May 2008

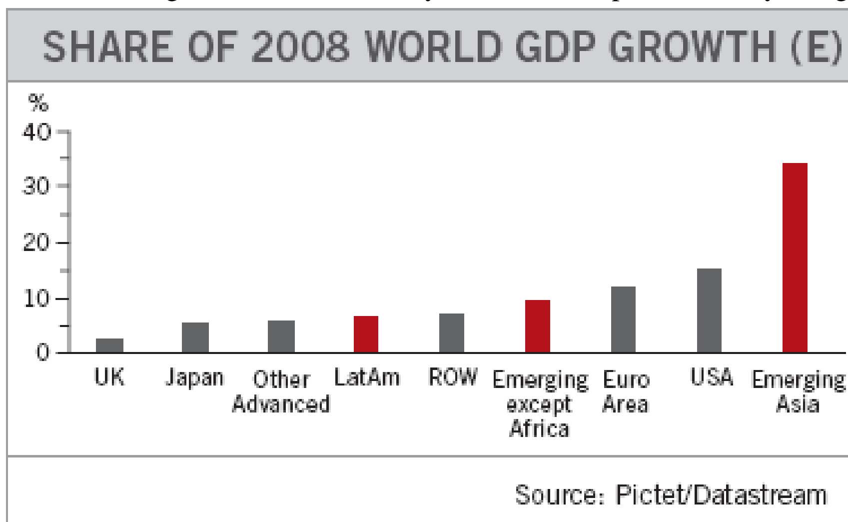
Pictet Asset Management

Real Economy Weakening, Just as Armageddon Is Averted

The equity market rally since the mid-March Bear Stearns' takeover by JP Morgan, acting as proxy for the Federal Reserve, has reassured investors that systemic financial meltdown will not happen. Aggressive interest rate cuts in the U.S. have been accompanied by a continued program of liquidity provision by central banks, further attempts to write down illiquid assets and bad debts in the financial sector and, most recently, by early signs of a major re-capitalization of the banking sector. However, just as the financial markets seem to be signaling that the worst case can be avoided, the indicators from the real economy have deteriorated sharply.

IMF Downgrades U.S. Economy as House Price Falls Continue

In its latest economic forecast published in early March, the IMF (International Monetary Fund) gave a bleak warning about the prospects for a global recession as it marked down growth projections and predicted ultimate losses of up to USD $1,000 B associated with the credit crisis. The supranational organization cut its U.S. growth forecast for 2008 to 0.5%, followed by just 0.6% in 2009, arguing that the recovery would be constrained by continued weakness in household and financials' balance sheets. The prospect of a vicious circle, in which falling property prices and a withdrawal of bank credit lines lead to declining consumer spending and employment, which further undermine the housing sector and add to banks' non-performing loans, remains a real risk in the view of many commentators. The S&P/Case-Shiller Home Price Index that maps house prices in 20 U.S. cities has now fallen at an accelerating rate for ten consecutive months, showing on the latest figures a fall in February of 12.7% compared with a year ago.



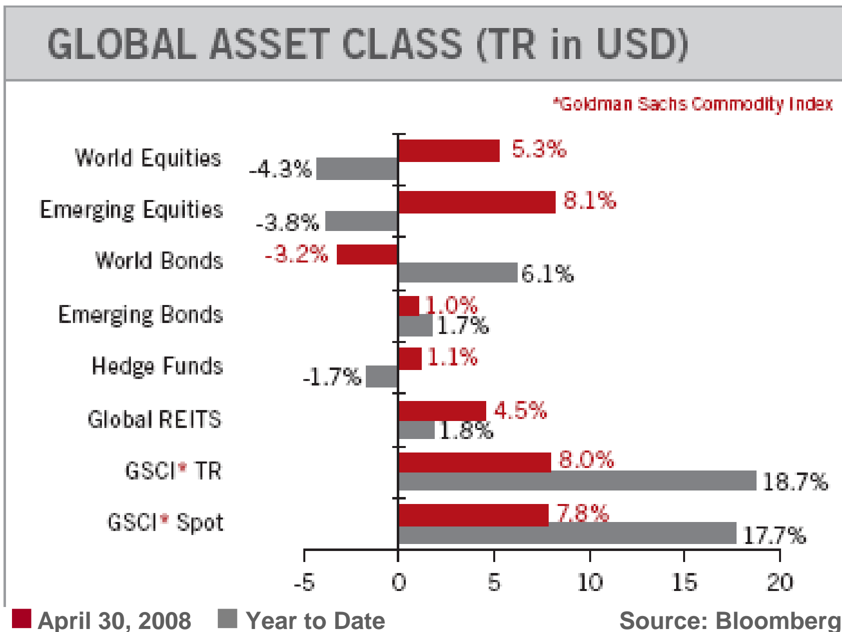
Adding to the gloomy picture, the most recent U.S. consumer confidence report shows the lowest reading since the Iraq war in March 2003.We see positive signs in these signals. We think that the substantial decline in house prices will help to clear excess inventory, which in the absence of any large-scale deterioration in employment should prevent a serious downturn.

