AllianceBernstein

Fall 2011

CAPITAL MARKETS OUTLOOK

Searching for Confidence

Volatility in reaction to risks such as Europe's fiscal crisis has tempered our near-term view of stocks, although we see long-term potential that should be pursued through active management.

A Rocky Stretch for Markets

Equity markets suffered a painful third quarter, with stocks sliding precipitously at times. Markets gyrated as investors struggled to maintain confidence amid mounting concerns.

Among the worries: growing doubt that the euro area will craft a strong solution to Greece's dire fiscal situation—and keep contagion from spreading. Markets also contemplated slower economic growth and the possibility of another recession.

Our view isn't as pessimistic. We're forecasting growth through 2012—though slower than we previously expected. We see a mix of good and bad in the fundamental picture, and we're closely watching risks—including waning confidence.

Volatility Tempers Equities

Based on long-term fundamentals, stocks offer sizable return potential, and corporate fundamentals are sound. From that standpoint, the arrow points to stocks. But the near-term assessment shows a bumpy road ahead, and risk aversion is very high.

The volatility in our forecast reduces our appetite, with stocks warranting an underweight relative to their long-term strategic allocation. Effective fiscal solutions and better economic growth are key signposts that would make us more positive on stocks.

Despite our caution toward equities, we believe investors should actively pursue opportunities within their stock allocations: we see much long-term potential in the market today.

Stocks are attractive long term…
but watch the volatility.

AllianceBernstein Capital Market Forecasts

	Potential Volatility	Potential Return
Global Stocks	Above Average	Above Average
Global Bonds	Below Average	Below Average

AllianceBernstein Economic Forecasts

Real GDP Growth	2011F	2012F
Global	2.8%	2.8%
Developed	1.5%	1.8%
US	1.9%	3.0%
EM	6.2%	5.5%

Inflation	2011F	2012F
Global	3.5%	2.7%
Developed	2.5%	1.9%
US	3.1%	2.5%
EM	5.8%	4.6%

Forecasts may not be achieved.
As of September 30, 2011
Volatility is measured by the standard deviation of annual returns. Above average means that, based on our models, the projected volatility or return is likely to exceed the long-term average for that particular asset class. Below average means that, based on our models, the projected volatility or return is likely to fall below the long-term average for that particular asset class.
Source: AllianceBernstein

There is no guarantee that any forecasts or opinions in this material will be realized. Information should not be construed as investment advice.

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Europe's Woes Cast a Growing Shadow

Developments in Europe will likely have a continuing impact on the global economy. Growth in emerging markets is still setting a relatively strong pace, but in much of the developed world, confidence is in short supply.

Soaring Risk Aversion

The equity market's gyrations have been driven by high anxiety. Based on our measure of global risk aversion, markets haven't been so skittish since the 2008 global financial crisis. It's akin to post-traumatic stress—a legacy of the global meltdown—with fear driving markets.

As a result, the fundamental laws of stock valuations have been suspended for the time being. Stocks in general are being painted with the same brush, with the distinctions between the financial strength and results of individual companies being ignored. Instead, the market has moved in broad waves: risk on and risk off.

The Euro Area's Fiscal Struggles

Europe remains at the center of the storm. Granted, the euro area is not a monolith: some nations, notably Germany, are faring much better based on economic growth and fundamentals. But Greece is teetering on the edge of default, and fears of contagion to larger economies such as Italy and Spain are key.

A structural flaw many see in the euro area is unified monetary policy but little in the way of fiscal unity. In our opinion, the euro area cannot continue in this form. The flaw has been amplified by the problems in Greece, which is debt-heavy, plagued by social turmoil as it enacts austerity measures—and dependent on massive aid from other euro nations.

Greek Default: If…or When?

We've laid out three possible scenarios for Greece over the next few months.

First, the euro area could muddle through, doing enough to avoid a Greek default for the time being. This would probably do little to satisfy markets in the near term. Second, Greek debt could be written off in an orderly way, along with reform of public finances and extra liquidity for banks. The third and most dangerous path is a disorderly default: Greece would run out of financing, with its economy and banking system likely collapsing—and possibly forcing Greece out of the euro area.

We think the most risky scenario is least likely, since everyone wants to avoid it. But even if one of the other two scenarios occurs, questions will linger as to whether contagion can be limited. This pessimism could feed a downward spiral that might prove difficult to contain. Coordinated, decisive action from Europe's policy makers is urgently needed.

