



August 2010

Pictet Asset Management—Monthly Global Outlook

RECOVERY IN RISK SENTIMENT RALLIES MARKETS

Equity markets recovered composure in July as investors took reassurance from the results of European bank stress tests and the success of several eurozone bond auctions. Despite data indicating a slowdown in the rate of recovery in most developed markets, economic activity has remained strong enough to support corporate earnings, and a steady stream of better-than-expected second quarter earnings reports have provided a boost to investor sentiment. We remain positive, but wary, on risk assets.

AN “UNUSUALLY UNCERTAIN” ECONOMIC OUTLOOK

Ben Bernanke, U.S. Federal Reserve Chairman, indicated during last month’s Senate testimony that the economic outlook was “unusually uncertain.” However, he did not offer further stimulus measures, noting that low interest rates and the expansion of the Federal Reserve balance sheet already provided supportive conditions. The U.S. Federal Reserve, though prepared to inject additional funds into the economy, seem to be waiting to observe the full extent of the current dip in growth before taking any action.

Data from the U.S. housing sector continued to reflect the fragile state of the recovery. Housing starts fell in June as sales faltered in the aftermath of the removal of government tax incentives. A lower Institute of Supply Management (ISM) Manufacturing Index, weaker factory orders and payroll data have also added to general investor pessimism. However, mortgage applications are responding positively to record-low financing costs, as households seek to rebuild balance sheets through attractive refinancing rates. Investors, therefore, remain sharply divided as to whether the U.S. economy is experiencing a temporary dip in the rate of recovery or is at risk of a renewed downturn.

QUESTIONABLE EU BANKING STRESS TESTS NONETHELESS REASSURES INVESTORS

Overall risk appetite recovered in July as the eurozone crisis eased. In part, this was due to stress tests carried out in Europe this month across 91 European Union (EU) banks, designed to assess whether the European banking sector had sufficient tier 1 capital to withstand renewed recession and a sovereign default in the region. Although markets had initially feared that the tests would show that huge amounts of new capital would be required, it became evident that the exercise was aimed at calming, rather than aggravating, investor nerves.

Five Spanish savings banks failed the tests along with *Hypo Real Estate* of Germany and Greece’s *ATE Bank*. Some commentators were critical of the relative ease with which European banks passed the stress test. The 2008 U.S. bank stress tests were successful largely because of their rigor; the 10 banks (out of 19) that failed their test immediately released plans to raise new capital. In the EU, only 7 of the 91 banks failed the test, which implied a total capital shortfall of just EUR 3.5 billion. Not only were the EU tests lacking rigor, making benign assumptions for the severity of any renewed recession and using modest estimates of the potential bond losses associated with a sovereign default, but no plans were drawn to raise more capital in response to the test results.

News from the European Central Bank (ECB) that its purchases of government bonds in the eurozone had slowed substantially—a sign that national debt markets were starting to function once again—added to the growing calm. The success of Spain’s auction of EUR 3 billion of 15-year bonds in July also helped ease concern over its ability to finance debt repayments. This renewed economic confidence was reflected in modestly higher German bond yields and by spreads narrowing in Spain, where the premium over German bunds fell by 41 basis points (bps) to 159 bps over the month (fig. 1).



Spanish funding pressures ease(1)



HEALTHY QUARTERLY EARNINGS HAVE BOLSTERED MARKET CONFIDENCE

In the U.S., stocks across a range of sectors, including *Intel*, *Alcoa*, *Apple* and *UPS* beat estimates—the technology sector in particular is showing strong demand. Banks, such as *Citigroup* and *Bank of America*, showed shrinkage in lending, as credit demand remained weak and efforts to rebuild their balance sheets continued.

In Japan, strong operating results were seen from the likes of *Sony* and *Komatsu*, *Samsung* in Korea and across a range of European companies including *Siemens*, *Volkswagen* and *Telefonica*. But global market sentiment remains fragile as investors assess the possibility that fiscal retrenchment could yet undermine the recovery, despite the continuation of positive earnings reports.

