

HIGHLIGHTS

- **Dollar was softer on the day, but remains largely range-bound as markets continue to fret about the credit crisis and US housing woes.** IMF warning that the end of US housing slump “not visible” yet wasn’t surprising, but may have had a larger impact due to the current fragility of confidence. Dollar/yen was dragged lower by falling US equity markets, but remained in recent ranges. Indeed, we see range-trading ahead of the key US jobs data on Friday. Biggest winners against the dollar on the day were RON, ZAR, HUF, CZK, and PLN while biggest losers were ISK, CLP, INR, MYR, and PEN. Mexican peso recovered from the Friday sell-off and appears ready to test 10 per USD again, break of which would target the 2002 low of 8.955. Outgoing Fed Governor Mishkin called for adoption of inflation targeting. CNY weakened even as speculation picks up that policy-makers are growing increasingly worried about slowing growth. US budget gap forecasts came in as expected (see below).
- **US equity markets ended down, as financials underperformed on renewed US concerns, while oil-related stocks outperformed as oil prices rose due to pipeline attacks by Nigerian rebels.** Asian ADRs fell in N. American trading, pointing to a weak start for regional stocks today, while Nikkei futures point to a lower open for Japan equities. Firmer yen should hurt Japan exporters.
- **US bonds were up, with the 2-year yield down 13 bp and the 10-year yield down 8 bp.** European bonds were up too, with 10-year yields down 4 bp in UK, down 9 bp in France, and down 8 bp in Germany. With pessimism picking up, Fed funds futures market decreased expectations for Fed tightening, with odds of Sep hike falling to 39% from 51% previously.

CURRENCY MARKETS

A month ago, many in the market were talking about the possibility of an August rate hike by the Fed. Such expectations have wilted, and fiscal policy now takes center stage. As expected, the Bush Administration announced its estimate of the FY09 budget deficit at a record -\$482 bln vs. a projected -\$407 bln back in Feb. The estimate was perhaps blunted by lower estimates for the current FY08 deficit of -\$389 bln vs. -\$410 bln previously. Slower growth means lower tax revenues and higher counter-cyclical spending, and the Bush administration cut the 2008 growth forecast to 1.6% vs. 2.7% previously and the 2009 forecast to 2.2% from 3.0% previously. In addition, the cost of the \$168 bln stimulus program is being picked up. Of note, much of the spending for the wars in Afghanistan and Iraq are not included in the estimates, but do in fact show up in actual spending. While the news is not good, the impact on the dollar is likely to be minimal.

German inflation may have accelerated unexpectedly in July if the regional data are any guide but that may have limited impact on the euro. The focus is shifting to the state of the euro zone economy and this week’s survey data are expected to point to further economic deterioration at the start of Q3. Inflation accelerated in Germany’s most populous state, North Rhine-Westphalia (up 3.3% vs. 3.0% in June). Rising food and energy and related sectors like transportation and rent (which includes electricity, water and gas) did accelerate, but so did the consumer goods and services ex-rent sectors. The remaining German states report CPI Tuesday and the factors that drove North Rhine-Westphalian CPI higher are likely to boost inflation in other regional states. That could boost overall German CPI. The market is currently expecting an unchanged pace of 3.4%/y in July. While inflation remains elevated, the economy and confidence data amongst euro zone businesses and consumers is softening. The German Economic Ministry has prepared the market for a contraction in the region’s largest and most competitive economy (Q2 GDP is due August 14th.). This week’s July euro zone PMI manufacturing report is expected to remain below 50 at 47.5). Euro zone business and consumer confidence data (expected at -0.02 vs. 0.14 in June and -18 vs. -17 in June respectively) are also likely to point to a further deterioration in the euro zone economy in Q3. Indeed, the risk of a contraction in overall euro zone GDP is rising. Interest rate expectations of ECB hikes over the coming year have already been scaled back to just 11 bp (vs. 40 bp a week ago) according to the OIS market. This week’s euro zone data will likely continue to limit expectations, possibly pushing expectations toward steady policy. That will help curb euro gains even as the market looks toward another soft US labor report Friday.

Colombia central bank hiked rates by 25 bp on Friday to 10%. With that move, every major Latin American central bank tightened policy this month, with the exception of Argentina. Indeed, we are likely to see further tightening ahead in all of those countries, as price pressures remain strong in the region. Ironically, it would appear that Latin America is currently further ahead of the inflation curve than Asia, a striking development that shows just how far Latin America has come from the hyperinflation of the 1980s and 1990s. For instance, Korea and Malaysia have yet to hike rates despite a spike in inflation. Near-term, the prospect of higher interest rates should help Latin American currencies firm. Looking towards year-end, however, falling commodity prices are likely to take a toll on Latin America so that the 2009 outlook is not so positive. We note that Latin American equities continue to outperform (as measured by MSCI), at -5.3% year-to-date vs. -15.4% for EMEA and -23.5% for Asia. What’s interesting is the shift in relative performance since the mid-year point, when Latin America was +8%, EMEA -7.5%, and Asia -22.8%. If current trends in commodity markets (lower prices) and the developed world continue (stronger US, weaker eurozone), we repeat our long-held assertion that Latin America and EMEA equities are likely to underperform in H2 while Asia is likely to outperform. Currencies are likely to mirror this relative performance between regions.

