CURRENCYVIEW

BROWN BROTHERS HARRIMAN

Asia Open: 16 October 2008 www.bbh.com/fx

HIGHLIGHTS

- **Dollar strengthened on the day as market pressures returned with a vengeance, despite all the efforts this past week to alleviate them. Besides bonds rallying and stocks tanking, the yen strengthened and the high yielders sold off. The only silver lining is that commodity prices continue to swoon. Biggest winners against USD on the day were JPY, PEN, CHF, and CNY, while biggest losers were ZAR, BRL, HUF, TRY, and MXN. Price action supports our belief that conditions for riskier assets are likely to remain poor in Q4 and even Q1 09. Interbank lending rates eased a bit further in response to the Fed flooding the market with dollars this week, but the interbank market remains nowhere near normal and so the ECB took further actions to loosen up frozen credit markets (see below). US retail sales were much weaker than expected, falling 1.2% m//m (-0.7% expected), while PPI rose slightly more than expected. RBI cut reserve requirements to 6.5% from 7.5% previously during North American hours, and is expected to cut interest rates outright in the coming weeks. Hungary was hit by concerns of Iceland-type meltdown, and S&P threw gas on the fire by putting Hungary's BBB+ rating on Creditwatch negative for possible downgrade. Brazil retail sales stronger than expected, Iceland central bank cut rates 350 bp to 12%, and Norway central bank cut rates 50 bp to 5.25%.**
- **US equity markets slumped sharply on continued earnings and growth concerns, ending the day at the lows. Oil-related stocks underperformed due to lower oil prices, while financials underperformed too due to ongoing financial sector concerns. Asian ADRs fell in N. American trading, pointing to weak start for regional stocks today, while Nikkei futures point to a lower open for Japan equities.**
- **US bonds were up as safe haven buying resumed, with the 2-year yield down 24 bp and the 10-year yield down 11 bp. European bonds were mixed, with 10-year yield down 3 bp in UK, down 2 bp in France, and up 1 bp in Germany.**

CURRENCY MARKETS

Fed Chairman Bernanke did not ease pressures on the asset markets or boost confidence. The VIX index remains elevated, and in the FX market the de-leveraging process appears to be continuing. Bernanke is not optimistic about a quick financial market or economic recovery in the short term but he is sending a clear message officials now have the tools in place to address the financial markets. This is not new news but an attempt to paint a broad picture that this crisis will be handled, that while there are limits to monetary policy, officials have been and are still open to options other than those in the current tool kit, and that preemptive actions mean that this crisis will not lead to a 1930's style depression. A major goal in ending the crisis will be the breaking of the downward spiral in home prices, either by returning credit markets and the economy to a healthier situation and/or directly help address distressed sectors of the housing market. **The Fed Beige book was not expected to be encouraging, especially after Bernanke's warnings of sustained economic weakness, and it was not.** Details of the report do show that economic weakness was reported in all districts. Credit conditions remained tight, hiring slowed along with consumption and some districts reported growing pessimism toward the economy. Housing and construction also continued to weaken or remained low providing no indication the housing cycle downtrend, which Bernanke indicated needed to be broken to help restore more normal conditions, would be interrupted in the near term. Price pressures, however, do appear to be abating. The Beige Book is very weak but is not out of line with expectations of a sustained period of economic weakness. The majority of economists surveyed by Bloomberg already expected a contraction in Q3 and Q4 2008 GDP. Nor does the Beige Book alter expectations in the Fed funds market. The Nov contract is continuing to price in a 70% chance of a 50bp cut Oct 29. Indeed, it will be de-leveraging and/or signs that the financial rescue packages are (or are not) beginning to provide some support to the credit markets that are likely to guide the dollar in the short-run.

