SPECIALFX

BROWN BROTHERS HARRIMAN

06 February 2009 www.bbh.com/fx

Two Overlooked But Revealing Developments

There were a couple of important developments that seemed to have been over-looked or under-appreciated in recent days, and I am not talking about the groundhog Punxsutawney Phil not seeing his shadow, foretelling another six weeks of winter.

Swiss National Bank Issues Dollar-Denominated Debt

The first speaks ideas in some quarters that the dollar's days as the world's premier currency are over. A combination of military overreach and financial excesses has done the greenback in. Some pundits thought that before the current crisis is over, the US might have to consider issuing bonds in foreign currencies, like Jimmy Carter did in the late 1970s and the Roosa bonds in the Kennedy Administration (named for the under-Secretary of the Treasury Robert Roosa and, later a partner at Brown Brothers Harriman). One analyst from a major bank had an op-ed piece in the Financial Times recently urging the Obama Administration to commit against issuing such bonds.

On February 2, the Swiss National Bank, a well respected central bank, announced that starting in the middle of February, it would issue its own US dollar denominated certificates—T-bills by another other name. These dollar-denominate bills will be sold every two weeks, starting Feb 16 and in tenors of 28, 84 and 168 days. Current counterparties of the Swiss National Bank can participate in the auctions and the bills can be used as collateral in other dealings with the central bank.

In days since the SNB's surprising announcement, the Swiss franc has under-performed. It has lost about 0.68% against the dollar, making it the second worst performer after the Japanese yen in recent days. The dollar reached its best level against the Swiss franc just before the horrible US jobs data, since the middle of December.

Why did the SNB decide to issue dollar denominated T-bills? The purpose does not appear to be a signal of monetary policy, though SNB officials seem to have expressed concern about the Swiss franc's strength and reminded the market recently that it could intervene, if needed.

The reason the SNB is raising dollars is to help alleviate the financial crisis in Switzerland. In particular, the SNB needs dollars to help finance its Stability Fund that is to purchase illiquid assets from troubled financial institutions like UBS. A good part of the toxic assets are believed to be denominated in dollars.

Fed's Balance Sheet

The other development that few seemed to pick up on is that for the fifth consecutive week and for six of the past seven weeks, the Federal Reserve's balance sheets shrank. In the latest week, it declined by $76 bln to stand at $1.85 trillion. This is the smallest the Fed's balance sheet has been since late October 08.

The reduction of the Fed's balance sheet reflects the self-liquidating nature of some of the facilities the Fed has established, like the commercial paper funding facility and the swap lines with foreign central banks. This past week's decline can be fully traced to the $78 bln decline in the liquidity swaps provided to other central banks, especially the European Central Bank. This partly seems to reflect unwinding swaps established in the period leading to the turn of the year.

The reduction in the Fed's balance sheet will likely prove temporary. As the Federal Reserve continues its purchases of mortgage backed securities, the balance sheet will likely resume its growth. The MBS purchasing program began in early Jan and has totaled a little more than $75bln, though it has not fully showed up yet in the weekly report, which only tracks settled trades.

Marc Chandler	212-493-8800
Win Thin	212 493-8361
Meg Browne	212-493-8744
Audrey Childe-Freeman	44 207 614 8791

Near-Term Dollar Prospects

The de-leveraging process has helped underpin the US dollar and yen in recent months. While the de-leveraging process appears to be continuing here in Q1, it does not appear to be having the same positive impact on the dollar in recent weeks, though to be sure the dollar is stronger against nearly all the major currencies and many emerging market currencies this year.

To the extent that momentum traders (trend followers) have dominated the short-term flows, it is important to recognize that the euro's downside momentum appears to be stalling. It recorded the low for the year thus far on Feb 2, just above $1.27. Those last downticks were short-lived and difficult to achieve. That marks a near-term base. On the upside, the euro has not traded above its 20-day moving average since Jan 5 and has not closed above that average since Jan 4. It comes in now around $1.3040. A convincing break above here would immediately target the $1.33-$1.34 area.

The British pound often appears to lead the euro and it seems to be doing so now. It recorded the low for the year and a multi-year low on Jan 23 near $1.35. A short-term trend indicator turned positive on Feb 4 as the 5 day moving average crossed above the 20-day average. The next objective is near $1.50. The cent band between $1.4550 and $1.4650 should now offer support.

The Japanese yen, as often is the case, is a different kettle of fish. Its strength appears to have cracked in recent days. The dollar put in its low so far this year on Jan 21 near JPY87.13. After trading choppily in recent weeks, the dollar rose to near a four week high on Feb 5 near JPY92.25. Once this level can be overcome, the JPY95 area becomes the next target. It may be difficult to achieve without a news stream that encourages operators to look past the immediate dismal news and be more optimistic that US and other countries are taking measures that may still pave the way for the beginnings of a recovery later this year. I

Marc Chandler
Global Head of Currency Strategy