CURRENCY VIEW

BROWN BROTHERS HARRIMAN

Asia Open: 18 July 2008 www.bbh.com/fx

HIGHLIGHTS

- **Dollar firmed on the day as optimism regarding the crisis picked up further, with sentiment boosted by yet another sharp fall in oil prices. Better than expected earnings from large US bank helped fuel this optimism too. However, after hours earnings report from big US house was worse than expected, so dollar ended North American trading on a soft note. Friday trading will be key to setting next week's dollar tone. With optimism about the US financial system and the US economy picking up, the yen and Swiss franc lost ground to the buck again. Biggest winners against the dollar on the day were COP, RON, TRY, PHP, and HUF, while biggest losers were JPY, NZD, PKR, PEN, and CAD. Oil and other energy prices were also hurt by report showing natural gas stockpiles in the US rose more than expected.**
- **US equity markets ended on a very strong note at the highs again as market optimism intensified. Financials outperformed on better than expected earnings report from big US bank, while oil-related stocks underperformed as oil prices plunged for a third straight day. 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 exporter shares. However, Asian outlook may be hurt by after hours report of worse than expected earnings by big US house.**
- **US bonds were down again, with the 2-year yield up 11 bp and the 10-year yield up 8 bp. European bonds were down too, with 10-year yields up 3 bp in UK, up 6 bp in France, and up 5 bp in Germany. Fed funds futures market increased slightly the expectations for Fed tightening, with odds of a September hike rising to 43% from 34%.**

CURRENCY MARKETS

Even for those investors who do not trade currency options, indications from that market sometimes help illuminate the overall FX market. This may be all the more important currently because in response to a question about intervention yesterday, Federal Reserve chief Bernanke suggested it should be considered in disorderly markets. Moreover, in the April G7 statement echoed earlier concerns that excessive volatility is not desirable. We monitor the correlation between implied volatility (3 month) and spot movement. This correlation can be thought of as an indicator of the strength of the underlying trend. Year-to-date there is little correlation between the direction of the euro and volatility. However, more recent periods, not only is there a positive correlation, but it has increased. For example over the past three months, the percentage change in the euro and the percentage change in implied volatility has a 4.7% correlation and 13% over the past 2 months and a impressive 41% over the past month. In comparison note that the correlation for last year was slightly negative and in 2006 it was about 29%. Turning to the yen, its correlation with volatility is more consistent and stable, but has been increasing recently as well. When looking at the dollar-yen pair, the correlation is often seen in the negative--so that when the dollar falls vs. the yen (yen rises vs. dollar), the correlation tends to rise. Year-to-date this correlation is nearly -42%, but over the last two months it has risen to almost -57% and over the past month it stands a little above -72.5%. In comparison it was about -47% in 2007 and -38% in 2006. There are several take away points from this little review. First, it suggests that the strength of underlying trends remains strong, but perhaps near extremes (given the assumption that there is a mean-reverting process here). Second, it means that officials may talk about volatility but there is a clear directional bias implication. In the current environment, lower volatility is correlated with a lower euro and a lower yen. Thirdly, to the extent that disorderly foreign exchange markets increase the risk of intervention, the foreign exchange market continues to trade in a fairly orderly fashion and arguably more orderly than many other parts of the capital markets.

The headline Philly Fed index number improved by less than expected falling -16.3 in July (vs. -15 exp) but that is still an improvement over the June reading of -17.1. Indeed, today's July report is the second best reading since Dec and suggests that US manufacturing began Q3 on a somewhat positive note. The data follows a better than expected July Empire manufacturing survey and the Richmond index, due out next Tuesday, is also expected to improve modestly. The data will most likely lead to some expected improvement for the Chicago and nationwide PMI surveys due out in late July/early August. Many of the components are somewhat less encouraging and the response to the general question points to upside inflation risks. On the components, the number of employees fell by 7.3 (vs. -6.9 in June). New orders fell by slightly less than in June or -12.1 vs. -12.4. Prices paid rose to 75.6 from 69.3 in July. The special question, which centered on price increases showed that over 60% of firms said they had increased base prices this year and that their suppliers had also raised prices and instituted surcharges for commodities, transport and energy.

Housing starts and building permits jumped unexpectedly but due to a change in a New York construction code which enabled builders to begin building projects many of which had previously been stalled. The change largely affected multifamily homes and overshadowed a further drop in single-family home sales. Single family home sales fell 5.3% to the lowest level in almost 18 years. If it had not been for the distortion caused by the change in code, housing starts, which jumped to a 1066 mln unit pace, would actually have fallen 4% or a 938K pace, lower than the Bloomberg consensus for 960k. Building permits jumped to a 1091k pace, vs. consensus of 965k. In May starts had run at an upwardly revised 977k pace (vs. 975k initially reported) and permits were at a revised 978k pace (vs. 969k).

