



July 2010

Pictet Asset Management Ltd.

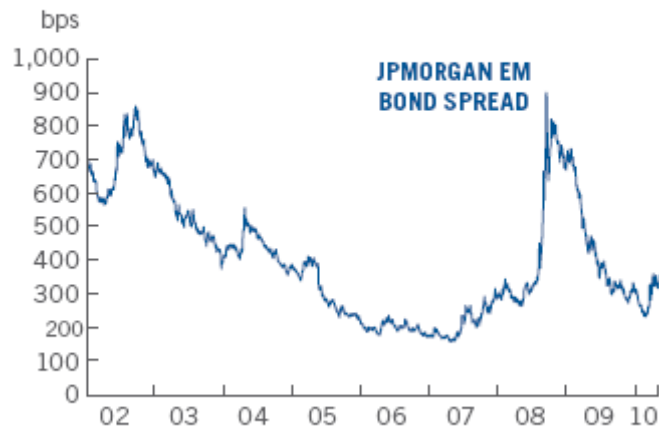
FURTHER TESTED BY SOVERIGN DEBT FEARS

As fiscal retrenchment threatens the pace of economic recovery in the developed world, still strong fundamentals suggest that past economic and financial reforms have given new resilience to emerging market countries. However sovereign debt fears continue to stalk investors—will these derail investment flows into emerging debt markets?

Emerging debt markets, together with their underlying currencies, were hard hit by the evaporation of liquidity which characterized the 2008 financial crisis. The spread of the emerging USD debt index over U.S. Treasuries rose to 900 basis points (bps) in October 2008 from 300 bps in June of that year. The ensuing financial and economic recovery has done much to validate the premise of substantially improved emerging market fundamentals and this has been reflected in the subsequent shrinkage in the spread, which dropped to near 240 bps in May 2010. Recently, however, fears of financial contagion, particularly within Eastern Europe, have caused spreads to widen once more, to reach 355 bps at the start of July (figure 1).

EM spreads widen on debt contagion fears (1)

JPMorgan EM Bond Spread Index 12/31/01–06/30/10



Data as of 06/30/10
Source: JPMorgan

The underlying investment case for EM (emerging market) debt has undoubtedly been thoroughly tested by the global financial crisis. In its aftermath, it is painfully evident that growth prospects in many developed countries remain severely compromised by excessive levels of public and private debt. The spread of Greece's financing problems across other, predominantly southern European states has led to the recognition that substantial fiscal adjustment is now required in much of Europe, the U.S. and Japan. The political traction that this understanding has gained, across Europe particularly, is occurring just as central banks support policies such as quantitative easing (QE), are being brought to a close.

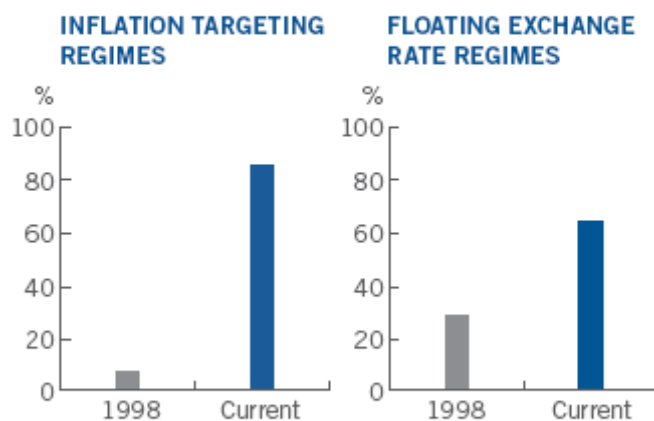
Concern regarding a renewed downturn, triggered by the too rapid withdrawal of fiscal support, has caused a marked shrinkage in risk appetite and global equity markets have retreated sharply. In developed markets, deflationary fears have replaced earlier concerns that the combination of stimulus monetary and fiscal policies would trigger renewed inflation. The increase in risk aversion, reflected in the widening of EM bond spreads, suggests that investors may be questioning the sustainability of the economic underpinnings of some emerging markets. Given the contribution to EM growth made by exports to consumers within the over-indebted developed world, such concerns may be understandable.



