

January 2008

## Pictet Asset Management

### Will Coordinated Supply of Liquidity Ease Money Market Stress?

While impressive in its coordination and scale, the joint action of North American and European central banks to supply liquidity to the short-term money markets will do nothing fundamental to ease credit market conditions until participants believe that banks have owned up fully to potential subprime losses. Moreover, in the absence of a severe downturn, central banks will be reluctant to cut rates too sharply while inflationary pressures from commodity-related sources remain. We expect slowing in America, but given firm demand from emerging economies, no recession.

The coordinated injection of liquidity in mid-December by the Federal Reserve, the European Central Bank (ECB), Bank of England, Bank of Canada, and the Swiss National Bank was a bold attempt to underpin market confidence and overcome the increasing sense of paralysis in money markets. The introduction of an auction-based facility, which extends the maturity of central bank borrowing resources and broadens the range of collateral against which banks can borrow, was aimed at easing the log-jam that had seen three-month interbank rates widen alarmingly over the fed funds rate.

The central bank action was targeted at the specific areas of the market showing distress, and came the day after the markets had reacted disappointedly to the latest 25 bps cut in the fed funds rate. Their aim was to increase liquidity without compromising the authorities' anti-inflation credentials through further unilateral cuts in short-term lending rates unjustified by fundamental economic conditions.

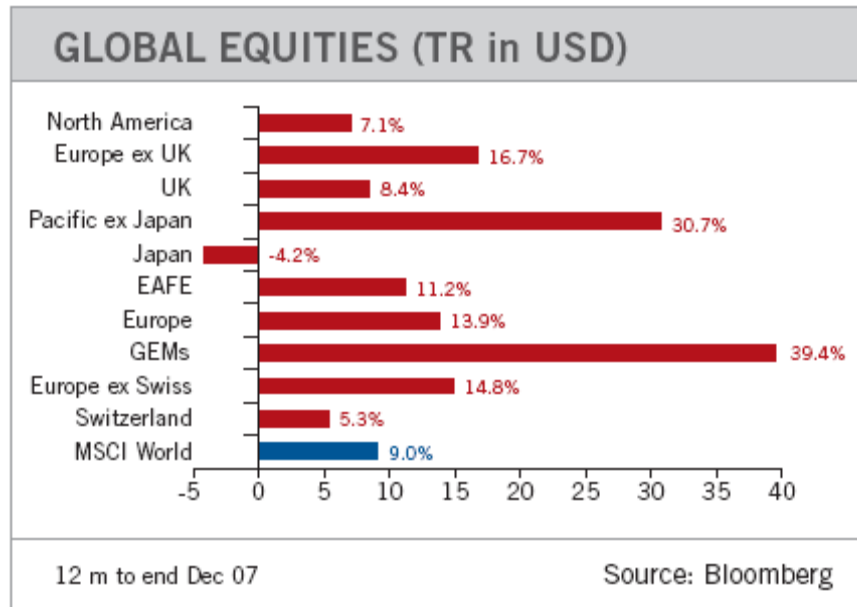
The role of the interbank rate (LIBOR/Euribor) in bank lending is central to the credit crisis, as the rate at which banks lend to each other; it is their unwillingness to provide capital to this market that has raised fears of a spiraling credit crunch and consequently recession.

Banks are driven to hoard capital partly because they fear that the unwinding of the subprime housing market will force them to fund internally operations that were formerly off-balance sheet, but also because they have little confidence in each others' potential creditworthiness. Bringing credit portfolios onto their balance sheets is likely to flush out more banks in need of fresh capital to follow Merrill Lynch, Citicorp, UBS, and Morgan Stanley. Lending strategy has undergone a complete volte-face, as banks shy away from their previous policies of aggressive credit creation in search of higher returns.

So will it work? The liquidity injection will do nothing to stop the unraveling of the subprime loans market and banks' need to replace associated off-balance sheet asset-backed mortgage securities with on-balance sheet capital. What liquidity does do, though, is raise confidence that central banks will provide whatever capital is necessary to mitigate the impact of the previous excess of lending. Until there is more transparency about future subprime losses and structured products the interbank market is unlikely to begin to function normally again. If the new year brings further evidence of slower growth, but no narrowing of interbank spreads, then investors seem bound to call for further cuts in interest rates, irrespective of short-term inflation data.

