AllianceBernstein

Fall 2010

CAPITAL MARKETS OUTLOOK

Navigating Through a Soft Patch

The global economy was slowing down entering the fourth quarter, with economic data yielding a mixed bag and markets calming down. But growth remains positive, and there's opportunity amid the rough spots.

The US Recession Is Declared Over

There were no bells sounding or trumpets blowing when the National Bureau of Economic Research declared that the Great Recession in the US had ended back in June 2009. Grim acknowledgment that the economy had managed to climb from the abyss was coupled with the recognition that plenty of uncertainty remains.

September's global equity rally brought welcome relief from what has otherwise been a frustrating and difficult 2010. Consumers and businesses struggled to cope with a wall of worry built from stubborn unemployment, huge government budget deficits, slowing growth in the Chinese economy and uncertainty about government regulation.

Slower Growth…But Opportunities Remain

As abundant concerns—both new and old—rolled across the front pages of newspapers or flashed onto television screens, the global economy continued to trudge through a soft patch. The pace of global growth has slowed considerably, and optimism has been tempered by mixed economic data—but the world economy did make progress.

It's understandably hard to remain on an even keel when markets are churning, but the truth is that chaotic environments can also create potential. In fact, it's often when conditions seem particularly bleak that opportunity is present in undervalued securities, sectors or asset classes.

Stocks are up in 2010, while bonds have produced solid returns

Major Index Returns (in USD)
As of September 30, 2010

Equities	Q3	YTD
Emerging Markets	**18.0%**	10.8%
EAFE	**16.5%**	1.1%
US	**11.3%**	3.9%
Credit		
EM Debt	**8.1%**	14.2%
Global High Yield	**7.4%**	12.8%
CMBS	**6.4%**	19.3%
Global Corp.	**4.0%**	8.9%
Government Bonds		
US	**2.7%**	8.7%
Euro Area	**2.3%**	4.8%
Japan	**1.1%**	3.3%

Past performance does not guarantee future results. Individuals cannot invest directly in an index. Please see back cover for index definitions.
Source: Barclays Capital, FactSet, Morgan Stanley Capital International (MSCI), Standard & Poor's and AllianceBernstein

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The Economic Expansion Slows

A decelerating global economy, a still-weak jobs outlook and a sluggish housing market are feeding a wall of worry. We've reduced our forecast for global growth, but we still see activity expanding through 2011.

Weak Housing Weighs on Consumers

As the global downturn faded further in the rearview mirror, jobs and homes remained among the key concerns for consumers in many countries, including the UK and the US. Signs of improvement are apparent, but both of these issues are sapping the economy of much-needed traction.

In the US, a housing collapse has taken a financial toll on homeowners' balance sheets and a psychological toll on the entire consumer sector. Excess supply related to overbuilding and a glut of home foreclosures still choke the market. Construction cutbacks have reduced the surplus, but it will take a while to clear this overhang. A home buyers' tax credit lifted demand for a time, but its expiration has exposed persistent weakness and fed fears of additional price declines.

Home prices in the UK dropped slightly during the third quarter, despite a slight uptick in September. Both the demand for and supply of homes remain low, as consumers continue to fret over a weak employment outlook.

A Stubborn Jobs Deficit

Unemployment continues to be a heavy drag on many parts of the world economy. Late in 2009, unemployment peaked at 7.9% in the UK, 10% in the euro area and 10.1% in the US. While the overall rate appears to have crested in these markets, job creation has been relatively weak in this recovery compared with prior rebounds.

In the US, for example, even sectors that have traditionally produced new jobs and helped lift the economy up, such as health care and other economically insensitive industries, haven't shouldered as much of the burden this time around.

Also weighing on the labor picture is the absence of job creation by small and medium-sized businesses. Small businesses created more than 60% of jobs in the US in the last 30 years, but less so in recent years—and they actually shed the most jobs in the recent downturn.[1] Leaders of small businesses also remain much more pessimistic than CEOs of large firms.

Fiscal Deficits and Policy Uncertainty Still Loom

Meanwhile, governments in many corners of the world are still grappling with massive deficits. At one point, these fiscal issues even called into question the solvency of nations themselves, feeding a groundswell of concern.

Some southern European nations have made progress in addressing their budget gaps. Spain, for one, reduced its deficit for the first seven months of 2010 to €25.9 billion, compared with a €49.8 billion deficit in the same period in 2009.[2] This progress has eased some of the fiscal pressure faced by governments, but efforts to improve national balance sheets must also avoid snuffing out growth.

