

HIGHLIGHTS

- Dollar consolidated another day in narrow rangebound trading, but we believe it is poised to strengthen further on an improved technical picture as we move towards year-end. 1.4330-50 is key, break of which targets 1.4160 and then 1.3970. Yen weakened on the crosses as risk appetite crept back, with dollar/yen making modest gains. High yielders gained most against the yen, and big winners on the day were BRL, ZAR, MXN, and AUD. Chile upgrade to A+ by S&P helped CLP firm a bit. US housing starts and permits remained weak in Nov, but came in slightly better than expected as starts fell -3.7% m/m and -24.2% y/y while permits fell -1.5% m/m and -24.6% y/y. Sterling underperformed on soft Nov UK inflation data, so EUR/GBP moved higher. Canada Nov target core CPI was soft, suggesting BOC can continue cutting rates in 2008.
- US equities remain volatile as US recession fears ebb and flow. Premier US investment house posted better than expected Q4 earnings and helped financial despite slowing in its primary growth areas. Oil and energy-related shares outperformed despite oil prices ending the day lower after Turkish ground forces ended raids and began withdrawal from Iraq. With US equities ending up modestly, Asian ADRs were up 1.7% on the day, so regional Asian equities are likely to open higher. Outlook for the Nikkei is positive due to a combination of the weaker yen on the crosses and stronger US equities.
- US bond prices were mixed as safe haven buying eased and equities rallied. The US 10 yield fell 2 bps, while the 2-year yield was unchanged. Despite firm Nov US data, market expectations are still centered on further Fed easing (25 bps almost fully priced in for January). European 10-year yields fell, with UK down 1 bps, France down 1 bps, and Germany down 1 bps.

CURRENCY MARKETS

The ECB flooded the market with liquidity Tuesday when it injected the equivalent of nearly \$500 bln for the next 16 days.

Euribor rates fell sharply on the news with two week rate falling 50 bps. The sheer magnitude of the operation caught the market off guard. The ECB noted that some 390 financial institutions bid for the funds and the ECB managed to satisfy some 90% of the bids. There is talk that some foreign banks (e.g. US and UK) may have taken in funds as well and at lower rates than they can secure from their respective markets. If this is true, this may lead to some euro sales as the borrowing are converted and/or hedged. This is similar, but different than the point we made about the ECB and SNB dollar refi operations, announced last week in coordination with the Federal Reserve. The collateral will be in local currencies, but the borrowing in this operation will be dollars, drawn from the swap agreements renewed with the Federal Reserve. That currency mismatch may also lead to some hedge related dollar purchases. To be sure, the FX implications of these money market operations are on the margin, but maybe part of the firmer US dollar story that many will overlook.

Philly Fed Pres Plosser, who will become a voting member of FOMC in 2008, said that the Fed should avoid using the “balance of risks” language in its policy statements. Specifically, he said “I have some concerns about our use of this balance of risks language. It has served a purpose at times but can also put the committee in an awkward position. Markets often use our balance of risks to infer something about what they think the path of the funds rate is going to be and that is not I believe the best way to do business. I would like us to be more explicit about how the evolution of the economy impacts our decisions, rather than signaling the path of the funds rate.” The December 11 statement dropped the “balance of risks” language completely, and so it would appear that Plosser is not alone in his thinking. Basically, during this highly uncertain time of slowing growth and rising inflation, Plosser (and others at the Fed) do not want market expectations to get too one-sided as the Fed struggles to address these contradictory risks. The Fed does not want to be railroaded into making a policy decision by the markets just because the Fed had identified a particular balance of risks in its previous statement. All in all, we would warn investors to expect fewer details from the Fed statements during this period of uncertainty. That means more guesswork ahead on the part of Fed watchers and analysts, and thus more potential volatility in the bond market ahead.

South Africa’s ruling ANC party has elected Jacob Zuma as party head over incumbent and President Mbeki by a 2329-1505 vote at its party conference. Officials such as Finance Minister Manuel have been stressing that orthodox economic policies will be maintained by the next government, whoever runs it. President Mbeki is limited to two presidential terms, but he was trying to remain head of the ANC so that he could influence who would succeed him as President after 2009 elections. Trade union Cosatu is pushing for more populist policies, including re-nationalizing some companies and possibly doing away with inflation targeting, with union officials saying orthodox policies have added to poverty and inequality. Cosatu supports Zuma, so look for clues on how much influence the union has. We expect the SARB to retain its hawkish bias, and this should help boost the rand going forward, as will high gold prices. Initial targets are 6.834, 6.798, and 6.762 which are all retracements of the December dollar rally. Break of 6.762 points to retest of the December low of 6.644. After that, we target a retest of the November low around 6.431.

The Federal Reserve wears two hats. The first is as a steward for the economy. Most of its actions since Aug is with this function in mind. The second is as a regulator and today it brandishes this hat. The Fed’s staff has put together a package of reforms that appears aimed at some of the excesses that took place in mortgage lending activity. On one hand, it is a bit like closing the barn door after the horses are gone. On the other, it seeks to prevent a repeat of some of the more objectionable practices under pressure from Congress. The main reforms include tightening restrictions on pre-payment penalties, banning loans with no or light documentation, escrowing taxes and insurance, and limiting compensation of mortgage brokers. The Fed is trying carefully balance conflicting policy goals. It does not want to curtail prudent lending and borrowing. It does not want to kill the sub-prime market. It wants to curb excesses. Some 3.2 mln households used subprime financing to purchase houses. Some of the most bearish estimates project that some 1.7-2.0 mln may eventually lose their homes. This is a tragedy, but that still means that 1.2-1.5 mln households will retain home ownership that could not have been achieved through conventional financing. The immediate market impact of the staff proposals, which was later unanimously approved by the FRB, is limited as it does nothing to address the current liquidity or solvency crisis.

