



The identity of who is propping up the Bitcoin market

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40% of cryptocurrency trading is Japanese yen-denominated

An 11 December Nikkei report stated that 40% of cryptocurrency trading in Oct-Nov was yen-denominated. Japanese traders have reportedly come to account for nearly half of cryptocurrency trading since China started to shut down cryptocurrency exchanges, and this is said to be widely known among industry insiders (various estimates exist). This report shows that Japanese men in their 30s and 40s who are engaged in leveraged FX trading (or who used to trade but have stopped) are driving the cryptocurrency market.

The true face of investors engaged in leveraged FX trading

"Mrs. Watanabe" is a buzzword often used by US/European media and market participants to symbolize the typical Japanese retail investor who trades in FX. We think that retail investors are shifting from leveraged FX trading to leveraged cryptocurrency trading. Japan accounts for a high 54% of global foreign exchange margin trading (leveraged FX trading), so Japanese retail investors are major players in FX markets. Data from GMO Click Securities indicates that men hold 79% of FX trading accounts, and 63% of these men are aged 30-49 (Figures 3-4). The typical Japanese leveraged FX trader is thus a man in his 30s or 40s and really ought to be called "Mr. Watanabe".

Financial literacy

How much financial literacy do retail investors engaged in leveraged FX/cryptocurrency trading possess?

According to a survey by the Central Council for Financial Services Information (the Bank of Japan), Japanese retail investors are less financially literate than their US peers across all age groups (Figure 6). Compared to the US, financial literacy is particularly poor among people 35-54 years of age.

Figure 8 shows the top 3 reasons that Japanese retail investors engage in leveraged FX trading: 1) expectations of high returns, 2) they can easily invest in foreign currencies, and 3) many investors are earning profits. Leveraged FX trading is essentially a zero-sum game. In Figure 5, we equate increases in FX trading account margins with wins, and decreases with losses. Over the past 10 quarters, we estimate that wins to losses were basically even in six quarters, while significant losses dominated in four quarters.

Unrealized gains are also virtual

The National Tax Agency recently indicated that profits generated by the sale or use of cryptocurrency are classified as miscellaneous income in principle and are required to be filed in income tax returns. We think that many investors are hesitant to realize profits because, these profits would be subject to income tax (up to 45% tax rate) and residence tax (around 10%).

Fair value of cryptocurrency

Cryptocurrency such as Bitcoin that have pure distributed systems do not have an underlying value like precious metals. Value is not guaranteed by an issuer because there is no issuer. The value of cryptocurrency is thus entirely based on the belief that it can be exchanged for goods or sovereign currencies (BoJ review of December 2015). While valuation of exchange rates between legal tender and cryptocurrency should be the vital factor, it is retail investors (including "Mr. Watanabe") who are currently carrying out price discovery.

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“Mrs. Watanabe” is a buzzword often used by US/European media and market participants to symbolize the typical Japanese retail investor who trades in FX. Following Abe and Kuroda, Watanabe may be the most famous Japanese name among market participants (although the purported creator of Bitcoin, Satoshi Nakamoto, is also famous).

Japan accounts for a high 54% of global foreign exchange margin trading (leveraged FX trading) (source: Forex Magnate, 1Q2017), so Japanese retail investors are major players in FX markets. Data from GMO Click Securities which is the top company in its industry indicates that men hold 79% of FX trading accounts, and 63% of these men are aged 30-49 (as of end-September 2017; Figures 3-4). The typical Japanese leveraged FX trader is thus a man in his 30s or 40s and really ought to be called “Mr. Watanabe”.

As the speculative frenzy over cryptocurrency heightens, the spotlight is falling on the unique characteristics of Japanese retail investors. The Nikkei report mentioned above cited an example of a 38-year-old business man who invested ¥8m (\$70,000) in Bitcoin, including his bonus. The average household income of a 38-year-old is about ¥6.1m, the average savings are ¥5m, and the average borrowings are ¥8.8m. This report was also a topic of conversation among the managers of Japanese financial institutions that I visited this week.

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Before the FSA started applying pressure, the core investment products sold by banks and brokers were investment trusts with distribution yields above 10% (products with yields above 20% were particularly popular) that took compound risks and drew down principal (the typical purchase commission was above 3% and annual management fees were over 2%).

Figure 8 shows the top 3 reasons that Japanese retail investors engage in leveraged FX trading: 1) expectations of high returns, 2) they can easily invest in foreign currencies, and 3) many investors are earning profits. However,



Figure 9 shows that most investors say they quit leveraged FX trading because they did not do well (only 7.5% said they realized their profit goals).

