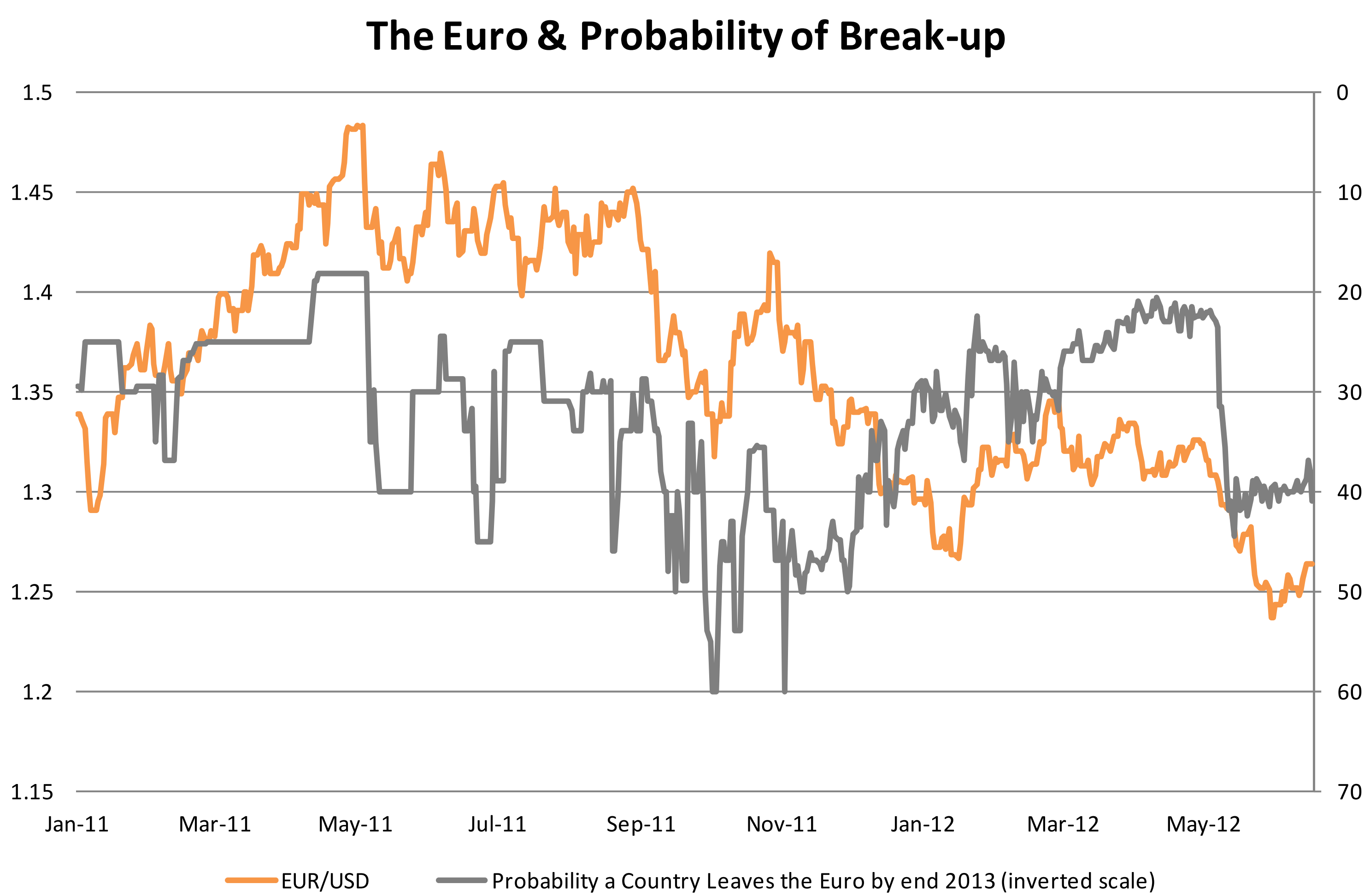
Foreign Exchange
2012 Third Quarter Report

Brown Brothers Harriman

FASTEN YOUR SEAT BELTS

CURRENCY FORECASTS AND OUTLOOK | G10 AND EM CENTRAL BANK WATCH | EM FX AND EQUITY MODELS | SOVEREIGN RATINGS MODELS



Source: Intrade & Bloomberg

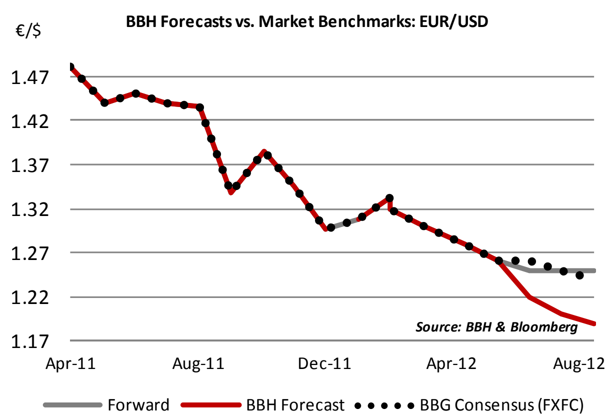
Contents

Outlook for G-10: Fasten Your Seatbelts

The beginning of the second half of the year provides an opportunity to step back and consider the "big picture." We can identify several major forces that are shaping the economic climate and creating both investment opportunities and challenges.

Deleveraging

The single most important of these is the ongoing deleveraging wave that was unleashed at the end of a great credit cycle. Debtors of all kinds and shapes are at a disadvantage. The modern financial system is all about debt. The financial systems of the major industrialized countries are still not working properly. This can be seen in a number of ways, but perhaps most clearly by considering how weak money supply growth has been in the face of the dramatic increase in central bank money.



In this regard, the US seems somewhat "less worse off" than Europe and Japan, as if the transmission mechanism has not completely broken down. Perhaps this due to the fact that the US had two channels of capital distribution - the banks and the markets. Prior to the crisis, for every dollar a US corporation would borrow from a bank, two would be raised in the capital markets. Europe and Japan were almost the opposite.

It is the failure of disintermediation that has been particularly telling in Europe. The linkages between the sovereigns and the banks lie at the heart of the financial crisis. In countries that experienced housing market booms or participated aggressively in international growth, bank's assets could be some multiple of a country's GDP. This is what happened in Iceland, Ireland, Spain and Cyprus, for example. Sovereigns were forced to rescue their financial systems and the price is steep.

In other countries, like Greece, Portugal and Italy, the banks were large owners of government bonds. The poor finances of the sovereign undermined the banks. It was the default of the sovereign in Greece, and under the conditions of no official participation (meaning the private sector bore the burden), that necessitated the recapitalization of Greek banks. The sovereign exposure of Italian banks is their largest vulnerability.

No Engine

The second main characteristic of the economic and investment climate is that there is no clear engine of growth. Over the past decade growth among the major industrialized countries was fueled by finance, real estate, government transfers, and exports to the rapidly growing emerging markets, like China.

None can act as engines of growth now. A combination of deleveraging and new regulations has sidelined the banking system. In countries that experienced housing market bubbles, the social and financial healing is not yet complete. In countries like Canada, Switzerland and Norway, officials are concerned about housing market excess. The deleveraging wave is squeezing sovereign debtors as well.

If anything, going forward, citizens may receive a smaller basket of goods/services from the state and may be required to pay more for those they do receive. In large developing countries, from Brazil to India and China, growth has slowed; they do not have the heft to lift the global economy.

The resolution of the stagflation of the 1970s was what we now associate with Reagan and Thatcher. It was based on deregulation of the capital markets, financial innovation, new shifts toward profits from wages and salaries, and the continued use of the government's balance sheet and credit to augment aggregate demand.

It now appears, helped by hindsight, that this course was largely exhausted in early 2000 with the end of the tech-bubble. The global easing after 9/11 reanimated the economies, but in an unstable and unsustainable way. Ireland offers great insight into this process. The integration of Ireland into the high tech economy helped transform it into the "Celtic Tiger". When the tech-bubble ended, Ireland was forced to reinvent itself. The banks were among the strongest domestic institutions and, with the advent of the euro, interest rates were generally low and stable in Ireland. However, this gave rise to over-lending and the housing market bubble that toppled Ireland.

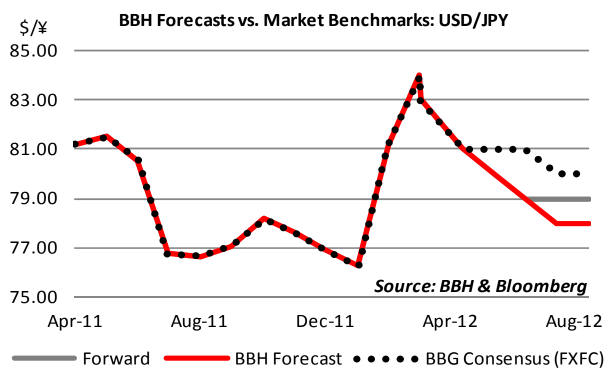
It was impossible to know that within 10-years of Nixon's wage and price controls and when he purported to have declared, "We are all Keynesians now", that supply-siders would move into ascendancy with Thatcher and then Reagan. Similarly, it is difficult for businesses, investors, and policy makers to see through the enormity of the current crisis.

Europe

The deleveraging wave has hit Europe hard. It exposed fissures at the heart of monetary union. The crisis itself has sapped the region's appetite for imports, which is contributing to the headwinds impacting Japan, China and a number of other countries in East Asia.

The initial phase of the deleveraging wave seemed more concentrated in the U.S., the ground-zero of the subprime mortgage securitization upon which the House of Finance was built. However, since the Greek crisis first emerged in late 2009, European events have more often than not driven the week-to-week moves in the global capital markets.

This is unlikely to change in the coming period. The European crisis is far from over. The first quarter was about the digestion of the Long-Term Repo Operations. The second quarter has been dominated by politics, especially in Greece and France. The ECB suspended its sovereign and covered bond purchases, and no fresh policy moves were taken outside of some collateral liberalization on the national level.



