Does the Fed Funds Rate Drive Bitcoin?

December Bitcoin at $40,000?!

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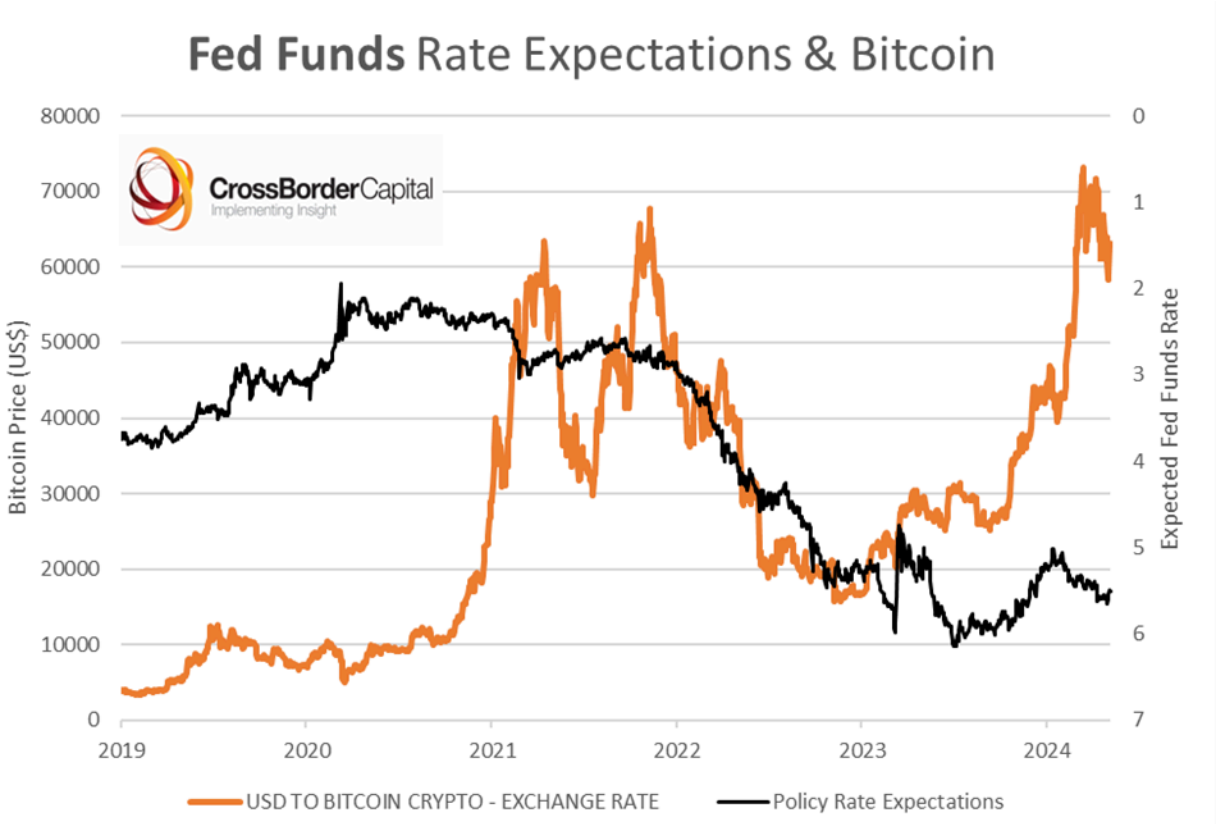
No, this is not our forecast, but a panelist at the FT's recent *Crypto and Digital Assets Summit* (8-9th May) did drop this party pooper. An outlier perhaps, since all other panelists expected BTC$ to exceed US$100,000 by year-end? But predicting near-term swings in a volatile instrument is always hazardous. **We prefer to make the long-term case.**

Here, a consensus of the panelists got behind the idea that regulation plainly matters for crypto. **Yet, an astonishing 45% of the audience polled believe that Bitcoin's price is purely driven by 'speculation', with monetary policy (17%) and geopolitics (15%) outpaced, but the only other notable drivers.** Our view is that none of these factors really count and what really matters are **Global Liquidity** and **fiscal policy**, or, put differently, the integrity of government debt.

History teaches that the most important price in every financial system is the price of the dominant economy's debt. Hence, yields on US Treasuries matter. Ideally, they should be low and stable. These yields are not driven by policy interest rates (in fact they ultimately determine policy rates), but rather they are largely determined by *term premia*and, in turn, by the excess demand and supply of coupon bonds.

Consider, first, the impact of the Fed Funds rates on the Bitcoin price. The chart below suggests there is **little relationship** (R-squared 0.035). Fed funds are drawn inverted to suggest that falling policy rates push Bitcoin higher. What matters more than policy interest rates is the **amount of liquidity** injected into markets by the Fed, which, in turn, often adds decisively to the bigger and far more important pool of Global Liquidity. Fed Liquidity is itself strongly influenced by the need to purchase Treasury debt. This was the generic source of QE (quantitative easing). **Paradoxically, the greater public debt supply and the more that the Fed is called upon to 'monetize' it, the higher are Treasury term premia.**

