Spring 2013

CAPITAL MARKETS OUTLOOK

Focusing on the Fundamentals

Against a solid—though uneven—macro backdrop, risk assets remained strong in the first quarter. We expect markets will focus more consistently on the fundamentals going forward.

Risk Assets Continued to Rally

As some investors focus on big-picture macro risks, others are looking to underlying economic fundamentals. Despite the risks, global growth has been solid, though the patterns are uneven.

In the US, a housing recovery and manufacturing rebound have been bolstering growth while European economies have continued to struggle. Japan has unveiled policies to revive its economy, and China's growth should remain strong— but with less upside potential.

Risk assets extended their strong performance from last year. The Dow Jones Industrial Average and S&P 500 Index both set all-time highs in the first quarter. In fixed income, most credit sectors continued to outpace government bonds.

Fundamentals in Sharper Focus

Focusing on the fundamentals may help uncover investment opportunities, too. In our view, active management based on strong research is the way to go.

We expect the long-run return for stocks to be below average but still reasonable. Government bonds are expensive and their expected returns well below average, but we don't believe there's a bubble. We see many opportunities to enhance bond returns.

Most important for allocation decisions, the expected equity risk premium—the difference between the return of equities and risk-free assets—is well above average. This is somewhat overshadowed by macro uncertainty, though expected volatility is below average.

Stocks present a relative opportunity in the long run

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	2.4%
Developed	1.1%
US	2.4%
Emerging Markets	5.1%

Inflation	2013F
Global	2.4%
Developed	1.6%
US	2.1%
Emerging Markets	4.1%

Forecasts may not be achieved.
April 5, 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

Global Growth Patterns Remain Uneven

We expect a continued solid economic expansion to pick up pace in the second half of 2013, with US growth accelerating and China setting the pace while the euro area continues to struggle.

Global Growth to Strengthen

Globally, our forecast for gross domestic product (GDP), a key measure of economic growth, is 2.4% for 2013. That's in line with consensus forecasts. However, not every country and region will grow at the same rate—and our forecasts differ from the consensus for some countries.

In our view, emerging markets should lead growth, with the euro area in recession and the US in line with global growth. Growth should accelerate during the year as a result of recent policy decisions around the world. By year end, the pace of growth should be markedly improved.

US Housing, Manufacturing Rebound

In the US, where our forecast is above consensus, a strong private sector should continue to be a major bright spot, in contrast with an anemic public sector. In fact, the private sector has been even stronger than GDP data suggests. Fourth-quarter private GDP growth was tempered by declining business inventories as firms remained cautious. In fact, first-quarter data indicates that businesses have already begun to ramp up production to refill the shelves.

Housing and manufacturing are rebounding, too. Since mid-2010, housing inventory has been declining and existing home sales rising, creating an improved supply-demand dynamic. As a result, we expect construction activity to pick up. US manufacturing has been enjoying a resurgence, with companies leaner, fitter and more competitive globally.

We're also seeing promising signs from consumption, the biggest component of the US economy. Consumers overall have more income to spend and less of it is going to pay financial obligations. Also, higher household net worth from rising stock and home prices has been encouraging more spending.

On the public side, while policymakers navigate the decisions of the sequester and long-term fiscal issues, we expect private sector strength and job gains to continue driving US growth.

Euro Periphery Still Struggling

Fundamentals in the euro area's peripheral countries remain weak, and the monetary union's competitive challenges extend beyond the periphery.

For a long time, onlookers have pointed to the largest core countries—notably Germany and France—as an anchor for the region's economy. Germany, France, Italy and Spain account for most of the euro area's economic output. In fact, with the exception of France, Spain and Italy, the combined GDP of all other EU countries is less than Germany's.

Of course, from a headline risk perspective, the size disparity is a bit of an illusion. As we saw with tiny Cyprus recently, the market tends to view developments even in smaller countries as possible indicators of what's in store for policy in larger, challenged economies.

While Spain's and Italy's troubles are well known, France is struggling, too. The country has banked on massive public spending to support growth, and its uncompetitive exports have declined relative to Germany's. In short, there doesn't seem to be a lot of "core" growth left in the euro core today.

