

Forward Institutional

# FORWARD MARKETS: *REVIEW AND COMMENTARY*

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All data shown in this document is the most current available as of 6/30/10.

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## U.S. Economic Road to Recovery

While investors may be looking at the recent decline in major market indices and questioning the support for a sustained economic recovery, reports about the possibility of a double dip recession have some questioning whether the U.S. economy will revisit the market levels of late 2008 and early 2009. Despite these growing concerns and the headlines they generate, we believe the U.S. economy is firmly on the path to recovery and that the recent market episode is a necessary and predictable component of a healthy economy.

To substantiate this view, we review Forward's 2010 Outlook from fourth quarter 2009 in which we posited that risky assets would cycle through three distinct phases as part of the overall economic recovery.

### Phases of the Current Economic Recovery *(as published in January 2010)*

**Phase 1:** Increase in the price of risky assets—such as stocks, investment grade credit, high yield bonds and commodities—brought on by cheap and available cash will begin to taper off as rates increase, thus signaling the end of quantitative easing. In addition, valuations will reach extreme levels and investor sentiment will become irrationally high, leading to a broad-based sell-off of risky assets.

**Phase 2:** Price correction in the risky assets could reach double digits as investors realize prices may be over-extended due to a number of systemic risks still putting pressure on the economy.

**Phase 3:** The final phase will be brought on by continued improvement in the economy, employment and consumer spending. The price of risky assets will again increase. However, such increases will likely be shallow compared to the Phase 1 rally.

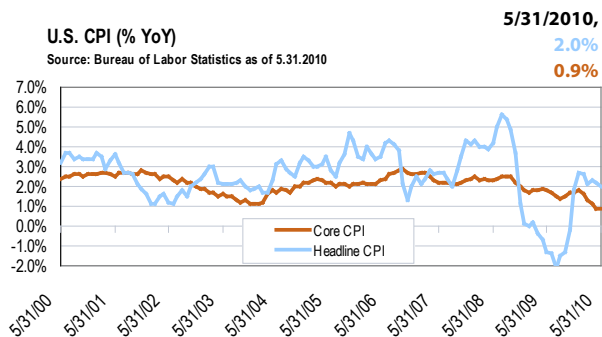
## Where We Stand Today

The S&P 500 Index reached a 52-week high on April 23, at 1217, likely marking the completion of the first phase and representing one of the most robust recoveries in the history of the U.S. market. At 17.9, the P/E multiple of the S&P 500 was higher than the historical average of 16.4.

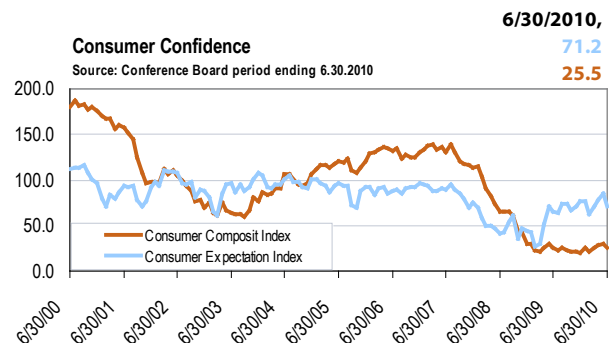
The fed began the tightening process by decreasing the money supply and while short-term rates remained at historic lows, long-term rates rose in anticipation of higher inflation.

The second phase in the recovery cycle subsequently ensued and continues to permeate the market today. Because the recovery was so robust in nature, it is not surprising that the anticipated correction has also been more severe. Since the correction began, at quarter end (June 30, 2010) stocks were off the April 23 peak by nearly 15% and have approached "bear market" status (defined as a 20% correction in stock prices). As such, it is important to step back and review the evidence to evaluate whether or not a bias toward sustained recovery is justified.

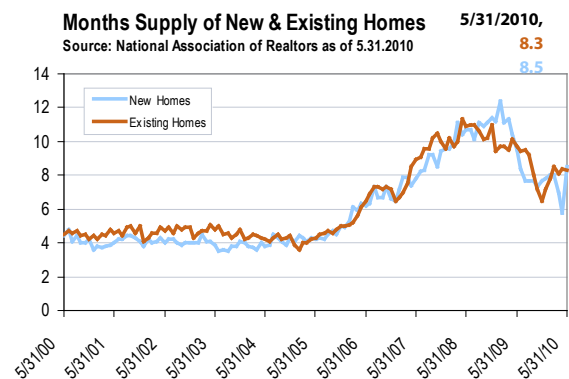
**Positives:** Increasing personal income, low to no inflation and a positive manufacturing trend that has extended over the past 12 months ending June 30, 2010, all provide evidence that the recovery is on track.