In the latter part of Q2 2012, crisis had pushed Spain into acknowledging it would need assistance at least to recapitalize its banks. As Q2 drew to a close, tiny Cyprus requested international assistance as well. Also, due to the climate as well as the loss of reform momentum and falling support for the technocrat prime minister, Mario Monti, Italian bond yields rose sharply.

The positive influence of the LTRO has dissipated and the dynamics have turned cruel, as sovereign credit down grades and rising yields force banks to pay higher yields. Also, the asset the banks just gorged on, sovereign bonds, were rapidly depreciating, weakening the bank balance sheets further. At the same time, the economic outlook has deteriorated and the contraction looks to last longer and be a bit deeper than policy makers had anticipated.

With commodity prices falling and price pressures easing, the ECB is likely to cut interest rates early in Q3. There had been some concern that the next rate cut would likely entail bringing the deposit rate (the interest rate the ECB pays banks) to zero, something not seen even during the post-Lehman response. Yet recent indications suggest officials may be somewhat less concerned about the potential negative impact on bank lending, and the worsening of economic conditions increases the need to act.

Adjusting interest rates is understood to be a key tool of monetary policy proper. It is not meant to address liquidity, but to ensure appropriate interest rates and money supply. The sovereign bond purchases were explained in terms of ensuring the monetary policy transmission mechanism was working properly. Since the monetary policy dial was set to accommodation, sharp rate hikes in peripheral countries effectively tightened monetary conditions. The ECB bought a modest amount of peripheral bonds over the objections of Germany, leading to two resignations.

A year ago, the EFSF and the ESM were authorized to buy sovereign bonds in the secondary market and at auctions. It requires a formal request and would likely be associated with a memorandum of understanding that conditioned the purchases on specific policy actions in a specific time frame. Because of the anticipated stigma and conditions, some countries, most notably Spain, Italy and France have been seeking purchases by the ECB.

However, ECB President Draghi has made it clear in word and deed that the central bank cannot be expected to fill the vacuum created by politicians. Now that the EFSF/ESM have the authority to buy sovereign bonds, the ECB has little interest in allowing countries to get a free pass so they can avoid stricter conditions.

Big Push

We suspect there is a good chance that the EFSF/ESM receives a formal request to support a country's bond market in Q3. The drawback of such a program for investors is that the ESM purchases, like the ECB's, but not the EFSF's, would subordinate private sector creditors. However, some legal scholars suggest that there are measures that officials could take that would not give the ESM seniority.

Another potential limitation is that it appears that the request needs to be approved by the members. In particular, the German Constitutional Court appears to require input by the Bundestag, the German parliament.

While these issues are important, ultimately, they are about triage. The initial architects of "Europe" understood that it could only be forged in crisis. It was the prospect of a united Germany that spurred Maastricht and the EMU. To deal with the current crisis, there has been an expansion of institutional capacity and the strengthening of what the Germans call the Stability and Growth Pact and what the French call a Growth and Stability Pact.

It seems increasingly clear that in order for Europe to face the challenges wrought by the end of the credit cycle, monetary union has to be transformed into something far larger. Otherwise, it literally risks coming apart at the seams.

Of course, a political union cannot take place overnight. However, one of the recurring debates in Q3 will be the roadmap to get Europe from here to there, perhaps over the next decade. In the meantime, the strategy will require greater harmonization of fiscal policy to the German metric. Greater coordination and harmonization in the banking sector is also necessary. In particular, there is likely to be an agreement on unified supervision. The proposals may crystallize by the EU summit in the beginning of Q4.

One of the real obstacles to political unification is simply nationalism. However, in the face of an existential crisis, countries have an ability to sacrifice a great degree of sovereignty for the sake of survival. While EU members have already accepted some loss of fiscal sovereignty, a more extensive shift takes place alongside the request for international assistance. Greece is an extreme example, but Spain's Prime Minister Rajoy appeared near his breaking point when he called for a centralized fiscal policy.

If political union is desirable or necessary, and individual countries are loath to give up more sovereignty without believing their existence is at stake, then the solution is a deeper crisis. This perverse logic would suggest that the creditor nations, led by Germany, will resist efforts to ease the underlying pressure, even if they concede some growth oriented proposals.

There are two ways for the pressure to be lifted. The first way is for countries to adopt the structural reforms necessary to earn the confidence of investors on one's own. The second way is to seek international assistance and have a specific program of structural reforms on timetables imposed by the EU. This means a redemption fund, which was initially proposed by Merkel's economic advisors, is unlikely to get off the ground. We have been sympathetic to a joint bill market, but we suspect this is unlikely to materialize this year.

The United States

This appears to be the third year in which US economic activity has followed the same stylized pattern: weakness in the first half followed by a stronger second half. The strength in the second half gives rise to hopes that a stronger recovery is at hand. The Fed has responded with additional unorthodox measures.

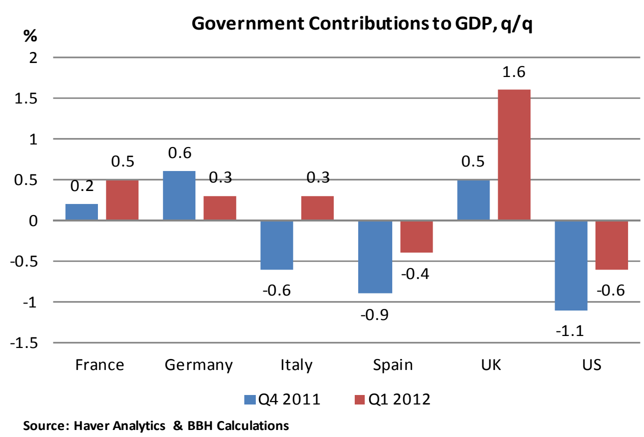
At the end of Q2, the Federal Reserve has announced an extension of what has been dubbed Operation Twist that involves selling short-term Treasury securities and buying longer-term Treasuries. This, the Fed says, will provide support for the economy through lower long-term interest rates. The extension of Operation Twist until the end of the year seems to raise the bar for a new round of asset purchases that would expand the Fed's balance sheet, as opposed to shifting its composition.

If the European crisis produces strong headwinds to the US economy, or if the ongoing deleveraging threatens to prevent the continuation of the cyclical expansion, the Federal Reserve is prepared to do more. However, there are good reasons to agree with the Fed's anticipation of the stronger economic momentum in the second half, besides the recent pattern.

Gasoline prices have fallen and this should help underpin consumption. There has been a notable increase in demand for credit from households and businesses, according to the most recent Fed survey of senior loan officers. Inventory-to-sales ratios are not out of line, suggesting little need to cut back output further. The housing market appears to be stabilizing and this eases an economic headwind without providing much of a tail wind yet. Nevertheless, with vacancy rates for single family and multi-family units falling, the prospects are the best they have been since the housing market bubble peaked.

If our analysis is correct, and barring some major economic deterioration, Fed monetary policy will remain focused on Operation Twist in Q3. Fiscal policy issues are likely to gain ascendancy, especially in the politically charged environment of political party conventions and the start of the campaigns proper toward the end of Q3.

Ironically, even though the U.S. has been rightfully criticized for not truly having a serious strategy to put fiscal policy back on a sustainable path, the government sector has been a serious drag on the U.S. economy and on job creation. Several European countries, which have been chafing under austerity, have actually seen the government sector a net contributor to GDP. In this context, the U.K. stands out, as the chart here shows.



Like the debtors in Europe, who seemingly move under pressure, U.S. officials still do not show the kind of urgency one would expect given the deficit and debt levels, the potential downgrades, and the looming fiscal cliff, when the so-called Bush tax cuts and other measures expire at the end of this year. Record low interest rates keep debt servicing costs modest.

European problems seem more intractable and this has helped preserve the safe haven bid for U.S. Treasuries. There is no reason to expect any meaningful resolution ahead of the November elections. After all, that is in part what the election will be fought over. While we expect the dollar to trade higher in Q3, we are not as sanguine about Q4, especially after the election, regardless of the outcome.

In sum, we expect European events to continue to be the single largest influence of the overall investment climate. The crisis is likely to deepen and this will likely weigh on risk appetite in general and lead to a modest strengthening of the dollar.

-Marc Chandler

Developed Markets: Sovereign Ratings Model

Developed Markets (DM) Ratings Model

We have produced the Developed Markets (DM) ratings model to assist investors in assessing relative sovereign risk over a wide range of countries. As in the case of the EM model, DM scores directly reflect a country's creditworthiness and its underlying ability to service sovereign debt obligations. Each country's score is determined through a weighted compilation of fifteen economic and political indicators, which include government debt/GDP, current account/GDP, GDP growth, Gross Fixed Capital Formation/GDP, actual and structural budget balance, per capita GDP, banking sector strength, and inflation. Please note that the score is scaled differently than our EM model. We have added Cyprus, Denmark, and Finland to bring total DM countries to 23.