The US also faces yawning budget gaps and a political tide that could shift meaningfully in November. Tax rates were still in question at the end of the third quarter, while health care legislation has many unanswered questions and unknown effects. As financial reform measures sweep the globe, they create added uncertainty in a vital—and still-healing—system.

This ambiguity creates a natural tendency for individuals and businesses to put plans on hold: buying a new car or home, hiring new workers at a family-owned business or initiating a major corporate expansion.

[1] US Census Bureau, Bureau of Labor Statistics and AllianceBernstein
[2] AllianceBernstein *Economics: European Perspectives* September 17, 2010

The Economy Downshifted…But the World Isn't Ending

Much concern has been expressed about the state of the flagging economy—some coming even from high-level policy makers.

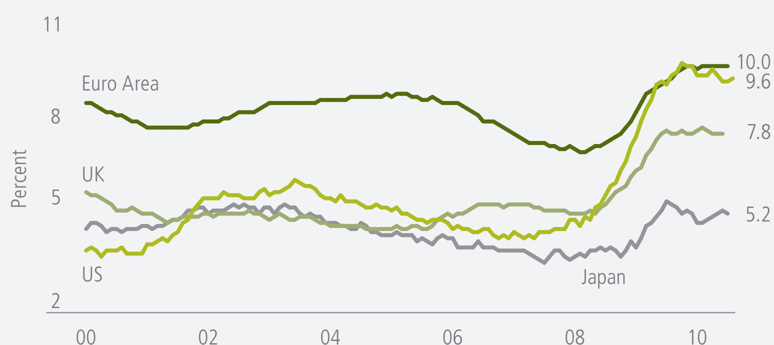
Indeed, weaker-than-expected second-quarter economic reports from the US and Japan led us to slightly lower our 2010 growth estimate for global gross domestic product (GDP)—a measure of overall economic output—to 3.7%, adjusted for inflation. We expect US GDP to grow by a modest 2.8% this year, down from previous estimates. Growth in other developed economies has also moderated. On the other hand, China's growth hasn't slowed as much as was first feared.

Global manufacturing and trade reports paint a picture of growth, although at a slower pace than the first half of 2010. A global index of manufacturing purchasing agents slipped to a 52.5 reading in September, the lowest since July 2009, but still above the demarcation line of 50, which indicates expansion.[3] Emerging markets continued to snap up goods exported from developed markets like the US, Germany and Japan—partially countering weaker demand from consumers and businesses in those countries.

What's more, credit markets in the US continued to recover. While the patient has merely moved from critical condition to fair, there are signs that loans could be starting to flow again from banks to small businesses—key engines of economic growth.

Unemployment may have crested, but it remains stubbornly high

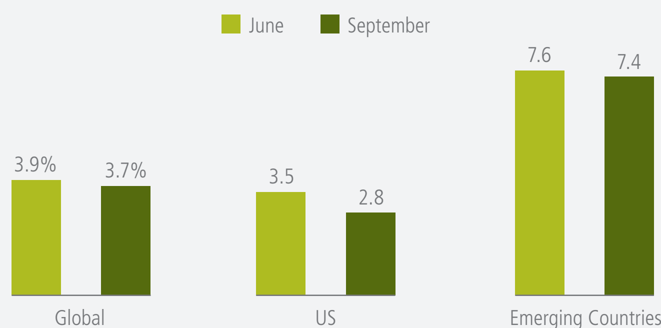
Unemployment Rate



Historical analysis does not guarantee future results.
UK data through June 2010; euro area and Japanese data through July 2010; US data through August 2010
All data are seasonally adjusted.
Source: Eurostat, Haver Analytics, Statistics Bureau of Japan, UK Office for National Statistics and US Bureau of Labor Statistics

We've lowered our growth forecast, but the world economy is still expanding

AllianceBernstein 2010 Real GDP Forecasts



Forecasts are as of month-end, subject to change and may not be attained.
As of October 1, 2010
Source: AllianceBernstein

[3]JPMorgan Global Manufacturing PMI Index as of September 2010. Please see back cover for index definitions.

Bond Bubble or Safety Bubble?

As money pours into government bonds, yields have fallen. To boost return potential, investors should consider looking beyond government securities—and across borders—to sectors like corporate bonds.

Assets Seeking Shelter

Investors began moving money back into global capital markets in 2009, but the money flowing in has, for the most part, been jumping the fence from the unnerving volatility of equities to the more stable ride of bonds. And a significant portion of the assets seeking shelter in fixed-income markets has found its way into government bonds.