**Concerns:** Consumer confidence has been erratic. Since 70% of the GDP (gross domestic product) is comprised of private consumption, the lack of confidence represents a risk to overall recovery.



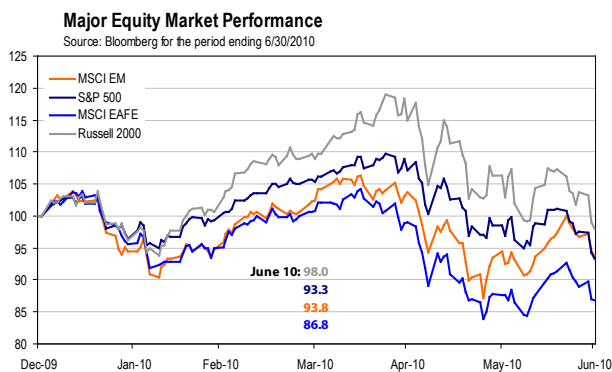
While home prices have rebounded slightly from the lows of 2009, the supply of new homes on the market has increased and the real impact of the now-expired home buyer credit remains to be seen.



Overall, the leading indicators support a recovery trend over the final months of 2010. As such, we believe that the economy may be entering Phase 3, and a gradual appreciation of risky assets will likely ensue. However, it is prudent to point out that some evidence suggests it may be too early to call. Therefore, we suggest a measured approach that includes dollar cost averaging into risky assets. Additionally, investors will need to exhibit patience, as persistent volatility may cause the faint of heart to question their convictions.

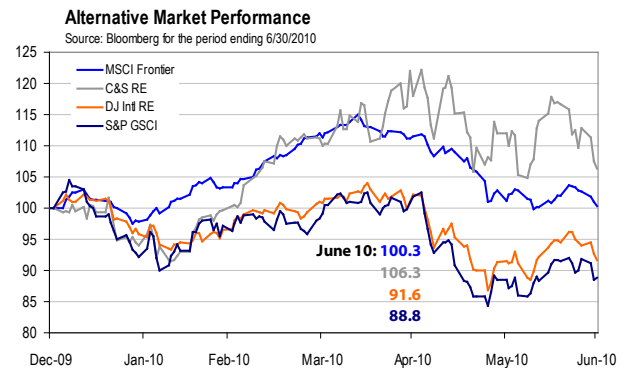
## Equity Markets Affected by Currency Crisis

Global equity markets, as measured by the MSCI All Country World Index (ACWI), declined by 11.9% during second quarter. The currency crisis in Europe, coupled with poor employment and real estate data suggesting a less-than-robust recovery, have all had a negative effect on equity markets. Emerging markets outperformed U.S. stocks by 3.2% and international stocks by 5.4%, as measured by the MSCI Emerging Markets Index, S&P 500 Index and the MSCI EAFE Index, respectively. Small cap stocks also outperformed large cap by 1.5% during second quarter, as measured by the Russell 2000 Index and the S&P 500 Index.



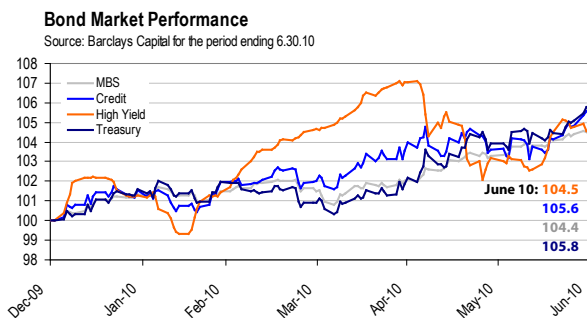
## Alternative Markets Reflect Investor Sentiment

Alternative assets were also affected by negative investor sentiment during second quarter, and declined accordingly. Frontier markets were in line with other equity markets, down 11.2% for the quarter as measured by the MSCI Frontier Markets Index. Real estate was a bit mixed as U.S. real estate fared better than international real estate. Poor performance in international real estate was exacerbated by the weak euro. Commodities, as measured by the S&P GSCI Commodity Index, fell 10.4% on U.S. dollar strength, as well as the perception that the economic recovery was stalling.



