

April 2008

## Pictet Asset Management

### Increased Regulation to Follow as Taxpayers Start to Foot the Bill

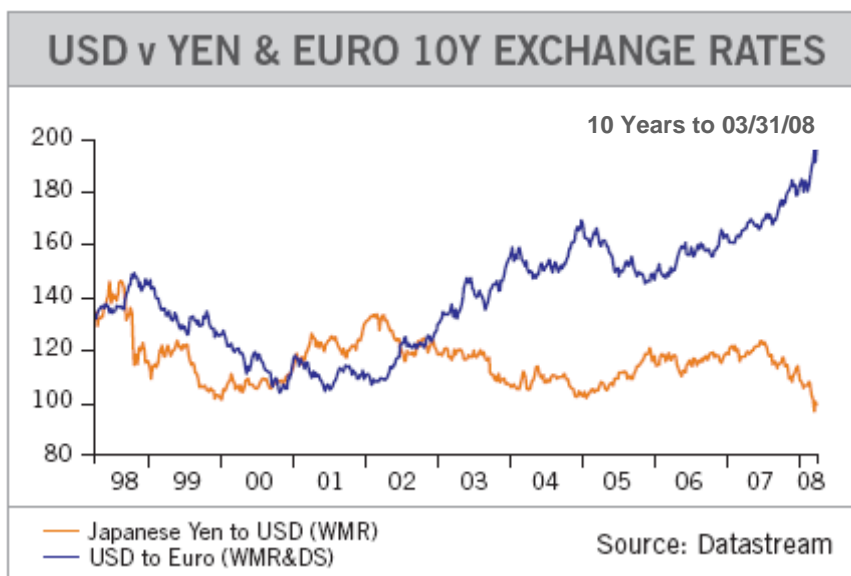
The financial crisis deepened in March as capital hoarding by banks caused the inter-bank market almost to cease functioning, forcing increased margin calls on hedge funds and other leveraged investors. The immediate consequence: fund collapses at Carlyle Capital, Thornburg Mortgage and Peloton Partners.

By mid-month, the Federal Reserve, in coordination with other central banks, was pouring liquidity into the market, eventually agreeing to allow investment banks access to the discount window against AAA non-government mortgage securities. Ironically, this action precipitated the largest casualty to date, as its counterparties forced Bear Stearns to cough up previously illiquid collateral, driving the hapless broker into the hungry maw of JP Morgan at a knockdown price. JP Morgan is only assuming USD \$1B of the USD \$30B of risk now being transferred to the Federal Reserve. If these assets are unrealizable at close to current mark-to-market values, then the U.S. taxpayer will ultimately foot the bill. Hank Paulson, the U.S. Treasury Secretary, noted that the investment banks' access to the discount window will inevitably put them under commercial bank-style supervision. Such regulation may well demand improved capitalization of investment banks—which suggests a series of rights issues or dividend cuts ahead. The action to support investment banks is also resulting in calls for more to be done to help individuals unable to meet mortgage payments. Thus, following rate cuts and liquidity injections, the coming weeks are likely to see a new phase of coordinated intervention by the U.S. authorities.

## REVIEW

### Surge in Gold, Oil and Dollar Weakness Continued

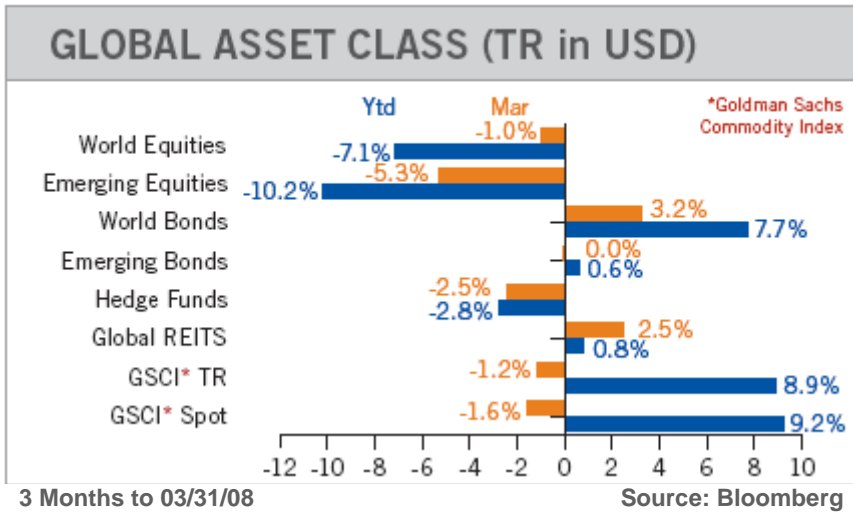
In the financial markets, commodity prices continued their surge; the gold price drove through USD \$1,000 an ounce, while oil established a fresh high of USD \$110 per barrel by mid-month. The U.S. dollar fell sharply, breaking through USD/yen 100 for the first time since 1995 and setting an all-time low of EUR/USD 1.56 against the euro.