DEVELOPED COUNTRY RISK INDEX Q3 12

Country	Current Score	Change vs. last	BBH Implied Rating	S&P	Agency Ratings Moody's	Fitch	5-Yr CDS (bp)	5-Yr Spread to US (bp) *to Germany	
Switzerland	7.6	1.0	AAA	AAA	Aaa	AAA	54	-53	*
Sweden	8.1	2.5	AAA	AAA	Aaa	AAA	61	50	*
Norway	10.0	-0.4	AAA	AAA	Aaa	AAA	30	113	*
Luxembourg	11.0	-0.6	AAA	AAA	Aaa	AAA			
Australia	16.1	1.1	AAA	AAA	Aaa	AAA	78	176	
Denmark	16.7	n/a	AAA	AAA	Aaa	AAA	119	3	
New Zealand	18.5	-1.9	AAA	AA	Aaa	AA	94	218	
Canada	19.1	2.2	AAA	AAA	Aaa	AAA		52	
Finland	19.3	n/a	AAA	AAA	Aaa	AAA	80	55	
Germany	20.5	0.4	AAA	AAA	Aaa	AAA	101	0	
Austria	23.8	0.6	AAA	AA+	Aaa	AAA	173	76	*
Netherlands	24.4	7.5	AAA	AAA	Aaa	AAA	112	62	*
US	29.5	2.1	AAA	AA+	Aaa	AAA	49		
France	34.1	2.6	AA	AA+	Aaa	AAA	198	83	*
Belgium	35.8	3.2	AA-	AA	Aa3	AA	250	147	*
UK	36.6	3.1	AA-	AAA	Aaa	AAA	72	17	
Japan	37.9	0.6	A+	AA-	Aa3	A+	95	-49	
Italy	48.3	4.5	BBB	BBB+	A3	A-	529	505	*
Spain	51.0	8.3	BBB-	BBB+	Baa3	BBB	581	552	*
Ireland	52.5	-1.7	BBB-	BBB+	Ba1	BBB+	619	589	*
Cyprus	53.4	n/a	BB+	BB+	Ba3	BB+	1401	1829	
Portugal	56.8	-1.0	BB	BB	Ba3	BB+	827	896	*
Greece	70.1	-2.7	CCC	CCC	C	CCC	6554	6065	*

Source: BBH, Bloomberg

DM Ratings Outlook

After several quarters of downgrading with abandon, all three ratings agencies took a bit of a breather in Q2. Yet this round, most implied ratings in DM were lower. With recession spreading from the periphery to the core, most debt ratios will likely deteriorate in 2012 and 2013, adding to further downward ratings pressure on the euro zone.

Our model introduces Denmark and Finland as AAA/Aaa/AAA countries. The U.S., Switzerland, Sweden, Norway, Luxembourg, Australia, New Zealand, Canada, Germany, Austria, and the Netherlands continue to be viewed as AAA credits.

We think that U.S. ratings will come back into focus after the November elections. Both Moody's and Fitch gave the U.S. some leeway until 2013 due to the political cycle. S&P did not and cut the U.S. to AA+ in 2011. We note that the U.S. implied rating is now very close to AA+/Aa1/AA+, and reflects what can only be described as rising downgrade risks.

Our model now has France as AA/Aa2/AA, down from AA+/Aa1/AA+ previously. Actual ratings of AA+/Aaa/AAA are thus subject to growing downgrade pressures. All three agencies have a negative outlook and so further downgrades seem likely.

After France, the next weakest core country is Belgium. Our model has an implied rating of AA-/Aa3/AA-, down from AA/Aa2/AA previously. As such, downgrade risks for Belgium remain in play given that a negative outlook has been kept by all three agencies. Actual ratings are split at AA/Aa3/AA.

Spain was downgraded in Q2 by all three agencies in multi-notch moves. Current ratings stand at BBB+/Baa3/BBB. Our model rates Spain at BBB-/Baa3/BBB- and lines up best with Moody's Baa3. All three have kept negative outlooks and so further cuts appear likely.

Italy's implied rating fell two notches this round to BBB/Baa2/BBB from A-/A3/A- previously. Actual ratings are currently BBB+/A3/A- and thus very much vulnerable to more downgrades. All three agencies have a negative outlook on Italy, but Moody's and Fitch are most off target at A3 and A-, respectively, and likely to cut soon.

Ireland's implied rating was steady at BBB-/Baa3/BBB- this round. This compares to actual ratings of BBB+/Ba1/BBB+. All three have maintained negative outlooks on Ireland, but the case for further cuts has lessened a bit as its fundamentals have stabilized.

Portugal's implied rating was also steady at BB/Ba2/BB compared to actual ratings of BB/Ba3/BB+. With all three agencies keeping a negative outlook, further downgrades are possible but current ratings appear close to the mark.

We have introduced Cyprus as a BB+/Ba1/BB+ credit in our model. While actual ratings of BB+/Ba3/BB+ look close to ours, Cyprus is still subject to downgrade pressures as the agencies have maintained negative outlooks. Fitch cut Cyprus below investment grade in late Q2. Moody's also cut Cyprus from Ba1 to Ba3 in Q2.

Greece was moved by S&P from SD (Selective Default) to CCC, while Fitch moved Greece from B- to CCC. That B- rating was given in Q1 after the debt exchange. We thought at the time that B+ was not warranted. Our model rates Greece at CCC/Caa/CCC.

While most of the rating moves in Q2 were in the euro zone, we stress that the U.K. remains vulnerable to losing its AAA/Aaa/AAA rating despite the aggressive fiscal tightening implemented by the Tory-led government. U.K. implied rating fell one notch to AA-/Aa3/AA-. Both Moody's and Fitch have moved the outlook to negative and so we see U.K. downgrades in 2012 or 2013.

Japan's implied rating fell one notch to an implied A+/A1/A+. Fitch cut Japan to A+. Actual ratings of AA-/Aa3/A+ are thus vulnerable to downgrades. Both S&P and Fitch have negative outlooks. After cutting Japan to Aa3 last August, Moody's moved outlook to stable.

-Win Thin

Currency Forecasts

Major Markets

In U.S. Dollar Terms	Current	Q3 2012	Q4 2012	Q1 2013	Q2 2013
Euro	1.25	1.19	1.24	1.21	1.23
Yen	79	78	79	80	82
Sterling	1.56	1.52	1.56	1.53	1.55
Canadian Dollar	1.03	1.05	1.01	1.03	1.00
Australian Dollar	1.01	0.95	0.99	0.96	0.99
New Zealand Dollar	0.79	0.75	0.78	0.76	0.78
Swedish Krona	7.06	7.40	7.18	7.33	7.15
Norwegian Krone	6.06	6.23	6.05	6.10	6.00
Swiss Franc	0.96	1.01	0.98	0.96	0.95
In Euro Terms	**Current**	**Q3 2012**	**Q4 2012**	**Q1 2013**	**Q2 2013**
Yen	99	93	98	97	101
Sterling	0.80	0.78	0.79	0.79	0.79
Swiss Franc	1.20	1.20	1.22	1.16	1.17
Swedish Krona	8.79	8.81	8.90	8.87	8.79
Norwegian Krone	7.55	7.41	7.50	7.38	7.38

Emerging Markets

In U.S. Dollar Terms	Current	Q3 2012	Q4 2012	Q1 2013	Q2 2013
Chinese Yuan	6.36	6.36	6.36	6.36	6.36
Hong Kong Dollar	7.76	7.77	7.77	7.77	7.77
Indian Rupee	56.81	59.00	58.00	57.00	56.00
South Korean Won	1154	1200	1150	1100	1075
Indonesian Rupiah	9494	9800	9700	9500	9400
Malaysian Ringgit	3.20	3.25	3.20	3.10	3.00
Philippine Peso	42.39	43.50	42.50	41.50	41.00
Singapore Dollar	1.28	1.30	1.27	1.25	1.22
New Taiwan Dollar	29.92	30.50	30.00	29.50	29.00
Thai Baht	31.86	32.50	32.00	31.50	31.00
Brazilian Real	2.08	2.10	2.05	2.00	1.95
Mexican Peso	13.58	14.50	14.25	14.00	13.50
Czech Koruna	20.71	22.27	21.31	20.40	19.84
Hungarian Forint	231	252	242	232	226
Polish Zloty	3.44	3.78	3.61	3.44	3.33
Russian Ruble	33.0	35.0	34.5	34.0	33.5
South African Rand	8.41	8.90	8.70	8.50	8.25
Turkish Lira	1.82	1.90	1.85	1.80	1.75
In Euro Terms	**Current**	**Q3 2012**	**Q4 2012**	**Q1 2013**	**Q2 2013**
Czech Koruna	25.80	26.50	26.00	25.50	25.00
Hungarian Forint	287	300	295	290	285
Polish Zloty	4.29	4.50	4.40	4.30	4.20

***There is no assurance that future forecasts will be attained.**

Outlook for Emerging Markets: Turbulence Returns

EM Weakens as Strains Intensify In Europe

Emerging Markets (EM) assets have weakened substantially after the sharp rally in January and February ran out of steam. The two massive ECB LTROs proved to be only temporary tonics for the markets, with focus returning back to solvency concerns for much of the periphery. The rapid manner in which EM came back during the first two months of the year supports our view that EM will eventually recover, but the ongoing euro zone crisis remains far from an end game. As a result, we are downgrading our EM FX outlook for this year to a more cautious stance.

April 2012 IMF Forecast Growth, change vs. January				
	2012	change	2013	change
Emerging Markets	**5.7%**	**0.3%**	**6.0%**	**0.1%**
Latin America	3.7%	0.1%	4.1%	0.2%
Brazil	3.0%	0.0%	4.1%	0.1%
Mexico	3.6%	0.1%	3.7%	0.2%
Central/E. Europe	1.9%	0.8%	2.9%	0.5%
Mid. East/N. Africa	4.2%	1.0%	3.7%	0.1%
Developing Asia	7.3%	0.0%	7.9%	0.1%
China	8.2%	0.0%	8.8%	0.0%
India	6.9%	-0.1%	7.3%	0.0%
ASEAN-5	5.4%	0.2%	6.2%	0.6%
Sub-Saharan Africa	5.4%	-0.1%	5.3%	0.0%

Source: IMF

Global Growth Outlook Worsens

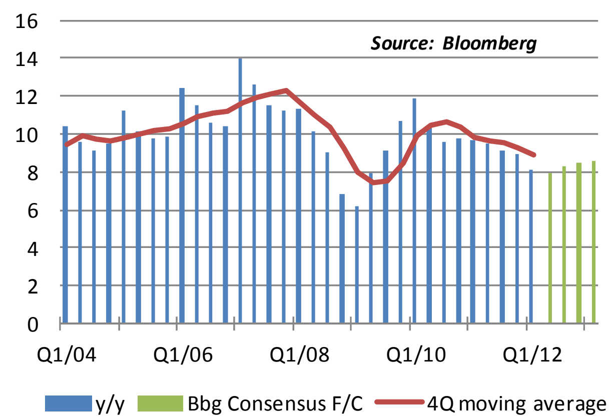
After remaining strong for much of 2011, EM exports and growth have slowed significantly in the first half of 2012. The IMF does not seem to recognize this given its modest upward revisions to its global growth forecasts in its April World Economic Outlook update. The U.S. outlook appears to have worsened, though not yet back in double dip risks. The euro zone is in recession, and mainland China is slowing more sharply than expected. Quite frankly, we cannot justify the IMF's improved outlook.

