

HIGHLIGHTS

- Dollar firmed on the day as optimism returned to the markets, with sentiment boosted by another sharp fall in oil prices. Fed's Bernanke offered nothing new in his House testimony, and we believe that his reply to a question about FX intervention in disorderly markets implied that he is in no hurry to intervene (markets now orderly, though it is Treasury's call). We continue to believe that the dollar is carving out a bottom vs. the euro, and though the dollar's resiliency is encouraging, we cannot rule out euro gains near-term while turmoil persists. With optimism about the US financial system and the US economy picking up, the yen and Swiss franc lost ground to the buck as well. Biggest winners against the dollar on the day were TRY, ZAR, MXN, UAH, and PLN, while biggest losers were ILS, NOK, SEK, PKR, and CHF. Fed's Hoenig noted that an improving US economy will help the dollar, but that was more an observation than a policy statement. Canada manufacturing shipments stronger than expected, but CAD little changed. FOMC minutes from June suggest other members besides dissenter Poole were thinking about rate hikes "very soon." However, most analysts have pushed back Fed rate hike expectations out after this latest bout of turmoil.
- US equity markets ended on a very strong note at the highs, as market shrugged off the recent pessimism. Financials outperformed on better than expected earnings report from big US bank, while oil-related stocks underperformed as oil prices plunged on bigger than expected build in US stockpiles. Asian ADRs rose in N. American trading, pointing to a good start for regional stocks today, while Nikkei futures point to a higher open for Japan equities. Weaker yen should help Japan exporters.
- US bonds were down, with the 2-year yield up 8 bp and the 10-year yield up 13 bp. European bonds were down too, with 10-year yields up 1 bp in UK, up 1 bp in France, and up 1 bp in Germany. Fed funds futures market increased slightly the expectations for Fed tightening, with odds of a September hike rising to 34% from 21%.

CURRENCY MARKETS

US June CPI was firmer than expected with headline CPI rising 1.1%/m/m (vs. 0.7% exp) and core CPI accelerating unexpectedly (up 0.3%/m/m vs. 0.2% exp). Annual core CPI jumped 2.4%/y vs. 2.3% in May. The jump in core prices suggests that there is some pass through effect from the rise in energy and food. The data also suggest that companies have some pricing power to pass on the rising costs. Persistently accelerating core CPI could tip the Fed toward a more hawkish outlook again. Fed Chairman Bernanke's testimony yesterday was slightly more dovish than the last FOMC statement. The Chairman shifted back to seeing significant downside risks to growth. The market had sharply reduced expectations of a September rate hike to 21% at Tuesday's close vs. 55% Monday. The market is likely to shift back toward a slightly greater chance of a hike in September. Details of the CPI data showed that sharp gains in energy prices (up 6.6%/m/m) as well as food prices (up 0.8%) boosted the headline number. Gains in the cost of living rose 1.1%, with rents accelerating. Rents make up about 40% of core CPI.

Long-term portfolio flows into the US slowed in May to \$67 bln from \$115.1 bln in April, which was the most since May 07. Including the short-term flows, the total inflows were slightly negative (\$2.5 bln). The news seemed to weigh on the dollar a bit, but is still in a consolidative mode. Total flows into the US are running well below a year ago which is fully accounted for by the private sector. Foreign central banks, according to the TIC data continue to be significant buyers of US assets, though only \$16.6 bln in May down from \$41.26 bln in April. Although the Fed's custody data suggests central banks were net buyers of Treasuries in May, the TIC data shows central bank were net sellers of about \$3 bln of Treasuries. Foreign private purchases of US assets were concentrated in corporate bonds (\$46.3 bln), which is more than in the first four months combined. Foreign investors also bought \$5 bln of US equities after having sold \$16 bln in April. Still the private sector bought \$76 bln of US long term paper, which is the most for the year. The data is old, but note that the TIC data shows foreign central banks bought almost \$14 bln of agency bonds in May and foreign central banks bought about \$11 bln.

We focused on the TIC data for China, which consists of both official and non-official holdings, and found that China was a big buyer of US securities in May. There has been no net dumping of dollar-denominated assets by the two in recent months, and in fact we have seen a steady increase in total dollar holdings by China over the past year. In May, China's net holdings of US Treasury securities rose \$4.6 bln (short-term fell \$6.9 bln, long-term rose \$11.5 bln). Furthermore, US Agency holdings rose \$14.9 bln and US corporate bond holdings rose \$9.1 bln, and the total gain across all US securities in May was \$28.7 bln vs. \$30 bln in April. All told, China's total US dollar holdings have increased \$136 bln since June 2007 to \$1.047 trln, according to TIC data. We stress again that for any country, it is important to look at the entire spectrum of investment holdings, and not just on the narrow US Treasury holdings. It is clear that there has been no sign that China is decreasing dollar holdings, but rather the data continue to show diversification within US securities. We stress that the big foreign holdings of US Agency paper was a very big reason why the US officials moved quickly to try to calm markets regarding the GSEs. If any of these foreign holders thought there was rising default risk on Agencies, then subsequent dumping could have led to a dollar rout. Of note, oil exporters bought \$10.4 bln of US Treasury securities in May vs. \$3.1 bln in April, while the Caribbean (viewed as mainly offshore funds) saw a \$7.8 bln drop in US Treasury securities vs. a gain of \$8.3 bln in April.

Industrial production rose more than expected in June by 0.5% (vs. 0.1% exp) after falling 0.2% in May. The data support the view that GDP is likely to have accelerated in Q2. However, details suggest that the pickup in June output may not be repeated in July. Utility and mining did contribute to the increase (rising 2.1% and 1.1% respectively). However, a pickup in auto and auto parts production after strikes abated in June helped to boost the numbers. Ex-auto factory output actually fell 0.1%. The pace of increase is unlikely to be sustained in July. The auto sector remains weak and after an initial pickup in production after the strikes, this particular sector of industrial production is likely to slow again in July. Capacity utilization also picked up unexpectedly to 79.9% (79.4% exp) and the May data were revised up to 79.4%. Still, the data do not point to tightening price pressures supporting the Fed's views that inflation is likely to abate.

