AllianceBernstein

Spring 2012

CAPITAL MARKETS OUTLOOK

Settling Down to Business

Promising economic data outside of Europe suggest further global growth, and a sharp drop in volatility has improved the risk/return trade-off for stocks. However, risks remain.

Riskier Assets Outperformed

In the first quarter of 2012, investors repriced riskier assets, which outperformed. Stocks rallied, and fixed-income sectors like emerging-market debt and corporate bonds outpaced developed government bonds.

What's changed? For one thing, economic data have improved, notably in the US. Also, policy actions across the globe have eased concern about a slowdown and should support growth, which we expect to be 2.6% this year.

Among the policy highlights: the European Central Bank provided liquidity to euro-area banks, helping them reduce the risk of a credit crunch, and China is easing its monetary policy, addressing worries that a major growth engine is slowing.

Risk/Return for Stocks Improves

In our view, long-term expected returns for stocks are slightly below normal, but the return potential on global government bonds is well below average. So the risk premium for equities—the amount by which their return potential exceeds bonds—is more than twice its historical average.

The markets have breathed a collective sigh of relief, despite remaining risks. As a result, our expectations for volatility in the year ahead have fallen almost back to normal levels.

The combination of attractive return potential and sharply lower volatility creates a more favorable risk/return trade-off for stocks. In our view, this warrants a moderate equity overweight versus long-term strategic targets.

Lower volatility improves our assessment of stocks

AllianceBernstein Capital Market Forecasts

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

AllianceBernstein Economic Forecasts

Real GDP Growth	2012F
Global	2.6%
Developed	1.5%
US	3.0%
Emerging Markets	5.3%

Inflation	2012F
Global	2.6%
Developed	1.9%
US	2.3%
Emerging Markets	4.7%

Forecasts may not be achieved.
As of March 1, 2012
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

The World Economy Forges Ahead

Prominent risks could still threaten the global economy, but we expect growth to continue in 2012. We believe that emerging nations, including China, will lead and that US growth should be faster than expected.

Risk Aversion Recedes, but Risks Remain

The relative calm of equity markets can be seen in the sharp decline of the Chicago Board Options Exchange Market Volatility Index. Known less formally as the "fear index," this indicator of expected volatility has fallen back toward normal levels. Bond yields for euro-area government bonds also declined in the first quarter, reflecting less near-term systemic risk.

These are welcome developments, but we're still watching certain key risks closely. Iran has threatened to close the Strait of Hormuz (about 20% of the world's oil production passes through this waterway.) It's unlikely that the strait will close, in our view, but if it did happen it would create a major supply disruption—and a big spike in oil prices. Uncertainty has already affected gasoline prices, which have risen sharply, in part due to refinery shutdowns.

There's been progress in the euro area, with the European Central Bank providing liquidity to euro-area banks and Greece receiving more aid. However, the fundamental problem of mounting sovereign debt remains. And in the longer term, the US still faces the challenge of growing interest payments and rising entitlement spending.

Global Growth Continues

These risks bear close monitoring, but they don't overshadow a spate of positive economic news. We expect real, or inflation-adjusted, global growth to check in at 2.6% in 2012—slightly ahead of the consensus estimate. Emerging economies should again lead, particularly in Asia, with a continuing contribution expected from China.

Developed Europe is a different story: We're forecasting a slight contraction this year in the euro area, with peripheral economies representing the biggest sources of weakness. We expect Greece to experience the biggest contraction in economic output, but Italy and Spain—two large economies—are also expected to remain weak.

US Expansion Could Outpace Consensus Estimates

In the US, our forecast is more optimistic than the consensus, which is one reason for our slightly higher global growth projection. We're calling for a 3% US expansion in calendar year 2012, while the consensus is for 2.2%.

The Index of Leading Economic Indicators (LEI) is strongly positive, suggesting continued expansion: The LEI has a strong history of forecasting the economy's direction.[1] US labor markets are starting to heal, with strong employment gains whittling away at the private unemployment rate. As frequent upward revisions have shown, job growth has been exceeding initial estimates. Between August 2011 and January 2012, household employment rose by 1.98 million—the fastest gain since 2005 and on par with the strong hiring patterns of the 1990s.

