Morgan Stanley

INVESTMENT MANAGEMENT

Tales From the Emerging World

Why Crypto Is Coming Out of the Shadows

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If you were trying to doom a newly invented currency to irrelevance, naming it "cryptocurrency"[1] would have been a crafty first step. "Crypto" means hidden or secret, and often describes a target of popular suspicion and fear, as in crypto-fascist or crypto-communist. But now, despite the jitters natural in a global pandemic, cryptocurrencies are rapidly gaining popular support as alternatives to gold (a store of value) and the dollar (as a means of payment).

The most widely circulated cryptocurrency, Bitcoin, is trading above $35,000, around 10 times its early 2020 low.[2] To some investors, this is a bubble. To others, including us, it is a sign that Bitcoin is following the natural path of new inventions, in which investor interest comes first from venture capital, then from hedge funds, and finally—about 10 years on—from traditional Wall Street players. Bitcoin first launched in 2009, and the resistance of traditionalists is waning as digital services of all kinds boom during the pandemic.

We see fundamental reasons to believe that—regardless of where the price of Bitcoin goes next—cryptocurrencies are here to stay as a serious asset class. One is growing distrust in fiat currencies, thanks to massive money printing by central banks. Another is generational: younger people hear the "crypto" in cryptocurrency as new and improved, an exciting digital advance over metal coins. The worst knock on cryptocurrency as a store of value is its volatility, but unflinching demand from millennials has helped lower the volatility of Bitcoin, even during the pandemic.

[1] Cryptocurrency (notably, Bitcoin) operates as a decentralized, peer-to-peer financial exchange and value storage that is used like money. It is not backed by any government. Federal, state or foreign governments may restrict the use and exchange of cryptocurrency. Cryptocurrency may experience very high volatility. The Global Emerging Markets strategies do not invest in cryptocurrency.

[2] Bloomberg. Intra-day trading low occurred on 3/12/20.

To this under-40 set, who grew up with digital tech, the open-source software behind Bitcoin makes it more transparent, transferrable and trustworthy than paper money printed by governments. Not less. And this crypto-confidence may reach even deeper in emerging markets, where distrust in centralized authority runs high.

Governments have been slow to recognize this evolution. When the pandemic hit, the dollar ruled the world as the favored medium of international trade, the anchor against which other nations value their currencies, and the "reserve currency" most central banks hold as savings. Before the United States, only five great powers had enjoyed the coveted "reserve currency" status, going back to the mid-1400s: Portugal, then Spain, the Netherlands, France and Britain. Those reigns lasted 94 years on average.[3] At the start of 2020 the dollar's run had endured 100 years, which was reason enough to question how much longer it could continue.

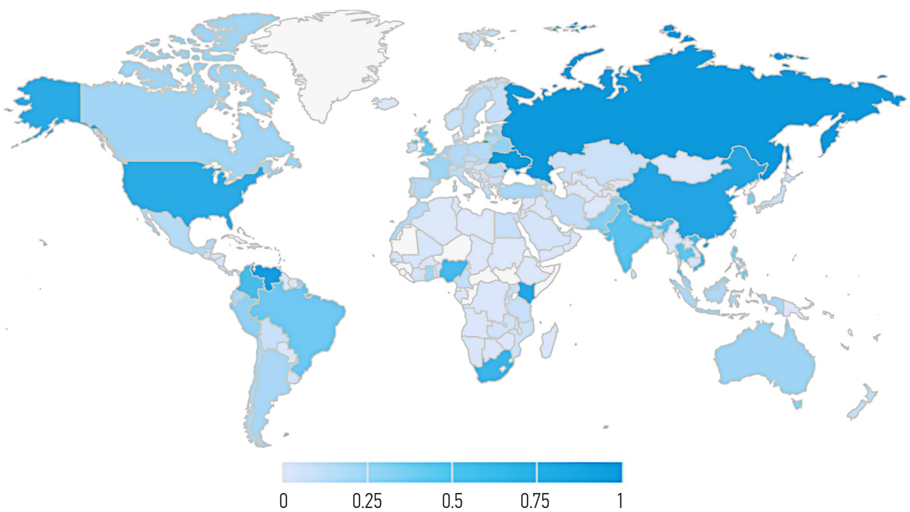
The dollar enjoyed one key bulwark that its predecessors did not: no challengers. Europe had hopes for the euro, but it was young, and burdened by doubts about Europe's multistate government. China had aspirations for the renminbi, which have been stymied by suspicions of the country's one-party state.

