Bitcoin's Liquidity Paradoxes

Could More 'Treasury QE' Explain Bitcoin's Recent Rebound?

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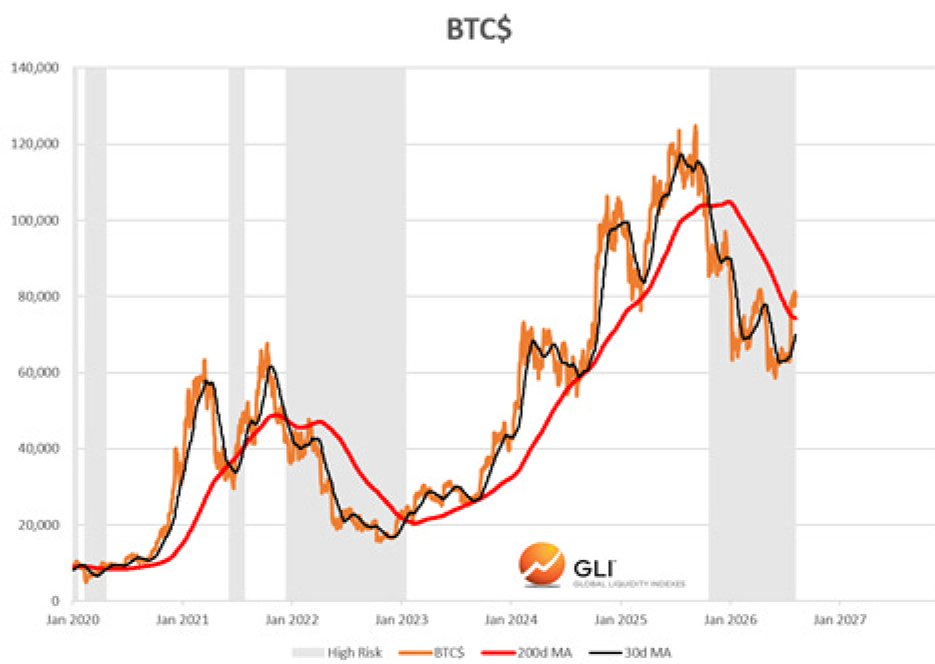
We view liquidity as circulating through two distinct channels: the financial economy and the real economy. We often express this idea by saying that *all money that is anywhere must be somewhere*; it cannot occupy two places simultaneously. In broad terms, liquidity in the financial sector supports bond prices and risk assets, while liquidity in the real economy fuels commodity markets, business activity and corporate profits. When liquidity shifts between these two circuits, equity P/Es may fall as bond yields rise, but stronger earnings can offset that pressure to a greater or lesser degree.

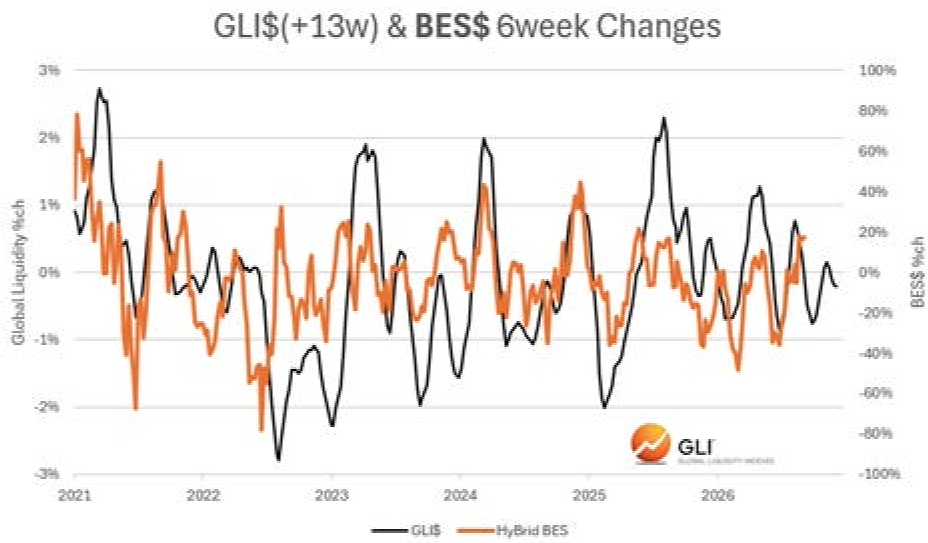
This paper advances a three-part argument. First, it distinguishes between financial-market liquidity and real-economy liquidity. Second, it examines how Treasury QE increasingly channels liquidity into the real economy rather than through the Federal Reserve's balance sheet. Third, it assesses **whether Bitcoin behaves more like a real asset than a purely financial one** by comparing its price dynamics with Treasury QE, Global Liquidity and PBoC Liquidity?