With falling oil prices likely to feed into lower inflation, we believe more and more countries will ease monetary policy in 2012. Up until now, EM easing has been on the modest side, as we believe many are keeping their powder dry for some sort of euro zone-related fallout. In any case, we stress that both DM and EM countries are starting this stage of the crisis with less degrees of freedom. The aggressive easing in 2008-2009 was only partially taken back in the ensuing years, and so policymakers now have less room to cut rates. The same goes for fiscal policy. After an aggressive policy response and recession left many EM fiscal balances in the red, the room for fiscal stimulus is not as large as it once was. In DM, monetary accommodation was never removed, while the poor state of DM budgets will prevent any significant fiscal response.

China Slowdown Is Deepening

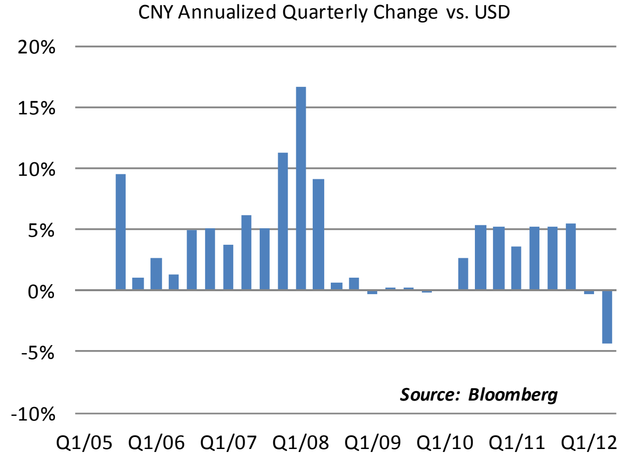
We believe recent China data have been signaling a more intense slowdown as we approach midyear. While this has revived fears of a hard landing, our base case remains one of soft landing. However, we acknowledge that China has not yet landed, and that data are likely to worsen in Q3 before modest improvement is seen towards year-end. PBOC has been easing at a very cautious pace, but we think the pace will pick up in the coming months. Falling oil prices have allowed China to announce in June the largest fuel price cuts since 2008. CPI inflation eased to 3.0% y/y in May, and further disinflationary pressures should allow for a faster pace of easing in H2 2012.

China GDP Growth



Despite the slowdown, consensus is for China to grow over 8% in 2012. This is likely too optimistic. However, if China does see increased risks of a harder landing, we remain confident that policymakers will use fiscal and monetary policy to boost growth again. Given the political transition this year, we expect China policy-makers to take no chances with regards to the economic backdrop and will work to maintain stability.

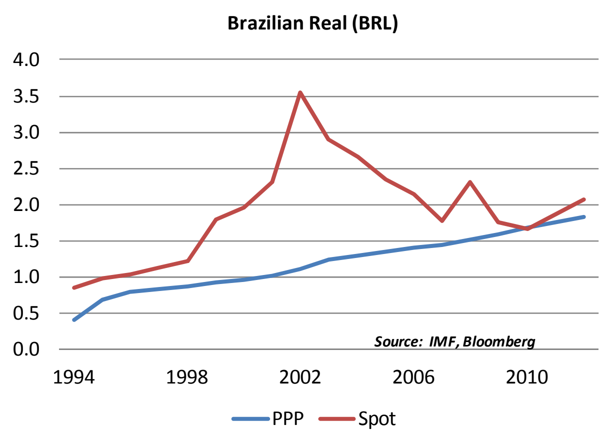
CNY Annualized Quarterly Change vs. USD



Within the context of greater macro risks to China, we see CNY appreciation on hold for 2012. In the worst case scenario of a harder landing than anticipated, we could envision an extended period of relative stability in the exchange rate such as the period from mid-2008 to mid-2010. Despite losing -1.1% vs. USD YTD, we do not think China will depreciate the yuan significantly in a U.S. election year. Instead, it will likely allow the yuan to appreciate in real terms given inflation and rising wage costs.

Brazil Finally Shifts Its Stance on the Exchange Rate

After taking numerous steps to weaken the real over the past year, Brazilian policymakers were finally forced to act to support the currency. During the March-May EM selloff, the real underperformed significantly, with the central bank intervening aggressively in late May as USD/BRL broke above 2.00 and then 2.10. Previous regulatory measures were reversed as well, and taken in conjunction with some stabilizing EM sentiment in June, the authorities have for now moved the real back to performing along with the rest of EM FX. If EM sells off due to euro zone crisis, we do not think Brazil will do much more than trying to prevent massive BRL underperformance. The IOF tax on fixed income inflows remains untouched at 6%, which we view as the bazooka in Mantega's pocket to be used in case of emergency. We are not there yet.



On the other hand, Brazil is intent on boosting the economy, as it has eased a total of 400 bp through June to take the SELIC rate to a record low 8.5% currently. Markets are expecting another 75-100 bp of easing still to come in 2012 that would take the SELIC rate below 8%. That is by far the most aggressive monetary response seen globally this past year. Despite the aggressive easing, the government's GDP growth forecast for 4-5% this year is way too optimistic. However, we could see more aggressive fiscal stimulus if growth continues to come up short in the coming quarters. To us, the combination of aggressive easing coupled with heightened inflation concerns should weigh on BRL.

India's Poor Fundamentals Stand Out

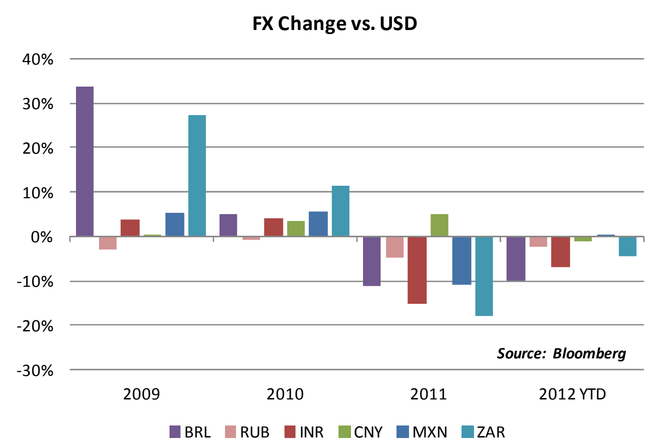
In a region that typically boasts low inflation, current account surpluses, and solid budget balances, India stands out for having none of the above. As a result, it is not surprising that the rupee has been the second worst EM performers this year (second only to the Brazilian real). Unfortunately, the negative macro trends look likely to continue for India, and so we believe USD/INR will continue to make new record highs in H2 2012. So far, measures to support the rupee have been timid and provided only temporary relief. High inflation prevented the RBI from cutting rates in June in order to address the economic slowdown, and policy paralysis has spread to most areas of the economy as much-needed fiscal reforms are at a standstill. Both S&P and Fitch have moved the outlook on India's BBB- rating to negative.

Russia Will Suffer From Low Oil Prices

Sharply lower oil prices will pressure the current account and fiscal balances. The breakeven price for Urals that obtains a balanced budget has risen to around $117 this year from $34 in 2007. The current spot price stands near $90. Russia is not as dependent on foreign capital flows as it was in the past, and the current account remains in surplus. However, private sector capital outflows have remained strong this year and along with lower oil prices, the fundamentals favor further ruble weakness. The ruble is typically a high-beta currency within EM and so underperforms during periods of market stress. The central bank has had to intervene in the FX market in Q2 to maintain the ruble corridor.

Investors Will Eventually Differentiate Amongst EM

One interesting development this year has been the high degree with which EM currencies and equity markets have traded in lockstep in 2012. After the protracted bout of risk off trading in the latter half of 2011, the early 2012 EM rally saw all of EM recover, even the weakest credits. This has been followed by several months of indiscriminate EM weakness. The notion that EM equity markets have been trading in lockstep this year is borne out by the data. Looking at the YTD returns for 25 major EM equity markets, the standard deviation near 8% is the lowest since we started compiling data in 1996 and is well below the average of nearly 31%% seen from 1996-2011.



A similar dynamic has been seen in the FX markets, with spot performances YTD of the major EM currencies also coming in very close together and at historically high levels of correlation. At some point this year, this high degree of correlation between EM asset markets should break down and allow for greater divergence of performances that are based more on fundamentals than on simple risk on/risk off trading. This is unlikely to happen, however, until we finally see some sort of closure to the euro zone debt crisis. For now, that remains the single biggest risk to EM.

Even under a scenario of continued stresses in Q3, we continue to believe that differentiation will continue to be the watchword for EM. Asian currencies look most attractive to us now as a defensive play, with EMEA the least attractive, and Latin America now somewhere in between. Latin America and Asia have switched places since last quarter, as we believe the commodity exporters of Latin America remain more vulnerable in the current environment. The China slowdown is likely to weigh disproportionately on Asia, but we acknowledge that several countries in Latin America count on China as a major export market.

-Win Thin

Emerging Markets: Sovereign Ratings Model

Emerging Markets (EM) Ratings Model

We have produced the following Emerging Markets ratings model to assist fixed income investors in assessing relative sovereign risk. An EM country's score directly reflects its creditworthiness and underlying ability to service its external debt obligations. Each EM country's score is determined through a weighted compilation of fifteen economic and political indicators, which include external debt/GDP, short-term debt/reserves, import cover, current account/GDP, GDP growth, GFCF/GDP, budget balance, and FDI/GDP. We find that our sovereign model is very useful in predicting rating changes by the major agencies, and we summarize our ratings conclusions below. We have added Ghana, Lebanon, and Mozambique to our EM model, bringing the total rated EM countries to 47.

