

March 2008

## Pictet Asset Management

### Is This the Ghost of Stagflation Past?

“By any common sense definition” the U.S. is in recession. Warren Buffett’s recent remark reflects the increasingly gloomy outlook after the Federal Reserve’s second downward adjustment to its growth forecast in the past four months. A combination of lower growth, higher inflation and rising unemployment provides a toxic mix reminiscent of the “stagflation” that proved so corrosive for markets during the 1970s. Still, the Fed seems to consider the growth threat bigger than the inflation threat, suggesting further accommodation. Emerging markets are still benefiting from commodity price strength, while the bond rally makes stocks look reasonably priced, even if still in fear of recession.

### Review

The continuing drop in U.S. housing, together with the still-spreading credit squeeze, caused the Fed to cut its growth forecast for 2008 by 0.5% to imply growth of between 1.3–2.0%. With an imminent recession now the central view of many investors, this was less worrying than the accompanying deterioration in the inflation picture.

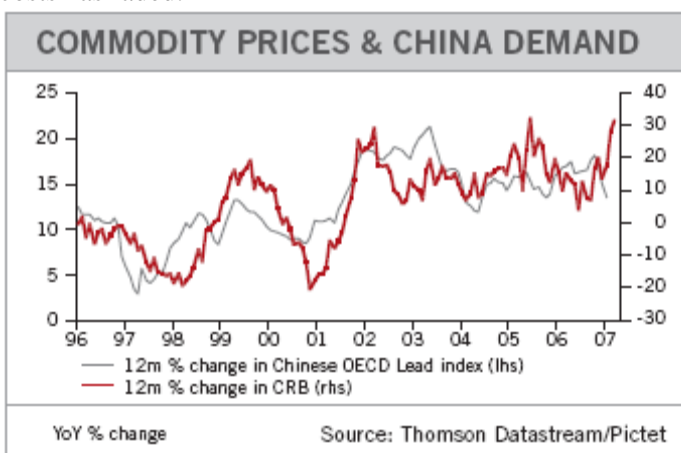
Given the outlook, developed equity markets could not hold on to gains made during the early part of the month and the MSCI World Index closed February with a fall of 0.5% (TR in USD terms). Although bond markets generally rallied in the face of economic weakness (10-year U.S. treasury yields fell to 3.64%), the rise in long-dated yields both in the U.S. and throughout Europe reflected worsening inflation figures.

Emerging markets generally responded well to rising commodity prices, as oil once more moved up through USD \$100 per barrel, suggesting that perhaps there is something in the decoupling argument after all. The MSCI EM Index rose by 7.4% (TR in USD) and now stands some 12% above the low recorded in late January.

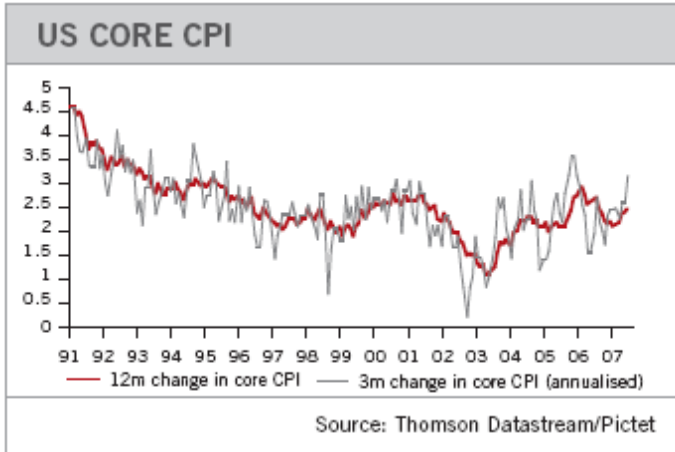
Taiwan rose 14.8% as an expected victory for the Kuomintang (KMT) Party in the presidential elections, due at the end of March, supported stocks benefiting from cross-border trade. The KMT is seen as “pro-China,” in the sense that it advocates not independence but reunification with the mainland under KMT leadership. Thailand rose by 13.4%, reflecting better political sentiment and a lifting of the capital controls imposed last year. India actually fell, by 2.4%, as stocks continued to give back some of the excess returns of late last year.