More than a few Japanese investors positively value volatility. We have believed that “Japan is the Galapagos of asset management markets, pursuing its own path amid the long period of deflation. Japan’s investment style is typified by a combination of low-risk, low-return deposits and high-risk, high-return investments” (see our 11 December 2014 report, “Initiation: Securities firms confront changing “Galapagos market”).

Investors’ winning percentage and turnover

New investors continuously enter the leveraged FX trading market and repeat the metabolism of being forced out by a margin call due to sharp market changes. This results in a market with a tumultuous annual participant turnover.

Leveraged FX trading is essentially a zero-sum game. Japanese retail investors are playing this zero-sum game with institutional investors engaged in algorithmic trading. It would be very difficult for business men trading on their smartphones during lunch or after work to sustain their trade wins.

In Figure 5, we equate increases in FX trading account margins with wins, and decreases with losses. Over the past 10 quarters, we estimate that wins to losses were basically even in six quarters, while significant losses dominated in four quarters.

From leveraged FX trading to leveraged cryptocurrency trading

We think that retail investors are shifting from leveraged FX trading to leveraged cryptocurrency trading. Firms such as the GMO Group and SBI Group are embracing the sense of urgency and starting to offer cryptocurrency trading services. Factor breakdown is difficult due to market variables, but leveraged FX trading has been sluggish since February 2017 (Figure 1).

Cryptocurrency has been trending up, so retail investors' unrealized gains are also rising. With few investors leaving and a steady inflow of new investors, the investor pool has been expanding.

We believe that investors participating in leveraged cryptocurrency trading are typically Japanese men in their 30s and 40s who are engaged in leveraged FX trading (or who used to trade but have stopped). We think that the pool of cryptocurrency investors not using leverage is even larger.

Margin call risk and fail risk

Leveraged cryptocurrency trading services are available in Japan. Some major FX brokers are using the same 25x leverage limit that applies to FX trading, but there are no direct rules in leveraged trading of cryptocurrency.

During the Swiss franc shock in January 2015, many retail investors not only received margin calls but also incurred losses greater than their margin balances, because forced settlements couldn’t be implemented in a timely manner. This shows that investors can suffer losses which brokers end up booking as credit losses even with leveraged FX trading of developed nation currencies.



Authentication of Bitcoin settlements takes at least 10 minutes. The risk of incurring losses greater than margin is higher than in normal FX trading, due to high intraday volatility. As a result, we believe that brokers also face a higher risk of failure.

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The National Tax Agency recently indicated that profits generated by the sale or use of cryptocurrency are classified as miscellaneous income in principle and are required to be filed in income tax returns. We think that many investors are hesitant to realize profits because, combined with other sources of income, these profits would be subject to income tax (up to 45% tax rate) and residence tax (around 10%).

The progressive taxation system means that the tax rate rises in keeping with income for a single fiscal year (on a calendar year basis). For investors thinking of taking profit in the near term, a rational tax trade would be to sell some holdings this year and the rest next year. In contrast, investors hoping that profits will be taxed as capital gains in future (20% tax rate; but we cannot see any movement towards this) may put off realizing profit.

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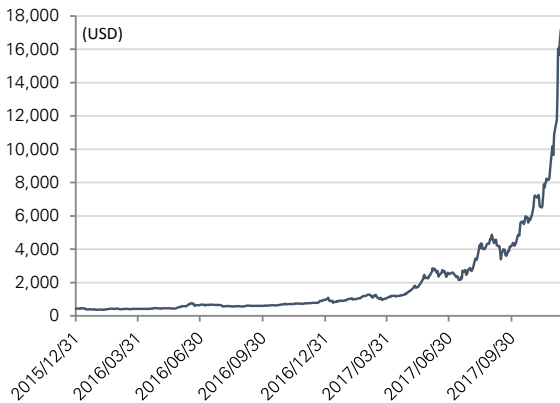
While valuation of exchange rates between legal tender and cryptocurrency should be the vital factor, it is retail investors (including "Mr. Watanabe") who are currently carrying out price discovery.

With a broader range of investors set to enter the market in 2018 and an increase in the ways to hedge (short selling), we expect to see the market's price discovery function being utilized. The CBOE Futures Exchange began offering Bitcoin futures trading on 10 December and the CME plans to start on the 18th (the US Futures Industry Association sent a critical letter to the Commodity Futures Trading Commission who self-certified new contracts for bitcoin futures products. The letter said that there has not been enough discussion on topics such as margin levels, transaction limits, stress tests, and settlement).

