Research @ Citi Podcast, Episode 26: The Future of Crypto

Recorded: March 3, 2025

Published: March 12, 2025

Host: Lucy Baldwin, Head of Citi Research

Guest: Alex Saunders, Head of Quantitative Global Macro and DeFi Research

Transcript:

Alex Saunders (00:01)

After the U.S. election, we think that we're going to go through a regulatory regime change in the U.S., I think it will open up these digital assets and these markets to more traditional players. As that happens and we get more integrated, there would be the potential for spillovers from one market to the other, right?

Lucy Baldwin (00:22)

Welcome to the Research @ Citi podcast. I'm your host, Lucy Baldwin, Head of Research at Citi. Today, I'm delighted to be joined by Alex Saunders, our head of Quant Global Macro, Asset Allocation, and critically, head of DeFi for Research here at Citi. Alex, thank you for joining us. Welcome to the show.

Alex Saunders (00:42)

Thank you, Lucy. Pleasure to be here.

Lucy Baldwin (00:44)

This is a really fun, broad topic, Alex. So I was hoping before we dive into some of the detail and some of the, you know, hot news around this space, you know, talk us through what we learned about the ecosystem and perhaps how distinct it was from traditional capital markets and what's happened in the last couple of years and then, you know, bring us back to where we are right now.

Alex Saunders (01:03)

Yeah, thanks, Lucy. And I think that's important because it's changing. And so, initially, the ‘21–‘22 period, we went through a period where there was not that much interest. There wasn't really that much client interest, I would say, from mainstream clients. And the queries that we did get around algorithmic stablecoins, around FTX and the bankruptcy there were, Well, how does this affect my asset class? Is there potential for contagion here? What are the spillovers? And at that time, we thought that the spillovers would be relatively— there wouldn't be much spillovers and that the turbulence would be relatively well contained for a couple of reasons.

One, is that the market caps, although they're kind of large, very large in absolute terms, were small, like in relation to traditional capital markets. And then the second one is really that the ecosystems were completely distinct. The big players in traditional financial markets typically didn't really have a presence within crypto markets and the crypto players typically weren't particularly involved in traditional markets. And so there wasn't that potential for spillovers or a pullback in one asset class or in crypto to impact the other asset classes. And that played out. But the important point there is, I think that's probably changing. And so we’re— after the U.S. election, we think that we're going to go through a regulatory regime change in the U.S., I think it will open up these digital assets and these markets to more traditional players. As that happens and we get more integrated, there would be the potential for spillovers from one market to the other, right? So it's not just unidirectional. The other point to make is obviously that the market cap's grown since that period '21–'22. So it's becoming a bit more of a meaningful part of the overall financial system and household balance sheets.

Lucy Baldwin (03:00)

Well, and on that point, Alex, we've obviously had a period of, I feel like much more broader adoption, particularly on the retail side, starting with the introduction of spot ETF products launched in the U.S. by some large asset managers. A lot of that happened last year, and we've seen some significant flows here. I know your work has shown, obviously, that that's tended to be a big driver of prices. Tell us a little bit about that, and then maybe we can dig into what's happening both in terms of regulation in the U.S. and outside as well.

Alex Saunders (03:27)

Yeah, exactly. So I think— we had the launch of spot Bitcoin initially, and then Ethereum ETFs in the U.S., and they have been pretty successful in terms of the amount of assets that they've raised, if you compare it — and we did — to the gold analogue, right, where we had the launch of gold ETFs. The level of flows, or even adjusting for inflation, has been much stronger than those ETFs took to get going. The second point, as you say, is that we really found quite a strong relationship between those flows and prices. That's surprisingly strong in my mind, given that it's only one region of global markets, right? But if you look at the association between the weekly flows and the weekly price action, there's a very, very strong relationship. So for the last year, it's really been a question of tracking those flows and tracking how they've been impacting prices. And as I said, we've seen this very strong association.

The other sort of related issue that the launch of these ETFs has raised is: Where does Bitcoin fit into a portfolio, right? And as you said, it has been primarily, I would say, retail adoption has been the first movers in terms of, like, buying these ETFs or putting money into these ETFs. And that's been an important sort of strand of our work has been around that sort of asset allocation question. And we think that in terms of those ETFs, it's probably set to grow. So we do think that the launch of the U.S. ETFs initially had really been because there were functioning futures markets around Ethereum and Bitcoin, in particular — that was the reason that the SEC kind of reluctantly somewhat permitted for those to be launched. And now with the regulatory environment changing, we think that there potentially could be a lot more permissive, and we could see other ETFs across a broader range of coins.

