Mike Green: FOMC + The Future of Digital Currency

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Erik: Joining me now is Mike Green, Chief Strategist and portfolio manager for Simplify Asset Management. Mike, it's great to have you back on the show. We had the big day today on Wednesday afternoon. We're recording this the day before this podcast airs with the Fed announced that they're intending to do what? Why don't you give us the full briefing of what the Fed did today and what it means and what you see on the horizon?

Mike: Well, I think the easiest way of just describing what happened today with Jerome Powell's testimony in the release statement is that the Fed came out more dovish than I think people had broadly expected them to. They indicated that yes, they will begin tapering. They have the ability to either back off or to accelerate against them. But I think the most important piece of information that came away from it was the Fed's continued emphasis on the fact that they believe inflation is transitory, and importantly, even in the labor market, which has traditionally been thought of as a key driver of the Fed's behavior that they do not see us as having normalized or come anywhere close to reaching full employment. And they're largely discounting many of the wage pressures that they're seeing.

You know, Powell was relatively humble in terms of the certainty of where they are, but I think it was somewhat unequivocal that this was a very dovish presentation. And the real question, I think is going to be how credible does the Street view the uncertainty around whether they should hike or not. Right? The direct words were when we reach full employment, then we'll figure out whether we're addressing the inflation components. Whether we've adequately met the inflation objectives. And I think that's a pretty important statement for one of the very first times you almost would have expected something like this out of you know, if a labor economist like Yellen, but Powell very clearly came out in favor of let's let the economic environment run hotter, as we tried to get people back into the labor force.

Erik: What is this going to mean for, let's start with equity markets?

Mike: Well, equity markets obviously are enthusiastic about it. We've seen a bit of a, you know, sharp rally in terms of US equities in particular. It appears to be led, you know, by many of the larger stocks, so not necessarily a remarkable move in terms of either inflation-oriented assets. And obviously, that's being affected by some dynamics that are going on in the commodity markets as we'll probably talk about later. But you're broadly seeing this dynamic of you know, the traditional leaders of the market. The large cap names are rising. My guess is that that's a function of people trying to put money to work rapidly. So buying the S&P 500 futures, for example, or buying the NASDAQ 100 futures, with the objective of trying to put money quickly to work. And then we'll shake that out over the next couple of days as people try to decide how they want to actually fully deploy that capital.

Erik: Well, you mentioned commodity impact let's talk about that next, because gold took a real nosedive, but it looks like it retraced almost half of that move. Crude oil on the other hand, just kept on nosediving.

Mike: Yeah, so to me, those are interesting, right? So gold is more inflation in terms of monetary sensitive or real rate sensitive. I would argue that, you know, I've been concerned about crude for a while, primarily because I think that China is significantly weaker than people think. And that is the primary market for crude, right? So yes, we're absolutely affected in the United States. We are absolutely looking at a situation where high crude oil prices are influencing our economic behavior, and have suggested that we would see inflationary conditions. Guess what I've been trying to reiterate. And I've said it over and over and over again, on Twitter. Part of what we need to remember in commodity markets is that China is the largest consumer, they're slowing dramatically. It's very unclear what 2022 is going to look like, once we clear many of the supply challenges here in the United States, to a lesser extent in Europe, there's been an awful lot of goods demand that has been pulled forward.

And as China is, you know, slowing in its economy, the crude markets are going to be pressured on that front. So again, it's a supply issue. And you see that I would argue, at least in terms of the construction of the curve, which has been very sharply in backwardation, right? So at the front of the curve, we're looking at, you know, $80 oil at the back of those, and that's $4 down from where it was, you know, earlier today. At the back of the curve, you know, two years out three years out, we're still looking at $60 oil. So this is a market that is very clearly saying this is a short term issue. And now it suggests that there's some uncertainty coming around in terms of what the potential demand curve looks like.

Erik: Why do you see that uncertainty? Is that China or something else?

Mike: China is the area I'm most concerned about in commodities. And you know, the other component I guess I would highlight is in very classical terms, the cure for high prices is high prices. What everybody had kind of hoped for was that cure was going to manifest itself in terms of higher production. In other words, the US was going to tool back up In terms of its supply dynamics. We've seen resistance on that and obviously, we've seen the Biden administration push back against the idea of expanding fossil fuel production in the United States. I think that had led people to think that we are going to see the potential for you know, I believe we heard Goldman Sachs come out with a call for a potential spike to $120 next year, a few days ago. My sense is that that is unlikely to happen if China continues to slow.