Put another way, asset allocation depends on choices between financial and real assets. The commodity/bond split is the simplest example. Indeed, their negative correlation was part of the logic behind the ultimately ill-fated 1981 merger that created *Phibro-Salomon*, a large American financial and commodities powerhouse combining *Phibro Corporation* (Philipp Brothers), then the world's largest commodities trading firm, with *Salomon Brothers*, the bond kings of Wall Street. The asymmetry soon became clear: Salomon benefited from the 1980s financial boom, while Phibro suffered through the commodity slump.

The key question is whether cryptocurrencies and precious metals should be viewed primarily as real assets or financial assets? We have long argued that they belong largely to the financial sphere. However, recent data suggest a more nuanced interpretation. The chart below suggests that Bitcoin is currently trying to find a floor. Could this get further support from the buoyant US real economy? [The grey shaded areas denote periods where the 50d MA is below the 200d MA.]



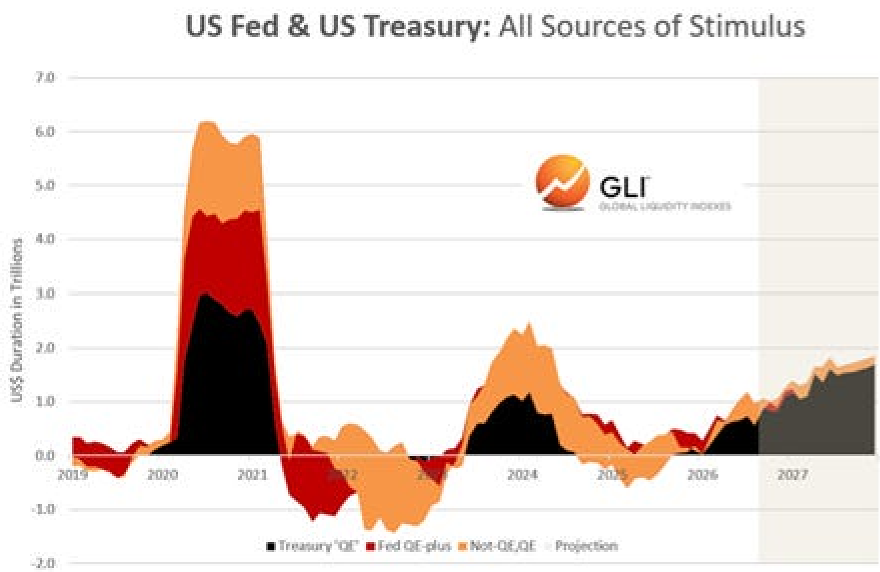
We already know that there exists a solid correlation between Global Liquidity, that is funds circulating through the financial sphere, and cryptocurrencies. Below, we reproduce the relationship between a basket of cryptocurrencies (BES$: 60% BTC$, 30% ETH$ and 10% SOL$) and Global Liquidity. This chart is shown weekly, using 6-week changes to eliminate 'noise' and with Global Liquidity advanced by 3 months.