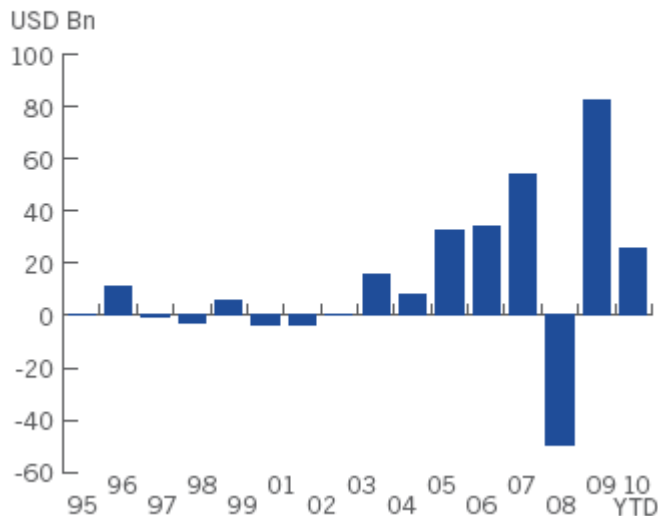
A LOWER, BUT MORE SUSTAINABLE GROWTH TRAJECTORY LIKELY FOR EMERGING MARKETS

The MSCI EM Index rose by 7.9% over the month as investor fund-flows accelerated as confidence in emerging markets grew (fig. 2). In particular, the strong financing position held by many Asian banks to support regional growth, as shown by notably strong bank lending figures in Indonesia, contrasts sharply with that of most developed market lenders.



YTD EM equity inflows healthy (2)

Inflows into EM Funds (USD Billions), 15 Years to 07/28/10



Source: PAM, Datastream, EPFR Global, Morgan Stanley
Data as of 07/28/2010

This comparative dynamism of many emerging economies is leading to a divergence of monetary policy regimes to their developed counterparts. Korea became the eighth country in the MSCI EM Index to raise interest rates since the financial crisis, after rate hikes in recent weeks by India, Malaysia, Thailand and Taiwan.

Moreover, we think Chinese interest rates will peak this summer. Although China's expansion cooled modestly in the second quarter to 10.3% as industrial production moderated, inflation has also subsided somewhat. Fears of a hard landing in China look overblown and growing investor confidence in a lower, but sustainable growth trajectory in the near term should continue to underpin risk appetite for emerging markets.

EVEN SO, OVERALL INVESTOR SENTIMENT REMAINS FRAGILE AS GOVERNMENT SPENDING CUTS LOOM

The recovery in global equity markets in July is encouraging, but sentiment remains fragile. Markets are supported by low interest rates, strong corporate earnings and balance sheets, and valuations are generally attractive. Global markets however remain vulnerable to renewed economic hazards by global imbalances, originally responsible for triggering the recent financial crisis, that continue to exist. Fiscal retrenchment will still be a substantial hurdle for future growth and may yet compromise the robust earnings and valuation picture. The frailty of confidence is illustrated by the current, relatively low levels of market liquidity, particularly characterized by poor credit conditions—both by banks' unwillingness to lend or by the absence of demand by consumers.

WE REMAIN CAUTIOUSLY POSITIVE ON RISK ASSETS

In our view, growth, supported by the momentum of emerging markets, will be sustained in the developed world; albeit at a subdued and uneven pace. Demand from emerging markets should enable earnings to continue to rise and low interest rates will act as an offset to fiscal retrenchment. Bond markets should stay quiescent as progress in fiscal policy is assessed. However, given that they are now discounting subdued growth, low inflation and delayed monetary tightening, a modest rise in yields is likely to accompany any uptick in momentum. Nonetheless, a swift resolution of the current equity market impasse is unlikely and patience will be required to make the most of trading rallies over the next few months.



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. 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.

Tier 1 capital is the core measure of a bank's financial strength from a regulator's point of view. It is composed of core capital, which consists primarily of equity capital and cash reserves, but may also include irredeemable non-cumulative preferred stock and retained earnings.

Sovereign default is a sovereign state's government's failure to pay back its debt in full.

The euro (sign: €; code: EUR) is the official currency of the European Union (EU).

The European Central Bank (ECB) is one of the world's most important central banks, responsible for monetary policy covering the fifteen member countries of the euro zone. The ECB, established by the European Union (EU) in 1998, is headquartered in Frankfurt, Germany.

A bund is a German federal government bond issued with maturities of up to 30 years.

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.

The MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global emerging markets. It is not possible to invest directly in an index.

Valuation is the process of determining the value of an asset or company based on earnings and the market value of assets.

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

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