

June 2010

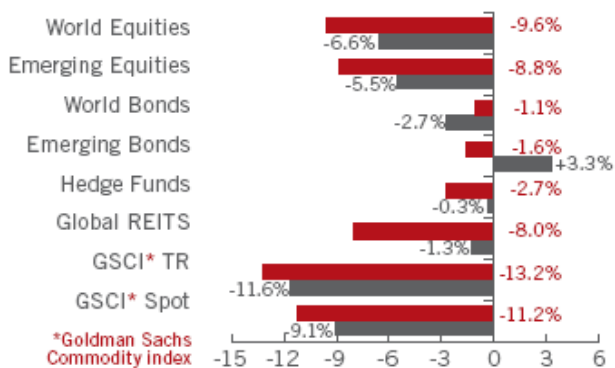
Pictet Asset Management—Monthly Global Outlook

Discord in Europe Triggers Correction

May saw a swing away from risk assets as ongoing European sovereign debt fears threatened a new phase of financial dislocation. The imposition of a short-selling ban by the German authorities on certain financial assets, widely perceived as a populist act of fiscal desperation, reminded investors the dangers that policy error posed to markets. In a month of vicious volatility for global markets, continued concern over policy tightening in China and mounting tension between North and South Korea added to investor nervousness (figure 1).

Risk assets in full retreat during May (1)

Asset class returns



Source: Bloomberg/MSCI
Data as of 05/31/2010

EU Officials Desperately Try to Get “Ahead of the Curve”...

As the European sovereign crisis began to threaten the viability of the eurozone, European ministers were forced into emergency session to fashion a European Union (EU)-wide stabilization package. The plan, amounting to some EUR750 billion, increased the EU balance of payments facility from EUR60 billion to EUR110 billion, created a European EUR440 billion stabilization fund and provided for an additional contribution of EUR250 billion from the IMF. The size of the package, roughly equivalent to one-third of the entire stock of outstanding Greek, Italian, Portuguese and Spanish public debt, was a clear attempt by EU officials, who have mostly lagged markets in their policy response during the crisis, to get “ahead of the curve.”

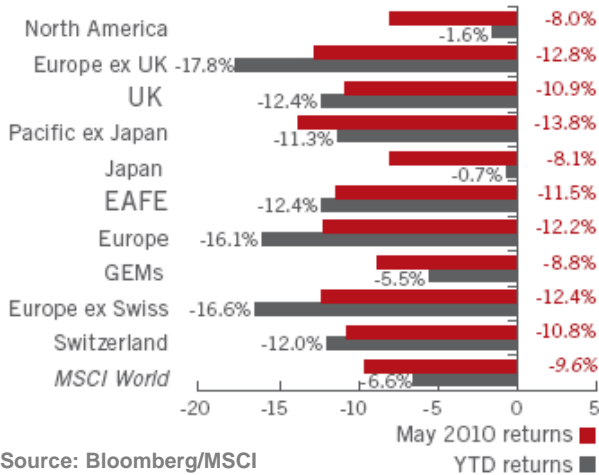
...but the Ensuing Relief Was Short Lived

The announcement of the bailout initially sparked euphoria across European stock markets. But after a short-lived rally, European equities fell sharply as renewed skepticism over the long-term viability of the eurozone set in (figure 2). Markets concluded that while the EU package provided sufficient liquidity to render a European sovereign debt default less likely over the next year or two, it did little to resolve the underlying solvency issues that Greece faces.

Ultimately, some kind of debt restructuring still remains at risk and financials were hard hit as investors contemplated the potential for a write-down of bank’s extensive debt-holdings in the fiscally strained countries of the eurozone. As a result, the euro has continued its fall in May as investors sought safe havens in mostly dollar-based assets, dropping to USD/EUR 1.2270 at month end (figure 3).

European stock markets hit hardest (2)

Regional equity returns



Source: Bloomberg/MSCI
Data as of 05/31/2010

Euro approaches five-year low against dollar (3)



Providing the liquidity to enable countries such as Greece to meet their bond payments is a necessary but insufficient response to what is a structural issue. Recent events have highlighted the acute difficulties of a common currency arrangement operating in the absence of political and fiscal union. Angela Merkel, the Chancellor of Germany, recently suggested that the crisis could provide the opportunity to correct the defects in European architecture. However, the Germans, having borne the cost of exchanging *ostmarks* for *deutschmarks* on a one-to-one basis to finance reunification in 1990, unsurprisingly now have little appetite for underwriting the eurozone's fiscal woes.