Brazil current account deficit was larger than expected at -\$2.6 bln in June vs. -\$691 mln in May. This is BRL-negative, and we look for some slowing in the process of making new lows for USD/BRL. For now, it appears that the downward sloping trendline for USD/BRL dating back to 2005 (and currently around 1.5620) is likely to hold. The 12-month current account deficit rose to -1.32% of GDP (-\$18.1 bln) from -1.1% (-\$15 bln) in May, the highest since January 2003. FDI rose to \$2.7 bln from \$1.3 bln in May, but the 12-month total plunged to \$30.4 bln from \$38 bln in May. While FDI continues to cover the current account gap, it is covering a much smaller share. The 12-month basic balance (CA + FDI) is now \$12.3 bln, down from \$23 bln in May and a high of \$45.5 bln in June 2007. Weekly trade data seen so far this month point to a slightly higher trade surplus compared to \$2.7 bln in June, with full July data out next week. Rising inflation and inflation expectations point to another 75 bp hike when the central bank next meets September 9/10. Prospects for higher interest rates should support BRL, and we note that in the most recent weekly central bank survey, market expectations for end-2009 policy rate rose to 14.0% vs. 13.75% previously and 14.25% expected for end-2008.

UPCOMING ECONOMIC RELEASES

Japan Jun retail sales and unemployment out, followed by South Africa Jun M3 and credit growth, German Jul state and nationwide CPI, and Mexico May IGAE. For US, May S&P/CaseShiller home prices and Conference Board Jul confidence out. India, Serbia, Pakistan, and Slovakia central banks hold policy meetings. Treasury’s McCormick speaks.

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	1.5743	0.2%	1.5685	1.5769
USD/JPY	107.44	-0.4%	107.35	108.08
USD/CHF	1.0343	-0.2%	1.0325	1.0389
GBP/USD	1.9942	0.1%	1.9841	1.9964
EUR/JPY	169.16	-0.1%	169.03	169.73
EUR/GBP	0.7896	0.1%	0.7880	0.7932
EUR/CHF	1.6283	0.0%	1.6267	1.6296

COMMODITY CURRENCIES	% Change	LOW	HIGH	
AUD/USD	0.9566	0.0%	0.9528	0.9595
NZD/USD	0.7445	0.4%	0.7409	0.7454
USD/ZAR	7.5408	-0.7%	7.4886	7.6052
USD/CAD	1.0230	0.3%	1.0175	1.0245

FROM NY OPEN			INTRADAY RANGES	
OTHER ASIA	16:00/20:00	% Change	LOW	HIGH
USD/TWD	30.40	0.0%	30.40	30.44
USD/PHP	44.01	0.1%	43.94	44.14
USD/THB	33.47	0.0%	33.21	33.68
USD/IDR	9118	-0.2%	9109	9133
USD/MYR	3.2675	0.6%	3.2605	3.2675
USD/SGD	1.3630	0.2%	1.3527	1.3648

FROM NY OPEN		% Change	INTRADAY RANGES	
LATIN AMERICA & NON EU EUROPE			LOW	HIGH
USD/MEX	10.0549	-0.3%	10.0470	10.0942
USD/BRL	1.5758	0.2%	1.5702	1.5770
EUR/CZK	23.69	-0.4%	23.65	23.82
EUR/PLN	3.2047	0.0%	3.2032	3.2113
EUR/HUF	230.66	-0.5%	230.30	232.46

MONEY MARKETS (3 MTHS)	LEVEL	SPREAD
U.S.	2.80%	---
Euro	4.92%	213bp
Japan	0.89%	-191bp
U.K.	5.76%	297bp
Canada	3.28%	49bp
Australia	7.69%	489bp
New Zealand	8.53%	573bp
Switzerland	2.71%	-9bp

BENCHMARK EQUITY INDICES				
INDEX	LEVEL	1 - DAY	YTD	YTD (US\$)
MSCI - World*	341	-0.9%	-15.6%	-15.6%
MSCI - Europe*	489	-0.5%	-17.7%	-17.7%
MSCI - EAFE	1894	-0.4%	-16.0%	-16.0%
MSCI - Asia Pacific	133	0.0%	-15.7%	-15.7%
MSCI - Emerging Mkts	1024	0.0%	-17.8%	-17.8%

AMERICAS EQUITY MARKETS				
INDEX	LEVEL	1 - DAY	YTD	YTD (US\$)
Dow Jones Industrials	11131	-2.1%	-16.1%	-16.1%
S&P 500 Index	1235	-1.8%	-15.9%	-15.9%
Nasdaq Composite	2264	-2.0%	-14.6%	-14.6%
Canada Toronto TSE	13299	-0.6%	-3.9%	-6.2%
Mexico Bolsa Index	26857	-0.8%	-9.1%	-1.4%
Brazil Bovespa Index	56843	-0.6%	-11.0%	0.5%

EUROPEAN EQUITY MARKETS				
INDEX	LEVEL	1 - DAY	YTD	YTD(US\$)
Eurotop (FTSE)	2447	-0.8%	-22.7%	-16.6%
FTSE Index	5313	-0.7%	-17.7%	-17.3%
German DAX Index	6351	-1.3%	-21.3%	-15.0%
French CAC 40 Index	4324	-1.2%	-23.0%	-16.9%
Italy MIB30	29238	-0.8%	-24.8%	-18.9%
Swiss MP Index	6969	-0.7%	-17.9%	-10.0%

COMMODITY MARKETS	Level	Previous	Change
NYMEX crude (near future)	\$124.64	\$123.26	\$1.38
Gold (near future)	\$930.20	\$926.80	\$3.40

BOND MARKETS	Level	Previous	Change
US 2-yr Note	2.58%	2.71%	-0.13%
US 10-yr Note	4.01%	4.10%	-0.08%
US 30-yr Bond	4.62%	4.69%	-0.07%
German 10-yr Bund	4.53%	4.60%	-0.08%
UK 10-yr Gilt	4.95%	4.99%	-0.04%
Canada 10-yr Bond	3.78%	3.84%	-0.06%

MARKET INDICATORS	Level	Previous	Change
VIX Index	24.40	22.91	1.49
EMBI+ Sov. Spread (prior close)	276bp		

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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