Divergent Growth Rates in Asia

We're confident that China will produce a relatively quiet GDP growth rate of 7.5% to 8%, without a lot of upside potential beyond those levels. Of course, "quiet" is a relative term, based on China's impressive growth record.

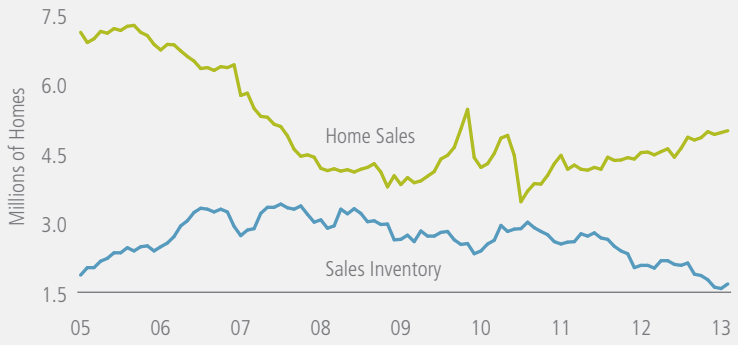
New infrastructure investment continued to dominate other components of the country's economy, but industrial production was relatively soft by China's standards. Also, China's anticorruption efforts and measures to curb housing speculation will likely limit the possibility of an upside surprise in economic growth.

In our view, the challenge for China isn't the current growth path, but its desire and need to change the structure of its economy. China must transition its economy from one led by investment and export to one driven by robust domestic demand.

Japan is working to pull its economy away from the risk of deflation and kick-start growth. The "Abe-nomics" program, named after the country's prime minister, involves big increases in monetary and fiscal stimulus as well as structural reforms. Ultimate success, though, will be measured by the ability to stimulate sustainable growth.

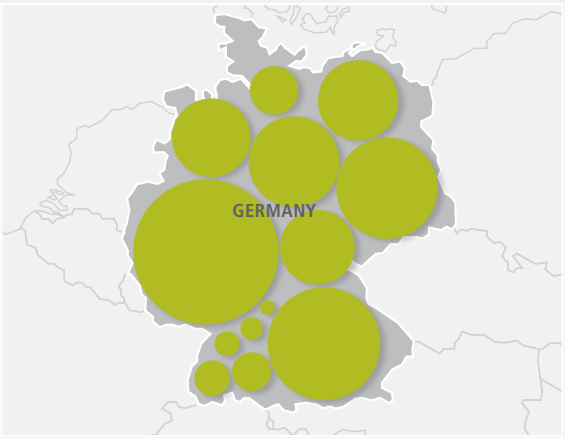
US home sales have been rising and inventories falling

Existing Home Sales vs. Existing Sales Inventory



Current analysis does not guarantee future results.
Through February 28, 2013
Source: Bloomberg, National Association of Realtors and AllianceBernstein

The size of Germany's economy dwarfs most others in the euro area



GERMANY	**€2,472**
FRANCE	**1,931**
ITALY	**1,547**
SPAIN	**1,063**
ALL OTHERS	**2,148**
NETHERLANDS	588
BELGIUM	354
AUSTRIA	286
GREECE	230
FINLAND	180
PORTUGAL	172
IRELAND	156
SLOVAKIA	66
LUXEMBURG	42
SLOVENIA	35
CYPRUS	17
ESTONIA	14
MALTA	6

Historical analysis does not guarantee future results.
Country GDP based on Nominal GDP in 2011 in billion EUR.
Source: European Commission and Haver Analytics

Stocks Still Offer Substantial Value

Despite a lengthy rally, stock valuations still seem reasonable and fundamentals are sound. We see compelling evidence to make the case for active management—and we see many ways investors can capitalize.

For Stocks, 2013 Is Not 2007

Stock prices have risen considerably in recent years, and both the Dow Jones Industrial Average and S&P 500 Index set all-time highs on the final day of the first quarter. But, even though these highs have investors leery, a closer look reveals differences between 2013 and 2007.

The market has staged its impressive rally without the benefit of the large inflows it enjoyed in 2007 and with weaker underlying economic growth. Volatility is higher today, but still lower than it was during the crisis. Valuations are more reasonable and yields are higher, while corporate fundamentals are better.

