

November 2007

## Pictet Asset Management

### Underlying Confidence Remains Despite Fragile Sentiment

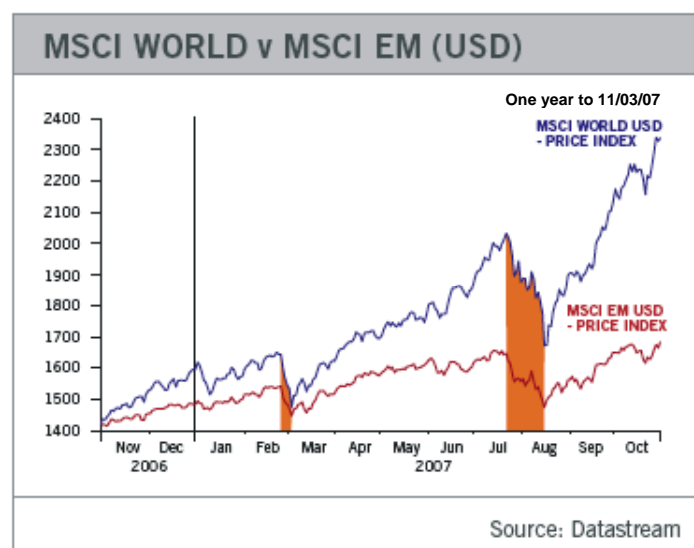
Despite very recent falls, the general buoyancy of financial markets seems to reflect an underlying confidence that the credit crisis will not spread sufficiently far and deep to drive the U.S. into recession. At the same time, potential inflationary threats from commodity prices and the weak dollar are likely to be dampened by a softening U.S. economy. Confidence in self-sustaining emerging world growth remains, independent of weakness in developed economies.

### Market Review

Global equities, especially emerging markets, continued to applaud the Federal Reserve's monetary easing in October. While the balance of risk in the U.S. is finely poised between fears of recession and rising inflation, the need to rebuild credit market confidence made a further cut in the Fed funds rate at the end of the month a virtual certainty. The Fed obliged with a cut of 25 bps to leave the rate at 4.5%.

Although broad market averages made further progress over the month, the returns from different sectors have diverged significantly, with market leadership driven by utilities, telecom services and IT, while health care stocks have lagged. In the U.S. particularly, financial stocks have remained weak. The huge sub prime loan write-offs by Wall Street giants such as Merrill Lynch, Citigroup and Bank of America have raised fears of systemic risk in the financial sector.

During the month, the MSCI World Index rose by 3.1% (TR in USD), led by the Pacific ex-Japan region with a gain of 7.8%, largely from the 11.0% rise in Hong Kong, driven by the expectation of mainland Chinese inflows. The MSCI Europe Index returned 4.7%, with the U.K. rising by 6.0%. Japan fell 0.4%, reflecting the continued apathy of domestic investors despite the evident value on offer. But it has been emerging markets that have once again dominated, as lower interest rates and strong growth provide an apparently irresistible draw. The MSCI EM Index rose by 11.2%, bringing the year-to-date index return to 49.9%. China and India gained around 17% supported by strong economic momentum and rising currencies. The Israel market was a relative laggard, rising by 4.2%, reflecting flat performance from the index-heavyweight Teva Pharmaceutical and weakness in financials.



Bond markets have reacted predictably to concern about slower developed world growth and the expectation of further central bank action on interest rates. The U.S. 10-year Treasury bond yield fell to 4.46% at month end.

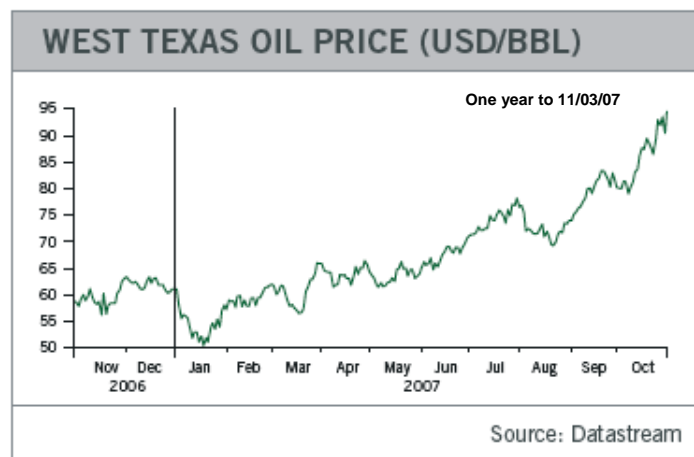
## Outlook

The fact that markets have continued to be firm, until the early November volatility, reflects the general expectation that any slowdown provoked by the credit crisis will be relatively mild, dampening incipient inflationary pressures but not severe enough to undermine seriously corporate earnings growth or derail the powerful Asia/emerging world economic cycle.

A recent review of the global economy by the International Monetary Fund (IMF) reflects the somewhat schizophrenic mood of investors. This once mighty supranational institution drew attention to the unrivalled period of growth enjoyed by the global economy since the energy-related slump of the late 1970s, and forecast an average annual growth rate (on a purchasing power parity, or PPP, basis) of 5.1% between 2004–2008. Emerging economies are largely driving this expansion, delivering an average growth rate of 7.8% a year, while the developed high-income countries achieve just 2.7%, annually. Emerging economies are assumed to remain strong, irrespective of any weakness in the developed economies. However, the IMF also identified several risks to the forecast, notably the impact of the credit squeeze and decline in the U.S. housing market—and the possibility of ensuing declines in housing in Europe. They also saw the loss of confidence in securitized credit markets and knock-on effects in the banking sector as a potential threaten their central, “rosy scenario.”

The U.S. housing market is still deteriorating, with the most recent Case-Schiller Index report indicating a 5% decline (year-over-year) in existing single-family home sales in August and sharp rises in foreclosures. Given the extent of predictable re-setting of adjustable rate mortgages in the sub prime sector, further declines look inevitable. While investors fear that banks, insurance companies and others have still to mark their holdings or sub prime and other securitized debt fully to market, market confidence is likely to remain fragile.

The continued rise in the price of oil, most recently attributed to reduced refinery output in Mexico, is another concern. At one level the market has reacted calmly; although a further squeeze on U.S. discretionary income, in terms of rising transport and heating costs, would hit consumption, most expect Fed policy to be accommodating. Elsewhere in developed markets the impact on input costs has been mitigated by the weaker dollar and in emerging economies the high oil price is seen partly as a counterpart to dynamic growth rates. What is less clear is the extent to which U.S. policy towards Iran, together with renewed tension between Turkey and the Iraqi Kurds, is beginning to be reflected in a geopolitical risk premium in oil. While the markets seem to be willing to put up with rising energy prices, an outright supply interruption in the Middle East would be less easily absorbed.



**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 Pacific ex-Japan Index is a free float-adjusted market capitalization weighted index designed to measure the equity market performance of the developed markets in the Pacific region, excluding Japan.

The MSCI Europe Index is a free float-adjusted market capitalization index that is designed to measure developed market equity performance in Europe.

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

The S&P/Case-Shiller U.S. National Home Price Index is a broad composite of single-family home price indexes for the nine U.S. Census divisions and is calculated quarterly.

It is not possible to invest directly in an index.

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