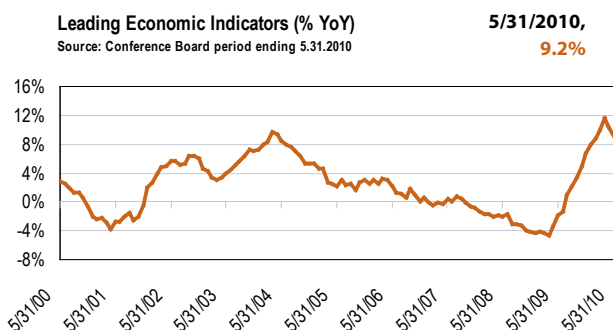
## Bond Markets Rally

Bond markets rallied in second quarter and the Barclays Capital Aggregate Bond Index was up 3.5%. The yield on 10-year treasuries fell during the quarter from 3.8% to 2.9% as the declining market caused investors to flee to the safety of bonds. In fact, U.S. Treasuries outperformed mortgages, credit and high yield, returning 4.7% during the quarter as measured by the Barclays Capital Treasury Index.



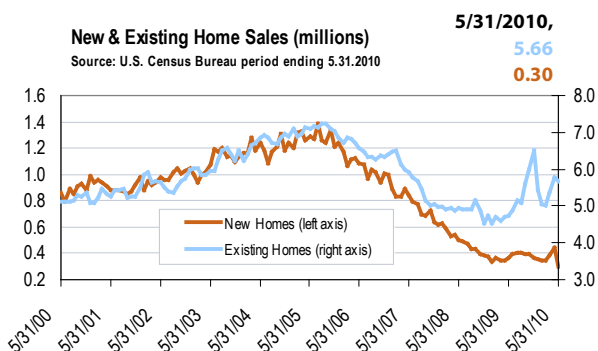
## U.S. Economy: Leading Economic Indicators Still Support Recovery

The Leading Economic Indicators Index continued to demonstrate strong year-over-year gains throughout second quarter. Although the index peaked in March with an 11.6% gain, both April and May posted solid gains. May closed with a 9.2% year-over-year gain, which approximates the index at the close of first quarter. The recent drawback in the index was largely driven by a correction in stock prices and a tightening of the money supply. The fundamental economic data that comprises the index continues to demonstrate support for a sustained recovery.

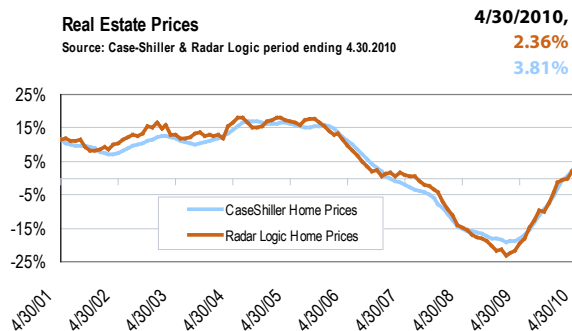


## Real Estate: Mixed Signals

The recovery of the U.S. real estate market continues to deliver mixed signals. New home inventory levels rose slightly over first quarter from 8 to 8.5 months, while existing home inventory exhibited a slight decline from the first quarter.



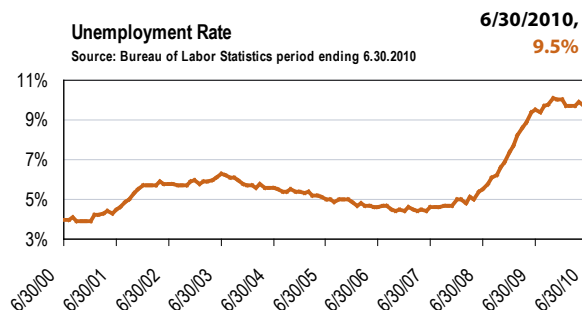
The Case Shiller Home Price Index rose higher than expected over first quarter, with April showing an overall improvement in home prices. This was likely due to increased seasonal demand and the looming expiration of the home buyers tax credit at the end of April. As noted earlier, it will be important to monitor these indices closely in coming months to determine if there is true market support for stability and recovery of the housing market.



## Employment: Slight Improvement

Total non-farm payroll employment declined by 125,000 in June, and overall unemployment edged down to 9.5%, as reported by U.S. Bureau of Labor Statistics. The decline in payroll employment reflected a decrease of 225,000, reflecting the number of temporary employees working on Census 2010. Private-sector payroll employment edged up by 83,000. While private-sector employment has increased by 593,000 since January 2010, June employment numbers were 7.9 million below peak levels reached in December 2007.

