Winter 2012/2013

CAPITAL MARKETS OUTLOOK

Clouds Parting, Revealing Opportunities

As the world economy continues to grow, some headwinds have been resolved, even as others remain. Based on the market environment, we think there's considerable potential for active management to thrive.

Markets Better than They Felt

For several years, investors have faced a "wall of worry," with many big-picture issues to fret about. Some of those headwinds began to ease in 2012, providing greater clarity in markets and the global economy.

The ride may not have been comfortable, but most asset classes produced strong returns in 2012. For example, global equities rallied and riskier fixed-income assets outpaced government bonds.

Meanwhile, we believe the global economy should continue to grow moderately. Our 2013 country forecasts for growth in gross domestic product (GDP), a key measure of economic activity, continue to show moderate growth in developed economies and stronger growth in emerging economies.

Assessing Opportunities

We assess the expected return for stocks as slightly below the long-term average but still reasonable. The expected return for global government bonds is still well below average.

As a result, the relative opportunity for investing in equities is still well above its historical average in our view. But it has been overshadowed by an uncertain macro environment, even though volatility is only slightly above average.

We also see indications that active management may be poised to come back into favor in equities and remains important in fixed income. Big-picture macro drivers seem to be receding, and sizable valuation differences among securities seem to present opportunities for research to thrive.

The relative opportunity for stocks appears well above average

AllianceBernstein Capital Market Forecasts

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

AllianceBernstein Economic Forecasts

Real GDP Growth	2013F
Global	2.5%
Developed	1.4%
US	2.7%
Emerging Markets	5.3%

Inflation	2013F
Global	2.3%
Developed	1.7%
US	2.1%
Emerging Markets	3.9%

Forecasts may not be achieved.
As of January 8, 2013
Volatility is measured by the standard deviation (the dispersion of a set of data from its mean) 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

Stronger Growth Depends on Policy Decisions

We expect moderate global growth in 2013. Public spending and housing should bolster the US economy, Europe is still challenged but has made some policy progress and China's growth should remain solid.

Moderate Growth Should Continue

During 2012, policy actions provided some clarity around several challenges to the global economy, helping to reduce risk aversion. For example, Europe took steps to aid banks and lower borrowing costs, election uncertainties were resolved in key economies and monetary stimulus from major central banks continued.

We expect moderate global economic growth again in 2013, with a projected 2.5% expansion in GDP; stronger growth would depend on how successfully policies resolve additional headwinds. We expect economic activity to improve in most regions and major countries year over year, even in the euro area, although that region will likely still lag the rest of the world.

US Expansion Broadens

We've been talking for a while about two headwinds to a stronger US economy: negative public-sector growth in contrast with solid private-sector growth and a chronically weak housing sector.

We see progress on both fronts. Public-sector GDP has begun to turn positive recently and the private-sector, meanwhile, has been growing even without the help of housing, which has been missing in action for years. Bigger contributions from these two segments of the economy should broaden the US recovery.

Compared with the length of a typical business cycle, the US cycle seems near the midway point. But a closer look implies that key aspects of the recovery may be younger. Several components that typically lead—housing and labor markets, for instance—have been slow starters this time around. This would seem to indicate that the expansion could still take stronger hold.

Fiscal policy shows signs of being in late-cycle mode, but is clearly still in flux. A last-minute deal avoided the fiscal cliff, but it seemed more like status quo to us than a grand bargain. To put it bluntly, it made the cliff less steep. Contentious discussions on spending cuts and the debt ceiling are still ahead.

European Periphery Starts to Rebalance, but Fundamentals Are Poor

In the euro area, programs such as the Long-Term Refinancing Operations and bond buying by the European Central Bank have helped reduce bigger policy risks. They've also lowered bond yields for struggling peripheral countries.

The euro economy is slowly starting to rebalance, but it's a painful process. On the surface, the current-account balance—the difference between exports and imports—has improved for troubled economies like Ireland, Spain and Portugal. For Ireland, in fact, exports now exceed imports, creating a current-account surplus.

