AllianceBernstein

Summer 2013

CAPITAL MARKETS OUTLOOK

Perspective Reveals Potential Opportunities…and Risks

Investors recoiled from concerns over the tapering of Fed bond buying, but we believe economic and asset-class fundamentals remain encouraging. In our view, investors should remain adaptable as markets evolve.

Changing Market Return Patterns

Risk assets had performed well for much of 2013's first half until May. Concerns about a "tapering" of the US Federal Reserve's bond buying as well as slower growth in China and the effectiveness of Japan's economic policies have caused stocks to pause and bond yields to rise sharply.

From our perspective, the pause in equities wasn't the start of a bear market. Investors seemed to use the Fed story as an excuse to take profits from an extended rally.

Fixed-income markets also reacted to concerns about a Fed taper, with 10-year Treasury yields jumping. Credit sectors underperformed—but due to a historic level of investment outflows, not deteriorating fundamentals.

The High-Level Assessment

Perspective is important, especially given recent developments. Economic, corporate and market fundamentals are generally encouraging, in our view. Despite recent volatility, equity returns have been solid so far in 2013; bond yields were destined to rise.

We don't believe that this is a bond bubble, and stocks generally don't seem overvalued. We expect long-run equity returns and volatility to be about average. For bonds, returns should be below average and volatility above average, notably for government bonds.

That's the asset-allocation perspective. Within each asset class, we see many opportunities for research and active management to enhance risk-adjusted returns. Investors should focus on the long-term, diversifying and adapting as markets evolve.

We expect volatility to be higher for bond markets

AllianceBernstein Capital Market Forecasts

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

AllianceBernstein Economic Forecasts

Real GDP Growth	2013F
Global	2.3%
Developed	1.1%
US	2.2%
Emerging Markets	4.6%

Inflation	2013F
Global	2.4%
Developed	1.5%
US	1.9%
Emerging Markets	4.1%

Forecasts may not be achieved.
July 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

Economic Growth Continues… with Diverse Patterns

We believe the global economy should continue to expand, accelerating in the second half of the year and into 2014. However, the patterns of economic growth are still varied.

The Pace of Expansion Should Pick Up

Developed-market policies are still accommodative, even with expectations of a tapering of the Fed's bond-buying program. Central banks are keeping short-term rates low relative to economic growth. They're also providing nontraditional stimulus—notably massive injections of liquidity to encourage activity.

Supported by these policies, we believe that the global economy should continue to expand. For 2013, we expect growth of about 2.3% in global GDP (gross domestic product), a common measure of economic output. The pace of growth should pick up during the second half of this year and should continue at a higher rate into 2014.

Emerging-market growth is expected to slow somewhat relative to initial forecasts but, driven by Asia, should once again lead the pack. For those worried that even modestly slowing emerging growth could hurt the US economy, we think any impact would be small.

US growth should be in line with global growth this year, accelerating as we move forward. We think the euro area will move out of recession in the second half of 2013.

The US Growth Mix Is Evolving

We expect the US to lead global growth in combination with Asia. US GDP growth should accelerate as the strength of the private sector continues, led by traditional early-stage sectors. We also expect the drag of a weakened public sector to decline.

Substantial cuts in defense spending had increased public-sector headwinds in the fourth quarter of last year and in the first quarter of this year. However, we think these headwinds will generally tail off. One reason: huge cuts in state and local public-sector jobs seem to have abated. On the private side, traditional drivers like housing and consumer activity have stepped up and increased their combined contribution to GDP.

We're seeing indications of strong support for a consumer rebound. Real disposable income has been rising since mid-2010, giving consumers more money to spend. And, much less of that money is needed to pay off financial obligations today: the ratio of household financial obligations to disposable income is near an all-time low. Meanwhile, household net worth is back to its 2007 heights, and rising wealth has historically contributed to higher consumption.

Euro Austerity to Ease, Not Disappear

The situation is a lot less positive in the euro area, where economic growth remains challenged as governments continue to search for an effective policy mix.

The austerity-focused approach of the last several years has improved current account balances of peripheral countries. But it's come at a cost—soaring unemployment and falling real wages. Spending cutbacks have improved current account deficits, but they've also punished households and hampered consumption, which is still chronically weak.