EM Ratings Outlook

Cracks are widening in EM, with the number of downgrades outnumbering upgrades this past quarter. EMEA remains the weak link in EM. S&P moved the outlook on South Africa's BBB+ rating from stable to negative. Our model rating fell one notch to BBB/Baa2/BBB, and so a downgrade is becoming more likely. S&P moved the outlook on Turkey's BB rating from positive to stable, but Moody's upgraded it from Ba2 to Ba1 with positive outlook. Tunisia was cut from BBB- to BB by S&P with a stable outlook, which lines up with our model rating. S&P also moved its outlook on Lebanon's B rating from stable to negative. Egypt continues to suffer, with Fitch cutting its rating from BB- to B+ with a negative outlook and S&P putting its B rating on CreditWatch Negative. Latvia bucked the trend with its S&P upgrade from BB+ to BBB- with stable outlook.

In Asia, India is under the microscope as S&P and Fitch cut the outlook on their BBB- rating from stable to negative. India's implied rating of BBB-/Baa3/BBB- is very close to the BB+/Ba1/BB+ cutoff and so downgrade risks are high. S&P raised the outlook on Vietnam's BB- rating from negative to stable. Moody's raised the outlook on its Ba2 rating for the Philippines from stable to positive. Philippines implied ratings of BBB/Baa2/BBB supports upgrades to actual ratings of BB/Ba2/BB+.

In Latin America, S&P upgraded Uruguay from BB+ to BBB- with stable outlook and Fitch raised the outlook on its BB+ rating from stable to positive. Our implied rating of A-/A1/A- suggests actual ratings of BBB-/Ba1/BB+ remain way too low and that an investment grade rating should be seen soon for all three. S&P cut the outlook on Argentina's B rating from stable to negative, while Fitch cut the outlook on Venezuela's B+ rating from stable to negative.

We continue to see several candidates for upgrades this year. In Asia, Malaysia's implied ratings of A+/A1/A+ suggest actual ratings of A-/A3/A- should be adjusted higher. Indonesia's implied ratings of A-/A3/A- suggest multiple upgrades ahead, as actual ratings of BB+/Baa3/BBB- appear far too low.

EM COUNTRY RISK INDEX Q3 12

Country	Current Score	Change vs. last	BBH Implied Rating	Agency Ratings S&P	Agency Ratings Moody's	Agency Ratings Fitch	5-Yr CDS (bp)	10-Yr Spread to US (bp) *to 10-Yr German (bp)	
Singapore	8.5	1.6	AAA	AAA	Aaa	AAA			
Hong Kong	13.9	1.2	AA	AAA	Aa1	AA+	75		
China	18.8	-0.6	AA-	AA-	Aa3	A+	125	225	
Chile	19.2	-0.3	AA-	A+	Aa3	A+	120	83	
Korea	20.4	-1.3	A+	A	A1	A+	123	172	
Taiwan	20.8	4.2	A+	AA-	Aa3	A+			
Israel	21.6	0.6	A+	A+	A1	A	173	175	
Malaysia	22.4	1.2	A+	A-	A3	A-	129	216	
Peru	25.9	-1.4	A	BBB	Baa3	BBB	163	183	
Russia	27.0	-4.3	A-	BBB	Baa1	BBB	246	269	
Uruguay	27.4	-1.1	A-	BBB-	Ba1	BB+		228	
Kazakhstan	28.8	-3.3	A-	BBB+	Baa2	BBB	263		
Indonesia	28.9	2.0	A-	BB+	Baa3	BBB-	202	258	
Czech Rep.	29.5	3.7	A-	AA-	A1	A +	136	158	*
Colombia	31.2	-0.1	BBB+	BBB-	Baa3	BBB-	147	183	
Mexico	31.7	1.0	BBB+	BBB	Baa1	BBB	146	214	
Thailand	31.7	-0.6	BBB+	BBB+	Baa1	BBB	155		
Brazil	32.0	-0.4	BBB+	BBB	Baa2	BBB	157	170	
Lithuania	33.4	-0.7	BBB	BBB	Baa1	BBB	275	356	
Algeria	33.8	-3.9	BBB	NR	NR	NR			
Philippines	33.9	-2.3	BBB	BB	Ba2	BB+	168	191	
So. Africa	34.0	2.4	BBB	BBB+	A3	BBB+	175	303	
Panama	34.3	-1.0	BBB	BBB-	Baa3	BBB	147	344	
Bulgaria	34.7	1.2	BBB	BBB	Baa2	BBB-	338		
Namibia	35.8	n/a	BBB	NR	Baa3	BBB-		248	
Nigeria	36.6	5.0	BBB-	B+	NR	BB-		440	
Latvia	37.6	-3.3	BBB-	BBB-	Baa3	BBB-	299	399	
Jordan	38.3	4.2	BBB-	BB	Ba2	NR			
Poland	38.5	-1.3	BBB-	A-	A2	A-	215	283	
Iceland	39.5	-3.5	BBB-	BBB-	Baa3	BBB-	294		
Romania	39.8	1.3	BBB-	BB+	Baa3	BBB-	424	467	*
Morocco	39.8	1.3	BBB-	BBB-	Ba1	BBB-	286	405	*
India	39.9	2.3	BBB-	BBB-	Baa3	BBB-			
Sri Lanka	40.4	-1.1	BB+	B+	B1	BB-		490	
Mozambique	41.8	n/a	BB+	B+	NR	B			
Hungary	43.6	-1.9	BB	BB+	Ba1	BB+	524	567	
Turkey	43.8	2.3	BB	BB	Ba1	BB+	251	355	
Argentina	44.5	2.7	BB	B	B3	B	1344	1272	
Ghana	44.7	n/a	BB	B	NR	B+		513	
Tunisia	44.8	2.1	BB	BB	Baa3	BBB-	255	438	
Venezuela	45.4	-3.9	BB	B+	B2	B+	934	1204	
Ukraine	45.4	-6.2	BB	B+	B2	B	854	922	
Egypt	47.0	4.4	BB-	B	B2	B+	695	578	
Kenya	48.2	-2.1	BB-	B+	NR	B+			
Vietnam	48.4	-0.3	BB-	BB-	B1	B+	353	432	
Tanzania	48.9	1.2	BB-	NR	NR	NR			
Lebanon	49.4	n/a	BB-	B	B1	B		479	
Pakistan	52.2	2.9	B+	B-	B3	NR	989	1157	

Source: BBH, Bloomberg

In Latin America, there are several good credit stories. Besides the likely upgrades mentioned earlier for Uruguay, we also see upgrade potential for Peru, Colombia, and to a lesser extent Brazil too. Peru's implied ratings of A/A2/A are way out of line with actual ratings of BBB/Baa3/BBB. Colombia stands at an implied BBB+/Baa1/BBB+, and so we see upgrades to its actual BBB-/Baa3/BBB- ratings in 2012. Brazil's BBB/Baa2/BBB ratings are one notch below our implied rating of BBB+/Baa1/BBB+.

In EMEA, we see very few candidates for upgrades (Kazakhstan and Ukraine) and many more for downgrades (South Africa, Czech Republic, Hungary, Poland). This is consistent with our view that this region has the weakest fundamentals in EM.

-Win Thin

Emerging Markets: FX Model

Our FX model covers 25 countries, with each country's score determined by a weighted composite ranking of 13 economic indicators that are each ranked against the rest of our model emerging markets universe for each category. Categories are external debt/GDP, interest rate differentials, short-term debt/reserves, import cover, external debt/exports, current account/GDP, export growth, GDP growth, FDI/GDP, nominal M3 growth, budget deficit/GDP, and inflation. We recently added the percentage deviation from PPP as a variable to our model, as we believe EM currencies that are near their PPP valuations have less room to appreciate than those that are very undervalued and far from PPP.

EM FX Summary

The 10 countries that are at the top of our table have VERY STRONG (1) or STRONG (2) fundamentals relative to our EM universe, while the 10 at the bottom have WEAK (4) or VERY WEAK (5) fundamentals. Those five in the middle have NEUTRAL (3) fundamentals. These scores do not imply a greater return for those countries with a higher ranking. Rather, our models simply seek to identify those currencies that are backed up by better underlying fundamentals compared to their EM peers. We stress that the composite rankings contained in this model are a relative measure, not an absolute one.

We note that those currencies with STRONG and VERY STRONG fundamentals lost an average of -2.7% (-3.1% average loss for VERY STRONG, -2.4% average loss for STRONG) against the dollar from 3/27/12-6/22/12, the period since we issued our last FXRR update. This compares to an average loss of -3.6% during the same period for those with WEAK and VERY WEAK fundamentals (-5.9% average loss for WEAK, -1.3% average loss for VERY WEAK) and a -5.8% average loss versus USD for those with NEUTRAL fundamentals. Our FX model thus had modest success in identifying the likely under- and outperformers during this past quarter.

In other periods, our model has performed much better. As correlations continue to run high, EM assets have been trading in lockstep this year which is borne out by the data. Looking at the YTD performances for our 25 EM currencies, the standard deviation of changes in 2012 near 4.5% is well below the average of 9.5% seen from 2000-2011. In other words, the spot performances of the major EM currencies are coming in very close together and at historically high levels of correlation. At some point this year, this high degree of correlation between EM asset markets should break down and allow for greater divergence of performances that are based more on fundamentals than on simple risk on risk off trading.

While correlations are still running high, we still recommend focusing on fundamentals as opposed to yield for the time being due to heightened global risks. Note that four of the top five currency picks this round are in Asia. This lines up with the conventional wisdom that Asia is well-placed to ride out this current bout of jitters, with most of the defensive low-beta currencies being in this region.

Latin American currencies have been compelling given high interest rates and adherence to sound budgetary policies. Even though most will be cutting rates in 2012, the underlying fundamentals remain sound. We note that many Latin American currencies have moved up towards the top of our league table. However, a key risk for this region is lower commodity prices if the global slowdown deepens. This is a major factor behind why we think Asia will outperform Latin America in Q3.

High yielders in the EMEA will always elicit investor interest but often do not have strong fundamental backing. Add in the vulnerability of Eastern Europe to developments in troubled Western Europe, and one can see headwinds ahead for EMEA currencies. Many from the EMEA region are near the bottom of our league table, and are also part of the high-beta grouping that typically underperforms during periods of market stress.