Even though the data suggests a continued improvement in unemployment numbers, investors have largely interpreted recent statistics surrounding unemployment as disappointing.

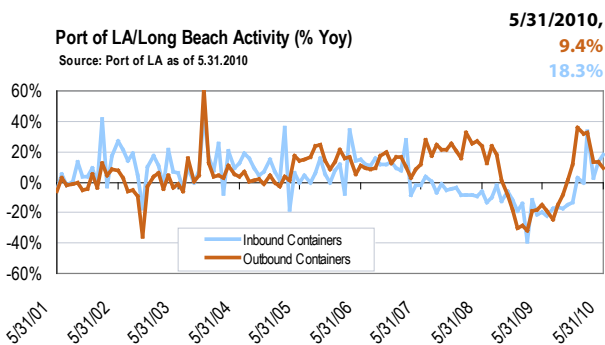


## Trade: Strong Dollar & Positive Trends



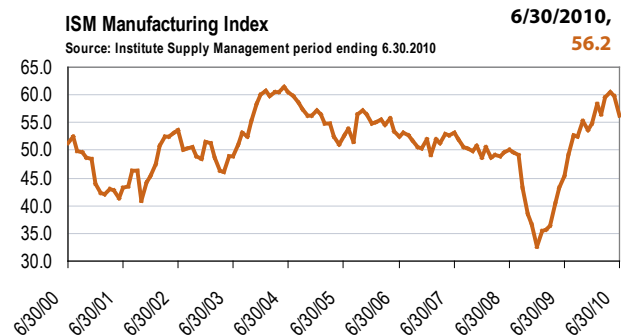
The U.S. Census Bureau and the U.S. Bureau of Economic Analysis, through the Department of Commerce, reported April exports of \$148.8 billion and imports of \$189.1 billion resulting in a goods and services deficit of \$40.3 billion, up from \$40.0 billion in March. The continued escalation of the Greek debt crisis during second quarter and the subsequent appreciation of the U.S. dollar largely contributed to the increased trade deficit.

On a positive note, ISM Export Orders continue to demonstrate growth. Although the pace has slowed in recent months, a positive trend extends over the past 12 months. This data is supported by the outbound freight from the ports of Los Angeles and Long Beach which has also demonstrated a positive year-over-year trend.

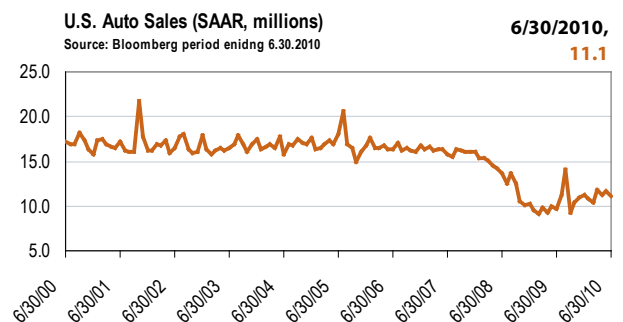


## Manufacturing: Still Growing

The ISM Manufacturing Index closed at 56.2 in June which represents a decline from the April high of 60.4. Inventories, which expanded in first quarter and contributed to a wholesale expansion in manufacturing, contracted over recent months. Overall, the manufacturing segment continues to demonstrate growth, albeit at a more moderate pace, which supports the continued economic recovery.



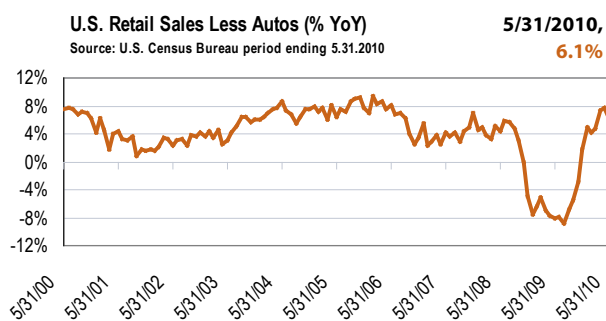
The U.S. Commerce Department reported June auto sales at annualized 11.1 million units, representing a 14% increase over June 2009. While auto sales have recovered from the lowest levels in early 2009, sales continue to be below the lowest point of the '90/'91 recession (even with a larger number of registered drivers), and are below most forecasts of around 11.4 million SAAR (seasonally adjusted annual rate).