We don't see austerity going away—it remains a part of the puzzle that Europe is trying to solve. But, in recent months, we've seen the austerity focus ease as policymakers relax timelines and implementation targets. This has fostered a more balanced approach to addressing the region's persistent challenges.

Asia: Growth Is Moderating

Overall growth in Asia's emerging economies have continued to set the pace for the world. However, the region's high growth rate is beginning to slow somewhat and has a limited upside in our view.

China's economy seems to be moving toward a slower growth path as new leadership focuses on other priorities. These include deleveraging and rebalancing its economy from the high investment-driven growth that has increased government debt and corporate leverage.

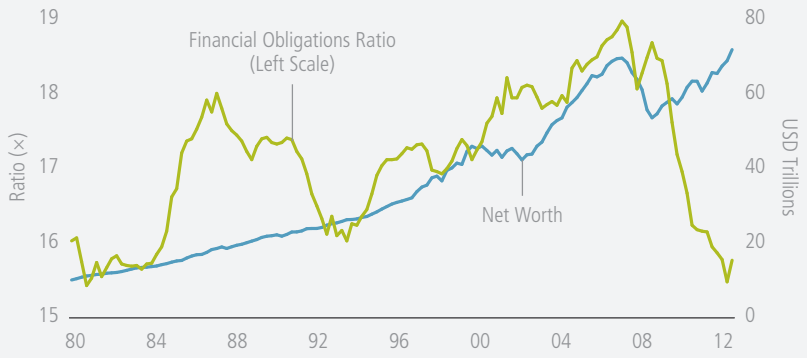
There's also a concerted effort to curb corruption by clamping down on extravagant spending by local officials, which has reduced consumption. However, we still believe that a hard landing is unlikely.

Growth is slowing elsewhere in Asia. Industrial production has been essentially flat for some time, while inflation has been relatively subdued and stable. This suggests that a continued stimulus bias—and perhaps added stimulus—may be necessary.

In Japan, we're monitoring the progress of Abe-nomics, the expansive policy plan named for the country's prime minister. Abe-nomics is attempting to revive inflation and growth in long-struggling Japan. It's too early to judge the policy's success, but expectations are high and there will be a more intense focus ahead on how the ambitious plan is delivered, particularly structural reform.

US households' net worth has risen and financial obligations have tumbled

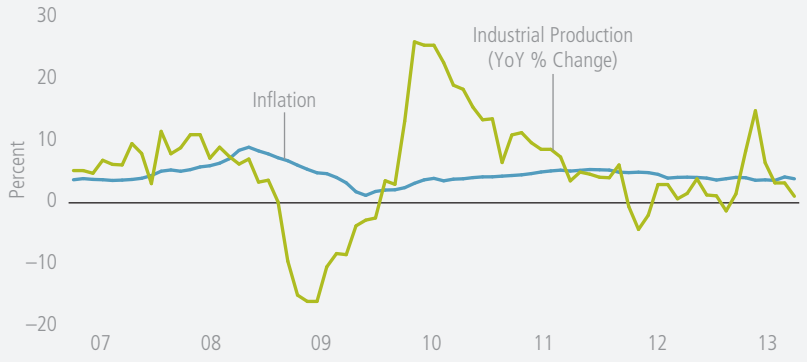
US Household Net Worth and Financial Obligations Ratio



Historical analysis does not guarantee future results.
Through March 31, 2013
Source: Bureau of Economic Analysis, The Conference Board, Haver Analytics, National Association of Realtors, US Census Bureau and US Federal Reserve Board.

Asia: weaker manufacturing and benign inflation add up to more policy easing

Asia ex-China and India



Historical analysis and future estimates do not guarantee future results.
Through June 4, 2013
Source: CEIC Data and AllianceBernstein estimates

In Equities, Uncertainty Calls for Balance and Flexibility

Investors' view of economic growth should inform their portfolios' market sensitivity, but the key is to be active. We believe longer-term opportunities to add value exist across markets.

