SALIENT EQUITIES TEAM

2018 Market Review & Outlook

We have finally reached the point at 103 months (and counting)—already one of the longest economic expansions in U.S. history—where everything old is new again. Global growth is back, fueling a resurgence in animal spirits and bringing long-dormant retail investors back to the market.

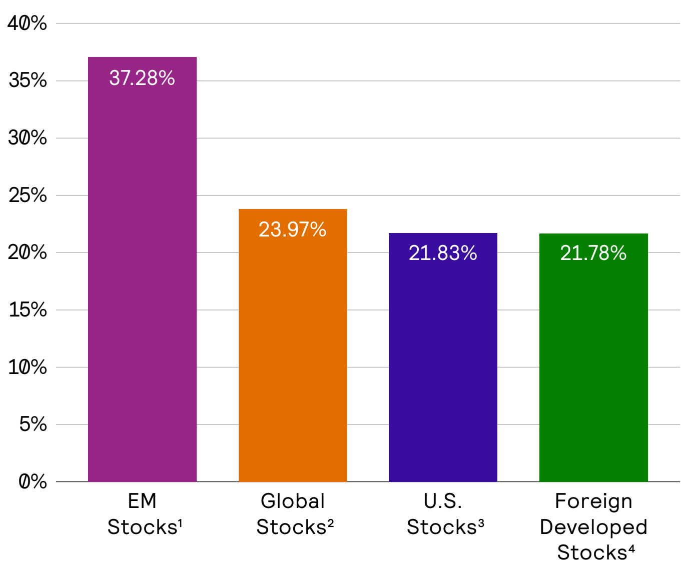
The world's economy accelerated notably in 2017, ending two years of slowing growth, as the U.S., Europe, Japan and most emerging markets (EM) contributed to the largest global economic acceleration since 2010. For the first time since the global financial crisis, every single one of the world's major economies is growing in a synchronized fashion. The more constructive global outlook rekindled optimism amongst investors in general, which had the predictable effect of pushing equities higher in 2017. Perhaps less predictable was the unusually steady way in which many of these equity indices (such as the Bloomberg World Index and MSCI ACWI) advanced every single month of the year—something that has not happened since their inception.

Somewhat surprisingly, given the improving economic backdrop, higher-priced growth equities outperformed lower-multiple value equities by the greatest margin since 1999. Unsurprisingly, at least according to our early year outlook, emerging markets outshined developed markets in 2017 and the overvalued U.S. dollar partially corrected. On a trade-weighted basis, the dollar slid the most in a calendar year since 2009.

For 2018, absent a major negative geopolitical event, the generally positive fundamentals suggest continued global economic improvement. While most economists agree that the recently passed tax cuts in the U.S. should likely benefit U.S. equities in the short term (facilitating higher dividend payments and share buybacks), there is also offsetting potential for the major central banks to begin reversing stimulative monetary policy.

FIGURE 1

Emerging Market Stocks Led 2017



Source: Morningstar, as of 12/31/17

1. MSCI Emerging Markets Index; 2. MCSI ACWI; 3. S&P 500 Index; 4. MSCI EAFE Index

For informational purposes only. Past performance is not indicative of how the index will perform in the future. The index reflects the reinvestment of dividends and income and does not reflect deductions for fees, expenses or taxes. The index is unmanaged and is not available for direct investment.

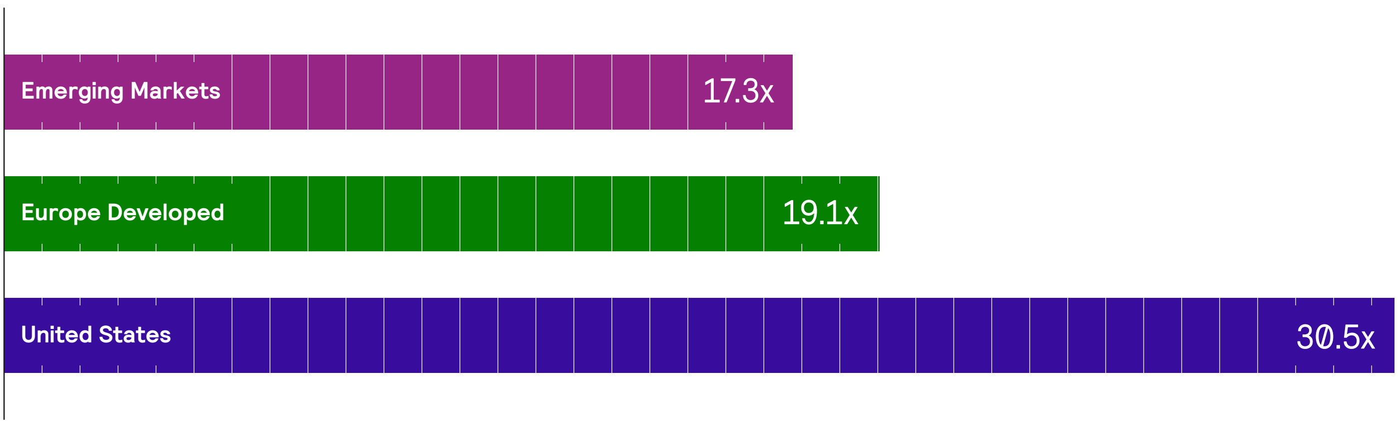
From a high level, our global observations include:

- Absent a high impact global shock, we believe the worldwide wave of economic activity will move higher in 2018. Momentum could potentially carry the global economy upward for at least two more quarters.
- Global economic strength will probably not return to 2003–2007 levels due to structural challenges of high debt, an aged demographic and moderate productivity improvement.
- In developed markets, we expect less improvement in Europe and Japan relative to the U.S.
- In EM, we believe China will slow with more market reforms, but not dramatically. We anticipate higher EM growth coming from other Asian economies.
- Strong recent performance has pushed global equity prices higher, but opportunities remain. There is a strong case to be made for exposure to non-U.S. equities on the basis of long-term valuation measures, such as the cyclically adjusted price-earnings (CAPE) ratio *(Figure 2)*.