Erik: Let's talk about the big one, which is fixed income, treasury yields. Of course, the big fear was, hey, if this is really the beginning of the next taper tantrum, you could be looking at a bond market crash. Well, we got a much more dovish statement, but still they are talking about tapering. So which way does this go in terms of bond yields?

Mike: Well and I think we've talked about this before, right. So the question is, how much should bond yields actually reflect inflation fears. The current level of inflation fears versus a longer term question about the stability and the inflationary conditions? I don't think and I think Powell actually speaking to this, but he told us very specifically is we're not in any rush to hike in the near term. We're waiting until we actually see the economic behavior. And we have seen some, you know, increase in yields and reaction to that, right? That dovish statement did result in bond yields rising by about three basis points. But we're on a long way away from a bond crash. And it's important to just highlight for people that while it feels like 157 on the US Treasury, the 10-year is ridiculously low. That's actually quite high on a global basis.

So I struggle with a lot of the interpretation that people have had, that we're gonna have a bond crash, because the Fed's steps away and stops buying. I'm actually just about to post a piece on Medium talking about the dynamic of who is buying bonds. And I think people under appreciate the unique role that bonds play in portfolios. They are unique amongst financial assets in offering certainty about future value in nominal terms. Other assets behave very, very differently. And so they're always going to be demand for bonds in portfolios. The idea that it's just going to collapse because people are fearing you know, Jack Dorsey's, you know, Hyperinflation is coming. That's going to be a long time before we actually end up seeing that dynamic play through.

Erik: Mike, you mentioned, your Twitter audience, you know, you get beaten up a lot, both on Twitter and when you've been on this show before. I think a lot of people think you are the I don't know, the crypto Antichrist or something. I want to try to set a record straight, I want to ask you some true or false questions, and I think that the answers are probably going to surprise our listeners.

So, Mike, in your opinion, true or false? The invention of the tokenized Secure Digital bearer asset that's the underlying invention that makes Bitcoin and cryptocurrencies and also decentralized finance possible. Is it true to say that that is an utterly game changing invention, which will completely reshape the face of finance over the next 25 years?

Mike: True.

Erik: You crypto guys that don't like Mike weren't expecting that one were you? Let's take it to the next step. Is it true that it is a near certainty that conventional currency systems will eventually be replaced by tokenized digital currency systems because they are inherently superior and offers so many benefits that we just can't possibly resist. long term, the temptation to replace all conventional currency with tokenized digital currency?

Mike: True.

Erik: You guys weren't expecting that from Mike, were you either? And is it also true that the benefits that these things offer substantially reduce counterparty risk and the systemic risks that have inherently plagued the financial system for years. Specifically, you think about the so called Lehman moment where one institution can take down the entire system because of how deeply its counterparty risk goes? Is it true that decentralized finance, that's the application of that secure digital bearer asset not just to currencies, but actually to all of the other securities creates a entirely new financial system that's based on assets rather than institutions and we don't have to have systemic risk that's tied to any one institution?

Mike: I'm going to give that one a partially true one. Because I think the design of that system, there's a choice. The current system relies on a and this is very well described by a very unpopular individual right now Omar Ova. The idea that what we have now is we have a banking system, we have a currency system that relies on agents of the government, not actually members of the government, but effectively the banking system and the shadow banking system to create most of the money that we see. The uncertainty about the quality of those counterparties is what you're referring to and the crises associated with that, as we were referring to. I agree with you that it is likely that that will change radically with the introduction of tokenized and digital securities.

Erik: So with tokenized securities and a tokenized financial system, we can really make a better mousetrap. A better financial system that has less systemic risk, more transparency, it's a better thing. It is the way of the future. You and I agree on that, don't we?

Mike: Yes, 100%.

Erik: Okay! Now, I think this is where we really have to draw the line and just say the only place where you and I don't necessarily agree with the Bitcoin maximalist crowd, is the idea that it will continue to be possible for private actors, that's basically the developers all around the world that contribute to the creation of the Bitcoin network. What I've predicted and you've predicted is that governments will eventually wake up and recognize that, hey, these guys are not the bunch of Jokers that the central bankers have described them as. They really do pose a threat to the government's monopoly over the issuance of currency. And eventually, you and I have predicted that governments will figure out, hey, if we don't do something about these guys, they really will replace all government issued money with something better, because they have come up with something better. The only place where you and I disagree with the crypto crowd, is we think that governments eventually will wake up and recognize they're about to lose that monopoly. And they'll probably freak out in a way that is extremely damaging to the privately issued cryptocurrencies that are designed to compete with government issued money. Is that the gist of it?