Normally in a recovery, job growth would benefit from new construction activity, but much of the recent improvement has occurred without a major contribution from that sector. We think that this will change, based on signs from several different stages of private construction. Real private construction spending is starting to grow again, architectural inquiries and billings are up, and new housing permits are rising.[2] If residential and nonresidential construction continue to recover as we expect, it should provide more momentum to US growth.

[1]Through February 2012. Conference Board
[2]As of January 31, 2012. American Institute of Architects, Bureau of Economic Analysis, Bureau of Labor Statistics, Haver Analytics and McGraw-Hill Construction

China Should Continue to Grow

For 2012, our forecast calls for China's real Gross Domestic Product (GDP) growth to top 8%. That may seem at odds with the recent announcement of a 7.5% economic growth target, but China's stated growth targets have historically been conservative.

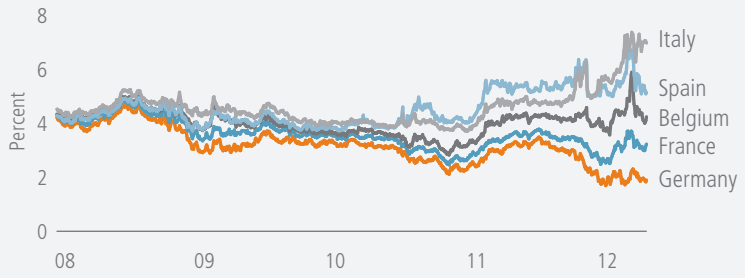
We're seeing signs that Chinese officials will continue to ease policies in support of growth. The required reserve ratio for financial institutions has been reduced, and we expect it to be lowered further, creating more flexibility for banks to increase lending. We also think that policymakers will cut the one-year base lending rate to further stimulate financial and economic activity.

Some onlookers have expressed concern that weak demand from the stalled euro area will hurt China's exports. The worry is that a major hit to exports will impair an economy expected to be a major source of global growth. But a closer look at the numbers offers important perspective.

Shipments to the weakest euro economies actually represent only a very small slice of China's overall export pie. Italy, Spain, Greece, Portugal and Ireland combined account for only 3.5% of China's $1.9 trillion in total exports.[3] That's a fairly small share, and it makes us confident that the impact of Europe's slowdown on China will be limited.

Declining euro-area bond yields reflect some progress in the region

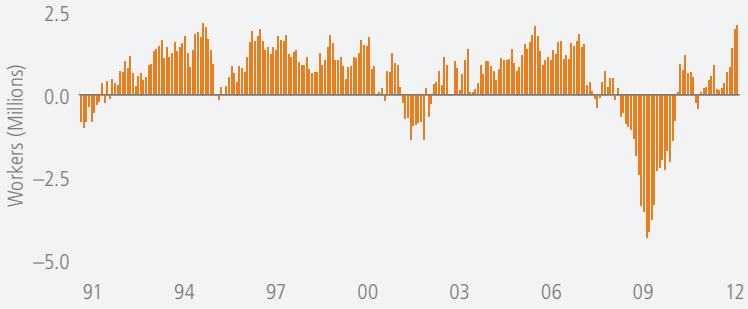
Sovereign 10-Year Bond Yields



Historical analysis does not guarantee future results.
Through March 6, 2012
Source: Bloomberg, Haver Analytics and AllianceBernstein

US job gains echo the strong hiring patterns of the 1990s

Household Employment (six-month sum)



Historical analysis does not guarantee future results.
Through January 2012
Source: US Bureau of Labor Statistics and AllianceBernstein

[3]As of January 31, 2012. IMF Direction of Trade Statistics and AllianceBernstein

A Sense of Calm Returns to Stocks

Volatility and risk aversion have returned to near-normal levels, but valuations are still distorted. This creates fertile ground for active equity investors to exploit misvaluations.

Correlations Lower, Valuations Still Distorted

During much of the fourth quarter of 2011, equity markets experienced abnormally high correlations among individual stock returns. It was yet another bout of the "risk on/risk off" mentality gripping markets, with macro concerns dominating investment decisions and causing stock returns to cluster together abnormally.

The environment has changed a lot since then. Correlations have fallen as stocks have once again started to trade more on their own merits. This is an important development for active managers who emphasize research-driven stock selection and fundamental distinctions between stocks.

