

## Will Sub-prime Mean Disaster for Currency Markets?

By Richard Lee Currency Analyst, *DailyFX.com*  
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With markets taking on an increasingly global feel, inter and intra-market relationships are growing more and more intertwined by the day. As a result, with the recent collapse of the Bear Stearns hedge funds, market investors are looking for further repercussions, if any, from a possible margin call by Merrill Lynch & Co. With a margin call, funds and banks holding collateralized debt obligations throughout the market would need to reposition themselves, while attempting to universally reprice instruments that are usually considered esoteric by nature. Even more important are the overall implications in the financial realm. With some considering the situation equivalent to past LTCM iniquities, current concerns surrounding the fund collapse are far reaching affecting both fixed income and foreign exchange markets. Questions that come to mind: Will this spell the end for the simultaneous bull market that has been taking place as of late? And even more importantly, will investor risk appetites revert back to recessionary conservatism, putting an end to carry trades? Either way, nascent fears support faint whispers of CONTAGION.

### Sub-prime Hits Hedge Funds

The market's main concern stems from the fact that Merrill Lynch & Co. has expressed intent on selling off assets that were placed up as collateral for two of Bear Stearns' hedge funds. The move comes amid completed transactions involving Goldman Sachs Group Inc., JPMorgan Chase & Co. and Bank of America Corp. To the tune of about \$850 million, the assets are comprised of high AAA grade debt with at least one CDO classified as BBB. With the rather illiquid nature and complicated pricing of each asset, the concern arises with, not the investment rating of the asset but, the pricing of the actual instrument. Recently with investors striving for higher rates of return, CDOs have been mass structured, sometimes with lower grade valuations. The impending sale would not only reveal this, but also send selling shockwaves through the market as a lower price would likely be favored in consideration of time as Merrill seeks to unload the seized assets. As a result, questions arise as to how low those assets will drop till a bid tone is established, helping to stabilize the market. With relation to fixed income, benchmark yields are surely to be affected with no investor definitively assured of a market bottom.

### FX Market Spillover Not Good for the Yen Crosses

And that brings us to foreign exchange. With closer ties to fixed income, currency markets will surely to be affected by the possible liquidation of collateralized assets. The biggest victim will be carry trades. Both asset classes offer higher rates of return and reflect the current appetite for risk in the market. However, should subprime woes finally make their way through to the financial system, and not just the economic side of analysis, it may spark a reversion back to more conservative measures. Notably, Japanese yen pairs would be most affected by the impending fallout as the pairs have remained the symbolic representation of a risk taking market. For the record, since the beginning of the year, three of the most sought after pairs have appreciated greatly against the Japanese yen as well as earning investors a considerable rate of return on the interest differential. Should a market contagion be witnessed, rest assured that these Yen crosses would see massive liquidation as investors look to book profits and protect capital on a shift in sentiment.

Currency Pair	Interest Rate Differential	Price Appreciation
NZDJPY	7.50%	16%
AUDJPY	5.75%	14%
CADJPY	3.75%	15%
GBPJPY	5.0%	8%

### But Not Likely to Be a Major Crisis

As compelling as the rather pessimistic outlook may be, the probability of a contagion effect is pretty slim. With banks still remembering the overblown catastrophe of LTCM, bailout is already being mentioned on several fronts. Including funds from the likes of Barclay's and Bear Stearns itself, Merrill will likely pare back on any threats of collateral liquidation. For foreign exchange markets, this simply means that the carry will likely go on. With a systemic problem being nipped at the bud, there is ample support for further risk taking behavior played out by favorite carry trades involving both the Japanese yen and the Swiss franc. Incidentally, this will leave bearish currency pundits hungering for yet another situation to arise in attempts to play the short side of the carry theme.

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