Mike: Yes. And I would go a step further, right. And say that, you know, where my concern lies is mostly in that reaction function, and the fact that it could end up much worse, right?And if that recognition is delayed, and we develop effectively a shadow currency system, or a shadow riskless asset systems, a shadow collateral system that is in opposition to the interests of governments, and by extension governments that are perhaps not competently pursuing it, but generally trying to do the right thing, and particularly in the case of the United States that the reaction function to that is going to be much worse. And so my biggest concern is the broad attitude of you can't stop us. You know, you have no power of us, you can't regulate us. If you try to, we're just going to pick up and take our ball and go home and play somewhere else. I just don't think that that's a realistic proposal. And I think it becomes quite bad.

Erik: Well, now I'm really going to surprise our listeners and part of this, I'm playing devil's advocate, but my you know, my view is evolving. When I wrote my book on this three years ago, I said, look, there's no way governments are ever going to allow the monopoly over the issuance of money to be taken away from them by a bunch of hackers on the internet who came up with the invention of a better kind of money. what always happens when you invent a really cool weapon and try to oppose a really powerful government with it, is they come and kill your soldiers and take your weapon away from you and copy it and use it for their own purposes. And I predicted that would happen. But I also said, you know, there is a certain point where it becomes politically very, very difficult to outlaw something, if it is received already enough government endorsement, where people have put their savings into it, and so forth. And we've reached a point, Mike, where we have SEC endorsed blessed Bitcoin ETFs that people are putting their retirement savings into.

It would be very difficult for the government to say, look, in the interest of national security, we have to ban this cryptocurrency stuff. And oh, the fact that a whole bunch of voting Americans put their life savings into this stuff through a regulated ETF that the SEC blessed. Well, sorry, shit happens. I think it's already getting to the point where although I do think that the stakes are so high that once governments figure out what really is at stake, they'll do what they have to do. But I think that the scenario I first saw, where it's a very easy fight, there's not a lot of bloodshed, governments just say, look, we're going to shut this thing down. The way we do that is we just outlaw the conversion. You know, we make it a crime for any bank to, you know, convert anything into or out of it to facilitate any kind of exchange into or out of cryptocurrency between fiat currency and cryptocurrency. Just doing that makes it so impractical, that it would really, really take a huge dent out of it. Well, it would be really hard to do that now politically, and it's getting harder. So at what point do you get to where it really becomes a major political bloodshed for the government to change its view on this thing?

Mike: I think two things one is again it goes and I by the way have had similar observations where my view is the best case scenario for the Bitcoin proponents. And again, this is going to draw massive amounts of hate. But it is that ultimately it turns into an executive order 6102 where the government says, here's the price that we will buy these assets from you for so that you don't experience a crippling loss. But it becomes a, you know, it doesn't become a pure taking in terms of its force to zero. But it does become a taking in the form of we will no longer allow this to develop. To me that feels like the best case and is roughly I think what you're alluding to.

Erik: Well I actually have a different view and I don't think we're there yet. I think there is still room for governments to wake up and recognize the threat that a better currency system poses to their monopoly. But if it goes much farther, what I would anticipate is that governments realize they can't outlaw it. And so what they do is they simply, quote, regulate it. That's regulate in air quotes, meaning that they're basically going to say, you have to completely redesign it to do the opposite of what it does, you have to replace all of those wonderful privacy features of Bitcoin and make it so it's completely totally traceable by the government. And if you don't do that, well, then it's illegal. And so we didn't outlaw it. We just said you had to add safety features to make it better. And of course, those features would really undermine what Bitcoin was actually designed to do. So I think they would force the fundamental change of what these things are in a way that undermines their design intention. And that would cause probably a fork where there's a bunch of people that say, I want to have legal cryptocurrency, whatever that means, and a bunch of other people who say, F that we're sticking with the good old Bitcoin standard, and let them try to shut us down. And I think they will shut them down eventually. But it'll be a difficult fight in the days of where I used to think it would be easy for government to shut it down. I think those days are numbered, if not over.

Mike: So I think it's always been difficult to shut it down. And, you know, I think this has been one of the broad misunderstandings, right? It's nobody is arguing that it is easy to shut this down, you absolutely can, you know, start up a meth lab or start up a crypto mining rig, and try to keep Bitcoin alive. Right? There's no question about that. But the question for me is, do you want to bear the costs associated with that, right? There's remarkable rewards that accrue to somebody who opens up a meth lab in terms of monetary compensation. There's also remarkable penalties associated with getting caught doing it. And so it exists in our society, but it is not celebrated on CNBC. That I think is I would argue that unfortunately, I would agree with the way they were saying that there is the potential for there to be a neutered asset that can be used as collateral etc.