Meanwhile, valuations are still distorted, with big gaps between the most expensive and cheapest stocks. A few months ago, when correlations and distortions were high, we saw it as a chance to position portfolios for a time when the market once again differentiated between individual stock fundamentals.

Appealing Valuations in SMID-Cap Stocks

One opportunity we see is in small- and mid-cap stocks—an asset class that may experience higher volatility than large-caps but still holds potential in our eyes. Take SMID-cap growth investing, which depends on finding companies whose earnings grow faster than expected. Successful growth companies have two key traits: positive earnings revisions, which means that analysts are raising their profit estimates; and positive earnings surprises that beat expectations. Our research shows that this combination has outperformed other SMID-cap growth stocks historically.[1]

In contrast, companies with both negative earnings revisions and negative earnings surprises have underperformed their SMID-cap growth counterparts. Today, companies in the stronger group aren't trading at the premium we'd expect. Judging by the forward price-to-earnings ratio—the price investors pay for next year's expected earnings—the two groups are valued roughly in line with each other today. We see this as an opportunity to buy attractive stocks at a discount.

We also see opportunities in SMID-value stocks, which are deeply discounted versus the S&P 500 Index. This holds true for both the price-to-book-value ratio (the price an investor has to pay for a company's net worth) and the price-to-sales ratio (the price that must be paid for a company's revenues). If investors can access these stocks at attractive prices, we believe that they'll be rewarded over the long run as the market acknowledges fundamentals.

Equity Income: Opportunity Remains

Dividend-paying stocks continue to offer potential by essentially paying investors to wait for further appreciation in equity prices. Companies remain flush with cash that they can put to work: one use is to buy back their own shares, which can drive up earnings per share; another is to pay dividends.

We expect dividend payments to rise because the ratio of dividend payments to earnings per share is lower than it's been in about 60 years. Many firms have held on to their cash as a legacy of the financial crisis—even as corporate profitability has soared.

Dividends have been a good source of income over the long run. Over the past four decades, the annual dividend growth of the S&P 500 Index has outpaced inflation.[2] This could provide an attractive source of income for investors in dividend-paying stocks. Of course, research and active management are necessary to identify sustainable dividend payers.

[1]SMID-cap growth stocks are represented by the S&P Small Cap 600 Growth Index.
[2]**Past performance is no guarantee of future results.** As of December 31, 2011. Individuals cannot invest directly in an index. Please see back cover for index definitions. Standard & Poor's and AllianceBernstein

Multiple Dimensions to Equity Opportunities

There are many equity strategies to choose from, including different styles, geographies and market caps. In recent years, another dimension has become clear—investment time horizons. How far ahead do stock pickers look as they make their choices?

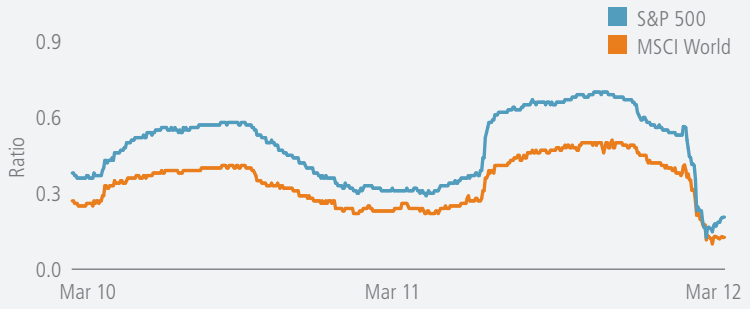
Some strategies, such as market-neutral and low-volatility approaches, focus on short-term indicators. Other strategies, such as equity income, harness free cash flow further out on the time horizon. By contrast, strategies that emphasize fundamentals generally take longer to be rewarded. Thematic investing is among the longest of equity time horizons because it seeks to identify sweeping global changes and invest in companies expected to benefit from them.

The time horizon affects the performance patterns of equity strategies—and the demand for them. When markets are volatile, many investors are risk-averse and uncertain about the future, so they look for short time- horizon strategies that have tended to produce results more quickly. Longer time-horizon strategies are generally out of favor at these times, as they have been the past few years. As confidence returns, longer-term equity strategies should once again be rewarded.

When building a portfolio, it makes sense to consider diversifying across time horizons, exposing the portfolio to more sources of return.