Lucy Baldwin (05:37)

Got it. No, that makes a lot of sense, Alex. And, you know, you referenced earlier that, you know, this is an asset class. You know, talk us through how and why you say that. Do we also read into what you just said around the preference of retail in these new ETF products that the next leg is institutional, assuming you get regulatory change? How do we think about that growth?

Alex Saunders (05:57)

Yeah, I think that's right. I mean, we even had some news flow on a very large institution, the U.S. government, potentially adopting a crypto strategic reserve, right? So that's some evidence of a large institution. And we've seen some evidence of some adoption, either via purchases of the ETFs or other vehicles of that institutional allocation, if you will — and then it becomes a portfolio allocation — to Bitcoin specifically or crypto more generally. And then in terms of the asset class, I think it's a very interesting debate in terms of whether it's an asset class or not. What we have seen is if you— if a lot of the ETFs have thought of or characterized Bitcoin as digital gold, right? So as an alternative to gold in terms of that commodity asset class. And we think in the long term, that's probably the direction that crypto assets will go in. But in the shorter term, when we look at the correlations, when we look at the macro factors, and when we look at the sort of stage of adoption, we're really at the very early stages of adoption of crypto assets in general. And so there is still this correlation with equity markets, right, and with technology companies, for example. And so the portfolio diversification benefits that you might get from an asset class like gold, we don't think are there, quite there yet, for the— Bitcoin in particular and the broader tokens, as well.

Lucy Baldwin (07:36)

That makes a lot of sense, Alex. And just to expand on what you've said there, you know, as you think about the regulatory landscape and how that's going to evolve, obviously the previous U.S. administration had overseen a crackdown on crypto due to concerns predominantly around fraud and money laundering. I guess it's one of these areas where you can really debate whether less regulation is a good thing or a bad thing. How are you, you know, expecting to see the regulatory landscape evolve? Is it just clarity you need rather than necessarily more or less regulation? What do you expect both in the U.S. but then also outside of the U.S.?

Alex Saunders (08:11)

So the U.S. prior to the election, I would say, was slightly behind in terms of regulation, at least in terms of legislation, right? And most of the rules around crypto in the U.S. were written either by the SEC through enforcement action, so after the fact, or in court cases, right? And that continues to be the case in the short term, but we think that, you know, you will get— and there was an executive order in January, asking really for a working group to come up with proposals for a framework. Now, Europe has already done that. There is a framework in place. So in that sense, the U.S. was behind. I mean, I think the SEC's stance really has changed to be much more open to having discussions rather than going down this enforcement route. And I think that for companies that are involved in the space, I think it's become a lot more exciting because they're able to have these discussions and they're able to have more of a back and forth with the regulators in terms of what will be permitted and what won't be permitted.

And as you say, what the industry writ large, I think, is really looking for is regulatory clarity, not wholesale deregulation, because we have had challenges in the past with over-leverage, right, with these bankruptcies and other issues. And so it's an area where you don't necessarily want less regulation, you actually want more regulation, but you want transparent and clear rules. And that's probably the direction that we'll go in. Crypto markets are very fast moving and not known for their patience. And obviously, these things like legislation and bills, they take time to create the framework, discuss it, come out of committee, et cetera. So that's an area that it will evolve. Will probably take longer than crypto markets would hope, but it's definitely a positive step in the long road.

Lucy Baldwin (10:16)

That makes sense Alex. And, you know, we're obviously recording this podcast at a time when we've just seen crypto prices jump, as you alluded to very recently. You must be inundated with people asking you: How do I think about this coin versus that coin? And there's obviously a huge proliferation now of meme coins that are out there. What's your approach when investors or asset managers ask you those sorts of questions around how to think about which coin in the space is going to be, you know, the next big thing?

