HORIZON KINETICS

Introduction to the Rise of a New Asset Class: Bitcoin, a Cryptocurrency

Some Historical Points to Consider

- The world has known coinage for 2,600 years, centuries before the advent of the Roman Empire. Almost as soon as coin money came into being, it appears that debasement of the currency likewise came into being. Inflation as has been with us ever since[1].

- The 1,500 year history of the Roman Empire itself provides an almost exhaustingly continuous record of successive currency devaluations and debasements over the decades, passing into centuries[2].

- The Gold standard is roughly two centuries old, dating to 1821, when England became the first nation to officially adopt a gold standard.

- The U.S. central bank system is only a century old (1913). Money was still actually gold or silver; the dollar "bills" or "notes" in one's pocket simply represented the amount of gold into which, upon demand, they could be converted. Under the Gold Standard Act of 1900, that amount was 25.8 grains of gold, nine-tenths fine (0.05897 ounces). Until April 1933, that is. Thereafter, a holder of U.S. dollar "bills" could no longer convert the paper into gold – thus, true paper money[3].

- A system of national fiat currencies, with floating exchange rates, is only decades old (1971).

- The world's first non-dilutable, fixed-supply currency is eight years old. Impelled by the Financial Crisis, and enabled only by advances in technology, bitcoin, now the dominant of a number of digital currencies, was created in January 2009. As of April 2017, it was recognized by a major central bank as legal tender, with another to follow in July.

- Since 2008, Central Banks' actions have distorted capital markets to a historically unheard of degree. This staved off a depression, but created the yield crisis. Interest rates are the lowest they have been in recorded history, and one can no longer get an adequate return on capital.

- Accordingly, purchasing power is eroding. Although inflation in the U.S. in recent years has been rather benign by historical standards, it now exceeds the near-zero rate of interest. We live in an era of negative real yields.

- U.S. debt, as a proportion of GDP is approximately 106%, surpassed only once before, at the end of World War II[4]. To reduce the impact of this debt, inflation remains, after a few thousand years, the easiest route for governments to take. This practice is essentially a wealth transfer from savers and the solvent, whose purchasing power is gradually eroded, to debtors, who repay in cheaper dollars. A recent measure: the U.S. money supply increased by 6.84% in 2016[5]; since Real GDP was only 2% higher[6], one's currency, upon which essentially nothing was earned, was devalued by an additional 4.84%.

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[1] The Story of Money, Norman Angell, Frederick A. Stokes Company, 1929

[2] Ibid.

[3] Grant, James. *Money of the Mind, Borrowing and Lending in America from the Civil War to Michael Milken,* Farrar Strauss Giroux, New York, 1992.

[4] http://www.usgovernmentspending.com/us_debt_to_gdp

[5] https://fred.stlouisfed.org/series/M2

[6] https://fred.stlouisfed.org/series/GDPC1

- Historically, to reduce the impact of inflation, investors diversified by asset class, by currency and by geography. But artificially low interest rates are a global phenomenon, with the consequence that asset prices have likewise been inflated globally, and have become correlated to an unprecedented degree. They are, in effect, all tied to interest rates and, accordingly, share the same systemic risk.

- Investors hope for trust and accountability in their financial institutions and systems, but history, both ancient and recent, is hardly suggestive of an affirmation of that hope. The alternative, at least in principle, is to seek liberation from Central Banks and the fiat currency system.

Bitcoin: Perhaps the Ultimate Store of Value, Perhaps the Ultimate Diversifier, A True Alternative

In the aftermath of the 2008 Financial Crisis, bitcoin was developed as an alternative to traditional currencies, which were being challenged by credit system collapse and liquidity needs in an environment of unpredictability and mistrust. In the four months between September 2008 and December 2008, the Federal Reserve increased its balance sheet by approximately 144%, from $939 billion to $2.3 trillion. As of May 2017: $4.5 trillion.

The singular aspect and value of bitcoin, which is a digital, computer-software based notation of ownership – like the modern-day U.S. Treasury Note you might own – is that there will never be more than 21 million of them (very much unlike U.S. Treasury Notes). Its supply is fixed. Which means that if this property is desired by more investors, the only mechanism by which to adjust the supply/demand imbalance is through the price. If enough people want more, they'll have to pay more.

Bitcoin:
- Is decentralized - No entity controls it, neither sovereign nor corporate.
- Allows you to transact outside of the existing "system". In a way, it is a hedge against the system.
- Is borderless.
- Poses less risk of inflation or currency collapse, as it is detached from country or institution.
- Does not benefit one sovereign versus another, a typical motive for erosion of currency valuations.

As well:
- Japan recognized bitcoin as a legal tender as of April 1, 2017.
- Australia will do the same as of July 1, 2017.
- The IRS has already recognized bitcoin, even if only to tax it, as property subject to capital gains taxes.
- The current scale of bitcoin, by market value, is almost vanishingly small within the scope of the U.S. and global economies. That perhaps most clearly defines the scope of its appreciation possibilities, should it achieve any meaningful degree of market acceptance.

Bitcoin is just the start; other currencies and opportunities will continue to present themselves as this area grows and matures. As in the past, Horizon Kinetics will follow the opportunity set and will seek to position itself to take advantage of it.

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