But the picture isn't as positive beneath the surface. Since 2008, the euro area's exports have been made more competitive as a result of cheaper labor costs due to better productivity. But this productivity improvement has come from wage cuts and layoffs, which have an obvious economic downside.

As an example, imports to the euro area from other nations have fallen, too, which also improves the balance. However, this has largely been because demand within the euro economies has been so feeble—that's not a positive development.

China: Improving Fundamentals, Headwinds Remain

Consensus concerns about a hard landing in China and questions about the leadership transition seem to have eased considerably as we see it. Industrial production, new investment and overall economic output are still strong—and we even expect growth to improve slightly in 2013.

The biggest remaining challenge for China isn't growth today, but the country's longer-term need to change the very structure of its economy. China must transition from an investment- and export-led economy to one driven by robust domestic demand, with consumers spending more and saving less.

This fundamental reorientation of China's economic growth patterns will require key structural shifts, including the development of social safety nets ranging from retirement plans to health insurance. Such structural changes reduce the need of individuals to save and are major components in the new administration's 10-year plan.

In the meantime, near-term challenges need to be navigated. For instance, the downturn in global trade has also impacted China. As world trade contracted in 2012, China's exports suffered and imports declined by an even larger percentage. The biggest import decline was in those goods destined for use by the Chinese themselves, highlighting the challenge of bolstering domestic demand.

Some global uncertainties have been addressed

Historical analysis does not guarantee future results.
Through December 31, 2012
*Incorporates equity index–implied volatilities, bond spreads, currency index–implied volatilities and equity mutual fund flows.
†Long-Term Refinancing Operations
‡European Union (EU) and European Central Bank (ECB)
Source: Bloomberg, Investment Company Institute and AllianceBernstein

What stage of the business cycle are we in?

Current US Business Cycle

	Early	Mid	Late
Cycle Length (Duration)		√	
Sector Leadership in GDP	√		
Labor Markets (Jobless Rate)	√		
Wage and Price Trends	√		
Household Leverage	√		
Nonfinancial Business Leverage		√	
Operating Profits		√	
Real Profit Margins		√	
Monetary Policy	√		
Fiscal Policy			√

Current analysis does not guarantee future results.
July 2009 through December 2012
Source: AllianceBernstein

Bigger Active Equity Opportunity Emerging?

Money has flowed out of active equities and into perceived safe havens. This has happened even as macro forces seem to be receding and valuation discrepancies point to a more promising road ahead for active equity managers.

Flight to Safety Continued

Even though equity returns were strong in 2012, investment flows didn't respond. The money in motion continued to head largely toward safety.

Specifically, investors favored assets that preserved capital and provided protection from major policy-related risks or that provided more predictable cash flows. Taxable and municipal bonds have benefited as money has flowed out of actively managed equities. The only equity category to see inflows was passive equities. Within equities, dividend-paying stocks were favored.

Positioning Portfolios for Different Environments

Clearly, portfolio construction should be informed by the market environment—whether it's financial crisis/recession, a risk-on/risk-off scenario, or recovery and normalization. And, the approach investors take to designing a portfolio strategy is also a key element.

For investors seeking safety, we think it's critical to focus on which yield curves and yield-curve positions are most efficient. In our view, we're currently in a risk-on/risk-off environment—the flight to cash flow we're seeing is typical. But it's important to be selective: value remains, but investors' choices with respect to issuer, company and structure can make a big difference.

We believe that we're eventually headed for recovery and normalization. In this coming environment, we'd expect to see a move to riskier assets and strategies that may generate excess return versus the broad market. Our suggestion: be active in this environment. As we'll discuss, recent market dynamics seem to be shifting in favor of active strategies that emphasize security selection.

Since environments evolve, it might make sense to consider a mix of more than one scenario. In a risk-on/risk-off environment with the potential to turn into a broader recovery, for instance, it might help to consider blending the suggested equity positioning for these two environments. Of course, due to the inherent fluctuating nature of equity markets, there's no guarantee that the investment approaches discussed will yield positive results or that the market environments described will occur.