This virtual flood of capital has continued to push government bond yields down to levels rarely seen through history. Take the 10-year US Treasury bond: its yield in October 2007 was 4.5%, by September 2010, it had tumbled to a mere 2.5%.[4] In the euro area, 10-year German bond yields today, at 2.3%, are just over half their October 2007 levels.[5]

The downward slide in bond yields has fueled fears among some investors of a new kind of asset bubble…in this case a "bond bubble." With bond yields so low, the worry is that the air will eventually come out of demand for these securities, leading to a painful period for fixed-income assets.

Opportunities Beyond Government Bonds

Based on our assessment, the market isn't so much creating a bond bubble as building a safety bubble. Government bonds and money-market securities have been driven to historically low yields; non-government bonds, notably corporate bonds, still hold value for investors willing to take on additional risk.

Let's take a closer look at US high-yield bonds, which have historically produced attractive risk-adjusted returns. At the depths of the financial crisis, as many investors saw Armageddon in the making, expectations built for a massive wave of high-yield bond defaults. A few intrepid investors ventured into the high-yield market early on, and the crowd gathered as credit markets continued to thaw.

Still Potential in High-Yield Bonds

The expected default tsunami never materialized, as evidenced by a recent estimate from credit-rating agency Moody's Investors Service. The agency expects defaults to decline to pre-crisis levels by year-end. Meanwhile, high-yield bonds have surged, chalking up a 77% cumulative return between January 2009 and September 2010.[6]

As high-yield bonds soared, the yield advantage they offer over Treasury bonds as compensation for their greater risk fell. From its peak near 18% in November 2008, this yield "spread" has fallen to about 6.2%. That's still an above-average yield premium, so we see further potential in high-yield bonds. Of course, past returns don't guarantee future success, so investors shouldn't assume that such stellar returns will continue.

Non-government bonds still hold value for investors willing to take on additional risk.

[4]Bloomberg
[5]As of September 30, 2010. Bloomberg
[6]**Past performance does not guarantee future results.** As of September 30, 2010. US high-yield bonds are represented by the Barclays Capital US Corporate High Yield, 2% Issuer Capped Index. An individual cannot invest directly in an index. Please see top chart on the following page for index definition.

Looking Beyond Borders

Although the yield spreads and returns we reviewed pertain to US high yield, we believe that the high-yield story is global. Attractive potential in high-income-producing securities is becoming less and less concentrated in individual regions of the world.

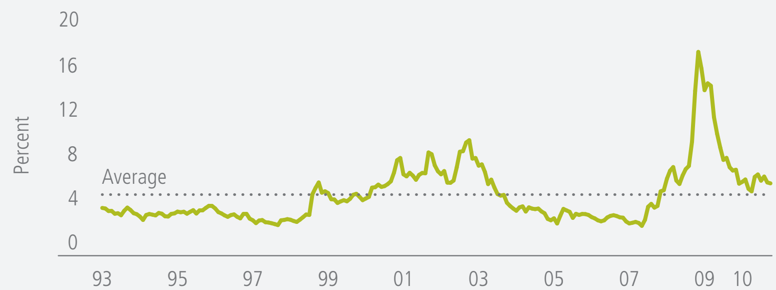
Non-US markets have rapidly grown to become equal partners in the global universe of corporate bonds—that's including both high-yield and investment-grade securities. Only a decade ago, non-US corporate bonds accounted for about a third of the global total. Today, that share has expanded to half, as the pace of issuance in markets outside of the US has accelerated.

The burgeoning European high-yield bond market, for instance, was virtually nonexistent before 1997. However, it's grown by leaps and bounds over the past decade or so, a process that was certainly accelerated by the birth of the euro currency.

With opportunities such as these in many regions of the world, it makes sense for investors to adopt a global approach to high-income opportunities in their portfolios. Whether it's a bond in the US, euro area or Latin America, investors should consider expanding their horizons by looking beyond borders.

The extra yield on high-yield bonds versus Treasury bonds is still above average

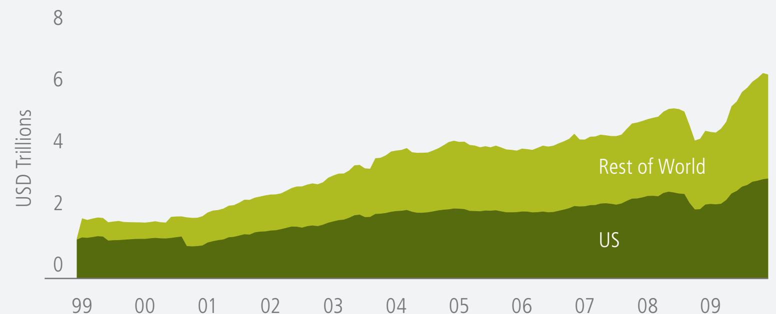
Extra Yield of US High-Yield Bonds versus US Treasuries