Moreover, led by the Fed, every major central bank has been printing money madly to keep economies afloat during the pandemic, undermining confidence in all national currencies. Twenty percent of all dollars in circulation were printed in 2020,[4] and that binge was a huge boost to the appeal of Bitcoin, which was designed with a gradual process for "mining" new coins and a limited supply. In effect, central banks conspired unintentionally to fuel the rush into cryptocurrencies, which have long been pitched as decentralized, democratic options to dollar dominance.

DISPLAY 1

Cryptocurrency: Surprisingly Advanced in Emerging Countries

The 2020 Global Crypto Adoption Index



Source: Chainalysis, The 2020 Geography of Cryptocurrency Report, September 2020.

Methodology: 154 countries are ranked on 4 cryptocurrency (CC) metrics (1 On-chain CC value received, weighted by purchasing power parity (PPP) per capita (PC); 2 On-chain retail value transferred, weighted by PPP PC; 3 Number of on-chain CC deposits, weighted by number of internet users (IU); 4 Peer-to-peer exchange trade volume, weighted by PPP PC and IU.) The geometric mean of each country's ranking in all four is then normalized for a final ranking on a scale from 0 to 1. The closer the country's final score is to 1, the higher the country's adoption of cryptocurrencies relative to the other ranked countries.

That is not to say that Bitcoin is poised to topple the dollar any time soon, only that traditionalists continue to dismiss the seriousness of the crypto challenge at their own risk. In 2019, after mounting for decades, U.S. debts to the rest of the world surpassed 50 percent of the nation's economic output—a threshold that often signals a coming crisis.[5] In 2020, heavy government borrowing pushed those liabilities up to 67 percent of output, deep in the warning zone.[6] Dollar dominance is likely to end when the rest of the world loses confidence that the U.S. can pay its bills.

Bitcoin was not only the hottest investment of 2020, it was the hottest investment of the decade ending in 2020, up more than 200 percent a year on average.[7] The Bitcoin market now totals around $690 billion, and represents a growing share of the $1.1 trillion cryptocurrency market.[8] But it is still tiny compared to a more traditional inflation hedge like gold, which is a $12 trillion global market.[9] That leaves plenty of room to grow.

Bitcoin is still volatile, with average annual price swings of 69 percent, compared to 27 percent for silver, 13 percent for gold, and around 20 percent for stocks.[10] But the volatility of gold and silver has barely changed in decades. Since the launch of Bitcoin, its volatility has come down from an annual average of more than 400 percent, so the volatility gap between Bitcoin and the traditional hedges is narrowing.[11] The risk-adjusted returns of Bitcoin are now in the same range as global or U.S. stocks.[12]

The remaining skeptics tend to be older investors who are more inclined to distrust the stateless "peer-to-peer" network that underpins Bitcoin. This is

[3] J.P. Morgan, HKMA, Erste Group.

[4] Federal Reserve Board

[5] IMF: External Liabilities and Crises

[6] MSIM, IMF, Haver.

[7] MSIM, Bloomberg, FactSet, Haver. Data from 2011-2020.

[8] CoinMarketCap data as of 2/3/21.

[9] Galaxy Fund Management.

[10] MSIM, Bloomberg, FactSet, Haver. Based on 3-year trailing monthly volatility annualized. Data as of 2/3/21.