Alex Saunders (10:45)

We do lean sort of on the model approach and really on the first principles of that. You know, if we're thinking about some of these models, what is the utility of that particular network? What's the use case of that network, right? And so when we look at it from— that's where we get more excited about these sort of real world applications, right? And so when we look at it through that lens, if you were to take meme coins, so these are coins that really don't have any utility — and the SEC has come out recently and clarified that they don't view them as securities, they view them as a collectible, right? For us, that's really a distraction from that sort of long-term adoption, people using it, right? And then us tracking people using a blockchain or a network for a specific purpose, right? I think that would be our view on that. So then when you think about the strategic reserve, from an adoption point of view, as we discussed, it's obviously a positive. You have a large institution, right, that's potentially going to adopt a digital assets strategy via this strategic reserve. So that is unequivocally a good thing.

And then the other thing is it seems reminiscent of in the UK, the UK government announced that they were going to sell gold, right? And then the price of gold moved, and then they sold it after the fact. And so this seems reminiscent of that kind of pre announcement. But yeah, from that standpoint, what we really like to focus is sort of the long-term value, the long-term adoption. So the areas I would highlight where we think there's a growing use case I think would be stablecoins, which can be used as a store of value and actually already are in some countries and for payments or tokenization, which is something that can deliver operational efficiencies and a whole host of other benefits.

Lucy Baldwin (12:49)

I hear you. And I suppose, then to sync this back up with the regulatory backdrop, it sounds as though, Alex, you and the team feel this is a genuine regime change for the industry that we're starting to see. But I suppose, Alex, that's all going to take a lot of time because regulations don't tend to get written in a day. And so in an industry that's perhaps not used to patience, it's going to have to try and, you know, be patient. Is that a fair summary of where we are from a regulatory perspective?

Alex Saunders (13:18)

Yeah, that's exactly right. In that longer term, it's sort of quite exciting and we have to wait and see what regulations we get, we'll have to look at them, we'll have to see what innovation there is, what the use cases are that are coming up. But that regime change is really, I think, a real positive for digital assets industry writ large, right? But as you say, it's an industry not known for its patience. And so, you know, to go back to the shorter-term catalysts, you have— probably will get broader ETF token approvals, potentially. There's talks of having staking within ETFs, which will open up Ethereum, for example. Right now, you don't get a staking yield if you buy the ETF, but you can if you hold it in a different manner. So that may be something that helps with those flows, right? You know, on that institutional adoption and even the retail adoption, we do think that thinking about crypto allocations in portfolios is going to become more and more important. So we've done work around that. So yeah, it's exciting times.

Lucy Baldwin (14:24)

And just on that, Alex, just as we start to close out, you know, when you think about allocations in portfolios, right? I know we don't make recommendations here, and I know one of the clever things you and the team have done is sort of try and reverse the question, almost, around correlations and volatilities and returns. Talk us through how you've tried to frame that to help people here.

Alex Saunders (14:46)

Yeah. We don't make forecasts on Bitcoin or any other tokens. But we know, we are very interested in how it fits into that portfolio context. And we've looked at it in a couple of ways. One way that's very popular, right, is that you just take their historical performance of Bitcoin or crypto assets, right? And then you add them to a portfolio, and you see how that portfolio's done. If you do that from 2014 when we had the first Investment Trust launched, or 2017, when we had futures launched on the CME, then you find that Bitcoin's additive to portfolios. That analysis is sort of necessary, but it's not sufficient, right? And it has a little bit of survivorship bias. It's kind of akin to, Well, if I bought Amazon in 1999 or some other tech stock, then that would have worked out great. So what we did to kind of try and frame that analysis in a more of a forward-looking sense is reverse the problem, as you say. So what returns would be consistent with an allocation of, let's say, 1% to Bitcoin, so from that we leaned on the first stage of Black–Litterman analysis. So you calibrate a risk aversion to recent or longer-term market returns. And then you look at what would be the return that would be consistent with me adding 1% to Bitcoin or let's say 5% to Bitcoin. Depending how you calibrate that, you end up with an answer that's sort of equity-plus, I would say. So it could be equity plus 4% if it's a small allocation and risk attitude is large, risk aversion is large, or it could be up to 12% if you're wanting to put a large amount, say a 5% allocation to Bitcoin. The other way that we do that analysis is from a pure risk standpoint. So if I take a 60:40 portfolio, I'll take 1% out of my equity, so I have a 59:40 portfolio, add that to Bitcoin, and I decompose the risk, how much risk of the portfolio is generated from that asset. And, interesting analysis, by the time you get to 4% allocation, you're talking about 10% of the risk of your portfolio now — your global equity and bond portfolio, your U.S. equity and bond portfolio — 10% of that risk is now driven by that one asset class, that new asset class Bitcoin. So those are sort of different ways to frame that portfolio allocation problem.