Stocks Have Been Rewarding, But Not for Everyone

Even with their recent pause, equity markets have produced solid returns in the past few years. Still, money has flowed into bonds—at a pace well above its pre-crisis trajectory—and cash. Flows into stocks have been similarly lower. So, stocks have been rewarding, but not necessarily for all investors.

Within equities, there's been a migration toward passively managed strategies in recent years, mainly at the expense of active management. Indexing does carry risks, though, including unintended concentrations.

For example, dividend-paying stocks have been very popular over the last couple of years, with their lower volatility and current cash. However, this popularity has caused dividend-paying stocks to carry a much higher weight within the S&P 500 Index, while stocks that offer a high return on equity (ROE) have seen their share decline.

We still see opportunity in dividend-paying stocks. But an index-like exposure to these stocks would put them at nearly 50% of a portfolio—an all-time high. At the same time, exposure to high ROE stocks is about 30%, an all-time low.[1] That doesn't sound optimal. And, dividend payers carry substantial interest rate risk today, leaving them vulnerable to rising rates. We've seen indexed concentrations cause trouble before—with expensive tech stocks during the tech bubble and in 2006 with financial stocks.

Active Potential Is Apparent

Lately, though, we've seen evidence that stock picking is still appreciated by investors. Among net active equity flows over the past five years, flows into concentrated portfolios with fewer holdings have been positive; portfolios with many holdings have lost assets. This seems to indicate interest in strategies that seek to differentiate themselves from broad market indexes.

In the current market environment, we're encouraged by the prospects for active management. Historically, it has thrived when dispersion is high or rising and correlations are low.

Put another way, 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. And, with dispersion at the lower end of its range over the last 17 years or so, we think it will eventually rise back toward its historical average.[2]

Sector Returns Highlight Market Opportunities

In fact, we see the signs of higher dispersion in recent sector returns. For the one-year period ended June 30, financial stocks returned 33% and consumer discretionary 29%. Tech stocks produced a modest 6% and utilities 2%.[3] In our view, those differences present an opportunity to take advantage of sector insights.

We believe that changing sector leadership provides opportunities. Recently, cyclical and defensive stocks traded leadership several times based on a ratio of the sectors' returns. Until early this year, cyclicals led, but then the market took on a defensive tone until April. In the spring, we saw a huge rotation back toward cyclical stocks. We see these shifting returns opening up opportunities for active management to add value.

[1]**Historical analysis does not guarantee future results.** As of June 30, 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. CRSP, FactSet, S&P Dow Jones and Alliance Bernstein

[2]**Past performance is no guarantee of future results.** As of May 31, 2013. Based on three-month rolling dispersion of returns within the AllianceBernstein US large-cap universe and six-month rolling intramarket correlations of returns within the S&P 500. Bloomberg, S&P Dow Jones and AllianceBernstein

[3]**Past performance is no guarantee of future results.** Bloomberg, S&P Dow Jones and AllianceBernstein

Outlook Should Inform Portfolio Positioning

How should investors position their portfolios to take advantage of the opportunities we see? It depends on the economic and market scenarios they expect.

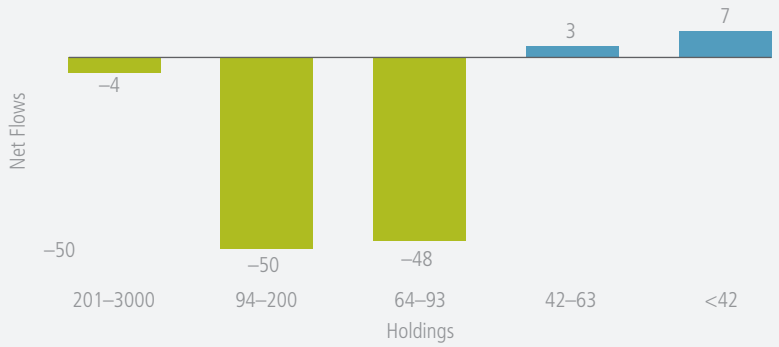
Two potential scenarios seem prevalent today. In a slow-growth environment, we'd expect steady profit margins and slow earnings growth. Overall stock valuations would likely be stable, reducing upside. Rates would likely rise at a moderate pace, while stock dividends would be largely unchanged. We believe that investors planning for this scenario might consider a defensively oriented portfolio.

