AllianceBernstein

**Fall 2013**

CAPITAL MARKETS OUTLOOK

# Perspectives in a Rising-Rate Environment

**Interest rates appear to have bottomed and are likely headed upward. Opportunities remain in capital markets, but investors should consider how to best position their portfolios.**

## Economic Growth Should Continue

Our forecast calls for moderate global economic growth that should pick up a bit in 2014, supported by monetary policy. Growth patterns seem to be more balanced, with improvement in developed economies and a downshift in emerging economies.

In capital markets, the biggest drivers of investor sentiment appeared to be the bottoming of the interest rate cycle and expectations of less-certain US policies ahead. These and other concerns made for a volatile third quarter.

Still, risk assets generally fared well. Yield spreads fell in many bond sectors, although outflows created headwinds for emerging-market bonds and munis. Global equity markets shrugged off a very disappointing August to finish the quarter with positive returns.

## Stocks Seem Attractive

Equity markets are still relatively attractive, based on our assessment. Government bond yields remain low globally, and equities still have solid return potential. We estimate that the equity risk premium is more than 5%; the "normal" premium is just over 3%.

We expect interest rates to rise, but the yield curve will increase gradually over several years. This gives investors time to plan, rather than panic. Many strategies may help bond portfolios weather rising rates. As for stocks, they've historically fared well in most rising-rate environments.

In both sectors, we see opportunities for active managers—and we believe that research is the key to capitalizing on them.

We expect moderate global economic growth to continue

AllianceBernstein Capital Market Forecasts

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

AllianceBernstein Economic Forecasts

| Real GDP Growth | 2013F | 2014F |
|---|---|---|
| Global | 2.3% | 3.2% |
| Developed | 1.2% | 2.2% |
| US | 1.8% | 3.0% |
| Emerging Markets | 4.5% | 5.1% |

| Inflation | 2013F | 2014F |
|---|---|---|
| Global | 2.4% | 2.8% |
| Developed | 1.3% | 2.0% |
| US | 1.6% | 2.4% |
| Emerging Markets | 4.5% | 4.3% |

**Forecasts may not be achieved.**
October 1, 2013
Volatility is measured by the standard deviation 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

# A More Balanced Global Expansion

**Monetary policies are accommodative globally, which should support continued economic expansion in our view. The growth gap appears to be closing a bit between developed and emerging economies.**

## Changing Economic Growth Patterns

We expect continued moderate growth in global gross domestic product (GDP), a key measure of economic activity. Based on our forecast, global GDP should expand 2.3% in 2013 and pick up to 3.2% in 2014.

We also see the patterns of growth becoming more balanced across developed and emerging countries. Emerging economies are still growing faster than developed economies, but the gap seems to be narrowing between the two worlds as developed growth accelerates and emerging growth moderates. We view this as a positive sign for the global economy.

One factor in this trend is the rate of manufacturing growth. Emerging economies had been outpacing developed countries for some time, but more recently, some momentum has left emerging markets while picking up in developed markets.

## US Driven by Early-Stage Leaders

In the US, we expect GDP to expand by 1.8% in 2013 and improve to 3.0% in 2014. Traditional early-stage growth sectors have stepped up, including the housing market. The number of homes on the market has risen modestly in 2013, but remains low historically, indicating reduced supply. And, a very high percentage of young adults are living at home, which hints at higher demand ahead.

There's anxiety that rising rates will hurt housing affordability, but we don't see an impediment yet. Rates will have an impact—but positive factors like job and income gains will act as an offset. We think the US Federal Reserve will continue to support the economy until it strengthens further.

This desire may be one reason for the delay in the planned "taper" of bond purchases. Concern over the taper and rising rates has caused many investors to dump money from bond funds into an increasingly illiquid market, which adds to an already more volatile market.

We think strong corporate and household fundamentals bode well for the US economy. Business profits continue to grow, and firms are relatively debt-lean. Households have strengthened their balance sheets, too, with lower debt burdens and income gains.

## Euro Area Inches Out of Recession

The euro-area economy seems to be inching its way out of a nagging recession. Our regional GDP forecast for 2013 is for a decline of about –0.3%, but, for 2014, we see growth picking up to 1.0%.

What's underpinning this forecast? Improved current accounts and real incomes have been bolstering business activity and aiding consumer confidence.

Of course, the pace of growth is likely to be modest compared with growth in other parts of the world—and with pre-crisis norms. Additionally, domestic demand is likely to recover slowly. The risk of an adverse economic outcome in the euro area is much lower, in our view, but long-term solvency issues will probably linger.