Earnings are the biggest story. Earnings per share are at record highs today and have been considerably more stable. What's more, we have reason to believe that earnings could remain robust and margins wide, providing a strong foundation for the corporate sector and equity markets.

We think these distinctions—particularly with earnings—indicate more potential ahead.

Reasons to Be Active in Equities

In our view, the environment has begun to favor research-driven strategies that distinguish between the prospects for individual stocks and sectors. And, unusually, the opportunities we're seeing are available across both growth and value styles.

Historically, active managers have been effective when correlations between stock price movements are lower and when dispersion between stock returns is high or rising. In layman's terms, that's when stocks are less prone to move in the same direction and by similar magnitudes.

From their last peak in late 2011, correlations have declined significantly. Dispersion is still low, but it's at the lower end of its range of the last 17 years or so. We think it's only a matter of time before it begins to rise again. In fact, we think we see the beginnings of higher dispersion in the performance gaps that have opened up between sectors.

Indexing Isn't as Diversified as You Think

Active management has the potential to generate alpha—in other words, outperforming indexes. However, our analysis indicates that active management may also help protect investors, because index investors today may be more concentrated and less diversified than they think.

Indexes fluctuate as the market value of companies and sectors rises and falls. This can concentrate index-based strategies in unintended ways. At the peak of the tech bubble, the top 20 stocks in the S&P 500 Index were 38% of its total market cap.[1] That included well-known tech companies that would soon be part of the collapse. Financial stocks in 2008 told a similar story.

A current example is high-dividend stocks. As investors have flocked to cash flow, they may also have exposed themselves to similar imbalances, since high-dividend payers are about 40% of the index.[2] These stocks tend to trade at less attractive valuations than the rest of the market. And, the companies represented by these stocks tend to generate earnings growth that is below the market average. An active strategy would be a way to shift a portfolio to a more favorable balance.

[1]CRSP, FactSet, S&P Dow Jones and AllianceBernstein

[2]As of March 31, 2013. High-dividend stocks are defined as stocks with yields that are 20% or more than the cap-weighted average for the S&P 500. 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: CRSP, FactSet, S&P Dow Jones and AllianceBernstein

Where to Invest? Check the Environment

Of course, saying that active investing makes sense is one thing—but which active strategies should investors consider? It helps to think about the expected environment and strategies that might be helpful in each one.

We'll start with a scenario we don't expect: financial crisis and recession, with a flight to safety. This might call for preservation-type investments like defensive equities. For fixed income, which we'll discuss later, high-grade government bonds and other defensive security types should be considered.

There's also a risk-on, risk-off landscape. We've seen this a lot lately, but it might be fading. This environment typically leads to a flight to cash flow and a focus on income—stability and global equities, fixed-income credit and real estate.

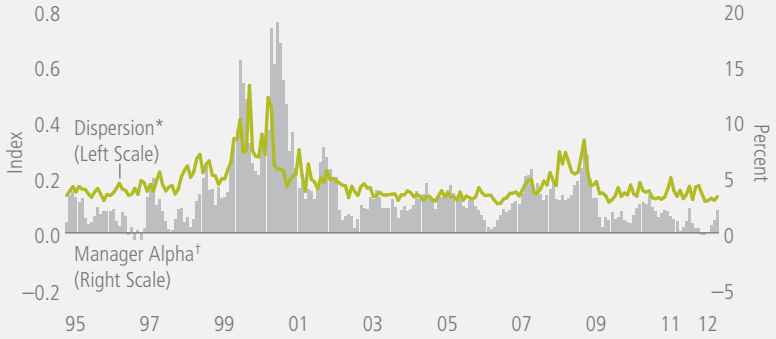
Then there's the scenario we think we're headed to—recovery and normalization. An appreciation focus might make sense. Equities would emphasize cyclical, non-US and emerging markets. Fixed income would feature highly market-sensitive credit, and commodities should be considered.

Depending on each investor's personal situation and expectations, a mix of multiple strategies might be prudent.