You know, at Simplify, we actually offer exposure to Bitcoin and to crypto in ways that are consistent with the regulated environment. I don't know how that is going to play out. I can't know with absolute certainty. But the whole focus for us is on encouraging that people take a responsible allocation to it rather than treat it as this is the certainty. This is an unstoppable force. So I don't know exactly how it's going to play out. It obviously, is stochastic and depends upon the reaction function. But there are lots of things that are illegal that have not been stamped out that I would guess the vast majority of people really, even though they can be profitable, really don't want to be involved with.

Erik: Well, I'm sure that might be true, like meth labs, but we really are talking about a superior form of currency system. And you know, I think that the reason that I have predicted and you've predicted the government's should object to it is it really is better, dramatically better. And that means that their monopoly over the issuance of money is at risk if they allow it to continue. I'm astonished that most government officials and particularly central bankers have not figured out that reality. They certainly seem to have woken up to the need for central bank digital currencies. But they don't seem to realize that there is, I think, a very real risk if they don't get their act together, that Ethereum or some other digital currency will reach a point where it's very hard to stop.

Mike: I think I mean, again, I agree. I'm not suggesting that it's going to be easy, in the same way that it's not easy to stamp out all sorts of illegal activity. But I don't, I still don't see the scenario in which it is embraced. And that maybe where we differ. I also would suggest that while I think that there are features around the tokenization and digital nature of the assets that are unique and superior to the attempts that tokenization that we have around the US currency, for example, right? The serial numbers that exist on $1 Bill, are a form of digitizing the asset trying to create scarcity around that individual asset. Now they're used ineffectively for tracing things like forgeries, counterfeiting, etc. But they are not in any way shape or form native to it. You cannot track it in the same manner. I think the point that I would broadly make around Bitcoin in that framework is that it is an asset that does a remarkably good job of one thing, which is if the government were to actually decide this is not okay. It would be very easy for the government to actually identify who were doing the things that are not okay. I think that is something people need to take very, very seriously.

Erik: Let's take a step back then from Bitcoin and just talk about Secure Digital bearer assets, which you and I agree are going to completely change the face of finance, and that really provide a way to create a far superior currency system that's much better than any conventional currency. Now, I know we've got a lot of listeners rolling their eyes saying, wait a minute, you know, the financial system has been digital for 30 years, you know, you do everything online wire transfers, whatever. What is this tokenized? What is so special about this? Why is it actually so much better, Mike? Other than a bunch of kids like it? What's so special about these tokenized, you know, currency dollars instead of just regular good old green dollar bills?

Mike: Well, the primary feature is actually that it allows you to one have a much more robust relationship between the government and most of its citizens. So many in the Bitcoin world highlight the challenge of the unbanked, right? That there are people who do not have access to financial services. Ultimately, digital securities allow you to create a individual relationship that doesn't require the outdated franchise relationship, again to steal from an unpopular author. There's what we have in the banking system, right. So the banking system basically exists as an authorized entity that has the capability of tapping into the Federal Reserve tapping into the actual core of the banking system, and does so by offering me assets that are the exact same thing that we see, by the way, in stock markets where I don't actually own the stock. I am a semi secured creditor of Merrill Lynch or fidelity or JP Morgan in terms of a brokerage relationship. The same thing is true within the banking relationship absent the FDIC insurance. As a depositor, I am an unsecured creditor within that banking system.

The digital token allows you to have a direct relationship where your claim is against the government itself. So effectively, any abrogation of that becomes the equivalent of the government choosing to default. It's much harder, much lower counterparty risk as you were referring to earlier transaction. Now, the fear and this is a very valid one is that when you replace that relationship, you've effectively created lots of small individuals against one giant bank. And that giant bank is presumed to have power and a willingness to use things like financial repression and inflation to quote unquote, steal the money of the population. That's one of the things that I think is so caustic about the current narrative, is that inherent lack of trust, right? Have they done the best job possible? Absolutely not. Have they done things to engender our trust? Very debatable. Are the choices that they have made as irrational as they're often presented? I don't think so.