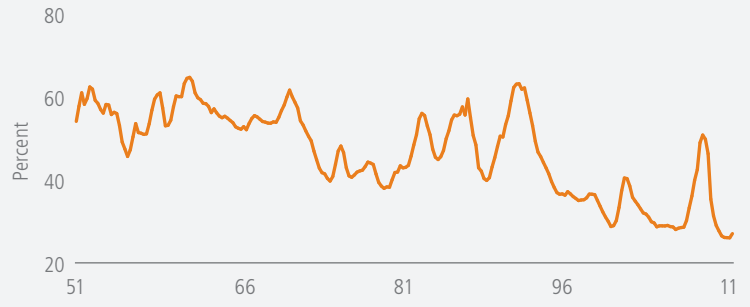
Lower correlations show that stocks are trading more on their individual merits

Intra-Stock Correlations (six months rolling)



Historical analysis does not guarantee future results.
Through March 31, 2012
Correlation using rolling daily returns over six months. Correlation is a statistical measure of how two values move in relation to each other.
Individuals cannot invest directly in an index. Please see back cover for index definitions.
Source: MSCI, S&P and AllianceBernstein

Dividend-payout ratios are near historical lows—will this last?



Historical analysis does not guarantee future results.
As of December 31, 2011
Trailing 12-month dividend-payout ratio for S&P 500 Index; calculated as dividend payments divided by net income
Source: Deutsche Bank, FactSet, S&P and AllianceBernstein

Surveying Fixed-Income Opportunities

We think that municipal bonds' tax advantages make them compelling and that globalizing a fixed-income portfolio can improve its risk/return profile. Inflation protection remains important.

Municipal Bonds Are Still Enticing

We continue to see opportunities for investors in the municipal bond market, where interest rates for intermediate-term muni bonds are still much higher than normal in relation to short-term rates. In investment terminology, the yield curve for municipal bonds is steep.

This type of environment can be exploited by active managers to enhance returns by "rolling down the yield curve." Roll is the natural price gain that a bond experiences as it moves toward its maturity date, assuming that interest rates don't change. Managing this process carefully may allow portfolio managers to augment bond portfolio returns.

Municipal bonds are also attractive because of their tax treatment: muni-bond income is exempt from federal taxes as well as many state and local taxes. How much of a difference does this tax-favorable treatment make?

To answer this question, it's important to compare muni bonds with taxable bonds on an apples-to-apples basis.

If we assume an income tax rate of 35% and adjust for the tax-free nature of muni income, we get a tax-equivalent yield for BBB-rated municipal bonds of 5.9%. That's significantly higher than the 4.2% yield on a BBB-rated corporate bond with the same maturity. Using the same comparison, the yield advantage of BBB muni bonds versus AAA muni bonds is over 3%, twice its historical average. Investors should note, though, that BBB bonds include greater risks, such as a higher risk of issuer default.

Global Bonds: Opportunities, Diversification, Resilience

The yield curve for taxable US bonds is also steep; in fact, yield curves are steep in a number of key developed markets. Globalizing portfolios can allow investors to cast a wider net for opportunities as well as reduce their portfolio's sensitivity to US rate changes by diversifying interest-rate cycles. That's because interest rates in each country tend to follow their own path.

In creating a global bond strategy, it's important to avoid unintended consequences. Some global strategies offer stable, "core"-like risk/return profiles, while others are much more volatile—often due to currency exposure. Many investors don't use strategies that hedge currency exposure because they assume that currency will boost returns and help them diversify. As it turns out, unhedged currency makes global bonds a lot riskier.

On the other hand, hedged global bonds have historically been much less risky than unhedged global bonds while delivering competitive returns. In fact, hedged global bonds have historically outperformed unhedged global bonds.[1]

Hedged global bonds have also captured most of the upside of US bond returns and been more resilient in down markets. Since 1990, US bonds have averaged returns of 2.5% in positive-return quarters; global bonds averaged 2.3% in the same quarters, capturing 92% of the upside of US bonds. That's because global government bonds tend to move together in widespread flights to quality.

In adverse bond markets, global bonds fared better than US bonds. While US bonds declined 1.1% on average in down quarters, global bonds lost only 0.7%. That's only 62% of the downside of US bonds, a significant advantage of country diversification, though diversification does not eliminate the risk of loss.