Japan, meanwhile, shows continued signs of recovery, with the three-pronged policy approach of Prime Minister Shinzo Abe providing short-term stimulus. The third prong, representing structural reform, still faces many unknowns, though we remain tentatively optimistic.

## Emerging Markets: Moderate Growth, Stable Inflation

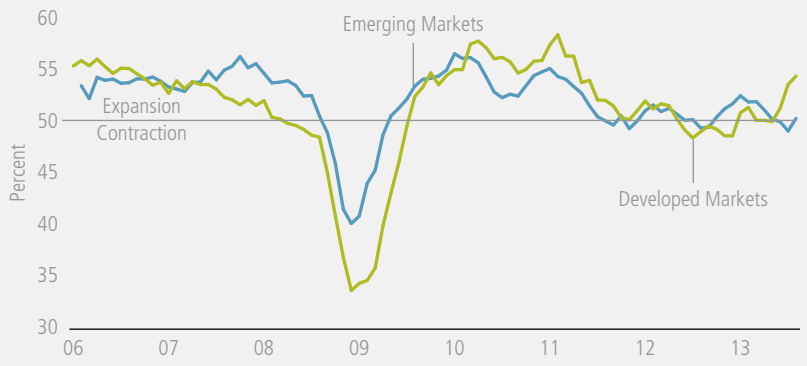
Emerging economies are still growing faster than developed economies, but growth has moderated to an expected 4.5% in 2013.

While we believe that growth rates have stabilized at this lower level, they could pick up some steam ahead—we're projecting GDP growth of 5.1% for 2014. Trade is one reason: exports are beginning to recover from low levels and should begin to benefit from improving demand in developed economies later this year and in 2014. That's one of the positives from the rebalancing of global economic patterns. Meanwhile, inflation in emerging economies is generally stable, suggesting little need for central banks to tighten monetary policies.

In China, recent growth has been relatively moderate by historical standards. We expect stepped-up infrastructure and environmental investment to begin contributing to near-term higher growth. However, we still think policymakers will turn their focus to reform and economic rebalancing in 2014 to ensure long-term growth sustainability at today's more moderate pace.

We see signs that developed and emerging economies are delinking

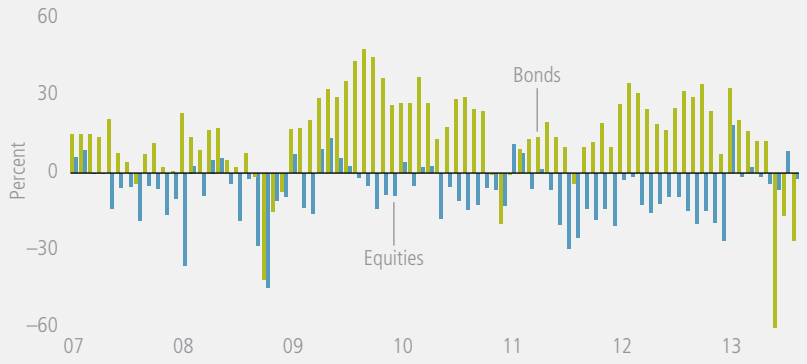
PMI*




**Historical analysis does not guarantee future results.**
Through August 31, 2013
*PMI: Purchasing Managers' Index. An investor cannot invest directly in an index and its performance does not reflect the performance of any AllianceBernstein portfolio.
Source: Bank of England, Bloomberg, Deutsche Bank, European Central Bank, Eurostat, Haver Analytics, International Monetary Fund, J.P. Morgan, Markit and AllianceBernstein

"Taper" concern has drained money from bond funds

Monthly Net New Cash Flow*




**Historical analysis does not guarantee future results.**
Through September 4, 2013
*Weekly cash flows are estimates that are adjusted to represent industry totals, based on reporting covering 95% of industry assets, while monthly flows are actual numbers.
Source: Barclays, Bloomberg, Haver Analytics, Investment Company Institute and AllianceBernstein

# Bond Investing in a Rising-Rate Environment

**US rates will likely take several years to rise back to "normal" levels, and this is a good time to prepare. There are a number of strategies that may reduce a bond portfolio's sensitivity to rising rates.**

## Likely a Long Path to Normal Rates

A multi-decade decline in interest rates had created a tailwind for bond market returns. However, rates appear to have reached a low and those outsized returns shouldn't be expected ahead. We think now is a good time to reset expectations for bond investing.

