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Market Note

Going Digital: A Brief Look at Spot Bitcoin ETFs and a U.S. CBDC

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Summary

- Over the past week, the SEC has been bombarded with applications by several large financial institutions to launch spot bitcoin ETFs. The flurry of applications was triggered by BlackRock's filing on June 15.
- The SEC has never approved a spot bitcoin ETF, despite there being more than 30 applications over the past five years, but Blackrock's filing is the first to address key SEC concerns.
- As digital currencies have become more popular, central banks across the world have been looking into CBDCs. While not classified as cryptocurrencies, the advancement and rollout of CBDCs in the U.S. has become a topic of increasing discussion, but a regulatory framework is needed.
- We will evaluate any spot bitcoin ETFs if they are launched, and we would consider adding them as a complement to our precious metals position.

Overview

Over the past week, the Securities and Exchange Commission (SEC) has been bombarded with a flurry of Bitcoin spot ETF applications by large financial institutions. This flurry was triggered by BlackRock, who, on June 15, filed an application for a spot bitcoin ETF, and was quickly followed by WisdomTree, who applied for the same type of ETF on June 20. Valkyrie Funds also lodged an application for a spot bitcoin ETF on June 21.[1]

While the SEC has never approved a spot bitcoin ETF (and there have been many applications), BlackRock's application has been widely considered as opening the door for other companies. Blackrock has a stellar track record for getting ETFs approved by the SEC and its filing addresses one of the SEC's key concerns, namely regulatory oversight to avoid potential market manipulation, amongst others.[2] Based on bitcoin's strong gains since the filing, markets are treating this as a 'Blackrock must know something' situation.

Further, the successful approval of a spot bitcoin ETF could be considered another step in the direction of the U.S. moving closer towards centralized digital currencies.

What are Bitcoin Spot ETFs?

There are several bitcoin futures ETFs currently trading in U.S. markets. Futures ETFs differ from spot ETFs in that they do not hold the physical asset, but rather a derivative (the futures). These types of ETFs aim to replicate the returns of the underlying asset through a combination of futures contracts and other financial instruments. The largest of these is the ProShares Bitcoin Strategy ETF, launched in October 2021, currently with $995 million in assets. Spot bitcoin ETFs do exist, but not in U.S. markets. There are several Bitcoin spot ETFs currently trading in Canada, including the Purpose Bitcoin ETF, which was launched in February 2021 and invests in and holds 99.9% of its assets in actual bitcoin. It has approximately CA$820 million in assets.

In the past, there have been more than 30 applications to the SEC for spot bitcoin ETFs, which have all been rejected on the same basis: the SEC does not like the unregulated nature of cryptocurrencies and believes that there are no means to "prevent fraudulent and manipulative acts and practices" and that "surveillance-sharing with a regulated market of significant size related to Bitcoin is necessary".[3]

Below is a list of some of the rejected applications. Note that some have been rejected by the SEC several times, or formally asked by the SEC to withdraw following rejections of similar applications:

Name	Outcome	Date
Winkelvoss Bitcoin Trust	Rejected Twice	March 2017
VanEck Vectors Bitcoin Strategy ETF	Withdrawal Request by SEC	Jan 2018
ProShares Bitcoin Futures Strategy ETF	Withdrawal Request by SEC	Jan 2018
ProShares Bitcoin/Blockchain Strategy ETF	Withdrawal Request by SEC	Jan2018
ProShares Bitcoin Futures/Equity Strat ETF	Withdrawal Request by SEC	Jan 2018
GraniteShares Bitcoin ETF	Rejected	Aug 2018
GraniteShares Short Bitcoin ETF	Rejected	Aug 2018
Direxion Daily Bitcoin Bear 1X Shares	Rejected	Aug 2018
Direxion Daily Bitcoin 1.5X Bull Shares	Rejected	Aug 2018
Direxion Daily Bitcoin 2X Bear Shares	Rejected	Aug 2018
ProShares Bitcoin ETF	Rejected	Aug 2018
ProShares Short Bitcoin ETF	Rejected	Aug 2018
Fidelity Wise Origin Bitcoin Trust	Rejected	Jan 2022
Grayscale Bitcoin Trust	Rejected	June 2022
Bitwise Bitcoin ETP Trust	Rejected	June 2022
WisdomTree Spot Bitcoin Trust	Rejected	Oct 2022
ARK21Shares Spot Bitcoin ETF	Rejected Twice	Jan 2023
VanEck Bitcoin Trust	Rejected Three Times	March 2023