ECB followed the path blazed by the Fed earlier this year, and announced that it had expanded the securities it is willing to accept as collateral from banks seeking liquidity. ECB will now accept debt denominated in currencies other than the euro, dollar, sterling, and yen. It also lowered the threshold of eligible assets to BBB- from A- previously. The expansion measures will remain in place until the end of 2009, and is simply another step in the process of thawing the frozen credit markets. The Fed took similar measures earlier in the crisis, but the ECB is getting more aggressive in recent weeks as the crisis intensified. One has to wonder about the reasons for widening the amount of currencies accepted as collateral and lowering the minimum rating. To us, this suggests that the ECB may be trying to throw a lifeline to Emerging Europe, such as Hungary, Poland, and many others that we have deemed vulnerable. These seem to be the countries that are most likely to have non-major currency, lower rated debt that they want to swap for much-needed liquidity from the ECB. The takeaway is that central banks around the world are throwing everything they can at the credit markets to get them working again. We note that LIBOR rates have been easing this week, but not nearly enough to get back to some semblance of normalcy. More needs to be done, and the ECB move acknowledges this.

S&P put several Korean banks on watch for potential downgrades, warning of "a more than 50% chance that the global liquidity squeeze could threaten Korean banks' foreign currency funding, and thus their overall creditworthiness." This comes a week after Moody's made a similar move. S&P noted that the Korean government hasn't introduced any wide-scale measures to ease overseas funding risks for its banks, noting that "Korean banks are exposed to foreign currency liquidity risk as they face increasing difficulty refinancing maturing borrowings, with the cost of borrowing rising even as maturities shorten amid tougher market conditions." Officials are downplaying the risks, with head of the Financial Supervisory Service stressing that "The government stands ready to take steps necessary to ensure a steady flow of credit in the market." S&P also said last week Korea's sovereign credit ratings may be at risk if deteriorating credit quality of the commercial banks forces sizeable government intervention. Korea has $183 bln of short-term external debt, equal to 76% of foreign reserves. It is the most vulnerable in Asia, in our view, due to this high ratio as well as a rising current account deficit. We note that during the Asian crisis, Korea's short-term debt/reserves was over 250%, so we don't think Korea is headed for another disaster (can't say the same for many of the EMEA countries). However, Korea is vulnerable enough that foreign investors continue to leave. Year-to-date, foreign investors have sold $34 bln of their equity holdings in Korea and comes after they sold $29 bln in 2007. Kospi is down 47% year-to-date in dollar terms. KRW remains vulnerable, and in this current risk-averse environment, USD/KRW is likely to head up.

UPCOMING ECONOMIC RELEASES

Korea Sep department store sales out, followed by China Sep PPI and Canada Aug manufacturing shipments. For US, weekly initial claims, Sep CPI, Aug TIC data, Sep IP, and Oct Philly Fed survey out. Fed's Rosengren, Bullard, and Stern 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	**1.3493**	-0.9%	1.3484	1.3687
USD/JPY	**99.92**	-2.1%	99.89	102.25
USD/CHF	**1.1336**	-0.3%	1.1299	1.1407
GBP/USD	**1.7285**	-0.6%	1.7270	1.7603
EUR/JPY	**134.82**	-3.0%	134.79	139.36
EUR/GBP	**0.7807**	-0.3%	0.7737	0.7831
EUR/CHF	**1.5296**	-1.2%	1.5275	1.5506

OTHER CURRENCIES		% Change	LOW	HIGH
AUD/USD	**0.6608**	-5.2%	0.6585	0.7076
NZD/USD	**0.5994**	-3.0%	0.5946	0.6277
USD/ZAR	**10.7465**	17.8%	9.0638	10.7475
USD/CAD	**1.1870**	2.1%	1.1538	1.1910

FROM NY OPEN			INTRADAY RANGES	
OTHER ASIA	**16:00/20:00**	**% Change**	**LOW**	**HIGH**
USD/TWD	**32.63**	0.6%	32.36	32.61
USD/PHP	**47.56**	0.7%	47.22	47.67
USD/THB	**34.14**	0.3%	33.97	34.35
USD/IDR	**9995**	2.0%	9728	10047
USD/MYR	**3.5125**	0.3%	3.4945	3.5178
USD/SGD	**1.4779**	1.0%	1.4635	1.4782