Erik: Now, I'm fascinated. You said that the principal benefit was that it allows essentially a direct digital relationship between the holder of currency and the government. I'm sure that a lot of the crypto audience is not going to enjoy that comment. As I say, wait a minute, it's not the government. It's specifically in the case of Bitcoin, not the government. So it really is the currency system that you have, you actually have a digital token that it can't be counterfeited. There, you don't have to worry about whether your bank goes under because you don't need the bank. You can keep your money in this digital tokenized system which you might have a custodian for, you might not have a custody and for, its secure. And once we get to tokenized assets, not just currencies, but also securities, you're using one tokenized asset to buy other tokenized assets. You don't have any counterparty risk, or any any custodial risk because you don't depend on a custodian to hold your stocks for you. They're actually you know, in your name in the digital system, so to speak.

But what you're saying is, well, you're making the assumption that the government is in charge of this digital system. Let's at least consider the possibility that what a lot of people are saying is look, governments are slow and inefficient and screwed up. And what the Bitcoin crowd think they're doing is to create a better currency system and it absolutely is better. Right now in its current implementation, using the proof of work based validation architecture. It's extremely inefficient in how it uses resources. That's all going to change. You know, the first version of any software, it always gets better over time. It will eventually outdo proof-of-work with proof-of-stake based systems, it's going to get much more efficient with time. But the question is, is it valid to say, you know what, government's never gonna do this. It's gonna be the private sector that creates the new currency systems of the future.

And you know, it is, it's probably not going to be Bitcoin, but it's going to be Facebook, whatever they're calling Libra these days, or it's going to be Google money, or Apple bucks or whatever. It's going to be Silicon Valley that basically partners with the government in saying, look, you gonna let this crypto thing go too far. And now if you want to save it, you're not gonna be able to save it with the pace of government. You're gonna have to make a deal with us, you're gonna have to make a deal with Google. And we'll create Google digital dollars, and you can bless them as United States Google digital dollars, and we'll be your vendor who's in charge of administering the global currency system that by the way, we'd like being in charge of. I think that is a plausible scenario. The one where Bitcoin which is designed to intentionally alienate and offend government officials with the features that it has to in order to allow people to hide their transactions from government oversight. I don't think that stuff's going to fly long term. I think it will eventually be outlawed. But the idea of Silicon Valley giant like Apple or Google or even Facebook, making a deal with the government saying, look, you guys let the cryptocurrency stuff get out of control, you got to have digital currency. But you got to get it in Silicon Valley pace, not Washington DC pace. Sign us up. Is that realistic?

Mike: I think that's super realistic. I don't know that it necessarily is Silicon Valley. And I don't know that it's, you know, not some form of government contractor. For all intents and purposes, it could end up being Lockheed Martin, right? We don't know the answer. Now, I would suggest that Google is better positioned for it, or Facebook is better positioned for it than Lockheed Martin in this situation. But ultimately, I completely agree with you that the government fully recognizes that their inability to work at that pace that is required for that adoption, is likely to push it into a public-private partnership. If you want a very simple model for how that could work, right? Just imagine, effectively a base layer system that is provided free of charge to all members of our society. So every individual receives a social security number when they are born, or when they become a US citizen. And on the back of that, or an employee identification number, when you become a company on the back of that you effectively have that as your bank account number sitting in a central repository that is then able to say, again, to use the today example for it. This piece of paper that we call $1 bill that has this particular serial number right now, add the richness of the digital tokenized format to that sits in this account and is available to be spent by this individual and there is no indication or no confusion about who actually owns and controls that, right? That base layer can be provided free of charge to everybody in our society. The next layer of service, let's say you are a corporation that wants to exceed a certain number of transactions, or wants to access complex financial relationships, things like OTC derivatives, etc, then you have to pay for value added services on top of that. That to me makes perfect sense. It feels like that's absolutely the direction that it's going.

Erik: I think that's the direction it's going to. I call them SVDCs for Silicon Valley digital currencies. And I suppose you're right doesn't have to be Silicon Valley, although I think that's the most likely origin of such a thing. And I really think unfortunately for the Bitcoin crowd, it is going to be the absolute antithesis of Bitcoin. I think that some big Silicon Valley company might be Facebook, might be Google will get in bed with the government and design a digital currency system with features exactly the opposite of Bitcoin's design objectives. Every single transaction will be traced, you know, there'll be a permanent audit trail that allows the government to see exactly every penny of wealth that you've ever had. Who you got it from, what circumstances you got it under, where it came from, where they got it from. It's all going to be traceable, and it's all going to be built as a security feature that helps us to fight off terrorism and all of Satoshi Nakamoto's goals. They're going to use his technology to create something that achieves exactly the opposite goals.