Source: SEC

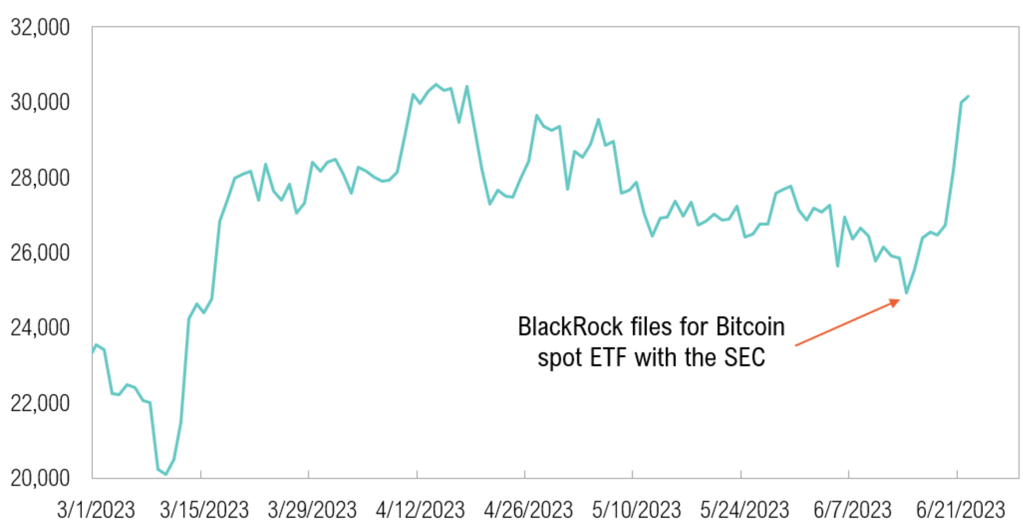
Bitcoin's most recent meteoritic rise, which started in October 2020, was driven by increased speculation and demand for fiat currency/macro hedging from both retail and institutional investors, coupled with massive COVID-19-related stimulus that created enormous demand for an asset with finite supply of the underlying asset (supply has a hard-coded cap at 21 million bitcoin). The chart below illustrates this rally, the subsequent crash, and highlights bitcoin's extreme volatility.

The Speculative Nature of Bitcoin Makes it a Highly Volatile Asset
Bitcoin Price, $

Source: Bloomberg

Following BlackRock's SEC filing on June 15, Bitcoin's price hit its highest levels since April, as excitement grew that BlackRock's application could be approved and finally provide a conduit for near-seamless retail and institutional investment. The hopes around this are not unjustified. There is a key difference between BlackRock's June 15 application and the prior 30+ that have been rejected. In BlackRock's application, the company cites that it intends to enter into a "surveillance sharing agreement" with the CME futures market.[4] Recalling that one of the SEC's past reasons for rejecting Bitcoin spot ETFs was that "surveillance-sharing with a regulated market of significant size related to Bitcoin is necessary"—this might be the golden ticket needed for the first successful application.[2,3]

Bitcoin Prices Have Skryocketed Since BlackRock's SEC Filing
Bitcoin Price, $



Source: Bloomberg

What are CBDCs?

A central bank digital currency (CBDC) is a digital form of central bank money that is widely available to the general public. Currently, there are two types of central bank money in the U.S.—physical currency issued by the Fed and digital balances held by commercial banks at the Fed. For many years, we have held money predominantly in digital form (in bank accounts, apps, and online payments); however, a CBDC would differ from the existing digital money in that it would be a liability of the Fed; not of commercial banks.[5]

In January 2022, the Fed announced that it was considering a CBDC as a means to expand safe payment options—not to reduce or replace them. It published a paper, Money and Payments: The U.S. Dollar in the Age of Digital Transformation, in which it pointed out that, while it would be challenging to secure CBDC, it could enhance the operational resilience of the payment system if designed with an offline capability. The paper served as a first step in a public decision between the Fed and stakeholders about a CBDC. The Fed's public intention was that further steps would only be taken if additional research showed benefits outweighing downside risks and that there was widespread support from both the public and the government.[6]