A second scenario of accelerating growth would likely see rising margins, faster earnings growth and expanding valuations, implying greater upside for equities. Rates would likely rise more aggressively than they would in a slow-growth environment, and dividend payments would be higher. In this environment, it would make sense to consider more market-responsive higher-beta stocks in our view.

Given the likelihood of volatility around these two scenarios and the fact that no one has a crystal ball for equity markets, we believe it seems sensible to keep a foot in both camps. That means exposure to both secular growth companies and more cyclically sensitive companies.

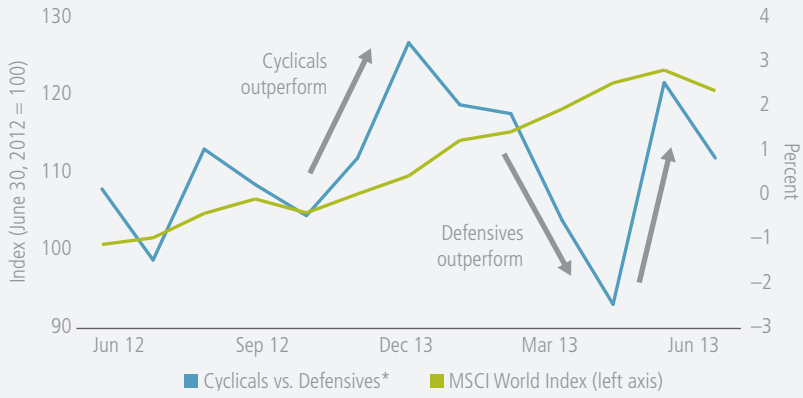
Within active equities, net flows have favored concentrated portfolios

Active US Large-Cap Core Fund 5-Year Net Flows by Number of Holdings (US$ Bil.)



Historical analysis does not guarantee future results.
As of December 31, 2012
Source: Dealogic, Deutsche Bank, FactSet, International Monetary Fund, Investment Company Institute, Morningstar, Simfund, Strategic Insight and AllianceBernstein

Changing sector leadership has created active-management potential



Past performance is no guarantee of future results. 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.
Through June 30, 2013
*Cyclicals consist of capital equipment, construction & housing, consumer cyclicals, technology and transportation. Defensives consist of consumer staples, medical, telecom and utilities. Cumulative returns, cyclicals minus defensives, indexed to 100 at June 30, 2012.
Source: MSCI and AllianceBernstein

Positioning Bonds for Rising Rates

Bond markets overreacted to a reinforcing message from the Fed. We certainly don't see an Armageddon scenario, and there's plenty investors can do to position for rising rates.

The Fed Reassures, Rates Soar Anyway

The dominant story since the second week of May has been the market reaction to the US Federal Reserve's discussion of its plans to "taper" its bond buying if economic improvement continues.

To boil it down, the Fed clearly laid out a flexible plan to taper buying and eventually increase rates gradually toward more normal levels—if the economy improves as expected. If economic data misses its forecasts, the Fed will adjust the plan.

The Fed thought this was good news communicated with clarity, but capital markets tumbled. Yields rose in many developed nations and yield spreads widened. In the US, inflation expectations fell and the dollar strengthened. The direction of these moves wasn't terribly surprising, but the magnitude and speed were.

The Impact of Rising Rates

Based on our forecast, the 10-year Treasury yield will rise to roughly 3.5% by the end of 2014, about 1% higher than it was at the end of the second quarter.

We can get a sense of the potential impact by looking at the roughly 11-month period from late July 2012 to late June 2013, when rates rose by a similar amount. The 10-year Treasury lost 6%. The Barclays US Aggregate Index, which represents a broad market strategy, was down substantially less—about 2%. Active management helped navigate rising rates: the average total return within the intermediate-term bond fund category was down only –0.8%.

That's because a lot of factors impact bond returns in a rising-rate environment, including: the amount and time frame of the increase, coupon income that's received and even yield-curve roll. Roll is the natural price gain of a bond as it ages, assuming rates don't change. Even as rates rise, roll can reduce some of the impact of rising rates, depending on how steep the yield curve is.

What's Next for Bonds?