### Outlook

The risk of resurgent inflation partly reflects the length of the economic upswing and a fading of the productivity gains that had earlier accompanied growth in the U.S. Also, the furious pace of economic expansion in Asia, and in China particularly, has put pressure on commodity prices, while the anti-inflation dividend of low emerging market labor input costs has faded.

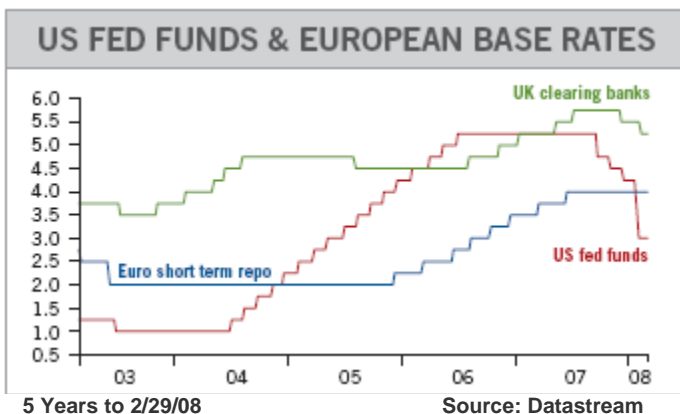


In the U.S., the “headline” rate of inflation reached 4.3% in January and, as the oil price once more touched record levels, the Fed gave warning that higher energy prices would result in core inflation (that is, excluding food and energy) moving above the Fed’s 2.0% “comfort-level” ceiling, having reached 2.5% in January. Given the current weak state of the economy, the U.S. central bank is clearly willing to look beyond the deterioration in inflation and continue its policy of monetary easing. But, this is dependent on inflationary expectations remaining subdued—adjusting for a “liquidity premium,” the Cleveland Fed estimates that the market’s ten year inflation expectations have increased from 2.3% in July to 3.2%.



Inflation is also giving concern elsewhere. In China it rose to an 11-year high of 7.1% in January, reflecting both soaring food costs and rising factory-gate output prices. Accelerating money supply and credit growth, as well as further food price increases, are likely to push China’s rate higher in the coming months. Food prices, accounting for around one-third of China’s CPI (consumer price index), were up 18% in January compared to a year earlier, and will continue to reflect the impact of the bad winter weather that affected parts of the country.

In Europe, the EC has raised eurozone inflation estimates, while cutting its GDP growth forecast for the current year. Eurozone inflation—reflecting higher energy and agricultural commodity costs—reached 3.2% in January, a 14-year high. The problem for policy makers, as well as for the financial markets, happens if inflationary expectations seep into wage demands. While rising unemployment would support central bank efforts to use monetary policy to help ease the credit crisis, it would do little to improve growth prospects or support a stabilization of the housing market in the U.S. and elsewhere.



Inflation risks aside, the rapid slowing in the U.S. will keep the Federal Reserve accommodative. Bernanke's recent report to the Senate Banking Committee noted that the Fed would provide support as needed to provide "adequate insurance against downside risk." The next Federal Open Market Committee (FOMC) meeting is scheduled for March 18; the market anticipates another cut, probably 50 bps, in the Fed Funds rate to 2.5%. Apart from lower interest rates, hopes for a soft economic landing rest with the expected stimulus provided from the USD \$152B economic package announced in mid February. The National Retail Federation suggests that around 40% of this sum will be spent, with the balance saved or used to pay off credit card debt. A one-off boost to the economy should be felt during the summer months; whether this, and lower interest rates, prove sufficient to steady the current slide in activity and consumer confidence remains an open question.

**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.

*You should consider the investment objectives, risks, charges, and expenses of the Forward Funds carefully before investing. You may obtain a prospectus with this and other information about the Funds by calling (800) 999-6809 for a prospectus or by downloading one at [www.forwardfunds.com](http://www.forwardfunds.com). Please read the prospectus carefully before investing.*

Forward Funds are distributed by ALPS Distributors, Inc.

FWD001346 033109