The vigorous growth enjoyed by emerging market economies, particularly in Asia and the Latin American region, reflects a variety of political, social and economic factors that are unlikely to be easily derailed. Of importance to the emerging market debt investment case, particularly in the local currency markets, has been the commitment to inflation targeting and to the adoption of floating exchange-rate regimes (figure 2). Previously the tendency was for many emerging countries to use interest rate policy as a mechanism of support for their local currencies whenever outflows threatened. The inevitable result was lower domestic growth and an erosion of foreign exchange reserves which exacerbated the pressure on the currency.

Structural shifts underpin economic resilience (2)

% of JPMorgan GBI EM Global Diversified index



Data as of 06/30/10

Sources: IMF, central bank websites, Pictet Asset Management estimates

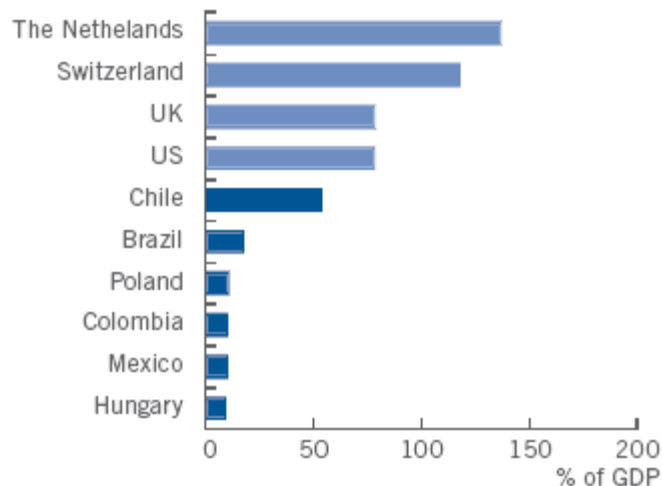
During the financial crisis, emerging market central banks were not panicked into trying to artificially support their currencies, which weakened sharply as investors sought safety. The subsequent recovery saw both currencies and bond markets rallying as investors acknowledged the greater discipline. The recent sovereign debt fears in Europe have, however, caused some renewed currency weakness, particularly in Eastern European countries such as Hungary, Poland and Romania.

Rapid economic expansion, rising productivity associated with urban population growth and positive demographic trends continue to underpin the emerging markets story. The case for EM debt additionally benefits from a long-term demand/supply imbalance for emerging market bonds. Debt issuance is likely to grow, helping to improve liquidity and deepen the capital markets. However it is unlikely to meet the growing demand for local currency bonds fueled both by foreign investment flows and also the nascent emerging market pension fund industry. In many developed markets, interest rates (and bond yields) are likely to remain constrained by a fragile recovery and the need to maintain pro-growth monetary policies. In such an environment the search for higher yielding fixed-income assets is likely to continue. Within U.S. pension funds, allocations to emerging market debt amounts to only 0.2% of total assets and in the U.K. it amounts to around 0.4%. As the improved credit quality of EM debt becomes more broadly recognized, we believe these allocations will increase (figure 3).



Pension funds realize the benefits of EM bonds (3)

Pension fund AUM



Data as of 06/30/10

Sources: International Federation of Pension Fund Administrators (FIAP), www.fiap.cl

The growth of pension assets within emerging markets is an additional source of demand, particularly in the Latin America region. Chile was the first country in the area to introduce a defined contribution (DC) pension fund scheme and their model is increasingly being adopted across the region. EM local currency bonds are a natural asset class for such schemes and together with increased allocations from foreign pension plans we anticipate demand will outstrip the supply of emerging debt.