While our forecast is for higher rates, no one knows what markets will do. However, a hypothetical 1% increase in the 10-year Treasury yield over 18 months would leave the Barclays Aggregate Index with modestly positive total returns, including income, in our assessment. That's true whether the increase happens abruptly or gradually.

Given our forecasts, this is unlikely to be an Armageddon scenario for bonds, even leaving aside the ability of active management to make a difference. And, we see plenty of strategies that investors can use to help their bond portfolios weather a rising-rate environment. Going global is one way, but there are many others—including credit and municipal bonds.

The High-Yield Credit Opportunity

High-yield bonds have historically withstood much of the impact of rising rates because of their credit exposure, which has historically benefited from a growing economy—when rates also tend to rise. That wasn't the case for much of May and June, largely due to massive bond outflows caused by concerns about Fed tapering.

Many investors worry about a high-yield bubble, but the market's current characteristics don't indicate such vulnerability. Also, our fundamental view of high yield is constructive, with moderate economic growth and very low default rates.

Muni Bonds: A Buffer Against Rising Rates

In our view, muni bonds are relatively attractive compared with taxable bonds on an after-tax basis and may help reduce interest rate risk. Muni yields have historically been less sensitive to rising rates than Treasuries. In May 2013, for example, five-year Treasury yields rose by 37 basis points, while five-year muni yields rose by only 20 basis points.

Where you invest on the yield curve can offer a big advantage, too, because yield-curve roll may add value to muni returns. Using roll may enhance returns, but, of course, other risks are associated with investing in bonds for a longer period, including interest rate risk. We've seen some of this rear its head in recent months.

This is why we've talked for some time about focusing on the "smart" part of the yield curve in municipal bonds. For instance, yield plus roll is higher for a 10-year bond than a 30-year bond, which carries significantly more interest rate risk and volatility!

For investors seeking to further enhance risk and return, we believe lower-rated muni bonds offer an attractive yield premium. For example, as of June 30, the yield advantage of BBB-rated munis over AAA-rated munis was about 1.4%. So, adding credit can significantly boost the yield of a muni bond portfolio.

Taper concerns rippled through fixed-income markets

Returns When Rates Rose by 1%

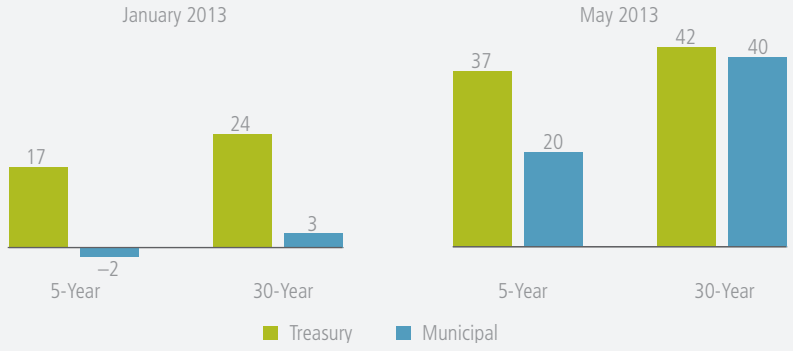
10-Year US Treasury Yields	
July 24, 2012	1.39%
June 20, 2013	2.41%

Returns (July 24, 2012–June 20, 2013)	
10-Year US Treasury	–6.01%
5-Year US Treasury	–2.13%
US Aggregate Index	–2.01%
Average Lipper Intermediate Bond Manager	**–0.78%**

Current analysis does not guarantee future results.
Returns are as of June 20, 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, Bloomberg, Lipper and AllianceBernstein

Muni bonds have provided a buffer against rising Treasury yields

Yield Changes (Basis Points*)



Past performance is no guarantee of future results.
*Basis point (b.p): A unit equal to 1/100th of 1% that is used to denote the change in a financial instrument.
Source: Barclays, Bloomberg, Delphis Hanover, J.P. Morgan, MorganMarkets, Municipal Market Data, The Yield Book and AllianceBernstein

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- Defining the importance of investment planning and portfolio construction in determining investment success

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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 MSCI World Index is a market-capitalization-weighted index measuring the performance of stock markets in 23 countries.

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