Expect Continued Growth in Asia

In other areas of the world, fundamentals are more positive. Japan's economy is recovering from March's earthquake and tsunami. We estimate that Japanese GDP (gross domestic product), a common measure of economic output, will have expanded at an annualized pace of more than 6% during the third quarter, once final numbers are tallied.

The rest of Asia has grown more impressively. Outside of Japan, we see year-over-year growth in GDP at 7.4% for 2011. And, while China's growth rate is slowing, we don't think a hard landing is likely. Demand from China and other Asian nations for exports from the developed world is helping to make up for flagging consumer demand in those more mature economies. Of course, if conditions deteriorate elsewhere in the world, it would hurt Asian growth through global trade links.

Modest US Growth Amid Uncertainty and Insecurity

Tepid consumer demand is nothing new to the US in this economic cycle. Big stock market declines over the summer will likely leave households feeling more vulnerable, somewhat offsetting the benefits of shedding significant amounts of debt.

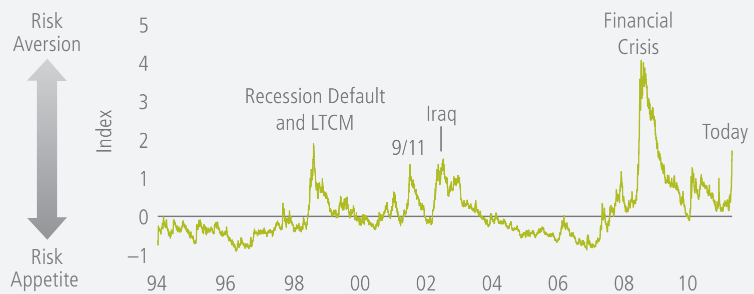
We've reduced our growth estimates for the second half of 2011 and lowered our 2012 growth forecast to 3%. This is above the consensus view, largely on the back of our forecasts for exports and capital expenditures.

We don't think a lack of liquidity is preventing stronger US growth; instead, we blame uncertainty about taxes, deficits and regulation. For the economy to grow faster in 2012, some of these issues must be resolved.

We also can't overlook how important confidence can be in determining the ultimate outcome: surveys of households and businesses show increasing pessimism in the US and many other developed economies. For instance, the European Commission's economic sentiment indicator—a widely followed indicator in the euro area—dropped sharply to 95.0 in September, its lowest level in almost two years and well below the long-term average of 100.[1] If this persists or worsens, it could lead to further hunkering down, chilling economic activity and making a greater slowdown a self-fulfilling prophecy.

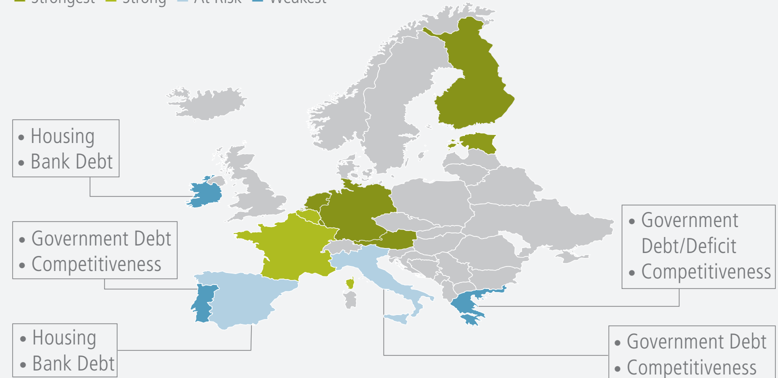
Risk aversion has surged to its highest level since the global financial crisis

Global Risk Aversion Indicator*



Historical analysis and current estimates do not guarantee future results.
Through September 30, 2011
*Measures the degree of risk aversion by combining the implied volatility of equities, currencies, commodities and bonds with credit spreads and mutual fund flows.
Source: FactSet, MSCI and AllianceBernstein

How far could problems in the periphery of the euro area spread?



As of September 30, 2011
Source: AllianceBernstein

[1]As of September 29, 2011. (European Commission services).

Short-Term Pain, Long-Term Gain?

Investors should prepare for more equity volatility ahead. But, with markets ignoring key differences between stocks, active management can identify attractively valued long-term opportunities.

Stocks Traveling in Lockstep

Investing in stocks was a challenging proposition during the third quarter. As July began, world equity markets were still nursing slightly positive returns, despite a difficult road. But stocks plummeted steadily in late July and early August and remain turbulent.