Improving Visibility, Compelling Valuations

Even though active management has been out of favor, several developments seem to indicate greater potential ahead. As we've noted, investors have been in risk-on/risk-off mode for some time, preferring to follow big-picture macro trends. But our analysis suggests that there's less of a macro current driving stocks today.

We also see a promising trend in the declining correlations between individual stock returns. We believe that this indicates that stocks are increasingly traveling their own paths. These two trends may signal that we're entering a period in which the distinctions between individual stock valuations will once again matter. Our research teams are also finding overall equity valuations to be compelling—even more so in certain market segments. We believe that this bodes well for active-management opportunities.

At the same time, fundamental risk in the corporate sector seems very low. Debt levels remain very light, firms still have plenty of cash, and a larger percentage of large-cap companies have been able to pass price increases on to their customers. We think this last item reduces the risk of eroding profit margins.

Backdrop Seems Right for Active Management

The promising equity backdrop has focused investors more closely on individual stock opportunities. Big discrepancies have emerged among market participants' views of company valuations. We think these gaps offer an opportunity for effective stock pickers to shine.

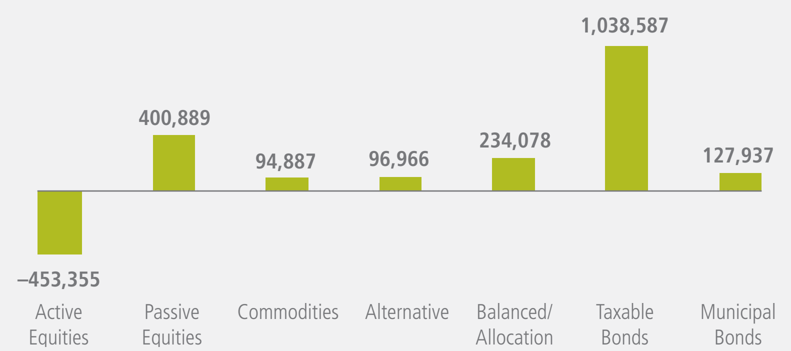
Company characteristics can be mispriced, too. For instance, investors have historically fared better when choosing the stocks of firms that have been more efficient at allocating their capital to profitable investments. In industry terminology, this means managements that pursue a high return on invested capital.

Another example: we're seeing sizable differences between the valuations of stocks in certain sectors—as measured by the price-to-book value ratio.[1] Take cyclical stocks: the valuation gap between the most expensive and least expensive stocks in many sectors is approaching its all-time high. That can translate into opportunities to differentiate between stocks.

In this improving environment, the range of potential outcomes in equity markets is wide, but we think it's also skewed positively. Historically, active management has outperformed as dispersion widens, because managers have historically been rewarded for successfully distinguishing winners from losers. In other words, we think this enhances the ability to add value above a benchmark.

Investment flows have reflected risk aversion

Net New Flows Jul 2008–Nov 2012 (USD Millions)



Historical analysis do not guarantee future results.
Source: Strategic Insight and AllianceBernstein

Market environments inform portfolio strategy

Potential Market Environments and Portfolio Strategies

	Financial Crisis/ Recession	Risk On/ Risk Off	Recovery/ Normalization
Economic Outlook	Negative real growth Fears of deflation	1–2% global GDP growth Fears shift between inflation/deflation	3–5% global GDP growth Healthy reflation
Market Volatility/ Return	High and sustained/ Negative	Shift between high and low/Modest	Low and sustained/ High
Securities	Government bonds, defensive and US equities, TIPS and hedged currencies	Credit, stability and global equities, real estate and partially hedged currencies	High-beta* credit, non-US and emerging market equities, cyclical equities, commodities and unhedged currencies

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As of December 31, 2012
There is no guarantee that the portfolio strategies presented will yield positive results or that the market environments presented will occur.
*Beta is a measure of the volatility, or systemic risk, of a security or a portfolio in comparison to the market as a whole.
Source: AllianceBernstein

[1]The price-to-book value ratio measures the amount an investor has to pay for each dollar of a company's net worth.