## Consumer: Reserved Spending

According to data provided by the U.S. Census Bureau, retail sales, less autos, rose year-over-year by 6.1% as of May 2010, representing an improvement over first quarter numbers—but off the 7.8% high posted in April 2010.

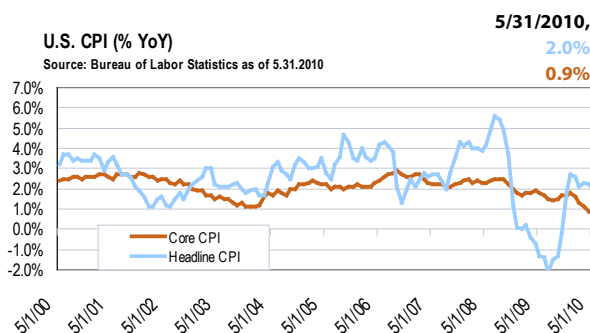
As noted earlier, consumer confidence dropped sharply in June. The Consumer Confidence Index, which had posted three consecutive monthly gains, retreated on increasing uncertainty over employment and the sustained U.S. economic recovery. Personal income, which increased \$53.7 billion or 0.4% in May, does not support the decline in consumer confidence and thus one must not assume that a drop in consumer confidence will translate to a decline in spending.



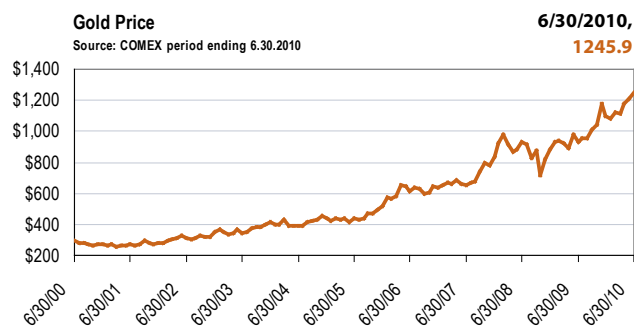
## Inflation: Fears Subside

U.S. Headline and Core CPI continued to decline in second quarter. At the end of May, Headline CPI declined from 2.1% to 2.0% and Core CPI, which excludes food and energy, experienced a more pronounced decline from 1.3% to 0.9% on an annualized basis, suggesting that the fear surrounding the prospect of inflation has largely subsided.

In another sign of longer-term confidence in the economic outlook, recently auctioned TIPS (Treasury Inflation Protected Securities) garnered one of the lowest yields since the Treasury started selling these securities in 1997.



However, gold prices contradicted inflation data and recorded a positive 11.9% return for the quarter. Since the price of gold is determined solely by what individuals are willing to pay, it is difficult to speculate about price direction in the gold market—leading some to speculate that we may be experiencing a bubble in the gold market



**Investing involves risk, including possible loss of principal. Index returns are for illustrative purposes only and do not represent actual performance of any securities. Index performance returns do not reflect any management fees, transaction costs or expenses. Indices are unmanaged and one cannot invest directly in an index. Past performance does not guarantee future results.**

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Definitions:

**Gross domestic product (GDP)** is the total market value of all final goods and services produced in a country in a given year, equal to total consumer, investment and government spending, plus the value of exports, minus the value of imports. The GDP of a country is one of the ways of measuring the size of its economy.

**Price to Earnings (P/E) Multiple** is valuation ratio of a company's current share price compared to its per-share earnings.

**The Barclays Capital Aggregate Bond Index** represents securities that are U.S. domestic, taxable, and dollar denominated. The index covers the U.S. investment grade fixed rate bond market, with index components for government and corporate securities, mortgage pass-through securities, and asset-backed securities. These major sectors are subdivided into more specific indices that are calculated and reported on a regular basis. Returns of the index do not reflect the deduction of any fees or expenses.

**The Barclays Capital Treasury Index** - Public obligations of the U.S. Treasury with a remaining maturity of one year or more.

**The S&P GSCI Index** provides a benchmark for investment performance in commodity markets. The index is calculated on a world production-weighted basis and is comprised of the principal physical commodities that are the subject of active, liquid futures markets.

**The MSCI EM Index** is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of emerging markets. As of June 2007 the MSCI EM consisted of 25 emerging market country indices.

**The MSCI Frontier Market Index** is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of frontier markets. As of Nov 2008 the MSCI Frontier consisted of 22 emerging market country indices.