FROM NY OPEN		% Change	INTRADAY RANGES	
LATIN AMERICA & OTHER EUROPE			**LOW**	**HIGH**
USD/MEX	**13.0225**	6.0%	12.2762	13.0520
USD/BRL	**2.2255**	7.2%	2.0743	2.2290
EUR/CZK	**24.86**	1.1%	24.56	24.88
EUR/PLN	**3.5966**	3.5%	3.4671	3.5966
EUR/HUF	**270.67**	6.7%	252.64	271.67

MONEY MARKETS (3 MTHS)	LEVEL	LEVEL	Change
U.S.	5.11%	5.32%	21bp
Euro	5.23%	5.28%	5bp
Japan	1.50%	1.50%	0bp
U.K.	6.25%	6.20%	-5bp
Canada	3.97%	4.00%	3bp
Australia	7.03%	7.25%	22bp
New Zealand	8.60%	8.88%	28bp
Switzerland	3.70%	3.57%	-14bp

BENCHMARK EQUITY INDICES				
INDEX	**LEVEL**	**1 - DAY**	**YTD**	**YTD (US$)**
MSCI - World*	236	-7.4%	-41.5%	-41.5%
MSCI - Europe*	322	-7.6%	-45.9%	-45.9%
MSCI - EAFE	1311	-4.8%	-41.8%	-41.8%
MSCI - Asia Pacific	95	-1.6%	-39.7%	-39.7%
MSCI - Emerging Mkts	615	-8.8%	-50.7%	-50.7%

AMERICAS EQUITY MARKETS				
INDEX	**LEVEL**	**1 - DAY**	**YTD**	**YTD (US$)**
Dow Jones Industrials	8578	-7.9%	-35.3%	-35.3%
S&P 500 Index	908	-9.0%	-38.2%	-38.2%
Nasdaq Composite	1628	-8.5%	-38.6%	-38.6%
Canada Toronto TSE	9324	-6.3%	-32.6%	-43.3%
Mexico Bolsa Index	21135	-5.0%	-28.4%	-40.1%
Brazil Bovespa Index	35810	-13.9%	-43.9%	-55.2%

EUROPEAN EQUITY MARKETS				
INDEX	**LEVEL**	**1 - DAY**	**YTD**	**YTD(US$)**
Eurotop (FTSE)	1935	-6.4%	-38.9%	-43.5%
FTSE Index	4080	-7.2%	-36.8%	-45.0%
German DAX Index	4862	-6.5%	-39.7%	-44.3%
French CAC 40 Index	3381	-6.8%	-39.8%	-44.3%

OTHER MARKETS	Level	Previous	Change
NYMEX crude (near future)	$74.20	$78.63	-$4.43
Gold (near future)	$844.50	$836.30	$8.20
VIX Index	69.25	55.13	14.12
EMBI+ Sov. Spread (prior close)	544bp		

BOND MARKETS	Level	Previous	Change
US 2-yr Note	1.58%	1.81%	-0.24%
US 10-yr Note	3.98%	4.08%	-0.10%
US 30-yr Bond	4.22%	4.28%	-0.06%
German 10-yr Bund	4.12%	4.12%	0.01%
UK 10-yr Gilt	4.71%	4.74%	-0.03%
Canada 10-yr Bond	3.76%	3.82%	-0.06%

POLICY ANALYSIS MARKET ODDS	LEVEL	PREV	Change
Obama will win Presidency**	82.3	80.0	2.3
McCain will win Presidency**	18.0	21.1	-3.1
A member drops euro by end-2010**	35.0	35.0	0.0

*Source: Bloomberg. * 'All Country' World & 'All Country' Europe indices covering developed and emerging markets for the respective regions. ** Source: www.intrade.com*