

Volatility Comes Off Its Lows

Capital-Markets Outlook—October 2014

The month of September saw volatility return to the markets, with the closely watched VIX climbing from 12.0% to 16.3%. Despite this rise, volatility is still below normal, and our Dynamic Asset Allocation service remains positioned accordingly.

Higher Recent Volatility

Volatility came off its lows in September, with greater risk aversion evident across the capital markets. This was not surprising. In fact, at the end of 2013, after roughly a year of exceptionally low volatility, we had predicted that volatility would return to higher levels. The mid-month Fed meeting, uncertainty about China’s economic growth, turmoil at PIMCO, and continued geopolitical tensions were among the factors driving this trend.

Stocks fell in all major regions during September, with the steepest losses coming in the emerging markets **(Display 1)**.

Real assets, which had advanced strongly in the second quarter, were down sharply, as signs of weakness in China, deteriorating conditions in Europe, and disappointing trade numbers from Japan drove natural resource stocks, commodity futures, and global real estate lower.

In the bond market, rates first moved up (and prices down) on expectations of Fed tightening, but this trend later reversed to some extent as risk-averse investors sought the perceived safety of bonds.

Despite the uptick, volatility is still somewhat below normal, and our research indicates that investors are being compensated for the incremental risk. Corporate fundamentals remain solid, policy stimulative, and global valuations fair.

In our Dynamic Asset Allocation service, we are positioned accordingly. We are overweight return-seeking assets (with a focus on developed-market equities) and underweight bonds **(Display 2)**.

As always, we continue to monitor the market closely and stand ready to adjust our exposures if conditions warrant. We are paying special attention to communications from the Federal Reserve regarding changes in its extraordinarily accommodative monetary policy.

Display 1

Major Markets Decline

Index Returns

	2014	
	Sep	Jan–Sep
Stocks		
US	(1.4)%	8.3%
Developed-Market Int'l	(3.8)	(1.4)
Emerging Markets	(7.4)	2.4
Bonds		
Municipal	(0.1)%	3.6%
Taxable	(0.7)	4.1
Alternatives		
Funds of Hedge Funds	N/A*	2.7% [†]
Real Assets	(6.9)%	0.1%

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-market 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 alternative investments by the Hedge Fund Research Inc.'s (HFRI's) Fund of Funds Composite Index. Real assets are represented by an equally weighted blend of MSCI ACWI Commodity Producers Index, FTSE EPRA/NAREIT Global Real Estate Index, and Dow Jones–UBS Commodity Index.

**The data are not yet available.*

*†Return from January through August
Source: Barclays, Dow Jones, FTSE, HFRI, Lipper, MSCI, and Standard & Poor's*

The Fed Treads Carefully

Policymakers held steady on two important decisions at the September meeting of the Federal Open Market Committee (FOMC). First, not surprisingly, the FOMC reasserted its intention to complete its asset purchase program by the end of October. Second, to the surprise of some, it maintained language stating that it will keep the fed funds rate at the current target level (0 to 25 basis points) for a “considerable time” after ending the asset purchase program.

The “considerable time” phrase has been closely watched for months, as investors strain to discern the future path of interest rates. Currently, many investors expect the FOMC to begin raising rates following its meeting on June 17, 2015.

We expect the Fed to raise rates sooner, on the back of a stronger US economy. After weather-related weakness in the first quarter of this year, the growth trend in the US got back on track in the second quarter and seems to have moved forward at a fast pace in the third quarter.

For the FOMC to be convinced that a rate rise is warranted, it may need to see solid GDP growth in the third quarter. This result will be available for policymakers to review when the FOMC holds its next scheduled meeting, in late October.

By that point, we expect that the weight of evidence will sway policymakers to remove their

“considerable time” language and raise the prospect of an earlier rate hike—possibly, we think, in the spring of 2015.

