

HIGHLIGHTS

- Euro made a marginal new high against the dollar, despite market speculation that ECB Governor Trichet may make some comments today after the ECB meeting regarding the strong euro. While we think further euro gains are likely, market hesitant to make a big move ahead of US jobs data Friday. Weak Feb ADP report (-23k private sector jobs) has markets looking for another bad US report, which is keeping Fed rate cut expectations alive. Sterling underperformed again, keeping EUR/GBP on track for .7700 eventually. Yen was softer across the board and with risk appetite up, the best performers on the day vs. USD were ZAR, CAD, AUD, and BRL. Commodity currencies were stronger as commodity prices recovered.
- US equities ended up on the day but ended off the highs. Financials underperformed, as news that monoline Ambac will try to raise \$1.5 bln in capital viewed by many as too little. Oil-related stocks outperformed on higher oil prices, as OPEC kept output steady and US stockpiles fell. Asian ADRs were up in N. American trading, pointing to a good start for Asian regional stocks today. Nikkei futures are pointing to higher Japan stocks, and the weaker yen should help Japan exporter shares.
- US yield curve steepened gain, with 2-year yield up 1 bp and the 10-year yield up 8 bp. European 10-year yields were up too, with UK up 7 bp, France up 10 bp, and Germany up 6 bp. Fed funds futures market is still pricing in 75 bps easing in March.

CURRENCY MARKETS

The Beige Book for the March 18 FOMC meeting was soft. Economic and credit conditions, two key concerns for the Fed, deteriorated. Economic conditions weakened with two thirds of the districts reporting slowing growth (vs. just three districts in the January release). Weakness was seen in the commercial real estate sector which had held up well until recently. Credit market conditions were described as tighter and a major factor in the deterioration of the commercial real estate sector. Given the survey was collected through Feb 25 and credit markets have tightened further, these conditions have likely continued to deteriorate since the survey. The districts saw limited wage pressures and some weakening in the jobs market. That is likely to be illustrated Friday when unemployment data are released. The report is in line with Bernanke's recent comments and supports the view that the Fed will cut rates March 18 by 75 bp.

The New Zealand dollar is firmer after the RBNZ kept rates steady at 8.25%. This was expected, but the central bank did not adopt a dovish stance. Instead, Gov Bollard warned rates would be left unchanged at 8.25% for an extended period to counter upside risks to inflation. There had been some expectation that the recent string of soft data would outweigh the upside risks to inflation. The RBNZ did acknowledge downside risks to growth but gave no hint of a cut down the road. Soft data will act as a damper on the kiwi in coming weeks and if conditions deteriorate further the RBNZ could adopt a softer tone down the road. For now, with rates elevated and firm commodity prices, the kiwi is likely to recoup its March losses. The next resistance level comes in at NZ\$0.8070.

The US services sector showed some signs of improvement in Feb rising to 49.3 from 44.6 in Jan and provided support to the US dollar. This is still a weak number. It is the second worst reading since March 2003 and indicates the services sector continued to slow in Feb. Details showed that employment also remained below the 50/50 boom/bust line though there was an improvement to 46.9 from 43.9. The data suggest employment remained weak in Feb and do not detract from the risk that this week's non-farm payroll data will fall. On the inflation front, the price component did slow but remains well above 50 at 67.9. Overall, this was better than expected but will do little to alter the outlook for Fed policy.

Bank of Korea meets Mar 7, and the last move was a 25 bps hike to 5.0% in August 2007. Market is looking for no change in rates this month. With inflation of 3.6% y/y in February still above the 2.5-3.5% target, there is sound reasoning behind the call, but we think that rising risks to growth may lead the BOK to cut rates later this year. For now, though, we see rates on hold. KRW has underperformed in Asia year-to-date, falling -1.3% vs. the dollar. Trade and current account surpluses are narrowing sharply, with the latter possible moving into deficit for 2008. Our FX model identifies Korea as having weak underlying fundamentals, and so we think the won is likely to continue underperforming. Equity market has also done poorly, down -13% in dollar terms year-to-date. Near-term target for USD/KRW is the 2008 high at 955.75, followed by congestion in the 966-967 area from 2006.

Philippines inflation accelerated to 5.4% y/y in Feb from 4.9% y/y in Jan, and was the highest rate since Oct 2006. The inflation target range is 3-5% for this year and 2.5-4.5% in 2009. Core CPI jumped 4% y/y vs. 3.4% y/y, so price pressures are broad-based. The central bank next meets March 13, and it last cut rates in January by 25 bps to 5.0%. However, the economy remains strong, with GDP up 7.4% y/y in Q4, same as in Q3, for a full year rate of 7.3% vs. 5.5% in 2006. The economy will undoubtedly slow in 2008 due to the global slowdown, but we think recent inflation data will prevent the bank from cutting rates further, and may eventually lead it to move towards a tightening bias. For now, though, the bank is likely on hold. Strong remittances from overseas workers continue to boost the current account surplus, but underlying fundamentals are amongst the weakest in the region and so PHP strength is likely overdone and the currency is likely to consolidate in the 40-42 range over the near-term.

Taiwan inflation picked up to 3.9% y/y in Feb from 3.0% y/y in Jan. The central bank meets March 20, and the last move was a 12.5 bps hike to 3.375% in December 2007. Market is looking for an end to the tightening cycle this year, but we think the inflation data seen so far in 2008 will lead to another 12.5 bps hike this month, which it has been doing quarterly since December 2004 so the yield differential will widen further in favor of the TWD this year. TWD is the top performer in Asia year-to-date vs. the dollar, up 5.1%. Equity market has also been one of the best performers in the region during this bear market, up 4.8% year-to-date in dollar terms. Taiwan has strong ties to China, with 40% of its exports headed to the mainland and Hong Kong, so Taiwan is better positioned to weather the G-7 slowdown than many of its regional competitors. Charts point to a retest of the 2005 low for USD/TWD of 30.673. After that is the 2000 low of 30.22.

UPCOMING ECONOMIC RELEASES

Japan weekly MOF capital flows, Jan leading index, and Feb machine tools orders out, followed by Malaysia, Australia, and Czech Jan trade. BOJ, BOE, ECB, and BI all hold policy meetings. For US, weekly jobless claims and Jan pending home sales out. Treasury's Paulson and Levey, Fed's Rosengren and Geithner speak.

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