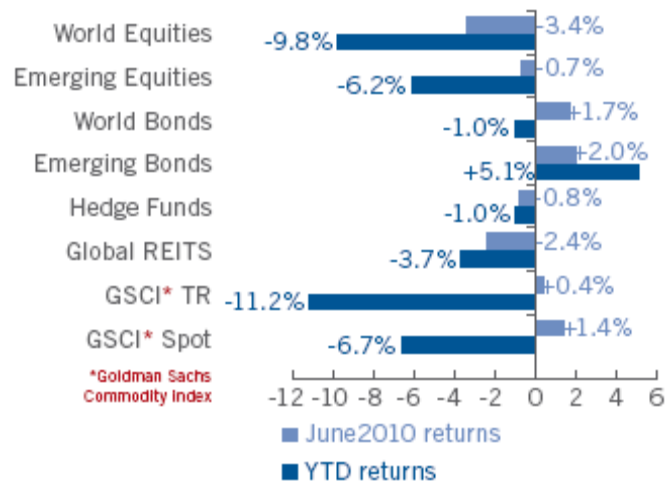
In the shorter term, markets are currently concerned with whether economic recovery can be maintained. Apart from the problems of Europe, investors are also questioning the risk of a sharp decline in China's growth as the government tries to prevent economic overheating. In recent months, China has moved to a substantially more restrictive policy as regards the property sector, reflecting evidence of growing leverage within the system, exposing the banks to the possibility of debt defaults. After expanding at an 11.9% annual rate in the first quarter, recent data, particularly in the manufacturing industry, shows a slackening in China's growth rate, even as inflation continues to accelerate. Our view is that inflation in China, predominantly driven by food costs, will peak during the summer at around 4%. China's development is likely to be characterized by a series of short-run cycles, however although investors are currently apt to interpret both strong and weak economic data from China in a negative light, we believe that a moderation in growth will be achieved. Confidence in a soft economic landing will likely cause a re-acceleration of investment flows into the wider region.

The set-back in global equity markets in recent months reflects the realization that many of the problems of excessive debt that contributed to the financial crisis remain largely unresolved. Policy makers reacted to the downturn by supporting financial markets, in order to break the evident negative feed-back loop that had developed between falling asset prices and real economic activity. As the stimulus policies that accompanied this effort are withdrawn, it is evident that private credit flows within major developed markets remain severely constrained. It seems that fears of a more restrictive regulatory regime for banks, including higher capital/deposit ratios and the possible imposition of penal taxes, are acting as a drag on commercial lending activity. This lack of market liquidity, even as interest rates are kept at record low levels in developed markets, is acting as a brake on investor risk appetite (figure 4).



Debt and growth worries trigger a setback in markets (4)

June 2010 & YTD returns



Data as of 06/30/10
Source: Bloomberg

A resolution of this impasse looks unlikely in the short term. However, if Europe's sovereign debt fears are eased over the summer by Spain managing to rollover some EUR 20 billion of debt which falls due, risk sentiment would improve sharply. In sharp contrast, reflecting generally lower levels of public and private debt (ex-Eastern Europe) some emerging markets, notably India and China, are now moving to remove excess liquidity.

In the medium term, in the context of developed economies which are likely to experience a sub-par recovery, emerging markets should continue to benefit from positive capital flows as investors search for scarce growth and currency diversification. Emerging local currency debt markets fell by some 2% (USD terms) in the second quarter, as investor sentiment deteriorated in the face of disappointing economic data. However, fiscal restraint is being offset by continued monetary ease in developed economies and after having a bias to hike rates in the first quarter, many emerging central banks, particularly in Asia and Latin America, now look more likely to maintain rates at current levels. The combination of relatively strong growth and a benign rate environment should do much to underpin investor appetite for the asset class.



The JPMorgan GBI-EM (Government Bond Index-Emerging Markets) Global Diversified Index is a comprehensive global local emerging markets index that consists of regularly traded, liquid fixed-rate, domestic currency government bonds and includes only the countries that give access to their capital markets to foreign investors (excludes China, India, and Thailand). The index is market capitalization weighted with at cap of 10% to any one country.

Sovereign debt is the total amount owed to the holders of the sovereign bonds (bonds issued by a national government).

BPS (basis point) is a unit that is equal to 1/100th of 1%, used to denote the change in a financial instrument. The basis point is commonly used for calculating changes in interest rates, equity indexes and the yield of a fixed-income security.

Quantitative easing refers to a form of monetary policy used to stimulate an economy where interest rates are either at, or close to, zero.

The euro (EUR) is the official currency of the European Union (EU).

Investing in foreign securities, especially emerging markets, will involve certain additional risks, including exchange rate fluctuation, less liquidity, greater volatility, and less regulation.

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