Looking further out, we think it’s highly likely that the fed funds rate, which has been in the range of nine basis points this year, will be close to 1% by the end of 2015.

Importantly, we don’t view an initial move in rates as negative for stocks. As we mentioned in last month’s Capital-Markets Outlook, equity returns are typically at their strongest when the Fed raises rates from very low levels (**Display 3**).

This is hardly surprising: when interest rates are very low, the Fed typically tightens policy because it sees signs that the economy is strengthening.

Equity markets tend to decline only after Fed policy is viewed as hurting future economic growth—a state of affairs that is far off, in our opinion.

Hedge Funds Can Help

If the start of the Fed’s tightening cycle does, indeed, amplify volatility, DAA is just one of the ways investors can protect their portfolios against drawdowns.

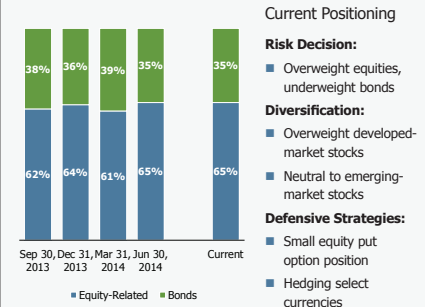
Under these conditions, diversifying asset classes such as alternatives may serve them particularly well. However, as one September headline indicated, not all investors agree about this.

The largest public pension fund in the US announced that it will no longer invest in hedge funds.

Display 2

Maintaining an Overweight in Return-Seeking Assets

Asset-Class Weights

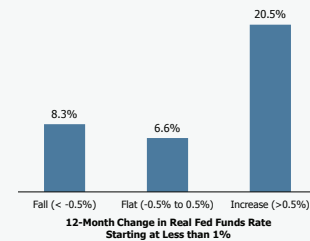


As of September 30, 2014
Source: AllianceBernstein

Display 3

Rates Rising from Low Levels Are Not a Threat to Stocks

S&P 500 Performance



As of July 31, 2014
Historical analysis is not necessarily predictive of future results.
S&P 500 monthly total returns from Jan 1928 through Jul 2014. S&P performance is the average monthly return multiplied by 12 for periods of falling, rising and flat real fed fund rates.
Real fed funds rate is the three-month implied real rate from Jan 1920 through Jul 2014 (three-month nominal Treasury – YoY CPI change)
Source: Barclays POINT, Bloomberg, Standard & Poors, and AllianceBernstein

According to Ted Eliopoulos, Interim Chief Investment Officer of the California Public Employees’ Retirement System (CalPERS), “Hedge funds are certainly a viable strategy for some, but at the end of the day,

when judged against their complexity, cost, and the lack of ability to scale at CalPERS' size, the [hedge fund] program is no longer warranted."

Unlike some observers, we don't foresee a stampede out of hedge funds. In fact, investors have been enlarging their allocations to hedge funds, not shrinking them. According to Hedge Fund Research, net flows to hedge funds in the first half of 2014 were nearly double those in the first half of 2013 and 65% higher than the net flows in all of 2012 (**Display 4**).

We expect hedge funds to prove very helpful when volatility rises to more normal levels. That's because hedge funds are relatively insensitive to market movements (i.e., they can have low beta), and their returns are often driven by an individual manager's skill in exploiting opportunities. During down periods for stocks, a diversified group of hedge funds can offset losses inside a balanced account (**Display 5**).

Overall, we believe that a properly diversified collection of hedge funds will be critical in the years to come.¹

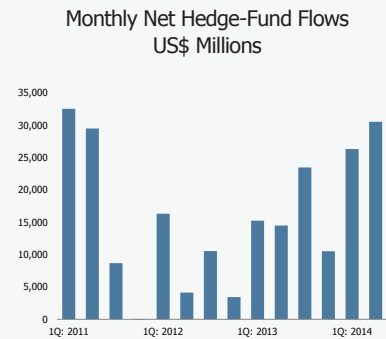
Conclusion

Volatility picked up in September, and only time will tell if it persists in the months ahead. During such periods, we need to determine if the increased risk is temporary or if it indicates longer-lasting problems. We place the September decline in the former category while remaining vigilant for any signs of deeper market instability.