-Win Thin

Current Rating	Country	FXRR Score	FX vs. USD (* vs. EUR) 3/27/12-6/22/12	Previous Rating
1	China	5.1	-0.9%	1
1	Singapore	7.1	-1.5%	1
1	Taiwan	7.9	-1.2%	1
1	Malaysia	8.5	-4.2%	2
1	Russia	8.7	-12.4%	1
2	Philippines	9.2	1.0%	2
2	Peru	9.8	0.7%	1
2	Korea	10.5	-2.0%	2
2	Thailand	10.8	-3.4%	3
2	Indonesia	11.2	-3.3%	2
3	Colombia	11.4	-1.5%	3
3	Mexico	11.4	-8.4%	3
3	Israel	12.0	-4.6%	3
3	India	12.4	-11.3%	3
3	Chile	12.7	-3.4%	2
4	Turkey	13.2	-1.5%	5
4	Brazil	13.4	-11.8%	4
4	Argentina	13.7	-3.0%	4
4	Egypt	13.8	-0.3%	4
4	Czech Rep*	14.0	-4.6%	4
5	So. Africa	14.0	-9.5%	4
5	Hungary*	14.4	1.4%	5
5	Iceland	14.5	0.7%	5
5	Poland*	16.4	-3.0%	5
5	Pakistan	16.6	-3.9%	5

Source: BBH, Bloomberg

Emerging Markets: Equity Allocation Model

We have produced the following equity allocation model to assist equity investors in assessing relative sovereign risk and optimal asset allocation across countries in the Emerging Markets universe. The countries covered include 20 of the 21 countries in the MSCI Emerging Markets (EM) Index as well as three (Israel, Hong Kong, and Singapore) from the MSCI Developed Markets (DM) Index and two (Argentina and Pakistan) from the MSCI Frontier Markets Index. A country's score is determined through a weighted composite of 15 economic and political indicators that are each ranked against the other 24 in our model EM universe. Categories include industrial production growth, real interest rates, export growth, expected P/E ratio, bank lending, retail sales, current account, real money growth, GDP growth, GFCF/GDP, inflation, ease of doing business, economic freedom, and FDI/GDP.

EM Ratings Summary

A country's score reflects its attractiveness for equity investors – the likelihood that its equity market will outperform the rest of our Emerging Markets universe over the next three months. A country that is typically ranked first in many of the categories will end up at the top of our composite rankings. Exchange rate fluctuations can have significant effects on the dollar return to foreign investors, and so we have chosen several variables that tend to highlight exchange rate risk. Others were chosen as leading indicators of economic growth.

From 3/27/12 to 6/22/12, MSCI EM Index fell -13.1% while the MSCI Developed Markets (DM) Index fell -8.8%. We think it is important to note that MSCI EM outperformed MSCI euro zone (-17.9%) and MSCI Japan (-11.6%), with only the US (-5.7%) pulling overall DM up past EM. Looking at regional EM performance, MSCI Asia fell -10.7% during this period, MSCI Latin America fell 17.8%, and MSCI EMEA fell -14.7%.

Within our model universe of 25 EM countries, those that were in the top fifth of our rankings with a 1 rating (VERY OVERWEIGHT equity position) fell an average -9.4% during this period. Those with a 2 rating (SLIGHTLY OVERWEIGHT) fell an average -17.3%, while those with a 3 rating (NEUTRAL) fell an average -11.3%. This compares to an average loss of -14.3% during the same period for those with a 4 rating (UNDERWEIGHT) and -9.2% average loss for those with a 5 rating (VERY UNDERWEIGHT). Average loss for 1 and 2 rated countries together was -13.3%, and average loss for 4 and 5 rated countries together was-11.7%.

EM equity returns this past quarter were thus virtually indistinguishable amongst countries that have significantly different fundamentals. Our model has not done a good job so far this year of identifying outperformers and underperformers, with correlations running high in 2012. The indiscriminate EM rally in early 2012 was followed by an equally indiscriminate EM selloff. Note that an outsized -43.8% loss for 2-rated Argentina made a big difference. Netting out Argentina, 2-rated countries average loss was -10.6% and 1- and 2-rated average loss was -9.9%.

Current Rating	Country	ERR Score	MSCI 3/27/12-6/22/12	Previous Rating	ETF
1	Singapore	6.5	-8.7%	1	EWS
1	China	8.5	-10.6%	1	FXI
1	Peru	8.9	-4.4%	1	EPU
1	Hong Kong	9.3	-11.1%	1	EWH
1	Malaysia	9.8	-4.5%	2	EWM
2	Chile	9.9	-12.0%	1	ECH
2	Russia	9.9	-23.5%	2	ERUS
2	Argentina	10.3	-43.8%	2	ARGT
2	Indonesia	10.3	-9.8%	2	EIDO
2	Korea	10.8	-11.2%	3	EWY
3	Colombia	11.2	-4.6%	2	COLX
3	Mexico	11.3	-7.2%	3	EWW
3	Thailand	11.8	-10.4%	3	THD
3	Taiwan	12.0	-11.4%	3	EWT
3	India	13.0	-13.9%	4	INP
4	Turkey	13.2	-5.4%	4	TUR
4	Israel	13.8	-16.3%	3	EIS
4	Czech Rep.	14.2	-16.7%	4	
4	Brazil	14.3	-23.3%	4	EWZ
4	Philippines	14.4	1.1%	5	EPHE
5	Poland	14.5	-12.0%	4	EPOL
5	Hungary	17.4	-14.7%	5	
5	Egypt	17.4	-18.2%	5	EGPT
5	South Africa	17.6	-9.0%	5	EZA
5	Pakistan	18.9	-5.2%	5	

Source: Bloomberg, BBH, iShares

The notion that EM equity markets have been trading in lockstep this year is borne out by the data. Looking at the YTD returns for our 25 EM equity markets, the standard deviation near 8% is the lowest since we started compiling data in 1996 and well below the average of 31% seen from 1996-2011. At some point this year, this high degree of correlation between EM asset markets should break down and allow for greater divergence of performances based more on fundamentals than on simple risk on risk off trading.

Given the undercurrents facing EM this year, it will remain paramount for global investors to continue focusing on the fundamentals. We remain optimistic that risk assets (including EM) will rally this year. However, we acknowledge that this asset class remains hostage to swings in generalized risk appetite. Correlations between EM and DM equity markets remain significant. For instance, the 60-day correlation between the S&P 500 and Brazil Bovespa has eased from the August 2011 high of 0.85 to stand near .73. This is above the low near .69 in early March. Decoupling could continue at a gradual pace over the course of the second half of this year, and so we continue to believe that picking EM equity markets with strong fundamentals remains a good strategy for global equity managers in the current environment.

-Win Thin

Central Bank Watch: Majors

Country	Market Rates	Exit Strategy Status
U.S.	Market Rate: 0.18%	We expect no new policy initiatives from the Fed in Q3. In June, the Fed announced an extension of Operation Twist through the end of the year. This is a way to help the Fed avoid having to make further policy decisions ahead of the Presidential election. It also allows the Fed to get a clearer picture of how policy makers will deal with the looming fiscal cliff and developments in the euro zone.
Japan	Market Rate: 0.07%	The BOJ is likely to be biased towards additional easing in Q3. The combination of fiscal tightening and a weakening economy also supports the case for further easing. Its next move may come at the July 12 meeting when it releases its Outlook Report, including a revision of its CPI forecast. Easing options may include an expansion of the APP and extensions of purchasing maturity.
Euro Zone	Market Rate: 0.33%	We expect the ECB to cut rates in Q3, as the economic outlook deteriorates and the debt crisis intensifies. The ECB left its policy rate unchanged in June and said that it is conducting a review into the impact of the measures already implemented. However, it signaled that some Governing Council members favored a rate cut and cited increased downside risks to the economic outlook.
U.K.	Market Rate: 0.65%	The BOE is expected to resume its QE program in Q3. We think the BOE is most likely to resume its QE program at the July 5 meeting after King pulled an end-around the MPC by working with the Treasury to increase credit availability and signal QE. The market expects the BOE to expand QE between £50 - 75 bln.
Switzerland	Market Rate : 0.01%	The SNB will maintain the EUR/CHF floor at 1.20 and intends for that rate to remain in place until deflation risks subsidize. It also stands ready to introduce further measures to counter appreciation pressures on CHF. Even though capital controls are unlikely at this juncture, it may be a last resort if developments in the euro zone force the SNB to react.
Canada	Market Rate: 0.93%	We expect the BOC to remain on hold in Q3. The BOC continues to retain a somewhat more hawkish, albeit conditional, tone on the policy outlook than most other major central banks. However, the intensification of the euro zone crisis and the moderation in US economic activity has seen the BOC soften its stance in light of these downside risks.
Australia	Market Rate: 3.83%	The RBA is expected to continue its easing cycle in Q3. With the underlying inflation rate contained, fiscal policy expected to tighten and headwinds to both external and domestic growth, the RBA still has scope to cut rates further. The recent upside surprises in Q1 GDP and May employment have reduced the odds of a cut in July but this would likely lead the RBA to cut in August.
New Zealand	Market Rate: 2.60%	The RBNZ should remain on hold in Q3, even though at its most recent policy meeting it left the door open for a rate cut. However, it is unlikely that the RBNZ cuts the policy rate this quarter and instead it shifts to a wait and see stance. The combination of soft inflation and a deteriorating global backdrop should continue to delay the RBNZ from raising rates either.
Norway	Market Rate: 2.50%	The Norges Bank is likely to remain on hold this quarter. The Norges Bank has moved to a wait and see stance after cutting the policy rate 75 bp in 2012. The domestic economy remains strong but the Norges Bank is prepared to take action if there is further deterioration in the global economic backdrop.
Sweden	Market Rate: 2.3%	We expect the Riksbank to ease policy this quarter following the intensification of the euro zone debt crisis. The Riksbank kept its policy unchanged in April following a stabilization of economic activity. However, recent minutes showed a slightly more dovish bias, with two voting members calling for a 50 bp rate cut.