And I think it will be private industry, you know, something like Facebook's Libra growing into a government. I don't know if it's sanctioned or government chartered thing, which eventually creates a private label digital currency that is adopted by several nations and becomes the new global reserve currency replacing the US dollar. Now, if that happens, there are very significant consequences to the US dollar and the US currency system and losing reserve currency status. And you know, that would have to all be factored into the plans and right now the planners don't seem to have figured out what Bitcoin is yet like 15 years later. So I'm not sure this is all going to go down in most perfectly efficient way. I don't know about you, but if there's one thing I do not want to see the George Washington dollar bill replaced with its Mark Zuckerberg dollar bill. What could be the risks here?

Mike: So I think you just hit on a bunch of them right? And this is part of the point that I make and it tends to drive people a little reactionary, I guess, is the kind of way of saying it. The US has many faults, and has made terrible policy choices. That's true for all countries. we tend not to pay attention to that, for the very simple reason that they are much smaller on the global stage. The closest analogue that we have to ourselves at this point is obviously China. And I think very few in the audience, even those who are Bitcoin maximalist would argue that they would prefer to live under the Chinese system than the US system. The US is somewhat unique in its willingness to consider these alternative systems, and ironically, many in the United States, right, who politically value what they refer to as freedom, right? I'm skeptical that what Ted Cruz really wants is freedom, but to speak in that way, are willing to consider systems that quote, unquote, weaken the government, right? The classic, you know, smaller government component.

Again, we're kind of 40 years into the Reagan Revolution. And they know that everyone is going to push back and say, you know, well, the government's bigger than it's ever been sort of thing. The reality is that we've gotten to this point that we say the government accomplishes nothing good and that's just not true. Right. Governance exists for a variety of reasons, but the most important one is that they are representing the social will of the people in the case of an elected democracy or an elected representative government, like we have in the United States. Do they do that particularly? Well, in many cases, they don't, right? But the alternative is much, much worse. And so when we engage in an attempt to tear down the US dollar, and reduce the influence of the US on the global stage. The real risk is not that a Bitcoin emerges de novo and becomes this fantastic new standard under which we all become wealthy and happy simply by participating in the system. The risk is that that power vacuum is filled by far more nefarious elements.

Erik: Let's move on to the subject of stablecoins generally, because I think as much as there's so much attention and hype and hoopla around Bitcoin and cryptocurrencies. Most people really don't want to take the speculative risk of betting on something, even if they're real true believers in where it's headed. You know, betting your life savings on an incredibly volatile asset class like Bitcoin, it's hard to sell most grown ups on. On the other hand, if you're talking about the promise, and I emphasize the word promise, that is, if you believed the sales pitch on stablecoins, it's kind of got all the benefits of a digital currency system, and it's a tokenized asset. It exists outside of the institutionalized financial system. You know, it has all this cool stuff to it. But it's magically tied to just automatically, you know, like a money market fund, it just never breaks the buck. It always stays tuned to the US dollar. So you know, you've got the stability of something like money market fund, but it's all tokenized and all these benefits. Sounds like a perfect thing to put your whole life savings into, doesn't it? Well, you and I think no, but the reasons that you and I think no, are really not obvious to the average retail investor, are they?

Mike: Well, I don't know if they are or they aren't right? But effectively, what it really is, is counterparty risk, right? So we have no idea about the stablecoins that are in existence today in terms of what the actual assets that backed them are. And the sponsors of these stablecoins, the Tethers, USDC's, etc, have completely failed despite incredible opportunity to do so to publish actually, audited results, right? So telling us exactly what they own, what the assets that they own that back these assets are, what the degree of backing is, we just don't know. And there's no reason why they can't. And so you mention money market mutual funds for example, right? Money market mutual funds are heavily regulated on every single day, literally, actually, minute by minute, we can know what these things own. The filing dynamics of a fidelity money market fund are going to tell us in excruciating detail, not only the individual securities that they own, but the broad classes, the liquidity characteristics, the interest rate that's being earned on those assets, etc.

We have nothing equivalent in the stablecoins that exist today. And that's what I think you and I ultimately object to because there is a demand for this digital asset. It is a superior security to a $1 bill that exists in my pocket that I can only send you economically if you and I both happen to have banking relationships that allow us to easily transfer funds between ourselves. Right now that can occur over a Venmo and It seems relatively simple. It can occur over a PayPal, or it can occur by handing you $1 Bill, right? A stablecoin theoretically functions similarly in the digital world. The question is we just don't know what they actually are. And that has always been the issue associated with these unregulated banking systems. It is an asset that we presume has stability that we really can't actually tell. And so it has very high what's referred to as jump to default risk. If it turns out that Tether is actually not money good. The risk is not that it's 99 cents, the risk is that it's three cents, that changes things or zero cents.

