyed, or ‘burned’, for every transaction. As a result, Eth is deflationary when the amount of Eth burned in transactions exceeds the newly minted Eth.

Crypto as a new financial tool

While cryptocurrency is used as a form of currency for the purchase of goods or services, the financial aspects of crypto go well beyond simple transactions. The greatest potential of cryptocurrency may be in an area known as “decentralized finance” – or simply “DeFi.”

“DeFi offers the ability to earn income from lending, staking and providing liquidity to trading pools,” explains Paul Landahl, Thrivent Asset Management Senior Quant Analyst. “This capability could ultimately lead to a sweeping transformation across the financial landscape. DeFi is the most important thing going on in the crypto space right now, and it could eventually reshape the financial world.”

Crypto innovators have already replicated most of the financial system on the blockchain, according to Landahl. “For example, with only a web browser, someone can construct something similar to an ETF (exchange traded fund) and sell it to investors.”

And that's just scratching the surface, adds Landahl. "Now DeFi is moving beyond what is possible in the traditional system. For example, DeFi allows people to earn fees by providing liquidity to market-making exchanges. Entirely new possibilities exist, such as uncollateralized 'flash loans' that allow anonymous users to borrow massive amounts of money for only a few seconds, perhaps for the purposes of executing an arbitrage across exchanges."

Adds Landahl: "Bitcoin was about replacing money; DeFi is about replacing finance. Decentralized autonomous organizations (DAOs) create a new way for people to build and manage organizations, corporations, and foundations. Hardware projects are underway that could replace the physical infrastructure of the internet with a truly decentralized network of wireless internet. The eventual goal is an uncensored world-wide financial system and communications network that is both private and broadly distributed."

While some critics speculate that cryptocurrency could be subject to malicious hacking attacks and security breaches, Landahl points out that traditional financial services frequently suffer from attacks, scams and breaches. "The value of the Bitcoin protocol is that it guarantees irrevocable and verifiable transactions. The block chain is public, and we can see a chain of custody for every unit of value."

However, Landahl is quick to point out that "new cryptocurrencies are created every day, and many contain fundamental flaws which could be exploited." While the blockchain can guarantee safe transactions, Landahl points out that cryptocurrency is subject to the same risks as traditional financial accounts. "They can be stolen by attackers who target user's phones, computers, or even centralized exchanges which take custody of funds – just as traditional financial accounts can be compromised by con artists who exploit account holders."

Who will catch the falling knife?

Perhaps the most troublesome aspect of cryptocurrency is its extreme volatility. It tends to go through bright periods of soaring growth followed by dark stretches of gut-wrenching declines, propelling crypto owners through a perpetual financial and emotional rollercoaster.

In 2011, I was assigned to write an article on Bitcoin for a magazine. As part of the assignment, I was required to buy 10 Bitcoins, which were selling for $10 per unit at the time. I bought the 10 Bitcoins for about $100. When I finished the article, I sold the 10 Bitcoins and recovered my $100 investment.

At its peak in 2021, a single Bitcoin was selling for about $67,000 – and the 10 Bitcoins I bought and sold for a total of $100 would have been worth $670,000. And optimistic prognosticators were suggesting that the price would continue to soar.

But instead of continuing to surge, Bitcoin began a seismic plunge, tanking to $50,000, then $40,000, and ultimately dipping below $30,000. That hypothetical $670,000 in Bitcoins would have dropped by more than $400,000 off its peak.

Therein lies perhaps the biggest drawback to cryptocurrency – the risk and emotional and financial toll of owning such a volatile and unpredictable asset. A quick look at Bitcoin's recent price history tells the story:

At the start of 2017, Bitcoin was selling for about $900 and quickly rose to nearly $20,000 by the end of that year. But by the end of 2018, it had dropped all the way back to about $3,000. After that, it meandered between about $5,000 to $10,000 through mid-2020, then exploded to about $62,000 in March 2021 before dropping back to about $30,000 in July 2021. Then it rocketed all the way up to about $67,000 in November 2021. After that, it reversed course all the way back to just under $30,000 in May 2022 – then crashed even further in mid-June to about $22,000.

It's those massive surges that bring such exhilaration for crypto owners – and those breath-taking plunges that continue to evoke the expression, "who will catch the falling knife?" Because no one really knows where crypto is headed at any given time.

With the stock market, there are well-accepted methods for determining a likely price range for each individual stock, such as earnings and earnings growth, revenue and revenue growth, cash flow, dividends, and the price-earnings ratio.

But there are no such universally accepted measurements for cryptocurrency. While the industry is making progress in this area, according to Landahl, "Analysts' estimates often diverge wildly in magnitude and direction." When things start heading south, most investors can do little more than hang on for dear life and hope that the big hitters will ultimately catch the falling knife and start to bid the price back up.

That's why crypto investing is not for everyone. While ownership surveys tend to vary, the vast majority of U.S. crypto owners – at least 80% – are between the ages of 18 and 45. Less than 2% are Baby Boomers (57 and over).[vi] About 74% of crypto owners are men.[vii]

To this point, the U.S. has not instituted measures to regulate the use of cryptocurrency, but in March, President Biden signed an executive order designed to develop a path toward regulating the use of cryptocurrency and protect consumers and businesses against harmful practices in the cryptocurrency industry.

There's no financial industry standard for how much crypto investors should hold in their portfolios. Landahl suggests that conservative investors may want to skip crypto altogether, while younger aggressive investors who are willing to take the risk of owning cryptocurrency may want to invest 5% to 10% of their new money into crypto. Because of its highly speculative nature – and the possibility of experiencing steep market declines – investors should carefully consider whether owning cryptocurrency is appropriate for them in light of their experience, objectives, financial resources, and other relevant circumstances.

If you have not yet allocated any money to crypto but are interested in dipping your toe in the water, Landahl offers this advice: "Every financial professional or interested investor could take the amount of money they would normally spend on a nice dinner out and invest it in crypto." After that, where it goes, nobody knows.

Cryptocurrencies including Bitcoin and Ethereum are very speculative, unregulated, experience significant price volatility, and are not suitable for all investors. Fluctuations in the underlying cryptocurrency's value between the time you place a trade and the time you attempt to liquidate it will affect the value and the potential profit and losses related to it. Be very cautious and monitor any investment that you make. Speculating in these markets should be considered a high-risk transaction. Investors must have the financial ability, sophistication/experience and willingness to bear the risks of an investment, and a potential total loss of their investment.

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[i] Source: Insider Intelligence, April 2022, "34 Million U.S. adults own cryptocurrency"

[ii] Zippia, April 2022. Cryptocurrency Facts + Trends

[iii] Source: CNBC.com, "Crypto firms say thousands of digital currencies will collapse, compare market to early dotcom days", June 3, 2022

[iv] Source: Coinmarketcap.com

[v] Source: Coinmarketcap.com

[vi] Source: Stilt.com, April 2022, "94% of crypto buys are Gen Z/Millennial"

[vii] Source: Gemini.com: 2021, "The state of U.S. crypto report"

All information and representations herein are as of 06/14/2022, unless otherwise noted.

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