Central Bank Watch: Emerging Markets

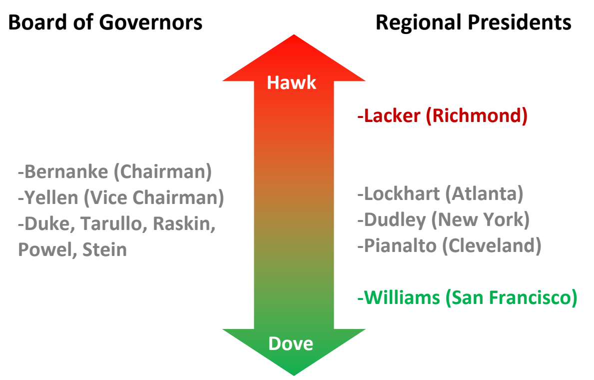
Country	Policy Rate	Country	Policy Rate
	Eastern Europe and Africa		
Czech Republic	Official Rate: 0.75% Cut 25 bp, May 2010 CPI 3.5% y/y, Target 1-3% Central bank may cut rates further in 2012 given weak economic and external backdrop.	Hungary	Official Rate: 7.0% Hiked 50 bp, December 2011 CPI 5.3% y/y, Target 2-4% Central bank has a dovish bias and is likely to ease when the IMF deal is finalized
Poland	Official Rate: 4.75% Hiked 25 bp, May 2012 CPI 3.6% y/y, Target 1.5-3.5% NBP surprised with a rate hike but unlikely to continue tightening due to slowing economy and inflation.	Russia	Refi Rate: 8.00%; Deposit Rate: 4.00% Cut Refi Rate 25 bp, December 2011 Hiked Depo Rate 25 bp, December 2011 CPI 3.6% y/y, Target 5-6% Central bank remains dovish as inflation falling and growth slowing due to lower oil prices.
South Africa	Official Rate: 5.50% Cut 50 bp, November 2010 CPI 5.7% y/y, Target 3-6% Weak growth, high unemployment vs. high inflation creating dilemma for SARB; we see on hold in 2012.	**Turkey**	Official Rate: 5.75% Cut 50 bp, August 2011 CPI 8.3% y/y, Target 3.5-7.5% Central bank continues to tighten liquidity by using high end of 5.5-11% rate corridor.
	Latin America		
Argentina	Repo Rate: 11.50% Actual inflation much higher than reported. Official CPI 9.9% y/y, No Explicit Target Limited central bank independence preventing an orthodox policy response to price pressures.	**Brazil**	Official Rate: 8.50% Cut 50 bp, May 2012 CPI 5.0% y/y, Target 2.5-6.5% Central bank likely to cut in July and August. Wholesale inflation turned higher and pass-through to consumer level is big risk ahead.
Chile	Official Rate: 5.00% Cut 25 bp, January 2012 CPI 3.1% y/y, Target 2-4% Central bank has been in a wait and see stance but external factors could lead to eventual cutting.	**Mexico**	Official Rate: 4.50% Cut 25 bp, July 2009 CPI 3.9% y/y, Target 2-4% U.S. and Mexico outlooks weaker, so market pricing in easing; we see on hold for 2012.
	Asia		
China	1-year Lending Rate: 6.31%, Cut 25 bp, June 2012 Reserve Req: 20.00%, Cut 50 bp, May 2012 CPI 3.0% y/y, 4% Target PBOC started cutting rates and more easing will be seen ahead and pace of easing should pick up soon.	**Hong Kong**	Base Rate: 0.50% CPI 4.7% y/y, No Explicit Target Inflation finally easing; HKMA likely to continue trying to limit real estate speculation.
India	Repo Rate: 8.00%, Cut 50 bp, April 2012 Reserve Requirement: 4.75%, Cut 75 bp, March 2012 CPI 10.4% y/y, No Explicit Target High inflation pressures prevent any significant RBI easing while economy is slowing.	**Indonesia**	Official Rate: 5.75% Cut 25 bp, February 2012 CPI 4.5% y/y, Target 3.5-5.5% BI likely to keep wait and see stance due to high inflation expectation and global uncertainties.
Malaysia	Official Rate: 3.00% Hiked 25 bp, May 2011 CPI 1.7% y/y, No Explicit Target Central bank will keep rates steady as growth and inflation risks balanced. Easing possible late in 2012.	**Philippines**	Official Rate: 4.00% Cut 25 bp, March 2012 CPI 2.9% y/y, Target 3-5% Central bank on hold now, but easing could continue as inflation falls.
Singapore	Monetary policy managed via undisclosed trade-weighted currency basket (NEER). CPI 5.0% y/y, No Explicit Target Tightening policy by increasing slope of S$NEER band in April 2012; on hold likely in October 2012.	**South Korea**	Official Rate: 3.25% Hiked 25 bp, June 2011 CPI 2.5% y/y, Target 2-4% BOK on hold but likely to ease in 2012 as inflation eases and growth slows.
Taiwan	Official Rate: 1.875% Hiked 12.5 bp, June 2011 CPI 1.7% y/y, No Explicit Target CBC likely to ease as economy slows, probably at typical modest pace 12.5bp per quarter.	**Thailand**	Official Rate: 3.00% Cut 25 bp, January 2012 Core CPI 2.0% y/y, Target 0.5-3% BOT on hold but likely to cut rates again sometime in 2012 as growth remains stagnant.

Central Bank Hawk/Dove Barometers

The Fed

The Fed recently chose to continue Operation Twist and extend the average maturity of its securities holding through the end of the year. It also maintained its existing conditional policy rate guidance through late 2014 and its existing policy of reinvesting principal payments from its holdings of agency debt. We suspect that the Fed's decision to extend QE through the end of the year is a way for the Fed to avoid having to make further policy choices ahead of the presidential election. The decision to extend Operation Twist also allows the Fed to get a clearer picture of how policymakers will deal with the looming fiscal cliff and developments in euro zone.

The Voting FOMC Members



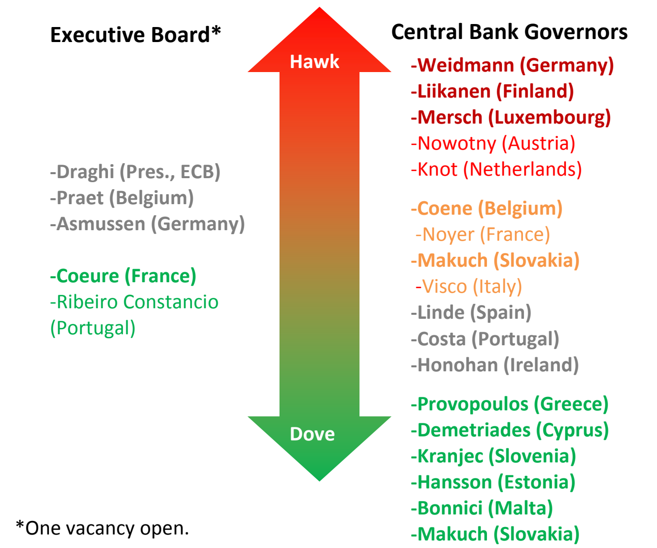
The Fed still maintains an easing bias. It continues to point to strains in the global financial markets as the main risk to the outlook. It also believes that economic growth will moderate in coming quarters. The committee said it is prepared to take further action as appropriate to support the recovery and generate a sustained improvement in labor market conditions in the context of price stability. This suggests that even though the Fed chose not to increase its balance sheet, it stands ready to do more if necessary. Yet we continue to believe that the bar for QE3 is much higher than many observers suggest and it would require the threat of deflation or a sharp loss in economic momentum - both of which are unlikely at this juncture.

The ECB

We expect the ECB to use the combination of conventional and unconventional monetary tools to try and stimulate the economy and mitigate the impacts of the crisis. The ECB has been unwilling to do more to mitigate the impact of the crisis since it judges the resolution to the crisis to be at the political level. The result is that further market pressure leads to further reform and closer integration. However, this policy choice has come at a cost, as financial market stress is weighing on real economic activity. The euro zone economy is expected to contract 0.7% q/q in Q3.

The ECB is likely to cut its policy rate 25 bp this quarter after the results of the June EU Summit are known. The risks are rising that the ECB cuts the policy rate 50 bp at its upcoming meeting. Yet we think it is more likely that it sticks with its piecemeal approach to monetary policy to continue to maintain pressure on politicians. This means that if the ECB eases by 25 bp in early Q3 there is scope for the ECB to ease again later on in the quarter. The ECB is likely to use unconventional tools to ease policy as well but we believe the odds are against another LTRO or restarting the SMP.

ECB Governing Council



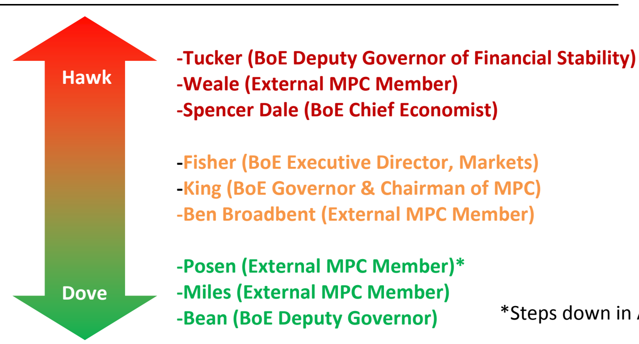
*One vacancy open.

The Bank of England

The BOE is likely to resume QE this quarter. Estimates range from an additional £50–£75 bln in gilt purchases. This comes on the heels of its recent move to improve access to credit. In June, the BOE and the Treasury announced a substantial joint credit easing program. It consists of a funding for lending scheme that would provide funding to banks, at below level rates, and funding auctions to increase banks liquidity. The use of these unconventional tools helps show the distinction between liquidity provisions and monetary policy proper. A rate cut is also possible in Q3 but recent statements from MPC members have downplayed its potential benefits, relative to QE and against the associated costs.