Erik: Well I think this is really important, Mike, because first of all, a lot of people would say, you're crazy, you don't understand, Tethers perfectly fine. But based on what you've said, and I happen to agree with you. I'm not an expert on this, but what little I know of Tether is, you know, they sort of kind of got a bank account in the Bahamas, kinda. Not sure, I really think that meets my definition of a secure currency system or asset backing. But it seems to me like this concept of a stablecoin, that is backed by a fully audited book of assets that fully secure those stablecoins so they really and truly are tied to the US dollar, and they can't break the buck. I mean, all the technology exists to create that it seems like the market for it is definitely there. You're saying Tether is not that. You know, it seems like it's a fraud, or it's a sham or it's or whatever. Why wouldn't somebody? I mean, why wouldn't your company create a better Tether that really and truly does have the assets and it's not in the Bahamas. It's in a US financial institution. It's fully audited by, you know, a top shelf US audit firm. Why doesn't somebody create one of those?

Mike: Well, the simple answer is that's what Libra was supposed to be. Right? And what they discovered with Libra, the idea was very straightforward. Under Libra, which is, we're going to offer this stablecoin. We're going to create a deposit taking institution that allows people to take their fiat currency, put it into a quote, unquote stablecoin, the Libra coin. And we're then going to benefit from the fact that we've taken in billions of dollars, which we can invest and earn a float for providing the services associated with that superior asset. What they discovered is in a world of zero and negative interest rates, and that's not a very profitable business. So this is part of the challenge that we have. Yes, absolutely. That's a service in the same way that the US government loses money when it prints $1 bill. Right? It's far more efficient for them to create a digital one currency exists as a service to the US public. We lose money on nickels, we lose money on pennies, we lose money on dollar bills, right? That's unfortunately, where we would be in today's low interest rate world if somebody tried to offer that service. It costs more than you're generating in return from it.

Erik: Oh, I trust the boys at Facebook to figure out all sorts of hidden ways to make a buck that nobody really knows what's going on until it's too late. So I don't know that they can't make it profitable. But certainly if you did it above boards, and advertise it was doing nothing more than be a stablecoin. I agree that's not too profitable. But I think this really is the crux, whoever is in charge of this. This goes back to the age old issue of governments not being able to understand and keep up with technology. Whoever's in charge of this is going to have incredible power, and regulators in charge of regulating it aren't going to really know what's going on.

Mike: I tend to think that's true. I think unfortunately, and this is absolutely true as it relates to something like Tether. When it exists and has grown in the manner that is grown outside of a regulated system where there is no regulatory authority, who has the ability to say you must show us exactly what you own at every moment. Or we at least have the ability to go in and take that because again, Tether is not regulated, right? They'll point to FinCEN and FinCEN is not a regulatory body. It is a registration body, meaning in other words, it's just hey, you know, give us your phone number basically, and maybe we'll call you at some point in the future. When you have that type of framework. It encourages all sorts of bad behavior. The worst case scenario would simply be that Tether is just taking the funds and absconding with them. I think that's probably unlikely. The second alternative is that they are providing the service primarily to the unregulated exchanges that facilitate the banking relationships effectively that are required for people to trade crypto, because I have to put money into an exchange. I have to put money into an account in order to effectuate trades.

The role of that in a stock market for example, when your brokerage relationship is filled by the money market mutual fund, it becomes the zero base asset. The zero volatility based asset that allows me to comfortably exist with any Charles Schwab or a Fidelity. That's what they're effectively trying to create and it's possible that they have relationships with the FTX's and the Kraken's, etc of the world, the binance's, where that's the service that they're providing and they're charging a fee for it associated with it. And they're choosing to invest those assets in things that are more speculative than we would otherwise believe. Right? That does create the potential for earning float. And there's a lot of rumors that float around things like Tether owns Chinese commercial paper. Again, we just don't know, right? We don't know. My hunch is that to the extent that they have backing by assets, it's ultimately just an IOU from their customers, the exchanges, right? You don't have a direct relationship with Tether, you have a relationship with Tether through an exchange. That's my hunch. My hunch is that to the extent there's assets there, it's effectively credit that is being extended to the exchanges. Whether that is good credit or bad credit, is somewhat unknowable. But when you are dealing with unregulated exchanges, the risk of them becoming regulated and being shut down, and those assets going to zero, and therefore everybody discovers that there's not enough assets to back the Tether component are quite high. And it doesn't feel like people are aware of that or willing to accept the role that that might play.