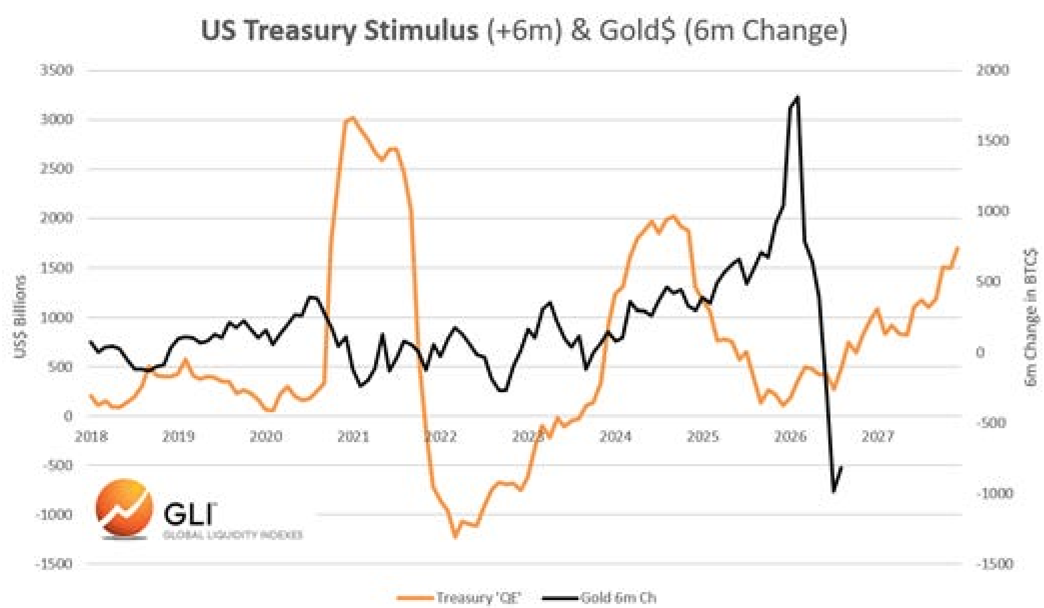
Treasury QE

Treasury QE is a useful extra dimension in order to test whether there is also an additional link to the real economy. We use the term Treasury QE to describe policies that alter the composition and maturity structure of outstanding government debt in a way that supports liquidity and economic activity without requiring a direct expansion of the Federal Reserve's balance sheet. Put simply, **Fed QE expands and alters the composition of the Federal Reserve's balance sheet, whereas Treasury QE changes the composition and maturity profile of outstanding government debt.** The former injects money into financial markets, whereas the latter is a direct injection into the real economy through government procurement and other spending.

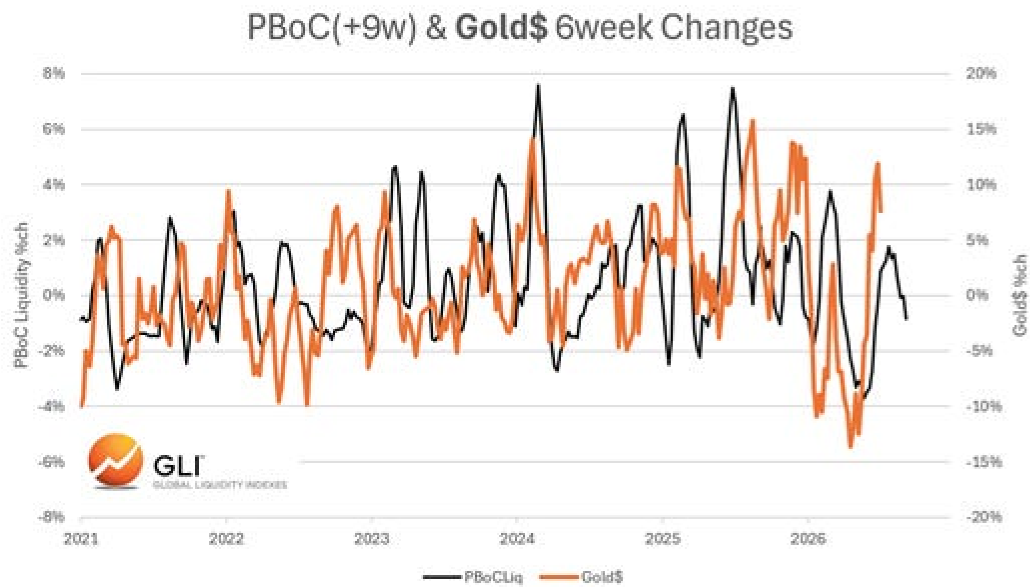
The following chart illustrates the recent shift from Fed QE to Treasury QE. Our calculations use the approximation that liquidity is proportional to net assets divided by duration. The data indicate the recent dominance of Treasury QE and a growing role for State spending financed through Treasury bill issuance.



Consider alongside the relatively weak relationship between changes in gold prices (a financial asset) and Treasury QE. This is consistent with our view that bullion prices are influenced primarily by Asian demand and, in particular, by liquidity conditions associated with the People's Bank of China (PBoC).