Past performance does not guarantee future results.
As of September 30, 2010
Data is represented by the Barclays Capital US Corporate High Yield, 2% Issuer Capped Index, which 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 is Ba1/BB+/BB+ or below. An investor cannot invest directly in an index.
Source: Barclays Capital and AllianceBernstein

Non-US securities now make up about half of the world's corporate bonds

Investment-Grade and High-Yield Outstanding Debt*



Historical analysis does not guarantee future results.
As of December 31, 2009
*US is represented by Barclays Capital US Investment-Grade Corporate and High-Yield indices. Rest of the world is represented by a blend of the following Barclays Capital indices: Euro-Aggregate Corporates, Pan European High Yield, Japan Corporate, and Non-Japan Asia USD Credit and JPMorgan Emerging-Market Debt in USD. An investor cannot invest directly in an index. Please see back cover for index definitions.
Source: Barclays Capital, JPMorgan Chase and AllianceBernstein

Equities Have Been Volatile

Stocks haven't been very hospitable to investors so far in 2010. Through September, the MSCI World Index, representing global stocks, was just slightly above where it stood at the beginning of the year. But it took a circuitous route to get there: losing 9.6% and 3.4% in May and June, respectively; gaining 8.1% in July; falling back 3.7% in August; and gaining 9.3% in September.[7]

We still see a relatively uncomfortable road ahead, so investors should bring a strong measure of resolve to equity markets and be prepared for the possibility of renewed bouts of volatility. But, based on our analysis, stocks are still attractively priced and fundamentals are encouraging. Corporate earnings have been strong, and larger companies have sound balance sheets with abundant cash and low debt.

Stocks Have Traveled in Herds

However, it's more challenging today for investors to be rewarded for identifying individual stocks that will stand out for the right—or wrong—reasons. The market hasn't distinguished much between stocks, even though the prospects of the companies they represent can be very diverse.

In statistical terms, the correlation between stocks—the degree to which they move together—is almost as high as it was at the market's bottom in early 2009. When correlations are rising, as when risk aversion grips the market, it's harder to win by picking individual stocks—even in less efficient markets like small-caps, where we see a better chance for research to make a difference. As correlations fall again (as they did throughout 2009), we expect individual stocks to increasingly drive returns.

Historical analysis does not guarantee future results.
As of October 1, 2010
Source: Credit Suisse, MSCI and AllianceBernstein

Investing with the Big Picture in Mind

However, another approach to stock investing may provide an alternate route for investors to tap equity potential. Thematic investing views opportunities through a different lens: employing a big-picture perspective to identify major trends that could have a sweeping impact across sectors.

For example, three decades ago personal computers were just beginning to arrive on the scene. At the time, few would have imagined that the technology sector would grow to represent nearly 20% of the S&P 500 Index by the first quarter of 2010.[8]

What themes will color tomorrow's opportunities? According to our research, they could range from a massive effort to abate climate change to new genetic therapies that redefine medicine.

Although top-down thematic investing and bottom-up stock selection may be in favor at different times, each can help investors capture opportunities—while being complementary in a combined portfolio.

[7] FactSet and MSCI
[8] Jeremy J. Siegel, professor University of Pennsylvania Wharton Business School, Standard & Poor's and AllianceBernstein

Understanding the Risk of Safety

Assets that provide shelter from market risk aren't nearly as effective as other assets at building wealth over the long term—especially when the impact of inflation is taken into account.

Low Yields in Safe-Haven Assets

Although we see value in stocks and non-government bonds, we acknowledge that markets may be vulnerable to sudden surges in volatility ahead. But market risk isn't the only risk investors need to think about when deciding where to put their assets to work. Investing in low-return assets that reduce or eliminate market losses can also present challenges.

That there can be risk in safety may sound like a strange concept, but when you're building wealth for the future, return potential is extremely important as well. Playing it too safe for too long in investments that provide low returns could cause you to fall short of your long-term wealth-building goals.

US Treasury bills provide a good example. They protect assets from market fluctuations, and there's virtually no chance of default. However, they offer only a tiny return in exchange for that security—T-bill yields are barely above 0% today. You'll probably maintain a smooth ride, but you'll do little to accumulate wealth for later in life.

