Will Bitcoin Trigger the Next Market Crash?

Description

It has been a spectacular ride for Bitcoin investors. The revolutionary digital currency has almost tripled in value over the last three months to be trading at just under US$12,000, giving it a market cap of almost US$199 billion compared to a mere US$12 billion a year ago. While the combined market cap of all cryptocurrencies only comes to US$354 million, or a mere 19th of the market cap of the **NASDAQ Composite Index** at the peak of the dot.com boom, they pose a very real threat to the stability of financial markets.

Now what?

Bitcoin and other cryptocurrencies exhibit many of the characteristics of being in a massive market bubble. These include manic speculative buying based on claims of the emergence of a new market paradigm, rapid appreciation in value, and a parabolic price curve. As the bubble expands, valuations increase at an even more frantic rate, accelerating at their fastest rate just before the bubble collapses. It does appear, however, that the bubble is far from its peak.

You see, Wall Street and other major financial institutions have only just started to pay attention to cryptocurrencies, meaning that the speculative fervor surrounding Bitcoin and its peers will keep growing for the time being. Major financial institutions are now jumping on the bandwagon to profit from what has become the hottest asset of 2017, which will only sharply increase the speculative activity in cryptocurrencies.

A Bitcoin investment fund exists called **Bitcoin Investment Trust** (NASDAQOTH:GBTC). It gives investors the ability to gain exposure to Bitcoin, while providing similar flexibility to that associated with owning a stock or ETF.

There is a slew of other cryptocurrency-related financial products on their way. Derivatives market maker **CME Group Inc.** has announced the introduction of Bitcoin futures, while Cboe Options Exchange and investment bank Cantor Fitzgerald have flagged plans to list financial products offering exposure to cryptocurrencies.

While it is claimed that these products will boost liquidity and reduce the extreme price volatility associated with Bitcoin, they also increase the risk of contagion. It is here where cryptocurrencies could pose a threat to the stability of other financial markets, despite only having a combined market cap that is a fraction of that for other asset classes.

The advent of exchange-traded cryptocurrency products will boost speculative activity, while significantly expanding the volume of money being pumped into cryptocurrencies. This will not only fuel the bubble but also expand their influence in what are already heavily interdependent financial markets. As the volume and value of cryptocurrency-related financial products grow, their tentacles will spread further throughout the financial system, significantly increasing the risk of contagion when the bubble bursts.

Because it is impossible to determine what Bitcoin or other cryptocurrencies are truly worth, along with a significant lack of regulation, it will be impossible to really know what derivatives have been chained to them. That means the fallout from the cryptocurrency bubble bursting could be far greater than many pundits anticipate.

Just like during the U.S. housing meltdown, the end of the cryptocurrency bubble could trigger a cascading series of market crises that would grow in volume, eventually triggering a massive market correction.

So what?

While the end of the Bitcoin bubble may be some way off its surging value, substantial volatility and lack of utility combined with the impending groundswell of cryptocurrency-related financial products poses considerable risks to markets. When it bursts, the fallout could spread far and wide, triggering the next market correction.

One of the best means of hedging against this risk is for investors to boost their exposure to defensive stocks like utilities. This is because electric utilities such as **Fortis Inc.** (TSX:FTS)(NYSE:FTS) are relatively insulated from market downturns because of their wide economic moats, the oligopolistic nature of the industry in which they operate and the inelastic demand for electricity.

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