Bonds: Opportunities in a Low-Rate Environment

In our view, municipal bonds remain attractive versus taxable bonds, and they've emerged from the fiscal-cliff deal with their tax advantages intact. For high-yield, the fundamental and technical pictures remain generally supportive.

High Yield Still Attractive, but Caution Warranted

In fixed-income markets, high-yield bonds have produced stellar performance the past few years. We still see high yield as attractive based on our assessment of technical conditions and fundamentals. However, we see some signs that fundamentals are softening, including an uptick in leverage as economic conditions improve.

One risk in high-yield bonds is default—a factor that's reflected in the yield advantage investors demand for the risk of losing principal. For the last few years, the probability of default reflected in high-yield valuations has been much higher than the actual default rate. In other words, investors seem to be receiving more compensation than is "necessary."

The supply-demand balance is also attractive. There's been a lot of issuance, but much of it has been related to refinancing outstanding debt. The actual "net" new supply after accounting for refinancing has been much lower. In 2012, net new supply was healthy—but much lower than total issuance would suggest. Less supply tends to support bond prices.

Despite the positives, we think it's important for investors to be selective in high yield. Many new issuers are of lower credit quality, and, historically, defaults have been much more likely for these issuers. So, it pays for investors to do their homework when buying high-yield bonds.

Municipals Seem Attractive versus Taxable Bonds

The tax-exempt status of income from municipal bonds wasn't eliminated during the fiscal-cliff negotiations, and municipal bonds in general remain relatively attractive compared with Treasury bonds. This is the case across most maturities, after adjusting for munis' tax advantages.

One exception is in much shorter-term maturities, where the two markets yield roughly the same on a tax-equivalent basis. In some cases, taxable bonds may even be more attractive, so it pays to monitor the relationship between the two markets. At times, it may make sense to add select taxable bond exposure to a tax-exempt muni portfolio.

The municipal bond market also seems well supported from a supply-demand perspective. Net supply has tailed off to virtually nothing the last few years, and we expect very low net issuance for 2013. Thin supply is especially true for high-yield munis, where about 20% of the market is subject to redemption over the next 18 months.[1]

Credit and Roll Offer Active Management Potential

Both municipal bonds and taxable bonds offer other opportunities for active management to potentially enhance returns. Including lower-rated bonds is one approach—these bonds typically offer additional yield to compensate for greater credit risk.

A steep yield curve could also translate into added potential if bond managers can take advantage of yield curve roll. Roll is the natural price gain that a bond experiences as it ages, assuming interest rates are unchanged. Of course, there are risks associated with investing in bonds for longer periods of time, including the risk that rising interest rates cause bond prices to fall.

[1]As of September 30, 2012. (Barclays Capital, Investment Company Institute, US Federal Reserve, Flow of Funds Accounts of the United States, 3Q:12 and AllianceBernstein)

Borderless Bond Investing

Yield-curve decisions don't have to be limited to one country's bond market. With a global bond strategy, investors can diversify across many yield curves, which may also provide additional active-management opportunities. Though, of course, diversification doesn't eliminate the risk of loss.

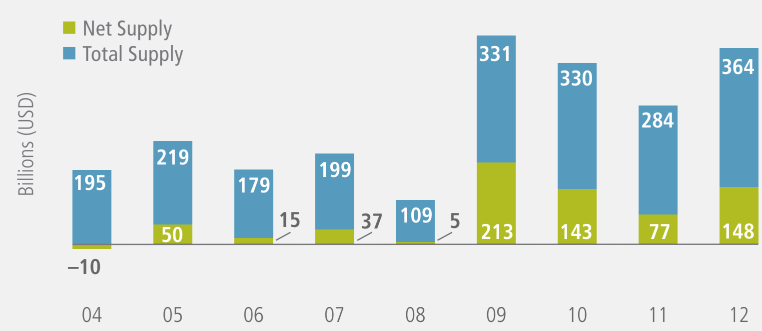
Based on returns hedged to remove the impact of currency changes, the euro area bond market had the best return in 2009 among major developed bond markets. The next two years, it finished near the bottom, before rebounding to the lead in 2012.

