Opinion: Bitcoin owners are bellyaching about its plunge, but the digital currency’s volatility is no more extreme than that of stocks

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Bitcoin is currently trading at a 33% discount to fair value
Some bitcoin owners are complaining about the cruel and unfair twists of fate that have led the cryptocurrency to plunge in recent days.

In a five-day period from last weekend to its Wednesday low, as cryptocurrency exchange FTX unraveled, bitcoin BTCUSD, 0.57% fell nearly 30%. And that came on top of the huge loss it had suffered in the previous year. (Bitcoin bounced Thursday, but it’s unclear whether that was just a so-called dead cat bounce.)

Big as those losses have been, bitcoin enthusiasts need to stop their bellyaching. They say they want bitcoin — along with other cryptocurrencies — to mature into a full-fledged asset class, as opposed to a basic currency.

But, if so, they must accept the inevitability that it will trade well above or below fair value. Wide as bitcoin’s deviations have been, they have been no more extreme than those of the S&P 500 SPX, +0.92% or gold GC00, +1.17%.

To reach those conclusions, I relied on the only bitcoin valuation model of which I am aware. It bases bitcoin’s fair value on something called Metcalfe’s Law, a formalization of what’s known as a network effect. This effect exists when the value of a network grows along with the number of users. The Metcalfe Law version holds that this value is proportional to the square of the number of users.

Claude Erb, a former commodities portfolio manager at TCW Group, is the analyst who has applied Metcalfe’s Law to bitcoin. He assumes that every bitcoin that has been mined represents one user in the network. The accompanying chart, below, plots bitcoin's actual price since 2010 alongside the estimate of Erb’s model.
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For the stock market, I assumed that fair value is based on the historical average price-to-earnings (P/E) ratio. On that assumption, the S&P 500 has at times traded for more than seven times its fair value and for as little as one-third.

For gold, I relied on a valuation model devised by Erb and Duke University finance professor Campbell Harvey, which bases gold’s fair value on the historical average ratio of bullion’s price to the Consumer Price Index (inflation). Using that model, gold historically has traded at more than twice its fair value and for as much as a 61% discount.

It’s also worth emphasizing that not only can marketable assets deviate significantly from fair value, but they can remain so for a very long time. The longest continuous stretch since 1871 of the S&P 500 trading for less than fair value lasted longer than 16 years. For gold since 1974, the comparable stretch is more than 19 years.

For bitcoin currently, in contrast, it’s been trading for less than fair value for just five months.

So bitcoin enthusiasts might want to be careful what they wish for when urging it and other cryptocurrencies be viewed as a full-fledged asset class. Not only can the market’s judgment of an asset be very harsh, it can remain that way for years.

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the bear market is alive and well

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