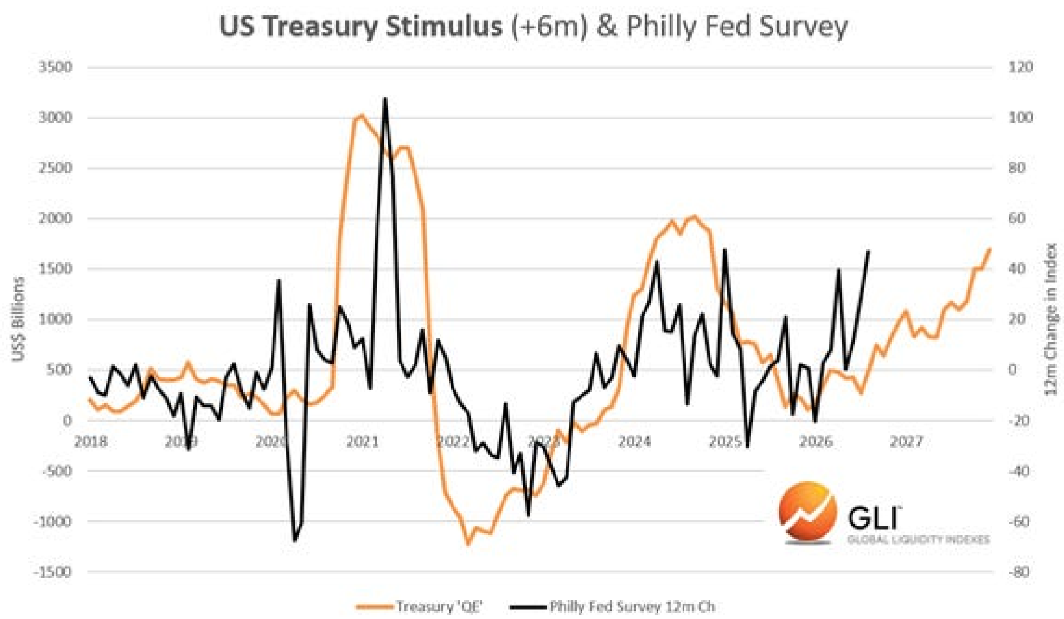


The China link is demonstrated in the following chart. While the relationship between Chinese Liquidity and gold is far from perfect, it is sufficiently strong to imply causation and so deserve closer attention.

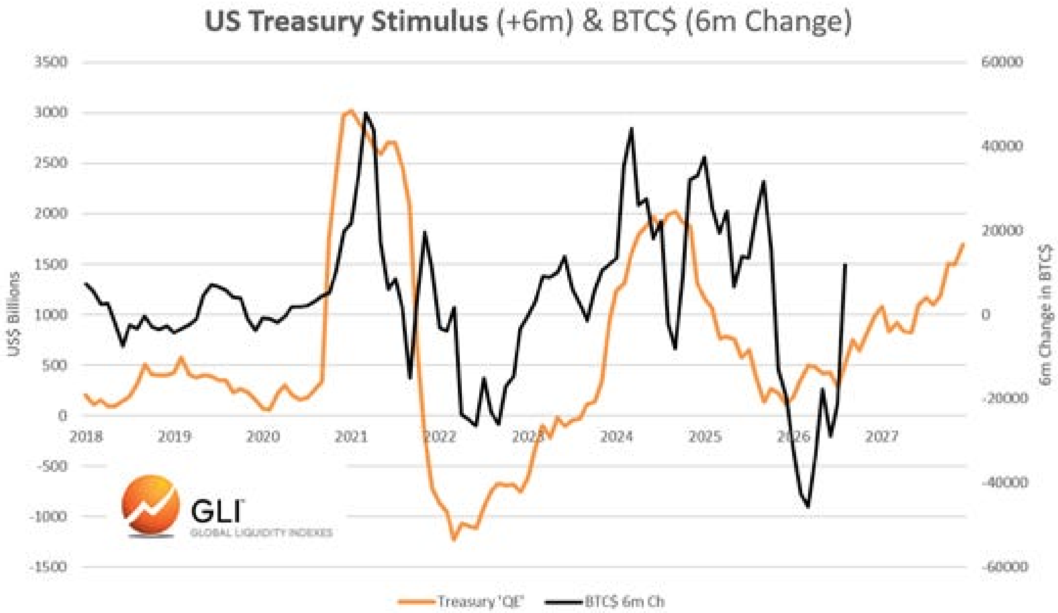


We already know that the intention of the ‘Treasury QE’ policy is to redirect liquidity away from Wall Street and into Main Street. This involves State spending in the real economy, largely funded by Treasury bill issuance, which in turn is **monetized** by private sector banks. Consequently, there should be a close alignment between the size of the Treasury QE stimulus and subsequent movements in the US real economy.