Rather than the cryptocurrency used for speculation, our focus is on the impact that distributed ledger technology (broadly defined as blockchain technology) can have on financial transactions and the business models of financial institutions (see our 6 December 2017 report, "[Blockchain seminar report](#)"). Furthermore, as speculation in cryptocurrency is growing to a scale that cannot be ignored, we plan to look more deeply into the potential impact on the market if the bubble should burst and the effect of concerns over this on regulations and monetary policy.

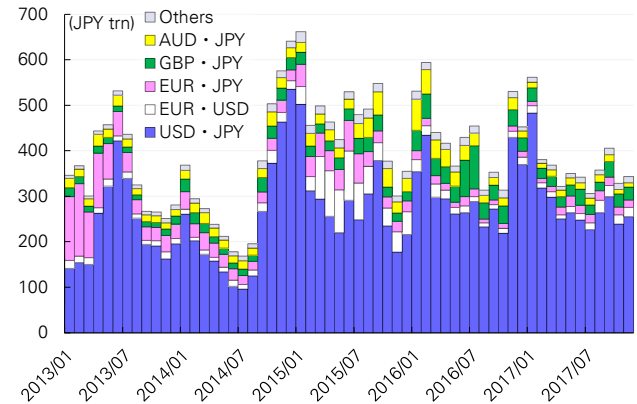


Figure 1: Price of Bitcoin



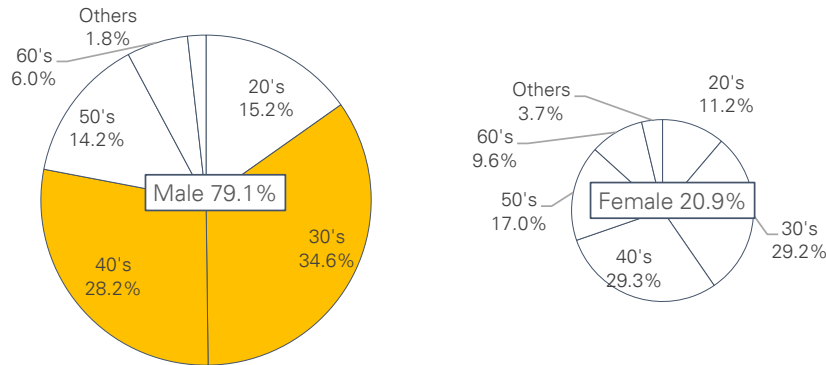
Source: Bloomberg Finance LP, Deutsche Securities

Figure 2: Monthly value of OTC FX trades



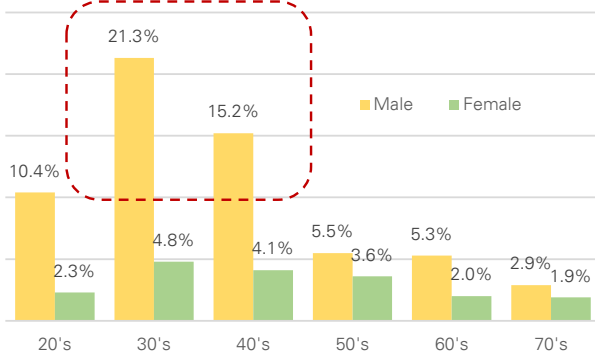
Source: Financial Futures Association of Japan (Monthly Statistical Bulletin on Over-The-Counter Retail FX Margin trading), Deutsche Securities

Figure 3: Customer profile in FX specialized account of GMO Click Securities (end of September 2017)



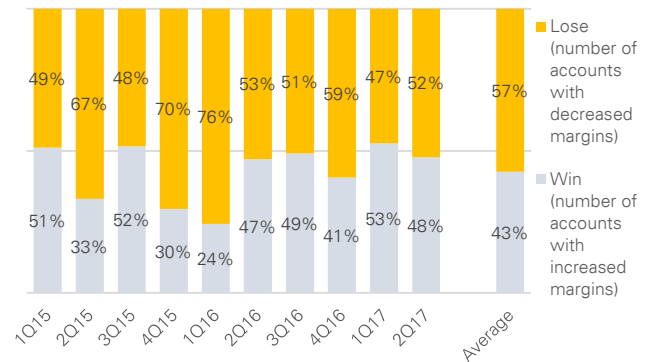
Source: Company materials, Deutsche Securities

Figure 4: Percentage of people with FX trading experience



Source: Financial Futures Association of Japan (April 2017; a survey on retail investor awareness of financial futures trading and a report on the survey results), Deutsche Securities