No single bond market wins all the time…that's why we think going global is important. Global bond portfolios have also been less sensitive to interest rate changes in any one home-country bond market. And, active managers can also use changing performance leadership in seeking to add value by adjusting geographic exposures.

For investors using global bonds as a core anchor to windward for their stocks, currency exposure can bring a lot of unexpected volatility. Unhedged global bonds have also been less of an offset to equity movements than domestic bonds have.

That's why we see currency-hedged global bonds offering the highest probability of capturing opportunities: they've historically exhibited much less risk and delivered competitive returns. Of course, investors should also keep in mind that investing in non-US securities may be more volatile because of certain political, regulatory, market or economic uncertainties.

Supply and demand dynamics are supportive in high yield



Historical analysis does not guarantee future results.
As of December 31, 2012
Net supply does not account for the impact from mutual fund flows and coupon reinvestments.
Source: Bank of America Merrill Lynch, Bloomberg, JP Morgan, Morgan Stanley and company reports.

The patterns of country returns vary over time

Global Bond Returns (Hedged to USD): Percent

	2008	2009	2010	2011	2012
Best Performer	Australia 15.1	Euro Area 4.1	UK 7.2	UK 16.1	Euro Area 11.2
	US 13.8	Japan 1.4	US 5.9	US 9.8	UK 2.4
	Canada 11.7	UK −1.6	Canada 5.6	Australia 8.9	Japan 2.2
	UK 10.4	Canada −1.9	Japan 2.9	Canada 8.3	US 2.0
	Euro Area 8.4	US −3.6	Euro Area 1.0	Japan 2.6	Australia 1.4
Worst Performer	Japan 6.7	Australia −5.9	Australia 0.3	Euro Area 2.6	Canada 1.4
Gap between best and worst	8.4	10.0	6.9	13.5	9.8

Past performance does not guarantee future results. These returns are for illustrative purposes only and do not reflect the performance of any fund. Please see back cover for index definitions.
As of December 31, 2012. Returns represented by respective Barclays Capital government bond indices within each country. An investor cannot invest directly in an index and its performance does not reflect the performance of any AllianceBernstein portfolio. The unmanaged index does not reflect fees and expenses associated with the active management of a portfolio.
Source: Barclays Capital, Bloomberg, JP Morgan, US Department of the Treasury, National Accounts and AllianceBernstein

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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.

Index Definitions: The **Barclays Capital US Treasury Index** includes fixed-rate, local currency sovereign debt that make up the US Treasury sector of the Global Aggregate Index. The **Barclays Capital Japan Treasury Index** includes fixed-rate, local currency sovereign debt that make up the Japanese Treasury sector of the Global Aggregate Index. The **Barclays Capital Euro Treasury Index** includes fixed-rate, local currency sovereign debt that make up the Euro Treasury sector of the Global Aggregate Index. The **Barclays Capital Canada Treasury Index** includes fixed-rate, local currency sovereign debt that make up the Canadian Treasury sector of the Global Aggregate Index. The **Barclays Capital Euro Area Treasury Index** includes fixed-rate, local currency sovereign debt that make up the Euro Area Treasury sector of the Global Aggregate Index. The **Barclays Capital United Kingdom Treasury Index** includes fixed-rate, local currency sovereign debt that make up the United Kingdom Treasury sector of the Global Aggregate Index. The **Barclays Capital Australia Treasury Index** includes fixed-rate, local currency sovereign debt that make up the Australian Treasury sector of the Global Aggregate Index. The **Barclays Capital Global High Yield Index** provides a broad-based measure of the global high-yield fixed-income markets. It 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.

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