**The MSCI Emerging Markets Index** is a free float-adjusted market capitalization weighted index that is designed to measure the equity market performance of emerging markets. As of June 2007 the MSCI EM consisted of 25 emerging market country indices.

**MSCI All Country World ex US** (Jan. 1972): The Morgan Stanley Capital International Indices (MSCI) are designed to measure the performance of the developed stock markets of the USA, Europe, Canada, Australia and the Far East, and that of industry groups.

**The Russell 2000 Index** is an unmanaged index comprised of the smallest 2,000 companies in the Russell 3000 Index, which is an unmanaged index composed of the 3,000 largest U.S. companies, as determined by float-adjusted market capitalization.

**The S&P 500 Index** is a capitalization-weighted index of 500 stocks traded on the NYSE, AMEX and OTC exchanges, and is comprised of industrial, financial, transportation and utility companies.

**The Conference Board Consumer Confidence Expectations Index** is an average of responses to the following questions: 1. Respondents expectations regarding business conditions six months hence. 2. Respondents expectations regarding employment conditions six months hence. 3. Respondents expectations regarding their total family income six months hence.

**The Conference Board Consumer Confidence Present Situation Index** is an average of responses to the following questions: 1. Respondents appraisal of current business conditions. 2. Respondents appraisal of the current employment conditions.

**The Institute of Supply Management (ISM) Manufacturing Index** is a monthly index that tracks the amount of manufacturing activity that occurred in the previous month. This data is considered a very important and trusted economic measure. If the index has a value below 50, due to a decrease in activity, it tends to indicate an economic recession, especially if the trend continues over several months. A value substantially above 50 likely indicates a time of economic growth. The values for the index can be between 0 and 100.

**The US Unemployment Rate Index** measures the US unemployment rate on a monthly basis. The unemployment rate represents the number unemployed persons as a percent of the labor force.

**The Leading Economic Indicators Index** measures average weekly hours, manufacturing, average weekly initial jobless claims, manufacturers' new orders, consumer, vendor performance, slower deliveries, manufacturers' new orders, capital, building permits, new private housing units, stock prices, 500 common stocks, money supply, interest rate spread, and index of consumer expectations.

**The US Auto Sales - SAAR Index** is seasonally adjusted annual sales of total light vehicles sold in U.S., in millions. Total sales are broken down by cars and light trucks that are manufactured in U.S., Mexico and Canada (Domestic), and those manufactured elsewhere (Imported).

**The US Retail Sales, Less Autos Index** measures adjusted retail sales, ex-autos, yearly percentage change. Adjusted for seasonal variation, for holiday and trading day differences, but not for price changes.

**The US Existing Home Sales Index** measures US Existing homes sold in a one month period. Total includes single-family homes, townhomes, condominiums and co-ops.

**The US New Home Sales Index:** As per the U.S. Commerce Departments Bureau of the Census, Median Sales for New One-Family Houses in dollars. As per the U.S. Commerce Departments Bureau of the Census, Average Sales for New One-Family Houses in dollars. Provides these totals broken into regions Northeast, Midwest, South and West.

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

**Consumer Price Index (CPI)** is an index number measuring the average price of consumer goods and services purchased by households. The percent change in the CPI is a measure of inflation.

**Crude Oil** is the world's most actively traded commodity, and the NYMEX Division light, sweet crude oil futures contract is the world's most liquid forum for crude oil trading, as well as the world's largest-volume futures contract trading on a physical commodity.

**Gold:** Troy ounces of refined gold, not less than .995 fineness, cast either in one bar or in three 1-kg. bars, and bearing a serial number and identifying stamp of a refiner approved and listed by the Exchange.

The Port of Long Beach monthly inbound containers: Tracked in TEUs ( Twenty foot equivalent units, a standardized maritime industry measurement used when counting cargo containers of varying lengths. The Port of Long Beach monthly outbound containers: Tracked in TEUs ( Twenty foot equivalent units, a standardized maritime industry measurement used when counting cargo containers of varying lengths.

The Port of Los Angeles monthly inbound containers: Tracked in TEUs ( Twenty foot equivalent units, a standardized maritime industry measurement used when counting cargo containers of varying lengths. The Port of Los Angeles monthly outbound containers: Tracked in TEUs ( Twenty foot equivalent units, a standardized maritime industry measurement used when counting cargo containers of varying lengths.

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