The result is clearly visible in the high correlation between stock returns—a measure that indicates how closely the performance of individual stocks track each other. Since the mid-1990s, the correlation between global stocks has averaged 0.2, not much above 0, which indicates no statistical relationship. But correlation has fluctuated over time, and today it's about as high as it's ever been—nearly three times its long-term average.

Good Companies at Attractive Prices

There's a bright side to this herding of stock returns—if investors aren't differentiating between weaker and stronger companies, it stands to reason that good companies can be purchased at bargain prices.

Stocks are indeed attractive. In the US, for example, the equity risk premium—or the compensation for investing in stocks versus bonds—stood at 8.5% at the end of the third quarter.[2] This risk premium is much bigger than average. So, while the volatility today argues for an underweight of equities relative to their long-term target allocations, we see opportunities that active management can help capture.

Being Paid to Weather Equity Volatility

For investors who can persevere through equity volatility to take advantage of a long-term opportunity, it makes sense to get paid to wait out the storm. That compensation can come in the form of dividend-paying stocks of cash-rich corporations. Dividends can provide steady income for investors, and dividend yields today exceed those of intermediate-term bonds for many companies.

Our research suggests that dividend-paying stocks tend to reward investors over time—and could end up being less volatile overall than the broader equity market. However, taking advantage of equity-income opportunities isn't quite as straightforward as picking the stocks with the highest dividend yield: the top 20% of stocks in terms of dividend yield haven't actually been the best performers.

Why is this? The highest yields might signal a company that's fundamentally weak or a company that may be paying an unsustainable dividend. Historical returns reveal that it's actually the *next* 20% of dividend-yielding stocks that have ended up on top. This relationship was especially true during the global financial crisis. Cash-heavy companies might also reward investors through share buybacks, which reduce the number of shares outstanding and tend to boost per-share prices. These gains may further enhance returns.

Pursuing equity-income strategies can be an effective strategy for investors who want to ride out the market's volatility and receive additional compensation for doing so. But it takes disciplined research and active management to build a portfolio of strong dividend-paying stocks while avoiding weaker ones—particularly those that may be forced to reduce dividend payments.

[2] Forecasts may not be achieved. As of September 30, 2011. Data do not represent past performance and are not a promise of actual results or range of future results. Bonds are represented by 10-year Treasury yields; stocks by the S&P 500. An individual cannot invest directly in an index. Please see back cover for index definitions. (Bloomberg, Standard & Poor's and AllianceBernstein)

Small Caps Going Global

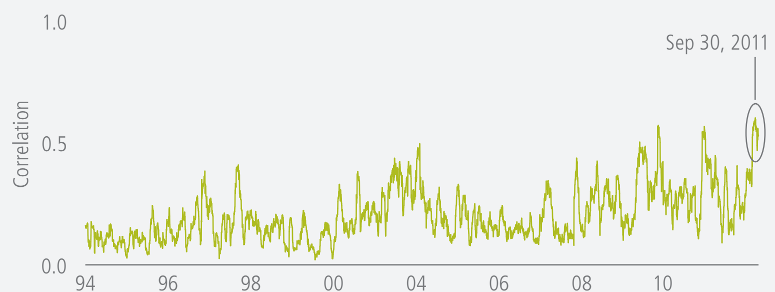
Another area where we think active management can provide an edge is in small-cap stocks, which have historically outperformed large-cap stocks over the long run. Small caps tend to be less traveled by research analysts, so there's a greater chance that a true information advantage can help an active investor stand out.

The increasingly global nature of smaller firms may also be making a global research focus more important. In 1990, non-US sales accounted for about 9% of the total revenue for US small-cap firms; by 2010, that percentage had risen to over 20%.[3] Businesses are also becoming more diversified in the markets they use as sources for parts and other inputs they need to do business.

Think of an auto-parts supplier in the Midwestern US—even one that sells predominantly to US customers. This business may by obtaining brake parts, oil filters, hoses or other items from markets as far away as Latin America or Asia. When something happens that affects the global supply chain, it's extremely advantageous to have a global research network to help understand the possible ramifications to the firm being analyzed.