Stocks are back at 2007 levels, but remain an attractive opportunity

Historical analysis does not guarantee future results.
Through March 31, 2013
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: Bloomberg, S&P/Dow Jones and AllianceBernstein

Active managers have fared well when dispersion has been high or rising



Past performance is no guarantee of future results.
Through December 31, 2012
*Three-month rolling dispersion of returns within the Bernstein US large-cap universe.
†Alpha is a measure of performance on a manager's excess returns. Six-month rolling premium of top quartile of US large-cap managers versus the S&P 500 Index. 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: Center for Research in Security Prices, eVestment Alliance, S&P/Dow Jones and AllianceBernstein

Bonds Offer Many Potential Paths to Opportunity

Even though interest rates are generally low, active management may add value in fixed income. And, a number of income-enhancing sectors are available to choose from. In our view, the key is to remain selective.

Efficiency in Global Investing

For core portfolios that include high-quality bonds, we believe efficiency is the key. We don't believe that there's a bond bubble, but developed-market government bonds are pretty expensive. An efficient approach to safety boils down to which yield curve to choose and where on those curves to invest.

Going global has historically reduced the direct sensitivity to interest-rate changes in any one country. It also offers the ability to actively manage country exposures. But currency exposure can add a lot of unexpected volatility, so we think the best approach to core investing is hedged global bonds. These have delivered less risk and competitive returns over time.

It's also efficient to invest in the "sweet spots" on individual country yield curves. For example, central bank policies around the world have made some maturities more attractive than others. They offer attractive combinations of yield and roll—the natural price gain a bond experiences as it ages, assuming rates are unchanged.

Of course, there are risks when investing in bonds for longer periods, including the risk that rising interest rates cause bond prices to fall.

The Value of Municipal Bonds

Combining yield and roll highlights one aspect of the value in municipal bonds today. At the end of the first quarter, the yield on a 10-year muni bond was about 2.5%. The potential gain from roll over a year, assuming rates don't change, could add as much as 1.4%. That boosts return potential to 3.9% before taxes.[1]

For people worried about rates rising, municipal bonds might offer another advantage. Historically, municipal bond yields haven't followed Treasury yields in lockstep. So, historically, when Treasury yields have risen, muni yields have risen much less.

There's also the opportunity to take advantage of the credit angle. The yield advantage of BBB-rated muni bonds above AAA-rated municipal bonds is about 1.4%, a relatively attractive premium.[2] And last, we expect only modestly positive net issuance in 2013, which should help support prices.

We Don't See a High-Yield Bubble

One credit-related sector that has come under scrutiny is high yield. It's true that prices have soared in the past few years, but that's from the depressed levels of 2008. As a result, high yield prices aren't particularly inflated today.

The average coupon rate of 7.7% provides attractive income, which can be enhanced by roll and other active strategies. Based on that foundation, high-yield prices would have to decline steeply to create a total return loss of even 20%, far short of the losses suffered in classic bubbles.[3]

That scenario seems unlikely to us. Defaults haven't been anywhere close to the levels needed to cause those losses. And, we don't see a big rush of supply that could hurt prices. Of course, there could be a massive sell-off due to changes in portfolio allocations. However, if that happened, we think yields would soar and—given the strong fundamentals—investors would quickly move back into high yield.

[1]As of March 31, 2013. There is no guarantee that this, or any, investment strategy will be successful in the short or long term. Source: Barclays, Bloomberg, Delphis Hanover, J.P. Morgan, MorganMarkets, Municipal Market Data, The Yield Book and AllianceBernstein

[2]As of December 31, 2012. Credit quality is a measure of the quality and safety of a bond or portfolio, based on the issuer's financial condition. AAA is highest (best) and D is lowest (worst). There is no guarantee that this, or any, investment strategy will be successful in the short or long term. Source: Barclays, Bloomberg, Delphis Hanover, J.P. Morgan, MorganMarkets, Municipal Market Data, The Yield Book and AllianceBernstein

[3]**Current forecasts do not guarantee future results.** As of March 31, 2013. High-yield characteristics and high-yield prices are represented by the Barclays US High-Yield 2% Issuer Capped Bond Index. Default rate is par weighted and forecasted by J.P. Morgan. 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, J.P. Morgan and AllianceBernstein

Other Sources of High Income

Beyond corporate high yield, there are other sources of income that diversified fixed-income investors should consider.