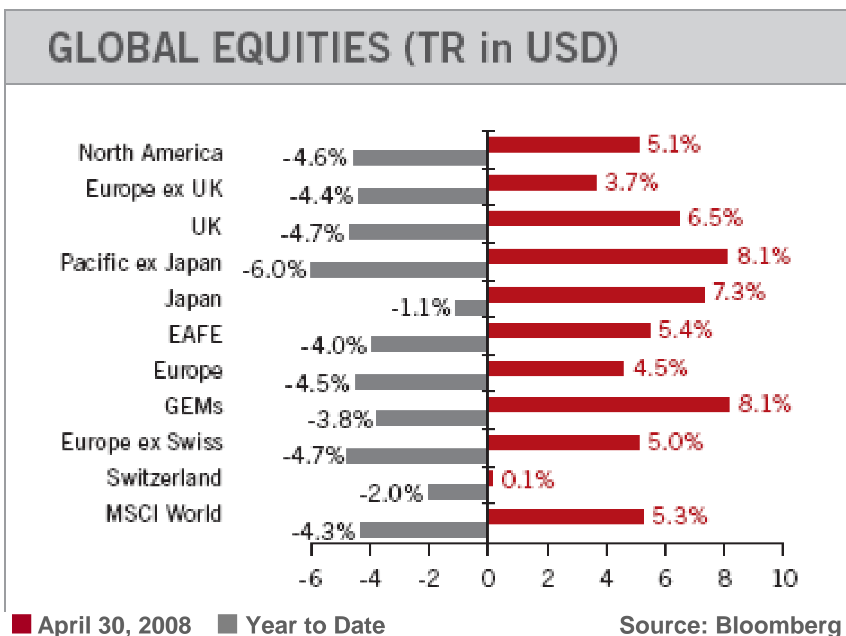
Better-than-Expected U.S. Corporate Results as Markets Recover Half Their Losses

The tone in equity markets much improved in April. The MSCI World Index rose by 5.3% (TR in USD) over the month, and now stands some halfway (10%) between the lows reached in mid-March and the peak levels reached at the end of October 2007. While central bank and government efforts to stabilize sentiment certainly helped, investors were also comforted by good first quarter earnings from the U.S., notably Apple, Intel, IBM and Caterpillar (which offset a below-expectations shock from GE). As for financials, large write downs and substantial capital-raising suggests that banks are making a real effort to repair their balance sheets once and for all.

Emerging Markets Bounce Strongly as Risk Aversion Fades

Emerging markets enjoyed a strong month as sentiment towards riskier assets improved, with the MSCI Emerging Markets Index rising by 8.1% (TR in USD). Having fallen 22% from the October 2007 peak to the recent lows in January 2008, emerging markets are now 14.5% above the low point and, in common with developed markets, stand some 10% below the all-time peak. Country returns diverged markedly. China (+15.6%) and India (+11.1%) recovered robustly from first quarter weakness, while Brazil (+15.4%) moved sharply higher as S&P upgraded its sovereign debt; Turkey (+16.6%) also benefited strongly. Indonesia, however, dropped 5.9% and the Philippines fell 9.7%, mainly reflecting inflationary concerns. In these countries, food accounts for 42% and 46%, respectively, of the CPI basket of goods.





Last of the Fed Funds Rate Cuts for the Time Being?

Fixed income markets saw yields rise as the earlier flight to safety in government bonds faded. The yield on two-year Treasury notes closed the month at 2.28% compared to 1.63% at the end of March and well above the 1.25% in the midst of the market crisis in mid-March. Bond markets, at least temporarily, seem to be in the process of moving from discounting the risk of systemic failure to reflecting on the growing risks of inflation. The Fed funds rate stands at 2.00% after a further cut of 0.25 percentage points at the end of April—down from 5.25% a year ago. Since then, sharply rising food and energy costs have raised inflationary expectations and threatened upward pressure on wages. Reflecting these fears in Europe, German 10-year bond yields rose to 4.12% from 3.90% at the end of March and in the U.K. from 4.35% to 4.67%.

Commodity Bubble May Be Rolling over

The markets are now digesting the possibility that the period of rapid U.S. monetary easing is largely over. Recent interest rate declines, together with a personal tax rebate in U.S. pay packets, may well offset the slowdown in growth. At the very least, there may be a pause in monetary easing as the Fed assesses the strength of the economic pulse and possible shape of subsequent recovery. The rise in the oil price has continued, seemingly impervious to recessionary fears in the developed economies. By the end of April, it had traded close to USD $120 a barrel, with Chakib Khelil, President of OPEC, suggesting a rise to USD $200 per barrel. Despite U.S. demand declining by nearly 2% year to date, the perception of tight supply constraints continues. Our view remains that many commodities, including oil, are in a bubble phase. The extended nature of the rise reflects partly the marginal increase in demand from emerging markets, notably China, partly the reflection of dollar weakness and partly pure speculation in commodity related assets. While the turn is always difficult to call, it is likely to be associated with a dollar recovery as U.S. interest rates form a base. Already, gold at USD $850/oz is well off the top, while rice prices have begun to fall and wheat futures have almost halved from their all-time high in February.

Investing in foreign securities, especially emerging markets, will involve additional risks including exchange rate fluctuations, social and political instability, liquidity, greater volatility, and less regulation.

The International Monetary Fund (IMF), located in Washington, D.C., is an international organization that oversees the global financial system by following the macroeconomic policies of its member countries, in particular those with an impact on exchange rates and the balance of payments. It also offers financial and technical assistance to its members, making it an international lender of last resort.

The Morgan Stanley Capital International World (MSCI World) Index is an unmanaged index composed of more than 1,400 stocks listed on exchanges in the U.S., Europe, Canada, Australia, New Zealand and the Far East.

The MSCI Emerging Markets (MSCI EM) Index is a free float-adjusted market capitalization index designed to measure equity market performance in the global emerging markets.

Consumer price index (CPI) is an index number measuring the average price of consumer goods and services purchased by households. The percent change in the CPI is a measure of inflation.

It is not possible to invest directly in an index.

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