The Markets Vacillate

Capital-Markets Outlook—April 2014

Feature: "The Capital Markets at a Glance," Page 5

The markets were in flux in the first quarter, reinforcing the benefit of asset and geographical diversification. But even as we monitor risk and return factors, we believe that the evidence suggests continued economic growth, supporting a pro-cyclical bent in our equity portfolios. In our Dynamic Asset Allocation service, we're maintaining a nearly neutral set of allocations, with a slight tilt toward stocks.

Asset-class returns varied significantly month-to-month in the first quarter (*Display 1*), with stocks losing ground in January, recovering in February, and alternating leadership with bonds in March. Over the three-month period, the S&P 500 beat its global counterparts, finishing the quarter with a return about in line with bonds. Developed-international stocks realized a smaller gain, and the emerging markets posted a modest loss (after a strong showing in February and March).

We can't put excessive weight on a period as short as one calendar quarter (indeed, if we look to the last 12 months, developed-market stocks beat bonds by a large margin).

But the fluctuations between New Year's 2014 and the end of March reflect shifts in investor sentiment, largely in response to macroeconomic factors. The markets' monthly performance changes—by asset class, geography, and (though not in our display) stock-investing style—are a compelling proof statement for the benefits of strategic diversification.

The tension introduced by Russia's annexation of Crimea and its potential incursion into other areas in eastern Ukraine hasn't had a great impact on the global markets to date. On the other hand, both the US and the European Union have levied economic sanctions against Russia, which could lead to escalating trade and political problems for all parties, especially considering the long-established trade relationship between Europe and Russia. The situation is in flux and highly volatile; we're monitoring it continuously.

Despite mixed economic data, our forecast is for modest growth. In the US, consumer and business balance sheets are healthy, and corporate earnings are growing at a solid clip: We look for GDP growth in the 3%+ range this year. Europe is coming out of a deep recession, with the economy and the labor market emerging from the doldrums. The jury is still out on Japanese Prime Minister Abe's economic program, but its intent is quite aggressive. And even in the slowing emerging markets, economic growth is expected to stay well ahead of the pace in the industrialized world.

Still, while most of the news about consumers and corporations is positive, we're cognizant of an array of

Display 1
The Ground Shifted Frequently in the First Quarter

Index Returns

	2014			
	Jan	Feb	Mar	Full Quarter
Stocks				
US	(3.5)%	4.6%	0.8%	1.8%
Developed-Market Int'l	(4.0)	5.6	(0.6)	0.7
Emerging Markets	(6.5)	3.3	3.1	(0.4)
Bonds				
Municipal	1.1%	0.7%	(0.3)%	1.5%
Taxable	1.5	0.5	(0.2)	1.8
Alternatives				
Funds of Hedge Funds	(0.4)%	1.7%	N/A*	N/A*

Past performance is not necessarily indicative of future results.
US stocks are represented by the S&P 500 index; developed-market international stocks by the Morgan Stanley Capital International (MSCI) EAFE Index of developed markets in Europe, Australasia, and the Far East; emerging-markets stocks by the MSCI Emerging Markets Index; municipal bonds by the Lipper Short/Intermediate Blended Municipal Fund Average; taxable bonds by the Barclays US Aggregate Bond Index; and alternatives by the Hedge Fund Research Inc.'s (HFRI's) Fund of Funds Composite Index. See "Information About MSCI" at the end of this report.
*The data are not yet available.
Source: Barclays, HFRI, Lipper, MSCI, and Standard & Poor's

risks (which is why our Dynamic Asset Allocation positioning is currently near neutral: *see below*).

Portfolio Implications

In stocks worldwide, we're leaning into cyclical industries, such as retailing, media, autos and housing, finance, and technology, to varying degrees by geography. Given our fundamental-research findings and the growing global economy, we're taking some extra exposure to economically sensitive companies.

At the same time, we're highly diversified by sector to help cushion risk and avoid overcommitment to a particular set of industries. As to valuations, while the bull market has passed its fifth anniversary, stocks globally look fairly valued (*see next page*), and indeed remain highly attractive versus low-yielding bonds.