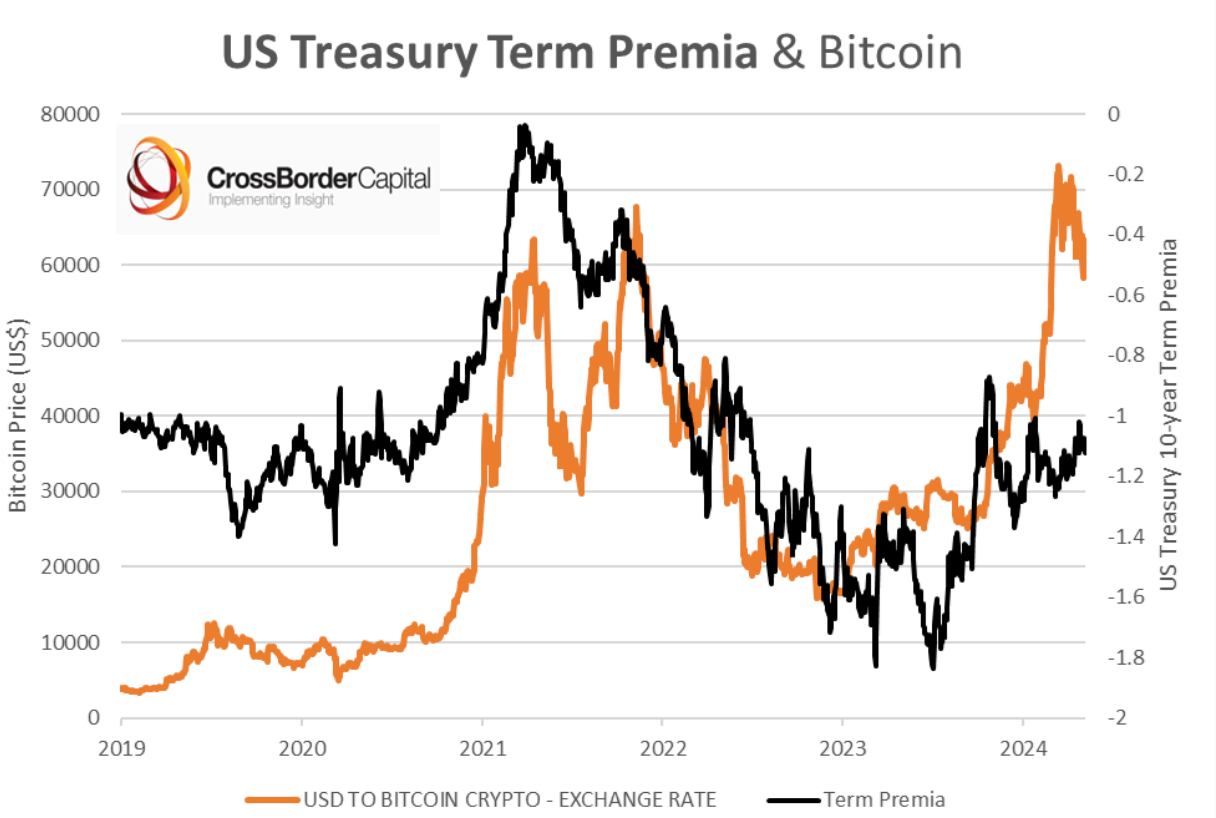


Term premia are a wonkish concept and have to be mathematically extracted from the term structure. **They represent the implied compensation demanded by investors to hold interest rate risk over the term of the bond.** They happen to be strongly affected by supply and demand. The greater Treasury

supply and the weaker the demand for these ‘safe’ assets, the more that term premia rise. Safe asset demand is strongly influenced by investors’ risk appetite and specifically by the threat of systemic risk. Because greater Fed Liquidity mitigates this risk, it correlates positively with term premia: more liquidity, means higher (not lower) term premia.

This effect can be seen clearly in the second chart. It reports the co-movement between US 10-year Treasury term premia and the Bitcoin price, daily since 2019. The relationship is not perfect, but it is both statistically significant and also far stronger that the weak link between Bitcoin and interest rate expectations (R-squared 0.20).

Historically, term premia have, on average, been positive and they also demonstrate significant mean-reversion. A further important point to make is that term premia measure the popularity and confidence in government debt. **Thus, rising term premia (falling bond prices) and surging Bitcoin prices are telling a very consistent story, namely that investors are voting against government fiat.**



It follows that as public debt spirals higher, it not only drives up the level of Global Liquidity, but it also means rising term premia and rising bond yields. Put another way, a higher debt/ GDP ratio inevitably means a higher liquidity/ GDP ratio. The implications for assets, like Bitcoin, that are higher sensitive to liquidity should be clear. This is why we remain bullish.

An earlier 'Capital Wars' Substack (https://capitalwars.substack.com/p/bitcoinnorth-of-richmond) evidenced the remarkable recent sensitivity of Bitcoin and Ethereum to changes in Global Liquidity. Compared to gold, which typically rises by 15% for every 10% jump in Global Liquidity, we evidenced that Bitcoin moves by around 90% and Ethereum by 150%. Admittedly, that was based on history and we cautioned not only not to expect similar gains, but also that the effect is two-way: lower Global Liquidity could mean that crypto investors get crushed. **Nonetheless, the two keys**

points are: (a) Bitcoin is more liquidity-sensitive than many other assets, and (b) we expect Global Liquidity to trend higher over time.

Consider, the chart below. This reports the contribution of the fiscal deficit to US credit expansions by decade. The growth in the public contribution is plain. **In fact, we are back to war-time levels of credit creation by the State!** Given the huge pressures on the fiscal purse, this is unlikely to change in the future. We are in a different World of *fiscal dominance*, where Central Banks are slaves to the needs of government spending and investors are buffeted by the consequences. **In this new World, the traditional 60:40 asset mix between equities and bonds does not work.** Asset allocation needs to be re-thought. Zero allocation to bonds may be too radical, but a significantly greater holding of Bitcoin and other monetary hedges, like gold, in portfolios makes sense to us.