The following chart illustrates the relationship between Treasury QE and US business activity, measured by the 12-month change in the Philadelphia Fed Manufacturing Survey, with liquidity advanced by six months.



If Bitcoin were purely a financial asset, like gold, it should in theory exhibit little relationship with Treasury QE. By contrast, if it possesses characteristics of a real asset, a stronger correlation would be expected. The evidence suggests a **surprisingly close relationship**. Treasury QE stimulus is advanced by 6 months and compared to the 6-month change in BTC$ prices. Given that we project further gains in Treasury QE, could this augur well for Bitcoin?



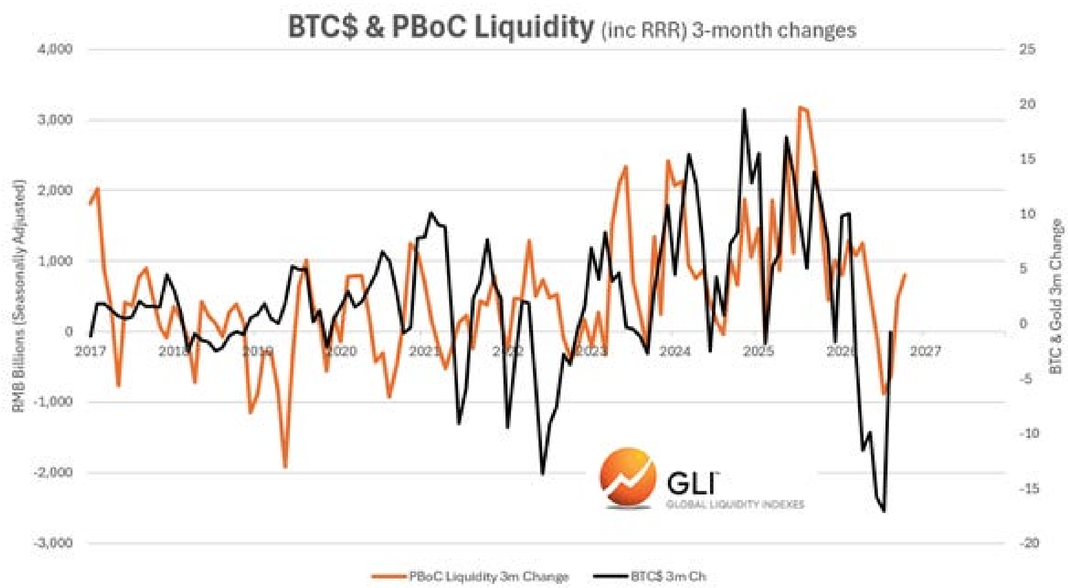
In sum, this analysis suggests that Bitcoin may be nearer a cyclical floor than would be implied if it behaved solely as a financial asset. The evidence remains **far from conclusive given the limited historical sample**, but it introduces an additional dimension that merits consideration.

A Second Paradox?

But financial markets have a way of upsetting the 'norms'. In dipping deeper into cryptocurrencies we uncovered another seeming paradox that further fuels the case that Bitcoin may be getting extra support.

China bans cryptocurrency trading and investment for residents: this despite the strong interest on the Mainland and the existence of many Chinese Bitcoin miners. It follows that there should be zero correlation between changes in PBoC (People's Bank) Liquidity and movements in Bitcoin. However, again **paradoxically the data suggest otherwise.**

The chart below plots changes in PBoC Liquidity and subsequent changes in BTC$, advanced by 3 months. What, in theory, should not occur appears to occur in practice. One possible explanation is the existence of indirect transmission mechanisms, including the long-run relationship between gold and Bitcoin as perceived hedges against monetary inflation. **The evidence is not definitive, but once again liquidity, whether Global, US or Chinese, emerges as a potentially powerful driver of cryptocurrency prices.**



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