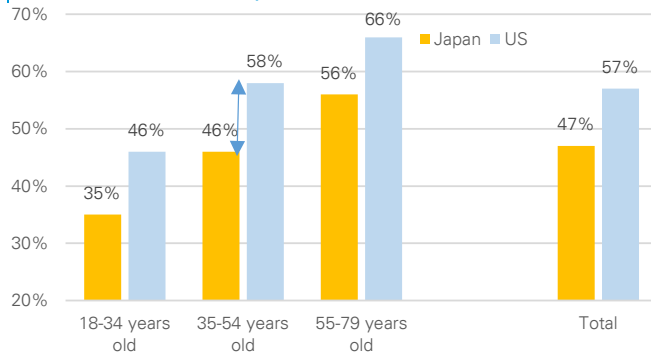
Figure 5: Winning percentage of FX traders



Source: Financial Futures Association of Japan (data related to percentage of accounts managed separately for each client, with net increases/decreases in balance), Deutsche Securities

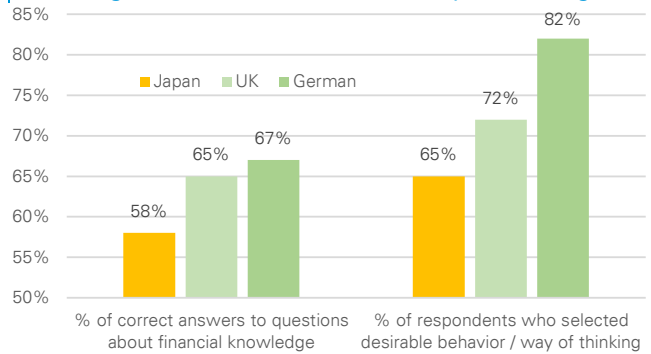


Figure 6: Average of correct answers to 5 questions about financial literacy



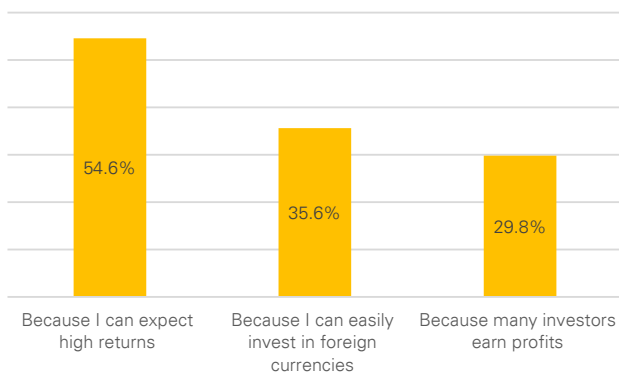
Source: Central Council for Financial Services Information (Bank of Japan Public Relations Department; Financial Literacy Survey 2016; released on 17 June 2016), Deutsche Securities

Figure 7: International comparison on financial knowledge and desirable behavior / way of thinking



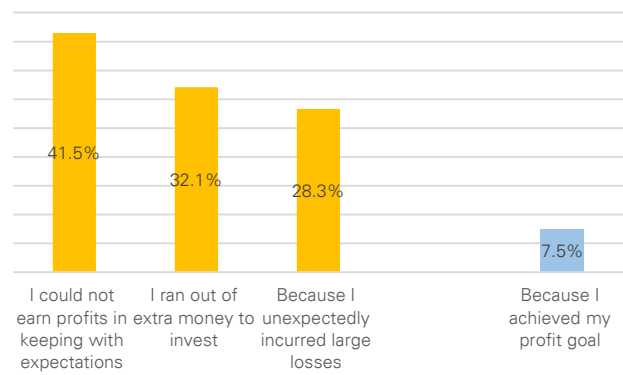
Source: Central Council for Financial Services Information (Bank of Japan Public Relations Department; Financial Literacy Survey 2016; released on 17 June 2016), Deutsche Securities

Figure 8: Reason for wanting to trade FX in future



Source: Financial Futures Association of Japan (April 2017; a survey on retail investor awareness of financial futures trading and a report on the survey results), Deutsche Securities

Figure 9: Reasons for quitting FX trading



Source: Financial Futures Association of Japan (April 2017; a survey on retail investor awareness of financial futures trading and a report on the survey results), Deutsche Securities



Appendix 1

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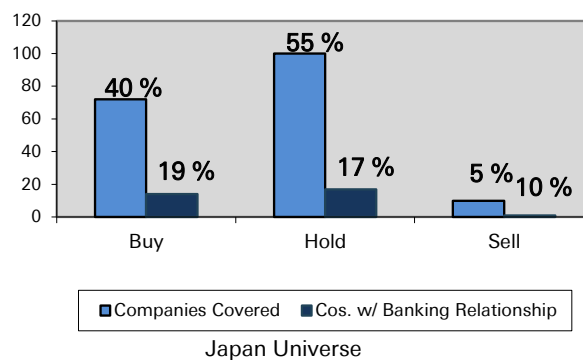
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