-Mark McCormick

BoE Monetary Policy Committee



*Steps down in August.

Global Currency Strategy Team

Marc Chandler, Global Head of Currency Strategy **marc.chandler@bbh.com**

Marc Chandler joined Brown Brothers Harriman in October 2005 as the Global Head of Currency Strategy. Previously he was the chief currency strategist for HSBC Bank USA and Mellon Bank. A prolific writer and speaker, Chandler's essays have been published in the Financial Times, Barron's, Euromoney, Corporate Finance, and Foreign Affairs. Marc holds a Masters in American history (1982) from Northern Illinois University and a Masters in International Political Economy from the University of Pittsburgh (1984). He has taught classes on International Political Economy at New York University since the early 1990s. In 2009, his first book, ***Making Sense of the Dollar***, was published by Bloomberg Press.

Mark McCormick, G-10 Currency Strategist **mark.mccormick@bbh.com**

Mark joined the BBH Currency Strategy team in New York, providing fundamental analysis of G-10 currencies. He spent several years at Bloomberg L.P. developing analytical models for the FX market. He has implemented those skills at BBH, bringing an added dimension to our analysis. Mark has a BA from Susquehanna University and is currently studying at Columbia University for a Masters in International Relations.

Win Thin, Global Head of EM Currency Strategy **win.thin@bbh.com**

Win Thin is the Global Head of Emerging Markets Currency Strategy, and has over twenty years of investment experience. He has a broad international background with a special interest in developing markets. Prior to joining BBH in June of 2007, he founded Mandalay Advisors, an independent research firm that provided sovereign EM analysis to institutional investors. Prior to that, Win covered the major EM countries in Asia and Latin America for Alliance Capital Management and HSBC. Win received his PhD in Economics from Columbia University in 1995, his Masters from Georgetown University in 1985, and his BA from Brandeis University in 1983.

Ilan Solot, Emerging Market Currency Strategist **ilan.solot@bbh.com**

Ilan Solot is the London-based EM Strategist at Brown Brothers Harriman. He received an MA in International Relations and Finance from Johns Hopkins University and holds an Executive MBA from Fundacao Getulio Vargas in Brazil. He joined BBH from Medley Global Advisors, where he worked as Director for Emerging Markets Strategy. Prior to that, he spent three years at the FX desk of the New York Fed, where he covered Emerging Markets analytically and was operationally responsible for trading major currencies, co-managing the Fed's FX reserve portfolio, and conducting currency swap transactions with the ECB and the SNB as part of the Fed's liquidity measures.

Masashi Murata, Emerging Market Currency Strategist **masashi.murata@bbh.com**

Masashi Murata joined the BBH Currency Strategy team in Tokyo, providing regional and Emerging Markets coverage. Previously, Masashi held the role of chief economist at GCI Capital and economist at Mitsubishi UFJ, and is well known in the Japanese financial media, appearing regularly on CNBC. Masashi has a Masters in International Relations from Columbia University as well as a Masters in Engineering from the Tokyo Institute of Technology. He is also a Chartered Financial Analyst.

DISCLOSURES

This material is provided solely for informational purposes by Brown Brothers Harriman & Co. and its subsidiaries ("BBH") to recipients who are classified as institutional or sophisticated investors, or as Professional Clients or Eligible Counterparties if in the European Economic Area ("EEA"). BBH is an independent FX research provider and this communication should not be construed as a recommendation to invest or not to invest in any country or to undertake any specific position or transaction in any currency, security, other asset class or any particular investment strategy. This material does not constitute legal, tax or investment advice. Any reference to tax matters is not intended to be used, and may not be used, for purposes of avoiding penalties under the U.S. Internal Revenue Code or for promotion, marketing or recommendation to third parties. This information has been obtained from sources believed to be reliable that are available upon request. This material does not comprise an offer of services. Any opinions expressed are subject to change without notice. Unauthorized use or distribution without the prior written permission of BBH is prohibited. This publication is approved for distribution in member states of the EEA by Brown Brothers Harriman Investor Services Limited, authorized and regulated by the Financial Services Authority. Please be advised that any analysis of individual countries, currencies, securities or other asset classes contained herein, including, but not limited to, rankings contained in BBH Country Risk Ratings, FX Risk Rankings and Equity Risk Rankings, should not be considered sufficient information upon which to base an investment decision. Such analysis is intended to serve as a preliminary screening tool, which should be supplemented by additional research.

This material contains “forward-looking statements” which include information relating to future events, projected future performance, statements regarding intentions, strategies, investments, expectations, the competitive and regulatory environments, predictions, and financial forecasts concerning future foreign exchange activities and results of operations and other future events or conditions based on the views and opinions of BBH. For this purpose, any statements contained herein that are not statements of historical fact may be deemed to be forward-looking statements.

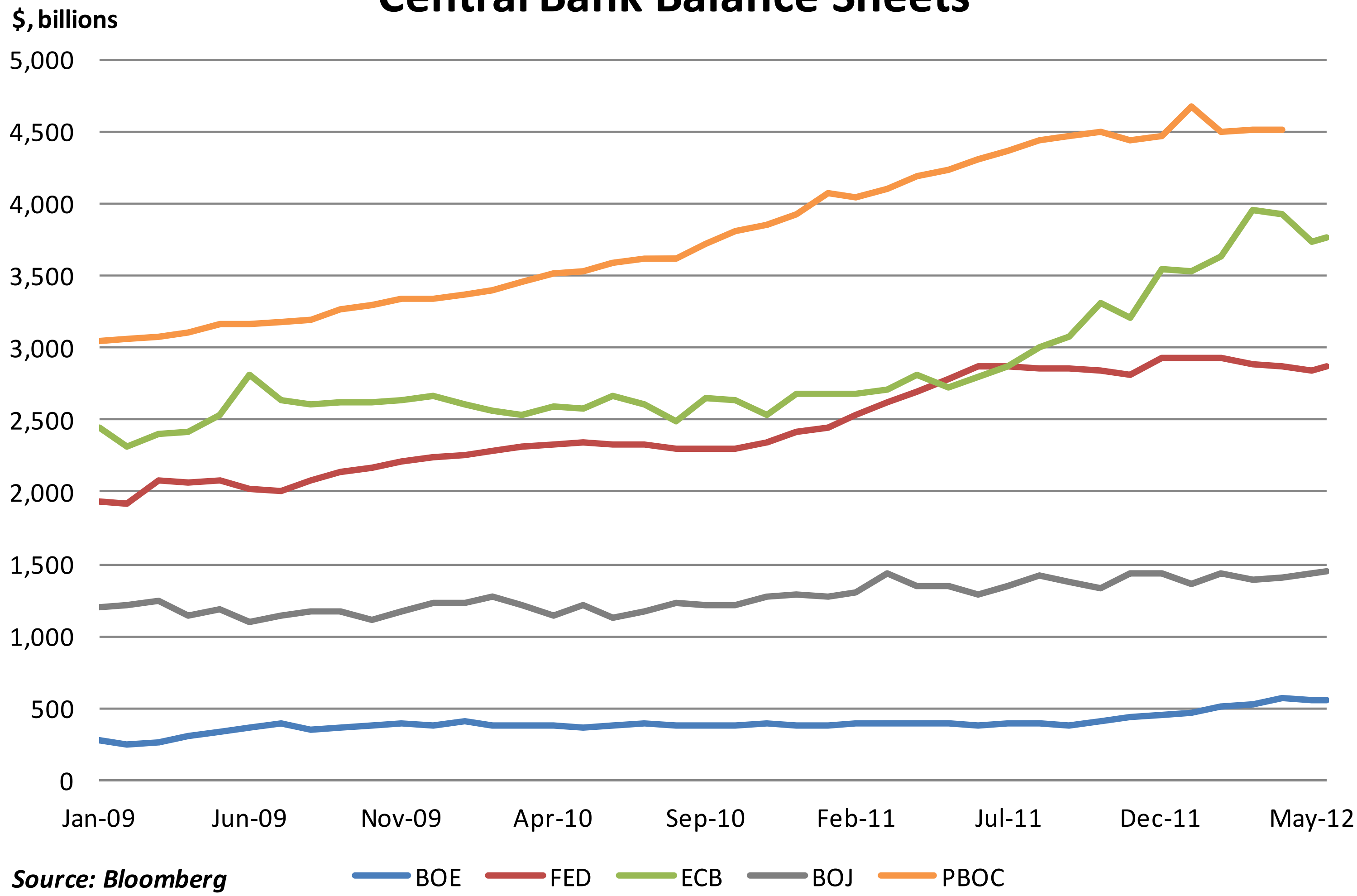
Forward-looking statements should not be read as a guarantee of future performance or results, and will not necessarily be accurate indications of the times at, or by, which such performance or results will be achieved. Forward-looking statements are based on information available at the time the statements are made and/or BBH’s good faith belief as of that time with respect to future events, and are subject to risks and uncertainties that could cause actual performance or results to differ materially from those expressed in, or suggested by, the forward-looking statements. Actual results of activities or actual events or conditions could differ materially from those estimated or forecasted in forward-looking statements due to a variety of factors.

There are risks associated with foreign currency investing, including but not limited to the use of leverage which may accelerate the velocity of potential losses. Foreign currencies are subject to rapid price fluctuations due to adverse political, social and economic developments. These risks are greater for currencies in emerging markets than for those in more developed countries. Foreign currency transactions may not be suitable for all investors depending on their financial sophistication and investment objectives. The services of an appropriate professional should be sought in connection with such matters.

BBH, its partners and employees may own currencies discussed in this communication and/or may make purchases or sales while this communication is in circulation.

Information has been obtained from sources believed to be reliable and in good faith. Sources are available upon request. Past performance is not a guide to future performance, future returns are not guaranteed, and a loss of original capital may occur. Any opinions expressed are subject to change without notice. This material has been prepared for use by the intended recipient(s) only. Unauthorized use or distribution without the prior written permission of BBH is prohibited. Please contact your BBH representative for additional information.

Central Bank Balance Sheets



Source: Bloomberg