FIGURE 2

Long-Term Valuation Measures Favor Non-U.S. Equities

CAPE Ratio as of December 31, 2017



Source: Star Capital, as of 12/31/17

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Regional Views

United States

We believe the U.S. will likely overcome the drag from monetary policy normalization. The tax cut passage should support U.S. gross domestic product growth and corporate earnings growth. Some labor slack remains, but more wage hikes will add to consumer incomes while higher equity and home prices will lead to increased household wealth, boosting hiring and capital spending. Hurricane-related rebuilding adds to the recovery and dollar weakness favorably impacts corporate earnings. Generally, U.S. equity valuation is not as attractive as other parts of the world and we believe stock selectivity will play a major role in 2018 performance.

Europe

Many of the same dynamics are largely at play in Europe, apart from the U.K., where Brexit uncertainties restrain business confidence and consumer spending. Most investors and economists believe that the European Central Bank will eventually follow the U.S. Federal Reserve in raising rates, but will likely be reticent to hike or remove stimulus aggressively given the tame inflation environment. Europe generally suffers from a weaker banking system and political instability, so the strong euro may drag on corporate profit growth relative to its U.S. counterparts. However, more attractive valuations and higher dividend yields still present equity investing opportunities in select European-based companies.

Japan

We believe Japan's better economic performance should continue in 2018. Infrastructure spend for the 2020 Olympics will be supportive and consumer spending has historically benefitted from strong tourism trends and higher wages, brought about by tight labor conditions. Like Europe, Japan's central bank will remove stimulus grudgingly based on statements made by the Bank of Japan, but Japan suffers less political intrigue and has better financial institutions. Moreover, the yen strengthened less than the euro in 2017, which points toward better corporate earnings compared to Europe.

Emerging Markets

Emerging markets are a mixed bag with inflation rates, political stability, business climates, growth fundamentals and equity valuations much more variable than developed markets. We anticipate that China's economy will decelerate as policymakers reduce financial leverage, trim excess industrial capacity and lower home price appreciation, though in a risk-adverse, gradualist manner. Labor market conditions remain stable with new industry job creation (e.g., ride sharing, cloud-based and other new technology jobs) offsetting traditional industries like coal and steel. Although the economy will potentially slow, the 6% plus growth rate remains at an enviable level versus other economies. Outside the technology sector, valuations are still attractive in many China industries.

Despite a slowing China, we believe Asia will contribute most to 2018 global economic growth as countries like Indonesia, the Philippines, Vietnam and Malaysia experience solid and accelerated growth. We believe India's growth will also likely rise as the disruptive impacts from demonetization and the imposition of the Goods & Services Tax fade. Further, India's government recently injected capital into the public banks to improve credit availability. Equity opportunities are relatively slim, however, due to high valuations. To be attractive, we believe the country needs not only cheaper equity prices, but financial institution reform, better infrastructure and greater market openness.

Based on economic trends and projections, South America's relatively anemic economy will likely improve and, if Chile's recent election is a guide, the political winds may turn toward a more pro-business and reform orientation. Emerging Europe has received a boost from Turkey and Poland, which we believe will continue, but we anticipate that Russia's recovery will remain relatively sluggish as it is burdened by poor infrastructure and unfavorable demographics, though Russia will get a short-term boost from 2018 World Cup tourism.

Conclusion

As mentioned previously, most of this outlook is prefaced on lack of a high impact global shock. Indeed, North Korea's nuclear threat, monetary policy mistakes by the world's major central banks and trade wars may be improbable, but any of these events could cause a dramatic business climate change. With that disclaimer, we think the positive economic backdrop should allow for continued economic momentum in general, creating a positive environment for equities.

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Derivative instruments involve risks different from those associated with investing directly in securities and may cause, among other things, increased volatility and transaction costs or a fund to lose more than the amount invested.

Foreign securities, especially emerging or frontier markets, will involve additional risks including exchange rate fluctuations, social and political instability, less liquidity, greater volatility and less regulation.

Investing in smaller companies generally will present greater investment risks, including greater price volatility, greater sensitivity to changing economic conditions and less liquidity than investing in larger, more mature companies.

There is no guarantee the companies in our portfolio will continue to pay dividends.

Definition of Terms

Bloomberg World Index is a capitalization-weighted index of all equities included in the Bloomberg World Index Series.

Cyclically adjusted price-earnings (CAPE) ratio measures the value of the S&P 500 equity market.

Momentum is the rate of acceleration of a security's price or volume.

Monetary policy refers to the actions of a central bank, currency board or other regulatory committee that determine the size and rate of growth of the money supply, including an increase in interest rates or changing the amount of money banks need to keep in bank reserves.

MSCI ACWI (All Country World Index) is a free float-adjusted market capitalization index that is designed to measure equity market performance in the global developed and emerging markets.

MSCI EAFE (Europe, Australasia and Far East) Index is a stock market index that is designed to measure the equity market performance of developed markets outside of the U.S. and Canada.

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.

S&P 500 Index is an unmanaged index of 500 common stocks chosen to reflect the industries in the U.S. economy.

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

Past performance is not indicative of how the index will perform in the future. The index reflects the reinvestment of dividends and income and does not reflect deductions for fees, expenses or taxes. The index is unmanaged and is not available for direct investment.

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Salient®

4265 San Felipe
8th Floor
Houston, TX 77027

800-994-0755

www.salientpartners.com

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