The next financing hurdles to be faced include a EUR442 billion long-term refinancing operation by the ECB in late June, to be followed by Spain's rollover of some EUR20 billion of debt in July. These re-financings will be a key test of the extent to which markets agree with the policy direction of European governments.

Spain Loses AAA Rating

However, Spain quickly saw their yields rise as fears that the country would be afflicted by fiscal contagion heightened when the government was forced to take control of the savings bank *Cajasur* and then arrange the merger of four other banks exposed heavily to

the collapse in the country's property market shortly afterwards (figure 4). As if to reinforce market fears, Fitch lowered Spain's credit rating from AAA to AA+ at the end of the month.

Spain suffers from closer scrutiny (4)



Source: Bloomberg

Safe-Haven Yields Fall As Deflationary Fears Rise

The safe-haven bond markets of the U.S., Germany and even the U.K. have seen yields fall as deflation fears have resurfaced—a reversal of earlier worries that unresolved fiscal deficits would cause sovereign yields in these countries to spike higher. In Germany, 10-year bund yields dropped 34 bps in May to close the month at 2.66%, while in the U.S., 10-year treasuries closed at 3.3%, down from close to 4.0% in early April (figure 5).

Spain's pain, Germany's gain (5)



Source: Bloomberg

Echoes of Japan...Policy Misjudgment could now be the Main Threat to Recovery

The rapid deterioration of global risk appetite is perhaps in part explained by the perception that, should the world economy slip into recession once more, governments are in no position to repeat the policy response to the 2008/2009 financial crisis. The transfer of private leverage to the public sector, together with aggressive fiscal stimulus has left government balance sheets severely constrained. And, at ultra-low rates, the policy levers to combat the risk of a double-dip recession have already been pulled.

Markets now require credible assurance that the authorities recognize the need for a coherent strategy to avert the debt crises that now seems to loom for many developed countries. The reaction of the German government, who imposed a ban on the naked short selling of certain financial instruments, suggests that piecemeal and uncoordinated reform of the financial sector may lie ahead.

Investors are also concerned that moves to impose more stringent regulation and punitive taxes on the banking system will shrink lending and stall economic recovery. As the momentum provided by quantitative easing policies fades, money supply growth remains very weak. This suggests that the recovery has not yet become self-sustaining in developed markets. Risks of a policy error, either by over aggressive fiscal austerity measures in parts of Europe or by the introduction of legislation that inhibits the flow of credit, have increased.

Increasingly, parallels are being drawn to the policy errors that consigned Japan to a twenty-year bear market it has yet to exit, and the apparent direction of European policy-making.

Are Risk Markets Now Oversold in the Short Term?

With Europe seemingly consigned to a possibly extended period of low growth and China tightening policy on fears of a possible property bubble, the risks to global recovery have grown. Yet despite the general gloom, we think markets may be oversold in the short term. Equity valuations now look attractive relative to bonds, and earnings estimates continue to be upgraded. Indeed, economic data has so far continued to broadly support the contention of recovering growth—U.S. durable good orders rose once more in April and U.S. consumer confidence in May climbed to the highest level since March 2008.

As such, markets could bounce sharply, particularly if data continues to support the case for economic recovery. However, geopolitical risks aside, until interbank market spreads narrow and money supply growth recovers, it is difficult to see a sustained recovery in equity markets.

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

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

The International Monetary Fund (IMF), located in Washington, D.C., is an international organization that oversees the global financial system by following the macroeconomic policies of its member countries, in particular those with an impact on exchange rates and the balance of payments. It also offers financial and technical assistance to its members, making it an international lender of last resort.

Ostmarks refer to the East German mark or Mark of the German Democratic Republic, the East German currency before 1990.

Deutschmarks refer to the official currency of West Germany (1948–1990) and Germany (1990–2002) until the adoption of the euro in 2002.

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.

Standard & Poor's (S&P) performs financial research and analysis on commercial and government entities. The company also ranks the credit-worthiness of borrowers using a standardized ratings scale. A rating of AAA indicates the lowest risk for investors, while AA+ indicates low risk for investors.

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.

Naked short selling is the practice of selling a stock short, without first borrowing the shares or ensuring that the shares can be borrowed as is done in a conventional short sale.

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

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

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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