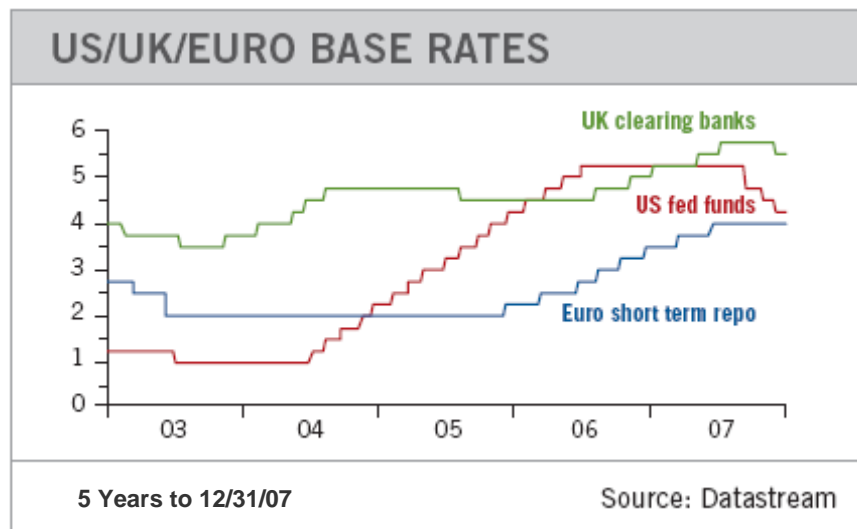
### Market Review

Global equity markets closed the year in subdued fashion with the MSCI World Index down by 1.3% in December to show a gain of 9.6% for 2007 as a whole (TR in USD). The MSCI Pacific ex-Japan Index was the strongest-performing region with a gain of 31.7%, reflecting a rise of 41.2% in Hong Kong, which is increasingly a proxy for China's growth. Japan has remained the laggard with a fall of 4.1% in USD terms. Emerging markets completed a sixth consecutive year of outperformance relative to developed markets, with a fractional rise in December to end with a return of 39.8% by the MSCI EM Index. The BRIC (Brazil, Russia, India, and China) markets continued to dominate, with Brazil rising by 80.0% in 2007 and India gaining 73.1%.



**Outlook**

Expectations for investment returns in 2008 are sharply divided as to whether the U.S. economy will slip into recession or continue to expand, if with a lower growth trajectory. Under recessionary conditions, the subprime-related liquidity squeeze of 2007 might create serious solvency problems for banks, as other parts of the credit market (such as credit card receivables, car loans and corporates) deteriorate. Stock market bears also note the potential for higher inflationary expectations arising from commodity and food price rises, which would constrain the ability of central banks to cut interest rates aggressively as the economy weakened. Such an outturn would prolong the downswing and provoke a more severe banking crisis. Although rates have been cut in both the U.S. and in the U.K. as growth has slowed, in the Eurozone the ECB has held rates at 4% since June 2007. With Eurozone inflation at a six-year high of 3.1%, the bank’s president, Jean-Claude Trichet, recently noted that some members of the ECB’s governing council wanted to raise interest rates.



We remain firmly in the “slower growth but no recession” camp, believing that a still-poor housing market and slower consumer demand will be offset by a continuation of the recent improvement in U.S. trade (as further growth in emerging market economies, particularly China) enables the U.S. to re-import some of the economic stimulus previously exported to the rest of the world. This is not to say that other economies will be immune to the U.S. slowdown, since reduced demand from the U.S. will be reflected elsewhere. However, slower growth will help dampen inflationary expectations, reduce the risk of second-round effects that push up wage rates and ultimately reduce the pressure on commodity prices. While the combination of lower growth and some stickiness in inflation rates seems not to provide a particularly attractive backcloth, equity market valuations appear to discount a fair degree of uncertainty.

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

The LIBOR, or London Interbank Offered Rate, is a daily reference rate based on the interest rates at which banks offer to lend unsecured funds to other banks in the London wholesale interbank market. The EURIBOR, or Euro Interbank Offered Rate, is a daily reference rate based on the averaged interest rates at which banks offer to lend unsecured funds to other banks in the euro wholesale interbank market.

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 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 Emerging Markets (MSCI EM) 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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