[11] MSIM, Bloomberg, FactSet, Haver. Based on 3-year rolling monthly volatility annualized from 7/31/11 to 2/3/21.

[12] Based on the 3-year trailing Sharpe ratio for Bitcoin, which is 0.80, compared to 0.47 for MSCI ACWI, and 0.77 for the S&P 500. This is a modified Sharpe ratio with the risk-free rate set at zero, given the low rates regime. Data from 1/31/16 to 2/3/21.

exactly the quality that appeals to many millennials: the absence of a big government or a financial institution playing middleman to every transaction. In a recent survey, only 3 percent of baby boomers in the United States said they own a cryptocurrency, compared to 27 percent of millennials.[13] Those numbers are likely to grow across generations; the recent boom has been fueled by established firms, run by aging financial moguls, joining millennials on the crypto-bandwagon.

Bitcoin is also starting to make progress on its ambition to replace the dollar as a medium of exchange. Today, virtually all Bitcoins are held as an investment, not used to pay bills, but that is changing. Last year popular payment platforms started accepting Bitcoin and other digital currencies, a major step forward in their campaign to challenge the dollar.

Cryptocurrencies promise to help solve problems that are particularly acute in emerging markets (EM). Their governments are often centralized but relatively unreliable, which destabilizes currencies, opens the door to profiteering middlemen, and erodes public trust. Blockchain, the technology behind Bitcoin's decentralized network, promises to cut out the grasping hands of governments and middlemen, and speed up transactions with more transparency and lower fees. It is offering what many EM customers are desperate for.

Recently the Chainalysis research and consulting firm ranked nations by how far they had gone in adopting cryptocurrencies. Surprisingly, many of the most advanced are emerging countries *(see Display 1)*. The three leaders were Russia, Ukraine and Venezuela; China was in a narrow second tier alongside the United States, and much of Asia and Latin America were as or more advanced than any country in Europe.[14] Smaller businesses are starting to use Bitcoin in international trade, particularly in countries where dollars can be hard to come by (such as Nigeria) or the local currency is unstable (Argentina). Last year, the number of internet searches for "Bitcoin" reached an all time high in many countries,[15] including emerging markets from Thailand to Turkey and Mexico.

One irresistibly practical EM application for cryptocurrency is the $470 billion market for remittances—the money ex-pat workers send home to low- and middle-income countries.[16] These transfers typically take one to five days, for a fee ranging from 5 to 9 percent.[17] Today, a payment system using cryptocurrency can send the same sum in seconds, for pennies.

It's hard to imagine why this alternative wouldn't have a strong future. Many regulators are less hostile than observers suppose. They have stepped in following exposure of fraud in new cryptocurrency launches or of crypto ties to criminal sales networks like Silk Road (which was shut in 2013). In general, regulators seem to be more focused on cleaning up crypto-markets than on preventing their growth.

So even if Bitcoin's price pops, as it has before, the rush of 2020 can't be dismissed as an irrational mania. Cryptocurrencies are still young, they still face growing pains. But they also promise speed, transparency, and low fees that traditional payment channels cannot match. They satisfy a growing demand for a digital alternative to gold, an asset likely to protect investors from massive money printing and the threat of inflation. To younger investors, "crypto" already evokes digital, stable and good, not shadowy and sinister. The rest would be well advised to recognize that the currency world is changing, or risk being left behind.

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13 Forbes, July 2020.

14 Chainalysis: The 2020 Geography of Cryptocurrency Report. September 2020

15 Citi, ICO Analytics, Google Trends.

16 World Bank

17 World Bank, TransferWise

18 Assets under management as of December 31, 2020. Morgan Stanley Investment Management ("MSIM") is the asset management business of Morgan Stanley. Assets are managed by teams representing different MSIM legal entities; portfolio management teams are primarily located in New York, Philadelphia, London, Amsterdam, Hong Kong, Singapore, Tokyo and Mumbai offices. Figure represents Morgan Stanley Investment Management's total assets under management/supervision.

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