Turkey central bank hiked rates 50 bp to 16.75%, as expected. Bank was hawkish, saying it will hike rates further if necessary. Given the combination of rising risk appetite and high yields, the lira continues to strengthen despite worrisome news on the economic and political front. USD/TRY broke the May low of 1.2030-40, and appears on track to retest the January low of 1.1479. Intermediate targets are some congestion around 1.1770-80 (lows from February) and then 1.1630-50 (lows from January-February). There are risks ahead, however, but market has put these risks on the back burner. The current account deficit was reported at -$4.6 bln in May, and the 12-month total rose to -$43.3 bln vs. -$42.2 bln in April. With growth picking up in 2008 after a subpar 2007, the external deficits are likely to continue deteriorating even as global liquidity dries up. Political uncertainty is likely to remain high due to the possible ban of the ruling AKP, with a ruling by the Supreme Court possible by mid-August. For now, TRY likely to remain bid, but will be one of the first to sell off if markets deteriorate.

UPCOMING ECONOMIC RELEASES

Japan Jun department store sales out, followed by May eurozone trade, Poland Jun IP and PPI, and Canada Jun leading index. Mexico central bank holds policy meeting, BOJ releases June minutes. No US data or US speakers today.

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	1.5835	0.1%	1.5783	1.5894
USD/JPY	106.68	1.5%	104.76	107.09
USD/CHF	1.0220	0.5%	1.0137	1.0260
GBP/USD	1.9984	0.0%	1.9950	2.0072
EUR/JPY	168.93	1.5%	166.01	169.10
EUR/GBP	0.7924	0.1%	0.7910	0.7934
EUR/CHF	1.6185	0.5%	1.6083	1.6215

COMMODITY CURRENCIES		% Change	LOW	HIGH
AUD/USD	0.9695	-0.6%	0.9679	0.9792
NZD/USD	0.7613	-1.4%	0.7590	0.7728
USD/ZAR	7.5704	-0.4%	7.5302	7.6331
USD/CAD	1.0068	0.5%	0.9980	1.0080

FROM NY OPEN			INTRADAY RANGES	
OTHER ASIA	16:00/20:00	% Change	LOW	HIGH
USD/TWD	30.30	-0.1%	30.26	30.37
USD/PHP	44.53	-1.5%	44.53	45.36
USD/THB	33.44	-0.1%	33.38	33.55
USD/IDR	9135	-0.1%	9132	9168
USD/MYR	3.2267	0.1%	3.2198	3.2375
USD/SGD	1.3521	0.2%	1.3482	1.3539

FROM NY OPEN		% Change	INTRADAY RANGES	
LATIN AMERICA & NON EU EUROPE			LOW	HIGH
USD/MEX	10.2211	-0.1%	10.2133	10.2395
USD/BRL	1.5975	0.1%	1.5875	1.6013
EUR/CZK	23.10	-0.1%	23.06	23.17
EUR/PLN	3.2237	0.4%	3.2083	3.2313
EUR/HUF	229.57	-0.5%	229.19	231.75

MONEY MARKETS (3 MTHS)	LEVEL	SPREAD
U.S.	3.00%	---
Euro	4.93%	193bp
Japan	0.93%	-207bp
U.K.	5.77%	277bp
Canada	3.34%	34bp
Australia	7.70%	470bp
New Zealand	8.58%	558bp
Switzerland	2.71%	-30bp

BENCHMARK EQUITY INDICES				
INDEX	LEVEL	1 - DAY	YTD	YTD (US$)
MSCI - World*	343	1.4%	-14.9%	-14.9%
MSCI - Europe*	490	2.8%	-17.6%	-17.6%
MSCI - EAFE	1890	2.4%	-16.1%	-16.1%
MSCI - Asia Pacific	131	1.1%	-17.1%	-17.1%
MSCI - Emerging Mkts	1032	1.6%	-17.2%	-17.2%

AMERICAS EQUITY MARKETS				
INDEX	LEVEL	1 - DAY	YTD	YTD (US$)
Dow Jones Industrials	11438	1.8%	-13.8%	-13.8%
S&P 500 Index	1260	1.2%	-14.2%	-14.2%
Nasdaq Composite	2312	1.2%	-12.8%	-12.8%
Canada Toronto TSE	13461	-0.3%	-2.7%	-3.5%
Mexico Bolsa Index	28178	0.7%	-4.6%	1.8%
Brazil Bovespa Index	60348	-2.8%	-5.5%	5.2%

EUROPEAN EQUITY MARKETS				
INDEX	LEVEL	1 - DAY	YTD	YTD(US$)
Eurotop (FTSE)	2413	2.5%	-23.8%	-17.3%
FTSE Index	5286	2.6%	-18.1%	-17.6%
German DAX Index	6271	1.9%	-22.3%	-15.6%
French CAC 40 Index	4226	2.8%	-24.7%	-18.3%
Italy MIB30	28591	1.6%	-26.5%	-20.2%
Swiss MP Index	6739	2.4%	-20.6%	-11.9%

COMMODITY MARKETS	Level	Previous	Change
NYMEX crude (near future)	$129.72	$134.60	-$4.88
Gold (near future)	$956.00	$962.70	-$6.70

BOND MARKETS	Level	Previous	Change
US 2-yr Note	2.54%	2.42%	0.12%
US 10-yr Note	4.02%	3.93%	0.09%
US 30-yr Bond	4.62%	4.59%	0.04%
German 10-yr Bund	4.44%	4.39%	0.05%
UK 10-yr Gilt	4.90%	4.87%	0.03%
Canada 10-yr Bond	3.79%	3.74%	0.05%

MARKET INDICATORS	Level	Previous	Change
VIX Index	24.87	25.10	-0.23
EMBI+ Sov. Spread (prior close)	301bp		

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