A rising-rate environment is likely to unfold gradually, and moderate bond returns are still possible in our view. When rates rose from the early 1950s through the early 1980s, the average annualized return for US Treasuries was about 4.5%.[1] That's not a bad total return for the highest-quality bonds, though investors shouldn't necessarily expect those returns ahead. Instead, we see volatility, as reduced liquidity is likely to continue impacting bonds.

Investors shouldn't allow these unfavorable technical conditions to obscure fundamentals or disrupt a long-term approach. The longer an investor's time horizon, the more factors like coupon income, reinvestment and yield-curve roll may be able to enhance total return. And there are a lot of ways to re-fit bond portfolios for a rising-rate environment.

## Don't Panic…Position!

To potentially create insulation as rates rise, we think it makes sense to look to bond sectors with lower "betas," or sensitivity, to US Treasuries—a very interest-rate-sensitive sector. The lower the beta, the lower the sensitivity to moves in US Treasury rates, so, when rates rise, these bonds should tend to outperform.

Global exposure has historically enhanced the risk-adjusted returns of US bonds, and going global creates a much bigger opportunity set for active bond managers. However, currency fluctuations can create unintended volatility, so we feel investors should consider a currency-hedged approach.

High yield has also been very insensitive to rates historically. In fact, its beta to Treasuries has been negative. That's because Treasuries tend to fare poorly when the US economy expands, as rates rise and investors fret about inflation and Fed tightening. High-yield bonds, on the other hand, tend to thrive as a better economy improves business fundamentals.

## High Yield Seems Attractive

Based on valuations and fundamentals, we think high-yield bonds offer attractive opportunities. In our view, BB- and B-rated high-yield bonds offer the most attractive mix of yield spread and default risk. We think defaults are likely to remain low in the foreseeable future, given moderate economic growth and generally solid balance sheets.

For CCC- and lower-rated bonds, however, there's historically been a much larger potential impairment from defaults should conditions change, and we don't feel that their yield spreads are large enough to compensate. Likewise, we're cautious on high-yield bank loans. Heavy inflows have supported the market, but have also led to increased issuance. In many cases, high demand has resulted in fewer covenants—clauses that protect investors' interests.

All in all, our view is that below-investment-grade corporate debt offers a compelling opportunity to enhance portfolio yield. However, every issuer is different, so fundamental credit analysis and careful security selection are critical.

[1]**Historical analysis does not guarantee future results.** Through September 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. Source: Barclays, Bloomberg and AllianceBernstein

[2]**Past performance is no guarantee of future results.** As of September 13, 2013. Source: Barclays and AllianceBernstein

[3]**Past performance does not guarantee future results.** As of September 30, 2013. Source: Barclays, Bloomberg, Delphis Hanover, J.P. Morgan, Municipal Market Data, The Yield Book and AllianceBernstein

## Muni Opportunities

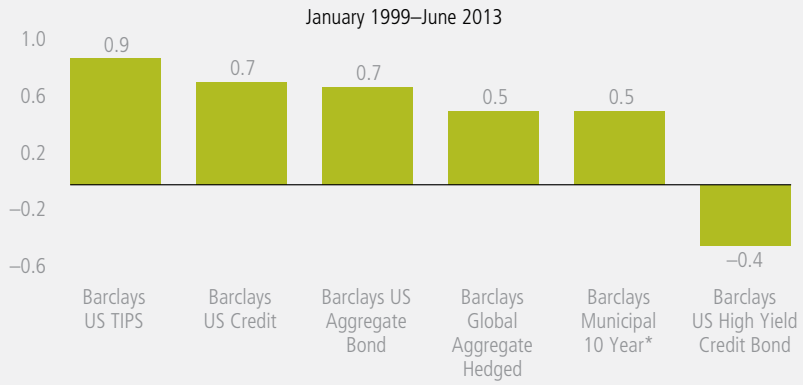
During the third quarter, munis clearly suffered outflows due to investors' concerns about rising rates and potential defaults. Yields rose as a result, making munis even more attractive in our view. Assuming the highest income tax bracket, the tax-adjusted 10-year muni yield is 5%, more than 2% higher than Treasuries.[2] Exposure to lower-rated munis offers the possibility of even higher risk premiums.