With fear driving markets, stock returns have been highly correlated

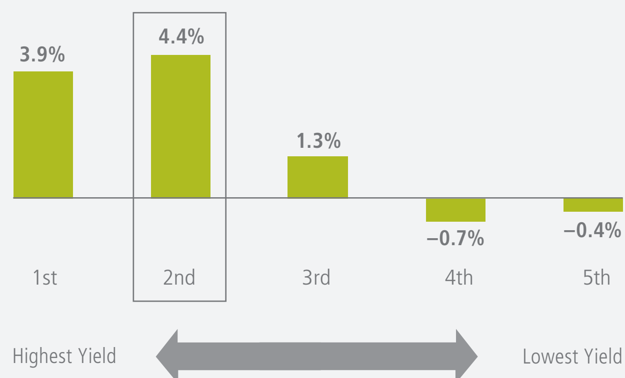
MSCI World Intra-Market Return Correlations*



Historical analysis and current estimates do not guarantee future results.
Through September 30, 2011
*Correlation using rolling daily returns over 30 days
Individuals cannot invest directly in an index. Please see back cover for index definitions.
Source: Credit Suisse, MSCI and AllianceBernstein

It's not necessarily the highest-yielding stocks that outperform

Long-Term Excess Return by Dividend Yield Quintiles (1971-2011)*



Current analysis and past performance do not guarantee future results.
*As of August 31, 2011. Based on the AllianceBernstein US Large Cap stock universe; excess return relative to the universe average.
Source: AllianceBernstein

[3]Small caps are represented by the Russell 2000 Index. (Russell Investment Group and AllianceBernstein).

Potential in Real Assets and Bonds

Real assets and high yield offer investors avenues to further diversify their equity exposure, while high-quality bonds continue to serve as a vital stabilizer, given increased equity volatility.

The "Twinflation" Challenge

For equity investors searching for greater diversification, real assets can serve as an effective complement to stock exposure—while adding inflation protection potential to a diversified portfolio.

Inflation may not seem like the top concern in some economies, but many developed economies face high debt, big budget deficits and slow growth today. Policies to address these trends create the potential for stagflation—low growth and high inflation—in developed markets. At the same time, emerging markets are growing much more steadily than developed economies and are more commodity-intensive, adding to upward price pressures.

The effects of this "twinflation" create a positive longer-term environment for real assets—including commodities, natural resource stocks and real estate investment trusts. Meanwhile, equities face headwinds in many economic environments where real assets thrive. We think this makes the case for diversifying equity portfolios with real assets—specifically, a diversified, actively managed mix of real-asset types.

High Yield: Equity Substitute?

In a volatile equity environment, high-yield corporate bonds could be a way to access historically equity-like returns with much lower volatility than stocks. High-yield has also demonstrated a low correlation to other investment types, aiding in diversification. These attributes may argue for giving high yield its own seat at the asset-allocation table within the larger portfolio context.

While we think capital markets will be more volatile ahead, our research also indicates that underlying business fundamentals remain strong—a point in favor of high-yield corporate debt. In addition to record profits and strong cash flows, many companies have refinanced their short-term debt into longer-term debt, alleviating concerns about near-term refinancing risk.

Despite these positives, concerns over economic fundamentals have pushed up high-yield spreads—the extra yield offered (versus government bonds) as risk compensation. If the bad-news scenarios don't unfold, these yield spreads could decline, enhancing high-yield returns.

High-Quality Bonds: Low Yields, But Vital Diversification

Since we expect volatility ahead for stocks, we think investment-grade bonds should be overweight versus their long-term targets. But government bond yields in key developed economies are near all-time lows. What's the best approach to investing in bonds?

First, bear in mind that one of the key benefits of bonds in a balanced portfolio is diversification, acting as a counterbalance to the typical return path of stocks. However, there are strategies bond investors can pursue to enhance this vital portfolio component. Global diversification is critical because the world's bond markets don't move in lockstep. Adding other bond sectors, such as corporate bonds, can offer diversification and return potential.

Another source of returns is "rolling down the yield curve." Short-term bond yields today are much lower than intermediate-term yields—a chart of interest rates at different maturities (known as the yield curve) appears to slope steeply in this environment. As intermediate-term bonds age, they gradually become shorter-term bonds that pay higher income than other short-term bonds. As these bonds "roll," their value can receive a boost, and actively managing this ride can enhance returns.

Opportunities Magnified in Municipal Bonds

Despite persistent alarmist headlines about municipal bonds, their potential is even more pronounced than taxable bonds.