### Fed Funds Cut Stems Widespread First Quarter Losses

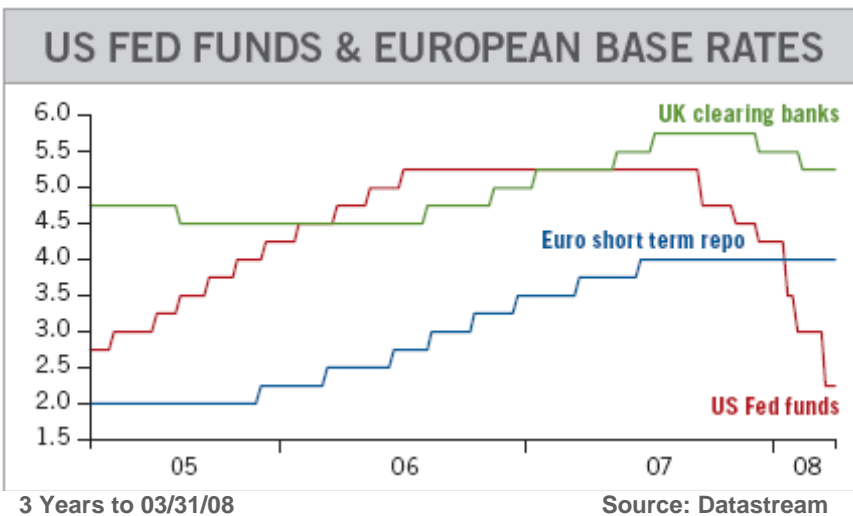
Equity markets fell sharply during the first half of the month, subsequently bouncing as central banks repeatedly intervened and the Federal Reserve reduced the Fed funds rate by a further 0.75 percentage points to 2.25%. Over the first

quarter, the MSCI World Index fell by 9.0% (TR in USD), after a fall of 0.9% in March. In emerging markets, the MSCI EM Index dropped 5.3% in March to show a loss of 10.9% over the quarter. China, India and Indonesia all fell by around 12% in March, as lending restrictions in China, a weak banking sector in India and worrying inflation data in Indonesia undermined confidence. Turkey fell 20.1% in USD terms, reflecting a weak domestic currency and concern over a higher-court decision against the ruling AKP—a party with its roots in political Islam now threatened with legal sanction.



**Fixed Income Yields Drop Further**

Fixed income markets have reflected the other side of this flight from risk. The fall of the 10-Year U.S. Treasury Yield to 3.43% from 4.04% at the start of the year is the other side of the flight from risk. Short-term rates have also dropped sharply in the face of central bank action. Two-year Treasury bonds now yield just 1.63%, compared to 3.08% at the beginning of the year. Longer-dated yields have held relatively firm, because of rising inflationary concerns. The U.S. Federal funds rate now stands at 2.25%, compared to 5.25% a year ago.



## OUTLOOK

### **De-leveraging May Continue until Investor Confidence Revives**

In spite of concerted central bank action, a sense of acute anxiety remains. Broadly speaking, the authorities have urged banks and other financial institutions to apply mark-to-market accounting regardless of how unrealistic they may think so-called market prices are. Others argue for the suspension of such rules in what are clearly exceptional conditions. The problem is that since banks have securitized and sold on much of their debt in a variety of packages to third parties (hedge funds and so on), the daily liquidity which previously allowed such instruments to be priced has evaporated, because these same third parties now refuse to trade as they desperately attempt to preserve capital. This has created a vicious de-leveraging cycle in which declining asset prices in the credit markets are forcing increased margin calls, compelling sales of assets at distressed prices because banks and prime brokers are increasingly unwilling to provide the capital to fund such calls. Whether these issues are ones of liquidity or solvency, they are ultimately underpinned by investor confidence, which is a long way from recovery.

### **Public Funds May be More Widely Used**

The U.S. policy response to the crisis has been vigorous both in terms of interest rate policy and in providing liquidity to markets. Most recently, the authorities have shown their willingness to use Government Sponsored Enterprises (GSEs) such as Fannie Mae and Freddie Mac, together with the Federal Home Loan Board (FHLB)—a co-operative of banks set up in the 1930s Depression era—to increase substantially their exposure to mortgage-backed securities. The move, orchestrated by Hank Paulson, implies that the government would stand behind such institutions as the guarantor of last resort—a step that some commentators believe might be followed by the eventual use of public funds to purchase mortgage securities outright. Further policy measures are expected by markets following the recent meeting in Rome of the Financial Stability Forum, established to provide a coordinated response to the financial market tumult.

### **Mixed Signs of Value Appearing in U.S. Housing Market; Fed's New Guarantees Underpin Temporary Bounce**

An eventual resolution of the crisis requires U.S. house prices to stabilize. Some cautious optimism might have been justified as March drew to a close, with the release of data showing a 2.9% increase in February's existing home sales. While the stock of unsold inventory also declined, inventory levels remain very high and the level of sales activity low. Nonetheless, there is a growing body of opinion that suggests there is value for investors in the housing market, both in terms of physical and financial assets. Combined with lower price levels, medium-term demographic trends influencing new household formation (the age pyramid and net new immigration) also suggest that the imbalance between housing supply and demand should soon begin to correct itself. Such optimism is countered by the recent report showing consumer confidence at its lowest since the invasion of Iraq in March 2003. With the market now awaiting first quarter earnings reports and expecting further substantial write-offs from the U.S. financial sector, a rapid recovery in sentiment within this key component of market turbulence seems a distant prospect. However, with the Fed willing to act as financial guarantor to the investment banks and the market responding positively to the rights issue from Lehman, as well as the deck-clearing write-downs from UBS, at least a temporary bounce in the sector seems to be underway.

**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 (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.

It is not possible to invest directly in an index.

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