Erik: Well it seems to me that the real point here is we urgently need a true stablecoin that is absolutely solidly backed and audited and nobody questions whether it's a sham or not. And it seems like we don't quite have one yet.

Mike: Well, that's the whole point behind central bank digital currencies, right? Because it eliminates the question of is it exchangeable for Fiat in a one-for-one basis? Right? I mean, the irony, that I would argue within the Bitcoin community is the role of stablecoins and playing that and facilitating it exactly as we're describing, like a money market, mutual fund within your Schwab account, that allows you to buy and sell, right? Because you have to remember, when I buy bitcoin, I need to have funds available to execute that immediately. When I sell Bitcoin, I need to have a place to put the proceeds. That's what a stablecoin fills, right? I can't, I don't actually have magically an ATM that then prints out US dollars from my computer. What I have is I have the ability to put it into a zero volatility asset on deposit effectively at that exchange or through that relationship. We have absolutely no idea what's underpinning that theoretically stable asset. I don't understand how people don't understand how important that is. And the second thing that I would highlight is that there's an awful lot of language around the idea that this can't possibly be influencing Bitcoin in this manner. It absolutely can, right? Because this is the source of liquidity for a very illiquid asset. So it's a question that can have a huge impact.

Erik: Yeah, let's just say that Tether has no impact on Bitcoin is to say that the US dollars have no impact on stock prices.

Mike: 100%

Erik: You pay for it with US dollars.

Mike: And so a perfect illustration of this is actually what happened in 2008. Right. So if you remember the first reserve, there are two issues associated with the failure of Lehman. One was a large money market mutual fund. The first reserve held Lehman bonds and because Lehman bonds, and again, money market mutual funds are regulated, they can only hold assets that have a certain rating. Because Lehman failed so quickly, it never had the opportunity to be downgraded. The process of downgrading the asset would have meant that it was transferred out of a riskless vehicle like first reserve, and sold it a very minor loss to the next person down the risk curve, who would be willing to take some speculative risk or had the capability of taking some speculative risk. Because it was a very sizable component and this happened. First reserve, quote, unquote, broke the buck, right? That meant that people who were using money market mutual funds as collateral in leveraged relationships, or who were relying on X amount of cash in their portfolios, suddenly found themselves with less cash. That meant they had to sell stocks or other risk assets. The second source of the panic that occurred around the collapse of Lehman, was many hedge funds had relationship with Lehman as a prime broker, or what they thought was their cash was sitting at Lehman. And when Lehman failed, it actually turned out that they just became an unsecured creditor and had to step into the Lehman claims line, which meant they didn't have cash. And in order to transact and deal with things, you need cash, and so they had to sell securities. And when everyone has to do that, together, you get the crash of Lehman.

Erik: Well Mike, I can't thank you enough for another terrific interview. But before I let you go, tell us a little bit more about Simplify Asset Management. Now, you and our friend Harley Bassman both kind of change jobs in order to go co-found this company or were involved with other founders. What's it about and why an ETF at this particular point in your career?

Mike: Yeah, so both Harley and I actually love to join a group of founders who had founded Simplify. Simplify is an ETF provider that is taking advantage of a significant change in the rules that govern ETFs and mutual funds that occurred, and a combination of 2019 and 2020. The rule changes, the ETF rule, which was introduced in 2019, effectively made it much easier to introduce new and innovative products in the ETF space without a lengthy comment period. And so it's facilitated the growth of things like actively managed ETFs, we're trying to do things a little bit differently. The second rule change happened in late 2020. It was what's referred to as the derivative rule, and it facilitated the ability to include derivative strategies within ETFs in a way that hadn't been done before. There's efficiencies associated with this. It removes the requirement to have complex relationships with a brokerage firm in terms of things like ISDA's right so that's effectively a credit agreement that exists between a hedge fund or a very wealthy individual and a bank. Because of the introduction of the derivative rule, we're now able to include derivative overlays within products like an S&P 500 Index Fund that allows people to participate in the market and many of your viewers have heard me talk about passive and the dynamics of how that's causing prices to rise. The growth of passive is causing prices to rise. Our objective is to take strategies that allow participation in that and effectively put a seatbelt on it right to protect against the more adverse conditions that people have heard me talk about.

Erik: Mike, we look forward to having you back in a few months for an update. Meanwhile, listeners, be sure to check out Simplify.us for more information on Mike's ETF offerings. Patrick Ceresna and I will be back as MacroVoices continues right after this message from our sponsor.