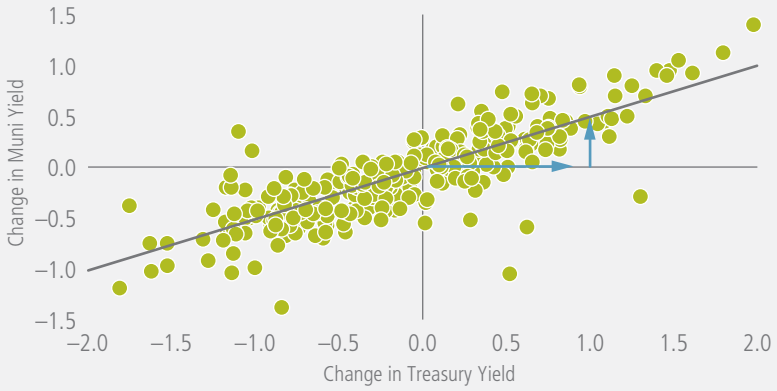
Emerging-market corporate bonds have been, on average, less sensitive to interest-rate movements and have had slightly higher credit quality than emerging-market sovereign bonds. And, they offer a yield advantage versus US corporates—in both investment grade and high yield. We think this makes emerging corporate bonds an attractive option for income seekers.

Of course, there are specific risks to be aware of with emerging-market debt, in addition to the typical risk factors in bond investing such as interest-rate risk and credit risk. Emerging-market debt securities may be more volatile due to political, regulatory, market and economic uncertainties—these risks can be magnified in emerging-market securities. Emerging-market bonds may also be exposed to fluctuating currency values.

Another place in fixed-income markets where we think investors can turn for income is US securitized credit. For example, commercial mortgage-backed securities (CMBS) offer very competitive yields compared to US corporate bonds. As with US corporates, it's important to be selective when choosing individual bonds.

Municipal bond yields tend to move less than Treasury yields

Changes in AAA 5-Year Munis vs. 5-Year Treasuries



Past performance and historical analysis do not guarantee future results.
From December 1986 through December 2012
Credit quality is a measure of the quality and safety of a bond or portfolio, based on the issuer's financial condition. AAA is highest (best) and D is lowest (worst).
There is no guarantee that this, or any, investment strategy will be successful in the short or long term.
Source: Barclays, Bloomberg, Delphis Hanover, J.P. Morgan, MorganMarkets, Municipal Market Data, The Yield Book and AllianceBernstein

The high-yield rally has merely been a recovery from depressed levels

Barclays US High-Yield 2% Issuer Capped Bond Index

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As of March 31, 2013
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, J.P. Morgan 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

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Important Risk Information Related to Investing in Emerging Markets and Foreign Currencies: Investing in emerging-market debt poses risks, including those generally associated with fixed-income investments. Fixed-income securities may lose value due to market fluctuations or changes in interest rates. Longer maturity bonds are more vulnerable to rising interest rates. A bond issuer's credit rating may be lowered due to deteriorating financial condition, which may result in losses and potentially default or failure to meet payment obligations. The default probability is higher in bonds with lower, non-investment-grade ratings (commonly known as "junk bonds").

There are other potential risks when investing in emerging-market debt. Non-US securities may be more volatile because of the associated political, regulatory, market and economic uncertainties; these risks can be magnified in emerging-market securities. Emerging-market bonds may also be exposed to fluctuating currency values. If a bond's currency weakens against the US dollar, this can negatively affect its value when translated back into US-dollar terms.

Index Definitions: Widely regarded as the best single gauge of the US equities market, the world-renowned Standard & Poor's 500 Index includes a representative sample of 500 leading companies in leading industries of the US economy.

The Barclays US High-Yield 2% Issuer Capped Bond Index is a component of the US Corporate High-Yield Bond Index, which covers the universe of fixed-rate, non-investment-grade corporate debt of issuers in non-emerging-market countries. It is not market capitalization-weighted—each issuer is capped at 2% of the index.

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