Commerce Trust
Banking | Investments | Planning™

Conversations with Commerce Trust podcast
Episode 4: Why are investors shedding riskier assets?
02/08/2023

Disclosure: The following commentary is only intended to provide educational information about cryptocurrency, special purpose acquisition companies and nonfungible tokens and is not a recommendation or an endorsement in favor of these investment vehicles. Commerce Trust views these investment vehicles as high risk and does not currently offer direct investment or custody in these assets. The regulatory environment surrounding digital assets, such as cryptocurrency and nonfungible tokens is uncertain, and these digital assets may not be backed by any central bank worldwide.

David Hagee: Hello and welcome to Conversations with Commerce Trust, our show about the markets, investment themes and economic insights that matter to you. I'm your host, David Hagee, chief investment officer with Commerce Trust. Today, we're going to discuss the current market environment as we transition from a remarkably accommodative monetary policy to a more restrictive one and the impact it could be having on some of the riskier investment vehicles. I'm joined today by Tara McConkey, our director of portfolio management here at Commerce Trust. Welcome to the podcast, Tara.

Tara McConkey: Glad to be here, thank you for having me.

David: So, I think it would be great for this conversation to review the environment that we were in for quite some time. You know, as we talk about accommodative Fed (Federal Reserve) definitionally, what does that mean? So, it's a combination of both interest rates that the Fed sets as well as the general environment that they create through their quantitative easing or tightening policies.

So, looking back to the great financial crisis of 2008-2009, maybe even 2007-2009, you can see that the Fed at that point began to take sort of wide-ranging measures to be able to provide liquidity inside the marketplace, but then also ease the overall conditions so that they can stimulate growth. But really, the environment that I'm reflecting on here is starts in 2012 when they embarked on really in earnest a quantitative easing program.

And what that means is that they are going out and buying bonds in the marketplace and putting cash into the U.S. economy, making it a much more accommodative environment, meaning it's easier for people to borrow money. It's easier for dollars to find their way into possibly some more speculative investments. Tara, any thoughts around sort of the environment that we've been in?

Tara: Certainly, you know, as you mentioned, it was, you know, roughly a decade long accommodative environment from 2012 to beginning of 2022 that provided an ideal incubator for riskier type investments. Then when you added COVID into this mix, the market was flush with cash, including historic amounts of monetary and fiscal policy. And this all this cash had to go somewhere. So, in 2020 and 2021, you had a low interest rate environment, so, people shied away from bonds, increased market volatility, kind of an uncertain IPO (Initial Public Offering) market and loads of cash. And this was a market made for speculative investments and that includes everything from cryptocurrency special purpose acquisition companies referred to as SPACs, and nonfungible tokens also referred to as NFTs.

David: Yes, the Fed explodes their balance sheet, pushes it up to $9 trillion, gets rates down to zero, probably an outcome of the COVID crisis that we went through or the pandemic, maybe more aptly said. And in that environment, these more speculative vehicles that you mentioned, both SPACs and NFTs, as well as crypto (cryptocurrency) thrived in that environment.

I think it'd be instructive to walk through sort of what these asset classes are and what their performance was over that time. Maybe we can start with the easy one, which are SPACs - special purpose acquisition companies that you mentioned earlier. What did those look like during this period of accommodation?

Tara: Right. So, it was a great time to be involved with a SPAC, though it only lasted a couple of years, really, in 2020 and 2021. Right. A SPAC or the Special Purpose Acquisition Company is very rightly nicknamed a "blank check company." So, this SPAC will raise capital through an IPO for the purpose of acquiring a private company. Since SPACs have nothing to analyze and no product, no revenue, you know, investors invest in a SPAC based upon the reputation of a manager.

The manager has about two years to find a private company and complete the reverse merger, essentially bringing a private company public. And SPACs are usually for early-stage companies that have a lot of debt, negative earnings. It's a fast way for the company to get cash in order to grow as well as it's a faster route to being brought public. WeWork, the office space leasing company, actually failed at going public via traditional IPO but eventually went public through a SPAC in October of 2021.

NFTs are the non-fungible tokens date back to about 2014. An NFT is actually a unit of data on the blockchain that stores electronic information. This information can take the form of art, images, videos, tweets, etc. The NFT is really the digital answer to collectibles, which is art, right? Like crypto is a digital currency. As the name implies, an NFT cannot be copied or divided. The most expensive NFT was actually sold at the end of 2021 for $91.8 million. It was a piece of art called "The Merge." I would highly suggest you go look at the piece of art that sold for almost $92 million. Very interesting piece. NFTs use blockchain and are purchased using crypto. So, crypto is also exploding during this time which helped funnel this NFT business and these type of big trades of $92 million for a piece of art and they trade mainly on the Ethereum blockchain.

David: Thanks for your thoughts broadly about the environment that we've been in. What are some thoughts around crypto in specific?

Tara: I think most are familiar with cryptocurrency being a digital currency that's mined or encrypted and it's not relying on a central authority. Certainly, Bitcoin and Ethereum are the most widely known cryptocurrencies. They all are backed by an infrastructure called blockchain. You can think of blockchain as a decentralized digital ledger that records transactions.