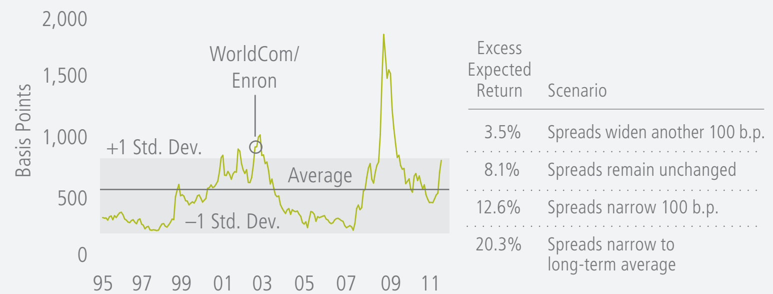
No doubt, municipalities have faced their share of challenges, including cutbacks in federal aid. But, we felt all along that the headlines were overstating the risk in much of the muni market. State and local governments have been tackling their issues using budget cuts, taxes, fees and other tools. These choices are painful, but the net result is stronger fundamentals than headlines imply.

For investors who take credit risk, municipal bonds offer attractive compensation—relative to historical municipal bond risk premiums. In addition, at many maturities, municipal bond yields are higher than those of their taxable counterparts—even before factoring in the tax-exemption of muni bond income. And the municipal bond yield curve is extremely steep today, providing ample roll opportunities.

Of course, in the municipal bond market, which is fragmented and can be challenging to navigate, a strong research effort and active management are the keys to capitalizing on opportunities: spotting potential in a broad swath of the muni market is one thing; realizing that potential by picking individual bonds is another.

High-yield corporate bonds could be a way to access historically equity-like returns

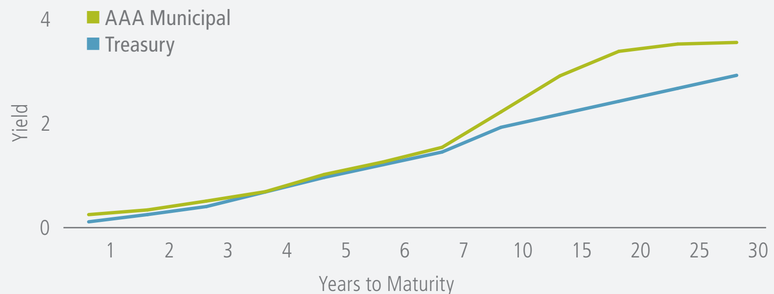
US High Yield, Spreads to Treasuries



Historical analysis and current estimates do not guarantee future results.
Spreads are option adjusted. Average and standard deviation are for January 1995 through September 30, 2011.
Expected return calculations are highly simplified and for illustrative purposes only. Assumptions:
12-month horizon; 4.53-year duration; change in spread (if any) occurs on last day of period.
Source: Barclays Capital and AllianceBernstein

Municipal yields are very attractive relative to Treasuries

AAA Municipal vs. Treasury Yield Curve



Historical analysis and current estimates do not guarantee future results.
As of September 30, 2011
Source: Municipal Market Data Corp. and AllianceBernstein estimates for AAA-rated, callable municipal bonds

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- Exploring the opportunities and risks of the world's capital markets and the innovations that can reshape them
- Helping investors overcome their emotions and keep their portfolios on track
- Defining the importance of investment planning and portfolio construction in determining investment success

Our research insights are a foundation to help investors build better outcomes. Speak to your financial advisor to learn how we can help you reach your goals.

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Index Definitions: The **MSCI World Index is a market capitalization-weighted index measuring the performance of stock markets in 23 countries.** Widely regarded as the best single gauge of the US equities market, this world-renowned **Standard & Poor's 500 Index** includes a representative sample of 500 leading companies in leading industries of the US economy. The **Barclays Capital US Corporate High Yield Index-2% Issuer Constrained covers the USD-denominated, non-investment grade, fixed-rate taxable corporate bonds that are classified as high yield in the middle rating of Moody's, Fitch and S&P as Ba1/BB+/BB+ or below. Excludes Emerging Market Caps issuers at 2%.** The **Russell 2000 Index** is a subset of the Russell 3000 Index. It includes approximately 2,000 of the smallest securities based on a combination of their market cap and current index membership. MSCI makes no express or implied warranties or representations, and shall have no liability whatsoever with respect to any MSCI data contained herein. The MSCI data may not be further redistributed or used as a basis for other indices, any securities or financial products. This report is not approved, reviewed or produced by MSCI. An investor cannot invest directly in an index.

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