Inflation Can Erode Wealth-Building Efforts

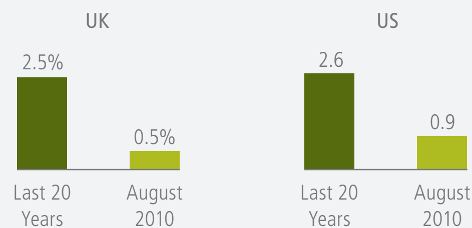
There's also the impact of inflation to consider. As we save money for the future, the prices of the goods and services we'll need to live on are also rising. If we subtract the expected rate of inflation from available bond yields, we can gauge not only the ability of an investment to generate returns but also to outpace the rising cost of living.

These inflation-adjusted, or "real," yields on government bonds are extremely low today. US Treasury bills actually have negative yields with inflation factored in, and even longer-term bonds offer very low real yields. For 10-year US Treasury bonds, the real yield has historically averaged about 2.6%; today, it's under 1%. And for 10-Year UK government bonds, the real yield has averaged about 2.5% through history; today, it's only 0.5%.

Once rising prices are taken into account, investors may find that they're earning even less than they thought they were by avoiding more volatile investments that are better at battling inflation. Viewed from this perspective, safety can exact a very steep price.

Real government bond yields are extremely low today

10-Year Treasury Real Yields (Nominal Yield Less Inflation)



Current valuations and historical analysis do not guarantee future returns.
As of August 31, 2010
Source: Bank of England, Bloomberg, Federal Reserve Bank of Cleveland and AllianceBernstein

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For the chart on page one, emerging market equities are represented by the MSCI Emerging Markets Index; non-US developed equities by the MSCI EAFE Index; and US equities by the S&P 500 Index. Global high yield is represented by the Barclays Capital Global High-Yield Index, US CMBS by the Barclays Capital Commercial Mortgage-Backed Securities (CMBS) Index, emerging market debt by the Barclays Capital US Dollar Emerging Markets Index and global corporate bonds by the Barclays Capital Global Corporate Bond Index. Euro, Japan and US government bonds are represented by the Barclays Capital Euro Treasury, Japan Treasury and US Treasury indices, respectively. Please see the definitions below for further details.

Index Definitions: The **Standard & Poor's 500 Index** is a common measure of the performance of the overall US stock market. The **MSCI EAFE Index** (Europe, Australasia, Far East) measures developed market equity performance, excluding the US and Canada. The **MSCI World Index** is a market capitalization–weighted index measuring the performance of stock markets in 23 countries. The **MSCI Emerging Markets Index** measures equity market performance in the global emerging markets. The **Barclays Capital US Dollar Emerging Markets Index** includes USD-denominated debt from emerging markets in the Americas, Europe, Middle East, Africa and Asia. The **Barclays Capital Global High-Yield Index** provides a broad-based measure of the global high-yield fixed-income markets and represents the union of the US High-Yield, Pan-European High-Yield, US Emerging Markets High-Yield, CMBS High-Yield and Pan-European Emerging Markets High-Yield Indices. The **Barclays Capital Commercial Mortgage-Backed Securities (CMBS) Index** tracks performance of publicly issued US dollar-denominated commercial mortgage-backed securities. The **Barclays Capital Global Corporate Bond Index** tracks performance of investment-grade corporate bonds publicly issued in the global market. The **Barclays Capital US Treasury Index, Barclays Capital Japan Treasury Index** and **Barclays Capital Euro Treasury Index** include fixed-rate, local currency sovereign debt that make up the US Treasury, Japanese Treasury and Euro Treasury sectors of the Global Aggregate Index respectively. The **Barclays Capital Global Treasury-UK Index** is the UK component of the Global Treasury Index. The **JPMorgan Global Manufacturing PMI Index** measures global economic and business conditions on a monthly basis. The **Barclays Capital US Investment-Grade Corporate Bond Index** and the **Barclays Capital Euro-Aggregate Corporate Index** are the corporate component of the **US Credit Index** and **Euro Aggregate Credit Index**, respectively. The **Barclays Capital Pan-European High Yield Index** covers fixed-rate, sub-investment-grade debt denominated in euros or other European currencies (except Swiss francs). The **Barclays Capital Japan Corporate Index** is the Japan component of the **Global Aggregate–Corporate Index**, which is the corporate component of the **Barclays Capital Global Aggregate Index**. The **Barclays Capital Non-Japan Asia USD Credit Index** represents USD-denominated securities that are issued by 13 Asian countries. **JPMorgan Emerging-Market Debt Index** currently includes USD-denominated Brady bonds, Eurobonds, and traded loans issued by sovereign and quasi-sovereign entities. 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.

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