Lucy Baldwin (17:21)

I see. And Alex, look, just to round things out and before we close, you said earlier we were talking about asset allocation, and is it an asset class, right? I think you said it's a little bit early on to talk about crypto as digital gold, right? And again, you sort of said that, look, gold acts as a hedge typically for geopolitical risk, and it tends to be, you know, a risk-off defensive asset. So when equities are down, it tends to have those defensive type of characteristics. Obviously, that's not been the case for crypto tokens. And I think I'm right in saying that they've tended to have a positive equity beta and they've sold off around geopolitical events. Tell us what you've just seen, you know, in the last couple of years, in terms of the evolution of correlation here, because I imagine that has changed in the last few years, and it'll probably continue to change. So how do we see that moving as we go forward, Alex?

Alex Saunders (18:12)

You're right. So the correlations have been quite time varying, and there have actually been times when cryptocurrencies have been correlated with gold prices and other times when they haven't, but if you take sort of a longer-term view, the equity beta is still the largest driver. So from that standpoint, we still think it's a bit premature to think of crypto as digital gold or as a portfolio diversifier. Now, there is a school of thought that crypto will end up acting like gold because you have that sort of fixed supply and you have the mining schedule. And so in that sense, it should act like a hedge for unexpected inflation, right, or debasement of currencies. But right now we don't see that. And you mentioned geopolitical risk, and we sort of saw a mini experiment in…last year, where— it was a weekend, it was a Saturday afternoon, I think, in New York, at least, that there was an escalation in the Middle East. Some Iranian drones were launched, and so all the other markets were closed, traditional finance markets. But we saw there is a stablecoin that's backed by gold. And then also Bitcoin were still trading. And we saw real divergence in that time period in the performance of those two assets, right? And it's always very difficult to control for all the other factors that are going on, but I think that was probably the cleanest example where you tended to see that there is that risk, or equity beta, embedded at the moment in crypto, in Bitcoin, and that is a very differential performance around— than you see around gold.

And then the other analysis that we've done from a portfolio diversifier standpoint is looking at months with particularly bad equity returns, right? And then looking at how gold returns, how crypto returns. And crypto returns are as bad as equities in those poor months, and even more so in recent years, whereas gold is sometimes positive performer. I think the medium case is flat, right? So it is giving you that diversification. We're not seeing that diversification now. Now, as we get more exceptions, as we get more adoption, then I think that, particularly with Bitcoin, specifically, that fixed supply schedule will probably mean that the correlations with gold will increase, right? And when we see that, right, if we see Bitcoin behave more consistently, with gold in terms of performance, maybe that is when we can say that as an asset class, it's truly matured.

Lucy Baldwin (21:02)

I get you. And I guess, presumably, from what you're saying, then, things like stablecoins, you know, which are cryptocurrencies whose market value is pegged to that of another asset, presumably, that then means that that category of coins, essentially, could end up reinforcing, I suppose, the U.S. dollar dominance.

Alex Saunders (21:20)

Yeah, yeah, that's right. And, you know, we see that even now, the large stablecoins are growing in market cap. We look at stablecoins really as an on-ramp at the moment, into the ecosystem, but they're very large holders of short-term Treasury bills, right? The U.S. ones have been much more predominant than other currencies.

Lucy Baldwin (21:43)

Fantastic, Alex. What a brilliant whistle stop tour of what's happening in the cryptocurrency space across digital assets very broadly and the future as to where this space is likely to go. Hugely enjoyed the conversation. Thanks for joining me.

Alex Saunders (21:57)

Thank you.

Lucy Baldwin (21:58)

This episode of Research @ Citi was recorded on Monday, the 3rd of March, 2025. I've been your host, Lucy Baldwin. Do join us next time as we discuss foreign direct investment into the United States of America on Research @ Citi.

[Disclaimer] (22:15)