We continue to believe that an overweight to equities is justified at this time, given the fundamentals in the equity market, the improving growth trajectory of many economies, and the fair valuations across the globe.

Display 4

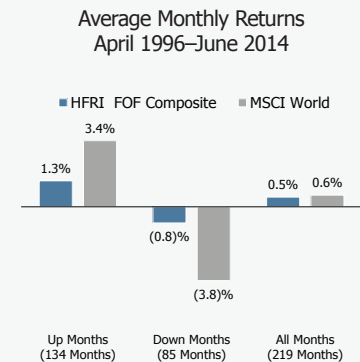
Growing Allocations to Hedge Funds



Through June 30, 2014
Source: HFR Global Hedge Fund Industry Report, Second Quarter 2014

Display 5

Hedge Funds Can Help Offset Declines in Stocks



Through June 30, 2014
Source: HFR Global Hedge Fund Industry Report, MSCI, and AllianceBernstein

¹Hedge funds pose particular risks, including the uncertainty of alpha, an unstable correlation to stocks, the absence of regulatory oversight, and potentially higher illiquidity in a market crisis. Rigorous due diligence and broad diversification across managers and categories are essential to mitigating these risks. In general, investors must be "qualified purchasers" to invest in hedge funds.

The Capital Markets at a Glance

As of September 30, 2014	Stock Indices*				
	GDP Estimates 2015F (AllianceBernstein)	September 2014 Return (USD)	Year-to-Date Return (USD)	Price/Earnings Next 12 Months	September 2014 Dividend Yield
Global	3.2%	(3.2)%	3.7%	14.2x	2.4%
US	3.9%	(1.4)%	8.3%	15.3x	2.0%
Developed International**	1.7%	(3.8)%	(1.4)%	13.8x	3.1%
Emerging Markets†	4.5%	(7.4)%	2.4%	10.3x	2.8

	Current	One Month Prior	One Year Prior
Yields			
US Effective Federal Funds Rate	0.08%	0.07%	0.06%
US Treasury, Three-Month	0.02%	0.03%	0.02%
US Treasury, Five-Year	1.78%	1.63%	1.39%
US Treasury, 10-Year	2.52%	2.35%	2.64%
Municipal Bond 1–10 Yr. Barclays Index	1.45%	1.40%	1.88%
Exchange Rates			
US Dollars per Euro	\$1.26	\$1.32	\$1.35
US Dollars per British Pound	\$1.62	\$1.66	\$1.62
Japanese Yen per US Dollar	¥109.70	¥103.89	¥98.13
Commodity Prices			
WTI Crude Oil (\$/bbl)	\$91.16	\$95.96	\$102.33
Gold (\$/ozt)	\$1,210.50	\$1,285.80	\$1,326.50
Economic Statistics			
US Unemployment Rate (July 31, 2014)	6.1%	6.2%	7.2%
US Inflation—CPI (July 31, 2014)	1.7%	2.0%	1.5%

Past performance is not necessarily indicative of future results.

*Stocks are represented by: Global—MSCI ACWI, US—S&P 500, Europe—Euro Stoxx 50, Germany—DAX, France—CAC 40, UK—FTSE 100, Japan—TOPIX 100, Developed International—MSCI EAFE, Emerging Markets—MSCI EM, China—SSE 180, India—India S&P BSE SENSEX, Russia—FTSE Russia, Brazil—Bovespa. S&P 500 returns are gross dividends reinvested. All other indices are net dividends reinvested. All returns are unhedged and 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: Barclays, FactSet, MSCI, S&P 500, US Bureau of Labor Statistics, and AllianceBernstein

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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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