

December 2007

## Pictet Asset Management

November saw a sudden loss of the fragile confidence that had been building in October, as markets absorbed the implications of further huge asset write-offs by money center banks. Emerging markets fell precipitously as the 'decoupling argument' lost credibility. Confidence has improved more recently as the U.S. authorities have indicated a bias towards monetary easing and floated measures to stabilize the housing sector. Equities look oversold relative to bonds.

### Market Review

A marked increase in investor risk aversion sent equity markets into wholesale retreat in November and caused government bond yields to tumble. The fragile confidence of October crumbled as UBS and Citigroup announced further asset write-downs and Citigroup's CEO, Chuck Prince, joined the growing list of corporate casualties of the credit crisis. The size of the write-offs raised fears that some banks might be forced to breach their capital reserve ratios and thus require recapitalization or force cuts in their dividend payouts.

The MSCI World Index fell by 4.0% (TR in USD) over the month, a decline which would have been worse, but for a month-end rally sparked by positive comments from the U.S. Federal Reserve on the prospect for interest rate cuts. Emerging markets were caught up in the sell-off as investors lost confidence in the always doubtful decoupling argument and reversed much of the gains seen in October as the MSCI EM Index declined by 7.1%.

The housing sector continues to provide fuel for the bears. Data for September showed U.S. housing starts falling to 1.2M—a level not seen since the recession of the early 1990s. With the stock of unsold homes also continuing to rise, there seems little prospect of immediate respite. A recent report from GaveKal Research points out that in previous U.S. housing cycles starts have fallen to the 800,000–900,000 level before demand has stabilized. The link from the housing market to the rest of the economy lies in the construction-industry employment numbers, which, according to GaveKal's forecasts, are likely to fall from the current level of 5.5% of total U.S. payrolls to a cyclical low of around 4.2%, similar to that seen in 1991. They suggest that this expected 1.3% reduction in the payroll will have a similarly sized negative impact on GDP growth in the U.S.

Sentiment in the market as a whole has been worsened by fears over the potential impact of the ARM (adjustable-rate mortgage) re-setting of rates, which fall due during the months ahead. According to estimates from Bank of America Securities, some \$85B USD of adjustable-rate subprime mortgages are being re-set in the current quarter, with around \$362B USD due for 2008 as a whole. In an effort to stem the tide of defaults, the Chairman of the FDIC has recently proposed that the initially discounted mortgage rates of likely subprime defaulters be frozen—the FDIC estimates that 1.2M borrowers due to have their mortgage rates re-set between now and the end of next year could qualify for such a freeze. This idea has been taken up by Henry Paulson, U.S. Treasury Secretary, with the aim of stabilizing both house prices and related securities, providing the underpinning necessary to improve sentiment as well as boost liquidity in the financial sector. A typical subprime mortgage has an initial interest rate of around 7% for the first two-to-three years of its life, higher than that of a more conventional loan, but well below the 9.5% to 11% charged when the initial period runs out. The intervention of Government agencies highlights the U.S. Administration's increasing concern over the outlook for the economy, reflected in its economic advisers lowered growth rate forecast from 3.1% to 2.7% for 2008.

The market rally during the closing days of November was sparked by comments from Donald Kohn, Vice-Chairman of the Federal Reserve, implying that the Fed was increasingly inclined to ease monetary policy further in the light of evident market and economic distress. This resulted in one of the best one-day rallies from the U.S. and Europe in four years, as hopes rose of a 25 bps or more Fed Funds rate cut from the current 4.50% level at the December 11th meeting. Ben Bernanke, the Fed Chairman, noted that the combination of high oil prices and a falling housing market would create a tougher environment for the consumer in the months ahead and that the Fed would therefore have to remain "alert and flexible" in setting policy.

**Outlook**

However, not all is gloom for the U.S. economy. GaveKal Research has noted the recent significant improvement in the U.S. trade picture as exports react positively to the weaker dollar. They cite a Federal Reserve Board study, covering 44 housing cycles in 18 countries, that notes the strong historical evidence that weakness in housing markets is typically accompanied by a marked improvement in export performance. The linkage reflects the tendency for upturns in housing to be accompanied by higher consumer spending and a shift in employment from manufacturing to housing-related sectors. The reversal of these trends when the housing market turns down is, according to GaveKal, being reflected in rising exports and lower imports of consumer goods. They point to two possible implications of this trend—lower growth in Europe as trade flows adjust and a likely recovery in the dollar, particularly against the Euro and Sterling.

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

The Morgan Stanley Capital International World Index (MSCI World) 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 Index is a free float-adjusted market capitalization index designed to measure equity market performance in the global emerging markets.

It is not possible to invest directly in an index.

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