So, this has been an unregulated industry, so again, speculative asset price movements. You get a lot of issues regarding the amount of energy that crypto expires. Certainly in 2020 the computer power needed for global mining of Bitcoin consumed more energy than it took to power all of Austria. It was pretty dramatic.

However, I will say in 2022, Ethereum moved to what they call a proof of stake method, which requires less than a percent of energy for verifying crypto on the blockchain. So, this in theory should increase the use of crypto and allow for faster transactions without really compromising the security. This change has essentially done nothing, unfortunately for the performance of cryptocurrency, but it has increased the scalability. You know, crypto is important because as you survey, many companies believe digital currency payments will be ever present in their industry over the next five years, though it could be more of a regulated industry than we see today.

David: Certainly, you saw SPACs maybe at that intersection with traditional assets where SPACs had to access the public markets at some point. But with NFTs and crypto, that was sort of outside of the traditional environment that we've operated in. You know, probably my favorite NFT was this group of NFTs called Cryptopunks. That looks like an early nineties video game type graphic that you see out there that were trading on the millions of dollars level for quite some time in 2021 and kind of when everything was all the rage out there.

So, as we look at this, these speculative assets that thrived inside this accommodative environment, things start to change in 2022 when you see the Fed begin to really raise rates, to be able to confront inflation. And you also see the quantitative tightening that we (the Fed) put in place starting in June of 2022. What's been the outcome for these more speculative asset classes? I mean certainly we touched on SPACs earlier that they have had a swing down, certainly. But what about NFTs and crypto?

Tara: So, in 2022, right there, the perfect storm arrived for speculative investments. As you mentioned, rising inflation, rising interest rates, market volatility, geopolitical instability, obviously with the Russian-Ukraine war, growing recession risk, this all caused these riskier speculative assets to really drop tremendously in value.

So, in terms of performance, let's just look at Bitcoin in the cryptocurrency world. It was trading roughly at $67,500 or so in November of 2021. A year later, at the end of 2022, Bitcoin had dropped almost 72%. It was trading right around $18,500. Volatility was also enhanced when FTX collapsed.

FTX was a crypto exchange market, so very similar to how equities are traded on the exchange if you want to trade cryptocurrencies, FTX was one of those exchanges. FTX did collapse due to alleged fraud, lack of liquidity, mismanagement. And this again has caused another large shadow of doubt on a very unregulated industry, with now potential regulation forthcoming.

In 2021, there were 679 SPAC IPOs, or approximately $172 billion, to 86 SPAC IPOs in 2022, which is about $13.4 billion. While that is pretty dramatic of a 90% decline year-over-year, SPACs did go back to trading in 2022 more in line with their historical averages from 2003-2019. NFT or nonfungible token values are a little harder to analyze as they trade basically using crypto which has fallen greatly in price. They're very diverse areas, again anything from art to a tweet can be followed in the NFT world. And the fact that investors tend to hold these for a long period of time. We did see, though, NFT's trading volume in the first nine months of 2022 drop 97% from $17 billion to $466 million. So, you can tell, right, as quantitative tightening took hold in 2022 a lot of these speculative assets went out of favor and people started dropping off and looking for other potentially less risky assets.

David: I do think that's an important distinction to mention, is that, you know, as we talk about SPACs being the beneficiary of this remarkably accommodative environment, they intersect with public markets and therefore subject to a little bit more regulation where crypto and the NFT markets didn't intersect with public markets and therefore weren't subject to as much regulation, if any. And that's how you see some of these outcomes that we've seen over the past several months, including the FTX bankruptcy that we're going through. So, as we transition from looking at these assets that have not performed well in tighter financial conditions today, what are some assets that we think could perform a little bit better inside these tighter financial conditions?

Tara: Certainly, investment grade bonds, as the Fed is likely towards the end of raising rates, investment grade bonds and yields that we can get on both municipal and taxable U.S. Treasury notes are very attractive, plus 4% on Treasuries makes it very attractive for people to move out of speculative assets, to have something a little bit more risk free. Certainly, cash yields are very attractive, and we certainly tend to prefer/favor cash investment grade bonds at this time.

David: I do think that's a great point to bring home is that as we look at, say, bonds in particular, bonds had extremely low yields for most of the past decade. And as we sit today, you know, bond yields have become attractive again. And they're a viable asset class for us to look for some investment to. Also cash yields have, as you mentioned, become much more attractive as the Fed has had to confront inflation with higher interest rates.

Also, on the stock side, you've seen the growth assets struggle over the course of 2022. In fact, there was almost a 20% difference between growth stocks, roughly defined as, say, health care and technology, but really technology companies, they lagged value investments. And I think you can define those as certainly assets that cash flow well. But then also maybe more specifically finance, energy, maybe some industrial companies inside there to give some color around what a value stock is.

Thank you for the wide-ranging discussion today. For more information about this topic and others, you can find more information at commercetrustcompany.com. Thanks for joining us on Conversations with Commerce Trust. I'm David Hagee. We'll talk again soon.

February 8, 2023
Commerce Trust is a division of Commerce Bank.