Despite last year's call by the Biden administration for "the highest urgency on research and development efforts" for a U.S. CBDC, the Fed has reiterated there is no decision on the U.S. issuing CBDC, nor any specific policy outcome intended.[7] The Fed has also stated that it would only proceed with issuance of a CBDC with an authorizing law. But Fed chairman Jerome Powell pointed out in his recent Congressional testimony:

> *"We do see payment stablecoins as a form of money, and in all advanced economies, the ultimate source of credibility in money is the central bank. We believe it would be appropriate [for stablecoins] to have quite a robust federal role."*[8]

Other central banks around the world have also shown interest in CBDCs. More than 100 countries are currently exploring CBDCs, with progress ranging from the early stages of research to planned functional roll-outs.[9] Some of the key reasons for all of the central bank interest in CBDCs include dwindling cash usage, growing interest in digital assets (such as bitcoin and other cryptocurrencies), a growing public disillusionment with central banks as payment innovators and reliable regulators, rising global payment systems (i.e. the flow of currencies between countries), and the need for control.[10]

Sweden's Riksbank has developed a proof of concept and currently is in the process of exploring the technology needed to roll out a CBDC.[11] Nigeria launched the eNaira in October 2021, and the United Arab Emirates and Saudi Arabia are currently testing a jointly issued digital currency as a potential instrument for domestic and cross-border transactions between the two countries.[10]

China's digital renminbi is at the forefront of CBDCs. First introduced in August 2020, the digital renminbi was designed to replace cash and coins and can be used for transactions on some of China's largest online platforms, including WeChat, Alibaba and JD.Com.[12] Because it is at least partially controlled and issued by a central bank, it is not classified as a cryptocurrency.

Whether or not the U.S. will take further steps to research or roll out a CBDC remains to be seen. As with the SEC and the barrage of rejected spot bitcoin ETFs, the Federal Reserve will need to implement a thorough regulatory framework to ensure that the benefits outweigh the risks.

Looking Ahead

We would generally view a substantial rally for an asset into an event like a product launch as a 'buy the rumor, sell the news' situation. An example would be the rally into, and subsequent decline after, the launch of bitcoin futures trading in late 2017. That said, we believe the launch of a bitcoin ETF could be different in that it will open access to a group of investors that may have avoided bitcoin due to the operational, regulatory, and other issues associated with bitcoin futures ETFs or buying it directly through online platforms.

While we have never formally approved a bitcoin-related ETF, we have invested in the broader digital assets space through venture investments and hedge funds. As it relates to spot bitcoin, we continue to view it as a potential complement to precious metals allocation *assuming it is sized conservatively*.

We will evaluate any spot bitcoin ETFs if they are launched, and we would consider adding them as a complement to our precious metals position.

Given the apparent push by global and U.S. authorities, we think a CBDC will eventually be launched in the U.S. If launched, we will be most interested in how a CBDC is used to reduce frictions in tax collections and fiscal stimulus.

Sincerely,

The SpringTide Investment Team

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Asset Class Definitions

Asset class performance was measured using the following benchmarks: U.S. Large Cap Stocks: S&P 500 TR Index; U.S. Small & Micro Cap: Russell 2000 TR Index; Intl Dev Large Cap Stocks: MSCI EAFE GR Index; Emerging & Frontier Market Stocks: MSCI Emerging Markets GR Index; U.S. Interm-Term Muni Bonds: Bloomberg Barclays 1-10 (1-12 Yr) Muni Bond TR Index; U.S. Interm-Term Bonds: Bloomberg Barclays U.S. Aggregate Bond TR Index; U.S. High Yield Bonds: Bloomberg Barclays U.S. Corporate High Yield TR Index; U.S. Bank Loans: S&P/LSTA U.S. Leveraged Loan Index; Intl Developed Bonds: Bloomberg Barclays Global Aggregate ex-U.S. Index; Emerging & Frontier Market Bonds: JPMorgan EMBI Global Diversified TR Index; U.S. REITs: MSCI U.S. REIT GR Index, Ex U.S. Real Estate Securities: S&P Global Ex-U.S. Property TR Index; Commodity Futures: Bloomberg Commodity TR Index; Midstream Energy: Alerian MLP TR Index; Gold: LBMA Gold Price, U.S. 60/40: 60% S&P 500 TR Index; 40% Bloomberg Barclays U.S. Aggregate Bond TR Index; Global 60/40: 60% MSCI ACWI GR Index; 40% Bloomberg Barclays Global Aggregate Bond TR Index.

Citations

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