Where you invest on the curve can be a big advantage, too, in terms of roll. Roll is the natural price gain a bond experiences as it moves closer to maturity, assuming interest rates don't change. Using roll may enhance returns, but there are risks with investing in bonds for longer periods, including interest rate risk. This is why we've talked about focusing on the "smart" part of the yield curve in municipal bonds—intermediate securities. For example, the yield and roll potential on a 10-year A-rated muni bond was about 5.3% at the end of September, compared to 5.2 for a 30-year muni.[3]

As to investors' concern about muni bonds defaults, we think this is overdone. While the headlines surrounding muni struggles have dominated at times, these big stories account for only a tiny fraction of the overall muni bond market.

Lower beta fixed-income sectors have less sensitivity to rising US interest rates

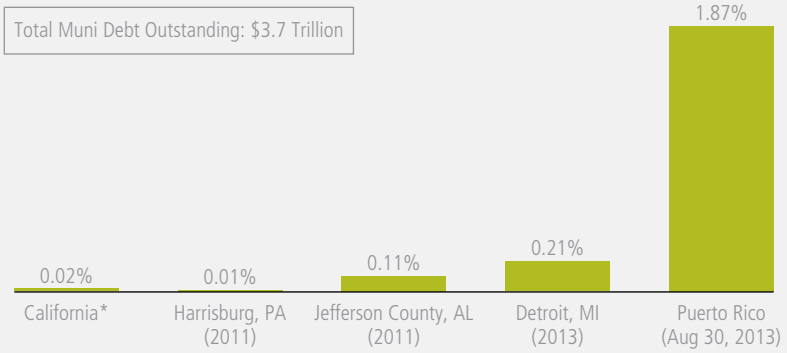
Bond Index Betas vs. US Treasuries




**Historical analysis does not guarantee future results.**
As of June 30, 2013
*Barclays Municipal 10-Year beta is calculated against the 10-Year US Treasury. US Treasuries represented by Barclays US Treasury (weighted index of all US Treasuries). 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 and AllianceBernstein

Headline credits have been only a tiny fraction of the muni market

Distressed Debt as a Percent of Total Market




**Historical analysis does not guarantee future results.**
As of August 31, 2013
*California includes Vallejo—2008, San Bernardino—2012 and Stockton —2012.
Source: Barclays, *The Bond Buyer*, Investment Company Institute, *Distressed Debt Securities* newsletter, Moody's Analytics, US Federal Reserve and AllianceBernstein

# An Encouraging Picture for Stocks

**We see sound fundamentals, reasonable valuations and active management opportunities in equity markets. Also, based on history, stocks have fared pretty well in rising-rate cycles.**

## Sound Fundamentals…and Shareholder-Friendly Moves

In our view, equity fundamentals seem pretty reasonable today, making the opportunity in stocks appear encouraging. Corporate revenues are solid and likely to improve along with US private-sector growth. Earnings per share have been rising in the US; globally, they've been sluggish but not declining. Profit margins had been generally climbing and we believe will remain stable.

Equally important, firms are being disciplined about how they use their capital, and they're putting it to use for shareholder-friendly activities such as share buybacks and dividends. Both are above-trend and have been accelerating over the past few years.

Share buybacks benefit equity investors by shrinking the number of shares outstanding. This provides a shot in the arm for earnings per share by helping them grow more rapidly as the number of shares outstanding is reduced—all things being equal. Dividend payments provide attractive income that enhances investors' equity total returns.

## Valuations Don't Seem Expensive

To add to the attractive picture, valuations indicate that despite the stability and solid fundamentals we're seeing in the asset class, stocks aren't expensive today relative to history.

We can see this in the price-to-forward-earnings ratio, which tells us how much a dollar of future equity earnings costs investors today given the share price. Based on this and other metrics, including price-to-cash flow and price-to-book value, equity valuations in most size segments—from large cap to small cap—have been trending upward but still seem reasonable.

And, the quality of those earnings seems better today compared with the market peaks of 2000 and 2007. Based on steady cash flows, smaller debt burdens and higher profitability, we don't think it's a stretch to say that the quality we see in equity markets hasn't been reflected yet in rising valuations. If sentiment improves and the market begins to fully appreciate this quality, we could envision further gains for stocks.

## How Interest Rate Sensitive Are Stocks?

Many investors have expressed concerns about the potential impact on equities from a rising interest rate cycle. While there may be some impact, particularly in the more interest rate-sensitive sectors, history shows that stocks generally have fared pretty well in these periods. Stocks have outperformed their long-term average returns in 12 of the 15 rising-rate cycles since 1970. And, they've posted an annualized return of more than 17% when viewed across all rising-rate cycles, compared with about 9% across all periods.