UPCOMING ECONOMIC RELEASES

German Dec IFO survey is due out. BOJ starts policy meeting, decision due Thursday, while BOE releases minutes. Sweden, Czech, and Poland central banks hold policy meetings today. S. Africa Nov CPI and Oct retail sales out, followed by Brazil Nov current account data. No US data due out, but Treasury’s Paulson and Fed’s Lacker speak 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	1.4404	0.0%	1.4367	1.4436
USD/JPY	113.39	0.4%	112.76	113.53
USD/CHF	1.1526	0.3%	1.1485	1.1536
GBP/USD	2.0123	-0.4%	2.0113	2.0226
EUR/JPY	163.34	0.4%	162.41	163.63
EUR/GBP	0.7158	0.5%	0.7119	0.7160
EUR/CHF	1.6601	0.3%	1.6543	1.6612

COMMODITY CURRENCIES	% Change	LOW	HIGH	
AUD/USD	0.8597	0.3%	0.8554	0.8645
NZD/USD	0.7549	0.0%	0.7509	0.7588
USD/ZAR	6.8975	-0.4%	6.8655	6.9475
USD/CAD	1.0053	0.0%	1.0014	1.0142

FROM NY OPEN			INTRADAY RANGES	
OTHER ASIA	16:00/20:00	% Change	LOW	HIGH
USD/TWD	32.58	0.3%	32.51	32.59
USD/PHP	41.80	0.7%	41.44	42.11
USD/THB	30.49	0.6%	30.31	30.69
USD/IDR	9390	-0.2%	9385	9443
USD/MYR	3.3512	0.2%	3.3405	3.3555
USD/SGD	1.4593	-0.1%	1.4565	1.4643

FROM NY OPEN		% Change	INTRADAY RANGES	
LATIN AMERICA & NON EU EUROPE			LOW	HIGH
USD/MEX	10.8462	-0.2%	10.8361	10.8753
USD/BRL	1.8065	-0.7%	1.7984	1.8199
EUR/CZK	26.12	-1.1%	26.10	26.44
EUR/PLN	3.6092	-0.5%	3.6082	3.6283
EUR/HUF	254.47	-0.3%	253.31	255.32

MONEY MARKETS (3 MTHS)	LEVEL	SPREAD
U.S.	5.05%	---
Euro	4.85%	-20bp
Japan	0.95%	-410bp
U.K.	6.28%	123bp
Canada	4.93%	-12bp
Australia	7.25%	221bp
New Zealand	9.13%	408bp
Switzerland	2.64%	-241bp

BENCHMARK EQUITY INDICES				
INDEX	LEVEL	1 - DAY	YTD	YTD (US\$)
MSCI - World*	394	0.3%	7.1%	7.1%
MSCI - Europe*	578	0.0%	8.8%	8.8%
MSCI - EAFE	2193	0.0%	5.7%	5.7%
MSCI - Asia Pacific	152	-0.1%	8.3%	8.3%
MSCI - Emerging Mkts	1190	0.5%	30.4%	30.4%

AMERICAS EQUITY MARKETS				
INDEX	LEVEL	1 - DAY	YTD	YTD (US\$)
Dow Jones Industrials	13227	0.5%	6.1%	6.1%
S&P 500 Index	1454	0.6%	2.5%	2.5%
Nasdaq Composite	2596	0.8%	7.5%	7.5%
Canada Toronto TSE	13379	-0.1%	3.6%	20.2%
Mexico Bolsa Index	29305	1.2%	10.8%	10.5%
Brazil Bovespa Index	61096	2.1%	37.4%	62.4%

EUROPEAN EQUITY MARKETS				
INDEX	LEVEL	1 - DAY	YTD	YTD(US\$)
Eurotop (FTSE)	3132	-0.2%	1.3%	10.5%
FTSE Index	6279	0.0%	0.9%	3.7%
German DAX Index	7851	0.3%	19.0%	29.9%
French CAC 40 Index	5509	-0.1%	-0.6%	8.5%
Italy MIB30	38517	0.0%	-7.3%	1.1%
Swiss MP Index	8467	-0.9%	-3.6%	1.9%

COMMODITY MARKETS	Level	Previous	Change
NYMEX crude (near future)	\$90.49	\$90.63	-\$0.14
Gold (near future)	\$803.00	\$794.80	\$8.20

BOND MARKETS	Level	Previous	Change
US 2-yr Note	3.17%	3.17%	0.00%
US 10-yr Note	4.12%	4.15%	-0.02%
US 30-yr Bond	4.54%	4.58%	-0.04%
German 10-yr Bund	4.29%	4.29%	0.00%
UK 10-yr Gilt	4.75%	4.76%	-0.01%
Canada 10-yr Bond	4.02%	4.06%	-0.04%

MARKET INDICATORS	Level	Previous	Change
VIX Index	22.95	24.52	-1.57
EMBI+ Sov. Spread (prior close)	229bp		

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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