Speaking of which, with many key interest rates *down* in the first quarter but expected to resume rising—indeed there were some increases between February and March—we're keeping our bond portfolios in the short- to intermediate-duration "sweet spot." And we're seeking out extra income along with extra sources of return. Overall, we anticipate modestly positive bond returns going forward.

Meanwhile, at this point we think it's likely that the Fed will continue tapering its bond purchases and hike the federal funds rate around mid-2015, or perhaps a few months earlier. We expect fed funds to level off about four years later—according to the latest Fed guidance at a level below the historical average of 4%.

For more information, see the first-quarter report to clients by Dianne Lob, Chairman of the Private Client Investment Policy Group, due out shortly.

Dynamic Asset Allocation Summary (*see box, top right*)

We are maintaining a close-to-neutral position in our allocations. We have a modest tilt toward return-seeking assets, focused on globally diversified stocks, and continue to be slightly underweight bonds.

- Equity performance in the developed markets has been strong over the last 18 months (and longer), reflecting a high degree of consensus about future growth. The rapid stock appreciation has brought valuations to near-average levels. And although volatility has edged up in the last few weeks, it remains at low levels.
- Interest rates are low. However, given US policymakers' intentions to gradually reduce liquidity, the global markets will likely become more sensitive to economic data.
- We are holding a small position in equity and interest-rate options to help offset the potential for an increase in volatility. We have also hedged some currency exposures.

Current Positioning

The recommended allocation for a 60/40 private-client investor is nearly neutral (*Display 2*). The weight in return-seeking assets has been gradually scaled back of late to its current level of 61%, via modest adjustments downward in February and March.

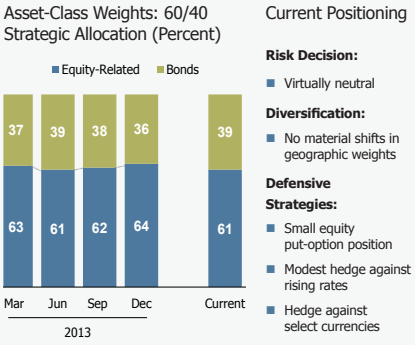
Meanwhile, market conditions remain largely benign. In the last 18 months, developed-market equity volatility has been low, and interest rates have also remained low. Over this period, we maintained an overweight to return-seeking assets (although the sizing and composition of the position have varied as our view of conditions changed), and as a consequence we captured additional upside for our clients.

However, stocks have appreciated rapidly, and recent economic data, though supporting continued growth, have been mixed relative to expectations. And so we have gradually taken down the risk in our portfolios toward neutral.

About Dynamic Asset Allocation

We continuously follow the capital markets, using our extensive research capabilities, with the goal of making short-term allocation adjustments to the portfolios of clients who have signed up for our Dynamic Asset Allocation (DAA) service. Since the inception of DAA, we've met our objective of reducing volatility while maintaining returns.

Display 2
Allocations Are Close to Neutral



As of March 24, 2014
Source: AllianceBernstein

A High-Consensus Market

As indicated above, market trends suggest continued economic growth. One way in which the market expresses a view on changing growth dynamics is in the slope of the bond-yield curve (the relationship between yields and maturities). A large difference between short- and long-term interest rates suggests that investors believe that rates will rise over time—likely owing to faster or persistent economic growth. *Display 3* plots the last 12 months of stock-market appreciation for various regions of the world against the slope of the yield curve in each location. It's clear that there is a strong alignment between these two factors.

In the US, for example, revisions in growth expectations have led to an unusually steep yield curve, while stocks have provided the greatest reward. The reverse is true in the emerging markets, where growth continues at a faster pace but where investors anticipate further slowing.

There is also a high degree of consensus that these trends will continue. *Display 4* shows a composite of growth forecasts for each of three major developed economies over the last 20 years. The current view is that recent modest expansion will continue.

