
**The Revenge of Liquidity

“Water, water, every where, Nor any drop to drink.”
– Samuel Taylor Coleridge, The Rhyme of the
Ancient Mariner

Over the past few days, starting on Feb 27, we have indeed seen the revenge of liquidity. The flight from quality, amplified by easy credit that produced liquidity where there was previously none, has become a flight to quality.

The safest haven for total return investors has become the ‘safest’ of securities, US Treasuries. The top performing sectors have quickly become the worst performing sectors. And, it all started with a sell off in the Shanghai market.

Or did it?

Over the past few quarters, as pundit after pundit voiced ‘I told you so’s’ over the correction in housing prices, here is what we told our clients in their quarterly Insurance Investing - Environmental Summary:

“Perhaps the press has overstated the negative ‘wealth’ effect from falling house prices and what the real residential realty bogeyman will be is upwardly adjustable mortgage payments.”

And, who is most hurt by upwardly adjustable mortgage payments? People in the most tenuous financial circumstances – those who are euphemistically called ‘sub prime’ borrowers.

Liquidity (leverage and low interest rates) made even investments in sub prime mortgage backed securities look good to a yield starved investment community. And now, with upwardly adjustable mortgages hurting sub prime borrowers, the sub

prime mortgage market has become the Ancient Mariner's albatross, the market has virtually killed the issuance of such debt. And, the market, like the Ancient Mariner and his crew must now pay.

The revenge of liquidity has meant the reassessment of risk levels for all investors. Where the thought was 'how to get a better yield/return', the thoughts now turn to 'how to protect ourselves from what might happen'. This reassessment of risk means a look at all financial positions and one of the riskiest of positions can be found in what is popularly known as the 'carry trade' (buy non-Yen denominated bonds and sell Yen denominated government bonds).

It was a 'no brainer' for years: borrow at less than 1% and invest at 4-5%. Banks would love this net interest margin and, unlike banks, hedge funds don't even have to allocate regulatory capital for the trade. Unbeatable, until...

Over the last few weeks, the slings and arrows of the Euro community were being felt in Japan. 'The Yen is too weak,' said the Europeans, 'This makes it difficult to compete.' While the US Treasury Secretary said little about this. As an ex-Goldman Sachs man, he knew what a stronger yen might bring: the potential unwinding of the carry trade. Hedge funds (very important clients of Goldman and the like) have continually used this strategy and levered it sometimes up to 30:1. The result: liquidity is produced.

But risk reassessment, influenced by the Shanghai sell off, caused the carry trade to be reconsidered. Liquidity can be a cruel task master when reversed and even a slight reversal of the carry trade can cause problems that accelerate. Ergo, the 2.7% in Yen strengthening that occurred on February 27, the beginning of swift market reaction.

As hedge funds unwind their carry trades and reduce investment in other risky asset classes, liquidity continues its revenge. Since that fateful day, the correlation between the Yen strengthening

and the S&P 500 falling has been approximately 92%. This compares to the previous six months (lack of) correlation of about 1%.

The carry trade, though still attractive, looks less so.

But what of the second order effects of the revenge of liquidity? What might be the result of a market that moves to less risky assets due to lower liquidity and leverage?

The sub prime market will not cause a problem according to Fed Chair Ben Bernanke, "I do not think at this point it has implications for the aggregate economy."

Maybe not, but consider that credit spreads of all types have widened considerably since Feb 27, with more widening the lower the credit rating. And, what of the holders of the 'equity' tranche of sub prime CMOs?

Primarily hedge funds, broker/dealers and the originators of these mortgages, they may see their investment in the riskiest of sub prime CMO tranches become nearly worthless. What might this mean for unregulated, leveraged hedge funds? Or regulated, leveraged broker dealers? Or lightly regulated, leveraged mortgage originators with the bulk of their business coming from sub prime loans?

So far, we only have the answer to the last question: Bankruptcy, accounting problems and possibly fraud may be involved in the most aggressive of mortgage originators.

But, what if those broker/dealers see a downgrade from this that jeopardizes their standing as counter party in the burgeoning over the counter derivatives market? What will that mean as investors look for ways to reduce risk?

Many well run hedge funds should shoulder this disruption, but when there are over 8000 funds with over \$1 trillion in assets...and 100% are

unregulated to a great degree...we certainly can expect some fallout.

Conversely, we believe that most insurers will not see the direct impact of the albatross of sub prime mortgages on their financials. Insurers investing in sub prime CMOs usually have AAA or AA rated tranches. However, it will be the second order effects noted above and some that we are unable to contemplate that will impact insurer portfolios.

These effects are already impacting the spreads on corporate bonds owned by insurers. Thus, it is incumbent upon all insurers to carefully consider their own risk management approach. Keeping in mind that the worst time to reduce risk significantly is when everyone else is doing so.

Perhaps the best way to look at the revenge of liquidity is to consider the humble glass of ice water. As the famous philosopher, Marx (Groucho, not Karl) once said, "Ice water? Eat an onion that'll make your eyes water."

We can only hope that will be the only significant negative impact on our portfolios from the revenge of liquidity.

As always, your comments and questions are much appreciated.

Thank you.

Best Regards,

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