[1]**Past performance does not guarantee future results. For the period January 1996–December 2011.** An individual cannot invest directly in an index. Please see back cover for index definitions. Barclays Capital and AllianceBernstein

Is Inflation Protection Worth It?

As mentioned earlier, many of the world's developed economies have rolled out sizable stimulus programs to spur growth. At the same time, many emerging economies are growing rapidly and consuming commodities hungrily along the way.

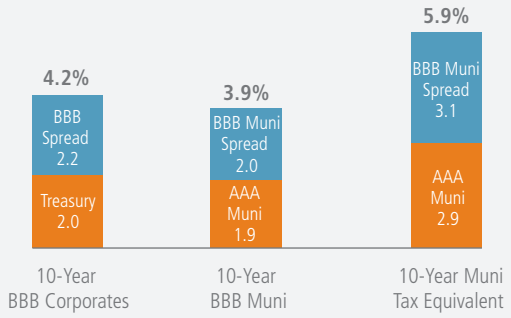
Many forces are at work that could create the conditions for unexpected inflation spikes. Surges in inflation have been unpredictable in the past, so if investors think that inflation could end up higher than the market expects, it might warrant inflation protection for a bond allocation. Others may simply want to protect against the potential for inflation.

But inflation protection shouldn't come at the expense of typical bond returns. The cost can be steep if investors focus on popular inflation-protection strategies like Treasury Inflation Protected Securities (TIPS). With the real yield on two-year TIPS currently at –1.8%, we think that the cost is high today.[2] In our opinion, it makes more sense to build a well-diversified, multisector bond portfolio and then wrap an inflation-protection strategy around it using other instruments.

If investors are looking for inflation protection with more equity-like returns, another effective approach might be a mix of real assets, each with inflation-fighting potential in various environments. This includes commodities, real estate and natural-resources stocks, blended in a dynamic strategy that shifts its allocations based on the prevailing environment.

After adjusting for their tax advantages, munis are compelling

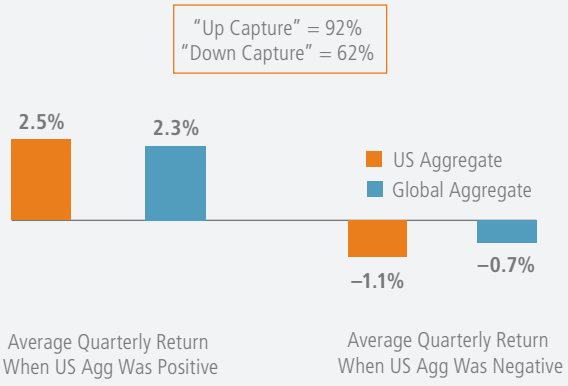
Comparative Bond Yields (%)



Past performance and historical analysis do not guarantee future results.
As of March 23, 2012
10-year muni tax-equivalent yield assumes 35% tax rate. Spreads are to 10-year BBB versus AAA municipals.
Source: Barclays Capital, Delphis Hanover and Municipal Market Data

Currency-hedged global bonds have been more resilient

Mar 1990–Dec 2011



Past performance does not guarantee future results.
As of December 31, 2011
Up capture reflects the percent of the Barclays US Aggregate's returns that the Barclays Global Aggregate generated in positive quarters; down capture reflects negative quarters.
Source: Barclays Capital and AllianceBernstein

[2]As of March 20, 2012. Bloomberg

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- Helping investors overcome their emotions and keep their portfolios on track
- Defining the importance of investment planning and portfolio construction in determining investment success

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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 **Standard & Poor's Small Cap 600 Growth Index** measures growth across separate dimensions of the **Standard & Poor's Small Cap 600 Index**, an index of small-cap stocks that covers a broad range of small-cap stocks in the US. The index is weighted according to market capitalization and covers about 3%-4% of the total market for equities in the US.

The **Barclays Capital US Aggregate Index** represents securities that are SEC-registered, taxable and dollar denominated. The index covers the US investment-grade fixed-rate bond market, with index components for government and corporate securities, mortgage pass-through securities and asset-backed securities.

The **Barclays Capital Global Aggregate Index** provides a broad-based measure of the global investment-grade fixed-income markets. The three major components of this index are the US Aggregate, the Pan-European Aggregate and the Asian-Pacific Aggregate indices.

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