What is more noteworthy is the uniformity of opinion: The dispersion among these forecasts is unusually compressed, as we show at the bottom of the display. And we're seeing a similar agreement in earnings forecasts. Lack of divergence in views may carry the risk that any disappointment could lead to a sharp downward market response. We're not predicting such an occurrence, but this risk is a consideration in our DAA positioning.

Returning to Normal?

We've been overweight stocks since late 2012. That decision was supported by some conditions that still exist today—notably, low interest rates and low equity volatility, but other metrics have changed.

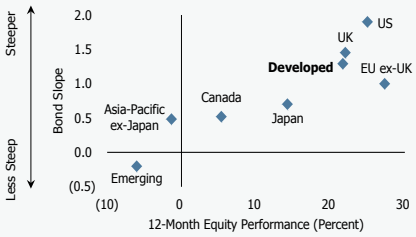
For one, valuations were highly attractive back then; **today, after double-digit returns in the developed markets, valuations are still reasonable—at about their long-term historical averages—while varying by region** (*Display 5, next page*). Prices are richer in the US, which has enjoyed the most buoyant recent market experience, and cheaper in the emerging markets, which have been going through a rough patch for quite a while now.

Of course, valuations should be assessed in the context of asset quality, and today, companies overall are showing unusual balance-sheet strength. In addition, stocks continue to be very attractive when measured against bonds.

Another issue to consider is the liquidity provided by central banks. Policy is not uniform across the major economies, but the US Federal Reserve has shown no inclination to abandon its plan to gradually reduce the pace of its bond purchases.

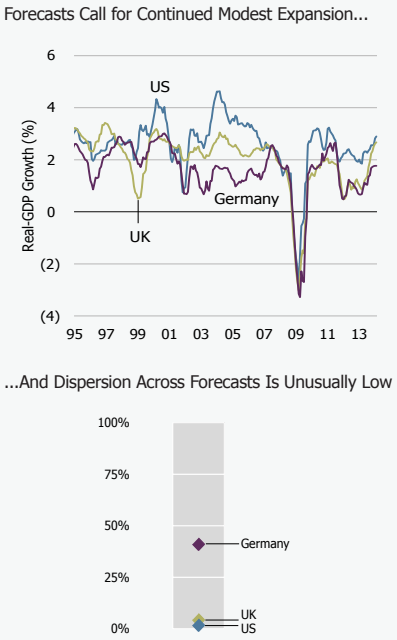
And so in the more normal market that we expect to see in the period ahead, without provocatively low valuations or extraordinary monetary

Display 3
Yield Curves and Stock Performance Reflect Economic Expectations



Past performance is not necessarily indicative of future results.
As of March 1, 2014
Equity performance is measured as the results over the last 12 months in USD for MSCI country and regional indexes. Bond yield-curve slope is a "Z-Score," which expresses the deviation in current slope away from the global average for each country and region, using a composite of 10-year minus three-month government-bond yields and 30-year minus 10-year government-bond yields.
Source: Bloomberg, MSCI, and AllianceBernstein

Display 4
Consensus Is Remarkable on Developed-Economy Growth Rates



Here and elsewhere in this report, historical analysis is not necessarily predictive of future results.
As of March 1, 2014
Forecasted GDP is the composite percent change over the next 12 months in consensus GDP forecasts for the current year and the following year. Dispersion in forecasts is measured as the standard deviation across the Consensus Economics sample.
Source: Consensus Economics and AllianceBernstein

accommodation, investors will need to rely on other signals for direction. Among the key indicators will be data on global economic health, and we systematically track such releases across all major economies. In a high-consensus environment, we are particularly interested in how the new data stack up against expectations: in other words, the degree of positive or negative surprise from actual versus predicted results.