We're confident in the potential we see in the equity market today. Of course, there will be plenty of bumps ahead—stock markets never take a straight path upward. Given the environment, we think investors would benefit from focusing not on traditional measures of volatility, but on the risk that adverse macro events cause stock prices to shift abruptly—and broadly.

This possibility is significant, given the major policy events that could unfold moving forward. But even though such a sudden equity downturn would be unnerving, we don't think it would be long-lasting given the solid and improving fundamentals we see ahead.

[1]**Past performance is no guarantee of future results.** As of August 31, 2013. Source: CRSP, eVestment Alliance, S&P Dow Jones and AllianceBernstein

## Active Equity Management Is Key

So, we see a lot of opportunity in stocks today, but there are certainly potential potholes ahead. Navigating those trouble spots as well as the changing fortunes of sectors and stocks makes active management vital, in our view.

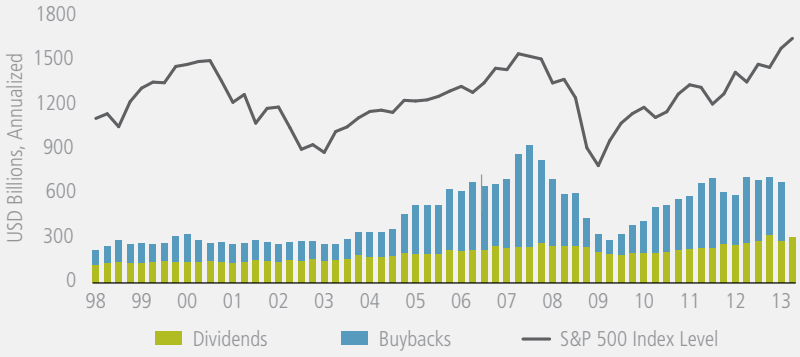
Historically, active management has thrived when dispersion is high or rising. To put it in layman's terms, that's when stock returns are less prone to be moving in similar magnitudes. Dispersion is low today, but it's also at the lower end of its range over the last 17 years or so.[1] We think it will eventually rise back toward its historical average.

In fact, we think we see the beginnings of higher dispersion based on the changing leadership of equity sector returns. Until early this year, cyclical stocks were leading. But the market took on a defensive tone through April, when we saw a massive rotation back toward cyclical stocks. Again, changing patterns create evolving opportunities.

So, we think active management has the potential to be very rewarding for equity investors, but it's important to pick your spots and keep a watchful eye on risks along the way.

Capital discipline and shareholder-friendly actions prevail in equities

S&P 500 Index Dividends & Buybacks

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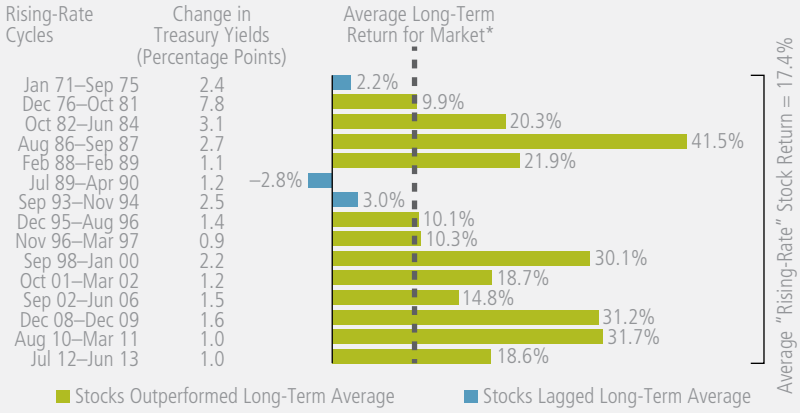
Through June 30, 2013
An investor cannot invest directly in an index and its performance does not reflect the performance of any AllianceBernstein portfolio. The unmanaged index does not reflect fees and expenses associated with the active management of a portfolio.
Source: S&P Dow Jones, Yardeni Research and AllianceBernstein

Equities have held up well when rates have risen

Annualized Global Stock Returns When Rates Have Risen




**Past performance does not guarantee future results.**
As of July 31, 2013
*Average annualized global stock returns from 1970 through July 31, 2013: 8.95%
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, MSCI and AllianceBernstein

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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.

**MSCI World Index** is a market capitalization–weighted index that measures the performance of stock markets in 24 countries.

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