UPCOMING ECONOMIC RELEASES

China Q2 GDP and June PPI, CPI, IP, and retail sales out, followed by Singapore June trade, HK Jun unemployment, and Mexico and Colombia May IP. For US, Jun housing starts and building permits, weekly jobless claims, and July Philly Fed survey out. Philippines and Turkey central banks hold policy meetings, BOC releases MPR. Fed's Kroszner and Braunstein speak.

RATES AND RANGES -- at 16:00 ET/21:00 GMT

FROM NY OPEN			INTRADAY RANGES	
MAJORS	16:00/20:00	% Change	LOW	HIGH
EUR/USD	1.5818	-0.6%	1.5801	1.5948
USD/JPY	105.17	0.4%	103.78	105.19
USD/CHF	1.0181	0.9%	1.0029	1.0188
GBP/USD	1.9989	-0.3%	1.9959	2.0097
EUR/JPY	166.35	-0.2%	165.32	166.86
EUR/GBP	0.7913	-0.3%	0.7909	0.7955
EUR/CHF	1.6104	0.3%	1.5991	1.6106

COMMODITY CURRENCIES	% Change	LOW	HIGH	
AUD/USD	0.9742	-0.5%	0.9729	0.9816
NZD/USD	0.7716	-0.1%	0.7684	0.7738
USD/ZAR	7.6084	-0.6%	7.5958	7.7038
USD/CAD	1.0020	0.0%	0.9998	1.0049

FROM NY OPEN			INTRADAY RANGES	
OTHER ASIA	16:00/20:00	% Change	LOW	HIGH
USD/TWD	30.32	-0.1%	30.32	30.39
USD/PHP	45.27	-0.1%	45.27	45.57
USD/THB	33.49	0.1%	33.34	33.59
USD/IDR	9141	0.0%	9128	9146
USD/MYR	3.2263	0.3%	3.2155	3.2286
USD/SGD	1.3493	0.1%	1.3462	1.3508

FROM NY OPEN		% Change	INTRADAY RANGES	
LATIN AMERICA & NON EU EUROPE			LOW	HIGH
USD/MEX	10.2361	-0.6%	10.2337	10.3169
USD/BRL	1.5962	0.2%	1.5880	1.5998
EUR/CZK	23.13	-0.9%	23.10	23.37
EUR/PLN	3.2124	-0.9%	3.2112	3.2462
EUR/HUF	230.74	-0.4%	230.70	233.44

MONEY MARKETS (3 MTHS)	LEVEL	SPREAD
U.S.	2.97%	---
Euro	4.93%	196bp
Japan	0.85%	-212bp
U.K.	5.78%	281bp
Canada	3.34%	37bp
Australia	7.68%	471bp
New Zealand	8.58%	561bp
Switzerland	2.80%	-18bp

BENCHMARK EQUITY INDICES				
INDEX	LEVEL	1 - DAY	YTD	YTD (US\$)
MSCI - World*	338	0.9%	-16.1%	-16.1%
MSCI - Europe*	476	-0.2%	-19.8%	-19.8%
MSCI - EAFE	1846	-0.3%	-18.1%	-18.1%
MSCI - Asia Pacific	129	-0.5%	-18.0%	-18.0%
MSCI - Emerging Mkts	1016	0.0%	-18.4%	-18.4%

AMERICAS EQUITY MARKETS				
INDEX	LEVEL	1 - DAY	YTD	YTD (US\$)
Dow Jones Industrials	11239	2.5%	-15.3%	-15.3%
S&P 500 Index	1245	2.5%	-15.2%	-15.2%
Nasdaq Composite	2285	3.1%	-13.9%	-13.9%
Canada Toronto TSE	13512	1.2%	-2.3%	-2.7%
Mexico Bolsa Index	27956	1.9%	-5.4%	0.9%
Brazil Bovespa Index	62091	1.8%	-2.8%	8.3%

EUROPEAN EQUITY MARKETS				
INDEX	LEVEL	1 - DAY	YTD	YTD(US\$)
Eurotop (FTSE)	2355	0.4%	-25.6%	-19.4%
FTSE Index	5151	-0.4%	-20.2%	-19.7%
German DAX Index	6155	1.2%	-23.7%	-17.3%
French CAC 40 Index	4112	1.3%	-26.7%	-20.6%
Italy MIB30	28135	0.3%	-27.6%	-21.6%
Swiss MP Index	6583	0.3%	-22.4%	-13.6%

COMMODITY MARKETS	Level	Previous	Change
NYMEX crude (near future)	\$134.27	\$138.74	-\$4.47
Gold (near future)	\$960.70	\$978.70	-\$18.00

BOND MARKETS	Level	Previous	Change
US 2-yr Note	2.44%	2.37%	0.07%
US 10-yr Note	3.95%	3.82%	0.13%
US 30-yr Bond	4.59%	4.46%	0.13%
German 10-yr Bund	4.39%	4.39%	0.01%
UK 10-yr Gilt	4.87%	4.86%	0.01%
Canada 10-yr Bond	3.75%	3.68%	0.06%

MARKET INDICATORS	Level	Previous	Change
VIX Index	25.04	28.54	-3.50
EMBI+ Sov. Spread (prior close)	311bp		

Source: Bloomberg. *These are the 'All Country' World & 'All Country' Europe indices, which cover developed and emerging markets for the respective regions.

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