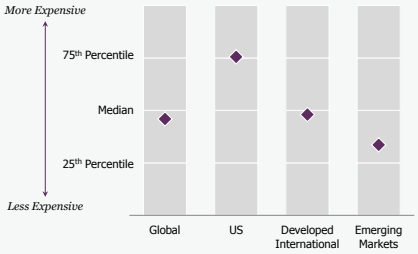
Our proprietary macroeconomic surprise indicator includes measures of employment, output, and sentiment across developed-market regions. The read has become more mixed of late. Still, where negative surprise exists, we need to be careful to take into account mitigating circumstances. For example, in the US it's not clear how much is transient, owing to severe winter weather.

Conclusion

The DAA team has positioned client portfolios to be close to neutral. As we weigh the factors discussed above, they do not provide us with the conviction to make significant adjustments to strategic allocations. However, we have chosen to maintain a small hedge on our equity and fixed-income positions, and have modified certain currency exposures in favor of the US dollar.

Display 5
Valuations Are Close to Average Globally but Dispersed Regionally

Global Developed Equity Markets: Quartile Rankings Since 1970*



As of February 28, 2014
Valuations are based on 12-month forward P/Es for the MSCI All Country World Index, the S&P 500 Index, the MSCI EAFE Index, and the MSCI Emerging Markets Index.
*Since January 1988 for the Emerging Markets
Source: MSCI, Standard & Poor's and AllianceBernstein

The Capital Markets at a Glance

As of Mar 31, 2014	GDP Estimates 2014F (AllianceBernstein)	Stock Indexes* March 2014 Return (USD)	Year-to-Date Returns (USD)	Price/Earnings Next 12 Months	March 2014 Dividend Yield
Global	3.1%	0.4%	1.1%	14.1x	2.5%
US	3.2%	0.8%	1.8%	15.2x	2.0%
Developed International†	1.9%	(0.6)%	0.7%	13.8x	3.1%
Emerging Markets‡	4.4%	3.1%	(0.4)%	10.0x	2.7%

	Current	One Month Prior	One Year Prior
Yields			
US Effective Federal Funds Rate	0.08%	0.06%	0.09%
US Treasury, 3-Month	0.05%	0.05%	0.07%
US Treasury, 5-Year	1.73%	1.51%	0.77%
US Treasury, 10-Year	2.73%	2.66%	1.87%
Municipal Bond 1–10 Yr. Barclays Index	1.70%	1.55%	1.33%
Exchange Rates			
US Dollars per Euro	$1.38	$1.38	$1.28
US Dollars per British Pound	$1.67	$1.68	$1.52
Japanese Yen per US Dollar	¥102.99	¥102.07	¥94.02
Commodity Prices			
WTI Crude Oil ($/bbl)	$101.58	$102.59	$97.23
Gold ($/ozt)	$1,283.40	$1,321.40	$1,594.80
US Unemployment Rate *(Feb 28, 2014)*	6.7%	6.6%	7.7%
US Inflation—CPI *(Feb 28, 2014)*	1.10%	1.56%	1.96%

Past performance is not necessarily indicative of future results.

**Stocks are represented by: Global—MSCI All Country World Index; US—S&P 500 Index; Developed International—MSCI EAFE Index; Emerging Markets—MSCI Emerging Markets. Index. S&P 500 returns include gross dividends reinvested; all others include net dividends reinvested. All returns are reported in US dollars.*

†Countries are weighted by 2012 nominal GDP; not all EAFE countries are individually forecasted, and Canada is not included in the EAFE Index.

‡Countries are weighted by 2012 nominal GDP.

Source: FactSet and AllianceBernstein

Disclosure About Dynamic Asset Allocation
There is no guarantee that the goals of the Dynamic Asset Allocation (DAA) overlay service will be achieved. An account invested in DAA may cause the account's overall exposure to equities, fixed income, real estate investment trusts (REITs), and other asset classes to vary significantly from the strategic long-term target allocations agreed upon for the account and may be different from information in this summary. Please read Bernstein's *Investment-Management Services and Policies* manual and the Prospectus for the DAA overlay portfolios for additional information about DAA, including the principal risks of investing in the DAA overlay portfolios.

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1345 Avenue of the Americas, New York, NY 10105, 1.212.486.5800

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